Insurance Coverage vs. Indemnification Obligations

by Joshua Gold

When calamity strikes, there may be a silver lining: the policyholder may benefit by having both insurance coverage and a right of indemnification from a third party to deal with the loss (or liability). This silver lining, however, may feel more like tin when the insurance company argues that its coverage obligations are actually "secondary" and that the indemnification must pay first before the primary coverage is triggered.

In effect, the insurer has converted its primary insurance coverage policy to an excess insurance policy. While this strategy may not always work, it can be devastating to the policyholder if it does, particularly if the indemnification is promised from a corporate affiliate rather than an unrelated third party.

Many policyholders have learned the hard way that some insurers will take the position that, if there is an inter-affiliate indemnification obligation between the policyholder and one of its corporate relatives, the indemnification becomes "primary" and the insurer's coverage obligations are supposedly rendered "secondary" or "excess." Such a position is troubling on a number of levels.

First, the entire point of purchasing insurance is to transfer the risk of loss or liability off of the policyholder's balance sheet. This is not fully accomplished if a corporate affiliate must end up absorbing the loss.

Problem number two is that the insurer, after receiving insurance premiums to take on a primary coverage obligation, would be positioning itself for a windfall by arguing that its coverage is excess of inter-company indemnity.

The third problem is that the insurer would be attempting to exploit an indemnity provision that was incorporated as a type of belt-and-suspenders protection to add more layers of security. Such provisions were never drafted with the intention of making primary insurance coverage "excess" and granting the insurer with a free pass.

Whether the indemnification clause is found in an acquisition agreement, corporate bylaws or some other company document, policyholders should resist insurer assertions that coverage obligations are relieved by the presence of the indemnification language. Most insurers that make this argument ultimately back away from it.

Nevertheless, some insurers may try to hold their ground, as some have been sneaking the concept of "indemnification" into their policies in the "other insurance" clause regularly found in liability policies.

A fundamental issue with insurers arguing that the presence of indemnification converts their primary coverage to excess is that there is usually no policy language supporting such a notion. Furthermore, when other provisions of inter-affiliate contracts or corporate documents are examined for context to determine the intended beneficiaries of the subject indemnification clauses, it becomes clear that there was never any intent to provide the insurer such protections.

To protect themselves against this novel coverage defense, policyholders and their affiliates would be wise to stipulate in their inter-affiliated company indemnity provisions that the indemnification is intended for the benefit of the indemnified parties, their heirs and their legal representatives. Such clauses arm the policyholder with clear evidence that that the benefits of the indemnification provision are not intended to extend to any insurer (or any other third party for that matter). It may also make sense to expressly indicate in such documents that the provided indemnification is not intended to relieve a primary insurer of its coverage obligations

While case law on this issue is limited, state appellate court judgment held that contractual indemnification provisions do not take precedence over general rules governing primary insurance coverage. Specifically, the appellate court ruled that: "While the loss at issue must be borne by [the primary insurance company], it is nothing more than what is bargained for, particularly given the absence of any evidence that it calculated its premium with an understanding that an indemnity agreement would exist between its insured and [a third party indemnitor]."

A corporate treatise written by R. Franklin Balotti & Jesse A. Finkelstein in Delaware Law of Corporations and Business Organizations, further supports this, stating that "Indemnification is not, of course, a substitute for insurance."

Nevertheless, policyholders should be on guard. Because some insurers have been tinkering with the "other insurance" clause (trying to make it an "other insurance and indemnifications" clause) in recent years, policyholders may be faced with this argument more frequently down the road.

When an insurer argues that their policy becomes excess to an indemnification agreement, policyholders should check the insurance policy, as well as the other provisions surrounding the indemnification clause to provide context for divining the intent. Policyholders should also check with the applicable authorities. It is likely that at least one of these sources, if not all of them, will seriously undercut the insurer's position concerning its obligations.■

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