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It Ain't Me Babe: Risk Transfer from the Claims Professional's Perspective

I. VEHICLES FOR RISK TRANSFER

A. Contracts

Risk transfer can be accomplished by various types of agreements. Parties to a contract—e.g., a general contractor and a subcontractor or a landlord and a tenant—can agree on provisions that are designed to ensure that one party assumes the liability of the other. An indemnity provision may require one party to defend, indemnify, and hold harmless the other under certain circumstances. Such protections usually apply where the acts or omissions of the party giving the indemnity (the indemnitor) create derivative liability to the party receiving the indemnity (the indemnitee). But some indemnity provisions extend protection even where the indemnitee faces liability for its own or another third party's acts or omissions. Several states have laws that limit or void certain indemnity provisions that require the indemnitor to protect against liability that did not result from the indemnitor's own acts or omissions. See, e.g., Cal. Civ. Code § 2782 (an indemnity agreement in a residential construction contract cannot require the indemnitor to indemnify for claims beyond claims arising from the indemnitor's own negligence). Because indemnity provisions are a key vehicle for risk transfer, the claims professional must understand the different types of indemnity provisions and whether they are enforceable in the jurisdiction in which they are asserted.

Parties to a contract may also agree that one party will be included as an additional insured on the other's liability insurance. For example, a construction contract between a general contractor and a subcontractor may require the subcontractor to include the general as an additional insured on the subcontractor's insurance for liability arising from the subcontractor's work or caused by the subcontractor's negligence. Such provisions may specify the amount of additional insurance the subcontractor is to obtain and the amount of time the additional insurance is to remain in place. Such provisions may also require that the additional insurance be included on specific Insurance Services Organization ("ISO") forms. If the subcontractor does not such additional insurance, that is a breach of the construction contract by the subcontractor; that failure does not create an obligation for the insurer.

B. Insurance Policies

At a foundational level, the insurance professional needs to determine who is entitled to coverage for a claim and the nature and scope of that coverage. A policy's Who Is an Insured provision extend coverage to certain individuals and entities who, based on their relationship with the named insured, could create vicarious liability for the named insured. This coverage generally is limited to the individuals' and entities' conduct performed in the course and scope of the named insured's business. For example, a named insured's officers, directors, and employees usually qualify for insurance under the Who Is an Insured provision.

Additional insured endorsements contain the insurer's and insured's agreement that certain other persons or entities may be entitled to coverage under certain circumstances. Those other persons and entities usually have a contractual or business relationship with the named insured. Some endorsements specifically identify the individual or entity that is the additional insured. Others—blanket additional insured endorsements—specify that the additional insurance will be provided "where required by written contract." To determine if a blanket additional insured endorsement applies, one must consult the named insured's contracts to see if they contain an applicable additional insurance provision.

The language in an additional insured endorsement defines the nature scope of insurance provided to the additional insured. For example, additional insured endorsements may provide coverage for liability "arising out of" the named insured's work or operations for the additional insured. They may provide coverage to liability "caused by" the named insured. They may limit coverage to liability arising out of the named insured's ongoing operations or completed operations. But the law in different jurisdictions may apply the language in these endorsements differently. For example, a court may interpret liability arising out of the named insured's ongoing operations to include only that liability that became actionable while the named insured was performing its work. But another court may interpret that limitation to mean that the named insured's negligent conduct must have occurred during its ongoing operations (which it always does), even though the liability does not arise until after those operations are completed. The claims professional therefore must not only understand how the policy language in the various additional insured endorsements applies, he or she must also understand how the law in a particular jurisdiction could affect that application.

The claims professional must also be mindful how specific terminology in the policy affects coverage. For example, the terms "you" and "you're" in liability policies generally refer only to the named insured. Many policy exclusions in general liability policies apply to damage is to "your work" or "your product," or that arises out of "your operations." This means that the exclusions will apply when such is to or arises out of the named insured's—and not the additional insured's—work, product, or operations. From an underwriting perspective, this makes sense because the insurance is written for risks created by the named insured.

II. INDEMNITY PROVISIONS AND INSURANCE COVERAGE

Where a contract contains an indemnify provision, but not an additional insurance provision, the claims professional must understand how that indemnity provision could affect coverage for its insurer's named insured. For example, construction contracts often include indemnity provisions requiring the subcontractor to indemnify the general contractor for liability arising out of the subcontractor's work. If the owner of a building sues the general contractor based on the subcontractor's negligence, the general contractor may tender its defense to the subcontractor. If the contract does include an additional insurance provision, the general contractor has a direct claim against the subcontractor, but not against the subcontractor's insurance. The subcontract in turn can tender the general's claim to its own liability insurer. The insured likely would be entitled to coverage for such a claim because it arose from an "insured contract." The claims professional must analyze coverage based on the insurer's obligation to the subcontractor; the insurer does not have any direct obligation to the general. The scope of the insurer's obligation to the subcontractor will depend on the language in the indemnity agreement and the facts surrounding the claim.

A. Scope of Indemnity Obligations

As set forth above, the claims professional must understand the language in the indemnity agreements to determine its scope and must also understand how the law may alter that scope. The claims professional must then apply the facts to the indemnity provision. For example, if the general contractor did not perform any construction work on a project and had only one subcontractor, and if claims against the general contractor are based solely on allegations relating to the subcontractor's negligence, then the subcontractor likely would have a full and complete obligation to indemnity the general contractor. But if the general contractor and other subcontractors performed work that could be implicated in the claims, the scope of insured's obligation is reduced relative to the other parties. And if the insured's potential liability to the general contractor is minimal, at best, the insured's obligation may be reduced even further.

The claims professional must understand its insured's potential liability to the general contractor under the indemnity agreement, as well as the potential liability of the general contractor and the other subcontractors. This is necessary to ensure that the insurer does not assume any liabilities that should be borne by others.

B. The Named Insured's Defense Obligation

Indemnity agreements usually provide indemnification for damages caused by the indemnitor's acts or omissions. But such obligations are not limited to indemnifying the indemnitee for damages caused by the indemnitor; they may also include an obligation to pay or reimburse the indemnitee's defense fees and costs incurred for claims that fall within the indemnity agreement. Often such a defense obligation is written into the indemnity agreement. But the law in many implies a defense obligation even where one is not explicitly stated.

An indemnity obligation to pay damages arises only when those damages are assessed against the indemnitee. But an indemnity obligation to pay for the indemnitee's defense fees and costs may either require the indemnitor to reimburse those fees and costs after the case is over or

may require the indemnitor to immediately provide a defense to the indemnitee. Whether an immediate obligation to defend arises will depend on the language in the indemnity provision and the law of the jurisdiction in which the obligation arises. For example, in California, the California Supreme Court's decision in *Crawford v. Weather Shield*, 44 Cal.4th 541 (2008), may require an indemnitor to immediately pay the indemnitee's defense fees and costs.

The claims professional must know the extent of the insured's indemnity obligations to properly apply the insured's policy to such obligations and to determine whether those obligations may be shared with others.

C. Coverage for the Named Insured's Defense Obligation

As mentioned above, where a third party seeks indemnity from an insured pursuant to a contract that does not have an additional insurance provision, the insurer's obligation is directly to the insured and not the third party. Any amount that an insurer pays to satisfy the insured's indemnity obligation will reduce the limits on the insured's policy. This is true even where the insured is obligated to pay the indemnitee's defense fees and costs.

Handling a claim for an immediate defense requires the claims professional to determine whether the indemnitee is entitled to such a defense and whether the insurer has an obligation to immediately pay for that defense. Unless the indemnitee obtains a judicial declaration that the insured had an immediate obligation to defend, the insurer may have an argument that the insured is not "legally obligated to pay" those defense fees and costs. On the other hand, where that obligation is clear, it may serve no purpose to delay the payment, especially where the insurer may incur costs outside the limit to defend against any effort by the indemnitee to obtain immediate relief. If the insurer decides that it should begin paying the indemnitee's defense fees and costs immediately and without a judicial declaration, the best practice is for the insurer to communicate openly with the insured regarding that course of action—including how it would reduce the liability limits on the insured's policy—and to get the insured's agreement to that approach.

The claims professional also must understand that indemnity obligations differ from insurance obligations, especially where the indemnity obligation requires the insured to provide a defense. In most jurisdictions, the insurer's defense obligation requires the insured to defend all claims against an insured, covered or not. But an indemnity obligation is limited on the liability or potential liability that the insured may have caused for the indemnitee. That means that the insured may not have an obligation to defend all claims against the indemnitee. The insurance professional should work with the insured's defense counsel to determine and negotiate an appropriate sharing arrangement with the other involved parties, including the indemnitee itself and other indemnitors. Moreover, if the indemnitee is being defended by its own insurer, the claims professional should consider how that could affect the sharing of the defense costs.

III. ADDITIONAL INSURANCE

Where a contract requires the insured to indemnify a third party and provide the third party with additional insurance, the claims professional should understand how those provisions affect the insurer's obligations. In that situation, the indemnity agreement fades in importance;

the insurer has direct obligations to the additional insured. The claims professional should consider how the insurance obligation may be shared with other insurers or if a priority of coverage exists that could affect what the insurer must pay.

A. Difference between Indemnity and Additional Insurance

Because an insurer has a direct obligation to the additional insured, if a claim against the additional insured creates the potential for coverage, the insurer will have the duty to defend all claims—covered or not—against the additional insured. If the policy does not have eroding limits, the amounts paid to defend the additional insured will be outside limits. This is so, even if the named insured also has an obligation to provide the additional insured with a defense under an indemnity provision. Because such defense obligations can be significant, the claims professional should analyze potential costs in the context of considering settlement.

B. Sharing Defense Fees and Costs

Many liability policies provide that where the insured is included as an additional insured on another policy, the other policy will be primary and non-contributory to the insured's own insurance. And some additional insured endorsements similarly provide that the named insured's policy will be primary and non-contributory to the additional insured's coverage. Most such provisions limit the primary obligation to overlapping coverage; namely, where the additional insured coverage is also provided by the additional insured's own policy. The claims professional should evaluate whether this limitation means that the additional insurer does not have a primary obligation. If, for example, the additional insured faces potential liability that is not covered by additional insured—e.g., a general contractor that faces liability for its own construction work—then there would be exposure coverage provided by the general's policy that would not be covered by the subcontractor's policy. In that situation, the additional insurer may wish to take the position that the additional insurance and the additional insured's own insurance are co-primary. This could result in significant savings to the additional insurer and create an incentive for the additional insured's own insurer to participate in settlement.