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Indemnification and Insurance: Contractual Risk Transfer Provisions

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Contractual indemnity provisions and insurance requirements play a central role in corporate risk management. Designed to shift responsibility from one potentially liable party to another, indemnity agreements are commonplace in contracts with vendors, suppliers, service providers, and other third parties. Many contractual indemnity agreements are coupled with insurance provisions. The imposition of minimum insurance requirements and the frequent insistence that indemnitees be named as additional insureds on the required policies reinforce the transfer of risk by circumventing uncertainty regarding the enforceability of the indemnity provision or the solvency of the indemnitor.

When tailored to the parties' relationship, these risk-shifting provisions can provide substantial protection to the company as a means of transferring risk to a third party and its insurers. As a practical matter, however, inconsistences in drafting both the contract provisions and the insurance policies maintained by the indemnitor spawn significant challenges. Enforceability aside,[1] the indemnity provisions in many corporate contracts are boilerplate inserts, copied and pasted from predecessor agreements with minimal customization. Indemnity clauses that were carefully crafted at the outset may be amended mid-term to address specific risks without attention to the associated insurance provisions, leading to disappointing results in the event of a substantial claim that exceeds the indemnitor's available resources. Other complications arise when an indemnitee learns after a loss that the indemnitor did not maintain insurance as agreed, leaving both parties exposed for liability that should have been transferred to an insurer.

TAKEAWAY. To reinforce the transfer of risk, indemnity provisions are often accompanied by requirements that the indemnitor maintain insurance at specified limits. These insurance provisions protect the indemnitee from uncertainty regarding (1) the enforceability of the indemnity provisions and (2) the solvency of the indemnitor.

This article focuses on the interplay between indemnity and insurance provisions in third-party contracts as a mechanism for transferring risk and the impact these provisions have on the insurance policies maintained by both the indemnitor and the indemnitee.

Indemnity Agreements

Contractual indemnity provisions seek to allocate or re-allocate risk between and among parties to an agreement. In Texas, indemnity provisions that purport to transfer to another the transferring party's own negligence are subject to strict fair notice requirements because they effectuate "an extraordinary shifting of risk."[2] These fair notice requirements consist of compliance with the express-negligence doctrine and conspicuousness.[3] Under the express-negligence doctrine, a party seeking indemnity from the consequences of that party's own negligence

[1] Michael A. Golemi & William W. Pugh, *Hoping for the Best, Preparing for the Worst: "Don't Worry, We Have Indemnity*," 78 THE ADVOC. 47, 48-50 (2017), *available at* https://www.liskow.com/portalresource/HopingfortheBest_PreparingfortheWorst (discussing legal obstacles to indemnity provision enforceability); William W. Pugh, *Maximizing Insurance Protection*, 2018 TXCLE-AOGERL 4-IV ("Generally, the insurance requirements should dovetail with the indemnity provisions, both for the purpose of insuring solvency and for the purpose of maximizing enforceability of the agreed risk allocation."); Lisa Cappelluti & David Roper, *Looking for the Trap Doors in Your* Contract, 12 NO. 4 IN-HOUSE DEF. Q. 60 (2017).
[2] *Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 508 (Tex. 1993) ("Although we recognize that most contractual provisions operate to transfer risk, these particular agreements are used to exculpate a party from the consequences of its own negligence. Because indemnification of a party for its own negligence is an extraordinary shifting of risk, this Court has developed fair notice requirements which apply to these types of agreements.").
[3] *Id.*

must express that intent in specific terms within the four corners of the contract.[4] To be conspicuous, "something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it."[5]

Distinguished from Insurance Policies

Importantly, indemnity agreements are *not* insurance policies. While indemnity agreements and insurance policies both transfer specified risks to another party and impose "indemnity" obligations, the similarities end there. As a starting point, compare any insurance policy with the standard indemnity clause in a company contract. The insurance policy is likely far more detailed, setting forth a complex assortment of terms, definitions, conditions, and exclusions. Even a well-drafted indemnity provision that meets the legal criteria for enforceability will typically be shorter and less detailed. Many insurance policies are written on standard, industry-promulgated, state-approved forms, and the insurance companies that issue these policies are often regulated by state insurance departments or commissioners of insurance that are in turn governed by state statutes—*e.g.*, the Texas Insurance Code.

While some rules of contract construction apply generally to both indemnity agreements and insurance policies, the presumptions and burdens are different:

> The strict construction of indemnity agreements against indemnity stands in contrast to the liberal interpretation of insurance policies in favor of coverage. In insurance, ties go to the insured; in indemnity, ties go to the indemnitor. Therefore, even if the indemnity agreement obligates the indemnitor to "defend" claims, the indemnitee should not expect the same kind of protection the indemnitee would enjoy as an additional insured under an insurance policy that provides defense of the "suit" even when most of the claims are not covered under the policy.[6]

Finally, and perhaps most importantly, for an indemnity agreement to be effective as a risk-transfer mechanism, the indemnitor must be solvent and financially capable of honoring its indemnity obligations.[7] Quite unlike the average indemnitor, insurance companies are subject to financial regulation designed to minimize insolvency and its impacts on policyholders and claimants.[8]

TAKEAWAY. While most readers will appreciate the distinctions between indemnity provisions in the company's third-party contracts and the company's insurance policies, business clients may conflate these risk-transfer tools, equating indemnity protection with insurance and treating capped contractual indemnity as another form of "insurance."

[4] *Id.*; *see Ethyl Corp. v. Daniel Const. Co.*, 725 S.W.2d 705, 707-08 (Tex.1987).
[5] *Dresser*, 853 S.W.2d at 508 (citation and internal quotation marks omitted).
[6] *See* Eric S. Peabody, *Indemnity: Don't get harmed by your "hold harmless" agreement!*, HANNA & PLAUT LLP (May 23, 2017), https://www.hannaplaut.com/indemnity-dont-get-harmed-hold-harmless-agreement/.
[7] *See* Mark Bell, *Indemnity and Additional Insured Requirements: Why Am I Demanding Them, Why Do Others Want Them, and What Does It All Mean?*, INTERNATIONAL RISK MANAGEMENT INSTITUTE (May 2013), https://www.irmi.com/articles/expert-commentary/indemnity-and-additional-insured-requirements ("Because an indemnity agreement is only as good as the indemnitor's financial ability to pay for a loss, a financially defunct indemnitor provides no meaningful protection to the indemnitee.").
[8] *See generally State Insurance Regulation*, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 4-5 (2011), , https://www.naic.org/documents/topics_white_paper_hist_ins_reg.pdf.

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