The Insurability of Indemnification Obligations:

Strategies to Limit Uninsured Liability

By Kelly Geary, National Practice Leader

Professional, Executive and Cyber Solutions Group

Effective risk management begins with having a full understanding of the risks and liabilities your firm faces. Risk transfer via professional liability insurance is one of the most fundamental ways a firm can manage its risk. Another way many businesses manage risk is via contractual indemnification. Unfortunately, the connection between coverage afforded by a professional liability insurance policy and liability assumed via a commercial contract is not always clear, nor consistent. This can leave a firm with risks and liabilities that are not always fully understood or expected.

Professional service firms routinely enter into service contracts with their clients. These contracts are a fundamental part of a firm's day-to-day business and lie at the heart of the relationship the firm has with its client. Traditionally, a firm could present a new client with a standard service contract and the client would accept the contract "as is". A recent trend, however, has the client taking a much more active role in the process. Today, many firms are being presented with service contracts that have been drafted by the client with terms that, of course, are more favorable to the client. This requires firms to negotiate protective provisions into the "client drafted" service contract and carve out unreasonable or overly broad provisions favoring the client. Most "client drafted" service contracts will contain an indemnification provision requiring the firm to indemnify the client for any losses the client may suffer as a result of services provided by the firm. If the indemnification provisions within such service contracts are not narrowly drafted, the firm could face substantial uninsured liability.

This article will discuss the interaction between contractual indemnification and professional liability insurance. We will also provide some practical suggestions that can help firms minimize uninsured liability flowing from indemnification obligations. However, ultimately, the acceptance of such provisions is a business decision that the firm must make based on the advice of legal counsel.

Indemnification – The Basics

The concept of "indemnification" is based upon the well settled principal of tort law which holds that everyone should be held legally responsible for damage they cause. Indemnity, in its most basic form, involves the shifting of liability from one party to another. Generally speaking, the shift occurs by operation of law (equitable indemnity) or by express agreement between the parties (express or contractual indemnity).

Express indemnification provisions have become standard in all commercial contracts. Today, the wording of such provisions is considered, by many, to be "boilerplate" and is often times cut and pasted from one contract to another without much regard to the potential changing impact. In fact, contractual indemnification provisions have become so standardized that they do not always receive as much scrutiny during a contract review, as do the manuscript provisions of a contract. Indemnification provisions that are within professional service contracts may receive even less attention because many believe that their professional liability insurance will cover any/all liability stemming from professional services provided pursuant to a service contract. Unfortunately, professional liability insurance will not always absorb liability assumed within an indemnification provision.

Professional Liability Insurance and Contractual Indemnity

Determining whether and to what extent indemnification obligations would be covered by a professional liability policy is a difficult task. As a basic proposition, professional liability insurance policies are intended to cover "wrongful acts" committed in the performance of professional services by the Insured.[1] The typical definition of "wrongful act" includes "any negligent act, error or omission." From a policy interpretation standpoint, "breaches of contract" are generally not considered "wrongful acts". In addition, many professional liability policies contain a specific exclusion for claims arising out of a breach of contract or liability assumed by contract. Most contract exclusions contain an exception for liability that would attach in the absence of the contract. Assuming the policy at issue has such an exception, if the liability assumed by virtue of the indemnity agreement would attach absent the contract ***and*** the liability falls squarely within the coverage provided by the policy there should be little, if any, uninsured exposure.

The connection (or lack thereof) between the scope of the indemnity obligation and the scope of coverage provided by the insurance policy will determine the extent of uninsured exposure. Coverage for any indemnification obligation will never extend beyond the coverage provided to the insured firm by the insurance policy. The question of whether (and to what extent) the liability falls within the insurance policy will depend largely upon the primary grant of coverage and certain standard definitions and exclusions within the policy. In short, an insured cannot expand the scope of what the insurance policy covers by agreeing to accept liability that is not otherwise covered by the policy.

Primary Coverage Grant – The Insuring Agreement

The first step is to examine the primary coverage grant provided by the policy – the Insuring Agreement. A typical Insuring Agreement in a professional liability policy has multiple elements that must be satisfied in order for the policy to "trigger". Below is an example of a typical Insuring Agreement within a professional liability policy. The key to coverage is satisfying *all* the elements of the coverage grant.

[1] Professional liability policies all have slightly different terms, conditions, exclusions and endorsements. It is important to read your policy carefully and consult with your insurance broker or attorney for guidance relative to coverage and policy interpretation.

However, for our purposes, we will focus on the core elements in **bold**:

> The Company shall pay on behalf of the Insured all covered **Loss** and **Defense Costs** that the Insured becomes legally obligated to pay arising from a **Claim**, first made against the Insured and reported to the Insurer during the Policy Period for negligent acts, errors or omissions in the performance of the Insured's Professional Services.

When reviewing or constructing an indemnification provision, great focus should be placed on the manner in which the insurance policy defines the words "Claim", "Loss" and "Defense Costs." If the indemnity obligation extends beyond what the policy considers a "Claim" and/or agrees to pay loss, damages or defense costs that do not fit within the policy definitions of "Loss" or "Defense Costs", you will have uninsured exposure.

In addition, pay close attention to the phrase "legally required to pay" within the Insuring Agreement. This phrase works closely with the definition of "Loss". If a client makes a claim for amounts that technically meet the definition of "Loss" but the insured firm is not "legally required to pay" such amounts, the policy will not provide coverage. For example, the client attempts to bring a suit against the firm but the statute of limitations has expired. Notwithstanding, the firm decides to provide the client with some amount in "settlement" for "business reasons". Since the firm would not be "legally required to pay" such an amount, there would be no coverage under the policy.

The chart below provides some specific things to be aware of with respect to the key definitions:

SIGNIFICANT DEFINITIONS

Definition	***Description/Significance***
Definition of "Claim":	Most policies define "Claim" as "a demand for money or services." Some policies will require the demand be "written". Many policies will <u>not</u> extend the definition to include demands for non-monetary/injunctive relief, criminal actions, regulatory investigations or subpoenas. While some policies will provide coverage for regulatory matters and subpoenas separately, such coverage is usually subject to a limit of insurance that is significantly lower than the primary limit. In order to ensure the maximum insurance coverage, the definition of "Claim" within the indemnity wording should closely match the definition within the policy. If the indemnity agreement extends to regulatory matters but your policy does not, you may not have any insurance coverage related to the assumed obligation.

Definition of "Loss"[2]	A typical definition of "Loss" includes: "compensatory sums, monetary judgments, settlements or awards." In some cases, punitive damages will be included within the definition but usually only to the extent such are insurable by law. For our purposes, the most important part of the definition of "Loss" relates to the amounts that are specifically **excluded.** The following items are routinely **excluded** from the definition of Loss in professional liability policies: fines, penalties, sanctions, taxes, pre/post-judgment interest, return/reduction/restitution of professional fees, commissions, disgorgement, attorney fees, appellate costs, costs to comply with injunctive or equitable relief, future profits, lost income, and any other matters deemed uninsurable by law. Some policies will even **exclude** "*amounts assumed by contract*" and/or "*liquidated damages*". With respect to "fines, penalties, sanctions and taxes", such are typically excluded from the definition of "Loss" if such are assessed against the insured firm. If assessed against a client, and the client then makes a claim against the firm to recover such fines, penalties etc…there could be coverage under the policy, assuming the matter is otherwise covered. The manner in which "Loss" is defined by the insurance policy will have a direct impact on the insurability of the indemnification obligation that has been assumed by the service contract. In order to fully understand the potential uninsured exposure flowing from client service contracts, look closely at how your policy defines covered "Loss".
Definition of "Defense Costs"[3]	A typical definition of "Defense Costs" would read as follows: "reasonable and necessary legal fees charged by an attorney to defend the Insured…". The key phrase here is: "*to defend the Insured*". The insurance policy will provide "defense costs coverage" to the Insured – NOT to a client of the Insured. In most instances, the insurance policy will not provide coverage for the costs associated with the "defense" of a client of the insured firm. The definition of "Defense Costs" could, on its own, prevent such coverage even if the other policy provisions did not (cross-reference the definition of Loss as well as the contract exclusion and state law.)

[2] Some policies may use the term "Damages" instead of "Loss". The analysis is the same regardless of the differing terminology.

[3] Some policies may use the term "Defense Expenses" or "Claim Expenses" instead of "Defense Costs". The analysis is the same regardless of the differing terminology.

Policy Exclusions

The next area of potential vulnerability in terms of uninsured exposure lies within the policy exclusions. While all policy exclusions narrow coverage to some extent, we will focus on a group of exclusions that tend to have the greatest impact relative to indemnity obligations.

SIGNIFICANT EXCLUSIONS TO CONSIDER

Exclusion	***Description/Significance***
Contract Exclusion	As noted previously, most contract exclusions contain an exception for "liability that would have attached absent the contract". Even if your policy does not contain such an exclusion, there may be "exclusionary wording" elsewhere within the policy that will operate to negate coverage for contract type claims and/or damages. Some examples would be the items "excluded" from the definition of "Loss" and the definition of "Wrongful Act." It is important to carefully review your entire policy with your insurance broker and/or legal counsel.
Intentional Act/Fraud Exclusion	Intentional Act/Fraud exclusions are very common within professional liability policies. While the specific wording varies from policy to policy, the exclusion precludes coverage for any claims based upon intentional, deliberate, malicious, willful or fraudulent acts. In most instances, the exclusion will contain an exception that allows for coverage unless or until the intentional or fraudulent act is legally proven. As a practical matter, it may very well be impossible to avoid agreeing to indemnify a client for intentional or fraudulent conduct of the professional/firm. However, it is important to be aware that the professional liability policy will not provide coverage for damages flowing from proven intentional or fraudulent conduct.
Bodily Injury/Property Damage Exclusion	Another standard exclusion in professional liability policies is the exclusion for claims based upon or arising from bodily injury and property damages. In some instances, the exclusion will apply to claims involving emotional distress. Accordingly, if your policy excludes such damages but the indemnification wording does not, you would have uninsured exposure.
Securities Exclusion	Some policies will specifically exclude claims arising out of services as a broker or dealer in securities. If a claim presented that was based on such activities, there would likely be no coverage under the professional liability policy.

Allocation

In some situations, you may have portions of an indemnification obligation that would be covered under the terms of the policy and portions that would not be covered. In this instance, the insurance carrier could look to allocate the obligations between covered and not covered portions and agree to pay only the covered portions. Some professional liability policies contain Allocation Provisions that set forth the manner in which an allocation would take place. If your policy does not contain an Allocation Provision, look to the Insuring Agreement. Carriers can simply use the word "covered" to describe "Loss" within the Insuring Agreement to allow for allocation. For example, the Insuring Agreement might read: "The

Company will pay…covered Loss"…" Even if the policy is silent on the issue of allocation, state law may allow the carrier to allocate between covered and uncovered loss.

Since every case presents differently, it is difficult to determine, with any real certainty, the insurability of any particular obligations unless or until you are presented with a live claim. However, a solid understanding of the coverage provided by your professional liability policy should give you a basic idea of the extent to which your indemnification obligations present potential uninsured exposure. Below we set forth some sample wording along with some tips to help you limit uninsured exposure.

Tips to Help Limit Uninsured Exposure

Once again, it is important to always remember that coverage for any indemnification obligation will never extend beyond the coverage provided to the insured firm under the professional liability insurance policy. In order to maximize the insurability of obligations set forth in an indemnification clause, the clause itself must be narrowly tailored to track the coverage provided by the policy. Overly broad indemnification provisions could leave the firm with significant uninsured liability. The following are common traps within indemnification clauses that can lead to uninsured exposure along with some tips to help minimize the possible exposure:

1. Limit the Number of Indemnitees:

   An overly expansive number of indemnitees could defeat coverage entirely under the insurance policy or result in an allocation of coverage between "covered" and "uncovered" individuals, which would result in uninsured exposure. Ideally, the goal should be to limit the number of indemnitees to as few individuals as possible. Consider the following examples:

Example A	***Example B***
Overly Expansive Number of Indemnitees	***Limited Number of Indemnitees***
FIRM shall indemnify and hold harmless CLIENT, its stockholders, officers, directors, employees, representatives, agents, volunteers, servants, successors and assigns…	*FIRM shall indemnify and hold harmless CLIENT, its officers, directors, agents and employees…*

2. Narrowly Construct the Wording on Causation and Type of Acts:

   Indemnification provisions with an overly broad scope as to causation could conflict with the insurance policy and result in uninsured exposure. As we have already discussed, in order to minimize potential uninsured exposure, the first step is to ensure that the wording of the indemnification provision is closely aligned with the primary grant of coverage provided by the insurance policy. Once again, professional liability policies generally only respond to claims **arising from negligent acts, errors or omission** by the Insured in the performance of professional services. Consider the following examples:

Example A	*Example B*
Broad Scope: Causation	***Narrow Scope – Causation***
The FIRM shall indemnify…CLIENT…from and against any and all claims…however caused, resulting from, arising out of, or in any way connected with the FIRM's acts, errors or omissions, recklessness or intentional wrongful conduct flowing from the performance of professional services provided pursuant to this contract.	*The FIRM shall indemnify…CLIENT….from and against damages arising from third-party claims to the extent such directly result from the FIRM's negligent acts, errors or omissions flowing from the performance of professional services provided pursuant to this contract.*

The broad scope set forth in Example A above, goes well beyond the four corners of a typical professional liability policy in terms of the trigger for causation. Consider the breadth of the following phrases within Example A: "any and all claims…however caused, resulting from, arising out of, or in any way connected with…" Aside from some pure redundancy, there are two phrases within the litany that are particularly concerning: (1) "any and all claims…however caused…" and (2) "…in any way connected with..." This wording could expose the firm to a wide range of exposures not even contemplated by a professional liability policy. The insurance policy will only respond if the insured firm actually or allegedly committed a negligent act. If the firm is absolved of liability, coverage under the insurance policy would be limited to the costs associated with the defense of the firm. In contrast, Example B uses more precise wording: "…from and against damages arising from third party claims to the extent such directly result from…" This wording requires there be "damages" from "third party claims" that "directly result from…" the firm's negligent acts.

With respect to the types of acts protected against, Example A's core problem is that it applies to any/all of the firm's "acts, errors or omissions…", specifically including any "reckless or intentional wrongful conduct." While it is reasonable, from a business perspective, to indemnify a client against intentional or fraudulent conduct by the firm, such conduct is not covered under the insurance policy. Example B tracks the wording used in most professional liability policies by adding the word "negligent" to describe "acts, errors or omissions".

3. <u>Limit to Indemnity Only – Not Defense:</u>

Generally speaking, the duty to indemnify and the duty to defend are distinct and separate. The duty to indemnify typically does not arise unless or until there is an adverse monetary judgment against the indemnitee that has resulted from negligence on the part of the indemnitor. The duty to defend is, in most cases, broader in scope than the duty to indemnify. The primary reason is that a defense obligation is usually interpreted to be immediate. It does not depend upon a finding of negligence. Accordingly, the defense obligation can exist even in the absence of an ultimate duty to indemnify.

Once again, most insurance policies will not provide coverage for liability assumed by contract, unless such liability exists, absent the contract. In most instances, the duty to defend the client would not exist absent the contract. As a result, if the indemnification provision contains the obligation to "defend", the insurance policy will most likely not provide coverage for such costs. Further, in certain cases, courts have held that the duty to defend exists within every indemnity agreement unless the provision specifically provides otherwise.[4]

Given the foregoing, a conservative approach would be to, not only avoid the use of the word "defend" within the indemnification provision, but to add "but not defend." Consider the following examples:

Example A	***Example B***
Indemnify and Defend	***No Defense Obligation***
*"The FIRM shall indemnify and **defend** CLIENT…from and against any and all claims, liabilities, damages, demands, obligations, costs, expenses (including, without limitation, reasonable attorneys' fees, expert witness fees, court costs and the costs of appellate proceedings)."*	*"The FIRM shall indemnify, **but not defend**, the CLIENT….from and against loss arising out of third-party claims that the CLIENT is legally obligated to pay as a result of negligent acts, errors or omissions of the FIRM or anyone the FIRM is legally responsible for…"*

4. Narrowly Define Claim:

As we discussed above, the definition of "Claim" within the professional liability policy is significant. Accordingly, it should receive the same level of significance in the context of the indemnification provision. The manner in which "claim" is defined will have a direct impact on whether or not the insurance policy will even respond. A conservative approach is represented by Example B. The ultimate goal is to mirror the definition within the insurance policy, with specific attention being paid to matters that are "excluded" from the definition of "Claim".

[4] There is a wealth of case law as well as statutory law on this subject. It is important to consult with experienced legal counsel in the jurisdictions in which you do business.

Consider the following:

Example A	***Example B***
Overly Broad Definition of Claim	***Narrowly Defined Definition of Claim***
"Claim(s)" shall mean any and all foreseeable or unforeseeable actions, causes of action (whether in tort, agreement or strict liability, and whether in law, equity, statutory or otherwise), claims, damages, demands, disbursements, judgments, lawsuits, legal proceedings, liability, litigation, losses, tangible property damage (including any harm, impairment, theft, loss or loss of use), sanctions, settlement payments, costs or expenses of any nature whatsoever, including, without limitation, reasonable attorneys' fees and costs (whether or not suit is brought)."	*"Claim(s)" shall mean all written demands for money asserted against the CLIENT….Claim(s) shall not include demands for non-monetary relief, regulatory actions or criminal matters of any kind."*

5. Narrowly Define Loss:

Narrowly defining loss within the context of the indemnity provision is one of the most effective ways to limit your potential for uninsured exposure. As we touched on previously, the typical definition of "Loss" within a professional liability policy has a long list of amounts that are "excluded". If the indemnification provision includes any amounts that the policy excludes, you will have uninsured exposure. Further, if the provision provides a vague reference to "damages" and fails to specifically exclude amounts that are so excluded by the policy, you will have uninsured exposure.

Example A	***Example B***
Overly Broad Definition of Loss	***Narrowly Defined Definition of Loss***
"This indemnification and hold harmless includes, but is not limited to, any financial or other loss including, but not limited to, any debts, liabilities, damages, demands, obligations, costs, expenses, attorney's fees, court costs, costs of appellate proceedings, civil or criminal fines or penalties, incurred by the CLIENT due to the negligent, fraudulent or criminal acts of the FIRM…Unless otherwise provided by law, the FIRM's indemnification obligations hereunder shall not be limited in any way by the amount or type of damages, compensation, or benefits payable under any insurance policy."	*"The FIRM shall indemnify, but not defend, CLIENT ….from and against loss arising out of third-party claims that the CLIENT is legally obligated to pay as a result of negligent acts, errors or omissions of the FIRM or anyone the FIRM is legally responsible for…"loss" shall not include: fines, penalties, sanctions, or attorney fees of any kind."*

Conclusion

The interplay between contractual indemnification and insurance coverage is challenging, to say the least. Unfortunately, we cannot present you with a one-size-fits-all approach. The issues are complex and require careful review of both the insurance contract as well as the contract containing the indemnity provision. In order to achieve the best results for your firm, it is best to involve experienced legal counsel and insurance professionals in the contract analysis.

Kelly Geary is Managing Principal at EPIC where she serves as the National Practice Leader for the Professional, Executive and Cyber Solutions group. Kelly provides clients with risk management advice and acts as a claims advocate for EPIC professional service clients. Kelly began her career as an insurance defense and coverage attorney in the professional lines space. After private practice, Kelly held Claims Counsel positions at large P&C insurers, handling claims on professional and financial lines products. Kelly also created and managed a full-service Claims Department at a large professional and financial lines insurer in the New York area. In this role, Kelly and her team of 20 claims attorneys were responsible for the management and resolution of over 5,000 Professional Liability/Financial Lines claims annually.