

Step 1 — Identify and Measure



Identifying

“If you do not identify a risk you cannot manage it.”

The focus of this chapter is on identifying the risks of loss that may arise out of the activity contemplated in a contract and making an estimate of the potential severity that may result from each type of identified risk. This sounds like a more complex concept than it is in application because as a practical matter, one cannot accurately predict the potential financial consequences of each type of loss that could arise from the contracted activity.

Since insurance is the principal source for financing risks arising out of contracts, some discussion of what risks (exposures) insurance addresses is a good start. Insurance policies protect against some type of insurable risk of loss. However, most are designed to address specific types of risks such as third-party injury or damage (liability insurance), economic loss due to crime (e.g., “theft” insurance) or professional errors (errors and omissions liability insurance), loss to one’s own property (property insurance), compensation for loss and expense due to work-related injury (workers compensation insurance), and more. Some of the most common risks addressed in contractual risk transfer are discussed below.

Insurable Risks

Contractual risk transfer involves not only allocating responsibility for loss arising out of the contracted activity, but financing the cost of the loss for the protection of all parties. The best and most common way of achieving that protection is insurance. Table 1 shows some of the common exposures to loss and typical types of policies for insuring them.

Table 1 — Insurable Risks of Loss (Exposures)

Exposure	What It Is	Applicable Coverage
Bodily Injury Liability (“BI”)	Includes bodily harm, sickness, or disease, including resulting death. It can be caused by a “tort” (a civil wrong), when someone negligently injures another, or by failure to exercise the level of care expected of a person held to a higher standard of care, such as an architect or engineer.	Bodily injury (“BI”) is insured under commercial general liability policies. BI is also covered under automobile liability, pollution liability, aircraft liability, professional liability and watercraft liability policies and other types.
Property Damage Liability (PD)	“Property damage” includes physical injury to tangible property including resulting loss of use of tangible property that has not been physically injured.” “Property damage liability,” refers to liability for causing damage to property of another.	Like “Bodily Injury,” property damage liability also may be covered under different types of liability policies, including general liability, auto liability, pollution liability, professional liability, aircraft liability, and watercraft liability policies.
Personal Injury	“Personal injury” and “bodily injury” are used interchangeably, notably by attorneys and in some umbrella liability policies. In primary liability policies, however, personal injury describes injuries that do not cause direct physical harm, such as: false arrest, detention, or imprisonment; malicious prosecution; wrongful eviction; slander; libel; invasion of privacy.	Personal injury coverage is included in standard general liability insurance policies.
Advertising Injury	“Advertising injury” includes the offenses of libel, slander, invasion of privacy, copyright infringement, and misappropriation of advertising ideas, when occurring in connection with the advertising of goods or services.	Advertising injury coverage is included in standard general liability insurance policies.
Environmental Damage Liability	Damage to the environment caused by negligence can result in fines and clean-up expenses, imposed by governmental agencies.	Policies specifically designed to address these costs are available under various names.

Exposure	What It Is	Applicable Coverage
Pollution Liability	Pollution liability resulting from a pollution incident includes property damage, loss of use, and clean up requirements and expense. This is a common exposure for many construction contractors.	This coverage can come in different forms, but a common type is contractor's pollution liability, which covers losses caused by the contractor's activities, such as excavation, or by release of pollutants brought onsite by the contractor.
Economic Loss Liability	"Economic loss" means monetary loss resulting from errors or omission, or as a result of crime. Examples include loss resulting from a building, that cannot be occupied because of an error made in the design of the ventilation system; delay in opening a housing project resulting in a loss of revenues; pollution cleanup; and losses due to crime such as forgery, theft, employee dishonesty are also economic losses.	Many different types of policies could cover economic loss, including: Crime Employee Fidelity Professional Liability Pollution Cyber Liability
Damage to One's Own Property	Most damage to property is caused by natural perils. However, humancaused perils can also result in loss, such as accidental or intentionally caused fire, lack of safety precautions, etc. Insuring loss of one's own property.	For owned property, standard commercial property insurance policies are appropriate. For property under construction, "builder's risk" insurance is often necessary. This coverage may be arranged by the contractor or by the owner.

Measuring

The next part of identifying risk arising out of a contract is to consider the types of [exposures](#) the contract may create and to measure (estimate) severity in order to select appropriate limits. Below is a very simplified exposure analysis register designed to help the contract administrator think about the possible financial consequences of loss associated with the activity and appropriate insurance. This process should help lead to logical conclusions about reasonable insurance limits and coverage specifications.

Selecting appropriate limits is not an easy decision. There is merit in consulting with others in your organization to achieve a consensus about how much may be enough.

However, selecting appropriate limits is a sensitive task. For most service agreements such as repair and service technicians, smaller contractors, other service providers, etc., typical limits are:

General liability insurance	\$1 million/occurrence \$2 million aggregate
Auto liability insurance	\$1 million combined single limit ("CSL")
Workers compensation insurance	Statutory benefits, \$1million employers' liability

Factors to consider when selecting limits are safety and loss prevention strategies; size, severity or probability of larger losses; insurance purchasing custom and practice in the geographical area of the activity, and more. Sometimes negotiation with bidders or chosen providers is also a factor. In other words, if your limit requirements are too high (or other conditions are too strict or unobtainable) bidders may walk away.

To evaluate the risk and need for insurance coverage from your organization’s contractors and service providers, you also may need to confer with your organization’s legal counsel or risk management advisor. The identification and measurement of risks involved in the contemplated activity is possibly the most important part of the process of managing risks in contract situations. It requires time and thought.

Table 2 shows some examples of typical exposures to consider and provides some thoughts about limits. As noted in the table, some limits decisions should also consider other exposures that will be insured under a single policy or several policies.

For example, a construction contractor’s general liability insurance policy covers a wide variety of potential losses from many different types of activities. Some of these exposures are found primarily in certain types of contracts such as projects involving cranes, work near a railroad, and demolition in construction. Other examples include aviation and watercraft usage, which are special risks with high loss probabilities and requirements for special insurance.

Generally, you should require limits based on the highest potential loss probability and largest potential loss exposures. For insurance requirements for exposures unique to certain activities, consider consulting advisors, including Synchronus.

Severity Measure

Table 2 – Severity Measurement Examples

Exposure	Risks	Insurance	Limits
Crowds	Multiple casualties, riot/civil commotion, property damage	General liability combined with excess liability for higher limits	Crowd exposures justify higher limits than provided in primary general liability. Consider limits of \$10 million or more
Physical violence/law enforcement	Possible different scenarios such as assault, demonstrations, etc.	General liability combined with excess liability for higher limits	Consider \$5 million or more depending on the estimated probability and severity of loss
Hazardous materials/waste remediation	Contamination, injury to third parties or employees, improper disposal	General liability and pollution or environmental impairment liability	For known exposures, \$5 million or more, depending on the estimated scope of the issue

Exposure	Risks	Insurance	Limits
Demolition	Collateral damage to property, discovery of hazardous materials, disposal errors	General liability and pollution or environmental impairment liability	Usually part of an overall construction liability coverage program, so limits should also consider related exposures
Excavation	Utility damage, release of pollutants, bodily injury	Contractors pollution liability, general liability, workers comp	Usually part of an overall construction liability coverage program, so limits should also consider related exposures
Proximity to bodies of water	Bodily Injury, flood, marine liability	Possible maritime liability (USL&H, Jones Act, etc.), flood, Protection & Indemnity coverage	Maritime exposures are at least partially excluded by general liability policies – limits usually should be \$5 million or more
Tunneling or boring	Collapse, sink holes, release of pollutants, bodily injury, third party property damage	Contractors pollution liability, general liability, workers comp	Usually part of an overall construction liability coverage program, so limits should also consider related exposures
Cranes	Possible major bodily injury and property damage from misuse, falling over	General liability and contractors' equipment coverage	High limits usually appropriate, depending on the size of the project and the crane – \$10 million or more is likely reasonable
Use of aircraft or watercraft	Bodily injury, property damage, damage to air or watercraft	Specific coverage for aviation or marine liability	General liability insurance excludes any significant aviation or marinerelated exposures. Generally higher limits for marine and aviation are appropriate.
Work near railroad	Damage to railroad tracks, equipment, rolling stock, derailment, collision	General liability modified to remove exclusions, and railroad protective liability insurance	The railroad granting access to the contract will set the limits, but your contract should make the contractor aware of the need

Exposure	Risks	Insurance	Limits
Professional services	Bodily injury, property damage, economic loss	General liability, appropriate professional liability, auto liability if used	Usually minimum (\$1MM) limits except for professional liability and higher limits for other liability for large projects — relatively few professional service providers carry more than \$2MM
Known exposure to flood, earth movement	Significant property damage and bodily injury potential	Property insurance: either permanent property or builder's risk, general liability, excess liability	For project (builders risk insurance) — completed value; for other e.g., lessees contents — replacement cost
Offsite property storage	Damage to property	Property insurance with specific coverage for offsite or in transit	Usually included with either permanent property coverage or builder's risk — replacement cost
Use of vehicles	Bodily injury and property damage	Auto liability, coverage for transport of hazardous materials if appropriate	Depends on use — minimum of \$1MM combined single limit, more for hauling, work in highway construction zones, etc.
Crime risk	Loss of money or valuable property forgery, extortion	Crime and/or employee fidelity insurance depending on circumstance	Value of exposure
Delay risk	Delay in start up during construction resulting in financial loss	Property insurance with specific coverage for delay from insurable events	Typically six months to a year's worth of lost revenue — may include extra expense
Alcohol service	Serving alcohol at events that could result in accidents due to alcohol consumption	Possible need for liquor liability coverage e.g., contracts with caterers	Try to get \$5 million, but there may be restrictions in available limits from coverage markets
Cyber risk	Intentional damage to systems, data breaches, extortion, theft,	Cyber liability	Require \$5 million or more cyber liability from information systems firms, less for other coverages, i.e., GL, Auto, etc.