



Risk Transfer in Contracts

One of the most effective tools of risk management is to transfer recognized risk to someone else. Fund members usually do this in two ways. One way is through coverage and the other is through contracts with contractors and vendors. Coverage transfers the risk of loss or damage to the member's people, customers, property or equipment to the Fund. The coverage documents of the Fund pay for many of the risks of loss for worker or customer injury, damage to vehicles, equipment or property and employment or governance matters. Jointly the members of the Fund pay for the transfer of risk by paying claims with contributions the members pay, reinsurance and if necessary, the accumulated assets of the Fund.

Contracts with contractors and vendors also accomplish the transfer by identifying the losses the contractor or vendor will assume and providing a method for paying for much of that assumption of loss. The first vital element for risk transfer in contracts is the language that obligates the vendor to accept the risk to the district or authority from their operations or services. Although the contractor may cause an injury to a customer, the district or authority could be partially responsible by establishing the type of services the contractor provides and overseeing their work. In the real world of litigation, the plaintiff's attorney is going to seek recovery from the contractor and the district or authority because both may be negligent in causing an injury or damage. Neither party to a contract wants to accept the other's negligence, but the district or authority's position is that if you want to do business with us you will accept part of our responsibility for a loss. A good example of this is a contractor's repair of an irrigation line that fails and floods some houses along the canal. The homeowner's attorney will try to sue the contractor and the district or authority. The contract between the district or authority and the contractor contains an indemnification clause that says:

Contractor will hold harmless and indemnify District or Authority and its directors, officers, employees and agents from any claims, losses, damages, judgments, liabilities, costs, expenses or obligations, including attorney's fees and expenses, arising out of or resulting from Contractor's negligence or acts.

(Sample from a Member Services Agreement)

Most indemnification clauses use many more words to say essentially the same thing, but this is a good summary of what is in most agreements. The key words are "will hold harmless and indemnify District or Authority" from any source of loss caused by the "Contractor's acts or negligence."

In the interest of fairness many indemnification agreements do not impose liability on the contractor arising out of the district or authority's "sole negligence." Good risk management practices will prevent this scenario from happening very often. Even with this language the indemnification agreement still transfers most of the risk to the contractor.

The second vital element of the transfer of risk is the contractor's ability to pay for "claims, losses, damages, judgments, liabilities, costs, expenses or obligations." Some contractors could probably handle these costs with their own reserves and financial strength, but most don't have the resources to absorb the costs. The solution required by the contract is in the contractor's insurance program.

Contractual liability that is created by the indemnification agreement is accepted by the contractor's General Liability insurance. If there's a written contract, the insurance company will respond to the obligations created by the agreement. There are several provisions in the General Liability policy that should be in place to make sure there is full acceptance of the obligation and enough money to pay for the losses. General Liability coverage responds to bodily injury or property damage to third parties arising out of the contractor's premises or operations. The canal bank failure mentioned earlier caused bodily injury to third parties, the homeowners. The contractor's contract with the district or authority obligates them to pay for the losses from the property damage and their General Liability accepts the transfer of risk from the contractor to them (Contractual Liability). They will pay the loss from their limits of liability which represent the total amount of money they will provide to pay the losses of their insured contractor. The Fund recommends:

- \$1,000,000 per occurrence (any one loss) and
- \$2,000,000 aggregate (all the insurance company will pay in one year for all losses).

In addition to adequate limits of liability, a full transfer of risk to the insurance company includes an endorsement to their policy that provides that they will provide defense for the district or authority in the event of legal action against the contractor and the district or authority. This is an "Additional Insured" endorsement. It provides defense by the attorneys hired by the insurance company as it relates to the particulars and allegations from the loss. The Fund recommends that you consult with your own counsel to make sure all the district or authority's interests are addressed. The insurance company will limit their defense of the district or authority to only the matters relating to bodily injury or property damage to the third party.

Another important part of your standard contract with contractors is an "Insurance Requirements" section. The requirements include limits of liability, endorsements such as "Additional Insured" and others such as:

- 30-day notice of cancellation or non-renewal to the district or authority on all policies.
- A "Waiver of Subrogation" on Workers' Compensation, General Liability, Automobile Liability and Umbrella. A "Waiver of Subrogation" prevents the insurance company from going after the district or authority to try to recover amounts they paid for losses

on your premises or through alleged negligence. This is especially important since there is no additional insured status allowed on a Workers' Compensation policy.

The Waiver of Subrogation would come into play if one of the contractor's employees was injured trying to repair the breach in the canal bank. Their insurance company would pay the worker's medical expenses and lost time benefits then try to recover those amounts from the district or authority because the contractor was working for the district or authority and the injury occurred on the district or authority's property. The Waiver of Subrogation prevents the insurance company from recovering any amounts from the Fund or the district or authority.

Sometimes the tables are turned on the district or authority by a vendor that has a strong negotiating position or a service the district or authority needs with no alternative bidders available. In that event the district or authority might have to comply with the contractor or vendor's insurance requirements and agree to an indemnification agreement where the district or authority assumes some of the vendor's liability. So, the transfer of risk goes the other direction with one important limitation. The indemnification agreement should be modified to include the phrase, "the district or authority hereby agrees to the extent permitted under the Constitution and the laws of the State of Texas to indemnify and hold harmless" the contractor or vendor. This will limit recoveries to the statutory limits in the Texas Tort Claims law.

Remember that the transfer of risk from the district or authority to its vendors or contractors requires two elements. The first is the indemnification agreement in the contract between the district or authority and the vendors or contractors. The second part, also in the contract, is the insurance requirements imposed on the vendors or contractors that pays for their acceptance of the district or authority's risk.

In all cases, please consult with the Fund about any contract, indemnification language, insurance requirements, coverages required and the various endorsements a provider might object to or think they can't get from their insurance company.

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Contact Richard Wigzell, Risk Management Consultant at 518-429-9974 or richard.wigzell@sedgwick.com, Mary Vasquez, Senior Underwriter at 512-427-2346 or mary.vasquez@sedgwick.com.

Additional resources are available at on the Fund's website www.twcarmf.org.