Contractual Risk Transfer: Tips for Managing Risk with Indemnity Provisions and Insurance Coverage

By Daniel Healy, Partner, Anderson Kill

Imagine you are in-house counsel at a company that is about to sign one of the largest transactions of the year, or maybe even of the past few years. But your company faces significant risks in performing its end of the bargain and some of those risks could be out of your company's control. Your CEO wants to know how to reduce the potential of those risks to undermine profitability and the ultimate success of the transaction. This article addresses some of the ways you might respond.

For example, if you are providing maintenance services to dangerous equipment that is operated by another company's employees who are not in your control, you may want to consider risk transfer. Your company may not wish to assume complete responsibility for any loss relating to the equipment simply because your company maintains or repairs it.

Risk transfer mechanisms take a number of forms. The most common forms are indemnification provisions and insurance contracts, but even those come I many iterations. Before you can employ the most appropriate risk transfer, you need to identify and analyze the risks.

Identifying the Risks That Need to Be Transferred

All agreements involve some level of risk, whether for construction service, providing product parts, obtaining equipment or having a house painted. The question commonly boils down to identifying the risks that would be so severe or frequent that your company is unwilling to bear them. Additionally, risks completely out of your control or exclusively in the control of someone else generally are good candidates for risk transfer.

For in-house counsel, indemnification provisions and insurance are not foreign concepts. It is important, however, for counsel to work with management to identify the risks presented by a particular transaction or relationship. Otherwise, counsel may draft an inappropriate indemnification or rely on insurance coverage that may not respond fully when needed.

As a first step, counsel needs to identify those risks that have high enough frequency or severity that they need to be controlled, at least partially, with indemnification provisions and insurance. A catastrophic event could put a company out of business, as could hundreds of small loses over a short period of time. Other questions to ask when identifying such risks include:

- Which party controls the risk?
- How is the risk allocated absent an agreement?
- Can insurance cover the risk?
- Which party has greater risk tolerance?
- What are the relative bargaining positions of the parties?

While ideally a party with control over a risk, and the best knowledge of a risk, should bear that risk, this ideal is not always met. Sometimes bargaining power rules the day. Other factors that often dictate which party bears the risk include ownership of property that may be at issue, customs and practices in a given industry and the ability to obtain insurance.

The relative size or monetary value of a potential risk also should be considered when looking at the proper mechanism for transferring that risk. A very large risk that is very unlikely should not necessarily hold up an otherwise agreed deal. The more likely the risk is to take place, the more important it is to agree as to how that risk will be borne.

Determining What May Happen Without Indemnification

Counsel in particular should understand how a risk will be allocated in the absence of an indemnification agreement. In the United States, absent an agreement, risk generally will be allocated accordingly to tort or contract law. Thus "ignoring" the risk inherent a given transaction or agreement could make sense for your company, if the particular area of law is well-developed, predictable and favorable to your company's position. More often than not, cases of tort liability are fact-driven and not entirely predictable. Where there is uncertainty and significant risk, there often is litigation, and litigation is another expensive undertaking to be avoided. A goal of a well-crafted indemnification provision is predictability.

Returning to the hypothetical, your company may already have identified some of the obvious and likely risks, including employee injury, injury to the other company's employees (or even to non-party employees) and equipment damage. Those risks may involve potentially high monetary value and enough frequency that you need to transfer them. Your partners may also know what is most likely to happen in the absence of an indemnification provision, perhaps from personal experience.

Drafting a Risk Transfer – Indemnification -- Provision

To transfer the risk by an indemnification provision, certain key ingredients are needed. The provision must identify the risk, identify who is responsible for it and set forth limitations on the parties' responsibility for a given risk. Often overlooked or generalized, the identification of the risk or the scope of a risk can be determinative. Client input may be particularly important in crafting the scope of the risk to be shifted to another party, or undertaken by an indemnitor.

One example is defense costs. Litigation could be between the parties to the indemnification agreement or non-parties and could lead to significant cost. Investigations by regulators are increasingly common in

continued on page 2

continued from page 1

certain industries and could be a relevant risk, as investigation responses often entail the same costs as litigation. If litigation and investigation costs are to be included among those for which indemnification is provided, they need to be spelled out. Defense costs also need to be tracked and recorded.

Many counsel instinctively draft air-tight provisions that broadly require the other party to indemnify against all contingencies relating to a given risk. Such "broad form" indemnity provisions state, in so many words, that you will indemnify me for a loss suffered because of your sole negligence, my sole negligence and our joint negligence. Put another way, you will indemnify me regardless of fault. Some broad form agreements even provide indemnification for gross negligence or intentional conduct. Such agreements can be very efficient, because they avoid disputes about liability for the risk of loss.

The problem with these "broad form" indemnity agreements is that they are not enforceable in numerous states. There are jurisdictions that have common law and sometimes statutory law that states a party cannot obtain contractual indemnification for gross negligence, intentional torts and, more importantly, for one's own sole negligence. Tough negotiating of a broad indemnification provision could prove fruitless in the event of a loss, if certain states law applies.

In Maryland, "The general rule is that contracts will not be construed to indemnify a person against his own negligence unless an intention to do so is expressed in those very words or in other unequivocal terms."[1] If you want a broad for indemnification in Maryland, be sure it is crystal clear as to the scope of what the risk is, what the limitations are and who is responsible.

Don't forget, though, that a company located in Maryland may not be attempting to enforce its indemnity rights under Maryland law. Obviously, choice of law provisions may control. In their absence and where goods, services or another party to the agreement are located outside Maryland, it may not be clear which law applies.

Other forms of indemnification agreements include intermediate and simple or narrow indemnification provisions. Intermediate indemnification agreements are slightly less protective and predictable than broad form language, but are more widely enforced. The indemnitor generally indemnifies against loss from its sole negligence and from joint negligence. In other words, unless your sole negligence caused the loss, then I have to indemnify you for it. Some predictability is lost because the indemnitee (in most states) need only prove that the indemnitor was partially liable (i.e., 3% liability) to require the indemnitor to pay for the entire loss.

Simple or narrow indemnification provisions require the indemnitor to pay for loss caused by the indemnitor's own sole negligence. Derivations of this include mutual indemnification provisions. The split of mutuality can be tied to negligence, property ownership or employees (i.e., you are responsible for your property and employees, and I am responsible for mine, but regardless of fault you do not have to pay for mine).

Depending on the industry or the complexity of a transaction, there could be any number of additional considerations that may be built into an indemnification provision appropriately. For example, financial resources and regulatory requirements may provide important limitations and require clear wording about the limits of the agreed indemnification. Counsel should be creative and clear in drafting an indemnification provision to serve the parties' intent.

Insurance Coverage Should Help Shape Indemnification Provisions

Often companies that need to provide some form of indemnification would like to have insurance pay for that liability. A starting point is to check the company's policies for exclusions of liability assumed by contract, and related carve outs and savings clauses, such as certain covered contracts usually defined as "Insured Contracts." Most liability policies have some language about contractual liability, whether covered, excluded or something between.

The risks identified in the indemnification agreement are important as well. Those risks ideally should be similar to those covered in a responding policy's coverage provisions, and not similar to specifically excluded risks.

An indemnitee may seek assurance that the indemnitor will be able to pay indemnification amounts. Some parties put language directly into indemnification provisions to require certain types of insurance policies to be maintained in certain amounts. But the language in those policies may be the key to coverage. If possible, specify the coverage terms needed.

Additional insured status is another method of risk transfer that often goes hand-in-hand with indemnification provisions. Whether being an additional insured means the indemnitor may rely 100% on its insurance coverage depends largely on the scope of the indemnification provision, the risk and the policy language. It may be that the indemnification and insurance provisions do not a align or, even if they do, that the insurance company erroneously determines they do not and denies coverage.

It also may be the case that a liability or property policy is not the best fit for an indemnification provision. Directors & Officers, Errors & Omissions or professional malpractice policies may better fit. Combinations of policies may also be required to encompass the full scope of an indemnification provision.

Lastly, as mentioned above, defense costs for litigation and investigations may be important risks for which indemnity is provided. If so, the indemnitor should consider the available insurance cover-

continued on page 3

[1]*Mass Transit Admin. v. CSX Transp.*, 349 Md. 299, 308-09 (Md. App. 1998); *Crockett v. Crothers*, 264 Md. 222, 227 (Md. App. 1972).

continued from page 2

age and whether it provides for defense coverage for other parties and additional insureds as well as for itself, and whether the defense costs erode limits. If they do erode limits, there potentially could be multiple sets of defense costs that leave no coverage for the second-sued party or that eat away at limits more rapidly than would a single party's defense costs, leaving no money to pay for the actual liability.

In sum, where indemnification provisions are needed, counsel should be clear, seek predictability to the greatest extent feasible, and remember to utilize insurance policies to maximize the protection for all parties. Doing so will make management happier and the transaction more financially secure.

About the Author: *Daniel J. Healy is a partner at the law firm of Anderson Kill, P.C. He can be reached at dhealy@andersonkill.com or (202) 416-6547.*