



Addressing the issues of third party notification of cancellation



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During 2009, many state regulators became concerned about the increasing occurrence of contractors on jobsites with inadequate or lapsed insurance. Clearly these situations had the potential to wreak financial and operational havoc on construction projects and needed to be addressed. After much collaboration, the construction insurance industry has created multiple solutions to the challenge of third party notice of cancellation.

How did the issue develop?

Owners and contractors questioned how this could happen. Most contracts signed by subcontractors and lower tier vendors required the subcontractor's insurance company to provide notice of pending cancellation to the "upstream" party. When that notice did not arrive and the owner found out later that the policy was no longer in effect, who did the owner have a course of action against? After all, the owner did not have a contractual relationship with the subcontractor's insurer. The owner could have elected to place the subcontractor in breach of contract for failure to meet the terms of the contract and pursued a surety remedy; however, that option was both costly and inefficient. Additionally, the damage may have already occurred if the owner was faced with an uncovered liability or workers' compensation claim.

In those situations, the owner turned to the subcontractor's certificate of insurance. This certificate typically included a section on cancellation notice to the certificate holder. Upon further review, the owner often discovered that the certificate stated the subcontractor's insurer will "endeavor" to send advanced notice of cancellation. However, this certificate did not state that the subcontractor's insurance company was "obligated" to send notice of cancellation. So if the certificate provided no assurances, the owner then turned to the actual terms and conditions of the subcontractor's insurance policy. After all, the owner was likely an additional insured under that policy and must have had some rights in it. However, after reviewing the policy, owners often found no requirement to notify certificate holders, additional insureds or any other interested third party.

This often created a difficult position for owners. They were not a party to the insurance contract between their subcontractor and its insurer, so they had minimal negotiating power. Furthermore, the certificate of insurance that was issued was informational only, included limited information and clearly stated that the certificate did not replace or broaden any terms and conditions on the actual policy. Not only did the certificate lack the policy terms and conditions, it was only a point in time view. Even if the policy did include a third party notice requirement at the time of certificate issuance, that policy condition could be altered days later. Since the certificate was only valid on the date of issue, that change to the policy would not get registered with the owner.

After insurance regulators were made aware of these issues by owners and contractors, they worked with Acord to modify the certificate wording. These modifications included the requirement that third party notice conditions must follow exactly what was on the subcontractor's policy.

This seems like it should have addressed the notice of cancellation problem, so why were the owners' concerns and issues not eliminated?

Many contractors found the contract notification requirements they signed with owners varied significantly.

What did the owners find?

The owners expected that once the certificate wording changed, they would receive the notification required in the contract they sign with their contractors and subcontractors. However, what they found was quite different.

The certificates now stated that the insurers were required to follow the terms of their policies. However, the vast majority of subcontractor insurance policies did not include any notification of cancellation provision to third parties. So, insurers were under no new or additional obligation with the change in the certificate wording. But owners were still left with the same challenge of not being notified in advance of a subcontractor's policy cancellation.

Because the same issue still existed, many owners blamed Acord for causing the problem. However, since the same problem existed before and after the Acord form change, the certificate change could not have caused the problem in the first place. What the change did do was awaken the industry to a problem that had existed all along, but remained under the radar.

What was the real problem?

If the certificate wording change did not solve the problem, then what was driving the issue and what was the solution?

Owners and contractors began to look at the terms of their contracts regarding third party notifications. This was an often overlooked section of the contract and therefore not reviewed in great detail. As owners began to ask more questions about the contractor's ability to comply, the contractors began to understand that they often did not have a mechanism in place to meet the contract terms.

Many contractors found the contract notification requirements they signed with owners varied significantly. They also realized their insurance policy did not often provide third party notification. Being the only party to both agreements (construction contract and insurance policy), contractors realized the terms between these two contracts did not match.

Choosing from multiple approaches

To bridge this contract gap, contractors would often have to choose from one of two approaches. The first would be to transfer all risk and responsibility to a third party. This would be accomplished by looking to the contractor's insurer to provide a policy endorsement to match all terms in the contract signed with the owner. However, the contracts themselves varied, so the insurance endorsement needed to be broad enough to match the broadest and most onerous contract. This often led to over notification and protection as well as huge inefficiencies in the process for both the insurer and contractor. Certain contract requirements would never be possible even with the broadest endorsement.

The second approach was to transfer no risk and assume all contract responsibility. Contractors following this path looked at the contract terms and responded by suggesting there was minimal chance of their policy cancelling due to the strong relationship with their insurance company. If their policy never cancelled, they would never be in breach of contract with the owner and would not have any damages under the contract. These contractors were willing to assume 100% of the minute risk of an actual cancellation.

While the first approach attempted to transfer the risk and the problem away, the second elected to retain the risk (assuming it to be very low). However, neither approach seemed to truly address the real problem. There had to be a middle ground.

A deeper look at the cancellation scenarios

As construction insurers looked at the specific contract terms, it became clear the solution would not be as simple as a short endorsement designed to meet the various contract terms. A key issue was the different scenarios under which policy cancellation occurs.

Active cancellation by the insurance company. This is perhaps the least common scenario, but the easiest to manage. Various reasons could include misrepresentation or significant change in operations. The insurance company is typically required to provide advanced notice to the contractor and that notice could easily be provided to certificate holders as well.

Non-payment of premium. This is often the most common scenario as well as the most challenging to manage. Premium payments are typically made monthly. If an insured misses a payment, the insurance company often provides advance notice that coverage would be cancelled within 10 days. While it is reasonable to provide this notice to interested third parties, in many cases, the premium is paid prior to the actual cancellation date and therefore the cancellation is rescinded. This scenario presents two challenges. First, the insurance company is required to provide a second notice to third parties indicating coverage was not cancelled. This process creates more work and is inefficient and costly. Secondly, and perhaps more importantly, every time a payment was late or lost in the mail, the insurance company would have to provide notice to all third parties that cancellation would occur. This would cause unnecessary challenges for subcontractors since the premium payments are generally paid and coverage is typically not cancelled.

Contractor request. A contractor can request immediate cancellation from their insurance company. This occurs if the contractor decides mid-term to change carriers or has other business circumstances that warrant cancellation. While these are exactly the scenarios that owners want to be made aware of, it is contractually impossible for an insurance company to provide advance notice of these changes. The only possible notification could occur subsequent to the cancellation.

Conditional non-renewal. At each renewal, many state regulations dictate when an insurance company has to provide a conditional non-renewal notice to a customer. These notices are often required when the policy is subject to a large rate action or change in terms and conditions. These changes may or may not actually occur; however, in order to comply with some construction contracts, the insurer would be obligated to provide this conditional non-renewal notice to all third parties. As discussed in the non-payment of premium issue, this could lead to unintended consequences for the contractor when coverage would remain in place.

Actual non-renewal. In some cases, the insurance company elects to non-renew a policy. The contractor may have negotiated a new program with a different carrier and would maintain adequate coverage; however, the expiring carrier may be expected to provide third party notice. This may occur at almost the same time the contractor provides a certificate of insurance from the new carrier. In this instance, an owner could receive a notice of cancellation and evidence of new insurance

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simultaneously. At a minimum, this is an inefficient process, and at worst, it causes unintended project disruption while the owner sorts through multiple pieces of information.

Often times, contractors found their contracts with owners treated all of these scenarios in the same way. However, as we've discussed, the insurance policies may treat them in many different ways.

How should the process work?

Beyond the specific notification requirements, contractors and insurers found they needed to explore the actual mechanics of providing notice to third parties. They wanted to determine the most efficient way to meet the owners' notification needs while minimizing expenses in such a cost sensitive and competitive environment. To address this ongoing issue, two key areas require discussion.

Who is in the best position to send the notice? Most owners expect the notice to come from a third party which makes sense as the subcontractor who has a genuine cancellation issue is not as likely to volunteer that information. Most contracts require notice to come from the insurance company; however, the insurance companies do not have record of the third parties under contract and/or certificate holders. This information is retained by the insurance broker. While the broker could transmit that information to the insurance company, the potential for error increases. So perhaps the broker is in the best position to provide notice of cancellation; however, most contracts do not provide that flexibility. The same is true for independent vendors with the infrastructure to provide notice in a timely and accurate fashion. The insurance company will simply notify one party via policy terms and the contractor's agreement allows for independent third party notification. While this appears to be an efficient process, many of today's contracts do not allow for that option.

Should the notice be in written or electronic format? Most, but not all contracts require written notice be sent to third parties. Electronic notification, however, provides many advantages. First and perhaps most importantly, it provides the quickest mechanism to deliver notice. Ultimately, speed is critical for project owners to address situations with contractors with minimum time elapsed; specifically when those contractors are uninsured and on the jobsite. Secondly, the efficiencies and reduction in potential errors or oversights are improved under an electronic method. The only challenge is an accurate accounting of email addresses.

Moving forward

It is obvious that to accomplish the goals of the owners and the insurance regulators, adjustments need to be made in the way insurers respond to third party notification. Closer review is also needed of the notification section of contracts to ensure the requirements meet the needs and concerns of the owner in a way that is practical and sensible.

Fortunately, the insurance industry has made significant progress addressing the notice of cancellation issue in the past year. Many leading insurers now provide endorsement options that offer reasonable notification to interested third parties. Additionally, many owners (both public and private) have reviewed their contract requirements and modified them to match reasonable market expectations.

It is obvious that to accomplish the goals of the owners and the insurance regulators, adjustments need to be made in the way insurers respond to third party notification.

Furthermore, some leading providers of standard contract language have also made changes to better reflect the ability for all parties to respond. Finally, everyone has learned more about risk management and these difficult contract management issues. The third party notice of cancellation issue is now being addressed by all parties in a generally responsible manner with increased knowledge and education.

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