TWO DOORS OF PROTECTION - PART 1

By: Carl Bloomfield, The Graham Company

One of the most confusing and misunderstood concepts in insurance and risk management is contractual risk transfer. However, it is one of the most important aspects of a sound risk management program. Every contract you sign likely contains some level of risk transfer, although there is no standard language to accomplish this feat. Courts are continually ruling on issues related to contractual risk transfer, which makes it very difficult to keep up-to-date on the appropriate language to use and what is allowable in each state in order to affect the risk transfer. Some contracts are one-sided and all the risk transfers to the party with the least amount of leverage. Some contracts are more balanced and attempt to assign liability squarely onto the responsible party. And some contracts accomplish nothing in the way of risk transfer despite having an exorbitant amount of words related to that topic. Knowing what risk is being transferred to you and what risk you are transferring to others is a critical consideration when negotiating a contract. It may be the deciding factor to enter into the contract or to walk away. That’s why I intend to dedicate this and the next two articles to this topic.

The purpose of this article is to provide a broad overview of contractual risk transfer. I will talk about the two separate doors of accomplishing this feat: indemnification and additional insured status. In subsequent articles I will go into great detail on each and lay out some of the important considerations contractors need to be aware of.

Door 1 - Indemnification

The word “indemnify” means to make compensation to another for hurt, loss or damage. In other words, it means to make that person or organization whole or return them to the status in which they were prior to the event triggering the indemnity. One of the biggest misconceptions about indemnification is that it is insurance. Indemnification is not insurance at all. Indemnity is an obligation that is placed purely onto another party through a contractual relationship. It is, however, likely that your insurance program will provide coverage for your indemnity obligation, but there are definite pitfalls related to this kind of insurance coverage. If required by contract, the obligation to indemnify another party exists even if insurance is available or not, so it is important to make sure that your insurance program backs up the indemnity obligations being placed upon you. This also requires striking the indemnity obligations from contracts in which insurance coverage is not available.

There are three levels of indemnification: Broad, Intermediate and Limited Form. Broad indemnification requires one party (indemnitor - party providing the indemnity) to assume the obligation to pay for another party’s liability even if that other party (indemnitee - party receiving the indemnity) is 100% at fault. For example, Contractor A subcontracts work to Contractor B. There is an accident on the jobsite as a direct result of Contractor A’s Safety and Project Plan, but arose due to work performed by Contractor B. Contractor A gets sued by the injured party and tenders the claim to Contractor B even though the allocations are that Contractor A was completely at fault. If Broad Indemnification is required in the contract between Contractor A and B, B would have to indemnify A, even if they are solely negligent. As result, many states have adopted Anti-Indemnity Statutes that prohibit Broad Form Indemnification. New Jersey, for example, prohibits Broad Form Indemnification for construction contracts only, but Pennsylvania does not.

Intermediate Form indemnification requires one party (indemnitor) to indemnify another party (indemnitee) for their negligence if the indemnitor is liable. For example, the same scenario as before, but this time Contractor A is 99.999% liable for the loss and Contractor B has the remaining liability. With these facts, Contractor B would have to indemnify Contractor A for their 99.999% liability. This form of indemnification is allowed in most states and is allowed in New Jersey as well.
The last form of indemnification, Limited Form, is not really indemnification at all, meaning it is the liability you would assume in the absence of any contract. Using the same example, but this time Contractor B is 100% at fault, Contractor B would be responsible for indemnifying Contractor A for any loss they suffer as a result of Contractor B’s negligence.

If you are in the position of power, the most advantageous form of indemnification you can receive from another party is Broad Form. If you are in the weaker position and required to provide indemnification to another party, you should attempt to limit your obligation to Limited Form. However, as you can imagine, nothing in the real world is as clear cut as the examples I have laid out. There are several other nuances to consider regarding indemnification. We will address these issues in much more detail in Part II of this article, which will appear in the next edition.

**Door 2 – Additional Insured Status**

Completely separate and independent from indemnification is something called Additional Insured Coverage. Unlike indemnification, this is in fact insurance. If you provide a third party Additional Insured status, you are giving them direct access to your insurance policies. Most often, Additional Insured Coverage must be endorsed onto the standard insurance policy because it is otherwise not included in the base form. Many years ago there used to be just a handful of endorsements that were needed to add a third party as an Additional Insured. Many people may remember, or still see in their contracts today, the requirement to use the General Liability form CG 20 10 11 83. In the insurance business we refer to this as the “Holy Grail” because this one endorsement satisfied most requests to add another party as an Additional Insured. Unfortunately, today, it has gotten much more complicated to add another party as an Additional Insured. There are literally hundreds of Additional Insured endorsements, each with their own problems or shortcomings. In Part III of this article, we will go into greater detail on the specific issues related to Additional Insured Coverage.

There are many similarities between Additional Insured Coverage and Indemnification. Just like indemnification, there are three levels of Additional Insured Coverage: Broad, Intermediate and Limited. However, you may recall that most states have adopted Anti-Indemnity Statutes which prohibit Broad Form Indemnity, but most often, these statutes don’t affect the level of Additional Insured Coverage that is required from one party to provide another. For example, in New Jersey, Broad Form Indemnity is not permitted, but there is no prohibition against requiring one of your subcontractors to provide you with Broad Form Additional Insured Coverage. In other words, coverage for your own sole negligence. This concept is often misunderstood by insureds and brokers alike.

**Which Door is Better?**

I often get asked by parties that are in the position of leverage, which is better – Indemnification or Additional Insured Coverage, and I am hesitant to provide an answer because the truth is you absolutely need both. In fact, a “belts and suspenders” approach is recommended. There was a time that Additional Insured Coverage was preferred over indemnification, because it gave an injured party direct access to an insurance policy instead of asking for being paid (indemnified). Because this has become so complicated to craft Additional Insured Coverage correctly, I no longer think that preference exists. The possibility that the Additional Insured Coverage is inadequate is too great with all the various endorsements that exist today.

As mentioned, Parts II and III of this article will expand upon each of these topics and go into detail on the pitfalls and issues to be aware of.

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