INDEMNIFICATION PROVISIONS AND ADDITIONAL INSURED ENDORSEMENTS

WE OWE YOU WHAT?

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The stark complexity of modern risk-allocation practices tends to be a source of great confusion – for contracting companies, for insurance carriers, and sometimes even for the attorneys asked to litigate the results. This is especially the case in instances where many parties (or potential parties) to a deal or lawsuit are involved, such as in construction defect cases. Often, reams of paper are dedicated to the musical chairs of allocating risk in a single deal. The reason is a singular focus for each party to avoid being the last one standing when the music stops – holding responsibility for indemnification, attorneys' fees, or contribution to the other party or parties to the deal. We sometimes encounter situations in our practice when a client is close to a resolution, only to find out that poor contract drafting or unwitting negotiation regarding additional insureds will leave it with significantly more liability than the client originally anticipated. This leads to roadblocks in the settlement process, and by extension, more attorneys' fees for the client.

What can be done to avoid these pitfalls? With some skillful contract drafting, effective negotiating chops, and understanding where and when to press on the enforceability (or lack thereof) of these provisions, fewer companies will be left wondering just how their liability got so disproportionately large in comparison to their scope of work, and how it happened so fast.

ADDITIONAL INSUREDS VS. CONTRACTUAL INDEMNITY

Many times, a contract for services will include contractual indemnity provisions as well as requirements that one party purchase insurance on behalf of the other, naming it as an additional insured. This belt-and-suspenders approach gives the party with potentially greater exposure (or deeper pockets) two discreet avenues to pursue protective coverage in a lawsuit.

The most common (and least-negotiated) risk-allocation device is contractual indemnity. Broadly, an indemnity agreement requires one party to reimburse another for any losses. Importantly, indemnification creates an obligation between the parties in contractual privity with one-another. Therefore, a demand for indemnification is a demand for specific performance under the contract's terms. Indemnification provisions, however, are sometimes rife with language that is over-inclusive as to liability and unenforceable due to nuances in state law, depending on the state and the type of contract.

Additional insureds, on the other hand, are added to the named insured's policy. Similar to indemnification, a contractual term will dictate the necessity of adding additional insureds. As an additional insured, a party has contractual privity with the insurance carrier. Stated differently, the insurance carrier must treat both its named insured and the additional insured as independent, unrelated customers – as if each had separately purchased a policy. This gives the additional insured rights against the insurer, by the terms of the endorsement, apart from its right to seek reimbursement through indemnification from the named insured.

Generally, additional insured status on a policy gives rise to greater obligations and potential exposure due to defense costs. Contractual indemnity clauses often provide significantly more room for negotiation of fees and costs when it comes time for settlement. Indemnity provisions tend to be easier to negotiate on a one-to-one basis between the parties to the contract. When entering into contracts, companies may wish to think twice before haphazardly adding additional insureds. Doing so may impact loss runs and increase premiums down the road.

Although a party with a contractual right of indemnification and protection as an additional insured will seek out both avenues of reimbursement, it will not recover twice for the same liability. For example, an allegedly negligent general contractor should tender a claim by a subcontractor's injured employee to the subcontractor's insurer (as an additional insured) and seek indemnification from the subcontractor itself as specific performance of their agreement. With both options at its disposal, the general contractor is unlikely to know at the outset of a claim which avenue might produce the more favorable result. The general contractor will eventually have to decide which provision it wishes to enforce. If an insurer covers all of the liability and attorneys' fees on the general contractor's behalf, principles of equity and common sense will not allow the general contractor to seek indemnity from its subcontractor for losses not actually sustained defending the claim.

DEFENDING AND LIMITING LIABILITY

Despite the general legal aphorism that two businesses coming to terms on a deal are "sophisticated parties dealing at arm's length," the reality is that one party is likely to be wielding significantly more leverage. For example, a small commercial electrician trying to expand its market share is not likely going to risk blowing the chance to win a bid by taking a stand against a general contractor on the language of an indemnification clause, when there are five other electricians waiting to step in on the general contractor's terms as written. The general contractor is much more likely to have retained expert legal counsel negotiating on its behalf, possibly directly with the subcontractor's business owner, who may have little knowledge of the nuance of risk allocation. Thus, the more powerful party will demand (and likely receive) the widest variety of liability protection and risk allocation that it desires.

If the subcontractor does have slightly more negotiating room, it should question whether the net gain of a project is worth incurring disproportionate potential liabilities. In those instances, the subcontractor may make a point of limiting an indemnification clause to only situations in which the subcontractor is more than 50% liable for the damages, or even trying to remove the indemnification language entirely. Another helpful course of action may be to negotiate the additional insured provision down to the smallest coverage possible, and ask the carrier to give the bare minimum coverage with the highest number of exclusions under the additional insured endorsement sufficient to comply with the contract's terms.[1] Working directly with the carrier throughout the negotiation process will ensure that the named insured has all the coverage it needs, separate and distinct from whatever coverage is mandated for the additional insured.

Defending against indemnification provisions of a contract is often a matter of pinpointing linguistic problems with enforceability, and then using those drafting snafus as advantages in litigation. For example, in states such as Wisconsin,[2] Pennsylvania,[3] and California,[4] the law strictly construes or voids indemnification clauses that require the indemnitor to reimburse the indemnitee for the indemnitee's own negligence. In some states, the standard is that language of general import such as "any and all liability" will not suffice to allow for indemnification of one's own negligence.[5] Furthermore, in other states, indemnification provisions must have a monetary limitation with a reasonable commercial relationship to the size and complexity of the project under contract, and must have the indemnification provision included in project specifications or bid documents to avoid unfair surprise.[6]

Another defense strategy (especially in construction cases) is to pinpoint the "time on risk" of each party and its insurer(s). "Time on risk" is evaluated as the period of effective coverage under an insurance policy among several concurrent or consecutive policies.[7] A dissertation could be written on this topic alone, including the various "triggering theories" of damage manifestations that implicate the coverage. This aspect of the law is unsettled in many states.[8] Suffice to say that when multiple consecutive or overlapping insurance policies are at issue, the ambiguities in the law allow for defense attorneys to craft creative arguments. For example, by advancing facts that show a particular stucco subcontractor's insurer was only "on the risk" for 30% of the period in which water damages occurred over time, the insurer may only be liable for that percentage of the total damages.

Defense attorneys also look at the time of tender as a means of reducing fees and costs of defense as part of a settlement. The insurer is likely only responsible for the costs of defending an action from the point of tender to the end of the claim. Thus, if a claim was defended by the general contractor's insurer prior to tendering as an additional insured under the subcontractor's policy, counsel for the subcontractor's insurer should insist on proportionally reducing any contribution towards defense costs.

CONCLUSION

Liability exposure through risk allocation can be reduced by understanding how the contractual obligations of the parties may end up affecting their litigation posture if the relationship breaks down. An easy way to minimize potential exposure is to work with a representative of one's insurance carrier or use counsel during negotiations to procure coverage that will provide sufficient liability protection as required by the contract. Another avenue is to give deeper consideration to disproportionate risk allocation in contracts that provide minimal economic upside in comparison. With sufficient study, the defense of incomprehensible exposure can become more sensible.

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1 *See Acceptance Ins. Co. v. Syufy Enters.*, 81 Cal. Rptr. 2d 557, 562-63 (Cal. Ct. App. 1999) (giving examples of limiting clauses in additional insured endorsements, and warning of the use of general language such as "arising out of the named insured's work," which will be construed liberally to provide coverage).

2 *See Fabco Equipment, Inc. v. Kreilkamp Trucking, Inc.*, 841 N.W.2d 542, 548 (Wisc. 2013).

3 *See Perry v. Payne*, 66 A. 553 (Pa. 1907).

4 California Civil Code § 2782; 2782.05 (2015).

5 *See, e.g., Ruzzi v. Butler Petroleum Co.*, 588 A.2d 1, 5 (Pa. 1991).

6 *E.g.*, Fla. Stat. § 725.06 (2015).

7 *Boston Gas Co. v. Century Indem. Co.*, 910 N.E.2d 290, 312-13 (Mass. 2009) (providing a thorough explanation of the time on risk approach to pro-rata distribution of continuing damages).

8 *See, e.g., Axis Surplus Ins. Co. v. Contravest Const. Co.*, 921 F. Supp. 2d 1338 (M.D. Fla. 2012) (discussing the uncertainty of trigger theory application under Florida law and engaging in analysis of which theory to apply).