

Introduction to Contractual Risk Transfer and Insurance Coverage Requirements

State of Vermont

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Benefits of Contractual Risk Transfer

- Protects the assets of the State
- Reduces the cost of claims
- Places responsibility for loss on the negligent party
- Insures parties doing business with the State have ability to fund claims
- Reduces litigation expenses

Contractual Risk Transfer Process

Many contract provisions can affect the allocation of risk in a transaction, and the treatment of accidental risks in a contract can be completely understood only by reading the entire document. The most obvious key provisions allocating risks in contracts include indemnity or hold harmless provisions, liability limitation and exculpatory provisions, waivers of subrogation, and insurance requirements.

Indemnity clauses alter the way liability is allocated between contracting parties by requiring one of the parties to indemnify the other for certain types of liability to third parties. The indemnification clause has become a common tool to contractually transfer the impact of risk to responsible party.

Liability limitation and exculpatory provisions also alter the application of legal liability principles. Rather than requiring one party to indemnify another for liability to a third party, however, they relieve one contracting party from liability to another contracting party or limit the extent of liability to some specified amount. This liability waiver or limitation is

usually intended to apply irrespective of whether the injured party has purchased insurance to cover the risk.

Waivers of subrogation are similar to liability limitation provisions in that they waive one contracting party's right to pursue recovery from the other contracting party. However, they generally apply only to the extent the other party is covered by insurance for its loss.

Insurance requirements impose specific coverage requirements on one or both contracting parties and generally require evidence that these requirements have been met.

- *To assure the financial viability of the entity's business partner.* Requiring the other party to the agreement to maintain a minimum level of insurance helps to qualify that party as a financially viable entity. Concerns as to the advisability of the entire transaction would arise if the party on whom the insurance requirement is placed does not provide and maintain traditional business insurance, e.g., workers compensation, general liability, and automobile liability. A party doing business with an uninsured entity increases its likelihood of incurring claims and/or having to find a replacement entity for one that becomes insolvent due to uninsured losses.
- *To provide for a coordinated and efficient insurance program.* By allocating certain risks and the responsibility to insure them to one of the contracting parties, a more efficient and less costly insurance program will often result.

- *To fund a recovery of damages inflicted by the negligence of the contracting party.* Many contracts deal with inherently hazardous business ventures where it is quite possible for one contracting party to damage another's property or injure its employees. In the event this occurs, the culpable party's liability insurance will be the primary source of funds to respond to its liability.
- *To insure the risks assumed in the indemnity provision of the contract or otherwise allocated to the contracting party.* Contractual liability insurance is security to the indemnitee supporting the indemnitor's promise to indemnify as set out in the contract.

Additional Insured Endorsement

Additional insured is a type of status associated with general, auto, and umbrella liability insurance policies that provides coverage to another entity. Under an additional insured endorsement, the additional insured will be covered under the contractors/vendor's policy and can file a claim in the event that additional insured is sued. As an example, a business may ask a contractor to add them as an additional insured in their general liability policy. This will protect the business in the event of legal claims that may arise as a result of the contractor's negligent work.

Additional insured status is only granted if there is an executed contract which requires an entity be named as additional insured. Coverage is void if no requirement or executed contract exists.

Additional insured status is generally not granted under professional liability policies.

Certificates of Insurance

A certificate of insurance is only a representation of coverage. It is not a legal binding document. It is provided as a convenience to a 3rd party to illustrate the insureds compliance with contractual insurance requirements. *[See sample for discussion]*

Professional Liability Insurance

Professional liability insurance, also commonly referred to as errors & omissions insurance (E&O) or malpractice insurance, is a type of insurance policy that covers claims related to malpractice, errors, omissions, negligence, during the course of providing a professional service. Claims can arise for the failure to perform or deliver the services described in scope of services section of the contract.

Professional liability is usually issued on a claims-made basis. Unlike a property policy, this means that you must report claims when you become aware of them. The claim attaches to the active policy when the matter is reported not when it occurred.

Professional Liability Insurance is generally required for any business that offers professional services, such as lawyers, accountants, consultants, investment advisors, real estate agents, architects, medical professionals, engineers, IT systems and software firms, specialty contractors, social

workers, veterinarians, specialty training firms, or anyone licensed or regulated by Federal, State, or County governments.

These professions require specialized education or training, and their practice must meet certain state, industry, contract, or client standards. Oftentimes, the professional is licensed for their trade.

General criteria for determining if a professional liability exposure exists include:

1. What is the financial impact if an error is made or if the services are not delivered on a timely basis?
2. Is there a risk of bodily injury, property damage or interruption of operations as a result of the failure to deliver or an error made in the professional services?

Cyber Insurance: Possible Contract Requirements

Cyber and privacy insurance is not standardized, and coverage under such a policy can vary greatly from insurer to insurer. Therefore, the insurance requirements should adequately address the risks to be transferred under the contract. The following provides an overview of the insurance requirements for the technology E&O, network security/privacy, and media liability coverage parts under a cyber and privacy insurance policy.

Technology E&O Coverage

If the contract requires a vendor to engage in software, hardware, or systems development, the insurance

requirements should specify technology E&O coverage, and the activities of the vendor or consultant to be covered should include the following.

- Systems analysis
- Software design
- Systems programming
- Data processing
- Systems integration
- Outsourcing, including outsourcing development and design
- Systems design, consulting, development, and modification
- Training services relating to computer software or hardware
- Management, repair, and maintenance of computer products, networks, and systems
- Marketing, selling, servicing, distributing, installing, and maintaining computer hardware or software
- Data entry, modification, verification, maintenance, storage, retrieval, or preparation of data output
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Network Security/Privacy Coverage

If the contract requires the vendor or consultant to provide services that require direct access to the organization's systems or holding sensitive information of the organization, then network security/privacy coverage should be

requested in lieu of or in addition to technology E&O coverage depending on the subject matter of the contract. Additionally, the contract must specifically require the vendor or consultant to protect the PII to which the vendor or consultant has access or is holding. The cyber exposures to be covered under network security/privacy coverage should include the following.

- Hostile action or a threat of hostile action with the intent to affect, alter, copy, corrupt, destroy, disrupt, damage, or provide unauthorized access/unauthorized use of a computer system, including exposing or publicizing confidential electronic data or causing electronic data to be inaccessible
- Computer viruses, Trojan horses, worms, and any other type of malicious or damaging code
- Dishonest, fraudulent, malicious, or criminal use of a computer system by a person, whether identified or not, and whether acting alone or in collusion with other persons, to affect, alter, copy, corrupt, delete, disrupt, or destroy a computer system or obtain financial benefit for any party or to steal or take electronic data
- Denial of service for which the vendor or consultant is responsible that results in the degradation of or loss of access to Internet or network activities or normal use of a computer system
- Loss of service for which the vendor or consultant is responsible that results in the inability of a third party, which is authorized to do so, to gain access to a computer system and conduct normal Internet or network activities

- Access to a computer system or computer system resources by an unauthorized person or an authorized person in an unauthorized manner
- Loss or disclosure of PII or confidential information no matter how such loss occurs

Media Liability Coverage

If the contract requires the vendor or consultant to provide content, such as software code, text, or data images, the insurance requirements should specify media liability coverage, and the cyber exposures to be covered should include the following.

- Infringement of copyright, title, slogan, trademark, trade name, trade dress, service mark, or service name
- Plagiarism
- Public disclosure or loss of misappropriated trade secrets or unauthorized use of titles, formats, performances of artists or other performers, style, charters, plots, or other program material
- Libel, trade libel, slander, disparagement of a person, organization, or product, or other forms of defamation
- Unauthorized disclosure of data, which results in an invasion of privacy or other invasion, infringement, or interference with the right of privacy or publicity
- Unfair competition including trademark dilution, deceptive trade practices, passing-off, and violations of Section 43(a) of the Lanham Act or similar statutes

- Breaches of contract that are implied in fact or in law, resulting from the alleged misuse of data
- False advertising or misrepresentation in advertising
- Errors and omissions and negligence in the production or publication of content

Adequacy of Per Claim and Annual Aggregate Limits

It is crucial that adequate per claim and annual limits of liability are specified in the insurance requirements. Some cyber exposures are more costly than others are. For example, costs for a vendor to comply with notification provisions in privacy breach laws, costs for computer forensics experts to investigate the source of a data breach, and costs to contain a data breach might be more expensive than other types of cyber exposures. Based on the cyber risks transferred under the contract, it may be appropriate for the insurance requirements to call for increased limits of liability for certain cyber loss exposures.

Additional Insured Issues

Traditionally, it has been very difficult to obtain additional insured status on E&O, professional, and similar lines of insurance, and that can be the case with cyber coverages. When available, however, being named as an additional insured on the vendor's or contractor's cyber and privacy policy can be an effective method for transferring risks arising from cyber, privacy, technology E&O, or media liabilities arising from the activities of vendors or consultants. Even if an organization is successful in being

named an additional insured under the vendor or consultant's policy, the coverage is usually limited solely to vicarious liability of the organization for the negligent acts, errors, or omissions of the named insured vendor or consultant. While the organization may seek to obtain a pre-loss waiver of subrogation from the vendor or consultant, such waiver of subrogation may have little practical effect if the organization is not successful in being named as an additional insured under the vendor or consultant's insurance policy.