CRUM & FORSTER®
A FAIRFAX COMPANY

RISK ENGINEERING

INTRODUCTION TO RISK TRANSFER

Insurance is risk transfer. Every insurance policy is a way to transfer risk from an insured to its insurance company. Understanding risk transfer issues is a critical part of business management, too. What other steps can you take to make certain that, for example, your operation isn't put out of business by a lawsuit?

When we talk about risk transfer, we're really talking about two distinct mechanisms: contractual indemnification and insurance procurement clauses. Both can be found in virtually all the agreements that your business signs with other businesses. They're present in almost every commercial contract, whether it's a lease requiring a tenant to indemnify a landlord and to name him as an additional insured, or an agreement between a homeowner and a roofer, or one between a general contractor and a subcontractor, or an equipment lease for a forklift or a crane. Each will almost certainly contain one or both of these indemnification and insurance/additional insured provisions.

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What does it mean to indemnify another business? When one business agrees to indemnify another, it agrees to settle claims and lawsuits against that business. Agreeing to procure insurance for another business, or make it an additional insured, has a similar effect. Depending on the situation, almost anyone can be either the party seeking to transfer risk or the party who is being asked to assume someone else's risk. It's because these two mechanisms – indemnity and insurance procurement clauses – are so prevalent that business owners must always read and understand the contracts they sign: you will either be transferring risk to another party or accepting another party's risk.

A general contractor, or GC, may have to indemnify a property owner against claims, but that same GC is going to attempt to transfer risk to subcontractors it contracts with. And while that subcontractor may owe the GC indemnity, it may also seek to be indemnifietd by its own subcontractor. While a tenant may owe indemnity to the property owner with whom he has a lease agreement, that same tenant may be entitled to indemnity from a janitorial service, a security guard service or a snow removal service it has contracted with. And in addition to the contractual indemnity clause, each one of these parties might be required to maintain designated levels of insurance and to name the owner, the GC, or the tenant as an additional insured on their insurance policy. A failure to name that party on their policy can lead to a claim that this failure was a breach of the contract, and that contractual breach is typically itself NOT a covered claim under that policy.

It's critical for the businesses involved to read these provisions carefully and to understand fully the impact and intent of the provisions. If your contract requires you to maintain commercial general liability insurance with primary limits of $2Million, and to name someone as an additional insured on a primary and non-contributory basis, the failure to do so can lead to very undesirable consequences. Remember that the insurance company is not a party to your contracts and typically does not know what specific contracts you've entered into or the details of those contracts.

The most comprehensive indemnification clause imaginable may still be worthless if it is found to be inapplicable or invalid based on some state law, or if it is found to be vague or ambiguous, or if the provision doesn't apply for some reason to the specific facts of a loss.

What can great risk transfer provisions do for you? They can shift the risk away from you; they can require another party (or other insurance company) to pay counsel fees and an ultimate indemnity payment, and they can hopefully reduce the overall cost of doing business. But just as your business may be transferring these costly obligations away, another party to the contract might be attempting to transfer them to you.

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