RISK INSIGHTS

Contractual Risk Transfer Explained

Contractual risk transfer (CRT) is a risk management mechanism that can be utilized by many businesses. It involves shifting potential liability through a non-insurance contract or agreement and is intended to transfer risk to the party (e.g., vendor, supplier, subcontractor) that is better situated to control it.

While insurance is the most common method to transfer risks, CRT is another tool that may be used. By sharing the risk burden through CRT, businesses can reduce claim and premium costs. This article provides more information on CRT, including when it may be used, commonly used CRT tools and other considerations.

When CRT Is Used

Contractual risk transfer may be suitable for various situations when a party is performing work on behalf of another business (e.g., subcontracting), or a party has taken on duties through a supplier, sales or lease agreement. In these circumstances, a business may consider utilizing CRT as it provides a means to transfer risk to the party who is better positioned to manage it.

For example, a landlord may contract with a building maintenance company to ensure the property is in good condition. However, if the building maintenance company neglects its duty, the landlord may be liable for associated damages without CRT. Additionally, a general contractor may use CRT so that a subcontractor completing work at a job site assumes liability for any losses the subcontractor's work creates.

These circumstances, and others with vicarious liability exposure, demonstrate how one party may be better situated to control risk than another party. In those cases, CRT may be a sensible way to transfer risk.

Contractual risk transfer is a tool that can be utilized by businesses to manage exposures by transferring risk to a party who is better positioned to control it.

Common Contractual Tools to Transfer Risk

CRT commonly takes place through the utilization of several tools, including hold-harmless agreements, indemnification agreements and waivers of subrogation. Businesses may also contractually require that they are named as "additional insureds" on another party's insurance. The following offers a more detailed explanation of common CRT tools:

- **Hold-harmless agreements** are part of a contract that releases one party from responsibility for the actions of another.
- **Indemnification agreements** detail how an indemnified party, or indemnitee, will be compensated by the indemnifier, or indemnitor, if a third-party claim is filed.

- **Waiver of subrogation** is a clause that prohibits a party's insurance company from seeking recovery from the other party's insurer for compensation it provided to a third party. For example, if an installer agrees to a waiver of subrogation with an equipment manufacturer, the installer's insurer cannot seek redress from the manufacturer or its insurer if the installer's insurer pays out a claim following damages caused by the equipment's installation.

- **Additional insureds** can be added to another party's insurance to receive its coverage. For example, if a contractor is named as an additional insured on a subcontractor's policy, the contractor would receive coverage from the subcontractor's insurance.

It is generally best practice for companies to require a certificate of insurance (COI) from parties who may create liabilities (e.g., subcontractors, vendors, lessors) and to contractually require that those parties name their company as an additional insured. It is also important to request a copy of the additional insured endorsement. This document, along with the COI, can help ensure insurance coverage is in place, and that it contains sufficient limits.

CRT Considerations

There are other considerations businesses must be mindful of when utilizing CRT. For example, laws regarding CRT vary by state and having an attorney who is familiar with them is recommended. An attorney can also provide guidance on the agreements to ensure that they are not overly broad and that they accomplish their intended goals. Additionally, it is essential that each party of a CRT is aware of their financial obligations in the event of a loss.

Conclusion

CRT can help businesses reduce their insurance claims and costs while placing risk with the party who is better positioned to control it. Along with securing insurance, CRT can be an integral part of a business's risk transfer strategy.

Contact Venbrook Insurance Services today to learn more about CRT.