You Can Reduce Your Contracting Risks

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One frustration all risk managers experience is being brought into the contract process when it is too late to reduce the risk. Only yesterday, I was asked to review a contract for the acquisition of health equipment. When I sent my recommendations back to our contract negotiator I was told “But it’s too late – we already told the supplier that the draft they approved was the final version.” The best time to negotiate contract terms and conditions is before the contract is signed! Contract law is complicated, involving numerous federal, state and municipal laws (not to mention internal policies, procedures and protocols!) that apply different conditions depending upon the type and cost of the item under consideration. Terms in the tender document or request for proposal are the starting point for most acquisition processes. The language of the tender or RFP is critical to successfully achieving a satisfactory relationship with the supplier of goods or services. The terms of the tender document, with the terms of the successful bidder’s response, are substantially the terms that will be included in the final contract. Procurement officers need to know the extent of negotiating ability they have upon receipt of bids or proposals. The variety in responses possible from bidders can often lead to very good reasons for going off in a new direction. But, straying too far from the tender specifications can quickly lead to multiple claims from unsuccessful bidders. Purchasing and Risk Management Departments must work closely with other corporate colleagues to review or create business contracts that limit the organization’s liability exposure. Well-drafted, the indemnification and insurance clauses ensure that if something goes wrong it is clear who will bear financial responsibility. The Risk Manager’s Role The importance of risk transfer requires Involving risk management early in the process. The risk manager can help examine the purpose of the contract from an ‘outsider’s perspective. Specifically - what could go wrong with the work (or product/service)? If something were to go wrong – what are the implications of that problem? “Implications” can be financial cost, a delay in using the end result (e.g. a building), negative publicity or any combination of these three outcomes. Risk manager can provide advice and consultation in structuring tender or RFP, assist colleagues in properly drafting contracts consistent with corporate policies and minimize financial risk by identifying and dealing with possible contingencies. They do this because they know that poorly prepared contracts can lead to nasty surprises. You want to enter into contracts with some assurance that the end result will satisfactorily meet your expectations. The classic risk management process is helpful in conducting a review of any proposed transaction. To avoid surprises, you need to identify risks by considering what potential downsides can arise from the project. Once this step is complete, assess the risk by determining how likely it is that something will go wrong and if it does, how expensive the problem is likely to be. The contribution of the risk manager to the contract language is central to successfully achieving risk transfer. Clearly define the circumstances under which the contractor will hold harmless and indemnify the municipality for losses arising from the supply of goods or services. If a serious loss occurs, these clauses can be analyzed word-by-word. Any ambiguity is likely to be held against you. Review and revise both the hold harmless and indemnify clauses until it is absolutely clear to you and to your procurement officer. The term “Contractual Risk Transfer” is used by risk managers to avoid saying ‘passing the buck’. The goal is to always make the party who has control over the products or services accept financial responsibility. Usually insurance does not cover problems arising from poorly-drafted contracts, negligence in the procurement process or poor performance of the work described by a contract. For example, there is usually no coverage for situations where unauthorized employees engage in work under an unapproved contract or for breach of contract claims. Poor business judgments and financial mistakes are also the responsibility of the organization. Claims arising from these errors typically must be paid by the municipality as those costs are rarely transferable to insurers or anyone else. The municipality is likely to incur all of their own costs arising from problems, plus any award to the claimant. Always use written contracts and state terms and conditions clearly. In many situations verbal agreements are legally permissible. Properly drafted written contracts, however, reduce the chance of misunderstandings in the future. Documented business transactions protect the rights of all parties to the contract. The written contract provides an audit trail and authorizes the use of funds when paying invoices. Further, if the subject of the contract becomes an adversarial issue due to a lawsuit, the contract can show the intent of both parties at the outset of the work. Written agreements ensure both parties have an opportunity to clear up at the negotiation stage any confusion or differing interpretations. The main purpose of written contracts is to prevent conflicts or litigation caused by inadequate documentation of crucial points. It is time-consuming and expensive to take issues to court for interpretation. Judges may interpret the contract differently than either party intended. The courts do not usually consider very great weight to verbal evidence as verbal statements are considered unreliable once a dispute has arisen. When contracts are vague or indefinite, or the intended performance cannot be determined, the court may rule the contract unenforceable - to the disappointment of both parties. Power does not always prevail – when one party is larger than the other it may make them feel that they can dictate contract terms and conditions. Remember that you want a contract that is enforceable. When unfair bargaining strength is used, it can become contentious later if other problems arise. It is in all parties’ best interest to avoid ambiguous language and unreasonable or unlawful conditions. Always be prepared to be flexible and to take the time required for a good result! Remember, it is important to note that any language showing a clear intention to negotiate cannot defeat an inherent duty of fairness with which the municipality must conduct themselves at all times. The trade-off is clear: the more extensive the negotiations, the more stress it puts on the municipality’s duty to be fair to all bidders. To ensure changes are binding make them in writing and have the amendments signed by duly authorized representatives of both parties. This documents the change, provides clarity and binds both parties should problems arise later. Three clauses complement and support the risk management process. They are hold harmless, indemnification and insurance. I recommend that these clauses be written separately. In most vendor-provided contract documents, the Indemnification/Hold Harmless provision is far broader than what your organization would want to accept. Many vendor-provided indemnification and hold harmless clauses are limitless. If you accept these clauses you may be accepting responsibilities that your organization never wanted nor intended to assume and may not be able to insure. Usually you want to only sign contracts where the language limits your liability to acts over which the municipality has control and to the extent that it exercises that control. Assuming liability for independent contractors and consultants who are not under the municipality’s control is unwise. The intention of the hold harmless clause is to describe exactly what type of circumstances the supplier accepts responsibility for. In particular, they specify who will pay for loss or damage arising out of the performance of the work contemplated by the contract. Most corporations will only enter into contracts in which the indemnification language limits their liability to acts over which they have control and to the extent that they exercise control. The hold harmless clause however, is only one clause of the trio needed to adequately protect the

parties. The second clause used is an ‘indemnity clause’. It will state that if something does occur leading to a loss, of a type that I/we have held you harmless for – then we will pay on your behalf (or reimburse you) any costs arising from our negligence. In other words, ‘the buck stops here’. The final clause of the trio is the insurance clause. The insurance clause promises that the party performing the work (e.g. builder, supplier, etc.) will obtain and maintain the type and amount of insurance that you have stipulated to pay for any claims, losses and related expenses that may arise out of their negligence in performing the work planned in the contract. The intention is to ensure that the contractor has sufficient financial resources to support the indemnification provision in the contract. With these three clauses, you have obtained a promise from your supplier or contractor to: 1. accept responsibility for their own errors or negligence, 2. pay any costs arising from those errors or negligence, and 3. carry insurance evidencing sufficient resources to keep their promises. Often, I find that contract document presented by contractors have been written by lawyers or other ‘non-insurance’ professionals. In these cases, the language used may be out-of-date or simply not reflective of terminology used by insurance professionals. When this occurs, it is prudent to revise or replace those clauses with descriptions and phrases commonly used in the insurance industry today. This reduces the chance of ambiguity and difficulty in obtaining evidence of the type of insurance you want the contractor to carry. The most common example I see is the phrase “Additional Insured’ VS ‘Additional Named Insured’. It is important that this phrase be limited to ‘Additional Insured’. Additional Named Insureds have at least two disadvantages: only Named Insureds are responsible for paying premiums and some policy exclusions apply only to Named Insureds. Benefits to your municipality of being an additional insured are: Coverage remains in force for Additional Insureds if a Named Insured breaches a policy condition, Reinforces risk transfer agreements in the contract, The Additional Insured has a right to claim defense from the insurer, and It usually prevents the insurer from subrogating from the Additional Insured. Certificates of Insurance: There is much debate amongst the risk management and insurance community about the value of obtaining and maintaining evidence of insurance on contracts. Certificates of Insurance verify the type of insurance that the Named Insured on the policy has purchased and specifies the coverage levels under that policy at the point in time that the certificate is issued. I firmly believe that certificates are of limited value – but they are the best and only evidence available at this time providing some level of comfort that contractors have a source of funds for defined claims situations. There are two broad categories of certificates, those that you receive coming in and those that your send out to other parties. Municipalities usually receive certificates and infrequently send them to others. Incoming certificates of Insurance are commonly issued by the contractor’s insurer or insurance broker. To be valid, I want to see the ‘live’ signature of a person authorized by the insurer to issue the certificate. Before issuing a certificate, the insurer wants some information describing reason for the certificate, the length of the subject of the certificate (e.g. a multi-year contract) and specific details of the name of the contact person/mailing address of their and at your organization. Upon receipt of a certificate in your office, you will want to see at least the following information: • name and address of the organization to whom the Certificate is being issued, • brief description of planned activities/work, • name and address of the Named Insured, (who must match the name on the contract) • amount and type of insurance in force, • effective dates of coverage, and • a statement that your municipality is included as an ‘additional insured’. When you are asked to issue certificates of insurance you should review the contract to be sure that you provide evidence of the proper type and amount of coverage required. Under no circumstances should you issue a certificate on behalf of any party or other organizations independent of your municipality, no matter how close a working relationship you may have with it. When reviewing tender or RFP documents and the contracts that arise from them you can effectively use the risk management process to review the proposal and draft appropriate language. Manage exposure in any contract situation by ensuring conformity with generally accepted ‘due diligence’ practices from the very beginning. Be sure that appropriate risk transfer provisions are included at the tender or RFP stage. Finally, once the contract draft is agreed upon, ensure that evidence of insurance (and bonding, if required) is obtained and maintained throughout the life of the contract. As a risk management professional, remember that your training and experience makes YOU an expert who can protect your municipality.

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