



TRY TO HOLD OFF ON USING HOLDBACKS

Failure to fully pay subcontractors can drive up costs in long run

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The profitability of the modern commercial construction project relies heavily on a complex system of risk transfer between project owner, general contractor and trade contractors. Central to this risk transfer system is “additional insured” (“AI”) coverage; insurance that downstream contractors are required by contract to provide to upstream owners and contractors for liability related to the trade contractors’ work.

AI coverage is especially important to trade contractors because they provide coverage to the entities they depend on for their next job. AI coverage, like all risk transfer, involves the shifting of liability for defense costs and damages to an insurance company and away from the contracting parties.

The recent economic downturn has caused many insurers to take more aggressive positions on claims, which leads to delays and sometimes outright denials of coverage. The effects of this trend are far reaching and often devastating, particularly with respect to AI coverage. In the face of delays and denials, upstream parties are more frequently electing to simply withhold contract payment from downstream parties (commonly referred to as a “holdback”) to offset their losses, rather than pursue the contractor’s AI coverage.

The problem with holdbacks is that, in circumventing the traditional risk-transfer system, they undermine the delicate economic balance that is the reality for most construction contracts. In the author’s ex-

perience, holdbacks can be avoided with a well-orchestrated insurance program which obviates the need for upstream parties to resort to self-help.

Downstream parties are in a difficult position to fight back against holdbacks, as subcontractors do not want to jeopardize their business relationships for fear of losing future jobs. The real trouble, however, is that over time holdbacks increase costs for everyone. Downstream parties are more likely to inflate their bids to preemptively counteract holdbacks, thereby raising costs of commercial building. The only real winner is the one with the least to lose—the insurer, who does not have to pay what otherwise would be a covered claim.

Holdback Catalysts

Most construction contracts afford upstream parties the right to holdback. Although traditionally holdbacks have been a last resort, holdbacks have been arising more frequently in three scenarios. First, an upstream party may holdback when there is a *perceived* disconnect between the construction contract’s insurance requirements and what the downstream party’s insurance delivers.

When an upstream party seeks AI coverage from a downstream party’s insurer, ideally the insurer should acknowledge the upstream party’s AI status while reserving its



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right to deny coverage on items unknown. Typically, however, the insurer issues an expansive reservation that calls the upstream party’s AI status into question. Although the insurer may in fact intend to pay the claim, many times the upstream party will respond to the insurer’s reservation by holding back.

Upstream parties may resort to holding back when coverage does not function as it should (i.e., when there is an *actual* disconnect between the contract’s insurance requirements and what the AI policy delivers). Included in this category is the contentious “horizontal exhaustion” issue. If policies are not properly endorsed to address the order in which they are triggered, upstream parties may find that they must first exhaust their own primary policy before gaining access to the downstream party’s excess insurance on which it should have AI status.

Lastly, holdbacks arise when parties fail to access available insurance due to lack of knowledge or failure to comply with insurance policy conditions. Experience tells us that a significant amount of insured construction loss or damage is either never pursued or is pursued

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improperly. Many times policyholders attempt to settle problems with upstream parties themselves without notifying their insurer. The unintended consequence of this practice can be disastrous—when damages mount and the insured at last turns to their insurer, the insurer denies coverage due to late notice or violation of the voluntary payment provision.

Limiting Holdbacks

Holdbacks can be avoided through careful planning and insurance education. Policyholders must familiarize themselves with their insurance coverage by requesting copies of their policies and reviewing the language carefully. In particular, downstream parties should confirm that their policy's AI endorsement complies with the upstream party's contractual requirements. Upstream parties should ensure that contract provisions regarding AI status are clear and specific. If possible, upstream parties should seek a scheduled (as opposed to broad-form) AI endorsement, and

downstream parties should obtain broader AI than is required by their contract.

Holdbacks can also be limited by writing protections into both the project contract documents and applicable insurance policies. Contracts should specify that insurance policies must be tapped first for any loss or damage, and that holdbacks will only be used as a last resort. Each insurance policy should be endorsed to address issues of horizontal exhaustion. If policies clearly set forth that upstream parties are entitled to AI primary and excess coverage before their corporate policies must respond, coverage is more likely to operate as desired and upstream parties are less likely to holdback.

Finally, key ground-level project personnel should be educated about the basic features of the relevant insurance program. Project decision-makers should be informed of the perils of "working out" disputes with upstream parties without reporting first to

the insurer. If these key players recognize the perils of late notice and voluntary payments, coverage problems may decrease and upstream parties will have no need to holdback.

Now more than ever it is of crucial importance for all contracting parties to understand the risk-transfer system and how to properly invoke AI coverage. Holdbacks can have severe financial consequences, especially for contractors that are already hard hit by bad economic times.

Moreover, holdbacks do not benefit upstream parties. Instead, the downstream party's increased costs of doing business will simply migrate up the ladder over time. A carefully planned insurance program should clearly address AI status and horizontal exhaustion, and should be paired with education of project personnel. This will limit the need to turn to the self-help remedy of holding back and will preserve the risk-transfer system for the future. ■