Risk transfer mechanisms

Protecting the company by shifting the risk **Interviewed by Denise T. Ward**

Accidents happen. Even if it is something out of the business owner's control, he or she could still face hefty damages. From large corporations to mom-and-pop shops, the issue of risk transfer carries the same weight. The ability to shift risk from one party to another could protect any business's bottom line.

According to Jay Freedman, a partner with the law firm of Newmeyer & Dillion, there are several ways business owners can protect themselves. Common options include general liability insurance, performance or surety bonds and indemnity agreements. Freedman says the key is to know which one is right for the particular business and situation. He also warns that many people sign indemnity agreements (which relieve one party of fault) without realizing it.

Smart Business spoke with Freedman about the importance of paying attention to details and how business owners and other parties can avoid facing costly risks.

Jay Freedman
Partner
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What is risk transfer, and what are the general methods a business can use to transfer risk?

Risk transfer is simply a business taking whatever risk it may potentially face, such as a loss of profits caused by an equipment failure, and trying to transfer that risk to someone else. The most common options are first-party and third-party insurance, and there are indemnity agreements and defense agreements.

How does an indemnity/defense agreement work?

Indemnity agreements require one party to bear a risk that might normally be born by another party. A typical situation could be if you're a commercial landlord and someone slips and falls on your property. As the owner, you can require the tenant to indemnify you for those accidents as a part of the lease.

They are fairly common in many instances and for various businesses, and they can be in the fine print or in the boilerplate on the back side of a standard purchase order. Business owners have to be aware that they exist and read documents carefully before signing and agreeing to them. Like anything else, the devil's in the details.

There are also defense provisions, which mean not only would someone be required to indemnify another party, but they could be required to cover the cost of the defense as well if a lawsuit is filed. The indemnity obligation is typically after the fact, and is usually a reimbursement. The party that is entitled to indemnity seeks reimbursement for money already paid out. On the other hand, the defense provision is typically prospective. It acts from the beginning of the dispute, and if properly worded in the agreement, can require an immediate defense. So, the party entitled to the defense isn't out-of-pocket at all.

What are the different types of indemnity agreements?

In California, there have been three types of indemnity agreements. Under a Type 1 agreement, our hypothetical commercial landlord could be deemed to take part in whatever causes harm to a tenant or customer and can still receive indemnity. The landlord, although negligent, can still transfer risks.

Under a Type 2 agreement, the party seeking indemnity can be passively negligent. The landlord could fail to notice something which later causes harm and still receive indemnity.

Under a Type 3 agreement, if the landlord is negligent at all, actively or passively, the landlord is not entitled to any indemnity.

What are some factors courts will consider in these types of disputes?

The courts want to determine both parties' intent at the time that the contract was signed. The Type 1, Type 2 and Type 3 classifications are generic terms used by the courts to label the indemnity provisions after they've determined the parties' intent. The courts will look at the language of the agreement, the respective bargaining strengths of the parties, their business sophistication and whether or not the particular interpretation, such as a Type 1 versus a Type 3, was commercially reasonable when the contract was signed.

Nonetheless, California has a strong policy of holding people responsible for contracts they enter into, even if they haven't read a particular provision. So if a business owner enters into an indemnity agreement without necessarily realizing it, he or she could be bound.

How can business owners protect themselves from facing risks?

First, they have to look at what their risks are. Different businesses have distinctive risks at all levels. They have to look at all the possible ways they can be affected by issues in and out of their control. Second, they should sit down and determine if they can transfer those risks to another party. Finally, they need to make sure that the contracts they're signing have the right indemnity language to meet the business owner's goals.

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