



## GUEST ESSAYS

### **Comparing and Maximizing Performance Bond and Commercial General Liability Protections**

Frank L. Pohl, Esq. and James C. Washburn, Esq.

Often when acting as the prime on a construction project, the design professional is asked to review, comment or even craft insurance and bonding specifications for the project. With an increasing number of general contractors and subcontractors experiencing financial difficulties due to the poor economy over the last couple of years, it becomes increasingly important for owners to protect themselves as much as possible through commercial general liability (CGL) policies and performance bonds. This article distinguishes between the nature of liability insurance and suretyship, analyzes the scope of coverage and protections afforded by each – including recent case law that arguably expands CGL coverage - and discusses how owners and general contractors might better protect themselves using these tools. This article also includes a brief description of owner-controlled insurance policies (OCIP) which may be appropriate for large construction projects.

#### **The Nature of Liability Insurance and Performance Bonds Distinguished**

A performance bond issued by a Surety is not insurance. Liability insurance is a contract pursuant to which the insurer agrees to indemnify and defend the insured against certain claims for damages, specifically losses covered under the insurance policy, for which the insured is otherwise liable to third parties. If the insurer pays out under the policy, it may not later seek indemnity from the insured. This is not the case with a performance bond. A performance bond is a three-party agreement issued by a Surety who guarantees to an obligee (i.e. the protected party) that the principal (i.e. the entity whose performance the Surety guarantees) will complete the work required under the bonded contract. Also, if the bond incorporates by reference the bonded contract, the Surety may become liable for post-completion damages such as repairs necessitated by latent defects.

While performance bonds are usually obtained by the general contractor for the protection of the owner, general contractors may also require their subcontractors to obtain performance bonds. Owners too may require the general contractor to demand its subcontractors to provide performance bonds. While doing so will increase the contract price, it has the benefit of excluding lower quality and financially struggling subcontractors who cannot obtain such bonding, as well as provide the bond protection.

Unlike liability insurance, if the Surety is required to incur costs to complete the contract or otherwise pay out under the performance bond due to the principal's default of the underlying contract, the Surety will seek indemnity from the principal. Moreover, as a condition of issuing the performance bond, the Surety likely will have required a general agreement of indemnity from not only the principal, but the individual stakeholders of the principal corporate entity and their wives. Also, the Surety has no duty to defend its principal against claims made against the performance bond.

It is important for the parties protected by the bond to recognize this distinction because it should alert them of the need to have counsel review the performance bond form being used on a project. Given the additional liability exposure to the principal under a performance bond and those individuals who signed a general agreement of indemnity to obtain the bond, the principal has an obvious incentive to propose a bond form that provides as little protection as possible. As discussed below, the protection afforded by a performance bond may differ significantly depending upon the bond form used.

## Performance Bond Coverage

Again, a performance bond is a means of guaranteeing the completion of a construction project upon the default of the principal. The Surety is lending its credit to the principal. The amount of protection afforded by a performance bond is the reasonable amount to complete the project in excess of the principal's available contract balance up to the penal sum of the bond

However, the Surety will not be liable to the obligee for all damages arising from the principal's default. Absent certain language in the bond form, there may be several types of contractual damages for which the principal may be contractually liable but that the performance bond will not cover. Unless the bonded contract is expressly incorporated into the performance bond, the Surety may not be liable for the correction of defective work or the performance of contractually required warranty work. Also, in certain jurisdictions, even though a principal is adjudicated liable for actual delay damages resulting from its breach of the contract, the Surety will not be held liable for such damages under the performance bond absent express terms in the bond form stating otherwise. See *American Home Assurance Co. v. Larkin General Hospital, Ltd*, 593 So. 2d 195 (Fla. 1992). Similarly, a performance bond Surety may not be held liable for lost profits or rents on the project arising from the principal's breach of the bonded project - again, even if the principal is found liable for such damages - absent express terms in the bond form stating otherwise. The scope of the performance bond will be limited to its express terms. However, through the negotiation of the bond form, the terms might be expanded to include these types of contract damages, thus expanding the obligee's protection beyond merely the completion or correction of work.

## Commercial General Liability Coverage

As commonly understood, the purpose of CGL insurance is to provide protection for personal injury or for property damage caused by an occurrence, such as the negligent performance of construction work, but not for the replacement and repair of such negligently performed work or the cost to complete unperformed work.<sup>1</sup> For example, if a roofing contractor negligently constructs a roof on a building which results in damage to property located inside the building, then a CGL policy issued to the roofing contractor may cover the damage to the property inside the building but not the cost to replace the roof.

However, CGL policies may include riders and endorsements that limit coverage otherwise provided by a standard policy, such as exclusions for mold or residential construction. Such exclusions could be devastating if they are indeed a potential risk. Design professionals working as the prime on a project should strongly encourage their owner clients to have the controlling CGL policy reviewed before the contract is entered. Most construction contracts merely require that a certificate of insurance be provided to establish proof of insurance. However, the certificate of insurance does not identify the scope of coverage. Only through a review of the insurance policy itself can the scope of coverage be determined.

## Recent Expansion of Commercial General Liability Coverage

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<sup>1</sup> The standard CGL policy form (such as a post-1986 standard ISO or Insurance Services Office, Inc.) provides coverage under its insuring agreement for the "sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damages' caused by an 'occurrence'". Exclusion (j)(6) of that same policy form excludes from coverage "property damage to that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it."



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While a standard CGL policy is not typically understood to cover the cost to repair and replace the insured's own defective work, a Supreme Court of Florida case holds that such a policy issued to the general contractor may provide coverage for the cost to repair and replace the damage to a completed project caused by a subcontractor's defective work. *U.S. Fire Ins. Co. v. J.S.U.B.*, 979 So. 2d 32 (Fla. 2007). The court's analysis of the CGL policy could be argued in other jurisdictions beyond Florida.

In the *J.S.U.B.* case, a general contractor constructed homes on soils that were not adequately compacted (such compaction being the responsibility of one of the subcontractors), resulting in settlement cracks to the homes, as well as, items placed in or affixed to the homes, such as wallpaper. The insurer argued that workmanship deficiencies that resulted in later damage to the homes constructed by the insured/general contractor should not be considered the result of an accident and, thus, should not be deemed an "occurrence" which is covered by the insuring agreement. However, the court disagreed and determined that there was coverage for the damaged homes.

In reaching its holding, the court found that settlement damage to the homes caused by improper compaction of the underlying soil was an "occurrence". As defined in the policy, an "occurrence" is "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The court held that when the term "accident" is undefined in a liability policy, as was the case, the term includes not only "accidental events" but also damages or injuries that are neither expected nor intended from the viewpoint of the insured – such as the negligence of its subcontractors. The court also recognized that there is a difference between a claim for the costs of repairing or removing defective work, which is not a claim for "property damage," and a claim for the costs of repairing damage caused by the defective work, which is a claim for "property damage." As for the "your work" exclusion, the operating policy included the following exception to that exclusion: "Paragraph (6) of this exclusion [i.e. the "your work" exclusion] does not apply to 'property damage' included in the 'products-completed operations hazard.'" The operating policy had products-completed operations hazard coverage.

The more expansive coverage provided by the Florida court's interpretation of the post-1986 ISO CGL policy arguably overlaps the protections afforded by a performance bond. Given the indemnity obligations of the principal on the bond, it should be expected that principals will likely use this case law to shift liability away from its Surety and towards the CGL carrier when there is damage to the project due to a subcontractor's deficient work.

It should be noted that the ISO has begun to issue an endorsement that may be included in a CGL policy which arguably eliminates coverage for the the cost to repair and replace the damage to another subcontractor's work necessitated by the insured's negligent performance, thus negating the Florida court's expanded interpretation of the standard post-1986 standard ISO CGL policy. Such an endorsement is not in the owner's or general contractor's interest. Accordingly, if an insurer has included this endorsement as a part of the CGL policy, an owner and general contractor would be advised to determine if the endorsement can be stricken and, if so, find out the cost for doing so and perform a cost/risk analysis. Further, the case high-lights the importance of obtaining products-completed operations hazards coverage as part of the CGL policy, i.e. coverage for occurrences that arise after the project is complete.



### **Additional Insured to a CGL Policy**

Owners should be advised to demand that they be named as an “additional insured” on all CGL policies protecting the project. Further, they should ensure that the insurer actually issues the endorsement naming them as an additional insured, as an action against a potentially insolvent subcontractor for breach of contract for failing to obtain the contractually required endorsement may not afford a sufficient remedy. An additional insured can make a direct claim against the policy and sue for a declaratory judgment establishing coverage. Absent being named an additional insured, only the insured can sue the insurer before the insured’s claim is resolved. Additionally, many states allow the prevailing party to recover their attorney’s fees in an action to recover against their own carrier for an insured loss.

### **Owner-Controlled Insurance Policy**

An owner-controlled insurance policy (OCIP), often referred to as a “wrap-up” policy, is a policy obtained by an owner to provide coverage for all of the project participants on very large construction projects or a combination of related projects.<sup>2</sup> Such a policy typically provides commercial general liability insurance for all parties, as well as, workers compensation, employer’s liability, personal injury and property coverage. Such policies can also include professional liability and builder’s risk coverage. The potential advantage of OCIP is to avoid multi-insurance lawsuits seeking recovery for various claims between the owner, architect, engineer, contractor, subcontractors and suppliers. However, unlike individually obtained policies, OCIP coverage typically expires at the end of the project - before liability exposure of project participants ends. Accordingly, the owner may be advised to require project participants to obtain additional coverage in excess of the wrap-up policy to address that concern. Given the complexities of these wrap-up policies, they should be purchased only after consulting with an experienced insurance broker and legal counsel.

### **Conclusion**

While owners may believe they have protected themselves by requiring CGL insurance and a performance bond for a project, a design professional acting as prime should advise their owner clients to conduct a more thorough review and negotiated modification to the insurance policy and bond form with the help of their legal counsel and insurance broker. Further, owners should be advised of the possible advantages of obtaining an OCIP or “wrap up” policy. Doing so can significantly expand their protections and increase the likelihood of a successful and profitable project.

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Frank L. Pohl, Esq. and James C. Washburn, Esq. are partners in the law firm of Pohl & Short, P.A. in Winter Park, Florida. Pohl & Short, P.A. is a business boutique law firm concentrating in four main areas of business law: commercial litigation, real estate law, corporate law and trusts and estates. Mr. Pohl has been advising clients involved in all aspects of real estate development for over 30 years. Mr. Washburn practices construction law and is Board Certified in Construction Law by The Florida Bar. Additional

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<sup>2</sup> Florida statutes allows state agencies to obtain OCIP coverage for certain public projects of an estimated total cost of \$75,000,000 or, with respect to the construction or renovation of two or more public schools during a fiscal year, \$30,000,000 or more. See §255.0517 “Owner-controlled insurance programs for public construction project.”



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information about the law firm can be obtained by visiting its website at [www.pohlshort.com](http://www.pohlshort.com). Mr. Pohl can be reached at (407) 647-7645 or [pohl@pohlshort.com](mailto:pohl@pohlshort.com).