

**ENSURING COVERAGE:  
INSURANCE ISSUES IN OUTSOURCING ARRANGEMENTS**

**John P. Beardwood, Partner**  
**416-868-3490**  
**jbeardwood@fasken.com**

**Mark McKay**  
**416-408-5419**  
**mmckay@jonesbrown.com**

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Fasken Martineau DuMoulin LLP  
Barristers and Solicitors  
Patent and Trade-mark Agents  
66 Wellington Street West  
Suite 4200, Toronto Dominion Bank Tower  
Box 20, Toronto-Dominion Centre  
Toronto, Ontario, Canada M5K 1N6  
Fax: 416-364-7813

Jones Brown Inc.  
Insurance Brokers & Consultants  
Suite 1100  
480 University Ave.  
Toronto, Ontario, Canada M5G 1V2

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## **A. INTRODUCTION**

It is by now a truism that counsel are often challenged in making their business people pay sufficient attention to addressing issues relating to the occurrence of adverse events. For a customer, this means making adequate provision for indemnities, events of force majeure, and transition assistance in the event of termination. However, these provisions are meaningless if the provider does not have sufficient assets to continue to provide the services, or, in the worst case scenario, pay for any awarded damages. Ensuring that the provider has sufficient insurance coverage is therefore critical.

In evaluating the role of insurance for each particular outsourcing transaction, each customer needs to consider how their risk profile may have changed by outsourcing a critical system or a business function to a third party. The customer by definition now has much less control over risk factors which, when the function or service was provided inhouse, were within the control of the customer. The risk profile can be further complicated where the provider is offshore, given the resulting variances in such risk management elements as legal environments, quality assurance regimes, safety standards, building codes, and inventory controls. Finally, where the outsourcing arrangement involves multiple providers (for example, where multiple providers may be providing a solution under the leadership of a single “integrator” vendor), not only may the responsibility for any adverse effect be difficult to determine, but the very interaction of such multiple providers may in itself create additional risks.

Unfortunately, notwithstanding its importance to increasingly complex outsourcing arrangements, the insurance requirements for an outsourcing arrangement often receive minimal if any attention. While a customer may send the insurance provision in the outsourcing contract to their insurance provider, rarely does the customer ask for a reevaluation of their own insurance requirements based on the fact of the outsourcing arrangement – that is, is it more risk? Is more coverage required? Or is it less risk, because the service is now being provided by a professional provider who provides these kinds of services as their core business?

Our paper focuses on an equally important problem wherein the outsourcing contract often addresses insurance issues using relatively standard “boilerplate” language, which lists only the types of policies and the extent of coverage, and which may require that a certificate of insurance be provided. In short, the failure of the customer to fully understand such insurance as it relates to the outsourcing arrangement, and in particular, the extent to which the provider has backstopped the contractual remedies of the customer with the required insurance coverage, may lead to a rude shock if and when the customer has the need to make a claim against the service provider.

The objective of this paper is to create a higher awareness of the strategic importance of insurance, and to expound further upon how insurance works, in outsourcing arrangements. At the beginning of the paper we first describe the role of first party and third party triggers in outsourcing arrangements. Next, we focus on typical inclusions and exclusions. Third, we examine key issues, regarding the general importance of

dovetailing the outsourcing contract and the applicable insurance coverage, the pitfalls of over-reliance on insurance certificates, the importance of including waivers of subrogation, and potential insurance minefields in the case of multijurisdictional outsourcing arrangements. Finally, we review the special issues of intellectual property infringement insurance and performance bonds.

## **B. THE ROLE OF INSURANCE IN OUTSOURCING ARRANGEMENTS**

While providers need also be aware of insurance issues, this paper focuses mainly on the insurance issues for customers. Outsourcing contracts normally impose *de minimis* insurance obligations on providers, whereas it is more unusual for the provider to impose insurance obligations on its customer. Customers impose these obligations for in order to achieve two discrete objectives.

First, the customer seeks to ensure that the provider will continue to be able to provide the contracted service throughout the term, such that in the event of an adverse event, the provider will have sufficient coverage to recover from such event. In insurance terms, the triggers which trigger such coverage are considered to be “**first party triggers**”, and include *direct damage triggers* – that is, events that result in direct damage or loss of tangible property (e.g. there is a fire at the server farm of the provider and insurance funds will be required in order to replace the servers)- and *business interruption triggers* – that is, where there is an adverse event (which could include the occurrence of an underlying direct damage trigger to an insured asset, or incapacitation of certain of the providers key personnel) that results in some form of interruption to the operations of a business such that the business is unable to fund ongoing costs without insurance funds.

Second, the customer wants to ensure that in the case where there is a material failure of the provider to perform, that the customer can recover damages from the provider. This is considered to be a “**third party trigger**”, in that there has been some form of injury, damage or loss to a third party – that is, the customer - as a result of the actions or omissions of the insured party. The following five third party triggers are the most relevant for outsourcing transactions.

- *Errors & Omissions Liability* triggers are those claims for damages which result from a wrongful act, error or omission in the provision of a professional service. Again, much like General Liability, the damages can range from purely compensatory to punitive. This, rather than the general liability policy, should be the form of insurance coverage with which an outsourcing customer should be most concerned, as this is the policy of the service provider which is intended to respond to a customer claim of failure to perform the outsourced service as the result of an error or omission. So, for example, in a classic technology services outsourcing, which involves:
  - the implementation of the IT system which is going to serve as the platform for the provision of the technology services, then the E&O policy will respond to claims as such implementation constitutes a professional service;

- the provision of the technology services through the operation of the IT system, then the E&O policy will respond to claims regarding failure to perform the service; and
- the provision of consulting services in connection with making process improvements, then the E&O policy will respond to claims regarding deficiencies in such service.

Again, E&O claims arising from criminal, fraudulent or dishonest acts are excluded.

- *General Liability* triggers are those claims of a customer for damages caused by the unintentional<sup>1</sup> actions or omissions of the provider, whether in the form of property damage, business interruption of the customer<sup>2</sup>, or bodily injury. The damages can range from strictly compensatory to as wide and unpredictable as punitive<sup>3</sup>. In a contractual arrangement the typical exposure to third parties is for “loss of use of tangible property” that results in an interruption of the business of the third party; for example, where a provider is hosting customer servers, and such hosting is interrupted by a physical damage event. Common exclusions include claims arising from (a) errors and omission in the provision of professional services (for which *errors and omissions insurance* is required) ; (b) criminal, fraudulent or dishonest acts, given that such acts would be considered to be “intentional” and therefore excluded (and thus for which *employee liability* or *crime insurance* is required: see below); and (c) claims for damage to property either owned by the insured (for which *property insurance* is required<sup>4</sup>), or in the care, custody and control of the insured as a result of the business operations of the insured (for which *bailee* or *property of others insurance* is required: see 20:30:10:10 below).
- *Employment Practices Liability* triggers stem from those claims for damages from wrongful acts which result from the acts of employees or contractors. In an outsourcing context, these can occur where, for example, the provider’s employees are being hosted by the customer, and one of the provider’s employees harasses one of the customer’s employees. If the customer employee then sues their employer on the basis that the customer fostered a hostile workplace, the customer may then seek recovery against the provider. It is the provider’s employment practices liability which would then respond to that claim by the customer. Much like Errors & Omissions Liability, the damages can range from purely compensatory to punitive. However, because the claims are generally related to the performance of duties in the

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<sup>1</sup> In general, damage caused intentionally is not covered under liability insurance policies.

<sup>2</sup> For example, most policies will respond to a claim for “loss of use of tangible property”. If the provider was alleged to be negligent, causing property damage to customer servers that resulted in the failure of the servers and thus caused interruption to the business of the customer, then there would be a duty on the insurer to defend a claim for business interruption.

<sup>3</sup> In general, punitive damages are less likely to be awarded in Canada than in the United States, for example.

<sup>4</sup> The customer and the provider should ensure that the property insurance includes electrical & mechanical breakdown.

workplace (in the example above, the performance of the provider's employees) rather than contract fulfillment, the damages will be related to employment compensation (in the example above, such compensation as the customer may be required to pay to their plaintiff employee). As a note, this exposure can be particularly an issue in the case of multijurisdictional outsourcing arrangements, which can involve significant differences in culture and management behaviors between a customer and its provider.

- *Employee Dishonesty* (or “crime insurance”) is an area of insurance very rarely understood. It is triggered upon the discovery of the theft of assets or information by employees, either acting alone or in collusion with others. In the outsourcing context this form of insurance is most applicable where the employees may have access to sensitive information – for example, where the customer is a financial institution or if they have control over the customer's goods through a consignment arrangement. In the context where a provider's employee has been involved in the theft of information or goods from a customer, the provider's property insurance will not respond to any claim by the provider because it is not the provider's property. Similarly, the general liability insurance of the provider will not respond to the claim, as intentional or criminal acts are excluded from the scope of coverage. Employee dishonesty insurance fills this gap. Note that this “fidelity bond” is not all-risk form of insurance: loss must result from dishonesty on the part of the employee, not from the error or omission of the employee.<sup>5</sup> For this reason, the evidence must show that the employee intended to defraud or embezzle<sup>6</sup>. What is of additional note from the point of view of the provider, is that an Employee Dishonesty policy may have a duty to defend provision in it if the provider has a contractual obligation to indemnify the customer for stolen goods held on consignment<sup>7</sup> - in that case, the provider may be able to look to its Employee Dishonesty insurer to defend the claim from the customer.
- *Specialty Liability* may include insurance coverage for patent infringement/enforcement, and for performance guarantees, as more particularly described in Section 23:50 below.

### C. COVERAGE ISSUES: INCLUSIONS & EXCLUSIONS

Once the customer is aware of the types of coverage which are appropriate for the particular outsourcing arrangement, it is critical that the customer familiarize themselves with the relevant inclusions and exclusions of coverage.

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<sup>5</sup> The insurance is written on a schedule basis – that is, to cover employee by name or position, or on a blanket coverage of all employees.

<sup>6</sup> The “manifest intent” clause of policies can apply when a particular result is certain to follow from an employee's conduct – however there must be more than mistake, carelessness or incompetence.

<sup>7</sup> An example of this is where a fulfillment house warehouses disk drives of a customer, and the disk drives are stolen as a result of alleged provider employee theft.

## 1. First Party

### (a) Inclusions

As described above, first party triggers will be relevant in the outsourcing context where the provider has custody or control of one or more customer assets – for example, where the provider is operating a number of a customer’s servers on their behalf – and the customer has required that the provider insure those servers.

In that circumstance, it is important to note that because the customer assets are third party assets – that is, assets in which the service provider does not have a demonstrable insurable (e.g. financial) interest - the insurer of the provider will not respond to a claim regarding such third party property unless the provider has expressly obtained from the insurer a commitment to insure the customer asset. The provider may obtain such a commitment in the form of:

- “Bailee coverage”, which is a form of legal liability coverage which responds to claims resulting from damage or destruction of the bailor's property while under the bailee's temporary care, custody, and control (including property on or in transit to and from the bailee's premises)<sup>8</sup>. Since the title to the bailed property resides with the bailor customer and this is a form of liability insurance, the customer retains the primary risk of loss or damage, and the insurer will only be responsible to the service provider bailee, and thus the service provider will seek to only be responsible to the customer bailor, for such loss or damage to the bailed property as results from the negligence of the provider. Bailee coverage provides a limited amount of coverage, which – because it is not based on the knowledge/assessment of the insurer of the actual assets in question, may or may not be sufficient to cover the damage or loss of the customer’s assets
- “Property of others” coverage: which is effectively an addition to the property coverage of the service provider, which otherwise will exclude the property of others which is in the custody, care and control of the provider. From the point of view of the customer, this is the preferred form of coverage as there is no precondition that there be negligence in order to recover against the policy. That being said, it is important the Service Provider evidence limits that are adequate for the property in question, which may or may not require insurer approval. Also optimally, the customer should contractually require (a) that both (i) the value and (ii) the basis of valuation (e.g. Replacement Cost (new)"; "Actual Cash Value (depreciated cost)" or "Agreed Value (appraisal)"), and (b) that the customer be identified as a *loss payee*, in each case in the policy (see 23:30:30 below). The

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<sup>8</sup>It is commonly obtained by businesses which have a high volume of third party property continuously on their premises – e.g. laundromats, or jewellery repairers.

benefit for the customer is that it is then not required to prove provider negligence to order to recover under a claim against the general liability policy of the provider<sup>9</sup>.

(b) *Exclusions*

In the case of business interruption insurance in favor of the provider, in addition to the normal excluded perils such as war, nuclear contamination, terrorism and gradual pollution, what will also generally be excluded is a provider's claim for business interruption that stem from damage to assets which are not owned by the provider, even though the cause of damage is an otherwise insured peril; for example, where the provider is managing the servers of a customer and relying on a power source that the customer controls; or where the provider is relying on a subcontractor and their site to provide an element of the service which the provider is providing to the customer.

However, the provider can address this exclusion by ensuring that their policy includes *Contingent Business Interruption* coverage, and in connection with such coverage lists each subcontractor's site as a location on the policy. The non-owned asset that is being relied upon is then expressly identified and the related business interruption risk insured through what is known as "recipient" (i.e. for provider) or "contributory" (i.e. for customer) contingent business interruption coverage<sup>10</sup>. Of course, for the customer the relevance of ensuring that the provider has responsive coverage is that the provider will be in a much better position to resume its operations if insurance funding is in place to mitigate any loss.

## 2. **Third Party**

(a) *Inclusions*

Third party coverage will typically provide coverage for the costs relating to the defense and the payment of damages relating to third party claims, as such damages are defined in the policy (see 23:30.20.20 below), provided that the underlying triggers are insured. Again, such third party triggers are more likely to apply to outsourcing transactions than are first party triggers. In most "occurrence based" insurance contracts the payment of defense costs are unlimited until settlement or adjudication of the claim. Coverage will also include certain investigation and court expenses. However, the provider should determine if the insurer has included a "hammer clause"<sup>11</sup>, as means of further limiting the insurer's exposure.

An insurer may dispute with an insured as to the best way to resolve a claim – for example, where the insurer may want to settle and the insured does not, or there is a

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<sup>9</sup> If this assumption of liability for customers' assets were not to be spelled out in the policy, as is often the case, the customer would need to solely rely on the provider's general liability policy, and thus would have to prove the provider as being negligent in order for the provider to obtain recovery under that policy.

<sup>10</sup> Again, if there is a third party reliance on the insurance proceeds, or assignment of same, then it must be identified and agreed by the insurer.

<sup>11</sup> Also known as a "pride" or "consent" clause.

judgment against the insured and insured wants to appeal but the insurer does not. The insured may have very good business reasons to want to continue to resist settlement or appeal a judgment. The settlement terms and the nature of the judgment could have adverse effects for the business of the insured which go far beyond the monetary consequences. For example, if the terms of the settlement require that the insured make a public apology, it could have a significant adverse effect on the market share of the insured party. However, for the insurer, it is more concerned about limiting the amount of proceeds which will payable in connection with the claim of the insured<sup>12</sup>.

A “hammer clause” allows the insurer to address this issue by capping or limit their ultimate exposure in a particular claim<sup>13</sup>. For example, some policies say that if the insured does not agree to settle a claim the insurer wants to settle, the insurer’s exposure is capped at the amount they would pay to settle the claim plus 50% of the future costs incurred in resolving the claim (including defense and indemnity). Thus in this instance the insurer is no longer obligated to pay 100% of all future defense costs and 100% of the covered portion of the ultimate loss; instead, the insurer will only have to pay 50% of those amounts<sup>14</sup>. Other hammer clauses state that if the insurer invokes the hammer clause, they cap their exposure at 150% of the amount of the proposed settlement or judgment the insurer was willing to accept<sup>15</sup>.

From the point of view of the customer, at first it seems as if the customer can be largely indifferent to the existence of such a clause, as long as the insurer will provide coverage for any settlement offer made by the customer. However, the customer should make themselves aware of the existence of such a clause for two reasons. First, if the customer makes an offer and the provider rejects same, the customer should be cognizant that the insurance of provider may not respond 100% to the claim. That could be of concern to the customer, if absent such coverage provider may not be able to pay the claim. Second, such information will provide the customer with a strategic advantage in the case where there should ever be a dispute with the provider, in that it lets the customer know that the provider will be under pressure from their insurer to settle should the customer make a reasonable settlement offer.

The issues start to get more complex where the customer has negotiated the right to approve any settlements involving third parties and the provider – for example, in the

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<sup>12</sup> One commentary on hammer clauses succinctly characterizes the issue as follows: “How can the insurer take your firm's ridiculously expensive premium for \$20 million in coverage and then turn around and reduce that coverage to a few hundred thousand if you insist on restoring your firm's good name?” See: “Hammered by the hammer clause: Does it mean what it says?” By Pope, Daniel J, in *Defense Counsel Journal*, Sunday, April 1 2001), at <http://www.allbusiness.com/legal/law-firms/979770-1.html>

<sup>13</sup> The trade-off may be a lower premium.

<sup>14</sup> For example, if the claim could be settled for \$20,000 and the insurer invokes the hammer, and the matter is further litigated with final costs (additional defense fees and judgment against the insured) of \$75,000 the insurer only pays \$57,500 and the insured must pay the rest.

<sup>15</sup> Note that in order for a settlement offer to trigger a hammer clause, the offer would have to come from the plaintiff, in order for the insurer to know that it would have accepted same. In other words, the insurer could not trigger the clause by suggesting the making of an offer without any basis to know that the plaintiff would accept such offer, as that would serve as the basis for a bad faith claim by the insured against the insurer.

case of an intellectual property infringement indemnity, wherein the provider has agreed to defend and hold harmless the customer for any third party infringement claims against the customer based on their use of intellectual property provided by the provider. Such obligation to defend is often conditioned on the provider having the right to settle any such claims, which the customer will in turn qualify by requiring a right of approval over any settlement which implicates the customer. In that case, the provider subject to a hammer clause may find itself between a rock and a hard place, in the sense that the provider will be under pressure to settle from the insurer, but will be contractually restricted from doing so without customer approval<sup>16</sup>.

*(b) Exclusions*

Unless clearly defined to the contrary in the insurance contract, the types of damages insured may be severely restricted. It is extremely important to ensure that contract language dovetails the insurance policy language. For example, in some cases a service provider's policy will only pay compensatory damages, while the outsourcing agreement may impose an obligation on the service provider to indemnify the customer for all damages, such as exemplary and punitive where allowed by law. To the extent that the scope of the provider's liability for damages under the outsourcing contract exceeds the scope of coverage under the policy, the provider will need to pay for such any such awarded damages out of their own pocket.

Both customers and service providers need to be cognizant of another critical exclusion - that is, the extent to which the right of the insured to undertake contractual indemnities is expressly excluded by the terms of the applicable policy. Most insurance contracts exclude the assumption of liability in a commercial contract (for example, through the provision of indemnities) by the insured, unless otherwise agreed by the insurer or if the liability to the other party (in this case, the customer) would have existed in the absence of a contract; as, for example, in the case of a tort claim. This exclusionary language could result in the denial of an otherwise insurable claim<sup>17</sup>. For example, typical General Liability insurance policy language reads as follows:

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<sup>16</sup> One commentator has concluded that there are several prerequisites to the successful application of the hammer clause. First, there must be reasonable settlement demand recommended by the insurer. Two, the demand must fully and finally resolve all claims. Three, the refusal of the insured to consent cannot be the result of poor counsel. Four, the right of the insurer to invoke the hammer clause may be limited by their obligation of good faith and fair dealing. See Kenneth S. Meyers, "Professional Liability Insurance: Beware of the Hammer Clause", *Assn of Business Trial Lawyers Rep.*, Vol. XXI, No. 2 (February 1999).

<sup>17</sup> We note that that insurers have the right of audit the subject matter of any statement in a declaration of exposure for the insured, including the audit of any material contracts for contractual assumptions of liability. Execution of a material contract was without disclosing same to an insurer could result in the denial of the claim.

*Exclusion - Contractual Liability*

*“bodily injury” or “property damage” for which the insured is obligated to pay damages by reason of the assumptions of liability in a contract or agreement. This exclusion does not apply for damages:*

- (1) That the insured would have in the absence of the contract or agreement; or*
- (2) Assumed in a contract or agreement that is an “insured contract”<sup>18</sup>, provided the “bodily injury” or “property damage” occurs subsequent to the execution of the contract.*

### **3. Certificate Rights vs. Additional (Named) Insureds & Loss Payees**

In both first party and third party insurance policy certificates terminology is used that evidences certain rights upon parties, however it does not confer these rights.

*(a) Certificate Holder*

On the side of the spectrum which provides the least protection to the customer, is the status of a “certificate holder”. In that case, the provider provides a “certificate of insurance” rather than an endorsement to the policy of the provider<sup>19</sup>. Again, it is important to note that a certificate itself is not a valid endorsement to a policy – in fact, there is case law that suggests that certificates alone do not provide coverage to additional insureds<sup>20</sup>. Of equal significance is the fact that a certificate of insurance will ordinarily not enumerate the specifics of what is covered. For this reason it is critical for the customer to require the production of a copy of the actual endorsement.

Without any further designation, the customer as merely a "certificate holder" is entitled only to notice from the insurance company prior to termination of the policy. As "certificate holder," the customer does not acquire any additional contractual rights, such as the right to obtain insurance proceeds, because it has not been named an additional insured.

*(b) Additional Insured*

In contrast, naming the customer as an additional insured reinforces this risk transfer from the customer to the provider (for example, as such risk transfer may manifest itself in the indemnity provisions in the outsourcing agreement), by providing the additional

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<sup>18</sup> The definition of an “insured contract” as it applies to the above sample language is limited to tort liability assumed under contract such as a municipal agreement, sidetrack agreement or real estate lease, however explicitly excluding contracts providing services of an architect, engineer or surveyor.

<sup>19</sup> Note that in the case of a certificate holder, a customer’s name should always appear in the "certificate holder" space on an insurance certificate.

<sup>20</sup> For a brief on the subject see Lowenstein Sandler’s February 2007 Claim Denied Publication authored by Mitchell Decter, Esq., entitled Certificate of Insurance Does Not Confer Any Rights that references Cvetkovic v. New Jersey Water Authority, et al., (Passaic County, Law Division L-980-04, January 30, 2006). Also reference Campbell v. Shura - US Court of Appeals for the 5th Cir. - November 05, 2003, Federal Circuits, Docket 03-30406

insured with direct rights under the named insured's policy. Typically this will occur in connection with third party trigger insurance. For example, in the case of general liability insurance, if a customer named as an additional insured is sued for negligence due to the actions of the provider, the customer can then look to the provider to defend the claim.

An additional insured is given rights under the policy of the named insured by virtue of an additional insured endorsement, wherein the named insured extends protection to the additional insured under the terms and conditions of such policy. It should be noted, however, that coverage provided under the additional insured endorsement is often limited to liability arising out of operations performed by or on behalf of the named insured. This means that typically the coverage will only respond to damages incurred by the additional insured if there is some connection with the operations of the named insured.<sup>21</sup>

(c) *Additional Named Insured*

Further along the spectrum is the status of additional "named" insured. In contrast to simple "additional insureds", in the case of an additional named insured the first named insured extends coverage under its liability policy to *all* of the operations of the additional named insured, rather than just those operations performed for the additional named insured by the first named insured. For this reason, additional named insureds are usually entities whose operations are closely tied to the first named insured (for example, affiliated entities).

Being identified as a named insured carries significant advantages for the customer. It ensures that the customer effectively receives double protection, in that not only can the customer receive the proceeds directly under the policy (typically on an Actual Cash Value basis), the receipt of such proceeds does not derogate from the contractual obligation of the service provider to replace the asset (by being named the customer should have the asset replaced on a Replacement Cost basis) and/or re-perform the services<sup>22</sup>. It also provides the customer with notification rights if the policy is cancelled or their status is modified for whatever reason<sup>23</sup>.

However, in many cases it is not appropriate for, and may actually be harmful to, the customer to be added as an additional insured. For example, as an additional named insured, all of the operations of the customer are insured. Not only will that likely trigger some resistance from the insurer, but if the insurer does accept the customer as an additional named insured:

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<sup>21</sup> For a brief and useful analysis of the differences between additional and additional named insureds, see the White Paper authored by The CSAC Excess Insurance Authority (EIA) at [http://www.csac-eia.org/pdfs/NamedInsured\\_vs\\_AdditionalInsured.pdf](http://www.csac-eia.org/pdfs/NamedInsured_vs_AdditionalInsured.pdf)

<sup>22</sup> Note that the contract will always be reviewed by an adjuster to ensure that there is no double indemnity, or "double dipping".

<sup>23</sup> The customer should also contractually obligate the provider to provide the customer with such notice.

- the insurer will have to assess the scope of exposure, including the value of any insured assets
- the insurance premiums will increase, for which payment either the provider or the insured customer will be responsible
- as an insured, the insurer will have more control over the customer generally, including in connection with contractual negotiations and general internal controls
- as an insured, the customer will have certain reporting obligations to the insurer
- some exclusions from coverage may apply to an additional named insured, where the same exclusions would not apply to an additional insured.

It is for this reason that while there are outsourcing agreements where the customer has imposed an obligation on the provider to add the customer as an additional *named* insured, we suspect that these obligations are being ‘observed only in the breach’ – that is, that when the service provider takes the obligation back to the insurer, the insurer is adding the customer as an additional insured only, and the customer – either through a lack of understanding or of follow-up post-contractual negotiation – is not aware of the difference.

However, even being named as a simple additional insured presents its own risks. By stepping into the shoes of the service provider, the customer benefits from being a party to the insurance policy, and thus sidesteps the challenge of being required to sue the provider for damages to recover the proceeds. The trade-off is that, as an insured, the customer is also subject to the same defences/objections to payment made by the insurer as is the service provider. For example, where the insurer objects to payment of the claim on the grounds that the provider breached a condition of the policy, or an exclusion to the policy applies, the customer, together with the provider, will equally be unable to recover. To assist in protecting against such circumstances, the customer should consider including a statement in the insurance provisions of the outsourcing agreement that their inclusion as an additional insured is not intended to nor shall limit any other remedies the customer may have under the agreement or otherwise in law or in equity, and/or include a standard mortgage clause (described below), to ensure that the exclusions do not apply to the customer.

In either case, where a triggering event occurs and the customer is insured both as a first named insured under its own policies and as an additional insured under the policy of the provider, the issue then is which policy is “**primary**” – that is, which policy will first cover the risk up to the limit of the policy – and which policy is “**excess**” – that is, will then be triggered only if or when the primary insurance is exhausted. This will be determined by the “other insurance” clauses of the policies and by the language of the endorsement. In any case, the customer should obligate the provider to ensure that the endorsement expressly states that the policy to which the customer is being added as an additional insured, is primary to that of the customer. However, in practice the insurer of the customer and the insurer of the provider will often defend and indemnify on a pro rata basis, in accordance with liability as finally adjudicated but subject to the applicable policy limits.

(d) *Loss Payee Provisions*

“Loss payee clauses” (or “loss payable clauses”) in an insurance policy have a similar effect to “additional insured” clauses, in that they provide that in the event of payment being made under the policy in relation to the insured risk, payment will be made to a third party – in this case, the customer – rather than to the insured beneficiary of the policy. As discussed, typically these provisions are found in first party insurance - for example, in the case of property of others insurance<sup>24</sup>. The loss payable clause in effect gives the customer a direct contractual right against the insurance company for direct damage. However, in some cases this direct settlement may allow for subrogation back against the customer. This issue will be addressed in Section 23:40.30

Further, as with additional insured provisions, under such clauses the third party customer is in no better position than the insured provider, in the sense that any action, omission or misrepresentation of the provider which might void or breach coverage under the policy would equally adversely effect the customer. “Standard mortgage” clauses were developed as a means of remedying this deficiency<sup>25</sup>. Effectively each such clause is a loss payee provision, but with the addition of a clause substantially equivalent to the following: “its terms shall supersede any policy provisions in conflict therewith, *but only to the interest of the mortgagee*” (*emphasis added*). In other words, to the extent that there are provisions, including exceptions to coverage, which conflict with the terms of the loss payee provision, they do not serve to limit the coverage provided to the loss payee. Again, however, while it is not uncommon to see a requirement for a “standard mortgage clause” being imposed on a provider in an outsourcing agreement, in most cases such a clause will not be applicable as it is a vehicle by which mortgagees insure their interest in real property. Nevertheless, it is still of utility to the customer to include an equivalent, non-mortgage-focused, clause ensuring that exceptions to coverage which could otherwise conflict with the loss payee provisions, will not do so.

#### **4. Creating Controls Before The Claim**

In order for expectations to be met at the time of a claim, it is critical to manage outcomes before they happen. Three critical controllable elements of an insurance contract should be addressed to ensure that all parties relying on the insurance-backed indemnity are comfortable with additional parties that become part of the claims process, after the claim. If provider fails to control the following elements, then by default the insurer will have all of the control:

- *Pre-Agreed Counsel*. If the contract indemnity is material and part of a complex contract, especially involving intellectual property, it is important that defense counsel be fully aware of the underlying business processes and practices of those insured. It is entirely possible to pre-appoint counsel with insurers. While not always a practical matter given that the customer and the service provider will have their

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<sup>24</sup> See 23:10:10 above for discussion of property of others insurance.

<sup>25</sup> For a brief history of the standard mortgage clause, see Carmen Place “Standard Mortgage Clause”, at <http://www.lindsaykenney.bc.ca/Publications/Standard%20Mortgage%20Clause.pdf>

own interests, it is at least important to table this issue for discussion. What would be especially disappointing is the appointment of counsel to represent the customer and service provider in a joint defense where the assigned counsel has little experience in complex litigation matters involving outsourcing agreements.

- *Pre-Agreed Adjuster.* If allowed, the assignment of a pre-loss professional adjuster should be made. Again, as with the Pre-Agreed Counsel, it is important to have knowledgeable professionals involved at the time of claim, to mitigate costs and expedite recovery. Both the customer and service provider should pay attention to this issue to ensure that the adjuster is experienced in adjudicating claims where third party interests are involved and there are sensitivities to the commercial relationship.
- *Advancement.* Many insurers will allow for an advancement of costs or proceeds prior to final claims settlement, whether due to first party or third party triggers, if the appropriate proof of loss has been submitted or appropriate cooperation has been maintained. In an outsourcing contract this can be critical for the provider as the indemnifying party in light of the fact that many indemnities require that the customer be indemnified not only for damages which have been ‘finally determined’ in connection with a third party claim, but also for the costs of the defense.

#### **D. KEY ISSUES: DOVETAILING THE CONTRACTS, CERTIFICATES OF INSURANCE, WAIVERS OF SUBROGATION & MULTI-JURISDICTIONAL INSURANCE ISSUES**

##### **1. Dovetailing Insurance Contracts & Commercial Contracts**

One theme which emerges from the above commentary is the importance of minimizing the disconnect between the language of the policy and that of the outsourcing contract. Similarly, both customers and service providers should note that if there is a reliance on any form of insurance for indemnity or recovery it is critical to disclose contracts in their entirety to insurers to the extent possible, especially where the insurance is material to the contract being executed. Note that because the entry into an outsourcing contract can itself be viewed as a material change in risk, it is the contract as a whole - not just the insurance covenants - that need to be disclosed to the insurer. Indeed, in some cases full disclosure can allow the insurer to provide the insured with valuable additional views on risks which may not have been contemplated by the insured.

##### **2. The Insurance Certificate – A False Reliance**

It is now relatively standard in outsourcing contract insurance provisions to require that the service provider - and in some cases, also the customer - provide a certificate of insurance as evidence that the contractually required coverage is in fact in place<sup>26</sup>.

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<sup>26</sup> Research and client experience has found that this trend is being driven primarily by a new compliance regime in the United States that is requiring a tightening of contract compliance and a philosophy of transferring risks to third parties to the greatest extent possible, without consideration of the effects. While this trend is positive to those charged with transferring risk away, it is somewhat alarming to those

However, we have above already described how being merely a certificate holder is much less helpful for the customer than it is, for example, to be loss payee. Yet there also are numerous other reasons why a customer should be cautious of overly relying in the provision of an insurance certificate, some of which we have outlined below.

1. *Certificate as representing coverage as of a point in time.* As noted above, a certificate of insurance is purely a representation of coverage at the time of issuance and confers no rights on the “certificate holder”. The customer should note that immediately after the certificate is issued by the broker or agent of the insured - most likely the service provider - the underlying policy can change without notice to the certificate holder unless there is an express obligation to do so set out in the outsourcing agreement.

The provider, in turn, should recall that the insurance policy provides coverage for more than just the particular outsourcing transaction in question, and in that sense is a “living” document that will be subject to change for various reasons which may have nothing to do with, and may have no effect on, the outsourcing arrangement with the other party. Thus the service provider may find itself in technical default of any contractual obligation to notify the customer of a change in the policy if it does not have the right to change such coverage that is not material to that arrangement without notice to the certificate holder.

2. *Certificate does not address exclusions for contractual assumptions of liability.* Notwithstanding the existence of a certificate of insurance, a claim can be denied primarily as a result of the contractual assumption of liability being excluded in most policies unless approved by the insurer<sup>27</sup>. For the service provider, the solution is to both (a) ensure that its insurance coverage expressly allows for all contractual assumption of risk, either written or oral, and (b) provide the entire agreements to its broker for its review, in order to forestall any argument that there was a lack of full disclosure and thus the claim should be denied. Similarly, the customer should seek a contractual commitment from the service provider that (a) the insurance coverage expressly allows for all contractual assumption of risk, either written or oral, and (b) for the very prudent customer, the entire agreement has been provided to and approved by the applicable service provider broker.

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absorbing the risk without fully understanding the implications on their insurance program’s ability to fund the obligations. The laundry list of insurance requirements is getting longer and longer, and in some case without relevance to the nature of the contract being insured. This trend is also a function of a boiler plate approach to a subject matter where contract negotiators are more focused on more material issues. Another significant trend is “limit creep”, which is the phenomenon of pushing up limit requirements based on subjective needs, and not the risk profile of the company providing the certification. For example, a provider may arbitrarily increase its general liability coverage by \$2 million in response to customer pressure, rather than in response to any new or increased risk.

<sup>27</sup> Other than contracts such as side-track agreements and premises leases.

3. *Certificate does not address indemnity basis for cost recovery.* While the insured may believe that it has purchased “soup to nuts” coverage of costs in connection with a claim - that is, coverage of the costs of defence as well as of damages - the insured may in fact only have coverage after the adjudication of a claim is complete, on what is known as an “indemnity basis”, wherein the insured is required to pay the claim first in order to make recovery. In that circumstance the insured could find itself funding an additional insured’s defence costs without recompense from the insurer until such time as the claim is finally adjudicated. Leaving aside the potential for an extended duration of the final adjudication of a claim where the insured is seeking an appeal, this could mean years of the insured making payments without corollary reimbursement by the insurer. To address this issue, the insured should ensure that the coverage responds on a “duty and right” to defend basis, and the claim is paid on a “pay on behalf of” basis.
4. *Certificate does not address limited territorial coverage.* While the insured may believe that it has purchased worldwide coverage that includes Canada and other jurisdictions, the policy may only provide coverage for claims for which the cause of action is brought in the jurisdiction defined in the policy. In this case, the service provider should ensure that its coverage responds on a worldwide basis. Another point to consider in this area is choice of forum. Many policies have embedded forum provisions – the provider just needs to ensure that these forum provisions dovetail with the main commercial contract<sup>28</sup>.
5. *Certificate does not address certain damages.* As noted above, in light of the fact that typical Canadian errors & omissions and general liability coverage only provides protection for “compensatory damages” (which are direct damages), the insured should ensure that the definition of damages in the policy should include all damages, whether they be compensatory, general, special punitive, exemplary or multiplied at best, and at a minimum there should be no definition of damages (i.e. so that it includes all damages as allowed by law). At the very least the definition of damages in the policy should be silent.

Providers should note that while it is increasingly common for customers to require that the certificates of insurance be expanded to include numerous additional endorsements and provisions (such as Waivers Of Subrogation, Primary & Non-Contributory Coverage, 90 Day Notice Of Cancellation, and Additional Insured Coverage Expanded Beyond Sole Negligence), it is very important for the provider to ensure that the language of their policies can, or can be made to, include such additional requirements. In short, each provider should ensure that it completely understands the implications before agreeing to

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<sup>28</sup> In addition, many territories have trade embargoes or sanctions forced on them from various U.S. regulators, such as Cuba. These restrictions also apply to U.S. based insurance companies that underwrite in Canada (which is most of the commercial underwriting in Canada). The implication is that where a service provider is exporting to or having service provided by a service provider located in an embargoed country, any certificate of insurance with respect to such services could be void as a result of it not being allowed by law. The provider should liaise with their broker to determine whether and the extent to which any such territorial restrictions may apply to the outsourcing arrangement.

any contractual terms regarding insurance coverage. If these terms are not understood and fail to match up with the applicable policies, there could be conflicts between the contractual obligations of provider, and the ultimate scope of insurance coverage.

### **3. Waivers Of Subrogation**

In almost all insurance contracts (first party and third party), the insurer retains the right of recovery, or subrogation, after the proceeds have been paid against third parties who are allegedly responsible for the loss, if it was a result of negligence that triggered the loss.

This rather esoteric feature of insurance is critical to control in an outsourcing arrangement in that it can cause friction between the service provider and customer, especially where the service provider's insurer takes an action against its customer for recovery. It is best to take control of this issue and make sure all policies have the option for the insured to waive subrogation rights of the insurer after a loss if agreed to between the service provider and customer in the main commercial contracts prior to a loss. This waiver should apply to both first party and third party contracts.

Thus, while a typical subrogation clause reads as follows:

*The insured is required to cooperate in any subrogation proceedings. The Company may require from the Insured an assignment or other transfer of all rights of recovery against any party for loss to the extent of the Company's payment.*

the insured can carve back this right of subrogation through the following clause:

*The Company will not acquire any rights of recovery that the Insured has expressly waived prior to a loss, nor will such waiver affect the Insured's rights under this Policy.*

### **4. Multi-Jurisdictional Outsourcing Issues**

International business has forced insurers to create contract language that tries to match exposures around the world. However, and unfortunately, this coverage match is not always in alignment with local licensing and regulatory requirements. If an outsourcing arrangement is multi-territorial, then it is critical that the service provider ensure that their insurer can warrant that all coverage is in compliance with local tax regimes and is placed on a 'licensed basis' in each territory. The licensed basis ensures that the insurer has met local regulatory requirements in each of the territories where coverage is required. It also mitigates any exposure to penalties for illegal insurance. This issue is of particular concern where the service provider is providing services from an emerging economy – for example, if a call centre has been outsourced to the Philippines, or to Sri Lanka. For example, Brazil requires that the insurance be carried by locally licensed insurers in order for the insurance to be valid.

It is also important that there be warranties that local insurance policy wording matches that of the master policy. In many cases terminology used in North American insurance

contracts differs materially from those in trading areas such as the E.U. While most insurance language is English, there will be territory and regulated nuances. That is, the local policy may be written in a different language and perhaps subject to additional statutory requirements, even though evidenced by a Certificate of Insurance. In this case, it is important that the policy have a “Liberalization Clause” or a “Difference In Conditions” which in essence ensures that all territories will enjoy the same coverage as the master policy.

(a) *Excise Taxes*

Excise Taxes can be a shocking surprise after the procurement of insurance or claims recovery. In some domiciles insurance recovery may be treated as ordinary income. In addition, taxes could range as high as 50% of the premium (e.g. Alberta), or even result in criminal penalties if not procured locally. Thus, it is important to seek insurance specific local tax and accounting advice when providing coverage for contracts in foreign territories. Even though a policy might provide “world-wide territory” it will not warrant that the policy is “world wide compliant” with local requirements. In some cases global policies will indemnify for local tax liabilities for those situations where insurance recoveries are taxable as income. However, it will not provide indemnity for tax liabilities that are as a result of an administrative penalty.

**23:50 SPECIAL ISSUES: IP INFRINGEMENT INSURANCE AND PERFORMANCE BONDS**

**1. Patent Enforcement & Infringement**

The current market for this type of coverage is somewhat limited and subject to significant underwriting and disclosure of patent positions. The coverage can be purchased for either the enforcement of a patent or the defense against allegations of patent infringement from a third party. The trigger for coverage for the *enforcement* protection is infringement of a insured patent – the policy will then pay for litigation expenses to enforce the patent up to a pre-set limit. The *infringement* product will pay for defense costs and in some cases awarded damages, up to a pre-set limit. In this class, there appears to be an emerging trend whereby contracts are requiring that any contributed intellectual capital be protected by insurance. As an example, where a service provider is bringing a technology to a relationship where the fulfillment of the contract is contingent upon the enforceability of the patent, certain customers are now asking for an insurance back-stop behind the patent. Customers should ensure that the provider’s policy does not expressly exclude coverage for intellectual property infringement.<sup>29</sup>

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<sup>29</sup> For example, a number of software developers, whether deliberately or through ignorance, will have insurance which excludes intellectual property infringement insurance. In the author’s view, this is the equivalent of the owner of a trucking fleet failing to insure their vehicles.

## 2. Performance Bonds

Performance guarantees can be back-stopped by performance bonds that are provided by special insurance companies known as Sureties. These bonds are basically three-party contracts whereby the Surety guarantees that the contract will be completed in the case of a default by the contractor.

Unlike *letters of credit*, which are demand instruments and effectively provide the creditor customer with direct access to the credit line of the provider, performance bonds can only be called in the case of default. Not unlike any other credit instrument, however, the bonds must be underwritten extensively and the Surety will usually ask for one or more of various forms of backstops, which may include personal guarantees from the principals of the provider; a capital retention agreement for the provider; an upstream guarantee from the parent; and/or a letter of credit. The advantage of bonds is that they typically do not require collateralization, are off-balance sheet and thus do not constitute an encumbrance for the provider, and are generally priced cheaper than letters of credit<sup>30</sup>.

## E. CONCLUSION

In summary, counsel for both customers and service providers should avoid taking a “boilerplate” approach to the insurance provisions in an outsourcing agreement, and rather should assess what coverages and exclusions are appropriate for the particular transaction. The critical point is that any contractual allocation of liability in the outsourcing agreement should dovetail with the insurance framework of the provider. For the customer, that means taking the appropriate steps to ensure that the provider will have the appropriate coverage – for example, by asking to review all endorsements which the customer has contractually required of the provider, and to review all exclusions to ensure that the expected bases of any customer claim are not excluded from the scope of the coverage of the provider. For the provider, that means closely liaising with their insurer in order to ensure that the required coverage is in place for each outsourcing contract. With regard to this issue at least, the interests of the customer and the service provider are closely aligned: in the case of any insurable issue arising, neither will want to hear the dreaded words “claim denied”.

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<sup>30</sup> At the time of writing there is a global credit squeeze occurring, but prior to such crisis letters of credit would generally cost 1% to 1.5% plus cost of money. In contrast, bond premiums, which will vary from one surety to another, could range from one-half (0.5%) to two (2) %, depending on the size, type and duration of the project and the contractor.