Indemnity and Insurance Provisions in Commercial Contracts

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Indemnity and insurance provisions of commercial contracts are tremendously important but often receive little or no attention during contract negotiation and drafting. When a claim arises, the parties and their insurers are likely to focus intently on the indemnity and insurance requirements, leading to disputes that may dwarf the underlying claim. This paper does not offer a checklist or simple rules for negotiating and drafting the indemnity and insurance provisions of a contract. In our view, trying to make these issues simple is a source of potentially severe mistakes. These are complex issues that require significant time and attention. Counsel negotiating or drafting these provisions should consider the particular purposes of the contract, the risks faced by each party, how those risks should be allocated between the parties, whether applicable law will allow the desired allocation, the extent to which insurance can help achieve that allocation, and under what policy language. In short, one size does not fit all. We will
describe some common scenarios and identify several issues that counsel may wish to consider when working on the next contract— or, unfortunately, the next claim.

**Threshold Consideration: Dealing With Not One But At Least Two Contracts**

When counsel is asked to review, draft or negotiate the indemnity and insurance provisions of a commercial contract, or to assess a claim relating to those provisions, the lawyer actually needs to consider at least two contracts. Obviously there is the commercial contract itself, which contains the terms and conditions to which the commercial parties have agreed. In addition, the attorney must consider one or more insurance policies, which have the terms and conditions agreed by and between the insurer and insured. Whether a commercial contract or an insurance contract, the terms and conditions may include certain definitions and exclusions that limit the who, what and when as to the indemnity.

Moreover, the commercial contract and the insurance contract relate to each other, implicitly or explicitly, and that intersection can be difficult to navigate. For example, in a November 9, 2012 opinion, the Illinois Appellate Court used the indemnity provision of a commercial contract as an aid in interpreting the additional insured endorsement to an insurance policy. *Pekin Ins. Co. v. Equilon Enterprises LLC*, 2012 IL App (1st) 111529. Other recent cases addressing the interplay of contractual indemnity and additional insured insurance coverage, with varying outcomes, include *In re Oil Spill by the Oil Rig “Deepwater Horizon” in the Gulf of Mexico*, 2011 WL 5547529 (E. D. La. Nov. 15, 2011); *Gilbane Bldg. Co. v. Empire Steel Erectors, LP*, 664 F.3d 589 (5th Cir. 2011); and *Norfolk & Dedham Mut. Fire Ins. Co. v. Morrison*, 79 Mass. App. 1128 (2011).
Construction Contracts

Most reported cases dealing with contractual indemnity and insurance requirements arise out of construction contracts. For example, if a general contractor’s employee is injured, he or she may sue various subcontractors as well as the owner, the architect and the engineer. All of the subcontracts probably required the subcontractors to indemnify at least the general contractor and owner, to carry substantial limits of commercial general liability insurance, and to make the general contractor and owner “additional insureds” under that CGL policy.

However, the particular language of the indemnity provisions of the subcontracts may vary, and depending on the specific facts of the accident, the subcontractors’ indemnity obligations may also vary widely. Consider this indemnification language from the 2007 American Institute of Architects Contract A401:

To the fullest extent permitted by law, the Subcontractor shall

indemnify and hold harmless the Owner, Contractor, Architect,

Architect’s consultants, and agents and employees of any of them

from and against claims, damages, losses and expenses, including

but not limited to attorney’s fees, arising out of or resulting from

performance of the Subcontractor’s Work under this Subcontract,

provided that any such claim, damage, loss or expense is

attributable to bodily injury, sickness, disease or death, or to injury

to or destruction of tangible property (other than the Work itself),

but only to the extent caused by the negligent acts or omissions of

the Subcontractor, the Subcontractor’s Subcontractors, anyone

directly or indirectly employed by them or anyone for whose acts
they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder

Many clients and counsel disregard this language as boilerplate, or they assume they already know exactly what it means in all circumstances. But it can be extremely important to invest the time to think about how this indemnity would operate in various real world scenarios.

- If you represent the Owner, Contractor or Architect, are you satisfied with what you are getting from the Subcontractor?
- If you represent the Subcontractor, are you sure what your obligations are?
- What happens if the Subcontractor manufactures, supplies or sells products used by the Contractor or other Subcontractors?
- Who hires and controls counsel to defend the case against the Owner, Contractor or Architect?
- When must the attorney’s fees and other litigation expenses be paid?
- Does one Subcontractor have to pay 100% of those fees and expenses, even if other Subcontractors signed similar contracts and are also defendants in the case? Even if the Owner, Contractor or Architect was negligent, as alleged by the plaintiff?
- Does the claim arise out of result from the performance of the Subcontractor’s work?
- To what extent was the claim caused by the negligent acts or omissions of the Subcontractor? Will this be determined conclusively in the underlying claim?
 Courts answer these questions differently, depending on which state’s law applies and on the particular facts of the case. Of course, the parties may use non-standard contract language with significantly different consequences. Notably, in *Crawford v. Weather Shield Mfg., Inc.*, 44 Cal. 4th 541 (2008), the California Supreme Court held that the word “defend” in a contractual indemnity agreement imposes essentially the same obligations on the indemnitor as an insurer’s duty to defend under an insurance policy. That is, the indemnitor must provide counsel and pay the entire cost of the indemnitee’s defense as long as any allegation in the underlying complaint is potentially within the indemnity language of the contract.

**Anti-Indemnification Statutes**

Another complication is new or revised anti-indemnity statutes, which differ from state to state. A partial list of these statutes is attached. Most allow indemnification for vicarious liability but preclude it for the indemnitee’s sole negligence. Some statutes allow full indemnification if both the indemnitor and indemnitee were negligent. Some limit indemnification to the percentage of negligence attributable to the indemnitor. Some statutes apply only to residential construction contracts, some to all construction contracts, and some to other types of contracts. For example, in the last few years, many states have passed new anti-indemnity statutes applicable to motor transportation contracts.

**Additional Insured Endorsements**

Many contracts have a separate section regarding insurance coverage. For example, a construction contractor will require the subcontractor to purchase certain types of policies, such as CGL and workers compensation / employer’s liability, with specified policy limits. In the
same section, the subcontractor typically will be required to make the contractor an “additional insured” on one or more of the subcontractor’s insurance policies. There are many different additional insured endorsements available from various insurance companies, and some may provide robust additional insured coverage while other endorsements provide no coverage at all to a particular party under the facts of the case. For example, the following are just some of the additional insured endorsements published by ISO Properties, Inc.:

- **CG 20 10 10 01**: covers an owner, lessee or contractor with respect to liability arising out of the named insured’s ongoing operations performed for the owner, lessee or contractor.

- **CG 20 10 07 04**: covers an owner, lessee or contractor with respect to liability for bodily injury, property damage, or personal and advertising injury caused, in whole or in part, by the named insured’s acts or omissions in the performance of the named insured’s ongoing operations.

- **CG 20 15 07 04**: covers a vendor with respect to bodily injury or property damage arising out of the named insured’s products which are sold in the regular course of the vendor’s business.

- **CG 20 26 07 04**: covers anyone whom the named insured has agreed in a written contract to include as an additional insured, with respect to liability for bodily injury, property damage, or personal and advertising injury caused, in whole or in part, by the named insured’s acts or omissions (a) in the performance of the named insured’s ongoing operations or (b) in connection with the named insured’s premises.
- CG 20 37 07 04: covers an owner, lessee or contractor with respect to liability for bodily injury or property damage caused, *in whole or in part*, by the named insured’s work for the additional insured and included in the *products-completed operations* hazard.

- CG 20 37 10 01: covers an owner, lessee or contractor with respect to liability *arising out of* the named insured’s work for the additional insured and included in the *products-completed operations* hazard.

Many insurance policies include the ISO forms without modification. However, it is also very common for insurance companies to issue additional insured endorsements with subtle but important variations in language from the ISO forms. Some insurers also issue their own propriety endorsement forms or will work with an insured to create a manuscript additional insured endorsement. The policyholder that purchases the policy should, of course, understand exactly which additional insured endorsement(s) it has. However, the prospective additional insured has at least as much incentive to know the precise terms of its additional insured coverage. Some construction contracts specify the ISO form that is required. In any event, the additional insured rarely will receive a copy of the actual endorsement until after a claim arises.

**Scenarios Other Than Construction Matters Under CGL Policies**

Separate from the GL and/or Construction context where contractual indemnities and additional insured provisions are commonplace, this section explores the intersection of contractual indemnities and other types of insurance including EPL, professional liability, fidelity coverage and liquor liability. We first review the impact of outside indemnities in the Employment Practices Liability context. Consider the following facts:
• Insurer issues EPL policy to Company A.

• Company A retains Company B, a consulting firm, to screen and interview potential employees and perform other Human Resources functions, but Company A makes all final hiring and firing decisions.

• The consulting agreement between Company A and Company B provided that Company A must indemnify Company B in the event of any claims involving alleged discriminatory practices in making employment decisions.

• A group of employees and potential employees bring a series of related claims against both Company A and Company B.

• Company B “tenders” to Company A, who then undertakes a joint defense of itself and Company B.

• Company A seeks defense and indemnity from its insurer.

What happens next depends on whether Company B is named as an additional insured. Typically, under a management liability or EPL policy, we would suggest no additional insured endorsement would have been issued. Nonetheless, Company A likely will seek coverage for the cost of its defense/indemnity as well as that of Company B which it is defending/indemnifying pursuant to contract. How does the insurer respond?

The insurer likely would deny coverage to Company B and/or deny that portion of Company A’s claim that relates to the indemnity provided to Company B. If a joint and common defense is being provided (same defense team defending both A and B), the insurer will likely demand an allocation. The policy may or may not have an allocation provision and the particular jurisdiction may or may not have case law on the issue, potentially leading to contentious coverage litigation. The insured takes that position that it is entitled to a complete defense as is
being provided, and that all the work being done by the common defense team would need to be done on its behalf alone even if Company B were not a named defendant – *i.e.*, the defense was not made larger due to Company B’s inclusion (*a la* the larger settlement/larger defense rule). On the other hand, the insurer will argue that it is not obligated under the policy, law or equity to provide a defense or indemnity to non-insured parties. Further, Company A’s indemnity of Company B arises pursuant to a preexisting contractual obligation which inherently is not insurable and not the intended subject matter of a liability policy. Indeed, Company A is not incurring costs on behalf of Company B as a result of a “Claim” made by Company B against Company A for a “Wrongful Act”, as those terms are typically defined in such policies. As such, no covered loss is being incurred by Company A pursuant to its indemnity obligations over Company B, and the insurer will not subsidize its insured’s contractual undertakings.

What if the insured is being indemnified by a third party pursuant to contract or otherwise? How does the liability coverage respond? Here is the scenario: Two related entities (a parent and a subsidiary) and several individuals that are employees or officers of those entities are named in a lawsuit. A common defense is provided under the parent company’s D&O policy until the policy exhausts. The defendants then look to a professional liability policy issued to the subsidiary. Only the subsidiary is an “insured” under such policy, as the parent company is not identified as an additional insured and the individuals are sued in their capacity as officers of the parent company rather than the subsidiary. The insurer affirms its duty to defend and provide 100% of a defense to its insured, but 0% for the parent and the individuals. A similar dispute as described above results – *i.e.*, whether the defense provided to all is the same as would be required to provide a complete defense to the insured alone. Should the non-insured defendants
get a free ride? Should there be an allocation based on the relative exposures of the defendants? In a further complicating wrinkle, as a result of an indemnity obligation (or otherwise), the parent company funds the defense of the subsidiary such that the subsidiary arguably has not incurred a “Loss”. May the insured still pursue a claim for coverage even just for its share of the defense/indemnity? May the parent company pursue a claim for coverage to the extent it indemnified the insured and arguably paid for the defense “on behalf of the insurer”? The insurer would likely argue that the parent company may not pursue a claim as it is not an insured under the policy. Further, because the insured incurred no loss (i.e., did not pay any of the legal bills and was not legally obligated to do so due to the indemnity provided by the parent company. However, see the Delaware Supreme Court decision in AT&T Corp. v. Clarendon American Insurance Co, 931 A.2d 409, 415 (Del. 2007)(California Law), holding that “Loss” did not require the directors to “actually suffer the entry of a judgment, or otherwise contractually promise to pay any judgment and/or costs of defense.”

In the first party insurance context, specifically under a fidelity bond or commercial crime policy, indemnity agreements outside the policy frequently come into play. First, a fidelity/crime policy affords indemnity for first party losses resulting from the fraudulent or dishonest acts of the employees of the named insured entity. Pursuant to a business arrangement or contract, the insured may agree to indemnify a third party for losses incurred by the third party as a result of the fraudulent or dishonest acts of a bonded employee. However, that does not necessarily mean the fidelity bond will indemnify the insured for that loss, and without more (such as an additional insured endorsement or other extension of coverage), such loss typically would not be covered as it would be a third party loss rather than a direct first party loss of the
insured. Under only limited circumstances will a third party liability be covered under a fidelity bond, notwithstanding the existence of a valid, enforceable indemnity agreement offered by the insured for the benefit of a third party. Additional insured requirements are commonplace in the context of mortgage lending and/or mortgage servicing. For example, Freddie Mac requires all correspondent lenders and servicers of its mortgage portfolio to carry on their respective fidelity bonds a “Freddie Mac Endorsement” that acknowledges Freddie Mac as an additional insured with a direct right of action under the first party bond issued solely (in the normal course) for the benefit of the named insured. But what if the correspondent lender fails to procure from its fidelity insurer the appropriate endorsement? Does Freddie Mac (or any other similarly situated warehouse lender or financial institution) have any recourse against the insurer? Does the fact that the service agreement between the two commercial parties requires the endorsement bind the insurer? Certainly, from the insurer’s perspective, the answer is no. In such a situation, not only does coverage litigation arise, but contentious reformation proceedings may ensue whereby a third party seeks to reform an insurance policy to which it is not a party. This gets quite complex, but these can be “bet the farm” scenarios that are not easily resolved.

As a final example outside the GL/Construction context, we note that liquor liability (Dram Shop) situations frequently involve outside indemnity agreements and the intersection between such agreements and insurance coverage. Most liquor liability laws hold a property owner or landlord liable for violations of the law. Similarly, and not coincidentally, in most lease agreements, property owners require tenants with liquor licenses to indemnify them for any liability arising out of the tenant’s operations, obtain and maintain appropriate liquor liability coverage, and name them as an additional insured under such policy. A problem can arise where
the policy does not name the landlord yet the insured must still indemnify and hold harmless the landlord. Again, issues of allocation and contribution may arise, and a full (and intended) risk transfer will not have been effectuated.