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PERSPECTIVES: 'Additional insured' troubles loom on the (Deepwater) horizon

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A Deepwater Horizon-related coverage dispute highlights the need for corporations to square their commercial contracts with their insurance policies. Christopher C. Loeber and Kelly A. Lloyd with the law firm Lowenstein Sandler L.L.P. discuss the interplay between indemnification agreements and "additional insured" provisions and the importance of retaining insurance coverage counsel to help navigate some very significant pitfalls.

Thousands of times a day, sophisticated companies around the globe negotiate commercial contracts. Virtually all of those contracts contain indemnification agreements of one kind or another. The majority also include "additional insured" provisions — requirements that one party be covered under the other's insurance policies.

Notwithstanding the great importance of indemnification and "additional insured" provisions, companies all too often include them without performing the proper due diligence. Specifically, contracting parties fail to analyze and understand the insurance policies that stand behind their commercial agreements.

Although this concern has always been top of mind for insurance coverage counsel, two recent events have thrust the indemnity vs. insurance issue into a broader spotlight: the latest Deepwater Horizon coverage battle, and the insurance industry's promulgation of new policy language. Taken together, these two events underscore how negotiating indemnity provisions without a comprehensive understanding of the related insurance policies can lead to disastrous results.

The Deepwater Horizon catastrophe in April 2010 left a devastating mark on people, businesses and the environment around the Gulf of Mexico. Now, its ever-expanding ripples are about to hit the world of insurance policy interpretation. A coverage dispute pending before the Texas Supreme Court involving BP P.L.C., Transocean Ltd. and their various subsidiaries, affiliates and insurers will have a significant impact on countless insurance policies across the country.

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It is a common practice among commercial entities to indemnify one another for losses arising out of their joint business operations. And it is equally common for such entities to add themselves as "additional insureds" under the other's general liability insurance policies. The question is: When a loss occurs, is the scope of recovery determined by the indemnity agreement or the insurance policy? This is the issue that the Texas Supreme Court is being asked to decide.

The scenario is simple: Company A hires Company B to perform services on its behalf. Company A insists that it be named as an "additional insured" on all of Company B's insurance policies. In their services contract, Company A agrees to indemnify Company B for any losses or claims attributable to Company A's negligence or fault.

In the Deepwater Horizon disaster, Company A was BP and Company B was Transocean, the owner of the Deepwater Horizon rig. BP engaged Transocean pursuant to a drilling contract, which required Transocean to maintain certain minimum insurance coverages and to name BP as an "additional insured." The drilling contract also stated that BP would indemnify Transocean for any pollution- or contamination-related liabilities deriving from below the surface of the water. Transocean would indemnify BP for any pollution- or contamination-related liabilities above the water's surface.

On April 20, 2010, the Deepwater Horizon exploded and sank. After the explosion, it became apparent that oil was leaking from the former drilling operation. The rest is well-documented history.

Over the past several years, as the liability issues have been winding their way through the courts, so too have the overriding insurance disputes. And now, in one of the Deepwater Horizon disaster's highest-profile coverage battles, BP is seeking coverage under Transocean's commercial general liability policies.

From the outset, BP has asserted that, as an "additional insured," it is entitled to full coverage under Transocean's policies. Transocean's insurers have disagreed and denied coverage. The insurers cite the drilling contract as evidence that Transocean is only responsible for pollution claims arising from incidents above the surface of the water. According to the insurers, the drilling contract limits BP's entitlement to "additional insured" coverage under Transocean's policy. In their view, BP is an "additional insured" only for above-the-surface incidents.

The foregoing disagreement frames the key legal question: Can the scope of an insurance policy be altered by a separate commercial contract?

This issue was first posed to the U.S. District Court for the Eastern District of Louisiana, where the Deepwater Horizon multidistrict litigation is venued. The District Court found that the drilling contract limited the insurance coverage and held that BP could not avail itself of Transocean's policy.

BP appealed the issue to the 5th U.S. Circuit Court of Appeals. In March 2013, the appeals court reversed the District Court's decision. The 5th Circuit concluded that the policy language should govern in situations where the insurance provision in the parties' contract is "separate and independent" from the indemnification provision in the parties' contract.

According to the court, to be separate and independent, the insurance provision must be a discrete requirement that is distinct from, and in addition to, any requirements under the indemnity provision. Applying that definition to the facts at bar, the 5th Circuit found that the BP/Transocean indemnity provision was "separate and independent" and, therefore, that BP was entitled to additional insured coverage under the Transocean policy.

After reviewing the March 2013 opinion, Transocean's carriers requested a rehearing. And, in August 2013, the 5th Circuit withdrew its initial decision. Citing the significance of the issue, the fact that Texas law governed the dispute and the lack of state law on point, the 5th Circuit certified two questions to the Texas Supreme Court:

- Whether the language of the insurance policy alone determines the extent of BP's coverage as an additional insured if, and so long as, the additional insured and indemnity provisions of the drilling contract are "separate and independent"; and
- Whether the doctrine of contra proferentem (where ambiguous terms are construed against their drafter — here, Transocean's insurers) applies in cases involving highly sophisticated parties.

As of this writing, the issues are fully briefed before the Texas Supreme Court. Oral argument is scheduled to take place on Sept. 16, 2014.

The insurance industry weighs in

The significance of the indemnity-vs.-insurance issue is highlighted by a separate, recent movement from within the insurance industry itself.

The Insurance Services Office Inc. collects statistical data, develops standard policy forms and files information with state regulators on behalf of insurance companies. From time to time, ISO changes the language in its standard policy forms. And, in its 2013 commercial general liability policy forms, ISO altered the previously existing "additional insured" language in an effort to address the very problem framed by the BP/Transocean insurance dispute.

Although these changes were not driven by the Deepwater Horizon disaster, they directly intersect with the insurance issues flowing from the case.

The following is an example of the provisions contained in ISO's new "additional insured" endorsements:

A. Section II – Who Is an Insured is amended to include as an additional insured the person(s) or organization(s) showing in the Schedule…

However:

1. *The insurance afforded to such additional insured only applies to the extent permitted by law; and*
2. *If coverage provided to the additional insured is required by a contract or agreement, the insurance afforded to such additional insured will not be broader than that which you are required by the contract or agreement to provide for such additional insured.*

B. With respect to the insurance afforded to these additional insureds, the following is added to Section III—Limits of Insurance:

If coverage provided to the additional insured is required by a contract or agreement, the most we will pay on behalf of the additional insured is the amount of insurance:

1. *Required by the contract or agreement; or*
2. *Available under the applicable Limits of Insurance shown in the Declarations; whichever is less. This endorsement shall not increase the applicable Limits of Insurance shown in the Declarations.*

There are many reasons the insurance industry is promulgating these new endorsements, most of which are beyond the scope of this article. But one clear objective cuts to the heart of the instant issue: Insurers want to limit the obligations they owe to "additional insureds" — and these endorsements are designed to prevent broadly worded insurance policies from expanding narrowly drafted contractual indemnities. In short, this language is designed to defeat the precise strategy that BP is currently pursuing.

The BP/Transocean coverage litigation is one to watch, as it is sure to become a seminal case in the indemnity vs. insurance debate. Similarly, ISO's new "additional insured" endorsements should be closely monitored as they make their way into policies, flower into coverage disputes and become subject to legal interpretation.

But regardless of how the Texas Supreme Court ultimately rules, or whether the new ISO endorsements hold up under judicial scrutiny, the confluence of these two events serves a more immediate purpose: It puts commercial entities everywhere on notice that contractual indemnity provisions are inextricably intertwined with insurance policies. And, it sounds a loud warning regarding the dangers of negotiating indemnity agreements in a vacuum.

Simply put, whether you are the party seeking broad indemnification and "additional insured" status, or the party conferring those terms, it is essential that you retain experienced coverage counsel to analyze and understand the insurance policies implicated by your commercial contracts. If the terms of those insurance policies are not squared with the underlying agreements, you may be getting much less than you bargained for, or giving away far more than you intended.

BP and Transocean are learning that lesson the hard way.

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