United Educators

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Improving Contracting on Campus

Part 2: Allocating Contracting Risks Between Parties*

A contract should not make your institution responsible for more negligence than it has bargained for. But if your contracts do not effectively allocate certain risks, you may be held liable for another party's negligence. Consider the following scenario:

> ABC College and Snowtown Inc. enter into a written contract for snow removal services over the next year. Snowtown is a small business with minimal assets. Following a heavy snowfall, Snowtown neglects to clear snow from one of the campus parking lots. A student falls on this lot and sustains a traumatic brain injury. He sues the college for his severe injuries. The college, without any contribution from Snowtown, incurs over $2 million in expenses to defend and resolve the student's claim.

Although the contract obligated Snowtown to clear the parking lots, the college must pay for the claim the company's negligence caused. The college may not have any financial help from Snowtown even if it were to pursue a breach of contract claim against the business or attempt to add Snowtown as a party to the student's lawsuit. As a small business with negligible assets, it may be unable to satisfy any judgment the college could obtain.

Sound campus contracting practices include using written contracts when possible, reviewing contracts carefully before signing them, and ensuring that an official with authority signs the institution's contracts. (See the October *Risk Research Bulletin* for more information.) Contracts and other insurance requirements offer further protection when they provide appropriate guidance about each contracting party's responsibilities for third-party injuries that occur during the term of the contract.

Risk Allocation Through Written Contracts

Understanding the risk allocation provision of a contract

Every written contract an institution enters into should contain a risk allocation provision that addresses the responsibility of each contracting party for third-party injuries arising out of the activities of the contract. This type of provision can span a wide spectrum of arrangements. At one end of the spectrum, a party may assume responsibility for all injuries that occur during the performance of the contract, regardless of which party's actions caused the injury. At the other end of the spectrum, each party may agree that it will be responsible for only those injuries that result from its own negligence. Between these outer ranges, the parties may agree to parse responsibility according to degrees of negligence (simple or gross) or their level of responsibility for the negligent act (sole or joint). Three common examples of how contracting parties may allocate responsibility for third-party injuries include:

**Note that "Part 1: A Layperson's Guide to Understanding Contract Basics" appeared in the October 2006* Risk Research Bulletin.

- *One-sided or broad*: One party to the contract agrees to assume all responsibility for negligent acts, both its own and the negligent acts of another party, even when the other party is solely responsible for a loss.
- *Intermediate*: One party to the contract agrees to assume responsibility for losses caused by the joint negligence of both parties. However, if the other party's sole negligence causes the loss, then the solely negligent party will be responsible.
- *Limited*: Each party to the agreement will remain responsible for losses caused by its own negligence. Neither party transfers risk to the other, but rather each remains responsible for its own actions or omissions in the same way that each would if the agreement did not exist.

The part of the contract that addresses the issue of risk allocation may be called an ***indemnification, hold harmless, release, waiver***, or ***exculpatory provision***. However, the contract need not use a special title or name to effect an agreement to allocate risk. All that is necessary is language that demonstrates that the parties agree to retain, transfer, or share responsibility for third-party claims. The actual language in the risk allocation provision controls what is accomplished.

The appropriate risk allocation provision for an institution's contract is often a matter of negotiation. Several factors influence whether an institution can negotiate a one-sided, intermediate, or limited allocation provision, including the following: (1) state law, (2) bargaining power relative to the other party, and (3) potential for financial or reputational loss if either the contract is not performed or the institution is responsible for injuries under the contract.

- **State law**: Individual state laws are relevant to the type of risks that institutions can allocate in their contracts. For example, many public institutions are prohibited under their state's constitution from using state funds to indemnify other parties. Also as a matter of public policy, some state laws prohibit parties from transferring liability for losses that arise from their sole negligence (as in a one-sided risk allocation scenario) or their gross negligence. Additionally, some jurisdictions will not permit a party to transfer its defense costs to another party under an indemnification provision unless the provision specifically states that it also applies to defense costs. And in still other instances, state law can prohibit a contracting party from transferring its risks to others in particular circumstances, such as construction contracts.
- **Bargaining power**: The strength of an institution's bargaining position is influenced by the pool of competing contractors, the level of interest or desire on the part of a potential contractor to do business with the institution, and the institution's desire or need for the goods and services provided by the contractor. The larger the pool of competing contractors or the more intense their interest in doing business with the institution, the more likely it is that the institution can negotiate an indemnification arrangement that favors the institution. If the institution is particularly desperate for the goods or services and the pool of competing contractors is relatively small, then it is more likely that the contractor can require the institution to accept a less favorable indemnification provision.
- **Risk of financial or reputational loss**: An institution's tolerance for risk can have an impact on the indemnification arrangements it will accept. Key considerations include the monetary amount of the contract; the institution's insurance coverages; the institution's financial ability to pay for third-party claims caused by another's negligence, including the effect that paying for such claims may have on the availability and affordability of the institution's insurance; the riskiness of the activities performed under the contract; and the potential for serious personal or reputational injury.

For these reasons, it is important for institutions to consult with legal counsel about state regulations before they negotiate contracts. Institutional staff should also speak with campus administrators, the risk manager, and the institution's broker to assess the contract's importance with respect to the institution's overall academic mission as well as the institution's willingness to assume liability for actions it has little to no ability to control.

Common problems related to risk allocation provisions

Problems can occur when contracts omit indemnification provisions or include flawed provisions. For example: (1) A contract does not include such a provision, leaving the institution vulnerable as the perceived "deep pocket," responsible party, or owner of the premises; (2) a contract includes an indemnification provision that is ambiguous and thus fails to clarify or shift responsibility; (3) a contract includes a one-sided indemnification provision that assigns responsibility to the institution for injuries resulting from activities outside of its control, and (4) a contract limits the amount of risk a contracting party will assume by capping the funds available to pay claims—most commonly, to the amount of the contract. (See part one of the appendix for summaries of actual claims that demonstrate the impact of poor indemnification provisions on UE members.) Consider the following ramifications:

> **No risk allocation provision**: Good Neighbor University allows a local high school baseball team to practice on one of its fields. One day the assistant coach takes the team's outfield to a tract of land adjacent to the practice field to work on fielding pop flies. During this drill, one of the players steps in a pothole and suffers a spiral fracture of his leg. The player sues Good Neighbor University for his injuries. Good Neighbor University has a contract with the high school, but the contract is completely silent on the issue of risk allocation.

Although the player was not on the designated field that Good Neighbor University had agreed the high school could use, there are still complications for the university. Because the contract between the high school and Good Neighbor University lacked a risk allocation provision, the university must defend the player's claim and then sue the local high school if it hopes to receive any contribution from the high school for the player's losses.

> **An ambiguous risk allocation provision**: A college enters into a written contract with Super Funk, a local rock band to perform a concert as part of the college's Emerging Artists Series. Before signing the agreement, the college's representative skims the contract to confirm that it includes an indemnity provision, but he does not pay particular attention to its exact language. During the concert, a member of the band throws a bottle into the audience injuring a student. The injured student sues the college and Super Funk.
>
> When the college's general counsel examines the Super Funk contract, she discovers that it says, "Each party promises to indemnify each other for claims or losses."

This language is so ambiguous that it probably renders the provision worthless. No clear guidance is given regarding whether Super Funk will defend and compensate the college for claims or losses arising from the band's actions or omissions. Rather, the college will likely have to expend its resources to defend this claim and perhaps ultimately contribute to a settlement or a jury verdict.

> **A one-sided risk allocation provision**: To host a graduation ceremony for a university's anthropology department, the university enters into a one-day rental contract with a local historical theater. After receiving the contract draft from the theater, the university representative raises a concern about the proposed hold harmless provision as it does

not use the language campus policy requires. In response, the theater management insists that it will not rent the theater without its provision in the contract. Believing no alternative exists, the university representative agrees.

At the ceremony, a grandparent of a student trips on a tool box that a theater maintenance worker left in one of the rows. The elderly woman falls and shatters her hip, and as a result, she will require full-time care for the rest of her life. She brings a lawsuit against both the university and the theater. On reading the contract while preparing to defend the university, the attorney discovers that the hold harmless provision says, "The University promises to defend, indemnify and hold harmless the Theater from any claims and losses arising from this contract."

This language is attempting to transfer any and all risk of loss that may arise under the theater's rental contract. Although the circumstances that caused the woman's accident were beyond the university's control, the institution may be held fully liable for her injuries because of this risk allocation provision unless state law prohibits this one-sided provision as against public policy.

Language that limits the amount of risk the contracting party will assume: A college enters into a contract with Fun Fun Fun Company to provide a Velcro wall at a festival sponsored by the college in exchange for $1,200. A student breaks his neck and is paralyzed when a portion of the Velcro wall collapses. The student sues both the college and Fun Fun Fun for his injuries. Under the contract, Fun Fun Fun agrees to indemnify the college for all claims of negligence; however, the contract limits the company's obligation to the amount of the contract.

Even though the university thought that Fun Fun Fun accepted responsibility for third-party claims, the risk allocation arrangement was effectively negated by the limit of the company's responsibility to $1,200, the amount of the contract. The university is now responsible for all amounts in excess of $1,200, which will not come close to compensating the student for his serious injury. With an indemnification provision like this, the contractor limits its risk to a known amount without any regard for the serious nature of injuries that can occur during the course of the contract. The amount of a contract is not a good indicator of the liability risks presented by that contract, and institutions should be wary of any monetary limits or caps on a contracting party's responsibility.

Risk Allocation Through Insurance Arrangements

When an indemnification provision in the parties' contract shifts some or all of the liability for third-party claims to a contracting party, the institution must confirm that the contracting party is able and willing to pay for the liability it has assumed. Institutions can accomplish this by requiring that the other party show proof of adequate insurance coverage and give the institution access to this coverage.

Institutions that adhere to the following four recommendations can ensure that they are covered by a contracting party's insurance. (See also part two of the appendix for a description of actual claims involving other insurance missteps.)

1. Require proof of insurance with adequate policy limits.

For proof that a contracting party has the finances to pay for losses, an institution should request a certificate of insurance. The certificate should reflect sufficient policy limits. Over the past 20 years, $1 million has been the standard policy limit required by most institutions, but nowadays $1 million does not go very far toward covering damages and defense costs related to claims. It is a good idea for institutions to reevaluate the policy limits they require of their contracting parties and, if necessary, consider increasing them.

Certificates of insurance should also include the name of the insurance company, name and address of the insured, type of policy, policy period, the insurer's A.M. Best rating, the policy's coverage trigger (occurrence or claims made), a description of services to be provided under the parties' contract, and the effective contract dates.

2. Require an additional insured endorsement.

An additional insured endorsement fills many of the gaps left by a certificate of insurance. While a certificate is valuable in showing a party's insurance coverage, it *does not*:

- Entitle the certificate holder access to the listed policies and, therefore, does not give an institution the right to review specific terms contained in the insurance contract.
- Provide coverage to guarantee that the certificate holder will be notified if there is a material change to the policy's coverage or a policy cancellation. The certificate merely provides basic information about coverage that is available to the contracting party.
- Provide information about whether the insurance policy's limits have been exhausted by other claims. The certificate also is worthless if the policy has expired, been cancelled, or excludes the type of claim that has occurred.

To gain ready access to another party's insurance policies, a certificate of insurance should include an endorsement that names the institution as an additional insured to the insurance policies listed (even excess policies, if necessary). The responsibility for keeping track of a certificate of insurance and an additional insured endorsement falls on the institution or party to which it was issued. Certificates of insurance typically are issued by a party's insurance broker in accordance with policy terms and without notice to the insurance carrier. This means that carriers generally do not track certificates or additional insured endorsements.

If an institution is named as an additional insured on a certificate of insurance, it *will gain* these benefits:

- Access to insurance policies to review and to confirm the coverage that is available under the policy.
- Full rights to coverage under the listed insurance policies for those losses assumed by the other party under the risk allocation provision.
- Notification from the carrier of any material changes to, or cancellation of, the policy upon the institution's request.

3. Review the other party's insurance policies.

An additional insured endorsement is only as good as the coverage provided by the insurance policies to which the endorsement relates. If the other party's insurance policy does not cover the risks that are most likely to occur under the contract, then the institution receives little to no insurance protection from other insurance. Consider this example:

> A college enters into a written contract with 007 Security Services to provide security on its campus. Legal counsel reviews the contract's risk allocation provision and determines that it lawfully transfers the risk of claims and losses arising out of the agreement to 007 Security Services. Furthermore, to ensure that 007 Security Services can pay for the claims that might arise and that the college is adequately protected, the college obtains a certificate of insurance, with an additional insured endorsement naming the college.

During the contract's performance, a female student alleges that a 007 Security Services' guard sexually assaulted her. She files a lawsuit against the college. When the college attempts to obtain coverage under 007 Security Services' insurance, they learn that the policy excludes coverage for sexual assault.

Institutions need copies of the actual policies listed in the endorsement to be sure of the coverage provisions, including exclusions and other coverage limitations. It is especially important to do so for long-term contracts and those that present severe risks of loss.

Institutions should also confirm the extent to which the aggregate limits of the policies listed on a certificate of insurance have been exhausted. This step will avoid situations in which an institution seeks coverage for a claim under a contracting party's insurance policy only to be denied coverage because that policy's limits have been exhausted.

4. Reinforce insurance requirements using the contract.

A contracting party's insurer will only assume coverage for a claim brought against the institution if all of the following are true:

- The contracting party has assumed responsibility for the claim under an enforceable contract.
- The institution is named as an additional insured to the policy.
- The policy has not expired.
- The policy's aggregate limits are not exhausted or impaired.
- The claim is covered by the policy.

Even when all these requirements are met, the contracting party's insurance carrier can challenge its obligation to extend coverage to the institution. The underlying contract can fortify your claim to other insurance coverage if you do the following:

- ***Require that the other party's insurance be primary to the institution's insurance***: By requiring that the contracting party's insurance be primary to the institution's insurance, an institution will eliminate any attempt by the contractor's insurer to share coverage with the institution's carrier when a third-party claim is made.
- ***List the required lines of insurance in the contract***: Lines that are typically required include commercial general liability, auto, workers' compensation, employers' legal liability, professional liability, and property. However, the specific lines of insurance that are appropriate will depend on the subject matter of the contract and the risks involved.
- ***Require quality and well-capitalized insurers***: If the other party's insurers are financially stable, it is more likely that they will be solvent to cover third-party claims. Consider requiring that the other party's insurers have a particular financial strength rating by a nationally recognized financial rating organization such as A.M. Best.
- ***Require appropriate limits***: Set minimum policy limits for each line of insurance required and consider requiring excess insurance, too. These limits should reflect the potential risk of loss from the contract's activities. Remember the price of a contract is not a good measure of the liability exposures presented by that contract.

- ***Require advance notice of a policy's cancellation or a material change to coverage***: As an additional insured under the contracting party's insurance policy, an institution will want sufficient notice so that it can provide adequate time for the other party to secure substitute insurance coverage in accordance with the contract.

Putting Risk Allocation into Practice on Campus

The following steps can be used to establish campus policy and procedures that promote a consistent approach to the task of allocating responsibility for third-party claims between your institution and its contractors.

1. Address risk allocation in the campus contracting policy.

An institution's contracting policy should include its approach to allocating responsibility for third-party injuries based on its tolerance for taking on risks from activities it may not control. Some institutions transfer as much risk as possible to the other party, while others may change the way risk is allocated depending upon the subject matter or amount of the underlying agreement, or the nature of the activities performed under the agreement. For example, an institution may transfer any risk in its facilities use agreements but decide on a case-by-case basis about contracts with guest lecturers.

To decide upon a policy, institutions must consider state law, bargaining power relative to the other party, and the potential for financial or reputational loss if the institution is responsible for injuries caused by a contracting party's negligence. Through this process, an institution should strive to establish the following:

- ***Model indemnity language***. Consult with legal counsel and the risk manager to draft model indemnity language for inclusion into an institution's written contracts.
- ***A process for considering and approving deviations to an institution's model indemnity language***. If a contracting party wants to modify the model indemnity language, an institution needs a clearly articulated process for considering and approving any deviations. This process should include review by legal counsel of any suggested changes. If the institution is prohibited by state law from indemnifying contractors for third-party injuries, the contracting policy should clearly state that deviations from the model language are not permitted.

The expertise of both the institution's risk manager and legal counsel is useful in this process as well as the input of relevant campus administrators.

2. Update form agreements.

Update any form contracts the institution uses (for example, purchase orders, facilities use, service contracts, and construction contracts) to include the model indemnity language. Also, if the institution uses a contract checklist when reviewing agreements, include the model indemnity provision in the checklist and require that contract reviewers check for that provision in any contract under consideration.

3. Inform potential contracting parties of insurance requirements.

Before a contractor ever bids on a contract or an entity entertains using an institution's facilities, the institution should establish and clearly state the insurance requirements for the other contracting party. Advance notice of insurance requirements will help to attract contracting parties that can meet the institution's requirements and prevent later disqualification.

4. Receive and review the certificate of insurance with the additional insured endorsement prior to signing the contract.

If an institution intends to handle third-party claims by obtaining coverage under the contracting party's insurance, then it must obtain and review all documentation about that party's insurance coverage before it signs the contract. Institutions must allot ample time to evaluate the certificate of insurance and additional insured endorsement as well as the other party's insurance coverage to make sure they comply with the institution's requirements and to ensure that the policy provides adequate coverage.

5. For ongoing or multiyear contractual relationships, confirm insurance requirements annually.

The contracting party's insurance coverage may change over time or even expire while your institution continues to do business with that party. Institutions need to review the terms of their insurance contract, the terms of the policies listed in the certificate of insurance, and the terms of the additional insured endorsement every year. When the original agreement, certificate, or endorsement has expired, a new one should be issued as long as the institution continues to do business with the other party.

6. Have a process for monitoring and storing insurance documents.

If a claim is brought, the institution has to prove it is covered by the contracting party's insurance policy. Because neither the contracting party nor its insurance carrier may keep track of the certificates of insurance or additional insured endorsements they issue, it is important that institutions maintain and monitor the status of certificates of insurance, additional insured endorsements, and copies of the relevant policies that it obtains in connection with a contractual relationship.

7. Publicize and educate relevant persons about the policy.

The institution needs to educate any staff or independent contractors who are authorized to negotiate, review, or sign contracts about the institution's indemnification or risk allocation practice as set out in the campus contracting policy. Methods for educating staff and publicizing the policy can include posting explanations of or instructions about the policy on the institution's website, conducting training seminars, and publishing articles in various campus communications.

When responsibility is unknowingly assumed for a contracting party's negligence, an institution may suffer large losses for actions or conditions that are out of its control. The time to consider who will bear the risk of loss for third-party injuries in contractual relationships is before an institution enters into a contract. Through proper contract language, insurance requirements, and a sound policy, institutions can better protect themselves in their contractual relationships.

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Appendix

Careful attention to contract indemnification provisions and other insurance requirements can help institutions avoid liability for injuries that they do not cause. However, if a misstep occurs during the process of allocating the risk of loss to the other contracting party, the repercussions for an institution can be both unexpected and serious. The following summary of claims from UE member institutions shows the type of problems that can arise.

I. Mistakes When Using Contracts to Allocate Risk

No written contract

Example A. A college entered into a joint venture with a local resort to provide ski instruction to its students. While participating in a skiing course, a student collided with a snowmobile and sustained severe injuries. The student sued the college for more than $2 million. Because there was no written contract between the college and the ski resort, a court will determine each party's responsibility for the student's injuries.

Example B. A minor suffered an injury while participating in a bungee-jump game operated by an amusement company at a university-hosted festival. The child's parents sued the university and the company. The university and the company did not have a written contract, so it is unclear who will be responsible for the minor's injuries.

Example C. A school allowed a local football league to play a scrimmage on one its fields. A minor participant was severely injured during the game and sued the school for his injuries. The school did not require the league to enter into a written contract that would clarify each party's responsibility for players' injuries. The school is the lone defendant in a lawsuit that will determine whether or not the school is responsible.

Unenforceable or unfavorable indemnification provision

Example A. An employee of a food service company slipped and fell while working at an event at the university. The food service employee sued the university for her injuries. The contract between the university and the food service company had expired two years earlier, so the language addressing risk allocation was no longer enforceable. The university spent tens of thousands of dollars to settle the claim.

Example B. A school and a local company entered into a contract to move furniture. One of the company's employees suffered a severe injury in a fall and sued the school and his employer. Because the contract between the school and the moving company was silent about the risk allocation arrangement between the parties, the school must continue to defend the lawsuit.

Example C. A college allowed a local high school girls' basketball team to use its gymnasium. One of the players fell during a practice and suffered a traumatic brain injury. The player filed a lawsuit against the college. While the college's contract with the high school contained a provision allocating responsibility for third-party claims, the provision was ambiguous. The college incurred costs of more than $1 million to defend against and resolve the high school player's claim.

Example D. An institution hired a company to provide security services on its campus. A security guard employed by the company molested a female student, and the student's parents filed suit against the institution. The contract between the institution and the security company was a form agreement that required the institution to indemnify the company from any claims and losses arising out of the agreement. Because the contract clearly placed responsibility on the institution, it incurred expenses over $150,000 to defend and ultimately settle the lawsuit.

II. Mistakes When Using Other Insurance to Allocate Risk

Defective certificate of insurance

Example. A college allowed a local league to host a basketball tournament at its facility. One of the players slipped on the court, severely injured his leg, and sued the college for his injuries. The college had required and obtained from the local league a certificate of insurance that named the college as an additional insured under the league's insurance policy. Unfortunately, the certificate failed to identify an actual insurance policy, stating only that the policy was "to be determined." Because of the certificate's shortcomings, the college must continue to defend against the player's claim.

Defective additional insured status

Example. A university retained three different contractors to renovate a campus building. After one of the contractors' employees fell from scaffolding at the project site and sustained severe injuries, he sued the university in its capacity as the premises owner as well as the three contractors. The institution did not use consistent approaches with each contractor in obtaining additional insured status to protect itself against the risk of third-party injuries. In one contract, the university required the contractor to indemnify for third-party injuries and also obtained an appropriate certificate of insurance and additional insured endorsement. In another arrangement, the university and the contractor agreed to a mutual indemnification provision, and the contractor provided a certificate of insurance, but named the university as an additional insured only on its excess policy. In yet another, the institution had neither a written contract nor any proof of insurance or additional insured status. Because of the confusion about each defendant's responsibility for the employee's injuries, the case was tried and resulted in a jury verdict exceeding $6 million. The court determined that the university was responsible for nearly a third of the verdict.

Deficient other insurance coverage

Example A. An employee of an electrical contractor suffered second- and third-degree burns over half of his body when he was electrocuted while performing work under a contract with the college. The institution and the electrical contractor had a written contract that contained an indemnification provision transferring liability for third-party claims to the contractor. Also, the institution had obtained a certificate of insurance and an additional insured endorsement. However, the limit of the contractor's insurance policy, $1 million, was insufficient to cover the contractor's extensive injuries, and the college had to contribute more than $1 million more.

Example B. A local group used a school's swimming pool for an event at which one of its participants drowned. The school's contract required the local group to indemnify the institution from all claims or losses arising from its use of the pool. The school also obtained a certificate of insurance and an additional insured endorsement. However, the policy listed in the certificate excluded coverage for bodily injury claims and, therefore, did not provide the school with any insurance coverage for the loss.

Example C. An educational institution contracted with a management company to maintain the apartment buildings it owned. While the management company was cleaning the common areas, an elderly tenant fell on a wet walkway and later sued the institution for her injuries. The contract between the institution and the company contained an indemnification provision, and the institution required a certificate of insurance. Yet, the policies listed on the certificate had expired in the middle of the contract's term. The institution is defending the claim, but expects it will incur six figures to defend or resolve the claim.

Resources

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