STRATEGY BRIEF SERIES 2

MITIGATING (OR ELIMINATING!) RISK: MANUFACTURERS FILL IN THE GAPS IN TRADITIONAL INSURANCE POLICIES

How today’s manufacturers are protecting their businesses with CRT and E&O contracts
Mitigating (Or Eliminating!) Risk: Manufacturers Fill in the Gaps in Traditional Insurance Policies

We’ve all watched the TV courtroom dramas and seen sensational headlines where a jury or judge decision can make or break a company by ordering millions of dollars in punitive or compensatory damages. It’s always just one company that is identified as the culprit. And the sums are often outrageous. But does that seem fair? Do companies operate in a vacuum?

Many businesses are inextricably linked to one another in supplying products and services. Shouldn’t the “blame,” or liability, be shared?

The judicial system doesn’t have an answer to this quandary yet—but the insurance industry does. Through Contractual Risk Transfer (CRT) and Errors & Omissions programs (E&O), businesses can now protect themselves relative to their respective role in the process. These programs can supplement General Liability policies to create risk or liability contracts that more accurately reflect their level of contribution to the conditions that might lead to a claim.

Instead of letting the courts decide—after the fact—why not put it all down in writing—before the fact?

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**Industrial Machine Production - Large Losses - 5 Year Trend**

**By Case Categories**

- **Total $ Amount for Listed Cases**
  - 31M Products
  - 16M Environment
  - 9M Business Practices Risks
  - 2M Other
  - 5M Workplace

**By Line of Business**

- **Total $ Amount for Listed Cases**
  - 31M Products Liability
  - 6M Miscellaneous
  - 16M Environment/Pollution Liability
  - 10M Directors & Officers Liability

Source: Advisen. The Master Significant Case & Action database (MSCAd) compiles details and statistics on significant large losses, including management liability cases such as securities class actions, auditing and other management malpractice, state and federal government regulatory fines, employment liability cases, and errors and omissions litigation. The consolidated data is subject to ongoing review and rigorous audit procedures to ensure both accuracy and timeliness.
Maybe one day holding one entity, or company, solely responsible for an accident, failure, or error will seem quaint. Until that time, Contractual Risk Transfer policies can spread potential liability more judiciously across all companies in the chain of design, fulfillment, assembly, installation, operation, and maintenance. By doing this, manufacturers reduce insurance premium costs, reduce risk exposure, and reduce the size of claim awards, if they get that far.

And today’s manufacturers don’t just need to be covered for operator accidents or machine failures that cause liability claims for compensation. There are many other ways a company can experience economic loss, such as production downtime, loss of revenue, or loss of a market opportunity. And there are many times when equipment or services just don’t meet end-user expectations or manufacturer promises.

Manufacturers protect themselves from these claims through Errors & Omissions policies that reduce the obligation to pay damages and also cover costs incurred to defend against claims. What’s more, many business contracts now require E&O insurance as a requirement for executing those contracts.

Both CRT and E&O policies are filling in the gaps of traditional insurance policies by offering protection against claims of any “Consequential Loss,” no matter how big or small. These programs require a sharp learning curve, as today’s contracts can be more complex and nuanced than what many manufacturers have become accustomed to. They are often customized solutions that fit like puzzle pieces into—or between—existing General Liability policies.

These two strategies fill in your insurance gaps from two different angles. While CRT is not insurance, per se, it enables companies to spread liability risk more equitably between companies working together. And while E&O is insurance, it does not replace General Liability insurance—it only complements it. But both require deep industry experience to navigate the contractual language and special clauses that are, in the end, “the devil in the details.”

**Contracts and Clauses**

The traditional “direct liability” model is changing to today’s “shared liability” reality. And if there is going to shared blame, shared liability, then why not shared risk?

Most people might assume that most contracts are between two parties, or companies. When in fact, there is no limit to how many parties are involved in a contract. And what’s more, today’s insurance clauses often require that more than one party take out certain insurance policies.

Contractual Risk Transfer is not the only common kind of Risk Transfer. A “Certificate of Insurance” with the proper policy language might transfer one company’s risk to another; a “Vendor’s Coverage” might cover retailers from product liability claims of a manufacturer; and a “Hold Harmless” document might indemnify a service supplier, from damages incurred during that subcontractor’s work.

But CRT is the glue that holds these all together in an airtight package. It is one of the most important risk management tools available to businesses that rely on outside vendors to provide goods and services, or provide goods and services to clients. The concept of risk transfer can be complicated and complex to understand.

To support the terms of the indemnity agreement, the contract will often include insurance requirements. These spell out the insurance required by the various parties entering into the contract. It is common for one party to include another as an additional insured under its Commercial Property, Commercial General Liability, Business Automobile, Umbrella, and Professional Liability policies.

Not everyone has the experience to negotiate CRT contracts with confidence. And it can be quite time-consuming. That’s why insurance consultation—and review by a lawyer—is always advised.

**Manufacturing CRT Agreements**

Properly structured CRT programs places the financial responsibility for an accident or injury to a third party on the person or entity closest to and best able to control...
the activity and, presumably, its outcome. As a machine manufacturer, contract review and obtaining certificates of insurance for component suppliers, subcontractors, and distributors is an essential component of your risk management program.

Through CRT, each company takes responsibility for its own actions (and their consequences), while contractual business partners assume a share of the risk that is relative to their ability to control it.

There are basically three major types of contractual risk transfer tools:
- Indemnification or “Hold Harmless” Agreement/Clause
- Waiver of Subrogation
- Additional Insured

Effective risk transfer can save companies money by lowering the overall cost of risk. Because companies may be part of a number of contractual relationships at any one time, it is essential to control the type and magnitude of liabilities the company assumes. Conversely, companies may benefit from looking for opportunities to manage risk by having others contractually assume their share of liability.

The indemnification agreement should state that if you were held liable for claims arising out of the components of your suppliers or the activities of your subcontractors, then they would assume your liability and reimburse (or “indemnify”) you for your liabilities and expense so that you are not “harmed” by the claim.

End-User Agreement Types

Well-written contracts have separate and distinct sections for indemnification and insurance requirements. Generally, there are three types of "hold harmless" and indemnity clauses:
- Broad Form: One party is responsible for all losses, regardless of which party is at fault.
- Intermediate: One party is responsible for all losses, unless the injury or damage was due to the other party’s sole negligence.
- Limited: Each party is only liable for its own fault (i.e., as in common law).

One of these might have covered the company in this example: A machinery operator was seriously injured from an electrical shock he sustained while operating a machine manufactured by ABC Company. The shock was caused due to a faulty component supplied by an electrical component supplier, which ABC uses on a majority of
the machines they build. The workers compensation carrier and the family of the injured worker sued ABC and they are found liable for a $950,000 judgment. ABC was not listed as an additional insured on the electrical component supplier’s policy, and therefore was not covered.

Who Needs Indemnification?
Many businesses sign hundreds of contracts each year, but do they know what liabilities are being assumed or waived in these contracts?

It is a common practice to enter into contractual agreements with those involved in a project to formalize the terms and responsibilities for all parties. These contracts often include an indemnity agreement, also known as “hold harmless,” and insurance clauses as a means to transfer the risk of future losses or damages from one party to another.

Indemnities are where one party agrees to reimburse the other party for the other party’s losses, often irrespective of whether the first party was negligent or not. The importance of reviewing both the indemnification clause and insurance clause of policies cannot be overstated.

Just to be clear: An agreement to indemnify another IS NOT INSURANCE and has nothing to do with insurance.

So, why do you need indemnity clauses as well as insurance coverage? What liabilities are assumed under indemnity clauses and not covered by insurance?

Because the liability assumed in the indemnification agreement of the contract can be broader than the insurance coverage provided. Always have a qualified person compare the two to determine what is covered by insurance and what is not.

For instance, insurance may pay for some, or all, of the obligations assumed in an indemnity agreement. However, insurance is completely independent of the obligation to indemnify. The “indemnitee” is not an insured in the liability policies of the “indemnitor.” While the indemnitee may benefit from the indemnitor’s policy, the indemnitee is not a party to the indemnitor’s policy.

CRT Contract Review Tips
Examples of some areas where risk management or insurance personnel should, in conjunction with legal advice, be endeavoring to minimize liability in contracts are:

- Amend "any act or omission" to "any negligent or wilful act or omission"
- Delete "or indirectly" from the phrase "directly or indirectly caused by."
- Contributory negligence: Add the words "except to extent that such loss (etc.) is attributable to the negligence of ..., its employees, servants, and agents" to any indemnity you are required to provide to others.
- Don't accept responsibility for "wilful, unlawful and/or intentional acts"
- When buying goods, don't have your employees limit or exclude your recovery rights against the Supplier (they will breach a provision of your liability insurance policy if they do so).
- If a tenant is obliged to reimburse the landlord for all or part of the landlord’s building insurance premium, amend the lease so that the tenant will not be liable for loss or damage caused by its negligence (after all, as the tenant is paying the premium, they should get the full benefit of the policy).

Always carefully review the indemnity agreement prior to finalizing the contract to determine the extent of your company’s liability. Once the scope is understood, you may want to negotiate the terms to limit your exposure. The application and enforcement of an indemnification agreement does, however, depend upon the statutory and common law of the jurisdiction in which enforcement is sought.

E&O and Professional Liability
In today’s business world, companies providing products or services to third parties need protection beyond their general liability (GL) policies. Among other perils, standard GL policies respond to claims or lawsuits made
by third parties for bodily or physical injury to, or loss of use of, tangible property.

However, due to the impaired property exclusion, GL policies do not provide protection for claims when the insured’s product fails to perform without physical damage accompanying that failure. In addition, GL policies do not respond to claims for injury to intangible property, such as damage to data. Companies need E&O insurance to ensure their assets are adequately protected.

One reason for the shift is the concept of “professional
liability.” This concept separated “professional” liability of “services” from “damage” liability of “products.” Today, most companies you can think of provide both products and services. The lines have blurred between strictly product manufacturing and service providers, and many companies can be part of the supply chain that brings any product, or machine, to market.

One can think of E&O insurance as covering the gaps between General Liability insurance that covers physical damage claims of traditional products, machines, and components and Professional Liability that covers the day-to-day services that the same company provides against non-physical claims of mistakes, omissions, and negligence. And a little overlap between E&O and GL policies is not necessarily a negative. “Better safe than sorry” is a motto to embrace.

Who Needs E&O?

Of course, the details of the products and services, their performance, and the consequences of poor performance can be completely outlined in a contract. In that case, a company can sue for breach of contract to recover losses.

But the reality of today’s litigious environment tells a different story. In order to increase the likelihood of success in a lawsuit, claimants against manufacturers have chosen more and more to claim negligence instead of breach of contract. By claiming negligence, they can recover intangible losses that stem from the poor performance of a product or service. This is where E&O insurance is most valuable.

Imagine a major consumer products good company preparing for a worldwide launch of new product. All the advertising, marketing, and merchandising has begun to launch. A machine on the packaging production line malfunctions due to inaccurate maintenance instructions on one component. This delays the launch because the product missed a key supply chain delivery deadline.

What damages could be claimed? “Economic losses” could include production downtime, increased shipping costs, rescinded retailer contracts—even brand reputation. Would that manufacturer’s—or the component supplier’s—general liability insurance cover all that? Or, more importantly, how valuable would it be if they could avoid going to court altogether?

There are a number of other reasons you need E&O protection:

- As you strive to meet your clients’ varied needs, additional services such as maintenance, installation, design and delivery are often provided, thereby increasing your exposure to E&O losses.
- While well-written contracts can help protect you against lawsuits, even clear and concise contracts are subject to legal attack. E&O shields you from legal claims and costs.
- As it can be difficult to determine which component part causes a product failure, all part providers in the supply and distribution chain may be sued.
- An E&O lawsuit must be defended against, even if the suit is unfounded and groundless.
- More and more contracts require E&O protection.
- If you do not have E&O insurance, your Directors and Officers may be liable for failure to obtain proper insurance.

Solutions That Protect

It is impossible to predict the ideal CRT and E&O programs for your company. Every situation is different, and business relationships can get complicated, so consultants are invaluable.

The review process itself can be expensive for manufacturers that choose to go it alone. It is time consuming and distracting for a company that has to shift its day-to-day operations and make insurance needs assessments a top priority.

E&O policies, even more than CRT agreements, must be contract-specific to be both fully appropriate and not excessive. Today, companies that purchase E&O insurance include those that manufacture, assemble, or
install to customer specifications; select raw material for others; provide services, advice, or instruction to others for a fee, and provide design work. If you’re just getting started, though, there are also entry-level programs to get your feet wet.

The learning curves are steep, to be sure, and the curves themselves are moving targets. Consultants that stay abreast of industry best practices, though, have answers at the ready. After all, the alternative is to call an attorney every time you turn around—and every time you realize you missed something.

Who is AHT?

AHT Insurance are insurance brokers and consultants with uniquely strong insights into the manufacturing industry with a high degree of specialization in product safety and product liability. The company has consulted on liability insurance policies from every angle for mid-to large-sized U.S. manufacturing companies.

What Can AHT Do for Your Company?

We will take you through step-by-step review processes that lead to the most cost-effective insurance solutions and the most prudent and comprehensive strategies. We provide our clients with balance sheet protection by providing thorough proprietary processes utilizing risk assessment methodologies and documentation.

We also ensure that this commitment to best-in-class safety is properly represented to those underwriters involved in developing premiums. Our credibility in the underwriting community was built over many years of engaging sound and profitable accounts using our unique processes. We bring that commitment back full circle for manufacturers eager to promote personal safety and mitigate financial risk.