



Red Flags in Contracts: Coverage, Exclusions and Risk Management

It is important for members to review legal agreements for potential risks—red flags in contracts—before finalizing them. MCIT can assist members in reviewing contractual provisions in a number of areas, including insurance provisions, additional insured status, hold harmless and indemnification, waiver of subrogation, limitation language and property coverage.

MCIT members enter into a variety of contractual agreements ranging from leases, construction contracts and contracts for services. Language in these agreements may expose members to liability in a variety of ways, such as accepting all responsibility for the parties involved. If members are not careful, they could unintentionally assume noncovered liability.

Contractual red flags discussed in this document are from a risk management perspective only; a member's county attorney or legal counsel should complete legal reviews of agreements. Members are encouraged to follow their entities' contract review processes and obtain the proper approval for agreements.

Basic Elements of a Contract

Contracts are an essential tool for doing business between parties. They are legally enforceable and should be in writing. The complexity of contracts and agreements varies greatly depending on the contracted work or service. Not all contracts need to be long and complex; however, they should contain the following basic elements.

- **Scope of service:** Identify the service to be provided early in the contract and spell out what will be performed.
- **Fee schedule:** It should set forth the basis, method of payment and cost of the contractor's services.
- **Performance schedule:** This establishes the timeline for the contractor to complete the work.
- **Insurance:** The party providing the service in the contract should provide insurance. Limits should be stated. Coverage commonly requested includes general liability, automobile liability, professional liability, workers' compensation and property (e.g., builder's risk property coverage).
- **Hold harmless and indemnification:** This clause should identify which party will defend and indemnify the other party in a claim situation; it may be a mutual agreement.
- **General terms and conditions:** These will comprise the business terms of the contract, which vary according to the contracted services.

Coverage/Insurance Requirements

One of the first red flags from a risk management perspective is a contract's insurance requirements. Members reviewing contracts often ask for MCIT's advice about the amount of insurance coverage that should be included.

A basic rule is that the insurance required should reflect the party's potential exposure. For example, an MCIT member rents office space from another party. In the contract/lease agreement, the building owner likely requests that the MCIT member have insurance.

The MCIT Coverage Document provides MCIT members with limits of general liability that mirror those found in Minnesota Statutes Section 466.04, Subdivision 1. The current maximum liability tort caps are:

- \$500,000 per claimant
- \$1.5 million per occurrence

These amounts should be listed in the agreement for the member's liability limits and will be shown on a certificate of insurance (MCIT calls this a "certificate of coverage") if requested by the building owner. The same limits of liability apply to automobile coverage if they are required in an agreement. (Certificates of insurance are discussed later.)

The member may be asked to verify workers' compensation coverage. Workers' compensation should be listed as per Minnesota Statutes Chapter 176. Employer's liability limits provided by MCIT for both accident and disease are:

- \$500,000 for each employee
- \$1.5 million per accident/coverage document limit

If a member agrees to limits greater than those provided by MCIT, it is self-insuring that amount or must obtain additional coverage outside MCIT.

A lease agreement may have property insurance requirements. Examples are property insurance for owned contents or specific computer-related equipment. If the member has coverage for the property item, it can be identified in the agreement and shown on the certificate of coverage.

In another type of lease agreement, an MCIT member leases space in its own building to another public entity, such as a township, city or school district. Because Minnesota Statutes also protect the public entity, Section 466.04, the tort caps on damages applies.

In a lease such as this, the MCIT member should set the insurance requirements for the lessee. The member should identify the maximum general liability limits found in Section 466.04 (the same amounts as the member's general liability limits).

Consider the same type of lease but instead, the member leases space in its buildings to a private entity not protected by Minnesota Statutes Section 466.04. A common question is, what limits should members request from a private party, especially if it is a corporation, partnership or sole proprietor? Consideration should be given to the exposures the organization brings to the specific agreement.

As a starting point, MCIT recommends that members require limits that are equal to or greater than the member's limits of liability found in Section 466.04. Limits in commercial liability insurance policies differ from that of public entity coverage.

Commercial insurance has an occurrence limit and an annual aggregate limit. Occurrence is the event or the loss sustained. The aggregate means the maximum amount payable for all losses for the policy term. The aggregate amount is usually double the occurrence limit. MCIT's minimum recommended limits of liability for contracts with a private entity are:

- \$1.5 million per occurrence
- \$3 million annual aggregate

In some contracts for service, a contractor may use automobiles in completing a project, for example a construction contractor. Often commercial automobile liability limits are stated as a combined single limit, meaning that bodily injury and property damage limits are added together for one single total limit.

Again, MCIT recommends members require contractors have limits equal to or greater than the member's automobile coverage limits of \$1.5 million.

Lessees or contractors can use umbrella or excess limits in combination with the primary insurance limits to reach the total recommended limits.

If the contractor has employees, workers' compensation coverage is mandatory. Workers' compensation should be listed as per Minnesota Statutes Chapter 176, the same as previously noted for MCIT members.

If the contractor has no employees, and has rejected workers' compensation coverage for him- or herself, the member should require that the contractor confirm this in writing. The member should revisit this issue if the contractor completes the job with "help."

Members should require professional liability coverage of independent contractors who perform professional or semi-professional services. Some examples of professionals who should obtain this type of coverage are those who perform medical services (e.g. psychologists, emergency medical technicians and paramedics), information technology consultants, architects, engineers, attorneys and other consultants.

MCIT recommends liability limits of:

- \$2 million per wrongful act or occurrence
- \$4 million annual aggregate

In a construction contract, a member may require a contracting party to maintain property insurance for the building project. MCIT recommends requesting all-risk property insurance coverage. Specifically a builder's risk and/or installation floater is the type of property coverage necessary for a building, addition or remodeling project for the completed value. (See Builder's Risk below for more information.)

MCIT members may want or be legally mandated to require a surety bond or performance bond for some agreements. These are typically used in construction contracts.

This type of bond provides a financial guarantee that the contractor will perform the work detailed in the contract and within the timeframe specified. Limits should be according to the individual project and indicated in the contract. Consider verifying bond certificates with the bond issuer to protect against fraud.

See the MCIT Resources "Understanding Insurance Language in Contracts" and "Bonds: What Public Entities Need to Know" for more details.

Certificates of Insurance

A certificate of insurance provides written verification of insurance coverage. The document demonstrates that the contractor has active insurance coverage. A certificate includes the name of the insurance carrier, policy numbers, and lines and limits of coverage issued to the individual or entity.

Lack of a certificate or coverage that has expired during the contract term is a red flag in the contracting process.

In most instances, the member asks an independent contractor, service provider or tenant in a lease agreement to provide verification of coverage on a certificate of insurance. It should be submitted to the member before a tenant moves in or a contractor commences work.

A party should be required to provide notice and an updated certificate upon renewal or cancellation of a policy.

Contractors or service providers will likely provide a certificate of insurance on an ACORD form, which is standard for commercial insurance carriers.

See the MCIT Resource "Certificate of Insurance" for more details.

In some circumstances, the member may be asked to provide a certificate of insurance to another party. In this case, members should request a certificate of coverage via the member portal at [MCIT.org](https://www.mcit.org). When members are asked to provide a certificate of insurance, MCIT has its own version (called a certificate of coverage) that better suits members.

Additional Insured or Additional Covered Party

Additional insured status provides extra protection to the MCIT member in the event of a claim. Additional insured refers to a person or organization covered by the insurance policy of another person or organization. This status is provided by an endorsement or written amendment to the contractor's policy.

Lack of additional insured status can be a red flag in agreements.

Like primary coverage, additional insured coverage typically provides both defense and indemnity (see below for more) to the additional insured. Rules may differ from policy to policy, but most insurance companies offer an additional insured endorsement.

Some insurance companies charge the contractor a fee for issuing an additional insured endorsement. Therefore, it is important that the contractor is aware of this requirement so he or she can build the expense into the estimate or bid.

Regardless of whether the member is eventually found to be responsible or even partially responsible for a third-party liability claim resulting from the contract or project, the process to determine this (e.g., litigation or arbitration) will likely be costly and time consuming.

Therefore, MCIT recommends that members request additional insured status with respect to the contractor's comprehensive general liability, automobile and excess/umbrella policies. Members should obtain a copy of the additional insured endorsement.

Additional insured status is typically not granted under workers' compensation or professional liability policies.

In some instances, contracting parties ask MCIT members to endorse them as additional insureds. MCIT has slightly different wording and endorses coverage as an additional covered party to match the MCIT Coverage Document wording.

Builder's Risk

A red flag for which to look in a new building project or remodel of a building is property coverage.

Builder's risk coverage provides protection to the building owner for property damage. It should be purchased for projects involving new construction and additions or alterations to existing buildings.

This type of property coverage protects against exposures such as windstorm or fire. The agreement should specify which party is responsible for placing and purchasing builder's risk coverage during the course of the project.

If an MCIT member is responsible for builder's risk coverage, MCIT's property coverage provides a limit of up to \$750,000. If the cost of the project is greater than \$750,000, the member should consider separate builder's risk coverage outside MCIT's property coverage. MCIT risk management consultants are available to assist members when a member wants or needs a separate policy for larger projects.

If the contractor agrees to provide coverage for the structure during construction, this should be stated in the agreement. Contractors may have automatic coverage in their own insurance policies and may be including this cost in his or her bid for the project.

Hold Harmless and Indemnification

Another potential red flag area of an agreement is in the hold harmless and indemnification wording. An important part of the risk management process is placing the responsibility (including attorney fees and damages) for negligent actions with the negligent party.

Agreements with contractors usually include statements confirming that they accept responsibility for their negligent acts by agreeing to hold the member harmless in the event of a claim. The hold harmless and indemnification clause can protect the member from costs and damages arising out of the negligent acts of the contractor. To ensure the contractor also pays for all attorney fees, the provision should read, “defend, hold harmless and indemnify.”

In its simplest form, indemnity means the contractor will compensate the member for any damages the member incurred as a result of the member being brought into a claim arising from the contractor’s negligent actions. Alternatively, the member may be asked to hold a contractor harmless and be responsible for defense costs and damages due to the member’s negligent acts.

Members can benefit by including a hold harmless and indemnification provision favorable to the member. The contractor should hold the member harmless from any claims, suits, costs or damages because of the contractor’s negligence.

The hold harmless provision can cover any type of expense, including but not limited to legal fees, professional fees, judgments and settlements. Legal fees for even a small lawsuit can extend into the hundreds or thousands of dollars before a settlement or other resolution. This is why it is important to have defense included, otherwise members can be responsible for that cost.

Sample language to be tailored to fit each individual situation:

The vendor agrees to defend, indemnify and hold [member name], its employees and officials harmless from any claims, demands, actions or causes of action, including reasonable attorney fees and expenses arising out of any act or omission on the part of the vendor, or its subcontractors, partners or independent contractors or any of their agents or employees in the performance of or with relation to any of the work or services to be performed or furnished by the vendor or the subcontractors, partners or independent contractors or any of their agents or employees under the agreement.

Waiver of Subrogation

Some parties ask members to include a waiver of subrogation in the agreement. This is a red flag. Subrogation is the right to recover the amount of a loss from one legally liable for the loss.

If a member agrees to waive subrogation, it could prevent MCIT from recovering damages from a negligent party after a loss. Recovering those costs replenishes MCIT and helps maintain the integrity of the pool.

Such recoveries are important for members, as adverse loss affects both rates and dividends. Therefore, MCIT asks members not to jeopardize their right of subrogation and to request that waiver of subrogation wording be deleted from agreements.

Example of waiver of subrogation wording from a railroad contract

The policy must name Railroad as an additional insured and shall contain a waiver of subrogation provision against Railroad, and to be so written that the insurers shall have no claim or recourse of any kind whatsoever against Railroad or Railroad’s property.

MCIT encourages members to remove this language from all contracts.

Limitation Language

Another red flag is the limitation clause. Common in technology agreements, they often appear in architectural, engineering and other contracts, as well.

Frequently not labelled “limitation,” they can be hard to find. Careful contract review is warranted to discover this worrisome language.

The limitation language sets the maximum liability of the contractor at a low figure, such as the contract amount. If the contractor is negligent or otherwise causes damage, the maximum the member may collect is the value of the agreement. In essence, you get your money back.

It is essential to set the liability limits in an agreement considering the hazards of the work to be performed, not the value of the contract. Limitation clauses artificially limit the indemnification provided by the contractor and expose members to potential liability for the contractor’s negligence.

MCIT encourages members to remove this language from all contracts.

Terms of the Agreement

The period the contract is in force can be a red flag. Generally, agreements are for a specific period or the completion of a job. MCIT recommends that contracts contain a completion date for a specific project. Certain circumstances may lend themselves to bidding a new agreement when a term has expired.

The agreement should also contain a cancellation or termination clause that identifies the conditions under which the parties can end the contract. Without this, the member may not easily be released from the agreement before the term expires.

For example, failure to perform a contract requirement could be cause for termination. If an agreement is not terminated properly, it could be considered a breach of the contract, which typically is not protected by MCIT’s liability coverage.

Data Practices Considerations

If a government entity contracts with a private person or entity to perform any of the government entity’s functions, the private person or entity is subject to the requirements of the Minnesota Government Data Practices Act (MGDPA).

The MGDPA requires that the contract terms make it clear that all data created, collected, received, stored, used, maintained or disseminated by the private person or entity in performing the government functions is subject to the MGDPA’s requirements and that the private person or entity must comply with those requirements as if it were a government entity.

Additionally, unless otherwise excluded by law, the MGDPA requires that in any contract where the government entity discloses government data on individuals to the contracting party, the contracting party must administer and maintain that data on individuals in accordance with the MGDPA.

Finally, members should not agree to confidentiality provisions that exceed the provisions of the Minnesota Government Data Practices Act.

A good practice is always to include a provision in the contract that articulates the contractor’s obligation to follow the requirements of the MGDPA when applicable.

See the MCIT Resource “An Introduction to the Minnesota Government Data Practices Act” for more details.

MCIT Exclusions That Could Affect Agreements

MCIT's liability coverage is broad; however, there are certain exclusions of which members should be aware when reviewing agreements. The most common exclusions that apply to agreements are noted here.

Contractual liability: Claims or suits for which the member is obligated to pay damages by reason of assumption of liability in a contract or agreement are excluded. This exclusion does not apply to covered party contracts, such as a lease, sidetrack agreement, elevator maintenance agreement or indemnification of a governmental entity as required by law.

Contractual penalties, breach of contract: Any claim based upon penalties for failure to comply with a contractual obligation, breach of contract or cost estimate overruns, or any contract or project whether the contract or agreement is written or oral is excluded. An example here is a road contract that has overruns to complete the project. They are excluded from MCIT coverage.

Tortious interference of contract: Any claim based upon interference with contractual obligations among other persons or entities is excluded.

Medical facility: Claims or suits arising out of the member's ownership, operation, control, direction or any other liability with respect to a hospital, nursing home or other premises providing medical services where overnight bed care is provided are excluded. A contract may request that a member provide the coverage on a medical facility. The member will need coverage outside MCIT to do this.

Pollution: Bodily injury or property damage arising out of the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants is excluded. Certain contracts, especially railroad contracts, will request that the member have pollution coverage. This specialized coverage needs to be obtained outside MCIT.

The list of exclusions above is not all-inclusive. Members are encouraged to contact their MCIT risk management consultant with any questions regarding exclusions to coverage and refer to the MCIT Coverage Document.

Careful Consideration Is Key

Contracts can bring additional loss exposures to MCIT members, but they can be managed with careful consideration prior to finalizing agreements. MCIT risk management consultants are available to review members' proposed agreements from a risk management perspective and offer recommendations. Members can contact their consultant at **1.866.547.6516**.