

Tips for Transferring Risk Through Indemnity and Insurance Coverage

By Dennis J. Nolan

New Jersey companies should make contractual risk transfer a vital component of their business strategy. Managing risk should not simply involve assembling the right insurance portfolio at the best price. Contractually transferring risks to a business partner or subcontractor that is in a better position to control those risks is an often-overlooked, cost-efficient alternative that, when properly structured, offers sound legal and financial protection.

Contracting parties shift the risk of loss in two ways: via contractual indemnity and via insurance requirements, including additional insured coverage. Although the additional insured requirement often is coupled with indemnity language in a contract, the two mechanisms are distinct methods of risk transfer. Indeed, the additional insured coverage backstops the indemnity provisions. Therefore, failing to coordinate indemnity and insurance requirement provisions might undermine your company's ability to seek recourse when faced with a potential liability or loss you thought you had offloaded.

Risk Transfer through Indemnification Provisions

Contractual indemnity agreements define which party bears the loss and expense of an accident. To properly indemnify a contracting party, several components are essential in an indemnification provision. The provision should identify the risk, the party responsible for it, and any limitations on the scope of the indemnification.

For example, litigation or regulatory investigations flowing from the subject of the contract can be a relevant, costly risk. The provision should spell out whether the indemnitor is responsible for the indemnitee's defense or investigation costs. As in several other jurisdictions, New Jersey courts strictly construct indemnity agreements. Absent an express clause, the indemnitor's duty to defend the indemnitee might not automatically apply.

Additionally, the agreement should specifically identify the breadth of liability. Liability might be required for damages "arising out of" the subject of the contract. Courts often construe that phrase broadly, which could trigger the indemnitor's responsibility to circumstances only loosely related to a party's work. That might be great for the indemnitee, but the indemnitor might consider clearer, more limited language, like liability for damages "resulting from" or "caused by" another's work or conduct.

Some parties negotiate comprehensive indemnification provisions, colloquially termed "broad form" indemnity agreements. There, an indemnitor assumes an unqualified obligation to hold the indemnitee harmless for all liability associated with the subject matter of the agreement – regardless of which party was at fault. In other words, the "broad form" agreement purports to indemnify me for your sole negligence, my sole negligence, or our joint negligence in the performance contemplated by the contract. Similarly, some broad form agreements provide indemnification for gross negligence or intentional conduct. Problematically, such an agreement might not be worth the paper it is written on. Common or statutory law in various states renders unenforceable

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agreements to indemnify someone for their gross negligence, intentional tort, or their own negligence. For example, agreements to indemnify parties for their sole negligence are generally unenforceable under N.J.S.A. 2A:40A-1. Note, however, that a choice of law provision may require application of the law of a state where such indemnification provisions are enforceable. Nevertheless, indemnity provisions, regardless of their scope, often contain a "savings clause" that preserves the clause from nullity should it be determined to be invalid. Standard savings language will contain language specifying that the clause shall be construed "to the fullest extent allowed by law..." In those cases, even if the indemnity provision itself was deemed invalid, for instance, in a jurisdiction that does not allow contractors to be indemnified for their own negligence.

For an indemnitee looking to avoid significant risk while at the same time maintaining peace of mind that a court will not strike the agreement, or where financial or business relationship considerations dictate, an intermediate indemnity agreement may make sense. These agreements might offer slightly less protection than broad form agreements, but they generally are more enforceable. There, the indemnitor assumes all risk for its own negligence and for joint negligence. Unless the indemnitee's sole negligence caused the loss, it will be indemnified. Of course, this type of agreement might trigger litigation over the parties' respective degree of culpability. In most states, if the indemnitee is less than 100% at fault, the indemnification obligation is enforceable. If the indemnitee proves that the indemnitor was even 1% liable, the indemnitor must pay the entire loss. While this type of agreement may necessitate a finding of fact, it mitigates the risk of a judicial finding that the clause is unenforceable.

Parties wishing to transfer risk may agree to a limited form indemnity agreement, which incorporates an analysis of comparative fault. It may include qualifying language like "to the extent caused by..." – that is, the indemnitor agrees to indemnify its contractual partner, but only to the extent that certain conditions are met (or not met). For instance, the agreement may be only to the extent that the other party is not negligent, or to the extent that the other party is not involved in the loss. Again, such wording might lead the parties into a factual dispute. But the contract language is designed to protect the indemnitee should they be found not entirely negligent.

Finally, any indemnification provisions should say clearly whether the defense and/or indemnity obligation is distinct from any requirement for the indemnitor to obtain insurance or name the indemnitee as an additional insured.

Insurance Coverage Considerations for Indemnification Obligations

Additional insured status on an indemnitor's liability policy goes hand-in-hand with indemnification agreements. Backstopping indemnification agreements with provisions requiring that the indemnitor procure insurance coverage for the indemnitee as an "additional insured" should be reflexive for both an indemnitor and an indemnitee. From an indemnitor's perspective, insurance can mitigate any losses that it must pay to the indemnitee under the contract. On the flip side, requiring an indemnitor to obtain and maintain insurance with specified limits provides an indemnitee some assurance that should the indemnitor be unable to pay, an insurance company's deep pockets serve as a financial back-up for the contractual indemnity obligation.

An indemnitee named as an additional insured enjoys the direct benefits of the insurance policy, including coverage for defense costs (usually outside policy limits) and standing to commence a breach of contract action against the insurance company, without paying premium. It also preserves the indemnitee's own insurance and prevents increased premiums in the future. However, an agreement requiring additional insured coverage is not an agreement between the indemnitee and the insurance company; rather, it is between the indemnitor and the indemnitee. Therefore, the indemnitee's remedy for the indemnitor's failure to obtain additional insured coverage properly is a breach of contract action against the indemnitor, not against the insurance company.

The indemnitor's insurance policy can convey additional insured status through a "blanket" endorsement or

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through named additional insured coverage. A blanket endorsement automatically provides coverage to any party to whom the named insured indemnitor has “agreed in writing in a contract or agreement” to add that party as an additional insured. Note that additional insured coverage might be limited to the parties that actually entered into the written contract with the original named insured (e.g., property owners who are not signatories to contracts between general contractors and subcontractors might not qualify as additional insureds). Further, language requiring only that the insured purchase and maintain insurance will not be construed as requiring the indemnitee to be named as an additional insured. Absent a blanket endorsement, the insurance policy might require that the indemnitee and the covered risk be specifically identified in the policy.

In order to ensure the additional insured coverage functions as intended, the parties should examine the named insured’s policies for exclusions for liabilities assumed by contract and any related carve-outs for “insured contracts” defined within the policies or duties or obligations that arise by law (i.e., tort liabilities). The risks set forth in the indemnification agreement should comport with the coverage provisions in the responding policy. Additionally, the insurance requirements should provide that the additional insured coverage (both primary and excess) should be on a “primary and non-contributory” basis. If a claim triggers both the indemnitor’s policy and the indemnitee’s policy, under that language, a court typically would hold that the indemnitee is entitled to coverage as an additional insured under the named insured’s policy before its own policy is triggered.

Finally, an indemnitee required to be covered as an additional insured would be wise to require either a copy of the indemnitor’s policy or the endorsement naming the indemnitee as an additional insured. While often the reciprocal party or its insurance company will provide a certificate of insurance, rarely will that certificate be proof of the indemnitee’s additional insured status. Should push come to shove, a court likely will look to the policy itself to determine additional insured status. A putative additional insured does not want to discover too late that it lacks that status.

Conclusion

Properly drafted indemnity provisions ensure that the party in the best position to control risks is responsible for resulting loss and helps businesses avoid being held liable for losses they did not cause. Coupling indemnity agreements with well-crafted insurance requirements can provide certainty in contracting and greatly increase the bargained-for protection needed for your company or business.

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Authors

[Dennis J. Nolan](#) / dnolan@andersonkill.com

Dennis is a shareholder in Anderson Kill's New York office and serves as co-chair of the Restaurant, Retail & Hospitality Industry Group, Bankruptcy Group, and Practice Group and Marine Cargo Group.

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