

Contractual Risk Transfer: The Basics

Upper tier contractors seek to avoid the financial costs that can arise out of bodily injury or property damage to a third party caused by a lower tier (subcontractor) for which they (the upper tier) could be held vicariously liable. Further, when allowed by statute, and sometimes even when not allowed, upper tier contractors attempt to avoid the financial consequences arising out of injury or damage for which they and the lower tier contractor are jointly liable. In extreme cases upper tier contractors may even contractually endeavor to relieve themselves of financial responsibility for liability arising from their sole negligence.

Vicarious Liability

Vicarious liability is created when one person or entity is or can be held legally liable for the results of another person's or entity's actions. Such indirect liability (also called imputed negligence) can arise out of a relationship (parent/child, employer/employee, etc.), position or contract. To be held vicariously liable, a person or entity must have the right, ability or duty to control the actions of the directly liable party. Without the opportunity or responsibility to control another's actions, there can be no vicarious liability.

Owners and general contractors (the upper tier) hold a position with a certain amount of control over and responsibility for the actions of lower tier contractors. This control leaves them vulnerable to being held vicariously liable for the actions of lower-level entities. Every state allows vicarious liability to be transferred back to the at-fault lower tier contractor (known as *limited transfer*).

Joint Liability

Joint liability, as the name suggests, is injury or damage caused by or attributable to both the upper tier and lower tier contractor. The term does not consider the "percentage" of fault assignable to each party, only that the actions of both parties resulted in the injury or damage. Approximately 19 states allow the upper tier contractor to contractually transfer joint negligence back to the jointly-liable lower tier contractor (known as *intermediate transfer*).

Sole Negligence

Sole negligence and liability exists when only the upper tier is found to be negligent and legally liable for the injury or damage. In sole negligence situations, there is no assignable negligence or legal liability to the lower tier contractor. According to the International Risk Management Institute (IRMI) only 10 states allow the contractual transfer of sole negligence from the upper tier to the lower tier (known as *broad transfer*). However, there are strict guidelines for such transfer in the states that allow this level.



Accomplishing Financial Risk Transfer

Upper tier contractors have access to and utilize several “tools” to accomplish the financial risk transfer they desire. Insurance professionals see these attempts and requests daily; so much so that it is likely the intricacies of each tool are not carefully considered. The four most commonly requested financial risk transfer “tools” are:

- Contractual risk transfer (indemnity agreements);
- Additional insured status for the upper tier;
- Waiver of subrogation endorsement requests; and
- “Primary and noncontributory” requirements related to additional insured status.

Contractual Risk Transfer

Contractual risk transfer is a non-insurance contract/agreement between two parties whereby one agrees to indemnify and hold another party harmless for specified actions, inactions, injuries or damages. This risk transfer accomplishes objectives found in both [risk financing](#) (finding a source to pay the cost of a claim) and [risk control](#) (developing a means to avoid or lessen the cost of a loss).

The ideal use and true purpose of contractual risk transfer is to place the financial burden of a loss on the party best able to control or prevent the incident leading to injury or damage. Presumably, the entity(ies) directly and actively participating in the activity have the best opportunity to prevent or avoid the loss; thus they are contractually required to protect an “innocent” supervising or non-participating party from financial harm following injury or damage.

Indemnification, Hold Harmless and Waiver: The Heart of Contractual Risk Transfer

Contractual risk transfer through the use of indemnification wording (referred to as “indemnity agreements”) require the lower tier to “**indemnify and hold harmless**” the upper tier for the upper tier’s legal liability arising out of some action or inaction of the lower tier contractor. Legal liability is liability imposed by the courts through common law or by statute on any person or entity responsible for the financial injury or damage suffered by another person, group or entity.

Indemnification is the contractual obligation placed on the lower tier contractor (aka, transferee, subcontractor or obligor) to return the upper tier contractor to essentially the same financial condition that existed prior to the loss or claim; or to stand in the transferor’s (upper tier’s) place as the source for financing the legal liability. (A person or entity can be held “legally liable” without committing a negligent act.)

Hold harmless wording requires the lower tier shield the upper tier contractor from the effects of the legal liability assignable to upper tier (aka, transferor or obligor). Essentially, the lower tier stands in place of the upper tier, taking onto themselves the legal liability that would have been placed on the upper tier. But the extent to which the lower tier subcontractor can stand in place of the upper tier is a function of individual state statute. States often limit the amount of “blame” a transferor is allowed to contractually transfer to the lower tier (limited, intermediate or broad – as mentioned previously).

Contractual *waiver of subrogation* is the third “leg” of the contractual risk transfer stool. Construction contracts nearly always require the lower tier to waive its right of recovery against the upper tier contractor. An insurance carrier’s subrogation rights flow from the right of the harmed party to be made whole by the party responsible for the injury or damage. If the right of the lower tier contractor to recover from the upper tier contractor has been contractually waived, then the insurance carrier has **no** right to recover from the upper tier contractor.

Additional Insured Status

Beyond the contractual risk transfer provisions found in construction contracts, the lower-tier subcontractor is nearly always required to endorse the upper tier contractor onto its CGL as an “additional insured.”

Because the upper tier is an additional insured protected as an additional insured by the named insured’s (lower tier contractor’s) insurance coverage for any claim caused *in whole or in part* by the named insured, the insurance carrier cannot seek recovery from the upper tier. As an insured, the upper tier’s policy will not be asked to contribute to the loss or even respond in subrogation.

Note: The 2007, “*in whole or in part*” wording protects the additional insured against its vicarious liability for the actions of the named insured, plus joint liability when both the named insured and additional insured are legally liable for the injury or damage. However, the 2013 version of the construction-related additional insured endorsements limits the breadth of protection extended to the additional insured to the level allowed by the subject state’s anti-indemnification statutes. If the state is a “limited transfer” state, the upper tier is protected only for its vicarious liability for the actions of the lower tier. In “intermediate transfer” states, the protection extends to include both vicarious and joint liability. A “hiccup” exists when the parties are in a “broad transfer” state. Neither the current nor the revised additional insured endorsements seem to extend protection all the way to the sole negligence of the upper tier.

Waiver of Subrogation Endorsement

Contracts appear to become “overly protective” when contractual risk transfer provisions, contractual waiver of subrogation and the requirement to extend additional insured status to the upper tier contractor are followed by the requirement to endorse a waiver of subrogation in favor of the upper tier contractor onto the various policies (CGL, auto, work comp and umbrella/excess). This is a “*belt and suspenders*” approach bordering on unilateral self-preservation by the upper tier contractor.

As noted previously, subrogation rights flow from the injured party’s right to recover from the at-fault party. If the contract requires the waiver of subrogation rights the insurance carrier cannot subrogate against the upper tier anyway.

By attaching the waiver of subrogation endorsement in favor of the upper tier, the insurance carrier, for the third time (because of additional insured status), is blocked from seeking recovery from the upper tier contractor for its actions in causing injury or damage.

Generally insurance carriers freely grant these endorsements for all underlying coverages (CGL, auto and work comp); however, some carriers balk at endorsing a Waiver of Subrogation onto the umbrella or excess policy. Such withholding makes no sense. Why would a carrier willingly give subrogation rights away in the underlying coverage but then want to retain subrogation rights in the umbrella? If the carrier is going to waive subrogation, all subrogation rights should be waived (granted, if the umbrella coverage is provided by a different carrier, this could become a legitimate issue).

The “Primary and Noncontributory” Requirement

“Primary and noncontributory” is an “inclusive” contractual requirement that can be met only if the protection extended to the upper tier contractor is provided on both a primary basis and a noncontributory basis. Analyzed in the context of a construction contract, the supposed goal of the “primary and noncontributory” requirement is

the protection of the upper tier contractor's financial resources from the effects of the lower tier's individual or joint negligence in causing injury or damage to a third party.

Theoretically, the "primary and noncontributory" requirement applies to only the protection extended to the upper tier as an additional insured.