ANDERSON KILL & OLICK, P.C.

TIPS FOR EFFECTIVELY TRANSFERRING RISK

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Introduction

Every commercial transaction involves risk - whether it is the risk that one party will not perform or the risk of not being paid for work done. However, contracts can be drafted to reduce the risk of loss and transfer that risk from one party to another. While every contract is unique, there are some guideposts to follow when transferring risk in a commercial contract.

1. Know where the risk of loss naturally rests if risk is not transferred.

The starting point in deciding whether and how to transfer risk is to evaluate which party bears the risk if it is not transferred. Consider, for example, a fixed-fee contract where a party agrees to excavate a certain volume of soil. The excavator prices the job based upon his estimate of the amount of time that it will take to perform the work based upon the soil conditions as he believes them to be. If the soil is more difficult to excavate than he thought and the job takes more time, different equipment, and/or additional manpower than he thought would be needed, then the excavator, being paid only a fixed fee, bears the risk that he will not make the profit that he anticipated – and also bears the risk that the job will be more expensive than he accounted for in his price.

The owner, by agreeing to a fixed-fee contract with the excavator, ensures that the risk that the excavation will be more time consuming or costly than the excavator anticipated rests with the excavator. The owner has no need to “transfer” risk to the excavator because the risk of cost overruns already sits with him. If the excavator wants to transfer the risk of unknown soil conditions to the owner, he could do that by charging an hourly rather than fixed fee for his services.

2. Be clear on when a duty to defend arises and how defense is provided.

It is common for one party to agree to “defend and indemnify” the other, but too often, contracting parties do not consider or specify what events will trigger that defense and indemnity obligation – and what that obligation actually means. When considering events that will trigger a defense obligation, do both contracting parties have to be named in the same lawsuit? Is it necessary that the lawsuit contain allegations that one party is responsible for the conduct of the other? What about if there is an arbitration demand – is there a duty to defend?

In addition, to specifying the events that trigger a duty to defend, contracting parties should also consider specifying matters like selection of defense counsel and control over the defense and settlement. For example, does the party who is providing the defense select the lawyer? If the party who is being defended is able to choose his defense counsel, then is there a limit on the hourly rate that he may charge? If the contract does not address these and other matters, then it may lead to litigation.

3. Where there are financial concerns, consider requiring insurance.

It may be prudent to require that a party purchase insurance to fund its defense and indemnity obligations. Otherwise, the promise to defend and indemnify may not be worth the paper that it is written on. Consider specifying the type of policy, limits, and even form, to have some comfort that your counter-party buys the right insurance. Your broker or other insurance professional may be able to identify the forms, policy and limits to specify.

By requiring counter-party to accept risk and buy insurance to fund its obligations, you may come close to a complete transfer of risk.

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4. Consider the dynamics of the business relationship and industry.

Once a decision is made to transfer risk, then the next consideration might be the dynamics of the business relationship between the contracting parties and how risk is typically transferred in the industry. For example, a small supplier may be willing to take on more risk for the privilege of doing business with a major counter-party.

5. Review risk transfer obligations for each contract.

While it may be tempting to use "boilerplate" or form language from another contract to, in theory, save time, it is important to carefully review risk transfer provisions in each contract and determine whether they are appropriate for the particular transaction. Depending upon factors such as the applicable law, insurance requirements, and dynamics of the business relationship and industry, provisions that were appropriate for one contract might not be for another.

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