Risk transfer: Managing 3rd party relationships

Introduction: case scenarios

- A painter's scaffold collapses resulting in severe injury to the painter and a pedestrian. The painter had no insurance. The building owner is held liable for all losses.
- A cabinet installer puts a long screw into a wall. It punctures a water pipe causing water damage. The installer's insurance policy was not renewed. The homeowner's insurance company sues and recovers the damages from the cabinet retailer who recommended the installer.
- A small motor manufacturer, to get the business of a big new customer, agrees to sign a contract which the customer requires of all vendors. If they don't sign it, there are plenty of other motor manufacturers who will.
- After a fire loss due to a customer's improper use of a motor, the motor manufacturer is surprised to find that the contract requires them to indemnify and hold harmless their customer for any and all losses associated with the motor.
- A "plastic" Pipe Manufacturer (PM) vendors the custom compounding of material used with swimming pools. The formula has been designed and tested to resist the harsh effects of sun and pool chemicals. The PM does not have a contract prohibiting the blender from making changes to the formulation. Without the PM’s knowledge, the blender changes the formulation to use a cheaper ingredient. The change makes the pipe vulnerable to the elements, enabling it to fail prematurely. The blender’s insurance limits are inadequate to deal with the magnitude of multiple losses.

All businesses depend on others to produce a finished product or service. Without proper planning and review of exposures these relationships create, a business can encounter unexpected claim costs. The intent of a ***Risk Transfer Review Program*** is to help assure that your business is not financially vulnerable to damages and claims due to acts, errors or omissions caused or contributed to by others. A program should be designed to uncover, remove and/or minimize exposure. Absent effective risk transfer, decisions of liability are often made in court. It is much better to have such decisions made in writing, at the beginning of a business relationship.

Risk transfer techniques and tools

For the purposes of this article, 'risk transfer' refers to ways to protect from having to pay for mistakes associated with activities and products that third parties (business partners, subcontractors, suppliers, etc.) control. The idea is to keep liability with the party best equipped to control exposures. The goal is also to make sure that these third parties are financially able to pay.

Key risk transfer tools include:

Certificate of insurance (COI). This document, from a third party's insurance company, confirms what coverage is in force at the time it is issued and the expiration date. (Updated certificates must be requested annually, prior to expiration.)

Hold harmless (HH) agreement. This document establishes that one party holds another harmless under described circumstances. E.g., a painter, hired by a building owner, provides the building owner with a HH agreement. The painter spills paint on a nearby car. This document says the painter, not the building owner, is liable for the damages. HH agreements can be special contracts or standard contracts like on a work order, purchase order, etc. (Great care should be used with HH agreements! Legal counsel should check the language. Such agreements may not always hold up in court.)

Vendors coverage (VC). This is an endorsement to a manufacturer's policy that says the manufacturer's insurance company extends its' product liability coverage to those who sell the manufacturer's products (usually retailers), without "change" in the event they are named in a product liability claim. (Carefully review terms of this endorsement to be aware of limitations of coverage such as what "change" activities may trigger an exclusion of coverage.)

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If you do business with numerous third parties, you may decide to focus your risk transfer efforts on volume or "critical" suppliers. In this context, "critical" means products, components and/or materials whose failure is more likely to result in serious and/or frequent losses.

A company's need will vary based on what they do and the number and type of third parties with whom they do business. Desirable ***Risk Transfer Review Program activities*** may include, but are not limited to:

- Review and assess exposures knowingly retained by your business.
- Review exposures from businesses you work with and depend on.
- Conduct a hazard analysis to identify key or critical third parties. The analysis may be formal or informal, depending on your business.
- Implement a process to establish appropriate risk transfer with new third party relationships and to obtain annually new COIs or VC from established business partners, prior to the expiration of the old ones.
- Establish a process to review language in contracts you use and contracts others ask you to sign to maximize the protection they may give you and to help avoid giving up valuable legal rights.

Each business relationship needs to be reviewed for potential exposures. Each exposure needs to be understood, evaluated and properly handled to help protect you from being drawn into unexpected financial liability. There are two types of financial exposures to loss: a) those you know about and b) those you don't (until the unexpected event).

Reviews should include risk management professionals, your insurance broker and/or legal counsel familiar with contracts and product liability law. They can assist in determining what tools or combinations of tools are best to help protect you from the liability of others. These precautions are no different than other investments of time and money to protect your company's assets. Like any other investment, it should not be a one time event, but a program that is enforced and gets periodic review and revision.

Other tools that can reinforce effective risk transfer include, but are not limited to:

- Strong long term relationships with suppliers, vendors, subcontractors and other business partners can mean a vested interest in "doing the right thing." Keep in mind, that regardless of these long term and trusting relationships, "if it is not written, it does not exist".
- Where appropriate, requiring certificates of conformance or independent testing.
- Developing quality control and/or testing procedures for incoming products and materials or for services.
- For key volume and/or critical suppliers, inspecting or requiring appropriate "certification" of a third party's procedures.

Conclusion

All liability will eventually find a home. Good planning and sound legal counsel can help avoid surprises and make sure all roles and responsibilities are predetermined, agreed upon by all parties involved and clearly documented before an "event."

For more information, log in to the Risk Control Customer Portal at travelers.com/riskcontrol. (Need help? Read our Registration Quick Guide.) You also can contact your Risk Control consultant or email Ask-Risk-Control@travelers.com.

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