Step 2 — Allocate the Risk

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Indemnity

Risks are allocated through an indemnity provision in contracts. To “indemnify” means to “compensate” or “make whole.” In the contract, indemnity means an agreement to compensate a party (the “indemnitee”) after a loss. The party agreeing to indemnify (the “indemnitor”) assumes financial responsibility to pay for the loss and may assume additional responsibility, such as settling claims and defending the indemnitee. By agreeing to such a provision, the indemnitor waives its right to be judged in court on negligence principles alone (“in Tort”) but also on contractual obligations (“in contract”).

This indemnity agreement is not the same thing as insurance. It is a contractual obligation voluntarily assumed by one party toward another. Whether or not insurance applies, the indemnitor becomes liable under contract for the obligation assumed. An indemnity agreement is the principal instrument by which the organization transfers risk to the contractor/supplier/service provider. Insurance backs up the transfer financially. Every contract should have both an indemnity provision and insurance requirements.

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The fact that a contractor may indemnify your organization does not mean that the organization avoids liability. The indemnity agreement is a promise to pay, but it does not transfer the "tort" liability to the indemnifying party. For example, suppose that a person is injured because of work on your organization's project and the contractor has promised to indemnify the organization. If the injured party sues your organization, the organization will turn to the contractor to defend and pay any damages (unless your organization is solely negligent).

If the contractor is unable to pay (or refuses), however, and the injured person gets a judgment against your organization, the organization is still liable to that person. The organization could be compelled to pay the injured party and then pursue the contractor for the cost. The reason our specifications always require insurance is that insurance may be a more reliable source of funds than a contractor's assets.

Auto and general liability insurance policies usually provide "contractual liability coverage," although indirectly through an exception to an exclusion. This coverage provides protection to the insured for liability assumed in a contract through an indemnity agreement.

However, as this manual discusses elsewhere, it is important to be more than just an indemnified party in a contract. Aside from the status as a party to the insurance contract as an additional insured, which provides "privity of contract" with the insurer, an additional insured gets defense costs covered in addition to policy limits.

Defense for an indemnitee is within limits, meaning that money spent to defend an indemnitee erodes the policy limits and reduces the financial protection for both the named insured and the additional insured. It is essential to require the indemnifying party (contractor) to make sure the organization is also an additional insured under the contractor's liability policy. This requirement does not apply to professional liability insurance or workers' compensation insurance, however.

Sample indemnity clauses are available online at the Synchrous website, under Resources/Templates. If you should decide to use any of the examples in this manual, you should still have the language reviewed by legal counsel for applicability to your particular contracting situation. Your organization's legal counsel should have a copy of this manual.

Someone knowledgeable about insurance also should review indemnity agreements. The indemnity agreement is almost always broader than the insurance provided to back it up. While the indemnity agreement may contain a few qualifiers that narrow the scope of application, the insurance policy is full of exclusions, limitations, and restricting definitions. It is likely that the indemnity agreement will obligate the indemnifying party to pay for losses that cannot be covered by insurance, whether or not the indemnifying party would even be willing to pay for the coverage. The party drafting the indemnity agreement should carefully consider whether or not it is really the intent to bankrupt the indemnitor under such circumstances.

It is important that the indemnity agreement contains wording that will actually "trigger" coverage under the indemnitor's policies and provide for certain contingencies. One example: in contemporary standard general liability insurance policies, defense coverage during litigation for an indemnitee (not an additional insured) is provided by the insurer only if the contract specifically requires it.

Furthermore, if defense is not required in the contract, and the indemnified party sustains a judgment and tenders the loss to the indemnitor, any defense expenses included in the tender will be considered damages, which erode the policy limits. If treated as defense obligation as required by contract, such costs are in addition to policy limits, increasing coverage for all.

Hold Harmless

Many texts on the subject of Contractual Risk Transfer make no distinction between “indemnity” and “hold harmless.” Some distinguish the two by classifying indemnity agreements as those in which an indemnitor agrees to reimburse an indemnitee for a loss sustained. Hold harmless agreements, on the other hand, are supposed to keep the party held from any “harm.” Some believe that the distinction between the two is that a hold harmless agreement will pay for defense in advance of a judgment or settlement, whereas an indemnity agreement will only reimburse expenses incurred.

In practice, however, most clauses transferring risk include elements of both types of protection and more. For example, many generic clauses require the other party to “defend, indemnify and hold harmless” the indemnitees.

Waivers

If two parties to a contract agree that one party will indemnify the other under certain circumstances, the parties do not want this agreement to be undone by an insurer seeking to recover its loss payments from one of the parties. The indemnitor’s insurer is in a position to do exactly that if the indemnitee (your organization) is all or partly responsible for a loss. The insurer could come after your organization to recoup the insurer’s payments. This type of action is called “subrogation.”

Subrogation is “the assumption by a third party (as a second creditor or an insurance company) of another’s legal right to collect a debt or damages.” [Source: Merriam-Webster online dictionary]

In a subrogation action, an insurer “stands in the shoes” of the insured who has a right of recovery. This is a right based in law.

> *“Subrogation is a doctrine of equity intended to compel the ultimate payment of a debt by the one who in justice, equity, and good conscience should pay it. For example, a property insurer that has indemnified its insured is usually subrogated to any rights the insured may have against the third party that is actually responsible for the loss. The theory behind this principle is that, absent repayment of the insurer, the insured would be unjustly enriched by virtue of recovery from both the insurer and the wrongdoer. More frequently, in the absence of such double recovery by the insured, the third party would emerge free from liability despite its legal obligation in connection with the loss”.*[1]

A waiver is the voluntary relinquishment or surrender of some known right or privilege. In the world of Contractual Risk Transfer, waivers can be used to effect the intent of the risk transfer. In other words, waivers can be used to make sure that the party intended to be responsible for loss actually covers the loss (through insurance, hopefully), and that the party intended to be protected from loss is protected. In CRT, waivers can prevent insurers from subrogating.

In the context of Contractual Risk Transfer and insurance, subrogation usually occurs when an insurance company, having paid a loss on behalf of its insured, attempts to recover its payments from another party responsible for causing the loss. A waiver can preclude such recovery in several ways.

1 Wielinski, Patrick; Woodward, Jeffrey; and Gibson, Jack; Contractual Risk Transfer, International Risk Management Institute, 2011

First, the insurer can voluntarily waive its right to recover. As noted above, this is a legal right not a contractual right, so it must be voluntarily surrendered if subrogation is to be prevented. An insurer may waive its recovery rights by endorsement to a policy. This usually occurs when an indemnitee in an agreement, such as your organization, requires such an endorsement waiving subrogation rights as a condition of the contract.

A second way recovery rights can be waived by an insurer is to grant to the named insured the power to waive its own right of recovery. If the insured has no right of recovery, the insurer cannot "stand in the shoes" of the insured to exercise a right that does not exist. Most contemporary property and liability insurance policies contain a clause that says the insured "must do nothing after loss" to impair the insurer's right to subrogate. This wording implies that if the insured does something before loss, such as waive its right of recovery, then the insurer will not subrogate.

Courts have consistently supported this interpretation. Thus, it is generally accepted that if an insured waives its recovery rights in a contract, the insurer cannot subrogate against the party that obtained the waiver. If your organization's contractor waives its recovery rights against your organization, the contractor's insurer won't be able to go against your organization under a subrogation right.

The exception to this type of protection for an indemnitee is workers' compensation, as the right in a workers' compensation claim does not belong to the named insured employer, and neither the employer nor the worker can waive that right. Therefore, many experts advise obtaining a waiver of subrogation endorsement from the contractor's workers' compensation insurer in favor of your organization.

Generally, an insurer may not subrogate (recover from a third party for a loss caused by the third party and paid for by the insurer) against its own insured. If your organization is added as an additional insured on general liability policies, as recommended, it should be safe from subrogation by the general liability insurer.

However, a few court cases have resulted in successful subrogation by the insurer against its own insured, most often in construction disputes (many cases have gone the opposite way as well). As a result, some experts advise that the specifications in a contract require the contractor's general liability insurer to specifically waive subrogation (by endorsement) against the additional insured. Other experts call this "belt and suspenders."

Such a request may meet with resistance from the general liability insurer who will argue that the additional insured status protects the organization. We recommend that your organization consider obtaining the waiver of subrogation when doing so will not add additional cost to the contract and/or the contracted activity is particularly hazardous or critical.

If the contractor has employees, the organization will also require an endorsement to the contractor's workers' compensation insurance waiving any right of subrogation that the insurer may have against the organization for injury to a contractor employee. You should be aware that many or most insurers will charge additional premium for a waiver of subrogation on a workers' compensation policy.

Sample general liability and workers' compensation waiver forms can be found in the next chapter under "Waiver."