AXIS

Understanding Contractual Indemnity Risk

Contractual Indemnity Risk

Contractual indemnities are legal provisions that can be found in most commercial contracts whereby one party agrees to assume the tort liability of another. They are a type of risk transfer that acts as a form of insurance for the indemnified party and a liability for the indemnifying party, allocating financial responsibility for certain risks between the parties.

By understanding how contractual indemnification provisions and insurance contracts interact, contractual indemnities can function as valuable assets for the indemnifying party when strategically crafted and deployed.

By providing indemnification, the party signals a commitment to standing behind its products, services, and contractual obligations, thereby making it a more attractive choice in competitive markets.

Unfortunately, in many cases, the indemnifying party is unaware of their indemnification obligations until a dispute arises, and since poorly understood contractual indemnities can impose a significant financial burden on the indemnifying party, a thorough contract review before executing the agreement will ensure these clauses are identified and their implications considered, which enables negotiations to mitigate their impact and assures alignment with risk tolerance and insurance objectives.

Contractual Indemnity as an Asset

Contractual indemnities come with significant risk, but they can be used as an asset under the right circumstances, particularly when deployed in conjunction with a carefully crafted insurance program.

Example

Consider a situation whereby a business operating in a competitive sector is struggling to attract new talent needed to advance a project. Despite offering attractive compensation and benefits packages, and the opportunity to contribute to an exciting, emerging technology, prospective new employees cite fear of litigation from their current employers over the non-compete and intellectual property clauses in their existing employment contracts as impediments.

By offering to indemnify the prospective employee from future liability arising from their existing employment contract and backstopping it with appropriate insurance coverage, the employer can overcome this obstacle, allowing them to compete for new talent with the confidence that they are protected should the need arise.

Contractual Indemnity as a Liability

Since contractual indemnities are usually written by and in favor of the party holding the most leverage at the negotiating table, typically a stronger party seeking to protect its interests when dealing with a comparatively weaker party, indemnification language contained in first-draft contracts is almost always written in broad terms requiring the indemnifying party to hold the indemnified party harmless for all losses arising from the contract.

Example

Consider a situation in which a software development company, competing to sell its services to build an online e-commerce platform for a large client, agrees to indemnify and hold the client harmless for all losses arising from the agreement. Later after launching the platform, the client is served with a lawsuit from a non-practicing entity alleging intellectual property infringement.

While the client provided the background intellectual property and specifications to the software developer to facilitate the project, the agreement states that all disputes related to intellectual property brought by a third party are to be defended solely by the developer and the client is to be indemnified for all associated costs.

As the developer wasn't aware of this risk, mitigation measures weren't considered, and appropriate insurance coverage was not placed, bringing into question the ability of the business to continue as a going concern.

A thorough contract review identifying this risk would have allowed the negotiation of mitigating language and the placement of adequate insurance coverage to ultimately avoid this uninsured loss.

Conclusion

Since all liability insurance policies focus on specific exposures and contain coverage exclusions, it is imperative to consult collaboratively with legal counsel and a knowledgeable insurance broker to narrow the scope of the indemnity language to risks that the insurance program applies to and impose liability caps consistent with coverage limits, otherwise one could find themselves paying out of pocket for uninsured losses that were never contemplated.

An insurance policy is a contractual indemnity that contains exclusions. Providing another party with unlimited contractual indemnity for all losses without limitations is akin to an insurance company providing an unlimited insurance policy without exclusions. An insurance company would never offer such a product, so why would any business?