

Today's GENERAL COUNSEL

Insurance Considerations When Negotiating Commercial Contracts

By Catherine J. Serafin

Insurance implications are routinely overlooked in commercial contracts. Too often outdated boilerplate provisions are copied from prior contracts. Contracts to receive or perform services, to supply or receive goods or raw materials, and evidencing mergers and acquisitions each have their own specific insurance considerations that should be examined. Moreover, insurance law varies by state, and standard insurance policy forms change from time to time. Thus, you may have insurance that is not providing the best protection for your company if the unthinkable happens. Below are three specific considerations to keep in mind when negotiating business contracts.

ADDITIONAL INSURED PROVISIONS

Many commercial contracts contain indemnification provisions, and often the indemnitor is required to name the indemnitee as an additional insured (AI) on its policies. Indemnification provisions vary from a broad obligation to indemnify for all loss caused by the indemnitee's sole negligence, to the most narrow obligation to indemnify only to the extent that the indemnitor's conduct caused the liability of the other party (as in cases of vicarious liability).

There also are variations taking into account willful misconduct and making distinctions between active and passive negligence. State law may limit how indemnity provisions are interpreted, and some states bar indemnification for another's gross negligence, for example. It is important to understand the applicable indemnification law, especially in view of the changes in AI contract language discussed below.

AI provisions may also require the promisor to purchase

a certain type of insurance, with stated limits of liability. This type of provision allows a company to use another entity's insurance to manage its risks. There is tension because the party receiving AI status wants the broadest possible coverage, but the party giving AI status wants to give more narrow coverage.

There have been recent revisions to standard form AI endorsements, and these changes seem designed to attempt to narrow coverage. For instance, one recent revision provides that the AI insurance applies only "to the extent permitted by law," which could create a coverage gap where the indemnification obligation is broad but the coverage provided will be interpreted more narrowly.

Some forms of AI endorsements provide coverage only for injury caused by the acts or omissions of the named insured, not the AI. Still others limit coverage to claims arising during the time the work or services are provided. In addition, the interplay between indemnification and AI provisions in commercial contracts has been the subject of recent litigation. If these two contractual provisions are not separate and independent, a court may interpret one provision as limiting the other. For instance, the contract may be read to require AI coverage only to the extent of the indemnification obligation.

For example, this year in *In re Deepwater Horizon*, the Texas Supreme Court noted that "the scope of indemnity and insurance clauses in services contracts are not necessarily congruent." However, the court found that the provision in the drilling contract at issue requiring Transocean, the drilling rig owner, to name BP, the oil field developer, as an AI on Transocean's primary and

excess insurance policies, was congruent and “inextricably intertwined” with certain indemnity provisions in the contract, and that those indemnity provisions, therefore, limited the amount of coverage available to the AI.

When negotiating a contract containing an AI provision, it is important to get legal guidance on at least the following issues:

- The differences between the available AI endorsements, and specifying in the contract as to what coverage is being provided.
- If you are receiving AI coverage, consider a provision making it a breach of contract not to procure the required insurance.
- If you are giving AI coverage, decide whether you want that coverage to include defense costs, which usually erodes your limits of liability.
- Beware of disappearing “completed operations” coverage. If you want coverage to be provided for claims asserted after the work is done, have the coverage apply to claims “arising out of your work.”
- Separate the contractual indemnification and insurance provisions so that they cannot be read as limitations on one another.

TAPPING INTO INSURANCE OF ACQUIRED COMPANIES

Mergers and acquisitions have significant insurance implications. The focus is on whether the acquiring company can access the insurance policies of the acquired company once the transaction is complete.

Until fairly recently, it was generally

assumed that a successor company could tap the historic insurance policies of the predecessor for latent liabilities, such as environmental or asbestos liabilities, despite the fact that most policies contain an “anti-assignment” clause prohibiting assignment without the insurer’s consent.

The purported reason for anti-assignment clauses is to prevent an increase in the insurer’s risk that had not been underwritten. However, such an increase in risk does not occur, and such clauses generally are disregarded, when the assignment takes place after the loss already occurred. The “risk” already has become a reality. The only question is who the insurer must pay. Thus, many courts found that a corporate successor could tap the insurance of a predecessor for liabilities arising out of the predecessor’s operations.

However, several cases since 2003 have changed the landscape on this issue, and courts are divided on whether a corporate successor may access a predecessor’s insurance coverage. If your company is considering acquiring another company, consult with counsel early in the process about ways to maximize the available insurance. This should include the following steps.

- Know the law in your state regarding whether insurance coverage flows to the successor company by “operation of law,” specific assignment, or otherwise.
- Investigate purchasing successor liability insurance coverage if it does not appear that the acquired company had adequate insurance, or if state law prohibits accessing prior coverage.



- Understand whether you need specific contractual provisions to make clear your right to access the historic insurance asset.

REPRESENTATION AND WARRANTY INSURANCE

An additional consideration when merging with or acquiring a company is whether representation and warranty insurance (RWI) is appropriate. This type of insurance has been available for some time, but has only recently become more widely used. Because demand for this product has increased, more insurance companies are now offering RWI, and the price has come down. Companies should analyze whether buyer-side or purchaser-side RWI might be a way to shift certain risks to an insurance company.

Purchase and acquisition agreements usually have “rep and warrant” provisions that have long-term financial consequences for the parties. Representations and warranties cover such things as the acquired company’s compliance with laws and regulations, environmental liabilities, the accuracy of financial statements and tax issues. Sellers retain liability for any inaccuracies, and it is not uncommon to require a percentage of the purchase price to be placed in escrow for a period of time to cover any breaches. Typically, these types of agreements also have provisions requiring one party to indemnify the other in the event a representation or warranty is inaccurate.

RWI is a highly customized product that can be purchased by a buyer or seller, or can be purchased jointly. The policies usually cover loss from claims made by a third party for any breach of, or inaccuracy in, representations and warranties in the purchase and sale agreement. RWI may be a way for a seller to exit a business cleanly, and immediately use capital for other

endeavors, rather than having it restricted in an escrow account.

A buyer may use RWI as a way to help distinguish its bid from others. It also may provide more certainty because in the future the buyer should be able to collect from a third party insurance company, as opposed to pursuing a seller with unknown assets, for breaches of representations or warranties.

Although the terms vary widely, buyers and sellers should consult experienced counsel with respect to at least the following issues if they are considering RWI.

- Consider whether “blanket” coverage for all representations and warranties, or coverage only for specific ones, is appropriate.
- The coverage usually is sold on a “claims made” basis, meaning the policy covers claims made during a specified time period, so it is important to consider the policy period in relation to the survival period of the representations and warranties.
- Among the key terms in RWI are what constitutes a breach and what “loss” covers. If defense costs are covered, the limits of the policy will be depleted more rapidly.
- RWI policies exclude known inaccuracies, but this exclusion can be narrowly drawn to apply only to inaccuracies discovered during the due diligence process by members of a defined deal team.

Commercial contracts implicate a surprising number of insurance issues, and AI provisions, successor liability issues and RWI are just three of them. If you have not recently examined your commercial contracts from the insurance perspective, perhaps it’s time to do so and to update them to better protect your company from future exposure and liability. ■



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