Indemnity And Insurance Provisions In Construction Contracts

By Jeffrey A. Kiburtz

In a profession with some notoriety for topics having little mass appeal, it takes a truly special area of the law to inspire judicial commentary like this:

> The comedy troupe Monty Python once made the subject of insurance—insurance of all things—the butt of a comedy skit. But we doubt that even comedians of their caliber would try to make "indemnity" the topic of comedy. It is a topic so deadly dull that it makes insurance look interesting. That is not to say, however, that the topic is not of vital importance in many commercial contexts, particularly in California's construction industry.

Crawford v. Weather Shield Mfg., Inc., 136 Cal. App. 4th 304, 306 fn.4 (2006). (See also https://www.youtube.com/watch?v=kO2R_DDZPCM.)

Setting aside whether indemnity is truly "deadly dull" and insurance is only generically boring, few can disagree that these risk allocation mechanisms are tremendously important in construction contracts. While numerous issues can lead to risk allocation not functioning as the parties intended, the lack of a clear relationship between the contractual indemnity provisions and insurance requirements can give rise to considerable uncertainty. It is important, therefore, to understand how indemnity and insurance provisions can interact, some key differences between the two, and related contracting considerations.

Indemnity Versus Insurance: Varying Scopes of Protection

While insurance is often considered a "backstop" to indemnity, it does not necessarily follow that the scope or nature of the insurance protection is coextensive with or limited to that provided by indemnity. Rather, insurance can provide protection under terms that are either broader or more restrictive than that provided under the indemnity provision.

Unlike typical indemnity provisions which can, subject to legislative limitations, provide protection against almost any loss bearing a sufficient connection to the indemnitor's activities, the coverage provided by commercial general liability (CGL) policies are generally limited to bodily injury and property damage, and numerous exclusions further limit the protection provided.

As one example of the differing scope between a typical indemnity provision and the insurance provided by a CGL policy, a contractor will likely be indemnified by an at-fault subcontractor for a pure delay claim brought by an owner, but unless there is bodily injury or property damage it is unlikely that the contractor would have insurance coverage for that same claim. Another possibility is situations in which the indemnity agreement obligates the indemnitor to assume contractual responsibilities going beyond those imposed by an ordinary tort standard of care. Under these circumstances, an insurer might claim that coverage is barred by the breach of contract exclusion common to CGL policies.

If there is concern that a critical subcontractor may not have sufficient resources to honor the full breadth of its indemnification obligations, CGL insurance therefore would not be an effective "backstop." Obtaining "additional insured" status under the subcontractor's CGL policies would not change that result, as the fundamental issue is a lack of coverage under the CGL policy.

One option for addressing this risk is the surety bond. While categorically different than insurance policies, surety bonds can offer protection against, among other items, pure delay and other risks generally not covered by CGL policies. Protections may be limited by the terms of the bond, however, and even when expressly encompassed within the scope of the bond there can be substantial delays and litigation required to effectuate performance. That is not always the case, however, and sureties often provide

1. Construction contracts typically contain two types of provisions under which a party will bargain for some form of protection against claims and losses: Indemnity and insurance. "Indemnity" involves one of the parties agreeing to provide that protection in its own right. "Insurance" is being used here to refer to protection provided by a third-party, usually an insurance company, even if the contractual arrangement is not technically "insurance" (as in the case of surety bonds).

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timely performance under a payment bond claim or when hiring a completing contractor.

Parties are increasingly looking to subcontractor default insurance (SDI or "Subguard"[2]) to address the risks associated with the default of a subcontractor, including those not covered under CGL policies. While SDI typically provides for interim payments which can address the delay in receiving the protection contemplated by surety bonds and insurance policies, SDI is not without limitations. Among others, SDI can be difficult for some contractors to obtain, and coverage for liquidated damages, delay and other costs is often subject to restrictive sublimits.

The foregoing discussion addresses situations in which the protection provided by third-parties is nominally more restrictive than that provided by indemnity, but that relationship is not always present. Indeed, due to "anti-indemnification" legislation passed in most jurisdictions, it is increasingly common for the indemnity terms to be less inclusive than the available protection from third-parties like insurance companies.

The issues raised by this type of relationship can be complex, as some states' "anti-indemnification" laws purport to limit insurance coverage to those situations in which indemnity can legally be negotiated. Even when there is no legislative restriction on the scope of coverage, courts have in certain circumstances looked to the underlying indemnity agreement rather than the terms of the policy itself to delineate the scope of protection provided. Accordingly, parties cannot necessarily assume that insurance coverage that is nominally broader than the underlying indemnity provision will ultimately perform as intended.

Indemnity Versus Insurance: Timing of Performance

While insurance and other third-party protection is often perceived as a "backstop" for indemnity, there is no hard-and-fast requirement that a party first pursue indemnification. Rather, in certain circumstances, the indemnitee can bypass the indemnitor and seek protection directly from the insurer or other third-party indemnitor. (Three such circumstances were mentioned earlier—"additional insured" status under a CGL policy, SDI, and surety bonds.)

The ability to seek performance directly from the third-party has significant benefits. For one, it increases the number of potential sources of funds. Thus, if the contractor is insolvent or has taken a very hard position on the claim, there is the possibility of a solvent, more malleable party from whom to recover. And, as discussed below, it is more likely that the third-party will present a better source of recovery.

Second, the nature of the third-party obligation in those circumstances is oftentimes more favorable. With SDI, for example, there is often the opportunity to submit interim proofs of loss to receive funds to address the default, which is an option that is rarely available under an indemnity provision. For its part, status as an "additional insured" carries the right to receive an immediate, insurer-funded defense. While cases such as *Crawford* provide that a contractor may have an immediate obligation to defend, that result turns on the specific indemnity language and can be difficult to achieve in practice.

Indemnity Versus Insurance: Likelihood of Performance

Central to likelihood of performance are two distinct factors—the party's willingness to pay and its ability to pay. For a variety of reasons—including the nature of regulatory scrutiny, differing institutional interests and differences in substantive law—there probably is, in general, a higher likelihood of receiving payment from a third-party indemnitor (most often, an insurance company) than a contractor. But, as discussed below, that is not always the case.

Regulatory scrutiny on insurance companies is focused heavily on solvency, and insurers as a whole therefore are generally likely to be able to pay claims. The differing nature of insurers' and contractors' respective businesses also provides vastly different incentives—while an insurer that pays a claim is merely doing what it was expected to do, payment of a claim by a contractor can be perceived as an admission that it did something it should not have done. Moreover, between the insurers' obligations of good faith and fair dealing to their insureds and more nuanced differences in how courts interpret insurance policies versus contractual indemnity provisions, the law also provides insurers with more incentives to pay than contractors.

That is not to say, however, that insurers are always more willing to pay. Various of the many parties involved in significant construction projects may be insured by non-admitted insurers with differing levels of regulatory scrutiny and/or concern for their reputation. Insurers' claims positions can also be driven by factors affecting the company or industry as a whole, rather than just the merits or economics of an individual claim. Conversely, contractors are often very mindful of their reputation within the industry and may have a strong desire to be perceived as "standing behind their work" and, therefore, may be willing to pay even when the merits of a particular claim do not necessarily warrant it.

Conclusion

When allocating risk inherent in a construction project, it is necessary to pay close attention to the interplay between indemnity and insurance to ensure the objectives of the parties are achieved. Each has its advantages and limitations, but can effectively be combined to secure the performance of the myriad participants in construction projects of all complexities.

2. "Subguard" is a registered trademark of Zurich Services Corporation, but is often used generically to refer to similar policies offered by a number of carriers.

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