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Using Insurance to Transfer Transaction Risks

There are several options, but first you need to analyze those risks

By Daniel J. Healy & Arthur Armstrong / Anderson Kill

As in-house counsel, imagine that your company is preparing to sign one of the largest transactions of the year, but it faces significant risks in performing under the agreement. These risks could impair your ability to deliver what you promise to do, and might also harm your employees or property, or the employees or properties of other parties. And the risks may be out of your company's control. Unsurprisingly, your CEO wants to know how to reduce the chance that they might undermine profitability and the ultimate success of the transaction.

So, how should you respond?

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

For example, you may be providing services that involve sensitive and valuable data stored on high-tech equipment operated by another company's employees who are not in your control. In such a case, you may want to consider risk transfer. Your company may not wish to assume complete responsibility for any loss involving data or equipment simply because your company provides services.

Identifying Risks

All agreements involve some level of risk, whether for construction, manufacturing parts, equipment rental, data services or even home landscaping. The question is: Which risks would be so severe or frequent that your company is unwilling to bear them? 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 with many legal documents, boilerplate language can create problems instead of solving them. Standard language can be appropriate, but should be purposeful, not simply cut and pasted.

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By initially identifying those risks that have high enough frequency or severity that they need to be controlled (at least partially), counsel lays the groundwork for drafting an effective provision. A catastrophic event could put a company out of business, as could hundreds of small losses over a short period of time. Here are important questions to ask:

- Which party controls the risk?
- How is the risk allocated absent an agreement?
- 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 viable. Sometimes bargaining power rules the day. Even then, it is important to have a framework for understanding the risks being transferred and how they align with other factors, such as ownership of property, industry customs and practices and available insurance.

The relative monetary value of a potential risk is an obvious factor, but should be tempered by the likelihood that the risk may come to pass.

Consider Why Indemnification Is Needed

Counsel, in particular, should understand how a risk will be allocated in the absence of an indemnification agreement. In the United States, without an agreement, risk generally is allocated according to tort or contract law. Indemnity provisions tend to address those risks governed by tort law, and the goal is to alter which party bears the risk under the law – or at least make it more predictable.

It is possible that ignoring a risk inherent in a given transaction makes sense, if relevant law is well-developed, predictable and favorable. But tort liability usually is fact-driven, decided under common law and not entirely predictable. Where there is uncertainty and significant risk, there often is litigation – another expensive undertaking. 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 injury to employees, to the counterparty's employees and to third parties, and damage to equipment. These risks may involve potentially high monetary value and frequency that justify transfer. The parties may also know where liability falls in the absence of an indemnification provision, perhaps from experience.

Drafting an Effective Provision

Transferring the risk by an indemnification provision requires certain key ingredients. The provision must identify the risk, identify who is responsible for it and set forth any agreed limitations on the parties' responsibilities. Often overlooked, the identification of the risk or the scope of the indemnification can be dispositive in the event of a dispute. Defining the scope of the project and the indemnity should involve the legal and risk management departments and those involved in the work covered by the agreement.

One example of a risk commonly overlooked is defense costs. Litigation could be between the parties to the indemnification agreement or nonparties and the costs could become significant. Investigations by regulators are increasingly common in many industries and could be a relevant risk, with costs similar to litigation. If litigation and investigation costs are to be indemnified, it is best to make sure that they are spelled out. These costs should also be tracked and recorded.

Many counsel instinctively draft airtight provisions that broadly require the other party to indemnify against all contingencies relating to a given risk. These "broad form" 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 differently, you indemnify me regardless of fault. Some transfer 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 broad form indemnity agreements is that they are not enforceable in numerous states. Some jurisdictions prohibit a party from obtaining contractual indemnification for its own gross negligence, intentional torts and, more importantly, sole negligence. Tough negotiating for broad indemnification could prove fruitless, depending upon applicable state law.

In Maryland, for example, "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." A broad form indemnification in Maryland should be crystal clear as to the scope of the risk, the responsibility for it and any indemnity limitations upon it.

Under New York law, a party may indemnify another party, including for that party's own sole negligence, provided that the contract language sets forth a clear and "unmistakable intent" to do so. New York strictly construes indemnification provisions, meaning that parties should state all items of costs or potential expenses meant to be included.

Don't forget, though, that a company located in Maryland or New York may not be attempting to enforce its indemnity rights under the laws of or in the courts of those states. Obviously, choice of law and venue provisions may be included and may control; but in their absence, depending on where the goods, services, parties and loss are located, it may be unclear which law applies.

Crafting Language That Fits a Contract

Instead of broad form, intermediate or narrow indemnification provisions may be more appropriate. Intermediate indemnification agreements are slightly less protective and predictable than broad form, but are more widely enforced. The indemnitor generally indemnifies against loss from its sole negligence and from joint negligence. In other words, unless the indemnitee's sole negligence caused the loss, the indemnitor must pay. Some predictability is lost because the indemnitee (in most states) need only prove that the indemnitor was partially liable (e.g., 3 percent) to require the indemnitor to pay for the entire loss.

Simple or narrow indemnification provisions require the indemnitor to pay for loss it solely caused. 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, regardless of fault).

Financial resources and regulatory requirements may provide important additional requirements. Counsel should be creative and clear in drafting an indemnification provision to reflect the parties' intent.

Policy Terms Should Be Reviewed

Often companies that assume 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 "Insured Contracts." Most liability policies include language about contractual liability – whether covered, excluded or something between.

The risks identified in the indemnification agreement are important as well. Ideally these should be similar to those covered in a responding policy's 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 insurance limits. 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 that the indemnitor may rely 100 percent on its insurance coverage depends largely on the scope of the indemnification provision, the risk and the policy language. Misalignment of these items should be avoided.

Sometimes a liability or property policy is not the best fit for a risk. Directors & Officers, Errors & Omissions or professional malpractice policies may provide the better coverage and should not be overlooked.

Lastly, if defense costs are important, the indemnitor should consider its insurance coverage and whether it pays defense and investigation costs for other parties (in the event of a litigation or an investigation). It should also evaluate whether the defense costs erode coverage limits. Eroding limits could leave insufficient coverage 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.

Daniel J. Healy *is a partner at the law firm of Anderson Kill in Washington, D.C. He has represented corporate policyholders in disputes across the country in order to successfully recover insurance proceeds to pay an array of first-party and third-party losses, including business interruption, consequential losses and attorney fees. He can be reached at dhealy@andersonkill.com.*

Arthur Armstrong *is a shareholder at Anderson Kill in Philadelphia. He has extensive experience in successfully resolving commercial contractual disputes, including insurance coverage disputes. He has appeared in state and federal courts across the country and regularly advises clients on contracts and insurance coverage issues. He can be reached at aarmstrong@andersonkill.com.*