Indemnity Agreements

Risk Shifting Devices – Or Not?

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Many business agreements – such as equipment and real property leases and construction and property management contracts, among others – contain indemnity provisions. Business people who have signed, or who have been asked to sign, an indemnity agreement may be interested in knowing how courts have dealt with the rights and obligations of *indemnitors* (the party promising to indemnify another) and *indemnitees* (the party receiving the protection).

Business owners should be aware that, as indemnitees, a common feature of an indemnity agreement is the requirement that the indemnitor pay for an attorney to defend their businesses against claims covered by the agreement. The ultimate indemnity agreement is the *liability insurance policy.* Courts analyze obligations under contractual indemnity agreements, much as they do under liability insurance policies. And in one case, the court stated that if a complaint alleges claims that fall within the coverage of the indemnity provision, then, according to the complaint allegation rule, the duty to defend begins.

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Business owners may wonder: who gets to control the defense? In the liability insurance context, the Hawai'i Supreme Court recognized that a liability insurer has the right to select the policyholder's defense counsel.

What if you're the business owner who's the indemnitee? The Hawai'i Supreme Court recognized that the policyholder has the right to reject the defense attorney selected by the insurer. However, the policyholder must then pay for its own defense, although the insurer remains obligated to indemnify the policyholder against liability covered by the insurance policy.

What if the parties to an indemnity agreement disagree over whether a claim or lawsuit is subject to the agreement? As a business owner who's the indemnitee to an agreement, you should be aware that your indemnitor could agree to pay for your defense subject to a *reservation of rights.* This is where a business is informed by its indemnitor that it will pay for a defense, but is not waiving any of its rights under the indemnity agreement. One such example is the right to show that the agreement does not apply to the claim or lawsuit at issue.

Since the Hawai'i Supreme Court's views on liability insurance have generally been applied to indemnity agreements, business owners may find that when the applicability of an indemnity agreement is disputed, it may be safer for their indemnitor to assume their business's defense under a reservation of rights. The potential consequences for an insurer that incorrectly fails to provide a defense can be harsh, according to Hawai'i Supreme Court announcements on liability insurance:

"[T]he insurer that refuses to defend does so at its own peril. For example, the insurer forfeits any right to control the defense costs and strategy, including the right to compel the insured's cooperation in the defense of the claims; if it loses its claim of no duty to defend, it will be obliged to reimburse the insured for all reasonable defense fees and costs properly incurred. Additionally, the breaching insurer waives its right to approve of any settlement. Under such circumstances, the insured is entitled to negotiate a reasonable and good faith settlement of the underlying claim which amount may then be utilized as presumptive evidence of the breaching insurer's liability. Thus, by refusing to provide a defense, the insurer risks liability for a settlement in an amount that, although reasonable, could be higher than it might have been able to secure. The same type of danger is inherent in a verdict rendered at trial."

However, business owners should be mindful of the potential consequences they may face should their indemnitor ultimately prevail on a claim that the indemnity agreement does not apply, after paying a significant amount of their business's attorney's fees? The Hawai'i appellate courts do not appear to have decided this "winning the battle, but losing the war" issue in any published opinion. Courts from other jurisdictions, however, have allowed the indemnitor in such a situation to obtain reimbursement from the indemnitee.

In one reported California case, Los Angeles Lakers' owner Jerry Buss was sued by H&H Sports after he terminated their contract for advertising and other services. Buss tendered his defense to his liability insurer, which agreed to defend because one of the 27 claims was potentially covered under Buss' insurance policy. The insurer, which wound up paying more than $1 million for Buss' defense, had sent him a letter in which it reserved its right "to be reimbursed and/or [to obtain] an allocation of attorney's fees and expenses . . . if it is determined that there is no coverage[.]"

Buss himself eventually paid $8.5 million to settle the lawsuit. When his insurer would not contribute toward the settlement, he sued the insurance company. The insurer filed and won a motion for summary judgment on a cross-complaint for reimbursement of defense costs, which Buss eventually appealed to the California Supreme Court. The court ultimately ruled that for claims that are at least potentially covered, the insurer may not seek reimbursement for defense costs, but can seek them for claims that are not even potentially covered. In a "mixed" action (in which both covered and non-covered claims are alleged), the court ruled that the insurer may obtain reimbursement for defense costs that can be allocated solely to the claims that are not even potentially covered.

Would Hawai'i courts follow the *Buss* decision? Perhaps not. The Hawai'i Supreme Court has held, "where a suit raises a potential for indemnification liability of the insurer to the insured, the insurer has a duty to accept the defense of *the entire suit* even though other claims of the complaint fall outside the policy's coverage." Thus, in a "mixed" action, it appears that under current law, Hawai'i courts would not allow insurers – or indemnitors – to obtain reimbursement of defense costs even if they could prove that certain costs were attributable solely to non-covered claims.

What about lawsuits that are not "mixed" actions? In a California case decided after *Buss,* a company, sued for misappropriation of trade secrets, tendered its defense to its liability insurer. The insurer accepted the tender under a

reservation of rights, paid for defense counsel, and filed suit for a declaration that it owed no duty to defend and was entitled to reimbursement of defense costs.

The trial court held that the insurance company had a duty to defend, which on appeal by the insurance company was reversed. The court of appeals held that the insurer was not required to defend, but also held that the insurer was not entitled to reimbursement of defense costs.

The insurer then petitioned the California Supreme Court, which held that since the underlying lawsuit did not allege any potentially covered claims, the insurer's duty to defend never really arose. The court based its decision on the insurance company's reservation of rights letter that had informed the policyholder that the insurer might seek to recover defense fees and costs *already* expended if it were *later* determined that the insurer did not owe a defense. "Such an announcement by the insurer permits the insured to decide whether to accept the insurer's terms for providing a defense, or instead to assume and control its own defense," according to the court's opinion. It upheld that an insurer, having reserved its right to do so, may obtain reimbursement of defense costs which, in hindsight, it never owed.

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The Hawai'i Supreme Court has held that a policyholder may reject the defense offered by an insurance company and assume (and pay for) its own defense. Would Hawai'i courts further follow the California court's reasoning and allow an insurer – or an indemnitor – to obtain reimbursement of defense costs incurred under a reservation of rights? This question is yet to be answered.

This article is intended to address issues of general interest, is not intended to be construed as legal advice, and does not take the place of consultation with qualified legal counsel.