



# Contract Guide: Transferring Risk and Liability

---

**Provided by:**

The Partners Group  
1111 Lake Washington Blvd N, Ste 400  
Renton, WA 98275  
425-455-5640



# Contents

Contents .....	2
What is Contractual Risk Transfer?.....	3
Legal Language Overview .....	4
Key Terms .....	4
The Common Types of Contractual Risk Transfer.....	7
Indemnity Provisions .....	8
Advantages/Disadvantages .....	8
Simplified Example .....	9
Additional Insured Provisions .....	10
Simplified Example .....	10
Waivers of Subrogation .....	12

## What is Contractual Risk Transfer?

Examining and managing risk exposures is one of the keys to the long-term success for businesses of all sizes. However, when you work with partners and other parties such as contractors, renters, component suppliers and service providers, you may be held accountable for their actions or negligence. And because your regular risk management procedures and insurance policies generally don't cover others, you could be found liable for huge losses.

The best protection in these situations is to shift risk and liability away from your business and onto other parties. Thankfully, you can do this when you draft a formal business contract by including provisions, clauses and other text that determines exactly who is liable for specific scenarios and losses. This is generally referred to as **contractual risk transfer** and can include a wide range of provisions on liability. For example, a business could agree to be responsible for losses only when employees or customers are on the premises.

Because properly worded contracts are legally binding in court, they can help protect your business in the event of a loss or dispute. Additionally, contracts can contain insurance requirements, waivers and other types of risk transfer that give your business legal counsel or direct financial compensation.

Although contractual risk transfer is an effective way to protect your bottom line when working with partners and other parties, the practice itself may expose your business to significant risks.

---

### **Whenever you draft a contract, you will have to negotiate and balance your best interests with existing business relationships and requirements regarding risk transfer.**

---

Many states have laws that require specific legal language in order to make contractual risk transfer enforceable, and some states have outlawed specific types of contractual risk transfer altogether.

This guide is meant to give a general overview of contractual risk transfer, including summaries of how and when specific types of risk transfer may be used. This guide should not be considered legal advice, and you should contact legal counsel for advice before you agree to a contract with other parties.

For more information on risk transfer and contracts, call The Partners Group today.

## Legal Language Overview

Because contracts and all other legal documents may be read by many different people, it's essential for them to be written in a way that ensures that they will be interpreted and enforced in a clear and consistent way. For this reason, words and phrases included in contracts are often interpreted literally, and their meaning can greatly differ from more informal, conversational language.

For example, think about the definition of the word "should." When a manager tells an employee that they "should" be in the office before a certain time every day, the employee has a general understanding that this is a job **expectation**. However, because the literal definition of "should" states that the action is only **probable** and not **guaranteed**, including "should" in a legal document could cause readers to interpret its meaning in a number of different ways. Instead, most legal documents use clearer language to outline expectations, such as "must", "will" and "shall."

### Key Terms

Here's an overview of key terms that are essential to understanding contractual risk transfer.



## Liability

---

The legal responsibility for a party's acts or omissions. Legal proceedings involving liability focus on finding the party that was ultimately responsible for a loss, injury or other damage. Then, any relevant contracts are examined to see if any liability was transferred to another party, and if those risk transfer provisions are relevant to the situation.

It's also important to note that courts often consider **vicarious liability** when investigating a case. Under this form of liability, a party can be responsible for a loss that they did not cause if they have a special legal relationship to the party who was ultimately at fault. For example, a person could sue an entire business if a single employee's negligence leads to their injury.



## Negligence

---

A failure to exercise the care toward an individual or situation that a normal, responsible person would take. Although negligence is accidental in nature, a negligent party can still be held responsible for a loss or damage. Most states have laws that prohibit or limit the transfer of liability that results from one party's own negligence.

Because negligence can involve the relationships between multiple parties' actions and inactions, there are a few different types of negligence with important distinctions:

- **Gross negligence:** An extreme form of negligence that is still accidental in nature, but also shows a reckless disregard for the safety or lives of others. Many contractual risk transfer provisions contain exclusions for gross negligence.

- **Sole negligence:** Negligence that can be attributed **entirely** to a single person or party. Sole negligence is extremely difficult to prove, because any involvement whatsoever by another party would qualify as a separate type of negligence. Many states have outlawed contractual provisions that contain sole negligence exclusions in order to protect parties that don't understand sole negligence and accept additional risk without their knowledge.
- **Joint or contributory negligence:** A situation where multiple people or parties are simultaneously negligent for a loss, injury or other damage. During a lawsuit, a court may find that multiple parties were negligent and assign different amounts of liability to each party. However, state laws concerning this form of negligence vary greatly.



## Diligence

---

The amount of reasonable care or attention that a normal, responsible person would take in any given situation. A party may attempt to avoid liability for a loss by proving that they were diligent and took reasonable steps to avoid damage or transfer responsibility for the situation to another reasonable person.



## Indemnify

---

The act of one party agreeing to provide some form of compensation for the loss, damage or liability of another party under one or more specific circumstances. This is one of the most common and broadest forms of contractual risk transfer, as the party that compensates for a loss takes on some of the other party's financial risk. Three additional terms are often used when discussing this process:

- **Indemnity:** The actual compensation that's exchanged when one party indemnifies another. The form of compensation may vary depending on the specific wording used in different indemnity clauses.
- **Indemnitor:** The party that promises compensation through an indemnity provision. This party takes on additional risk by offering the reimbursement in a contract.
- **Indemnitee:** The party that will receive compensation through an indemnity provision. This party has transferred part of their risk elsewhere by getting a promise of reimbursement through the indemnity provision.



## Hold harmless

---

When used in a contract, the term hold harmless refers to the act of one party protecting another party from losses and liability. Although some experts believe that the terms indemnify and hold harmless can be used interchangeably, not everyone agrees. Courts generally find that hold harmless is a broader

term that refers to protection against both liability and losses, while indemnify only protects against losses by promising compensation after damage has already occurred. However, both terms are often included in indemnity provisions in order to offer more protection and avoid confusion.



## Duty to defend

---

The promise to provide for a legal defense or transfer funds to hire counsel. Many contracts include a duty to defend provision in which one party promises to accept responsibility for any costs or work related to lawsuits.



## Insured contract

---

A term that's used to provide partial or full exceptions to the contractual liability exclusion in most commercial general liability (CGL) insurance policies. Most CGL policies don't provide coverage for damage that comes from one party's agreement to take on extra liability, since this extra risk wasn't considered during the insurance underwriting process. However, if the extra liability was a part of a contract, an insurer may label the extra liability as part of an insured contract and provide coverage.



## Subrogation

---

Subrogation is the legal ability of a person or group to use the rights of another when resolving debt or an insurance claim. When talking about contracts, subrogation usually refers to an insurance company that's trying to recover their losses from a loss that it paid out. For example, if an insurance company pays for one of its policyholder's losses, it can legally use that person's right to sue the at-fault party to try to recover the damages.

Waivers of subrogation are a common form of contractual risk transfer where the parties forming a contract deny this right to insurers. As a result, insurance premiums may go up.

## The Common Types of Contractual Risk Transfer

Contracts are binding legal documents that outline the relationship between your business and another party, and the different sections included in a contract will detail how you operate together. In order to transfer liability from one party to another, contracts include dedicated sections—often called clauses or provisions— that describe the subject of risk and liability. Because contracts are a negotiated agreement, there are a number of ways to transfer liability during the drafting process. However, there are three main types of contractual risk transfer:

- Indemnity provisions
- Additional insured provisions
- Waivers of subrogation

Each type of contractual risk transfer has unique advantages and disadvantages, and you should examine each one to see what's right for your business. For example, many states have laws that limit some of the types of contractual risk transfer, and some may be outlawed entirely.

When determining the type of risk transfer that's best for you, you should consider the following questions:

- How can I establish the best working relationships with others?
- What types of risk transfer are most common in my area and industry?
- What type of risk transfer offers me the most financial protection in this scenario?
- Who will review my contract to ensure it's both legal and in my best interest?

In order to help you answer these questions, the following pages will detail the three main types of risk transfer and provide you with an overview of their advantages, disadvantages and more.

## Indemnity Provisions

Indemnity provisions transfer risk through an agreement made by one party to indemnify, defend or hold harmless another party. These provisions are commonly used to formalize how all of the parties involved in a contract will divide risk and liability between each other, and often include specifics on the duration of the risk transfer, monetary limits on compensation and specific scenarios in which the indemnity provision applies.



There are three main types of indemnity provisions:

1. **Limited** provisions are the most common and require an indemnitor to protect an indemnitee from losses involving the indemnitor's own negligence, but not for the negligence of another party. If more than one party is found to be liable for a loss, limited provisions only require the indemnitor to provide compensation for the specific amount of the loss that it's liable for, as determined during the claims process or a court ruling.
2. **Intermediate** provisions require an indemnitor to protect an indemnitee from all related losses, unless those losses were a result of the indemnitee's sole negligence. Many states have limited the use of intermediate provisions in order to protect parties that don't understand the difficulty of proving sole negligence and accept additional risk without their full knowledge.
3. **Broad** provisions require an indemnitor to protect an indemnitee from all losses, even if the loss was the result of the indemnitee's sole negligence. Most states outlaw or limit broad provisions, as making one party contractually liable for the negligence of another party usually violates public policy—the unwritten principles that laws are based on.

### Advantages/Disadvantages

These provisions are essentially negotiations over the amount of financial risk that your business is willing to take, with the final agreement formalized into enforceable law through an indemnity provision. Because of this, the advantages and disadvantages of this type of risk transfer depend on a number of factors.

Here are some key issues to consider:

- **Timeliness**—A party that takes on additional liability in order to fulfill a contract quickly likely won't accept as much risk transfer.
- **Triggers**—Indemnity provisions can be written to include specific triggers, exclusions and durations. For example, a business could specify that a provision can't be triggered in a specific location.

- **Working relationships and reputation**—Asking a party to accept too much additional risk may cause your business relationships or reputation with customers to suffer.

### Simplified Example

Hired Halls is a business that provides venues for large-scale events. Another business, Stellar Sales, selected a Hired Halls venue for a company social event and signed a contract that included a limited indemnity provision to indemnify, defend and hold harmless Hired Halls for any loss, injury or damage during the event.

During the party, an attendee knocked a light fixture off of the ceiling, and multiple guests were injured when it landed close to a dance floor. When Stellar Sales brought a lawsuit against Hired Halls, the court dismissed the case because of the indemnity agreement in the contract between the two businesses.

In this case, the indemnity provision in the contract protected Hired Halls, because the injuries were the result of Stellar Sales' event and not Hired Halls' own negligence.

## Additional Insured Provisions

An additional insured provision is a form of risk transfer that allows one party to obtain insurance coverage under another party's policy. The party that's added as an additional insured then has direct access to the insurance policy without having to pay any premiums or deductibles.

These provisions protect a party that may be exposed to risks that result from the named policyholder's operations. Additionally, because insurance policies often provide broader coverage than the specifics written into indemnity provisions, using both additional insured provisions and indemnity provisions can provide a form of backup risk transfer. Then, if an indemnity agreement is found to be unenforceable for any reason, an additional insured may provide coverage by making a claim under the named insured's policy.

Although additional insured provisions usually only function as a secondary form of risk transfer, businesses need to examine a number of key issues:

- **Contacting the insurance carrier**—Adding insurance requirements to a contract is only one step in this risk transfer process. First, the policyholder must contact their insurance carrier and see if it's possible to add another party to the policy with an endorsement.



**It's important to note that most CGL policies exclude coverage for a third party's liability. However, there's an exception to this exclusion that's commonly referred to as an "insured contract." The exception essentially allows a policyholder to gain coverage if their own breach of an enforceable contract leads to a loss. However, an insured contract doesn't provide coverage to any other party involved in the contract. The only reliable way for one party to get the full rights of an additional insured status is to obtain an endorsement on the original policy that defines when the coverage is triggered and the amount of coverage granted.**

- **Establishing limits**—Because insurance policies can offer a wider range of protection than indemnity provisions, it's important to establish limits on the additional insured coverage and communicate them to the insurance carrier. For example, an additional insured may be able to request coverage for damage that was caused by its sole negligence, even if an indemnity provision in the original contract directly excluded protection from sole negligence. Additional insured endorsements on the original insurance policy can be used alongside indemnity agreements to add more coverage limits, if needed.
- **Obtaining proof of insurance**—Once an additional insured provision is added to a contract, the party that's added to the policy should request proof of insurance to verify coverage and the policy's limits. The best way to do this is to obtain a copy of the endorsement itself, as well as any relevant documents that outline coverage limits, terms and conditions.

### Simplified Example

Fantastic Footwear decides to rent space in a commercial property owned by Better Buildings. As a part of the leasing contract, Fantastic Footwear is required to add Better Buildings to its general liability

## Advantages/ disadvantages

### Advantages

- Both parties can use additional insured provisions as a backup form of risk transfer to help ensure a contract's intent remains intact.
- The scope of the insurance coverage may be broader than indemnity agreements, which can help the additional insured and harm the named insured.
- The named insured's legal defense can act quickly to defend the additional insured, but the additional insured may not be able to select a legal team.
- State laws that limit indemnity provisions may not apply.

### Disadvantages

- The named insured's carrier may attempt to dispute coverage or place excessive limits on the additional insured.
- The additional insured will obtain coverage without affecting their own insurance limits, while the named insured will reach their limits more quickly.

policy as an additional insured. The insurer issues an endorsement to the policy, but notes that coverage for Better Buildings will only apply to claims that result from the ownership, maintenance or use of Fantastic Footwear's rented space.

Later, a customer visiting Fantastic Footwear tripped over broken tiles and severely injured her leg. Although the retailer had asked Better Buildings to repair the flooring well in advance, Fantastic Footwear had also failed to address the hazard—such as by roping the area off or covering it with furniture.

After the customer sued both companies for bodily injury, Fantastic Footwear's general liability insurance policy also provided coverage for Better Buildings. Because the loss was the result of the use of the rented space, the additional insured provision endorsement triggered and the insurer covered damages and defense costs.

In this example, the loss was the result of joint negligence. Better Buildings failed to repair the tile, but Fantastic Footwear could have prevented customers from walking near the hazardous area. As a result, the additional insured endorsement provided both businesses with a broad form of risk transfer—an indemnity agreement alone may not have provided protection.

## Advantages/ disadvantages

### Advantages

- A project or business transaction can proceed without worrying about time-consuming lawsuits.
- Business relationships can improve if there's no possibility of accusatory scenarios.

### Disadvantages

- Parties usually pay higher premiums.
- Policyholders may have to pay higher costs in the result of a loss, even if they aren't at fault.

## Waivers of Subrogation

**Overview:** These contractual provisions prevent one party's insurance carrier from trying to recover funds for a loss they've covered by suing another party in the contract, even if that party was at fault for or contributed to the loss. Simply put, subrogation lets an insurer use their policyholder's right to recover damages from the at-fault party, and waivers of subrogation prevent this and therefore transfer more risk to insurers.

**Remember, subrogation is the legal ability to use the rights of another when resolving debt. When talking about contracts, subrogation usually refers to an insurance company that's trying to recover their losses from a claim.**



Waivers of subrogation can help business relationships by minimizing the risk of lawsuits and allowing each party's insurance to cover the losses. Because these provisions limit an insurance carrier's ability to reclaim funds, some carriers refuse to grant them or require policyholders to pay an additional premium.

Although waivers of subrogation appear to contradict indemnity provisions by limiting insurance coverage to the named policyholder, some courts have ruled that indemnity protects against third-party claims while waivers of subrogation apply to a loss that occurs between the parties named in a contract. However, other courts have examined all aspects of the contract to find the each party's original intent.

### Simplified example:

Peaceful Parks creates a contract with Capable Constructors to design and build a new camp center. To finish the building, Capable Constructors then subcontracts work on the entrance to Dazzling Doors. This subcontract includes a waiver of subrogation provision, unknown to Peaceful Parks.

Dazzling Doors completed its work, but improperly installed large glass panels. Later, a large storm destroyed a large portion of the entrance and an investigation found the faulty installation of the glass panels was the cause. Peaceful Parks' insurer paid for the damages and successfully recovered the funds from Capable Constructors. However, the waiver of subrogation in the subcontract meant that the business actually at fault—Dazzling Doors—wouldn't be responsible for the damage.