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## Protecting your bottom line from careless third parties

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So, you're contemplating significant levels of self insurance. How can you ensure that your contractors and other business partners comply with *their* insurance, contractual and statutory obligations? This article reviews the importance of contractor compliance and tracking.

If you are considering self insuring through a captive insurer or significantly increasing your level of deductibles, have you considered liabilities created by your contractors, lessees, licensees, suppliers and other business partners in your risk assessment? Do you know what those liabilities are and have you quantified them? Whichever approach you take, your company's risk exposure can be reduced by ensuring its business partners and contractors comply with their contractual and statutory obligations as well as the extent to which you can rely on their insurance cover.

When work is outsourced to utilise specific skills not available in your company or to achieve cost savings, you cannot assume that your business partners' work practices will meet the highest standards. Organisations often suffer physical, financial and other losses when their business partners or contractors make mistakes or fail to comply with their contractual and statutory obligations. It is essential to have a contingency plan for this.

It is not just in the United States that multi-million dollar losses occur. Remember the following cases?

- On 30 August 1994, Knox City Council in Melbourne suffered a major fire which was estimated to have cost \$12.5 million.
- On 1 July 1997, Bankstown City Council work being carried in the Civic Centre caused a \$30 million fire.
- One of the most dramatic contractor related incidents in Australia happened on 5 May 1998 aboard the HMAS Westralia, when flexible oil hoses in the engine room burst causing a serious fire in which four sailors died and the ship itself was damaged. The enquiry found that the Royal Australian Navy (RAN) and the contractor did not critically examine their course of action and that

key personnel in the RAN and the contractor were insufficiently trained and qualified.

- A catastrophic fire at the Brescia furniture factory on Parramatta Road at Ashfield in Sydney on 11 March 2005 was one of the largest in the Sydney metropolitan area for many years. Total damage and insured and consequential losses were stated at \$17.3 million. The cause of the fire was sparks from an angle grinder which ignited flammable residues in the immediate vicinity.
- The Metropolitan Fire and Emergency Services Board in Melbourne has reported that 165 fires were started by cutting and welding in Melbourne over a five-year period. This work often involves contractors.

So how do you protect your company against the risk of contractor negligence and default? The answer is to conduct appropriate project risk assessments, implement a contractor compliance program and optimise your contractual risk transfer.

### Risk assessment

The importance of contractor management is often overlooked in risk assessments. To make your risk transfer efforts as effective as possible it is fundamental that you conduct a risk assessment of every new activity, contract or project where contractors are involved because you cannot manage risks that you do not understand.

Project risk assessment should involve:

- determining (and documenting) the context of the contract/project/activity, the stakeholders, assumptions and your organisation's objectives;
- identifying, quantifying and rating all risks of the contract/project/activity;
- ranking the risks in order of size and determining the maximum foreseeable loss (MFL); and
- identifying the parties best placed to manage the risks you have identified.

## Documenting the contract

Formal contracts should be used to record the terms of the agreement for major work or projects. Specify the licensing and other relevant regulations you require third parties to comply with and prescribe the evidence they must provide. In each contract, clearly allocate who is responsible for managing the various risks. This may be as simple as a contractor agreeing to accept all operational risks. If the contractor cannot eliminate or control the risk, you will have to modify your approach.

There will be situations where formal contracts will not be practical. In these cases, purchase orders or a letter of acceptance countersigned by both parties should incorporate the basic terms of the contract including indemnities and insurance conditions.

It is worth retaining a lawyer experienced in both insurance law and litigation to create a standard suite of contracts and agreements with model indemnity and insurance clauses and drafting notes for different contract types which can be used in the majority of cases.

## Indemnities

Rather than relying on a common law right of action against a negligent business partner, a comprehensive indemnity, which forms part of the contract with the business partner or contractor, can provide wider protection.

The benefit of effective indemnities is illustrated by the experience of one NSW Government entity. Of 135 reported incidents over a two-year period, 39 proceeded as claims. In 20 of those cases, an indemnity enabled recovery from a third party. Generally, you will seek the broadest indemnity possible in your favour and ensure that indemnities you give are as narrow as possible.

Most liability and special risks policies exclude contractual liability, such as a broad indemnity, that is not concurrent and co-existent with liability in tort for the negligence of the third party. Accordingly, unless special insurance cover is obtained, your ability to recover under a broad indemnity will depend upon whether the third party has the financial resources to cover the relevant loss.

## Insurance clauses

It is essential to consider the wording of the insurance policies obtained, not only for your company but also the policies that you require your business partners and contractors to obtain, as follows:

- Insurance policies and relevant specific clauses must cover your reasonably anticipated risk exposures. Check the policy limits, the type of cover, the period of cover, the relevant exclusions and the deductible excess. Your risk assessment will be crucial in ensuring these are appropriate.

- Public/product liability and property policies should be extended to cover you either as a named insured or, endorsed to note your interests. Section 84 of the Insurance Contracts Act 1984 (CW) states that “where a person who is not a party to a contract of general insurance is specified or referred to in the contract ... that person has a right to recover the amount of the person’s loss from the insurer ... notwithstanding that the person is not a party to the contract”. If this is done properly, you can simply pass any legal action over to your business partner’s insurer to handle on your behalf.
- Specify your requirements for proof of insurance. Certificates of currency are considered to be sufficient by many; however they do not disclose the policy wording and exclusions. Decide and specify what level of detail you will accept. This may vary for different levels of risk exposure.
- Consider how you will respond to business partners and contractors who have high excesses/deductibles in their insurance policies. If they do not have sufficient capacity to meet that deductible, it is likely you will have to involve your own insurance cover. Decide and specify the maximum level of deductible you are prepared to accept and the evidence that you require of their capacity to pay that deductible. Bear in mind this capacity may change over time.
- Consider adopting and specifying objective criteria to guide all parties on the minimum acceptable level of insurer security. For example, you may require insurers to be approved by the Australian Prudential Regulatory Authority (APRA) and meet a minimum solvency rating by AM Best/S&P instead of just referring to “insurers acceptable to the principal”.
- Insurance clauses must reflect market conditions. There is no point including requirements that cannot be met. In longer term arrangements, the availability and cost of the preferred insurance may change. For example, the market for professional indemnity cover can be quite volatile and may be unaffordable at certain points in the insurance cycle. Therefore, you should include a clause which allows the parties to re-negotiate the requirements should circumstances outside the parties’ control change.

## Why verify contractor compliance?

Beyond ensuring that your business partners and contractors hold the required insurance, licences and other statutory obligations, verification and tracking of these documents over the life of the contract and for the balance of the claim limitation period is essential so that:

# Risk Management

Today

- they can be located when required for insurance claims, legal disputes and other circumstances; and
- you can rely on the insurance policy to provide the protection required when called upon.

Organisations which fail to adequately protect themselves against the risk of non-complying or non-existent insurance and statutory compliance generally fall into one of two categories:

- those that do not track compliance documentation at all; or
- those that do it once when they're initiating a contract but then allow the documents to expire.

Allowing cover to lapse is particularly common with professional Indemnity (PI) insurance, which is often required to be carried for years after the work has been done. Some PI insurance only responds to claims made during the currency of the policy and frequently such claims only emerge several years after the work has been done.

Document tracking and verification is often poorly resourced in terms of personnel and systems. For example, a poll of people handling insurance documents in one organisation found that:

- 35% said they did not follow up on policies which expired during the contract;
- 85% did not check the claims paying rating of the contractors' insurer;
- 55% said they had inadequate systems for managing contractors' insurance;
- 74% felt that people checking insurance documentation had inadequate insurance experience; and
- none followed up expiring PI insurance.

Seeking to enforce indemnities without solid knowledge of the insurance situation may be unsuccessful in achieving any recovery and permanently damage an otherwise fruitful relationship.

The NSW WorkCover Subcontractor's Statement requires certification that the contractor has workers compensation insurance, that all employees are being paid at the appropriate award or industrial agreement rate and that the contractor is paying its liability for payroll tax. Unless the principal has obtained the subcontractor's statement it can be liable to WorkCover for the unpaid premium relevant to the contracted work, to the contractor's employees for any amount they were underpaid or the NSW Office of State Revenue for unpaid payroll tax relevant to the contracted work.

The occupational health and safety (OH&S) legislation, including the new provisions dealing with workplace fatalities, will have an impact if there is an

accident in which the contractor or one of their employees does not hold a current appropriate licence for the activity concerned. Penalties for breaches of the OH&S Act 2000 (NSW) and OH&S Regulations 2001 (NSW) are substantial — up to \$55,000 for individuals and \$825,000 for corporations. If a death in the workplace is involved, the penalties are up to \$165,000 and/or five years imprisonment for individuals and \$1,650,000 for a corporation.

Certificates of insurance, licences and other important documents accepted without checking may contain deficiencies that will not be identified until the document is called upon after something has gone wrong. The reasons for accepting deficient documents may include:

- lack of experience and a lack of appreciation of the consequences by the reviewer;
- lack of standard documentation in the insurance industry;
- use of technical jargon; and
- lack of detail offered by brokers/insurers in certificates.

## Issues encountered in reviewing insurance documentation

Some of the important issues likely to be missed by inexperienced reviewers include:

- Deductible excesses which are higher than that acceptable to the principal. We have seen deductibles in the range \$300,000 to \$1,000,000 carried by some large firms. This may be acceptable if that organisation has sufficient financial resources. *But what if they don't?*
- Brokers can be reluctant to disclose the level of excess. The principal is entitled to know the point at which the policy will become effective in order to manage its own risks. While this may test the relationship, it should be done at the beginning when the goodwill between the parties is the highest.
- Failure to name the principal on the policy or note the principal's interests.
- Failure to disclose the identity of the insurer where the underwriting agency is named as the insurer. The underwriter is not the risk carrier and this prevents a review of the actual insurer's solvency rating.
- Offshore insurers not approved by APRA and without an acceptable rating from a recognised rating agency.

## What are the options for tracking and verifying insurance and other compliance documents?

### *Do-it-yourself approach*

Spreadsheets are suitable for many tasks, but have serious limitations when large volumes of data and

scanned images are involved. They also require a reasonably high level of skill to set them up in the first place and are limited in their functionality. Your staff has multiple responsibilities which are often given priority over timely document verification and tracking so ideally you would have an appropriately configured web-based software application.

Such a system needs to incorporate:

- secure access to users across the organisation;
- automated workflows;
- reminders and escalation processes;
- dashboards with reminders;
- limited access for third parties to upload their own documents; and
- checklists and prompts to assist users to confidently validate the documents received.

### ***Decentralisation of the do-it-yourself***

This usually means that the job is spread out around the organisation but unless staff is using the same system, there is increased opportunity for inconsistencies and mistakes due to lack of insurance knowledge. This usually involves even less priority with other responsibilities.

### ***Outsource the process to an insurance broker***

Some insurance brokers will handle this process for their major contracts/agreements but the client's largest potential exposure lies with smaller operators who probably don't have a broker themselves and may disappear or go out of business without warning, large scale certificate tracking is not a core activity for insurance brokers. If the organisation changes its insurance broker (as happens frequently) access to documents or historical data may not be available.

### ***Outsource the task to a specialist***

A specialist firm with the right software and experienced people can provide an outsourced service but this comes at a cost per certificate or per contactor which can quickly add up.

When considering the cost of an in-house or outsourced system, ensure you take into account the potential costs of not doing it at all.



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