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Risk Management Through Contracts and Insurance: A Primer

Introduction

Contracts are part of everyday business life and regrettably many business people do not take them seriously—or seriously enough. Many business people do not read or really understand the "fine print" in the agreements they sign. They have no established policies for who can sign a contract or what needs to be done before accepting an agreement.

As this discussion points out, there are serious implications—both legal and insurance-related—for this lax attitude. Fortunately a little bit of knowledge, planning, and forethought can go a long way. Going into negotiations with an understanding of the various points addressed in this paper can help to ensure contracts become an asset to all the signing parties and not a liability that can drag the company into misunderstandings and costly, distracting disagreements and lawsuits.

Because every business situation is different, and the risk, legal, and insurance environments are constantly evolving, this document should not be relied upon as legal, risk, or insurance advice.

A bit about the authors:

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Bob is licensed in California, Oregon, and Washington and has offices in both San Francisco and Truckee, California. He also has a Masters degree in Taxation from New York University. Bob founded Buchanan Law Group (BLG) in 2002 to better deliver ongoing, efficient, and "just-in-time" legal services to his clients. BLG focuses on:

- Business purchase and sale transactions
- Restructurings
- Startups and emerging growth companies
- Intellectual property
- Equity and incentive compensation
- General business

In addition to these specialty areas, Bob works closely with a broad network of legal colleagues who offer services for almost any need. Prospective clients can reach Buchanan Law Group through www.buchananlawgroup.com or by calling (415) 395-4700.

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Risk Management Through Contracts and Insurance: A Primer

Charles T. Wilson is a Certified Management Consultant (CMC®) and a specialist in risk management and insurance. As a consultant, speaker, and trusted advisor, Charles educates and helps business owners to:

- Identify and understand their key risks.
- Ensure that their protection and contingency plans are as strong as their products and customer service.
- Obtain the best coverage at the best price, the right broker and service, and the least amount of risk.

He founded RiskSmart Solutions® in 2000. The firm is independent and does **not** sell insurance. Clients benefit from proven strategies that Charles developed over his 28-year career in international insurance underwriting, sales, and risk analysis. He has extensive experience starting, growing, and fixing small business units in Europe, Canada, and the US. Charles offers an integrated and creative, solution-oriented approach to business risk assessment, problem solving, and crisis management. He works with your organization and key advisors to quickly and effectively implement his proposed solutions.

Contact Charles with any questions or comments and get a no-obligation initial consultation for your business risks, contingency plans, and insurance.

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The Basics of Contracts and the Contracting Process

Basics of Contract Law

A contract is an agreement between two or more parties that sets forth the rights and obligations of each with respect to a certain relationship or undertaking. It is arguably one of the most influential pillars of the business world; no goods are delivered, skyscrapers built, services rendered, or companies purchased without having some kind of agreement between the parties involved—whether they know it or not! The pervasiveness of contracts as a component of everyday business means we all need a general understanding of what constitutes a contract.

If a contract's terms are clear and generally fair to both parties, you will probably not require a judge or an arbitrator to determine if the contract actually means what you thought it did when you agreed to it, even in case of a serious dispute. Of course, your agreement must not be for an illegal purpose or against public policy. For example, if you enter into a contract to steal hubcaps or commit arson, it cannot be enforced in court—even if you have completed the promised performance. The elements of a contract (discussed below) may all be there but this kind of agreement could not be enforced in a court action because the subject matter is illegal.

Generally, three things must be present in order to have a valid contract:

- Offer
- Acceptance
- Consideration (usually money)

Offer

When you offer to do something for or sell something to another person or business entity at a price, you've just made an "offer." An offer is a proposal to enter into some kind of bargain. An offer generally remains open until it: (1) is accepted, (2) is rejected, (3) is revoked before acceptance, (4) is countered, or (5) expires according to its terms. If I say "I offer to sell you this loaf of bread for $2.00," the response of "I accept your offer, but at $1.50" is not an acceptance, as it does not mirror the offer. Instead, because it is a counteroffer, there is no binding contract yet.

An offer must be clear enough for both parties to clearly understand what the nature of the agreement will be. An effective offer sets forth its key elements—such as price, quantity, and description—in a manner that is sufficiently specific for a court to be able to enforce the terms. "I offer to sell you my cat," is an example of an incomplete offer. Even if I accept and sue to enforce our alleged agreement, what is the price? By what date am I obligated to deliver? Keep in mind, too, that if you are making the offer, you can retract it at any time before acceptance.

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Acceptance

Because an offer may be retracted at any time before acceptance, it's important to understand when acceptance occurs. The person to whom an offer is communicated is the only one vested with the power of acceptance. For example, "I will give you $10 if you tie 3 fishing flies for me" is an offer. How is this offer accepted? Offers are accepted either by a return promise or by performance. In this case, you could simply tie the three flies and present them. If the offer is still open, I would be contractually obligated to give you $10.

Consideration

No contract is enforceable unless it is supported by consideration. Both parties must give up something of value. This can be something tangible (like money or property), something intangible (like some legal right – "In exchange for this severance package, I agree not sue you – employer – for any claims I might have against you"), or some kind of performance ("In exchange for $20, I agree to mow your lawn"). In our fly tying example, one person performs services (ties the flies) and receives $10, and the other person pays $10 and receives the flies. If I say "I promise to wash your car," you couldn't sue me for not washing it, as you haven't given up anything: your half of the deal isn't supported by consideration.

The Process

The contracting process is a perfect example of the interplay between supply and demand, and of how the value of a given product or service is determined. A contract starts with a party in need. Perhaps it's a farmer who needs a new steering wheel for his tractor or a consultant to assist him in planning a proper crop rotation cycle. For the steering wheel, the farmer knows that enough companies make this kind of standard part that the price is fairly well established. When the part is purchased from a parts store, his "contract" will consist of the mutual promises made:

- The salesperson's verbal assertions, such as "Yes I'm sure this is the right size and strength."
- The farmer's promise to pay for the part (if the purchase is not for cash).
- In the paperwork he will receive from the parts store (and perhaps asked to sign) there will likely be additional promises, such as warranties, or clauses renouncing consequential damages (disclaimers).
- Some promises may be implied in any business transaction, such as a warranty that the part will be fit for the purpose the farmer intends to use the part, and a warranty that the product is of reasonable quality (a warranty of "merchantability").

For contracts involving services, there tends to be more negotiation and often a negotiated written agreement, as the value of services can be more difficult to determine. The price charged for services will depend on the level of expertise needed, the value expected by the client, the difficulty of the task (which increases a consultant's risk, and therefore will often result in a higher fee), and the length of time the services are needed. If the relationship is to

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last for awhile, the farmer would be wise to set some standards for performance, so that if the consultant isn't doing his job, the farmer can end the contract without further liability.

Other Things to Think About

In many cases, bargaining power is unequally distributed. For example, if you are a small company that offers computer consulting services, and a Morgan Stanley branch office wants to hire you for a project, the branch office will have its own contract prepared by its corporate attorneys who ensure that it is full of provisions that protect Morgan Stanley. It is always more beneficial to be the first party to come to the table with a contract draft, as it will inevitably be drafted in a manner most favorable to the drafter. A small company often has very little bargaining power if the services contracted for are easily performed by another party. If you don't agree to all the contract terms, Morgan Stanley knows there are plenty of other consultants who can perform the same services. Such a contract is called a contract of adhesion[*]—you are being forced to adhere to that party's contract terms, with little opportunity (if any) to independently negotiate any particular provisions.

Something else to keep in mind is enforceability:

- Does the way in which the agreement is reached make the contract unenforceable? Sometimes a person signs on behalf of a company but they really aren't authorized. This doesn't generally bind the company.
- Has there been a misrepresentation which induced one party to sign the contract? If big enough, the induced party can successfully defend against a breach of contract claim.
- Were there mistakes in writing up what the parties agreed to? If these are material, the contract can be voided.
- Is the subject matter of the contract illegal, or are certain provisions unconscionable (such that a court will refuse to enforce the provision because it is simply against public policy)?

If there are differences of opinion as to what a contract means, courts will prefer to look only within the "four corners" of the agreement to determine the parties' intent. If there is an ambiguity, it is often construed against the drafting party, as this is the party with the most control over avoiding ambiguity. In limited circumstances a court will allow evidence to be

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[*] An adhesion contract is a contract between two parties where there is no room for negotiation; i.e., a "take-it-or-leave-it" agreement. This is typical when a large company with all the bargaining power presents its form contract to the "little guy" (an individual consultant, for instance), and the little guy has no opportunity to recommend changes in the terms. As you can imagine, they are often favorable to the big company, and can be rather unfavorable to the little guy.

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brought into court outside the contract to clarify what the terms in the contract really mean. If you enter into a contract to construct a detached garage for a client, and the contract states it is to be of the same dimension, square footage and general design as “the neighbor’s garage”, what is the agreement? Is it the neighbor to the left or the right or the one across the street? You may be able to show the court evidence from outside the contract that clarifies which house the contract refers to.

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Some Important Contract Provisions

Now that you understand the basics about how a contract is formed and the general contract formation process, it's time to focus a bit on the provisions within the contract itself. Aside from the terms of the agreement—that is, what each party must do or pay, what they are to receive, and by when—most contracts also contain a lot of additional "window dressing" that can dramatically affect your rights. This window dressing can include provisions that describe the importance of dates and times in the contract; make clear that no other outside discussions or agreements can contradict the agreement; stipulate in which county (or even state) a lawsuit must be brought; and declare whether or not the parties have agreed to go through alternative dispute resolution (such as mediation or arbitration) before resorting to the courts to settle a dispute in litigation.

Time is of the Essence

Let's say you sell software through a website and wish to update your website with the addition of a whole new product line. As part of this process, you are planning a launch party and marketing campaign surrounding the new tools you offer. In preparation, you contract with a website developer to revamp your business website. The contract calls for the work to be completed on a certain date. But what happens if the developer is late? Generally, a delay in performing under a contract isn't considered a "material" breach that excuses you from paying for the services unless there is a provision which says that "time is of the essence." When a contract says performance must occur by a specific date, it had better be done!

Courts apply a balancing test in these cases: They compare what the party who is late loses if the provision is enforced with the harm done to the party who has to put up with the delay. A "time is of the essence" clause in the website developer contract means the dates are critically important or "material" and could allow you to withhold payment, even for work performed, in the event the developer is late by even one day. The calculation of damages caused by the delay can be difficult to prove. If damages are too speculative or difficult to prove, a party may not be entitled to them at all. Therefore, parties often agree in advance in the contract itself on what a fair dollar amount will be in the event of a breach. For instance, you might say that for each day the website isn't ready to launch the developer owes you $1,000. This stipulated damages amount is called "liquidated damages" because it is a known quantity, having been set in advance. Now if the developer is late, you don't have to sue for breach of the contract and try and prove what your actual losses were; rather, the defaulting party will simply owe $1,000 for each day he or she is late.

Integration

Usually, in the process of negotiating a written contract there are many conversations about the terms, and e-mails and faxes going back and forth between the parties before the final terms are agreed upon. When the final written agreement is executed, does it contain all the terms the parties agreed to? There is usually a clause within contracts called an "integration" or "merger" clause—very often under the heading of "Entire Agreement" or "Integration." This has the

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legal effect of providing that no matter what you may have discussed, and no matter what terms were scrawled on napkins prior to the written agreement, this one agreement embodies the final expression of the parties' intent. All prior discussions and communications are "integrated" into this final written agreement. It's important to make sure you have compared the final agreement carefully with your understanding of your prior discussions to make sure it includes all the terms you want.

It is also important to ensure that the provisions of a multi-agreement transaction do not conflict with each other. Such agreements, therefore, usually contain provisions providing rules for what should happen if a conflict occurs. For instance, if we are talking about a business sale, and, as the seller, you are obligated not to work in the same business for two years after the sale, and you are also employed by the buyer as a consultant, it obviously isn't the intent of the buyer that you not be able to complete your work as a consultant during a defined transition period. This potential conflict should be addressed in both agreements.

Venue & Choice of Law

Other provisions within a contract to watch carefully—especially if you are not the contract drafter—are the venue or jurisdiction and the choice of law provisions. If a conflict does arise, where does the contract mandate that you bring an action? And which state's laws apply? Parties are generally able, within certain limits, to choose the place where they must meet to duke out their disputes, and to select which state's laws a court must look to in interpreting the terms of your contract. Let's say you negotiate an employment agreement with a new CFO to head up your operations outside California. This new CFO is going to become privy to all kinds of confidential information about your business which would be valuable to your competitors, so you have a clause in the contract prohibiting the CFO from working for a competitor for a certain number of years after a termination of employment. If California law applies to the contract, you may be out of luck, as these kinds of provisions may not be enforceable in California. However, if the state in which the CFO is to be employed permits non-competition clauses, then by having that state's laws apply to the employment agreement then you can prevent the CFO from working for a competitor.

Alternate Dispute Resolution (ADR)

Instead of going to court to solve disputes, it is very common for contracts to contain "alternative dispute resolution" (ADR) procedures. A contract will often provide that the parties agree that instead of bringing a lawsuit against the other party, they both agree to instead use the alternative to litigation described in the agreement. The two general categories of ADR are mediation and arbitration. Mediation involves hiring an outside party to sit down with the contracting parties and attempt to help them find common ground and reach an agreement. Contracts can also call for arbitration of disputes. This is akin to court, but much faster and streamlined, and often much less expensive. Here, each party submits its side of the story to an arbitrator, and the arbitrator makes a decision by which the parties have agreed to be bound.

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Summary

The above discussion touches upon just a few concepts and contract provisions which can really come back to bite you if you aren't careful in what you agree to in writing. There can be a tendency to avoid using a lawyer due to perceived costs, or to use a contract template bought online, or wording from a very different and possibly inappropriate situation. Your transaction is unique to you and your business, and using the right tools and advice will prevent costly disputes.

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Risk Transfers in Contracts

When negotiating business contracts, the parties may wish to preserve the risks or duties imposed on them under common law (the law developed by court decisions), such as the duty one party might owe another party not to be "negligent." Or, they may wish to alter the provisions they negotiate for their agreement. Whether a court will honor the parties' contractual allocation of duties can depend on their relative bargaining strength. If one party is a Fortune 500™ company and the other is a small business owner, courts will subject the allocation of risk and duties to more scrutiny.

In general, the first questions to consider with regard to the appropriate risk allocation provisions for a contract are the following:

- Where does the duty or obligation come from? Is it statutory, contractual, or based upon tort law (the law of personal injuries or negligence)?
- What duties and obligations are the parties willing and best able to assume?
- What things are the parties willing to promise each other about the facts (like future sales)?

Once these issues are considered, the appropriate means of allocating a particular risk can be selected among various risk allocation devices: indemnification provisions, exculpatory provisions (also referred to as releases), or waivers.

Indemnification

Indemnity is the promise of one party (the "indemnitor") to reimburse the loss of another party (the "indemnitee") resulting from a suit brought by someone outside the contract (an injured third party). For example, a major computer company may hire independent contractors to assist in developing software. A contract between these parties may provide that if the contractor (indemnitee) is sued by an end user (injured party), the computer company (indemnitor) will financially reimburse the contractor for attorney fees, a judgment, etc. The indemnitee remains liable to the injured third party, but with an indemnification agreement in place may seek reimbursement from the indemnitor for damages arising from the liability. The promise of reimbursement is only as solid as the indemnitor's financial strength and the assets or insurance (if any) that have been committed to secure the indemnification promise. One often sees the combined phrase "indemnify and hold harmless" in contracts. A "hold harmless" provision by itself means one party agrees to not hold the other party responsible for damages, but doesn't necessarily imply that the party will reimburse the other party for losses due to damages claimed by third parties.

Exculpation Clauses

An exculpation clause limits a party's liability for warranties and other claims under a contract. If I sell you a computer and it doesn't work, then I have breached my implied warranty that it was of reasonable quality and I would have to refund your money or give you a computer that worked. However, if we had a written purchase contract with an "exculpation clause"

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addressing warranties, then I may be off the hook. Such a clause "exculpates" me through your agreement to not hold me at fault.

A release is a form of exculpatory provision, and usually arises in the context of personal injury or death. With a typical release, one party agrees to release another from all liability or damages resulting from personal injury, death, or property damage relating to the conduct of the released party during the performance of the agreement. Releases are not favored in the law. The terms of a release are strictly construed against the released party, especially where the released party drafted the provision. Enforceability of such a provision can depend on the relative bargaining power of the parties and whether the provision was specifically discussed and negotiated. To be enforceable, a release needs to be in simple, clear, and unambiguous language which a layperson can understand, and the typeface must be big enough to read comfortably (it used to be that parties would try to hide these provisions in small print, which courts have found to be impermissible). Releases are very common in recreational activities. For instance, you might sign up for an extended backcountry backpacking trip through REI™, where REI™ personnel are leading the trip. You will almost certainly be asked to sign a release, which is your expression that you understand it's dangerous to go into the backcountry, and you won't hold REI™ personnel responsible if you fall off a cliff, eat poisonous berries, or get attacked by a badger. If you are injured—no matter what duty you might otherwise have been able to argue REI™ owed you that it breached—you agree to release them from any liability for your injuries.

Yet another form of exculpatory clause is an "assumption of risk." An express (i.e., written) assumption of risk is often used in activities where there is some degree of danger, such as sitting directly behind the goalie at a hockey game, or parking your car in a public garage where someone may break into it. Language on tickets or signs generally contain an "assumption of risk" provision, which generally makes this statement from the user: "I know that there is a risk of getting whacked by a puck, or that someone might steal my dry cleaning from my car, but I recognize this risk, and agree that I will take that risk myself (i.e., "assume") and not hold you liable."

Waiver

A waiver is where a party gives up a right, such as the right to rely on a certain defense under a contract or to enforce a provision. Waivers can be agreed to contractually, or implied from the conduct of a party. An implied waiver might be argued where a party accepts 3 late payments under a contract without complaint, and then attempts to raise an issue on the fourth late payment.

Many of the above provisions seek to shift all the risk to another party. Aside from a wholesale shifting of risk, there are also contract provisions which, rather than shifting all the risk, seek to limit the amount of damages or risk for which the parties are responsible.

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Limitation of Liability

In addition to contract provisions which let one party skirt the duties otherwise owed to another party, the focus of a provision can limit the amount of the damages or the available remedies in the event of a breach (a "breach" is a failure to perform some promised act or obligation). Liability can be limited by (1) limiting the kinds of damages available, (2) putting a dollar cap on what the breacher owes, or (3) limiting what kinds of relief a party can get (for instance, contracting away the right to obtain an injunction, which is a kind of equitable "relief").

Representations and Warranties

Representations and warranties are powerful tools in business contracts. The terms "representations and warranties" almost always go hand in hand. A party is making certain statements (the "representations") and warranting (or, guarantying) that the statements are true. Most powerful is the ability to go back against the other party when there is a misrepresentation or the breach of a warranty. For instance, if you bought a honey farm, and your purchase price was based on your understanding that each hive produced 60 pounds of honey every 3 weeks during the 12 weeks when blossoms were available, what would you do if the actual figure was closer to 30 pounds every 5 weeks? If the purchase price was based on the "promised" yield, you wouldn't be happy. What would you do? If you have a statement in the agreement from the seller that clearly represents the 60 pound/3 week yield and a promise that you will be able to attain a similar yield, then an actual lower yield would be a breach of this warranty, thus giving you recourse against the seller for damages, or a reduced price.

Personal Guarantees

Often, people incorporate their business operation or form a limited liability company because these forms of doing business (among others) limit the owners' (the shareholders or members) exposure to claims by business creditors. However, regardless of company structure, a personal guaranty is often required from a small or new business without a financial history, or from a business with assets (net of liabilities and other possible claims to them) that would be insufficient to make good on the obligations set forth in the contract. The most common example is a loan agreement between a bank and newly formed company. A personal guaranty in such a loan agreement would enable the bank to go after the owners' individual assets to the extent the corporation or limited liability cannot pay back the loan.

Risk of Loss in the Sale of Goods

The notion of when the "risk of loss" passes is a very important concept if the contract involves the sale of goods or other tangible assets. "Risk of loss" asks the question of who bears the financial loss in the event the goods are lost or destroyed between the time they are purchased, and the time the buyer has taken possession.

The seller is often responsible for the safe and undamaged arrival of the goods until they are unloaded at the buyer's destination. However, this may be modified by the contract which

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could provide for shipping "FOB" (Free On Board), which means the buyer is responsible for the goods from the point of departure, typically the seller's warehouse or shipping port.

Risks in the Purchase of Assets of a Business

In the process of purchasing a company's assets, certain losses arising prior to the purchase may follow the assets. For instance, an unwary buyer may be liable for obligations of the seller (like unpaid payroll and unemployment taxes, or unpaid sales tax). Such liabilities are referred to as "successor liabilities" because they are liabilities of a previous owner, but payable by the buyer who succeeded the seller as the new owner of the business. Buyers can avoid such successor liabilities, or be reimbursed for them, requiring that the seller indemnify the buyer for any such liabilities. It's a good idea in such a case to require the seller to take a large enough portion of the purchase price in the form of a promissory note so that any ghosts in the closet can be offset against the amount due under the note.

Other Considerations

Regardless of what a contract says, a court may impose indemnity on a party if there are considerations of equity – a court asking "what's fair?", regardless of whether a statute or regulation provides relief. The doctrine of "equitable indemnification" involves the notion that, as a matter of fairness, wrong-doers should share loss in relative proportion to their responsibility for the wrong (in tort), or in relation to their relative breach (in contract).

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Insurance: a Primer

While legal contracts can often prevent problems—especially if they are clear and fair—insurance is also a necessary part of any business's protection plan. In this section we will examine how to integrate comprehensive insurance coverage into a coordinated risk-management program.

Insurance has long been an important foundation for business transactions and financial protection—both personal and commercial. Insurance policies and protections began in early history and were made famous by Lloyd's® of London and the ocean shipping trade.

The theory of insurance might be best understood by referring to the community mutual aid societies in pioneer days. If your barn burned down, your neighbors donated time and materials to help you re-build it. And you were "obligated" to do the same for them.

Today, insurance companies collect the small premiums of the many and pay the large losses of the few—that's the Law of Large Numbers. In practical terms this means no one insures for small losses; you can cover these yourself without paying for the overhead and profit of an insurance company. If your shed burned in pioneer days, you fixed it yourself. In today's world we usually insure to protect ourselves from the possibility of a large loss that would cause significant financial harm—for example, from a major fire or from a lawsuit and the costs of defending against it. The higher the possibility that a loss will *actually* occur and the more it might cost, the more likely we are to want insurance protection.

Sometimes it may feel crazy to willingly pay for something you hope never to have to use! Think about it this way: the insurance company is letting you trade a large, potentially devastating and variable risk for a known, smaller fixed cost.

Types of Insurance

Insurance exists for myriad risks and loss possibilities. Some examples include:

- General liability for bodily injury or property damage you cause to third parties. This area includes Primary liability policies, usually with $1,000,000 limits; Foreign general liability policies (both local and master controlled); and Umbrella or Excess liability policies with additional limits. Note that these policies often provide coverage above and beyond General Liability, Auto Liability, Employers Liability, and perhaps other liability exposures.
- Errors & Omissions or professional liability for erroneous advice that causes financial loss (not bodily injury or property damage) to third parties.
- Fire, windstorm, earthquake, and flood damage to buildings, dwellings and contents.
- Loss or theft of valuable property—both tangible and intangible. This includes loss, destruction, or misappropriation of important documents, fine arts or a valuable collection, and computer data, or intellectual property.
- Physical damage to automobiles, watercraft, and aircraft.

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- Accident and sickness, life (actually, death), medical costs (health insurance, long term care, disability).
- Pollution—both property damage and liability to others.
- Identity theft—both the expenses arising from loss of yours and your liability to others if you are responsible for their identity being stolen.
- Theft of company assets, money, etc., including crime, check fraud, embezzlement, all whether caused by employees, third parties (e.g., vendors) or computer hackers (unknown parties).
- Intellectual property (e.g., patents, copyrights, and trademarks)—both your loss and your liability to others.
- Construction defect liability.
- Loss of income or profit and required extra expense due to business interruption from a covered loss like fire, for example.
- Insurance policies covering livestock, timber, or crops.

The different types of insurance are usually organized by the type of customer who buys them (for example, homeowners, small business owners, mega-corporations, not-for-profits, and associations) or by the types of risks they cover, for example: property, liability, automobile, etc. Insurance underwriters, and sometimes brokers, are often specialists in one of these categories. Let's look at some of the more important categories.

PROPERTY

Property insurance policies are called first-party because they cover property you own, lease, or have a financial interest in. They cover buildings (real property), contents (personal property), tenant improvements, machinery (from motors to HVAC systems), equipment (like computers or copiers), tools, valuable papers, fine art, business income (when it is impaired due to another covered loss like fire), crime, or employee theft. More specialized property insurance includes computer data, intellectual property, builder's risk (covering buildings and materials in the course of construction), aviation (covering the plane itself), marine hull and cargo, pollution damage discovered on your property, earthquake, and weather (for example, hail damage to crops).

LIABILITY

Policies in this category are divided into personal liability (included in homeowners or renters policies) and commercial liability. Liability insurance covers accidents or injuries that occur on your premises (home or business) or as a direct result of your activities elsewhere. This could include being responsible for tripping someone in your home or a restaurant, injuring someone with the products you sell, or causing harm through faulty work (like causing burns by using the wrong product in a hair salon). It also includes personal or advertising liability (usually libel or slander) and medical payments for others to allow for quick response to a minor injury.

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More exotic kinds of liability policies include media or cyber liability, errors & omissions or professional liability, directors & officers liability, employment practices liability (for discrimination, harassment, etc.), and liability for construction projects, for pollution, for aviation, and for marine operations. Workers' compensation and employers' liability are usually included in the Liability insurance area as well.

AUTOMOBILE

Here we find both personal and commercial policies that cover:

- Liability for bodily injury and property damage (Personal Injury Protection, or PIP, in some states).
- Uninsured and under-insured motorists (where you are the victim of hit-and-run claims and accidents/injuries caused by others with no or low-limit insurance).
- Medical payments (that cover injuries to you).
- Physical damage to the vehicles as the result of collision, and losses due to fire and theft.

There are often other available options such as towing, replacement car rental, and trip interruption expenses.

SPECIAL CATEGORIES

Some less common policy types include performance or payment Surety Bonds (sometimes required by municipalities or utilities), kidnap and ransom (K&R), and credit insurance.

Parts of an Insurance Policy

Insurance policies have generic sections, but that doesn't mean these sections are always identical. Some of the more relevant ones are the following:

Declarations: a summary of who and what are covered; the limits; schedules of property, equipment, autos, etc.; deductibles; premiums; and often a list of all policy forms and endorsements.

Insurance Agreements: a simple business owner's policy will include sections for each type of insurance, such as property, liability, and medical payments. These sections will include basic coverage descriptions, exclusions, coverage extensions, coverage limitations, and often definitions.

Endorsements: a change to something in the basic policy; can serve a wide variety of purposes. For example, they can add coverage; clarify definitions, wording, or intent; or add exclusions or limitations. Some common endorsements will add Additional Insureds, new locations, equipment, or autos. Others may modify limits or deductibles.

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Territory: an important clause that often limits coverage to work done or claims arising in the US and Canada. If you have suppliers or customers abroad or travel on business be sure to get an expanded territory definition—worldwide for both accidents and claims.

Conditions: usually govern how the policy and coverages will be interpreted by the insurance company. These may include how a loss will be settled, the insured's responsibilities, legal options for disputes, etc.

Exclusions: can arise and be hiding anywhere! Excluded coverage can be found in Insuring Agreements, endorsements, and even in the Definitions for certain types of property, claims, insured parties, and situations. Care must be taken to ensure understanding—especially when there are exceptions to exclusions (that grant coverage) or limitations on extensions which can do the opposite!

Costs

Insurance costs or premiums can be one of the most complex areas to predict and compare. Because insurance companies don't know the real cost of what they are selling (the losses they will end up paying) until after a policy is sold—and perhaps much later—it can be difficult for them to determine prices exactly. Will that auto policy they sold you for $1,000 cost the insurance company just the $500 to print, mail and pay the broker's commission so they make a nice profit, or the $1,000,000 policy limit for a bodily injury claim against the insured?

Risks of loss that are normal and well known (like automobile risks, for example) will have extensive actuarial studies to determine probabilities, frequencies, severities, inflation rates, lengths of time for settlement, etc. to help set premium rates with a fair degree of precision. In other areas it's much harder: Will there be 10 or 15 major hurricanes this year? How many will hit land or populated areas? The answers to these questions, never known in advance, can significantly affect the degree of an insurance company's risk, and thus the premium it will want to charge. Additionally, newer risks that don't have many losses yet or the legal precedents of court cases (like some age discrimination claims against employers) are also much harder to accurately price.

Note that the longer it is expected to take to settle a loss, the longer an insurance company will be able to hold on to pre-paid premium dollars and earn investment income. This is often calculated into pricing formulas. Property losses, for example, are usually straight-forward and settle relatively quickly. Liability losses can take years or decades to settle and be paid (consider asbestos claims, pollution claims, and medical malpractice where a victim needs to wait to see the extent of injury and future disability). Therefore liability premium rates will often benefit from expected investment earnings.

Of course, the deductibles an insured party chooses—and often the prevention and loss-control measures put into place—will have an impact on the premiums as well. The risk of extensive fire damage is reduced when a building has sprinklers, so the insurance company will charge less for this exposure. From an insured's point of view, these loss-control measures are costs too, so a cost-benefit analysis will be needed. These comprehensive studies include both hard expenses—cost to install the sprinklers—and soft costs, such as a business owner's time,

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distraction, and hassle (lost opportunity costs). Most studies show significant paybacks from investments in safety and loss prevention—often between 5 and 10 to 1.

Having some form of self insurance—even, for example, very high deductibles—merits serious consideration because an insurance company often targets in the area of 50% loss ratios. That means if you have $100,000 in regular, predictable equipment losses in a year, an insurer may want to charge you $200,000 in premium (or premium and deductibles).

These cost considerations also underscore the need to choose an insurance company that has a great deal of experience in your industry and understands the types of losses to be expected. These companies will be better able to charge appropriate, stable premiums, so your rates will not have to go up and down with expected losses.

Insurance and Contracts

Insurance often gets interwoven into contracts of all kinds; the complexities here can be mind-boggling. Insurance is used by contracting parties to back-stop the various promises that are made. In many business transactions, the wisest move is to encourage the party who has the most experience or control over the risks to take the responsibility for handling those potential problems. For example general contractors will engage a specialist to do particular jobs like blasting, underground piping, and major structural erection. These specialists are usually the ones who are responsible for anything that goes wrong in their work because they know best how to prevent and avoid losses. A contract for these projects should include a hold harmless and indemnity clause from the specialist (Sub) to the general contractor (GC) that holds the Sub responsible for not only the success of the special job, but also the losses that might arise from it. Additionally the contract will usually require the purchase of certain insurances to guarantee the Sub's ability to pay.

Often a contract will require that certain changes be made to existing or standard insurance policies. For example a lease agreement will often have "primary" wording (so the Landlord's policy is not involved), provide coverage for the lease agreement as an insured contract, and require that the Tenant add the Landlord as an additional insured. It will also often waive subrogation. This final requirement would prevent the insurance company from exercising its legal right to pursue third parties responsible for causing damage, for example if the Landlord is partially responsible for a fire causing damages to the Tenant's property.

Here are some examples in the context of a general contractor (GC) – sub-contractor (Sub) relationship:

- A usual requirement is that the Sub must add the GC as an additional insured on the Sub's General Liability policy (and often on the Automobile Liability policy as well). This means that the GC is insured by the Sub's policy and will not have to report to his own insurance company a claim involving the Sub's negligence where the GC is also sued. The Sub's policy will not only cover the legal defense costs for the GC, but pay—up to the policy limits—any settlement that otherwise might involve the GC's policy. This can simplify the loss settlement process and perhaps keep costs in check

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(because only one insurance company, adjuster, and lawyer will be working on a claim, not two).

- If there is a high or moderate possibility of loss and the GC really wants to ensure proper protection, he or she must obtain and carefully review a complete copy of the Sub's policy. Remember that coverages, restrictions, exclusions, and conditions can vary—sometimes significantly—in different policies. These are not revealed in detail on a Certificate of Insurance.
- Also, some GCs may require that the Sub have General Liability coverage that applies specifically to the project in question. If this is not the case, the Sub's insurance limits, which have an annual aggregate maximum, might be used up by other claims. Claims from another jobsite could mean no protection—defense or settlement money—would be available for the GC in this contract.
- Contracts can specify that the Sub's policy be 'primary' so the GC's policy does not get involved in sharing the loss. The 'secondary' policy, then, would only be called upon to cover losses in excess of the primary policy. All policies have 'Other Insurance' clauses that say if any other insurance exists to cover the same loss both will share in a pro-rata way. If this clause is not modified by 'primary' wording it can diminish or take away the risk-transfer intent of the written contract.
- Many contracts will require special coverages, such as "broad form" contractual liability. Many insurance policies have restrictions on covering contracts and include only 'insured contracts' which are limited to lease-type agreements. A broad form endorsement may cover all contractual agreements made prior to a loss. Often the insurance company will want to review individual contracts before agreeing to include them.
- Another contractual requirement often seen is a waiver of subrogation in favor of the GC. This provision is often requested with regard to general liability insurance and almost always for Workers' Compensation. This means that the insurance company will not try to pursue a recovery against another party who may have been partially or wholly responsible for the loss. In other words, if the GC could be partially responsible for a slip and fall on the site where the Sub is working, but the Sub has obtained agreement from its insurer to waive subrogation against the GC, there will be no attempt to collect from the partially responsible party. Without this clause the additional insured status discussed above would be diminished or eliminated.

Other examples that demonstrate how insurance can be important in backing up certain contractual promises might include:

- You engage a computer service firm to help with hardware and software maintenance and upgrades. You want them to be responsible for any errors they make—such as releasing personal data to the internet, causing a virus to infect your customers' or email contacts' equipment, or erasing data and causing you a serious business interruption. Your contract needs to require they have Media Liability insurance to cover these possibilities.

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- You agree to let a professional financial advisor manage your stock portfolio. You will not be able to hold them responsible if the market goes down, but you can have them agree to certain best practices, like allocations of money (i.e., to diversify your portfolio). Your contract needs to require they have professional liability to cover a clerical error or a mistake in your file that causes you a significant loss.
- You may offer your marketing services to a large client and they want you to agree in their contract that you will be responsible for their confidential information and you will not infringe copyrights with your work. Their contract will require you to have Errors & Omissions insurance to back up your agreements.
- You may be offered a job inspecting underground fuel tanks for a large petrochemical firm and making sure that the tanks are not leaking pollutants. Their contract will oblige you to hold them harmless for any losses caused by your work and indemnify them if they are also sued for any problems. They may also want to have you be responsible for the safety of other workers nearby or injuries caused by your excavations or other actions.

Sometimes these contractual clauses may not seem very fair and balanced—and they often are not! You need to choose carefully what risks you are willing to take. To do so, you must be sure to understand both the legal implications of a contract clause and the insurance implications. Be sure to carefully read the contracts others want you to sign; they are not always equitable. You often get their 'boiler-plate' insurance requirements, which may have no relevance to the products or services you are providing.

Great caution needs to be paid to those circumstances where contractual wording is very broad and no insurance coverage can, or will, completely fulfill the obligations that are imposed. This can happen, for example, if a Tenant is held liable "for any and all" bodily injury claims—even ones occurring outside the premises—and the imposed $1,000,000 or $2,000,000 insurance limits prove to be inadequate. It can also happen when, for example, a Tenant installs an emergency generator and a small diesel fuel tank, but is required to be responsible for "any and all" toxic substances in and around the building. Even a Pollution insurance policy will not cover "any and all" toxic substances. This is an example of legal over-kill or ignorance in the drafting of the special lease clause. Other parties often don't understand, or care, about the potential limitations of your insurance protections.

It can be okay to agree to be responsible for certain things that insurance won't cover—if you understand what you're getting in to. Warren Buffet once said, "Risk comes from not knowing what you're doing." Get good advice up front so you know where you are covered and where you are 'self-insured.'

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Specialized Insurance Coverages

Three types of business insurance that are becoming much more prevalent merit the attention of small and mid-size business owners. Note that standard business insurance policies, such as General Liability, do not cover these types of risks.

Directors & Officers Liability

A directors and officers (D&O) insurance policy covers actual or alleged wrongful acts committed by Directors and company officers who may be named individually in a lawsuit. It's a type of errors and omissions policy for the directors and sometimes for the corporation itself. It's a 'claims-made' policy that is quite different from standard 'occurrence'-based liability policies. It covers only economic loss, not bodily injury or property damage. Note that directors' *personal* assets are at stake if they are found to have breached the duties owed to shareholders or the corporation.

Examples of wrongful acts include allegations of committing fraud, mishandling finances, practicing deceptive trade practices, competing unfairly, pursuing a failed merger deal that cost the target company money, misappropriating trade secrets (with a new hire), breaching the duty of care in handling the sale of the corporation, and any other claims by any party with which the corporation contracts or even discusses a contractual relationship (whether a competitor, customer, or other contracting party).[*]

It is important to make sure that the policy covers 'allegations' even if they are for criminal or fraudulent activity. These acts, if proven, will be excluded from actual insurance coverage. Many lawsuits involve false allegations of criminal or fraudulent actions or conduct. An insurance company should be there to defend the directors until these allegations are proven false.

In today's litigious business environment, claims are increasing in severity and lawsuits are more frequently targeting private (non-public) small and mid-size firms. Sarbanes-Oxley is the post-Enron® law that mandates both honesty and transparency in financial statements and corporate accountability of senior officers in publicly traded corporations. Many claims and lawsuits based on these mandates have rocked large public firms, and, as a result, claims and lawsuits are now starting to trickle down to smaller companies. Consequently, stakeholders of smaller firms have greatly increased expectations for prudent management. Corporate governance practices and policies that focus on transparency and accountability, as well as

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[*] Some claim these examples are from "Why Every Privately Held Firm should Have D&O" by Michael A. Rossi, Troop Steuber Pasich Reddick & Tobey LLP, Los Angeles.

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management and staff training in carrying out these mandates, are important factors in avoiding claims in the first place.

Premium costs for small and mid-size firms can be very affordable. Of course, premiums can vary significantly and will depend on the industry (some, like financial institutions, are subject to many more claims), the company size, and the nature of operations, as well as on the types of clients or members, past loss history, and prevention policies.

Employment Practices Liability

An employment practices liability insurance (EPLI) policy protects employers from wrongful employment acts like harassment and discrimination. Available policies cover both first-party claims by employees and third-party claims alleging harassment by or to persons outside the firm. For example, third-party employment practices liability can arise if one of your employees is getting unwanted advances from a delivery person, or if one of your employees is harassing an independent contractor.

These types of claims are becoming much more frequent and costly. Smaller organizations are much more vulnerable than larger firms because they often don't have or properly use correct policies and procedures and appropriate human resources or legal expertise. Employees know their rights and how to get attention for an increasingly wide variety of discrimination claims. Examples include: age discrimination; all varieties of sexual preference discrimination; wrongful hiring, promotion, training, and termination; retaliatory discharge in the context of "whistle blowing;" or violations of the Family Medical Leave Act.

Recently a survey of small firms by The Chubb Group found that 50% of business owners expected an employee lawsuit within the next 12 months and 10% expected to pay more than $1,000,000. Littler Mendelson, a nationwide law firm specializing in employment practices, recently declared that defense costs for a typical discrimination suit will amount to $250,000—if you win.

Premium costs for EPL insurance vary depending on the number of employees and the robustness of employee training, human resource polices, and company practices.

E-business and Cyber Liability

These policies are variously referred to as technology, e-business, media, cyber, network security, or internet liability policies. They can provide coverage for losses to you, such as when your website or on-line store is shut down by hackers. Such policies can also provide third-party liability coverage for damages you cause to others when you:

- Accidentally release private information (personal, medical, financial) over the internet, resulting in embarrassment or identity theft.
- Send spam or viruses to others due to programming errors or failure to use appropriate filters, update patches, etc.
- Allow hackers to access credit card information.

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- Permit confidential information to be taken from the business premises on laptops, thumb drives, or other storage devices.
- Enable hackers to steal information at Wi-Fi sites due to poor security.
- Infringe on another's intellectual property or copyrighted materials.

Damages resulting from these errors or negligent security can be significant. Identity theft, for example, can cause loss of time, income, and employer productivity. It can also lead to great expense for individuals (employees or customers) and banks, which must clean up client files, re-issue credit or ATM cards, etc. Regulatory authorities may impose additional fines that are not insurable.

Because cyber liability is an evolving area of insurance, policy wordings, definitions, coverages, and exclusions vary significantly among insurers. It is important to understand your exposures, carefully communicate your needs, and verify your coverages.

Pricing for these coverages can also vary significantly depending on the size and nature of the operations, information stored, security systems implemented, etc. Make sure you have an insurance broker who is very familiar with this area of insurance and who can provide up-to-date coverage, insurer and pricing advice, security audits, and other assistance.

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Conclusion

As you can tell from this discussion, there are many ways to shift risk among the participants in any business transaction. The path to the right mix of contract protections and insurance coverage is rife with pitfalls, traps for the unwary, and needless additional expense.

For help minimizing your vulnerability and exposure to these and other associated risks, we strongly encourage you to consult qualified legal and insurance professionals.

If you found this document helpful and would like to learn more, please don't hesitate to contact Bob or Charles.

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