Risk Management: Transferring Risk Through Insurance

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Editor's note: This is the second in a three-part series on risk management. The first part discussed the basics of risk management and how to structure a risk management program.

Mitigation of risk typically involves three approaches: avoidance, reduction and transfer. These techniques can be used alone or in combination to control risk.

While insurance is a key component of a successful risk-transfer program, people often simply assume that they are covered because they have insurance. Failure to review and understand insurance policies can be a very costly mistake. This can be particularly damaging in the commercial context, because businesses are generally charged with having read and understood their insurance policies. Thus, a crucial aspect of risk transfer is understanding the different types of insurance available and the structure of insurance that best fits your needs. For example, you should understand the different hazards that are covered by general liability and errors and omissions policies. Both provide coverage for negligence, but one is focused on bodily injury and property damage while the other excludes these claims. While this article focuses on general liability insurance, these concepts apply to other forms of insurance as well, including directors and officers, errors and omissions and workers' compensation coverages.

Know your policies. Double-check everything. Review your policy and talk with your broker and your attorney about the key provisions, particularly if you do not understand something. Have a summary of your coverage prepared by each indicating what is and is not covered. Know your claims history. Remember that insurance is the exchange of risk (potentially high costs) for the certainty of premiums. Understand your limits of insurance both per occurrence and in the aggregate. What is the deductible or self-insured retention? Is your insurance adequate to cover your potential liabilities? Simply carrying the minimum level of insurance required by your contractual obligations could leave you in a dire situation if you have multiple claims during a particular policy period.

For businesses involved in commercial contracts that include indemnification or insurance provisions, there are several key concepts to be aware of when building or evaluating your insurance program. Who is an insured and who is an additional insured (additional named insured) under your policies? Do you need to do anything to add an additional insured to the policy and, if so, what? Does the policy contain an insured contract provision that provides coverage to you for liability you assume in contracts? General liability policies typically exclude coverage for liabilities imposed by contract (that is, they do not provide coverage for breach of contract even if negligence is the cause of the breach). However, they often have an exception to the exclusion for what are defined as insured contracts. The definition of an insured contract can have multiple

components, including when you agree to indemnify someone else for their own tort liability.

Does your policy contain a separation of insureds provision? Assume the following: A cleaning company enters into a contract with a bakery to provide cleaning services at its facilities, and the cleaner agrees to indemnify the bakery and add it as an additional insured under the cleaner's general liability insurance for any claims arising out of its cleaning work at the bakery's facilities. A bakery employee slips on the freshly waxed floor and breaks a leg. The employee sues the cleaner for the injuries. Absent a separation of insured provision in the insurance policy, this claim could be excluded if the insured and additional insured are treated as one under the policy.

Does your policy contain a co-insurance provision? These provisions are pretty standard now, but they address the order in which multiple insurance policies will apply. Take the example above. Assume that the cleaner subcontracted the floor waxing to a waxing company, and that the waxing company agreed to include the cleaner and bakery as additional insureds under its general liability policy. Now assume the bakery's injured employee sues both the cleaner and waxing company. The co-insurance provisions would control whether this claim would be defended under the waxing company's policy, the cleaner's policy or jointly. These provisions are also important for related claims that span multiple policy periods, particularly when multiple insurance companies are involved. Asbestos claims and pollution claims are two of the more common examples of situations that implicate co-insurance provisions.

These are but a few examples of some common issues that arise in situations involving assumed liability. They illustrate the importance of knowing both your risks and your coverages. Once you have a clear picture of your risks and the insurance coverages available for those risks, you can make an informed decision on how to structure your insurance program to fit your budget and appetite for risk.

From the standpoint of the insured at its most basic, there is primary and excess coverage. Primary insurance is the first layer of insurance and is responsible for handling claims. Excess coverage is any policy above the primary policy and applies in the event of a large loss or when the primary policy is exhausted. There can be multiple layers of excess coverage. Umbrella policies typically provide coverage that is broader than the primary insurance, and thus act as primary insurance for certain types of risk and excess for those risks covered by the primary policy. A true excess policy typically provides the exact same coverage as the primary policy. The excess insurer generally has the right to associate in the defense of any claim that will impact its coverage, either a large loss or when the underlying aggregate limit is nearing exhaustion. In a properly constructed insurance program the excess coverage will drop down and take the place of the primary coverage when the primary coverage is exhausted.

This can be further stratified by including a layer of retained risk: deductibles or self-insured retentions. Deductibles are the amount the insured must pay out of pocket in connection with a claim and are often paid to the insurance company. By contrast, a self-insured retention typically connotes a system where the insured pays the amount of

the retention directly before insurance applies. Either can apply per occurrence or in the aggregate.

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