



Contracts v. Insurance:
Understanding Legal Risk Transfer Provisions and
How They Relate to Insurance Coverage

The purpose of insurance

The basic function of insurance is risk transfer. In exchange for premium payments, insurers assume risks on behalf of their insureds. These risks come in many different forms, from weather events to cyber attacks. Managing risk through a thoughtful and comprehensive insurance program is an important part of any successful business, large or small.

Insurance is not the only risk transfer mechanism in the business world. Contracts, which are enforceable agreements between two or more parties, also transfer risks. When we think of contracts, the focus is typically on the mutual obligations, e.g., the work to be done and the compensation for that work.

It is also important, however, to consider what risks are being transferred and the related implications. Contractual risk transfer typically comes in two forms: (1) the transfer of business risks, e.g., the risk of non-payment or consequences for performance delays; and, (2) the transfer of liability risks. The latter often involves insurance and thoughtful risk management requires consideration of the type of liability risk that is transferred and the coverages in place.

Transferring risk through insurance and transferring it through contracts are interrelated concepts. Many contracts contain indemnification clauses, requiring one party to indemnify the other for damages and attorney fees that arise from liability claims. When a claim arises, the indemnitee, the party protected by the indemnification clause, can demand that the indemnitor hold it harmless from any claim-related damages or attorney fees. The protection afforded by this type of clause is only as strong as the indemnitor's financial ability to honor its obligations. Because of this reality, the party seeking to transfer some of its liability risk should seek to bolster its protection through an additional insured provision.



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Under this type of provision, a person or organization that is not normally included as an insured under an insurance policy is added as an insured to satisfy a contractual requirement. For example, general contractors typically require subcontractors to provide proof of general liability coverage and name the general contractor as an additional insured for claims arising from the subcontractor's work. In order to affect the intent of the parties, it is important for everyone involved to ensure that the coverage is actually in place through an endorsement to the policy. A certificate of insurance is not enough and if a question arises, what is in the policy controls. A subcontractor that neglects to follow through on its obligation to add the general contractor as an additional insured could face a breach of contract claim and effectively find itself standing in the shoes of the insurer.

Effective risk management requires risk awareness, which requires an understanding of a business's risk profile. This process starts with analyzing the organization's operations and contractual relationships. Seeking the advice of counsel, whether in-house or outside the organization, can be helpful in understanding the full scope of the risks that may arise, some of which may not be apparent from a lay perspective. From there, a business's insurance team can make sure the insurance program matches the exposure to ensure appropriate coverage when a claim arises.



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