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Twelve Tips to Optimize Your Indemnity Provisions and Related Insurance Coverage

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In-house counsel regularly face negotiations to determine how to deal with risks under written agreements. Risks inherent in all transactions and business dealings are often allocated to one party or another by indemnity provisions. Almost equally often, where one party agrees to indemnify the other, the indemnitor intends to rely on insurance coverage to pay the indemnity obligation. What follows are tips for increasing the likelihood an indemnity provision will be effective and enforceable and that insurance intended to pay indemnity obligations will be applicable and responsive.

1. Identify the Likely Risks

The first step in drafting effective indemnity provisions does not involve drafting. Identifying the risks and assessing their probable frequency and severity before beginning to draft a provision enables counsel, working in concert with management and business clients, to make informed decisions about what risks to accept, transfer, insure or deal with in other ways. Those decisions necessarily drive the drafting process, including the scope, duration and type of indemnity agreement. This step is too often glossed over. And it may be just as important for both the indemnitee and the indemnitor to know what risks assumed by the indemnitor will be covered by the indemnitor's insurance.

2. Identify Which Party Has Control of the Key Risks

While most people identify quickly the party with superior bargaining power, not everyone considers who has control over a particular risk. From an objective viewpoint, the party with more control over a particular risk should bear that risk, because that party is more capable of avoiding the risk.

For example, you may transfer your data to a service provider and that data may include sensitive and valuable information stored on high-tech equipment operated by the service provider's employees who are not in your control. In such a case, you may want to consider risk transfer because you do not control the risk of a data breach or misuse of information. The party hosting the data controls it and thereby has much greater, if not nearly complete, control over the security of the data. An indemnity provision can move the risk of a breach to the other party, even if your company owns the data and, under applicable law, can be held liable for a data breach.

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3. Identify Which Party Has Superior Knowledge of the Risk

If your company provides 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, but it may be difficult for your company to transfer all such risk. If your company has specialized or expert knowledge and you approve the equipment for continued use, then arguably your company has greater knowledge of the risks. It would make sense for your company to bear the risk of the equipment malfunctioning or unexpectedly causing injury or property damage. Objectively speaking, there is legitimate reason for your company to keep some risk. If you want to transfer it, you will need to have good reasons or transfer it by means of insurance.

4. Avoid Boilerplate Language

As with many legal documents, language copied from prior agreements can create rather than solve problems. While standard language can be appropriate and efficient once developed for routine contracts, it must be purposeful, not simply cut and pasted.

Many form indemnity provisions, as well as limitation of liability provisions, can be found online and elsewhere. But not all apply universally. Importantly, some of them contain industry-specific language, terms appropriate for goods and not services (or visa-versa) or even inconsistent clauses. Care should be taken to think through existing provisions and to draft new provisions with care and specificity.

5. Fully Assess the Parties' Ability to Pay a Loss

The potential monetary value of a risk is an obvious factor when considering risk transfer, as is a party's ability to pay for a loss. Insurance can aid in transferring the risk to the right party, transforming or even negating the ability to pay as an issue in a negotiation. An indemnity provision can require certain insurance coverage, cap indemnification at the dollar amount an insurance policy or program will pay for a covered loss, or tie the indemnity obligation to insurance coverage (i.e., indemnity is up to the amount of one party's coverage limits, whatever they may be).

6. Evaluate Why Indemnification Is Needed

Counsel should understand how a risk will be allocated in the absence of an indemnification provision. In the United States, absent an agreement, risk generally is allocated according to tort or contract law. Indemnity provisions tend to alter which party bears the risk under the law, or at least make it more predictable and efficient to resolve who will pay for the loss. "Ignoring" a risk inherent in a given transaction may make 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.

7. Include the Key Terms

Effective risk transfer by indemnity provision requires certain key ingredients. The provision must identify the risk, the party is responsible for it and any agreed limitation on the party's responsibilities. Often overlooked, the identification of the risk or the scope of the indemnification can be dispositive in the event of a dispute. The scope can be defined by the services to be provided, a location, a duration or any number of other concepts. More often than not, disputes over indemnity obligations come down to the scope of the provision requiring indemnity. Crafting the scope of the indemnity should involve input from legal, risk management and those involved in the work covered by the agreement.

8. Understand the Extent of Defense Obligations

Defense costs for litigation could be between the parties to the indemnification agreement or against non-parties. Investigations by regulators are increasingly common in many industries and could be a relevant risk, similar to litigation and just as costly. If litigation and investigation costs are to be indemnified, it is best to make sure they are spelled out. Defense costs also should be tracked and recorded.

Inherent in defense costs is the concept of control. Parties often are eager to obtain payment for defense or investigation costs, but reluctant to give up control over the defense of a lawsuit, particularly if their reputation may be at stake. In considering the need for defense costs, the question of who controls the defense should be considered. An air tight provision requiring the other party to assume all costs and responsibilities for any lawsuits arising out of the agreement may not be in the indemnitor's best interest.

9. Is a Broad Form Indemnity Provision Enforceable and Insurable?

Many counsel instinctively draft broad provisions that provide for 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 provisions is that some states prohibit their enforcement. Other states prohibit policyholders from purchasing insurance coverage for the sole negligence of another. While the majority of states allow for both broad form indemnity and coverage for that indemnity by the

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indemnitor, it is worth knowing whether the state law that applies to the agreement and the risk permit such agreements and coverage. Some notable states prohibiting them include California and Texas.

10. Understand the Insurance Expected to Pay the Indemnity Obligation

Often parties look to insurance policies to pay for indemnity obligations owed under contracts. Generally these losses are paid under a liability policy. Most form general liability policies exclude coverage for contractual liability (i.e., for breach of contract), but provide coverage for when the policyholder must undertake to indemnify pursuant to contract terms (i.e., perform its contractual obligations). But be sure the contract is an "Insured Contract" under the relevant insurance policies i.e., that those policies pay for a policyholder to perform its promise to indemnify another party under contract. Such coverage only is for insured contracts. Some insurance policies require insured contracts to be specifically identified, while others provide for automatic coverage of contracts that relate to the policyholder's business and require the policyholder to indemnify the counterparty. The requirements of the insurance policy that is expected to respond ideally should be learned and kept in mind when crafting an indemnity provision.

11. Look at the Pros and Cons of Being an Additional Insured.

Generally, being named as an additional insured on another party's insurance policy is a benefit. It provides "free" coverage and, if done correctly, provides an additional method for paying a loss. Often, it is a preferred way to confirm that the promise of indemnity is real and will be paid, even if the indemnitor is not specifically paying. On the other hand, an additional insured generally must waive rights of subrogation and to claim against co-insureds. Such waivers may mean the insurance policy will not pay if one insured needs to pursue the other insured for indemnity and, at worst, could mean that the indemnitee cannot pursue the indemnitor because rights to do so were waived. The benefits and consequences of being an additional insured will be defined by the policy as well as the indemnitee agreement. When the policy and the indemnity provision differ, courts have disagreed as to which controls. The best practice is to make them match.

12. Give Notice

Take seriously the notice requirements in insurance policies, whether in the ones you purchase or the ones on which you are an additional insured seeking coverage. Create procedures ahead of time to draft, approve and send written notice of potential claims and losses. Ask insurance brokers to give notice on all potentially applicable policies, including different lines of coverage and primary and excess policies for all possible coverage periods. Late notice is too often a ground for denying coverage. It can lead to forfeiture of coverage for otherwise valid claims.

In conclusion, indemnity provisions can be very important forms of risk management and transfer. They should be carefully considered, particularly in contract that are routinely used. Hand-in-hand with indemnity provisions, applicable insurance coverage should be considered, both from the perspective of one's own insurance responding and of seeking coverage under another's policy. If these factors are considered on the front end, obtaining indemnity payment or insurance proceeds to pay an indemnity obligation should be easier on the back end.

About the Author:

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