Handling Risk Through Insurance
The Mere Purchase of an Insurance Policy Doesn’t Cover All Losses

By Charles F. Patterson

“'I am insured.'

How many times have you heard a contractor say that. Indeed, have you ever said it to yourself, believing like the other fellow that the mere purchase of an insurance policy automatically provides complete coverage against just about any type of loss that could occur.

The truth of the matter is, any insurance policy provides very special kinds of coverage and the extent and limit of this coverage determines the amount of premium you pay. It is not always the case that you are paying for the kind of coverage you want or need.

In the coming months, the purpose of these articles will be to inform and educate contractors in the buying of insurance that they need and not what the insurance broker or company is selling. To be effective in the buying of insurance one must thoroughly understand the concept of risk management. We will be referring to risk management where one might expect to see that tried and true old term, insurance. Risk management is a much broader concept in that it deals with the firm’s total risk problem rather than just one of the solutions.

We should recognize that there are three distinct categories of accidental loss:

First, every business has a number of small losses which occur annually but, in the aggregate, have no particular disrupting financial effect. It is basically uneconomical to process these relatively small accidental losses to the extent of an insurance mechanism because the end result is to trade dollars with an insurance company, paying for the privilege. It is generally far more efficient to simply absorb them as a cost of doing business, like most other stable, routine business expenses.

The second category of accidental losses involves fewer incidents but larger costs individually and annually. There is less stability in this category and budgeting is more difficult. The most frequent solution to this problem has been insurance, in which the premium expense is often the sum of the losses plus the expense of insurance company’s claims administration, overhead, taxes, and profit. In many instances, scrutiny of cost elements uncovers possible savings through deductibles, self insured areas, or other risk management alternatives.

The third category is catastrophic loss where, although in occurrence, the maximum possible loss is so great that it could materially effect the liquidity, profitability, or solvency of the enterprise. Insurance remains a preferred solution to this problem, but even here there are some variable risk management alternatives.

Understanding that most contractors and other business ventures face a combination of these risk perils, we can apply a proven equation to managing risk:

Risk Management equals minimizing the sum of:

Self-insurable losses +
Insurance Premiums +
Loss Control Expenses +
Administrative Costs

Looks simple, perhaps deceptively so because realization of that goal involves:

Identifying and Analysing Risk Problems,
Formulation of Feasible Courses of Action,
Selecting the best alternatives,
Monitoring the results and revising strategy as necessary.
Thorough knowledge of the insurance marketplace and the exercise of technical control over potential source of loss, then, are essential ingredients of effective risk management as compared with the simple purchase of an insurance policy for what one may only assume is the right price.

Few circumstances are more frustrating to insurance professionals charged with managing a contractors business risk than to examine insurance specifications after an award has been made and then have to explain that additional costs are involved which will come out of profit. It is frustrating because it is unnecessary. Recognizing that doing so for every significant job being bid automatically involves some fruitless efforts, we none the less urge that your insurance representative be given an opportunity to see the insurance provisions before your bid is submitted.

Where time is short, read them to him by phone to determine whether anything unusual is specified.

Sometimes the project will be a "wrap-up". Here, the owner or general contractor intends to purchase Workman’s Compensation and General Liability Insurance applicable to everyone working at the site, requiring a “ex-insurance” contract price. This usually permits deduction of your normal overhead cost for those coverages (only) from your bid, but not always.

In other cases, additional costs will be necessary because of requirements that you provide builder’s risk insurance or ultra high limits of liability. Occasionally, a perfectly legal hold-harmless clause may prove to be uninsurable to a significant extent. How much better to find out early enough. In short, send your representative things to read. You will gain significantly by doing so.

You will also want to sit down at least once annually to adjust normal insurance overhead factors as required by change in manual rates and your own loss experience modifiers. Ask to be promptly informed of any mandatory mid-term rate increase which may effect you.