Specialty Human Services

Protect and Point Fingers: Third Party Liability and Risk Transfer

All nonprofits depend on support and services from external partners such as for-profit vendors, public entities, and other nonprofits. These relationships remain beneficial when a nonprofit team understands why and how to transfer responsibility for risk to its partner entities. Prepare to protect your mission, assets, and reputation by understanding and applying smart risk transfer strategies.

Why Transfer Risk?

Risk transfer is a method of funding losses using external funds (such as insurance), or by sharing responsibility for financial or legal ramifications with another organization. Risk transfer can help protect an organization from harm or damage caused by its partners, for example, in situations like these:

- You allow another charity to host a meeting in your office space, and your guests accidentally trigger the sprinkler system, causing significant water damage to your property
- You engage a partner organization to facilitate a unique day program for the developmentally disabled adults living in one of your facilities and learn that one of the partner's employees allegedly assaulted one of your clients
- Your hospital relies on third-party software to manage the electronic health records of your patients; the software vendor experiences a data breach and your patients' protected health information is exposed
- You hire an electrician who leaves uncovered cables out in your office space, and an employee trips on the cables and breaks her ankle
- Your caterer fails to follow safe food handling practices and hundreds of guests become severely ill at your fundraising gala

How to Transfer Risk to Partner Entities

Risk is often shared with—or transferred to—another party through a contractual agreement. In a contract, risk is transferred through two primary methods:

- Indemnification provisions
- Insurance requirements

Indemnification Provisions

Black's Law Dictionary defines *indemnity* as "a duty to make good any loss, damage, or liability incurred by another." Indemnification has the power to transfer the cost of defending and paying damages that arise from a third party claim or lawsuit filed against your organization. In a contract, the indemnification provisions explain how one party will make its partner whole for losses that the party incurs. Essentially, indemnification language describes which contract parties are responsible for losses.

Ideally, indemnification provisions should place responsibility for specific risks on the parties who have the greatest control over the potential sources of risk. Using indemnification, risk can ideally be shared equitably, making each party responsible for its own acts or omissions that might result in losses. Nonprofit leaders should be careful not to assume responsibility for any acts that are outside of their team's control, or that are within the control of a partner entity. Indemnification wording should remain broad, not to exceed what is allowed by state statutes or case law. In some cases, language should clearly indicate the costs that are being transferred to the partner entity, for example, legal defense costs as well as costs from property damages and bodily injury caused by the partner.

Nonprofit leaders might also be familiar with the term *hold harmless agreement*, which is another type of language used in contracts that provides for a release of liability. Its purpose is to ensure that one party will not hold the other party liable for any losses. Hold harmless agreements are either mutual or unilateral, usually protecting one or both contract parties from being sued.

Explore opinions about **using indemnity or hold harmless language** (or both), and review **state statutes** to understand the types of language that will most benefit your nonprofit in contractual risk transfer. Also, invest in a legal review of your contracts to ensure that they truly provide the protection you need.

Insurance Requirements

Contracts should include various insurance requirements that the nonprofit expects its partner entity to have in place in the event of a loss. It is important to note that indemnification and insurance exist independently, so it is crucial to confirm that a third party is actually prepared to pay for potential losses using its insurance. When designing partnership contracts, take the time to ensure that these two components—indemnification language and insurance requirements—will work effectively together to provide the level of protection your organization deems necessary.

Begin setting insurance requirements by understanding the insurable risks that might arise from your partnership and your partner's activities. Determine the types of insurance and insurance limits your partner should have in place. Ensure that a partner's insurance policy covers contractual liability and does not exclude coverage for specific losses that could potentially arise from your partnership. Also, determine whether legal defense costs are included within insurance limits; if they are, any defense costs will erode the limits of coverage available to your organization. Consider establishing specific procedures to check a partner's compliance with the insurance requirements laid forth in your contract, for example, use contract language that requires a partner to notify you of changes or cancellations to their coverage.

A nonprofit should procure a certificate of insurance from its partner as evidence that the partner has the required insurance in place. Certificates themselves do not actually transfer risk, so along with a certificate, the nonprofit should also procure any relevant endorsements of its partner's insurance coverage. For example, if you require that your organization be named as an additional insured on the partner's insurance coverage, you should request an endorsement to confirm that the partner's coverage was amended as you requested. Endorsements illustrate changes made to insurance policies.

Additional insured status gives an organization certain rights and access to coverage from its partner's insurance policy. For example, being an additional insured could potentially provide coverage for your organization in the event that you are sued for harm that your partner caused. Depending on the language in an additional insured endorsement, your organization might be afforded full policy protection. In other circumstances, the additional insured's rights might be narrower than coverage available for the named insured or primary policyholder. For example, additional insureds are only covered for events that involve the named insured in some way; and, additional insured endorsements might outline specific exclusions that apply only to the additional insured. A nonprofit team must take care to fully understand its rights as an additional insured on any partner's coverage.

Collaborate with your trusted insurance agent or broker to learn more about insurance requirements relevant to contracts and your goals for risk transfer.

Related Resources

Transferring risk is a critical component of risk management when leveraging third parties. Establish effective partnerships by exploring these related risk management resources shared by the Nonprofit Risk Management Center:

- **Collaboration: Building the Intentional Partnership**
- **Drafting a Memorandum of Understanding**
