7 tips for maximizing coverage

Risk Transfer Nightmares Addressing and Avoiding Potentially Disastrous Traps

Indemnity and insurance arrangements are prevalent nowadays in virtually every business setting. The goal is simple, to shift potential liability and loss from one party to a transaction to the other by way of an indemnity, and to pass that risk through to insurance. In practice, achieving the simple goal of insuring risks through an indemnity and insurance is mired with legal complexities. Worse yet, the myriad of legal issues involved typically arise only after a claim is made, and the resulting implications can be downright alarming.

The scope of the problem is universal to almost all kinds of businesses. It is, for instance, common practice for construction contractors to attempt to pass the risk of construction claims on to the insurance of subcontractors. Similarly, retailers seek to pass the risk of products liability claims on to the insurance of product manufacturers and others in the supply chain. Investment bankers often hope to shift liability arising from the sale of securities to those issuing the securities. Likewise, landlords generally attempt to cover tenant risks under tenant insurance policies. Virtually any transaction having risk contains insurance and indemnity requirements, and virtually no business segment is exempt from the devastating impact of a useless indemnity without insurance to back up the loss.

On its face, this indemnity and insurance paradigm appears to afford a company broad protection against liability arising out of its business relationships and transactions. Too often, however, such protection proves illusory. The reasons for failure are often far from obvious. More often than not, failure results from an insurance carrier's attempt to manipulate the complexities of insurance and indemnity law.

The following example is illustrative. Residential Condos LLC ("Residential"), a developer of condominium buildings, is insured under its own $5 million general liability policy. Residential enters into an Agreement (the "Agreement") with Builders, Inc., ("Builders") pursuant to which Builders agrees to act as lead contractor for a new condominium project. The Agreement contains an indemnity provision which obligates Builders to indemnify Residential for any and all liability arising out of Builders' performance under the agreement. In addition, the Agreement requires that Builders purchase a $1 million general liability insurance policy, as well as a $5 million umbrella, or excess policy, and that both policies name Residential as an additional insured.

A nightmare scenario later unfolds in this hypothetical, when a scaffolding collapses at the project and kills a subcontractor. The victim's family sues both Builders and Residential, and the parties ultimately settle for $6 million. Pursuant to the Agreement's indemnity, Residential believes that Builders should pay the settlement. Moreover, pursuant to the Agreement, and the insurance procured pursuant to the Agreement, the settlement should be passed through and paid by Builders' insurance carriers. Given the insurance in place, this should not be an issue.

However, rather than paying the settlement, Builders' insurers ask their attorneys to get them out of the situation. The insurers' attorneys come up with some arguments to avoid paying the judgment, which they vigorously pursue in a separate insurance coverage action. The insurers raise four primary arguments:

> **First,** the indemnity is invalid under applicable state law, and therefore, Builders has no obligation to pay Residential's portion of the judgment;
>
> **Second,** Residential is not covered under Builders' insurance as an "additional insured;"
>
> **Third,** even assuming Residential is an "additional insured" under Builders' policies, Residential's own insurance (or self-insurance) is "other insurance" which must be exhausted before Builders' policies are required to pay;
>
> **And fourth,** liability between Builders and Residential must be re-litigated in the coverage action, because an apportionment of fault was not set forth in the underlying settlement agreement.

As a result, despite the intent of the contractual protections bargained for, the matter is tied up in years of coverage litigation without any end in sight.

The scenario above, with variations, occurs all the time in virtually every kind of business setting. As a result, legitimate well-planned efforts to shift liabilities can fail.

Fortunately, measures can be taken to ensure that this potential doomsday scenario never unfolds.

1 DRAFT VALID INDEMNITY PROVISIONS

The first step to effective risk transfer is ensuring that the indemnity agreement is comprehensive, valid and enforceable under controlling law. Courts generally view indemnity provisions with close scrutiny, particularly where the clause purports to relieve a party for liability resulting from its own negligence. While the law varies state by state, most jurisdictions require that a party wishing to transfer liability for its own negligence to a contractor or similar party spell out such intent in clear, unambiguous and conspicuous language. Otherwise, courts will not hesitate to find the indemnity provision unenforceable.

Unfortunately, the line between valid and unenforceable may not be clear to the casual observer. For example, the following indemnity provisions have been struck down by courts:

> "To the fullest extent permitted by law, contractor shall indemnify, hold harmless, and defend company from and against all claims, losses, damages and expenses arising out of or resulting from the performance of contractor's work."

> "Contractor shall indemnify owner for losses arising out of or in any way connected with or attributable to the performance or non-performance of work hereunder by contractor; *however, contractor will not be liable to indemnify owner for claims arising from the sole negligence of owner."*

> "Contractor shall indemnify and hold harmless company for any loss as a result of operations growing out of the performance of this contract and caused by the negligence or carelessness of contractor."

In contrast, the following language has been upheld as valid and enforceable:

> "Contractor agrees to indemnify owner in any manner arising from the work performed hereunder, including but not limited to any negligent act or omission of owner."

> "Contractor assumes entire responsibility and liability for any claim or actions based on or arising out of injuries to persons or damages to property, sustained in connection with the performance of this contract by Contractor, regardless of whether such claims or actions are founded in whole or in part upon alleged negligence of Owner."

As evidenced by the examples above, the line between a valid indemnity provision and an unenforceable one is thin, particularly in the eyes of a layman. For this reason, it is imperative that indemnity provisions be drafted by an attorney with expertise in the fields of indemnity and insurance law.

2 KNOW THE LEGAL LIMITATIONS OF THE INDEMNITY

Despite how well the indemnity is drafted, it may not apply to all circumstances. Most states prohibit the indemnification of liability stemming from fraudulent acts, and many place strict limitations on transferring risk for one's own negligence. These limitations can only be addressed by understanding them prior to drafting and executing the indemnity.

3 MAKE THE INDEMNITY CONSPICUOUS

In most instances, a contractual indemnity provision or exculpatory clause is part of a larger contractual agreement, which may span tens or even hundreds of pages. As a result, courts often require that an indemnity provision contained in a larger contract or services agreement be conspicuous. Typically, an indemnity is deemed sufficiently conspicuous when set forth under a separate capital heading and in language of contrasting color or font. In short, make sure the indemnity requirements stand out.

4 SELECT AN APPROPRIATE "CHOICE OF LAW"

Law regarding the validity of indemnity agreements varies from jurisdiction to jurisdiction. What passes muster under one state's law may be deemed insufficient under another's. Accordingly, it is prudent practice to include a "choice of law" provision specifying the parties' intent that the indemnity be construed pursuant to a particular state's law, and to draft the indemnity provision specifically in compliance with the choice of law selected.

5 REQUEST MORE THAN JUST "ADDITIONAL INSURED" STATUS

Once the indemnity agreement is properly drafted, it's time to focus on insurance. While most companies have their own insurance in place, the goal is to transfer risk of loss from the company's own insurance to another's policies. This is typically accomplished through standard form provisions in a policy, or through an additional insured endorsement. While "additional insured" provisions are commonplace, not all are created equal. The scope of coverage afforded by such clauses or endorsements varies greatly.

Many liability policies simply contain boilerplate (or "blanket") additional insured language. The following provision is typical:

> Who is An Insured is amended to add: Any person or organization who you are obligated to include as an additional insured under this policy, as a result of any contract or agreement, but only with respect to liability arising out of your operations or premises owned by you.

Notwithstanding such language, issues may arise regarding the scope of coverage provided to the company as an additional insured under a policy. A plethora of judicial decisions have, for instance, tackled the issue whether the phrase "arising out of," as set forth in the above provision, provides coverage to the additional insured for liability stemming from its own negligence, with courts often reaching opposite and conflicting conclusions. Likewise, insurers often attempt to seize on the "your operations or premises" language in an effort to limit coverage owed to an additional insured.

The language above is just one example of the more than thirty standard additional insured endorsements available in the insurance market. The various forms are typically tailored to certain types of businesses and liabilities. Insurance requirements in the underlying contract need to specify the correct kind of endorsement or insurance requirements to achieve the intended purpose. Here, at a minimum, the underlying contract should require that the company be listed as an additional insured and expressly delineate the scope of the intended coverage, clarifying that the additional insured is entitled to coverage under the policy for all losses arising out of the parties' work or business relationship, including loss or liability resulting from the additional insured's own negligent conduct. Where specific insurance forms are requested, an analysis of coverage afforded under those forms should be conducted to make certain they achieve the intended goals.

Finally, in addition to requesting the correct kind of additional insured status from an indemnitor, you must follow up and verify that you received what was asked for. In this regard, simply requesting a certificate of insurance indicating that you have been added to the policy as an additional insured is not enough, as insurers routinely deny that certificates of insurance bind them to coverage.

6 MAKE CERTAIN THAT THE POLICY LANGUAGE CONFORMS TO THE PARTIES' INTENT

The most common point of failure, unfortunately, is one of the hardest to control. Although you can't altogether prevent insurers from denying claims, you can make it harder for them to act in their own best interest at the expense of policyholders and additional insureds. There is simply no alternative to obtaining and reviewing copies of the policies. Summaries of coverage, broker analysis, or common insurance wisdom about how insurance works, have no meaning to coverage once a claim is filed. The policies must be reviewed to confirm that there is additional insured status in the context of the types of potential claims anticipated. This is not always an easy task, given that the law on issues pertaining to additional insured status varies from jurisdiction to jurisdiction.

7 ADDRESS "OTHER INSURANCE" ISSUES

Most liability policies contain an "other insurance" clause. The purpose of these provisions is to prioritize payment where a company has insurance coverage for a particular loss under more than one insurance policy. This may be the case where, for instance, a company has several insurance policies, such as a general liability policy, a products liability policy, and an umbrella policy, and each responds per its terms to a particular claim. Although these "other insurance" clauses may have a legitimate purpose with respect to prioritizing payments with policies issued to the same insured, insurance carriers are now using them for an entirely different purpose – to defeat coverage afforded to additional insureds.

There are a multitude of problems that can arise with respect to "other insurance." An insurer may seek to avoid coverage for an additional insured by claiming that the additional insured's self-insurance under a high-deductible program must be exhausted before it pays. Similarly, insurers routinely argue that self-insurance afforded through captives should apply, even though the insurance and indemnity requirements specify otherwise. Finally, an insurer may drag the additional insured's actual insurers into the fight, unnecessarily raising the complexity of the dispute.

The question of which entity's insurance policy is implicated often depends on analysis of the policies' respective "other insurance" clauses. To avoid potential disputes, the company should address "other insurance" language in both parties' policies. First, the "other insurance" clause in a company's own policies should be written to make coverage ***excess*** of any policy under which the company is entitled to coverage as an additional insured. The following language is an example of an "other insurance" clause which would effectuate such intent:

> If other valid and collectible insurance is available to an insured for a loss we cover, our obligations are limited as follows:
>
> **a. Primary Insurance**
> This insurance is primary except when **b.** below applies.
>
> **b. Excess.**
> This insurance is excess over:
>
> * * *
>
> (2) Any other insurance available to you covering liability for damages arising out of the premises or operations . . . for which you have been added as an additional insured by attachment or endorsement.

Second, a company must make sure that the policies procured to insure the indemnity are written as "primary" coverage. Perhaps the most effective method of achieving this result is via express language in the "additional insured" clause. The endorsement can state, for example, that any coverage provided under the policy pursuant to the additional insured endorsement will be primary over the additional insured's own insurance.

Conclusion

Solving indemnity and insurance issues such as those addressed herein can be a difficult task. The prudent course is to address these issues long before any potential claim is made. To do this, review your indemnity provisions to ensure that the exculpatory clauses are valid and enforceable under applicable law. Moreover, do not assume that others have complied with their contractual obligations to procure the requisite insurance. Request copies of the insurance policies and all relevant endorsements yearly, and review them for compliance and coverage in accordance with the terms and conditions of the underlying agreement.

Unfortunately, these issues cannot always be addressed before a claim has been made. Under such circumstances, it is good to know that an insurer that raises these arguments to defeat coverage may be liable for bad faith and punitive damages. *See Colorado Interstate Gas Co. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*, No. 08CV4157 (Colo. D. Ct. June 28, 2012).

In the end, there is no way to get around the complexities of indemnification and insurance law. Almost always, it is one company's intent to transfer the risk of loss emanating from the relationship to the other party, and almost always, it is an insurance carrier who raises arguments to defeat that intent. If indemnities and insurance are an important part of your risk management strategies, competent counsel familiar with both insurance and indemnity law may be able to help you avoid potential future risk transfer nightmares. Moreover, if the issues are not recognized until after a claim has been made, it is best to hire counsel who has addressed and prevailed on these issues before.

Tab R. Turano Miller Friel, PLLC
October, 2013