

Bulletin #82, Why Do Insurers Like Standard Form Contracts? (December 14, 2004)

Standard form contracts, like those drafted by the AIA and AGC, are everywhere in the construction industry. The success of your company is dependent upon your ability to properly recognize a project's risk. Since risk management is often synonymous with insurance, the question arises whether standard form contracts present insurance advantages.

Standard Form Contracts Have Numerous Insurance-Related Advantages

Standard form contracts are generally easier to interpret because of their use of common meanings of words and phrases. As opposed to having to negotiate a contract from scratch, standard contracts can lower transactional costs because they offer common ground from which parties can begin to negotiate. The advantages of standard form contracts appeal not only to builders/contractors, but also to the insurance industry.

Standard Form Contracts Attempt to Properly Allocate Risks Based on a Party's Ability to Evaluate, Control, Manage, and Assume the Risks

In the construction industry, builders' risk insurance is purchased, usually by the owner, while the project is under construction to insure the property or project against damage to or destruction by fire, flood, earthquake, or other peril. General liability insurance, as well as Workers' Compensation or employer's liability insurance, is purchased to insure a contractor against liability for bodily injury. General liability insurance, in certain circumstances, also offers coverage for property damage. Finally, subcontractors' insurance covers damage to the project, excluding the cost to repair or replace defective work.

According to research conducted by the American Association of Cost Engineers published in 1998, an overwhelming majority of all contracting parties seek to equitably share risks. Due to the amount of risk inherent in construction projects and the contracting parties' desire to allocate the risk in an equitable manner, a reasoned risk allocation approach is taken by standard form contracts to allocate risk to those parties who are best able to control or prevent a risk from becoming a reality. Standard form contracts implement a reasoned risk allocation approach not only to reflect the contracting parties' expectations of risk allocation, but also with the idea that the parties can expect their projects to involve fewer claims (better control of the risks), less cost (less litigation), and they can expect a timely completion of the project (fewer disputes over who is obligated to do what and when).

Standard Form Contracts Strike a Fair Balance Among the Contracting Parties

Standard form contracts attempt to fairly allocate risk to ensure that the proper party bears the burden of managing a particular risk, but they are also beneficial to all parties to a contract because they strive to make sure the risk is reasonably allocated among the contracting parties. An equitable balance is achieved in form contracts through committee members, who draft the documents, receive input from owners, general contractors, subcontractors, lawyers, insurers, and others. Likewise, the committee specifically focuses on balancing the interests of all parties in a manner that ensures no one interest is unfairly represented or under represented. The result of this thorough and deliberate process is documents that fairly and realistically balance the interests of all parties, which provides an appropriate baseline for the contracting parties' legal relationship.

Standard Form Contracts Clearly Address Claims for Bodily Injury and Property Damage

Standard form contracts allocate risk for bodily injury losses through Workers' Compensation or employer's liability, automobile, and general liability coverage. As far as property damage is concerned, standard form contracts allocate responsibility through builders' risk insurance, as well as, in some circumstances, through general liability coverage. Therefore, even without supplemental conditions, standard form contracts offer the contracting parties a good foundation for risk allocation.

Standard Form Contracts are Regularly Revised to Reflect the Current Law, as well as, Changes in Construction and Insurance Industry Practices

The major form contracts (AIA and AGC) are regularly revised (assuming you use the most up-to-date forms) to reflect nationwide changes in the law, as well as, changes in the insurance industry. As a result, contracting parties, who use standard form contracts (with proper modifications to reflect the law of a local jurisdiction), have peace of mind knowing that if a problem occurs and the other party will not cooperate, the contract is consistent with industry practices and will likely be enforceable in court. In contrast, parties using custom contracts, which are not updated on a regular basis, arguably run a greater risk of using a contract that no longer accurately reflects industry practices or the law. Therefore, regularly revised standard form contracts, as long as they are modified to the extent needed to reflect the applicable jurisdiction's law, supply a solid foundation for the contracting parties' legal relationship.

Standard Form Contracts Can Reduce the Cost of Insurance

Standard Form Contracts Offer Insurer Predictability, Which May Reduce Insurance Premiums

Standard form contracts reflect industry practices and standards, which provide a consensus-based model for participants. As mentioned above, standard form contracts are created by committees that seek input from owners, general contractors, subcontractors, and others. As a result, the terms and conditions of the contract reflect the general expectations of a particular trade. Consequently, insurers are provided with a reasonable expectation that an insured will act in a manner that will not increase the likelihood of a claim.

Furthermore, past litigation, over the terms and conditions of standard form contracts, aids an insurer in predicting the results of a particular claim. As a consequence, since standard form contracts offer an insurer a reasonable expectation that an insured will act in an acceptable manner, and since there is past litigation interpreting the provisions of standard contracts, an insurer is better able to predict the chances of a claim and its results.

The predictability created by standard form contracts allows an insurer to more accurately assess the risk involved and potentially offer contractors insurance at a lower premium. In effect, as recognized in a recent article written by Joe Jones of Victor O. Schinnerer & Co., entitled *Why Insurers Like Standard Form Contracts*, insurers look at standard form contracts as risk management tools. For example, CNA/Schinnerer's application for professional liability and pollution coverage for contractors asks which

standard form contract an insured uses as part of its business to determine if an insured qualifies for a premium credit. Therefore, the use of standard form contracts may add to your bottom line. Contacting your insurer to see if a discount is provided for standard contracts is worthwhile.

Standard Form Contracts May Also Ease the Claim Process and, Thereby, Decrease a Contracting Party's Loss

If a loss occurs and an insurance claim is made, standard form contracts will benefit all parties involved. There may be a decreased chance that an insurer will dispute coverage required by a standard form contract. As mentioned earlier, one of the benefits of standard form contracts is that they are regularly revised to reflect changes not only in the law, but also in the insurance industry. Hence, the use of a standard form contract may lead to less insurance coverage-related disputes.

As a result, an insurer is able to resolve the matter in a more efficient manner with less disruption to all parties involved. Thus, the parties involved may be more likely to continue the project with as little of an interruption as possible, which may also lessen friction between the contracting parties helping you maintain a favorable business relationship with them throughout the construction process.

The Flexibility of Standard Form Contracts Is Another Attractive Feature

Since Insurance Laws Often Vary State to State, Flexibility is Not Only an Attractive Feature but is Crucial to Your Success in Reaping the Benefits of Using Standard Form Contracts

Standard form contracts, given their ability to be modified to accommodate individual project demands, provide a solid foundation for the legal relationship between you and the other contracting parties. They provide advantages over newly created contracts even though modification may be required. As mentioned above, standard form contracts are intended for nationwide use and are not drafted to conform to the law of any one state. Accordingly, you must make sure that the standard documents comply with the relevant jurisdiction.

Furthermore, standard form contracts simply cannot account for all transaction-specific terms, which might be inserted into an agreement. You should make sure that the standard form contract reflects the obligations you have agreed to assume.

However, you must remember that modifying a standard form may also have implications on the other provisions within the agreement. Consultation with counsel will help you avoid changes that have unintended negative repercussions on other provisions.

Additionally, the advantages obtained by using standard form contracts make it easy for users to become "contract complacent." Avoid this trap. Although other parties may be willing to accept your proposed standard form contract, you should thoroughly review each project and make sure that it does not necessitate a second look at specific boilerplate language, which in the past has served you well.

Conclusion

Although a standard form contract is not a true one-size-fits-all tool, with the appropriate modifications, it can reasonably reflect the contracting parties' insurance needs and will serve as a good baseline. Standard form contracts have numerous insurance related advantages. Standard contracts (1) properly allocate risks based on an analysis of which party is best able to control and prevent loss; (2) are drafted in a thorough and deliberate manner that strikes an equitable balance between the risk allocation interests of the contracting parties; (3) reasonably allocate coverage for bodily injury and property damage; (4) are regularly revised to reflect the law, as well as, changes in the insurance industry; (5) may reduce your insurance premium; (6) ease the claim process, if an insurance claim is made; and (7) are flexible (meaning that you can easily modify a standard contract without losing the advantages in using it).

Remember, although standard form contracts provide a great foundation on which to base your legal relationships, you must still be diligent to ensure that the contract contains terms and conditions consistent with your expectations for the project. Don't assume that "boilerplate" language that worked for one contract will automatically be appropriate for the next contract. Only you can ensure that you fulfill the obligations you assumed under the contract. While standard form contracts may decrease your transaction costs, they do not eliminate your responsibility to carefully review all your contracts, whether they are a "custom" or "standard" form.

SMACNA wants the Contracts Bulletins to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e-mail: syoch@felhaber.com; telephone 651 312 6040) or Tom Soles, SMACNA's Executive Director – Market Sectors, (e-mail: tsoles@smacna.org; telephone: 703 803 2988).

Sheet Metal and Air Conditioning Contractors' National Association
4201 Lafayette Center Drive Chantilly, Virginia 20151-1209
Tel (703) 803-2980 Fax (703) 803-3732 info@smacna.org



Copyright © 2008 SMACNA. All rights reserved.
Created by Matrix Group International