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Insurance, Indemnification, And Limitation Of Liability Provisions In Business Contracts

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If your job includes reviewing, drafting or negotiating contracts, you've probably seen these provisions. Are they boilerplate that you spend little time on? Do you fully understand exactly what they do? Do you negotiate or revise them?

Allocation of Risk

Fundamentally, the purpose of insurance, indemnification, and limitation clauses is to allocate risks. In general, insurance transfers risk from the contracting parties to a third party—an insurance company. Indemnification usually transfers risk between the parties to the contract. Limitation of liability prevents or limits the transfer of risk between the parties. With those basic concepts in mind, think about the risks that arise out or relate to the contract. Take the time to imagine nightmare scenarios as well as other events that might be less devastating but more likely to occur. Then think about who should bear each of those risks. Do the insurance, indemnification, and limitation of liability provisions allocate the risks appropriately? If not, the parties should consider carefully negotiating to reach agreement on the risk allocation and then drafting or revising the provisions necessary to accomplish their mutual intentions. These issues can be as important as price and other material terms in the contract.

Clear Drafting

As with any contract provision, ambiguity can be bad for both parties. If you're uncertain how the risk allocation provisions apply to one of the risk scenarios that concerns you, consider adding language that specifically addresses that situation. Make it as clear as you can, and consider not just who should bear the risk but how that should work. Should there be a deadline for one party to notify the other? Should the party bearing the risk be required or even permitted to control the defense of third-party litigation? If insurance covers only part of the problem, what happens to the rest? Whatever your answers to these questions, it may be important to address them specifically in the insurance, indemnification, or limitation of liability provisions of the contract.

Obstacles to Enforcement

The law governing the contract can make a big difference in whether a risk allocation provision will be enforceable. For example, many states have

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statutes limiting the extent to which a party can be indemnified for its own acts, especially in industries such as construction, transportation, oil and gas, and health care. Some courts also apply those anti-indemnity laws to limitation of liability provisions. States differ on the extent to which the contract between the parties may impact their common law rights and remedies. Insurance coverage may or may not hinge on the language of the insurance requirements in the contract or on the indemnity provision. All of these variables are worth considering.

Understanding Insurance

Contractual insurance requirements often describe the type of policies that one or both parties must carry, and they may even identify some terms and endorsements that must be included. The parties dutifully purchase the specified policies but unfortunately may misunderstand the coverage. For example, Owner hires Contractor to erect a second building on Owner's site, and their contract requires Owner to be an additional insured under Contractor's commercial general liability policy. In the course of the project, Owner's existing first building is damaged. Owner may think that its additional insured status allows it to submit a claim to Contractor's CGL insurer and get paid for the damage. Probably not. It's a commercial general liability policy, covering the insured's liability to third parties. Being an additional insured can allow Owner to be covered against a third party's claim for injury or damage, such as an injury suffered by a subcontractor's employee. There may still be an avenue for Owner to have Contractor's CGL policy pay for the damage to Owner's property. If the facts support an allegation that the damage was caused by an act or omission of Contractor, Owner can demand or sue Contractor, and then the CGL carrier may pay for Contractor's liability for damaging Owner's first building. B

ut that has nothing to do with Owner's status as an additional insured. If you're not sure about something in the insurance provision of your contract, talk to coverage counsel or someone else who does. Regardless of which party(ies) must purchase insurance, make sure you understand the requirements and can verify compliance with them. This space is insufficient to address all the complexities or offer tips for drafting insurance, indemnification, and limitation of liability provisions in business contracts. If you take the time to think carefully about these issues, you're already doing more for your business than someone who considers those provisions to be mere boilerplate not worth the effort.