

ARM – 56 Risk Financing

Presented by:
Erike Young, MPPA, CSP, ARM

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Chapter 8

Contractual Risk Transfer

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Contractual Risk Transfer

Educational Objectives

After learning the content of this assignment, you should be able to:

- ▶ Describe the types of contractual risk transfer for hazard risk.
- ▶ Describe contractual risk transfer by type of transaction.
- ▶ Explain how contractual risk transfer for hazard risk can alter common-law liabilities.
- ▶ Describe the types of statutory limitations on hold-harmless agreements.
- ▶ Explain how to manage contractual risk transfer for hazard risk.

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Types of Contractual Risk Transfer

- ▶ Noninsurance Risk Control Transfer
 - Transferring the risk itself is a risk control technique because it rids transferor of some or all of the loss exposure
- ▶ Noninsurance Risk Financing Transfer
 - When transfer changes neither the frequency nor the severity of potential losses, but only who pays for losses when they occur, then the transfer involves only risk financing.

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Types of Noninsurance Risk Transfer

▶ Considerations

- A contract is formed before any loss occurs
- Risk financing transfer only provides protection only after funds to restore loss are paid
- Issue of bankruptcy and insured endorsements

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Noninsurance Risk Control Transfer

- ▶ In many cases, risk management professionals don't deal with contracts, but many of the following contracts contain risk control transfer provisions
 - Incorporation
 - Leasing
 - Sale and lease back arrangement
 - Contracting for services
 - Professional Service Agreements
 - Suretyship and guaranty agreements
 - Construction or performance contracts
 - Waivers
 - Facility use agreement or activity use (bouncehouse, flag football)
 - Limitations of liability
 - Computer software examples
 - Disclaimer of warranties
 - Used cars

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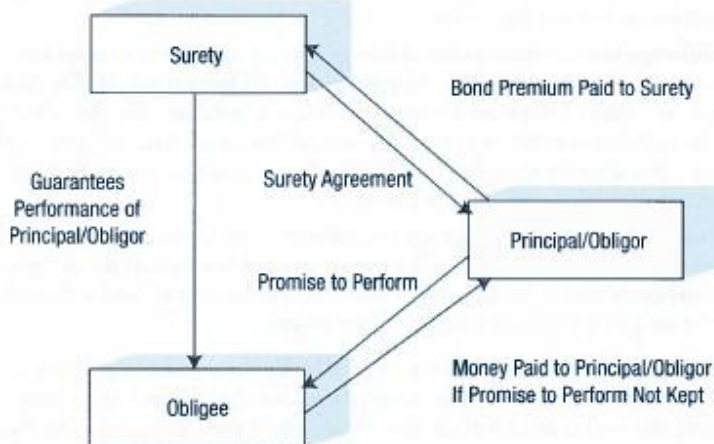
Risk Control Transfer

- ▶ Leasing
 - Sale and lease back arrangement
 - Common Area Management
 - ADA, sidewalk maintenance, etc..
- ▶ Contracting for services
 - Generally, any property, net income, or personnel loss exposure can be transferred fairly easy
 - Liability loss exposures causing harm to third parties are more difficult to transfer
 - Need to make sure subcontractor has adequate insurance to pay for claims

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Risk Control Transfer

Surety Agreements



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Risk Control Transfer

A surety has several rights that protect it against loss from the principal's misconduct or from collusion between the principal and the obligee:

- **Exoneration**—For example, assume that a principal has fallen behind its project schedule, and the obligee has failed to preserve its rights against the principal. In such a case, the surety is released from its liability to the extent that it can show that the obligee's inaction increased the loss of or otherwise harmed the surety.
- **Subrogation**—A subrogation clause in a surety agreement entitles the surety to the same payment the principal would have received. For example, if a surety completes the construction of a building after the default of the building-contractor principal, the building owner (the obligee) must pay the surety for the portion of the work completed on the same basis on which it would have paid the contractor.
- **Indemnity**—The surety can proceed directly against the principal to recover the fair value of its effort or any funds it has paid to the obligee as compensation for the principal's inaction. The principal must indemnify the surety for the costs of fulfilling the promise.

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Risk Control Transfer

- ▶ **Waivers**
 - Voluntary relinquishment of a known right
- ▶ **Exculpatory Clause/Agreement**
 - Contractual provision purporting to excuse a party from liability resulting from negligence or an otherwise wrongful act
- ▶ **Waiver of Subrogation**
 - Pre-loss voluntary relinquishment by an insurer of its right to seek reimbursement for payment for damages that were caused by a party other than the insured

To be effective, a waiver should comply with the following criteria:

- The waiving party must not have been forced to sign it by uneven bargaining power.
- It must be obtained honestly, not by deceit or concealment.
- It must state the specific right that is being waived in a clear and unambiguous manner.
- It must be supported by legal consideration paid to the party waiving the right.

Risk Control Transfer

▶ Limitations of Liability

- Software language limiting liability to purchase price of software

In no event will (transferor) be liable to (transferee) or any third party for any incidental or consequential damages arising out of use or of inability to use (transferor's product which is being sold to transferee), or for any claim by any other party, even if (transferor) has been advised of the possibility of such damages. (Transferor's) total liability with respect to (transferor's product) shall not exceed the purchase price paid by the (transferee). (Transferee) acknowledges that these limitations permit (transferor) to provide this product at a lower cost than it otherwise could, and such limitations on liability are reasonable.

▶ Disclaimer of Warranties

- May deny any express warranties made in conjunction with a property's sale

(Seller's property) is provided "as is." To the maximum extent permitted by law, (seller) disclaims all warranties of any kind, either express or implied, including without limitation, implied warranties of fitness for a particular purpose and merchantability.

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Risk Financing Transfers

▶ Hold Harmless Agreements

- Contract under which one party agrees to assume the liability of a second party on those specific activities outlined in the contract
- Indemnity clause provides transferor with funds for restoring accidental losses to property, net income, liability claims.

The (transferee) shall hold harmless and indemnify (the transferor) for any losses, claims, damages, awards, penalties, or injuries incurred by any third party, including reasonable attorney's fees, which arise from any alleged breach of such indemnifying party's representations and warranties made under this agreement, provided that the indemnifying party is promptly notified of any such claims. The indemnifying party shall have the sole right to defend such claims at its own expense. The other party shall provide, at the indemnifying party's expense, such assistance in investigating and defending such claims as the indemnifying party may request. This indemnity shall survive the termination of this agreement.

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Risk Financing Transfers

- ▶ Transfer of Risk to Transferee's Insurer
 - Modification of an insurance agreement to treat a specified third party as an additionally insured
 - Additional Insured Endorsement
 - Endorsement that adds coverage for one or more persons or organizations to the named insured's policy

An **additional insured endorsement** offers a transferor several advantages:

- Rights under the policy that are independent of the enforceability of the general business contract between the transferor and the transferee
- Waiver by the transferee's insurer of its right to subrogate against the transferor
- Additional source of funds to pay for the transferor's losses
- The right to demand that the transferee's insurer pay the costs to defend the transferor for a covered liability loss
- Free coverage because the transferor often does not contribute funds toward payment of the transferee's insurance premium

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Risk Financing Transfers

- ▶ Transfer of Risk to Transferee's Insurer
 - Modification of an insurance agreement to treat a specified third party as an additionally insured
 - Named Insured Endorsement
 - Similar to insured endorsement, but elevates new insured to named insured with special rights and obligations.

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Risk Financing Transfers

▶ Transfer of Risk to Transferee's Insurer

- Advantages/Disadvantages
 - A transferor's agents, employees, officers, and directors are considered insureds and therefore are included in the transferee's coverage
 - The transferor, as the named insured, is likely entitled to receive notice if the transferee's policy is canceled or endorsed
- Disadvantages
 - The transferee's insurer may have a right to inspect the transferor's business and financial records.
 - The transferor may unknowingly be agreeing to provide periodic reports to the insurer
 - The transferor may become involved in litigation unrelated to the relevant insurance coverages

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Types of Transactions

- ▶ Noninsurance transfer language commonly found in these types of contracts
 - Construction contracts
 - Service and maintenance contracts
 - Purchase order contracts
 - Lease of premises contracts
 - Equipment lease contracts
 - Bailment Contracts
 - Sale and Supply Contracts
 - Free on Board (FOB), Cost Insurance Freight (CIF)

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Contractual Risk Transfer Common-Law Liabilities

Common-law liabilities affecting a transferor's potential or actual liability loss exposures can be altered by three forms of contract provisions. Categorized by how they alter common law, these provisions can be grouped according to the extent of responsibility they transfer. For example, assume the contracting parties are a building owner (O) and a general contractor (C). They may enter any one of three forms of contractual risk transfer agreement:

- Limited form—Party C holds Party O harmless from responsibility for losses that are exclusively Party C's fault.
- Intermediate form—Party C holds Party O harmless from responsibility for losses resulting from Party C's sole fault and from Party C's and Party O's joint fault.
- Broad form—Party C holds Party O harmless from responsibility for losses resulting from party C's sole fault, both parties' joint fault, and Party O's sole fault.

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Contractual Risk Transfer Common-Law Liabilities

1. Transferring responsibility for joint fault (limited form)
2. Transferring all responsibility, except for transferor's fault (intermediate form)
3. Transferring all responsibility (broad form)

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Contractual Risk Transfer Common-Law Liabilities

▶ Limited Form

The contractor agrees to indemnify and hold harmless the owner against claims, damages, bodily injury, or property damage arising out of the contractor's work and caused by any act of omission of the contractor, his agents, and his employees.

▶ Intermediate Form

Lessee shall be liable for, and shall hold the Lessor harmless with respect to, all claims relating to damage or injury to the property or persons of others alleged to have occurred on or have been caused by the condition of the leased premises, if such injury or damage is alleged to have been caused by an act or neglect of the Lessee (including anyone in the Lessee's control or employ) or the joint act or neglect of the Lessee and Lessor.

▶ Broad Form

The contractor shall indemnify and hold harmless the owner from and against all claims, damages, bodily injury, or property damage whether or not caused in part by the owner's act or omission.

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Limitations on Hold-Harmless Agreements

▶ Statutory Limitations

- All inclusive statutes
- Statutes prohibiting certain wording
- Statutes prescribing certain wording

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Managing Noninsurance Risk Transfers

▶ Considerations

- Enforceability
 - Legal enforceability of contract provisions

- Ability to Manage Risk
 - The relative abilities of parties to manage risk

- Nature and Extend of Risk Transferred
 - The price or other legal consideration the transferor explicitly or implicitly pays or gives transferee

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Strategic and Administrative Considerations

Elements of a Noninsurance Risk Transfer Program

The first and most important element of a sound noninsurance risk transfer control program is a consistent transfer strategy. Such a strategy ensures that the organization does the following:

1. Becomes a transferor when this role serves both the organization and the general economy
2. Becomes a transferee when this role is similarly appropriate
3. Avoids assuming both roles simultaneously when appropriate

- General Admin Controls
- Records of Contractual Transfers
- Specific Control Measures
 - How can risk be reduced?
 - Can provisions be deleted?

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Fundamental Guidelines of Contractual Risk Transfer Management

- Ensure that the indemnitor can fulfill its commitment financially. Legal precedent mandates that the commitment be backed by insurance of at least \$1 million per occurrence.
- Require a certificate of insurance for contractual liability coverage before contract operations begin.
- Be named as an additional insured on the transferee's policy. Although being added as an additional insured can pose problems—such as an increased possibility of policy cancellation or nonrenewal—its advantages far outweigh the disadvantages.
- Avoid being too severe. If a contractual transfer is too extreme, courts may construe it as invalid because it is unconscionable or contrary to public policy. The farther apart the two parties are in their bargaining power and knowledge of contract terms, the greater the probability that the contract will be unenforceable.
- Avoid ambiguity. Courts unfavorably view contracts that indemnify individuals or organizations against the consequences of their own negligence or intentional wrongdoing. If contract language is ambiguous, courts generally construe a hold-harmless agreement to make it consistent with common law and public policy. Generally, this means that a person or an organization is indemnified for liability, especially if the person or organization was only passively negligent in causing property damage or bodily injury.
- Become more actively involved in legislation. Many of the current statutes limiting contractual indemnification are the products of lobbying efforts. Risk management professionals have an obligation to their organizations and to the public to present compelling reasons for laws that can benefit an organization, the economy, and society.