Coverage of Contract Indemnities

Coverage 2004-05

From 1 July 2004, Comcover’s standard terms of cover will no longer confer automatic coverage of contract indemnities. Comcover will now conform to commercial practice in that:

We will not pay for liability arising out of any indemnity unless the liability would have arisen in the absence of such indemnity (Clause 2.9.12).

By its very nature, this change applies principally to the General Liability and Professional Indemnity Policy.

If a contract indemnity does not increase exposure to legal liability, then a Fund Member can still be covered on the basis that liability would have arisen in the absence of the indemnity in any event.

The change in cover is only concerned with indemnities promised by the Fund Member – it is not concerned with indemnities promised to a member.

This is designed to reflect standard commercial insurance practice and encourage clients to better manage risk. Indemnities are not usually insurable in the commercial market because they remove incentives to manage risk.

The exclusion will only apply to indemnities contained in contracts entered into on or after 1 July 2004.

Context – Financial Management


The legislative requirements of the FMA Act and associated Regulations must be satisfied even where an indemnity may be covered by Comcover insurance. Comcover coverage cannot be relied upon to limit the risk of financial exposure, as coverage is subject to terms, conditions and limits (and so is not a known quantity until a claim arises and has been investigated). In addition, the Comcover liability policy responds not to the date of a contract, but to the date a claim arises. It is possible that liability arising out of an indemnity may crystallise at a time in the future, when insurance is not guaranteed.

Insurance should be viewed as a potential protection against financial risk, not as a total risk treatment.

The ultimate responsibility for risk management of indemnities resides with the individual agencies and their Chief Executives.

Comcover will seek to provide budget protection where the exposure is an insurable risk that can properly be shared by the Fund.

Taking into account agency obligations under the FMA Act, FMA Regulations, Financial Management Guidance No.6, and the Finance Circular 2004/10, the risks associated with the provision of an indemnity should already be identified and documented prior to any material being submitted to Comcover seeking to have cover extended to an indemnity.

While Finance guidance for FMA Act agencies does not apply directly to Fund Members operating under the Commonwealth Authorities and Companies Act 1997, it is anticipated that it will still serve such Fund Members as a useful reference on prudent risk management of indemnities.

Comcover expect that all Fund Members will be able to meet the documentation standards set out below, as a requirement of the Fund Member’s process for approving indemnities within their agencies.

Comcover can assist Fund Members with risk management services to help improve indemnity management processes.

**Underwriting Principles**

An indemnity is a legally binding promise whereby a party undertakes to accept the risk of loss or damage another party may suffer.

When considering underwriting a contract indemnity, the issues for Comcover are: (a) Is the event that triggers (crystallises) liability an insurable event?; and (b) What is the financial exposure?

Not all events will be regarded as insurable. The event must be a conventional insurance risk. For example, calls on warranties and guarantees are not insurance risks.
Even where an indemnity trigger is an insurable event, it will only be eligible to be underwritten on normal terms and conditions. Events that are excluded from cover by other exclusions will not be covered in most instances. For example, liabilities relating to breach of contract or termination of a contract are not covered (Clauses 2.1.23 and 2.9.19).

The change in standard cover is intended to apply to indemnities that attract liability that a Fund Member would not otherwise have been exposed to.

If the activity covered by an indemnity is regarded properly as part of the agency’s core business, Comcover will be inclined to extend cover, provided the risk (both the chance and the potential cost exposure) can be regarded as an acceptable insurable risk.

If the indemnity requires the agency to insure liabilities pertaining to the other parties and the other party should be covering these liabilities themselves, would be expected to do so under normal circumstances and are able to purchase the relevant insurance cover, then this should be taken into consideration before Comcover accepts covering the indemnity. There should be compelling reasons for Comcover to agree to issue cover to the other parties.

Where extension of cover is agreed, it will be noted on your Schedule of Cover. An extra premium may apply.

Fund Members should be aware of Comcover’s disclosure and subrogation rights (Clause 2.10.3 and 2.10.9) and the affect this has in the event of capping of liability within their contracts. Clauses that limit the liability of a contractor, and therefore limit Comcover's rights to recovery if an insured event occurs, may prejudice a Fund Member’s entitlement to claim for full loss recovery. Comcover will not waive subrogation rights.

**Requesting an extension of cover**

As mentioned above, Fund Members will be guided by Financial Management Guidance No. 6 on entry into contracts containing indemnities. The contract approval process will generate documentation that will identify indemnities, assess their effect and the potential for crystallisation of liability, and estimate the potential financial exposure. It is the Fund Member’s responsibility to meet these standards.

Extension of cover will be considered on a case-by-case basis. Requests and enquiries should be directed to Comcover Insurance Services.

**Materiality**

Fund Members should not submit every contract indemnity. Fund Members should vet contracts for materiality against this guidance.
**Timing**

Consideration of a request will be expedited by proper provision of supporting documentation. Fund Members should allow seven (7) business days for a response. More time may be required if the request has implications for Comcover’s reinsurance program.

**Supporting Material**

It is expected that in most cases a Fund Member will not need to prepare additional documentation for Comcover, as the material required by Comcover to assess a request for extension of cover will be the material generated by the contract approval process.

A request for cover of a contract indemnity will need to be supported by the following documentation:

- the relevant contract clause(s);
- a risk management report recording the reasons why an indemnity should be issued and identifying the physical and financial exposures to your agency as a result of issuing the indemnity;
- any legal advice on what the potential exposure could be; and
- the determination accepting inclusion of the indemnity within the contract.