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Navigating The Choppy Waters Of Indemnification

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Many types of contracts require one party to indemnify another for first-party losses or against claims made by third parties. The indemnity obligation also may be imposed by law in the absence of a contractual obligation. But, as the person entitled to indemnity (the indemnitee), making sure you get what you intended isn't always a simple trip from right to remedy. It requires the preparation and attention of a skilled mariner charting the best course and tacking through changing winds and choppy seas. This post discusses some of the most important considerations.

What does the contract say?

- In the case of contractual indemnity, the rights and obligations of the parties begin with the language of their contract. The parties should be clear about what indemnity is being given and for what types of losses or claims. The particulars will differ in each case, but a checklist of topics to consider includes:

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RELATED TOPICS

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Contractual Insurance

- Does the indemnity apply to first-party losses, third-party claims, or both?
- What is the scope of conduct or events that will trigger the indemnity obligation?
- Is there anything that should be expressly carved out from the indemnity obligation?
- Is there a duty to defend in addition to a duty to indemnify?
- If there is a duty to defend, who chooses defense counsel?
- If there is insurance for the indemnity obligation, does the indemnitee have a duty to cooperate with the indemnitor's insurance company or any other obligations with respect to that insurance?
- Is there any cap or other limit on the indemnity obligation?

Is insurance involved?

Many contracts contain both insurance and indemnity obligations. These seemingly separate obligations can conflict and require careful navigation. For example, parties are often surprised to discover that an agreement to procure insurance for a particular loss may limit the parties' obligations to each other in the event of an insured loss or claim.

In the construction setting, for example, contracts generally require the owner to purchase property or builder's risk insurance and require contractors to provide liability insurance. The interests of contractors are often covered by the builder's risk policy and the owner and higher tiers of contractors are typically named as additional insureds on contractors' liability insurance.

In addition, the contracts and insurance policies typically contain waivers of subrogation and other waiver clauses. When a loss occurs, questions arise as to which insurance applies and whether any responsible party may be liable outside of that insurance.

Many courts have held that this arrangement places the risk of loss solely on the applicable insurance, not on any insured. They further have noted that whatever policy applies, that insurance company is barred from subrogating against other parties or their insurance. The applicable insurance may therefore be the sole remedy for a loss, even if the loss exceeds the limits of insurance.

This situation can be complicated by the terms of the insurance and/or by the terms of the parties' contracts. Disputes frequently arise about what caused a particular loss – typically, whether it was caused by external, fortuitous forces (covered by builder's risk or the owner's property insurance), or by the negligence of a contractor or subcontractor (excluded by builder's risk and property insurance, but typically covered by liability insurance). Even if negligence is involved, disputes may arise between the design team and the construction team over who was responsible for the loss.

It is not uncommon for an owner to make a claim or to demand indemnity from its co-party(ies) on the design and/or construction side, and for those parties to demand indemnity from the parties and insurers down their respective contractual chains. Sorting out the respective rights and obligations of the various parties and their insurers can be a complex task,

particularly when those parties and insurers start issuing reservation of rights letters. And, because the duty to defend is broader than the duty to indemnify, several parties and their insurers may have a duty to defend any particular party in their contractual chain.

It is important to understand how the respective contractual and insurance policy language works, and how the various courts interpret that language, in this complex context.

Is a tender required?

Most states require only notice, and not formal tender, to trigger an insurance company's duty to defend. Some states require tender – Illinois, for example, allows something called a "targeted tender," by which an insured can choose which insurer will provide its defense. Most states also allow insurers to bring contribution claims against other insurers who they contend also owe a duty to defend their insured. Things can get even more complicated depending on what the policies' "other insurance" clauses say, whether the policies have different deductibles or self-insured retentions (SIRs), and whether the policies are written on a primary, umbrella or excess basis. All of these issues require careful navigation.

Outside the insurance context, few people understand what is required of an indemnitee to protect its rights to indemnification. Too often, indemnitees look out for their own interests and do not involve the indemnitor until after the claim is resolved or significant resources have been spent. Or, indemnitees take conflicting positions the compromise their rights to indemnity.

The perils of not appropriately navigating these waters are illustrated by the recent case of *AXIS Ins. Co. v. Am. Specialty Ins. & Risk Servs., Inc.*. The case in the U.S. District Court for the Northern District of Indiana involved a claim by a professional football player against his team for an off-the-field injury. The team tendered the claim to its insurer, AXIS, which denied coverage. The team contended that AXIS' underwriter, American Specialty, had represented that coverage would exist for the type of claim, and the Program Management Agreement between AXIS and American Specialty contained an indemnity clause.

Rather than tendering the claim to American Specialty or otherwise involving American Specialty in resolution of the claim, AXIS directed American Specialty to stay out of the matter. AXIS then paid to settle the player's claim at mediation and sued American Specialty for indemnity.

The court granted summary judgment for American Specialty based on AXIS' coverage denial and failure to tender the claim. After surveying the law from various jurisdictions, the court concluded: "Courts traditionally have required a tender of defense; and when that tender has not been made, or when the party has not been informed of the settlement until afterwards or not participated in the negotiations and approved the agreement, the right to indemnity has been lost, absent a showing of actual liability." The court noted further that, "[a] contract might write a different obligation, but the court today has not been presented with argument that this one did."

While the law allowed AXIS to prove it was entitled to indemnity because it was actually liable for the claim, AXIS' coverage denial and staunch denial of liability doomed its indemnity claim. The court concluded, "Given what the policy said about coverage, AXIS cannot claim that its liability was 'actual.'"

In general, if an indemnitee gives its indemnitor an opportunity to settle or take over the defense of a claim or lawsuit, it does not need to prove actual liability for recovery. It is therefore important for an indemnitee to tender its defense and to involve the indemnitor in settlement discussions. Many indemnitees are reluctant to give any control over to their indemnitors. But, that issue can be controlled, or at least mitigated, in two ways.

First, the control issue can be addressed in the parties' contract. Indemnity clauses frequently state that the indemnitee may choose its own counsel and/or control the defense of the claim. While this freedom of contract generally will protect the indemnitee, assuming it can bargain for the right, insurance issues may come into play. The indemnitee may be named as an additional insured under the indemnitor's insurance policy, for instance, and may be required to comply with provisions of the policy concerning the defense of claims or lawsuits. In such cases, the indemnitee must navigate both its rights to indemnity and its rights as an insured, which are not always consistent with each other.

Second, an indemnitor or its insurer will rarely unconditionally concede that indemnity is owed. More often, the indemnitor and/or its insurer will conditionally acknowledge a defense and/or indemnity obligation, subject to a reservation of rights. A body of law exists over the rights and obligations of parties issuing or receiving a reservation of rights that is beyond the scope of this post. But, such a reservation of rights may give an indemnitee the right to independent counsel and to control a claim for which it claims the right to indemnity. Indemnitees should take advantage of this right, where available.

Indemnity is simple on its face: one party agrees to indemnify another for something. In practice, it is one of the more complicated areas of the law. Rights can be gained or lost at multiple stages, depending on the moves of each party – from the terms of the initial contract to the tender (or not) of a claim or loss to the existence (or not) of insurance and rights and obligations under those insurance policies, to settlement negotiations, to ultimate resolution at trial or on appeal. Navigating these choppy waters takes skill, experience, and a vigilant eye on the indemnity horizon.