Liberty Technical Update 2 - Hold Harmless

Hold Harmless Clauses and Waiver of Subrogation Rights

What is a Hold Harmless Clause?

In our last Technical Update we examined indemnity clauses and the impact they may have on liability insurance coverage. In this update we look at a particular type of indemnity clause known as a "hold harmless clause" and what implications such clauses have for liability insurance coverage.

We often come across indemnity clauses in contracts which require one contracting party to "hold harmless" the other contracting party. There are also judicial statements to the effect that an indemnity is a contract by one party to keep the other harmless against loss. So, is there a difference between an indemnity clause and a hold harmless clause? More particularly, what are their insurance implications from a company's financial liability standpoint?

Essentially, a "hold harmless" clause gives the recipient of that clause ("the recipient") the benefit of being "held harmless" - or "not be legally bothered" - by the other contracting party or any other party claiming against the recipient. Like an indemnity clause, a hold harmless clause is a risk transfer mechanism. In fact, the expression "hold harmless" is derived from the Latin word indemnis which means "not harmed". An indemnity is sometimes distinguished from a hold harmless by saying the indemnity relates only to reimbursement of an actual loss and that the "hold harmless" obligation requires the grantor of that benefit to hold harmless the recipient from risks of potential loss as well as actual loss. Other views are that the two terms are synonymous or, in fact, exclusive from each other.

An example of a hold harmless clause is: "The contractor holds the principal harmless from any action, claims, liability or loss in respect of the performance of the services." Under this hold harmless clause, the contractor is not only prevented from bringing any claim against the principal (even if the principal has contributed to the loss or liability in the first place), the contractor may be required to "hold the principal harmless" by ensuring that the principal does not suffer any loss or liability as a result of the performance of the services which may include claims by a third party.

The reality is that the precise operation and application of the clauses depend very much on the actual wording of the clauses and the courts' interpretation of them. At a simplistic level, however, we can say that the practical effects of both types of clauses are similar - they are both about risk allocation and the extent of risks that each party is prepared to assume. Careful drafting of the clauses determines the extent of the protection that is given to the recipient of the hold harmless obligation.

Insurance Implications – Waiver of Subrogation Rights

If an insured agrees in a contract to "hold harmless" another party without any right to adjust their respective liabilities according to each party's contribution to the loss or liability, this may jeopardise a company's insurance for financial liability risks.

First, a hold harmless clause involves an assumption of contractual liability which is typically excluded by contractual liability exclusions in insurance policies. (This issue was canvassed in Liberty Technical Update 1.) Whilst an extension may be provided in a policy to cover liability assumed under contracts, insureds must read the wording of the extension carefully to ensure that they understand the precise ambit of the cover. For instance, if the contractual liability extension covers only the loss that results from an act, error or omission of the insured in the provision of the relevant services or supply, then a loss that falls within the hold harmless provision but did not in fact result from an act, error or omission of the insured would not be covered by the policy.

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Liberty International Underwriters

Furthermore, a hold harmless clause, like an indemnity clause, also involves a waiver of the insurer's right of subrogation which is an issue often overlooked when parties agree to accept risks under such clauses.

Insurers have a right of subrogation, both as a matter of law and under the insurance contract, to "step into the shoes" of the insured and bring a claim against other parties who have some responsibility for the loss or damage. This right is a key element of an insurance contract because it allows insurers to recoup some of what they have paid to the insured by way of the insurance claim. But, in subrogating "into the shoes of the insured", the insurer can only exercise those rights that an insured has.

If, for instance, a clause in a contract provides that Party A must hold harmless Party B in respect of "any action, claims, liability or loss arising from the performance or supply of the services provided under the agreement", then the insurer of Party A is similarly constrained by the terms of that hold harmless clause. One effect of the hold harmless agreement is that Party A is prevented from suing Party B for any loss caused by Party B. Then the insurer of Party A is similarly prevented by the hold harmless agreement from suing and recovering anything from Party B. By allocating risks between the contracting parties, hold harmless clauses can therefore operate to waive or limit an insurer's subrogation rights.

If Party A (in the above example) claimed under its Professional Indemnity Insurance Policy for its liability to Party B, would that claim be successful? Most insurance polices provide as a condition of the contract of insurance that the insured must not do anything to impair the insurer's rights of subrogation. A breach of such a condition may prejudice the insured's claim under the policy. Depending on the precise wording of the condition in the policy and the extent of the prejudice suffered by the insurer, the insured's claim might be reduced to nil.

What to Look for in a Policy

Having said that, some insurers in the marketplace acknowledge the fact that indemnity and hold harmless clauses are common negotiating tools in commercial contracts and so, notwithstanding the fact that such clauses have the effect of waiving some or all of the insurer's subrogation rights, specifically provide by way of an extension that such clauses will not prejudice the insured's claim under the policy.

To see an example of how Liberty addresses this issue click here to view Extension 2.11 - Limitation of Liability Contracts in our New Civil Liability Professional Indemnity Insurance Policy.

Such an extension is a significant concession on the part of the insurer. In the example above, the insurer of Party A having indemnified Party A would not be able to subrogate into Party A's shoes and bring a claim against Party B, irrespective of the fact that Party B may have contributed to the loss. Much depends, however, on the precise wording of the indemnity or hold harmless clause in determining the extent to which insurer's right of subrogation has been waived or limited.

Some policies, however, whilst accepting the existence of indemnity and hold harmless clauses and providing policy coverage for liability assumed under contracts contain, nevertheless, conditions in the policy which prohibit the insured from limiting the insurer's rights of subrogation. In such cases, there is an inconsistency in the insurance policy coverage. On the one hand, the insurer is providing coverage for contractual liability assumed under contracts but, on the other hand, they are saying that any waiver or limitation of the insurer's subrogation rights may prejudice the insured's insurance coverage.

Companies are therefore advised to read their policy carefully and discuss this issue with their insurance advisors.

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