

Contractual Risk Transfer

How Businesses Avoid Paying for Others' Mistakes

Business owners: Take a look at your Income Statement. After payroll, what's your biggest expense? If you're like many companies, your answer is employee benefits, followed by business insurance.

Fortunately, business insurance is one area where you have some control over the cost.

- If you have better-than-average claims experience, you pay less.
- If you have worse-than-average claims experience, you pay more. Simple enough.

However, here's where it gets complicated:

If you haven't taken steps to limit your exposures, you may be paying insurance rates that have been inflated by four sources of liability claims:

- 1. Claims generated by your company.** For example, let's say you own a building and you fail to clear the snow and ice from its entrance. If a visitor slips and falls, breaking a hip, are you on the hook? The answer is YES, probably.
- 2. Claims generated by your subcontractors.** Now, let's say that you own a building and you've subcontracted a property manager to clear the snow and ice from the entrance every day. On the day in question, your subcontractor fails to complete the job and that is why the visitor slipped and fell. Are you on the hook? The answer is YES, probably – *unless you've transferred the risk.*
- 3. Claims generated by your suppliers.** Now let's say that there is no property manager, but your team took steps to clear the ice by properly applying a deicer. However, instead of melting the ice, the deicer made it extra slippery. Are you on the hook for the visitor's fall? The answer is YES, probably – *unless you've transferred the risk.*
- 4. Claims generated by your vendors.** Now let's say that there is no subcontractor involved, and in fact, there was no snow. What really happened was that a window washing company that you hired spilled soapy water in the entrance of your building and failed to clean it up, which caused the slip and fall. Now are you on the hook? The answer is YES, probably – *unless you've transferred the risk.*

Now that you know the possible scenarios, do you have concerns? Does it seem fair for your company to pay for the claims caused in all four of these scenarios?

Ready to take control? Let's explore the power of Contractual Risk Transfer.

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.

What is Contractual Risk Transfer (CRT)?

- **The short answer:** It is a method of shifting risk from one party to another.
- **The long answer:** It involves a non-insurance contract and/or agreement between two parties whereby one agrees to hold another party harmless for specified actions, inactions, injuries or damages and indemnify the owner.

Ideally, CRT shifts the potential liability to the party who is in the best position to control it. In the examples above, contractual risk transfer would require the subcontractor, the supplier and the vendor to pay all or part of the claim costs in each of their respective scenarios.

Subcontractors, suppliers and vendors can choose to pay the claim costs outright or they can purchase General Liability Insurance to cover the risks that may be caused by their work, including coverage for claims for contractual indemnification. The subcontractor, supplier or vendor must confirm that the General Liability policy they purchase covers claims for contractual indemnification for the type of business they operate.

With CRT, your business can share the burden of risk with other businesses. This strategy reduces claim costs and helps you avoid increased insurance rates, thereby increasing your competitive advantage. When you pay less for risk and insurance, you have more to spend on labor, supplies and marketing.

How is Contractual Risk Transfer Different than Risk Transfer?

Risk transfer is a broader term that refers to many methods of transferring risk. One of the most commonly used forms of risk transfer is insurance. Every time you purchase an insurance policy, you are engaging in a form of risk transfer.

Another common way to transfer risk is through a contract. This is referred to as Contractual Risk Transfer.

Case in Point

- **The Scenario:** A property owner hires a private security firm to provide services for his building rather than hiring his own staff of security personnel. By doing this, the property owner theoretically transfers the risk of potential claims or losses onto the security firm hired.
- **The Question:** Does hiring the firm transfer the risk automatically or is a contract needed?
- **The Answer:** At a minimum, the property owner should require an “Additional Insured” status and obtain a Certificate of Insurance confirming that status from the security company. Also, the property owner should work with legal counsel to draft a written contract between the two parties. A well-drafted risk transfer agreement is one of the most effective ways to ensure risk of loss is properly allocated to the party that both creates the risk and has the ability to control that risk. The contract should include an indemnification clause that specifies the security company’s insurance is primary, non-contributory and holds the property owner harmless, eliminating the risk of being included in a loss resulting from security company’s operations. When permitted, such terms should also be included within the Additional Insured insurance.

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.

Does Contractual Risk Transfer Really Work?

In most cases, CRT is effective as long as the contract:

- Complies with applicable state laws
- Was signed by both parties prior to the damage or injury

Courts typically respect and enforce properly drafted contracts with rulings consistent with the terms of the contracts in question.

Similarly, liability insurance policies provide coverage for properly drafted risk transfer contracts and the other insurance policy can cover all or part of the risk.

It's worth noting that some statutes and laws limit the degree of risk that can be transferred. For this reason, the upstream business owner seeking risk transfer may not be able to transfer 100% of the liability to its downstream contractor.

Get Started with CRT in Three Steps

Like many worthwhile endeavors, getting started with CRT requires some foundational work.

You'll need to:

1. Assess your risk and identify the opportunities for risk transfer.
2. Collaborate with your legal counsel to draft the needed contracts.
3. Update your internal vendor/supplier/subcontractor vetting, contracting and Certificate of Insurance recordkeeping procedures.

Common Terms to Know

Contractual Liability: Liability imposed on an entity by the terms of a contract.

Contractual Liability Insurance: Insurance that covers liability of the insured assumed in a contract under the standard commercial general liability (CGL) policy.

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.

Step 1: Assess Risk and Identify Opportunities for CRT

One way to assess and identify opportunities for CRT is to create a list of all the aspects of your operation and the vendors, suppliers and subcontractors involved, then identify the potential exposures that could arise if one of these parties made a mistake. If a mistake could result in a high dollar claim, there may be an opportunity to transfer all or some of the risk using CRT.

Sample Risk Assessment List for an Apartment Building Owner

Type of Risk	Potential Exposures
Property Manager	Failure to fix/repair building issue results in physical damage, or Results in harm to residents Discriminatory practices in tenant screening/selection
Window Washer	Slip & Fall Invasion of Privacy Theft
Landscaper	Damage to trees and shrubs Harm to residents
Maintenance Company	Fail to ID problem with hot water heater or furnace could result in discomfort or major harm such as CO exposure
Swimming pool/spa maintenance company	Wrong mix of chemicals or failure to maintain properly could cause harm to resident or guest
Background Checker	Data breach or inappropriate use of private data
Accountant or Bookkeeper	Theft, fraud or negligence
Janitor	Theft of property or damage to property
Security	Harm to resident or guest Failure to act when needed
IT/Data Breach	Failure to safeguard private data
Onsite Fitness Company	Failure to safely maintain equipment Harm to resident or guest Childcare exposures

**Note: This is an abbreviated list for example only and should not be used for actual risk identification purposes.*

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.

Step 2: Work with Your Legal Counsel to Draft Contracts

Now that you know the types of risks you face and their potential exposures, work with your legal counsel to review and update contracts with your suppliers, vendors and subcontractors.

Your contractual agreement should transfer the financial consequences of legal liability from you to the other party – the party that is most able to control the risk.

CRT is achieved through a contract, drafted by legal counsel, with five parts:

- 1. A Hold Harmless Agreement:** A clause in the contract that releases one party from consequences or liabilities due to the act of the other party. It is important to note that hold harmless agreements work both ways – and you need to ensure that this agreement is in your favor.
- 2. An Indemnification Agreement:** An indemnity agreement ensuring that proper compensation is available for losses or damage.
- 3. A Waiver of Subrogation:** An endorsement that prohibits an insurance carrier from recovering the money they paid on a claim from a third party that may be negligent.
- 4. A Primary and Noncontributory Requirement:** An inclusive contractual requirement that requires the vendor's or subcontractor's policy to pay before other applicable primary policies and without seeking contribution from other policies that also claim to be primary - noncontributory.
- 5. Additional Insured Status:** The vendor or subcontractor is required to endorse the property owner onto its Commercial General Liability policy as an "additional Insured."

Ask suppliers, subcontractors and vendors to sign your updated contracts. Keep these contracts on file and be sure to revisit this process annually to ensure that your CRT strategy provides optimal protection.

Don't Make This Mistake!

Never assume that you've transferred the risk because you obtained a Certificate of Insurance (COI) from your vendor or subcontractor.

A COI serves as proof that a person or organization carries insurance at a moment in time. That's it! It is not a contract between you and the other party. It is not a guarantee that the person will continue to carry insurance.

Most importantly, the COI does not specify who will be responsible for losses incurred.

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.

Step 3: Vetting, Contracting and COI Recordkeeping Procedures

Like any new process or procedure, CRT is only effective if it is maintained and followed. Therefore, it's important to create a written checklist for your team to follow whenever you are partnering with a new supplier, subcontractor or vendor.

Your checklist should include vetting, contracting and obtaining Certificates of Insurance.

Vetting: The purpose of vetting is to select the best partners possible. You should choose partners with strong risk management protocols already in place. A strong vetting program is a loss prevention tactic which will help you avoid risk and claims.

Screening steps to consider include checking:

- References as well as online reviews and ratings.
- OSHA and Secretary of State records for safety violations.
- The companies' policies and procedures for hiring, background/driving record checks and drug testing, if applicable.
- The companies' workplace safety protocols.

Contracting: All new vendors, suppliers and subcontractors should sign a written contract which includes the CRT components outlined in Step 2 of this guide. Contracting (with CRT) must be completed every time you start a new relationship, before any work has been completed.

- Contracts must be signed and in writing. Oral contracts will not suffice.
- Every contract must be reviewed by your legal counsel.
- Be prepared for negotiation and know your acceptable fallback position if the other party wants to adjust the terms you've offered.
- If a company fails to sign your contract within a reasonable timeframe, work and/or payment should be interrupted until a signed contract is on file.

Certificates of Insurance: In addition to the contract, you should obtain Certificates of Insurance annually. Obtain a COI for all relevant coverage types. Most companies should carry property, general liability, workers' compensation and commercial auto coverage. Other coverages may be needed depending on the type of work to be performed.

- Use the COI to verify that your subcontractor carries appropriate coverage types and limits.
- Confirm that you are added as an Additional Insured where required by your contract (Step 2).
- Protect your own interests. In some situations, you may be required to pay for losses arising from subcontractors who don't carry their own coverage. Those without coverage may also be considered your company's employees in some cases.

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.

3 Steps of COI Recordkeeping

1. Create a process in which you request updated COI documentation annually. If you do not receive the required information, work and/or payment should be interrupted until documentation is received.
2. Obtain COIs directly from the other party's insurance agency or insurer to avoid the risk of fraudulent paperwork.
3. Keep Certificates of Insurance well-organized in project files, alphabetical subcontractor/vendor files and COI X-Date files.
 - X-Date files are organized by insurance expiration dates. For example, keep all certificates that expire in January in a "January" file so you can easily request updates for them the following January.

Taking a little extra time up front to properly vet and contract your business partners will reap great rewards over time. You'll choose better partners, avoid countless claims and take control of your business insurance costs.

If you're interested in paying less and controlling your liabilities, implement a CRT strategy today! With CRT in place, you can stop paying for other companies' mistakes!

Final Note: Beware of the Risk Transferred to You

Just as you are looking for ways to contractually transfer risk to your downline partners, your upline partners may be looking for ways to transfer risk to you.

Now that you understand the process, you can engage in these negotiations with a better understanding of the risks involved. Be sure to have your legal counsel review any and all documents before you sign them. Also, be sure that your employees know that all contracts must be reviewed by your firm's leadership team and legal counsel.

If you are incurring significant risk due to contractual risk transfer, consider having your professional insurance agent review your exposures and determine if your general liability policy provides coverage.

The information provided in this article does not, and is not intended to, constitute legal advice; instead, all information, content, and materials available on this site are for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Readers of this article should contact their attorney to obtain advice with respect to any particular legal matter. No reader of this article should act or refrain from acting on the basis of information on this site without first seeking legal advice from counsel. Only your individual attorney can provide assurances that the information contained herein – and your interpretation of it – is applicable or appropriate to your particular situation. All liability with respect to actions taken or not taken based on the contents of this article are hereby expressly disclaimed.