Healthcare

INBRIEF®

A Risk Management Bulletin for Allied Healthcare Facilities | 2021 Issue 1

Contractual Risks: Understanding Indemnification and Subrogation

Via third-party contracts, many healthcare organizations outsource a wide range of clinical, technical and administrative functions, such as:

- **Physicians, nurses, technicians, pharmacists and other staff positions** for both inpatient and outpatient settings.
- **Physical, occupational and respiratory staff and therapies** for aging services residents and rehabilitation patients.
- **Laboratory, radiology, pharmaceutical and other ancillary services** in hospitals, aging services facilities and ambulatory settings.
- **Medical director oversight** for aging services and allied health facilities, as well as home healthcare providers and physician group practices.
- **Payroll, billing, purchasing, equipment maintenance and information technology support** in a variety of healthcare settings.

Unfavorable or **ambiguous contract terms** may lead to unexpected **risk exposures and potential legal conflicts**, and also may **affect insurance coverage**.

Such arrangements can go both ways. In addition to relying upon outside service providers to lower operating costs and increase flexibility, some allied health facilities provide their services to other healthcare organizations in order to generate revenue and expand their reach. In either situation, however, unfavorable or ambiguous contract terms may lead to unexpected risk exposures and potential legal conflicts, and also may affect insurance coverage.

Contracts with vendors and non-employed personnel often include provisions designed to protect one or both parties in the event a patient is harmed by the negligent actions of one of the parties. Known as *indemnification clauses* and *subrogation waivers*, these contractual provisions have significant liability implications for both parties, as well as for the insurer or agent (hereafter referred to as "insurer"). For this reason, it is important that they be carefully negotiated with contractors, drafted in consultation with legal counsel and communicated to insurers. Failure to do so could have a negative impact on both current insurance coverage and future underwriting decisions.

This edition of *inBrief*® examines these two distinct but related types of contract terms, especially in relation to the drafting of healthcare agreements and managing of potential claims. Also included is a questionnaire on page 5 listing some of the important points to consider when drafting and negotiating indemnification provisions.

What Is an Indemnification Provision?

In a general sense, to *indemnify* means to make good another's loss or damage. In the context of healthcare service contracts, an indemnification provision may refer to an agreement to compensate outside providers and vendors for costs and expenses incurred as a result of their own negligence. In contracts lacking such indemnity language, each party is held responsible for any third-party claims associated with its own acts or omissions.

Hypothetical example: A healthcare entity enters into a contract with a pharmacy services vendor to provide prescription ordering support services and dispensary operations. Under the contract, the healthcare organization agrees to indemnify the contractor for certain types of third-party claims, including allegations involving personal injury. After the contract is signed, an error linked to the pharmaceutical ordering software results in an overdose of a prescribed medication. The injured patient subsequently sues the healthcare organization where the medication was dispensed, as well as the contractor that provided the software used to order the drug. Although the outside vendor is at least partly at fault in this situation, the healthcare organization assumes full liability, because it had contractually agreed to "make whole" (i.e., reimburse) the vendor for judgments, attorney fees and other claim-related expenses.

Indemnification can be unilateral, as in the above scenario, or mutual, whereby both parties assume responsibility for their own acts or omissions, and indemnify the other party against any such claims.

Before making any decisions in regard to indemnification, administrators, executive directors and risk managers should consider specific circumstances and consult with their legal counsel regarding applicable state law. In addition, as indemnification agreements may affect insurance coverage, it is prudent to ask the insurer about the potential impact of indemnification language on the underlying insurance policy and the desirability of securing appropriate additional coverage.

Issues may arise if the **insured signs** a contract that includes **a waiver of subrogation** and then **fails to notify the insurer**.

What Is a Waiver of Subrogation?

After resolving a liability claim, the insurer is entitled by law to all the rights and remedies belonging to the insured against outside parties with respect to covered losses. In other words, the insurance company can *subrogate* – i.e., pursue recovery of money paid out on behalf of the insured via a claim against the third party that caused the loss. By supporting their insurance company's subrogation efforts, insureds help offset indemnity payments and related costs, thus keeping premiums more stable. In fact, most insurance policy forms require the insured to cooperate with the insurer with respect to any subrogation. (See "Seven Steps to Prepare for a Potentially Subrogated Claim" on page 3.)

On occasion, the insurance company is asked to forfeit this potential course of action by issuing what is known as a *waiver of subrogation* clause within the policy form. A waiver of subrogation rights is designed to reassure contracting service providers that neither the healthcare organization nor its insurance company will pursue recovery of damages if the contractor is found partially responsible for injury to a patient. Note that issues may arise if the insured signs a contract that includes a waiver of subrogation and then fails to notify the insurer, as the waiver could affect the subrogation or cooperation clause of the policy.

Hypothetical example: During contract negotiations, an outside provider of diagnostic imaging services requests that the insurance policy of the outsourcing healthcare facility cover 100 percent of losses for which the external provider may be partially at fault, precluding the facility's insurance company from later recouping some or all of its costs from the vendor. In response to this demand, the healthcare facility asks its insurer to issue a waiver of subrogation, which it does. Soon afterward, an X-ray is misread by imaging services personnel, resulting in patient injury and a lawsuit alleging substandard care by the vendor and healthcare facility. The case is resolved in the patient's favor, with the healthcare facility's insurer paying the court-ordered award. Since a waiver of subrogation was included in the policy upon its issuance, the insurer cannot seek to recover claim-related damages from the vendor.

Subrogation waivers are commonly found in general liability or property insurance policies, but also may be included in professional liability policies. Liability insurers typically ask insureds to refrain from taking any actions that could block or limit their right of subrogation. If the outside vendor asks to be granted a subrogation waiver during contract negotiations, always notify the insurance company before complying and request that the waiver be included in the policy form.

Checklist: Seven Steps to Prepare for a Potentially Subrogated Claim

When a Claim Is Filed Against the Organization …	(Yes/No)	Comments
1. **Inform the insurance company of the claim** and inquire about its subrogation-related policies and procedures.		
2. **Work with the insurance agent or broker to assess potential for subrogation** and develop practicable theories of liability.		
3. **Secure patient healthcare information records and other pertinent evidence and documentation,** including the facility's own professional liability insurance policy forms.		
4. **Identify all parties of interest** and determine whether potential defendants have professional and/or general liability insurance.		
5. **Have faulty equipment tested and sequestered internally** to support possible later assertions of negligent operation or manufacturing.		
6. **Consult legal counsel regarding expert witness requirements** with respect to the subrogation process, if requested to do so by the insurance company.		
7. **Communicate on a regular basis with the claim department of the insurance company** concerning case activity and status, evaluation of liability and subrogation potential, and other significant developments.		

How Do These Legal Concepts Differ?

While frequently appearing together in contracts, the two types of provisions differ significantly. Indemnification is intended to allocate risk and expense in the event of a breach, default or any other type of misconduct by one of the parties. *Mutual indemnification* means that both parties agree to compensate the other party for losses arising out of the agreement to the extent that those losses are caused by the indemnifying party's breach of the contract. In a *one-way indemnification*, only one party provides this indemnity in favor of the other party. Indemnification provisions are typically included in agreements when the risks associated with a party's non-performance, breach or misconduct are high.* Unlike indemnification, the right of subrogation involves two parties: the insured and the insurance company, which assumes certain rights of the insured in order to pursue recovery against a third party that is not a signatory to the insurance policy.

Note that the two provisions exist independently. In the event of a claim involving a contractually indemnified third party, the insurer may opt to pursue subrogation against that entity, unless a waiver of subrogation has been issued.

Why Are These Provisions Offered?

Indemnification and subrogation represent "equitable principles" of law, meaning they seek to achieve fairness among insurer, insured and relevant third parties (such as the non-employed provider who bears responsibility for the wrongful act). These contractual provisions help prevent complex litigation scenarios in which multiple cross-claims may be filed among various entities. They also reduce the potential for legal conflicts that could damage the underlying business relationship between contracting parties.

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* See Paley, J. "Indemnification Provisions in Contracts." Nolo, a wholly owned subsidiary of MH Sub I, LLC.

When Are Indemnification Provisions Used?

In many cases, healthcare organizations utilize these legal provisions to attract reputable service providers, who may be reluctant to enter into a contract lacking indemnity protection. Larger healthcare entities often consider indemnification a cost of doing business, and factor in these added risks when negotiating payment and service rates.

Indemnity provisions, which can range from simple "blanket" agreements to detailed clauses tailored to highly specific situations, should be included in contracts only after a thorough consideration of all pertinent factors. As the wording of such provisions is critically important in determining risk allocation, contract language should be drafted and negotiated in consultation with legal counsel. In addition, it is advisable to contact insurance underwriting representatives with respect to provisions that may affect coverage. (For more guidance in initiating and evaluating a proposed indemnity agreement, see "Questions to Ask When Negotiating an Indemnification Provision" on page 5.)

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When Are Subrogation Waivers Sought and Granted?

Organizations typically consider issuing subrogation waivers in order to maintain relationships with key outside providers and so remain competitive in the local healthcare marketplace. However, such waivers may adversely affect a healthcare organization's loss experience, premium renewal rates and even insurability. These risks and benefits must be carefully weighed when negotiating contracts.

From an insurer point of view, waivers of subrogation are often issued when additional insureds are named in an insurance policy. During the underwriting process, the insurer should be informed about the additional insureds seeking a waiver, such as the nature and value of the services they perform, as well as the business reasons for including a waiver of subrogation. The insurance company representative may or may not grant the request, depending upon the nature of the parties' services and the risks they may present, among other considerations.

Some healthcare service agreements – such as those involving IT support and equipment maintenance – may involve outside parties that subcontract certain tasks to other vendors who then request a waiver of subrogation in their contract with the main contractor. To prevent later questions and conflicts, healthcare entities should perform due diligence regarding the subcontracting arrangements of their business partners and communicate pertinent findings to their own insurer.

Indemnification and subrogation are central liability and risk-sharing concepts. By fully understanding these terms, and consulting with their legal counsel, healthcare leaders will be better equipped to draft mutually satisfactory contracts, forge stronger relationships with vendors, communicate more clearly with their own insurance companies and make fully informed choices about the types of risks that they contractually assume. For more information on the nuances and complexities of contractual risk, you may wish to contact a CNA underwriting professional.

Questions to Ask When Negotiating an Indemnification Provision

Major Considerations	Findings and Comments
When evaluating the appropriateness of entering into an indemnity agreement, consider the following questions:	
Does the contract expressly state the risks that will be indemnified, e.g., bodily injury, death, property damage, business loss?	
What events may trigger the indemnification clause, and do these circumstances include routine occurrences, as well as rare and catastrophic ones?	
What is the probability that the indemnification provision will become operative, based upon the history of the outside contractor and the organization?	
Can specified risks be addressed by an alternative risk transfer arrangement, such as guarantees, covenants or warranties?	
What is the total loss potential if the indemnification clause is enforced, including worst-case scenarios?	
Are specified risks fully or partly within the control of one or both of the contracting parties, and, if not, why should they be contractually assumed?	
Is it likely that risk factors will change over the duration of the contract?	
When negotiating an indemnity provision, consider the following questions:	
Does the proposed indemnification provision allocate risk fairly, based upon a reasonable assessment of loss exposure?	
Is the proposed indemnity provision aligned with state law, or is it vulnerable to legal challenge (e.g., could a provision intended to be unilateral possibly be interpreted by a court as reciprocal)?	
Does the contract clearly identify all parties, i.e., is there one specific indemnitee or a broad class of individuals/entities?	
Has the potential cost of indemnification been calculated, and is it within the financial capacity of the indemnifying organization?	
Could the indemnity provision adversely affect current insurance coverage, potentially requiring some modification of policy language?	
Before including an indemnification provision in a contract, consider the following questions, in consultation with legal counsel:	
Does state law permit a contracting party to limit its indemnification exposure, either by imposing dollar limits on liability or restricting the types of recoverable losses?	
Does the proposed indemnification provision include reasonable exclusions, such as …	
• **Consequential (or "indirect") damages,** e.g., downstream loss of profits caused by the claim, as well as punitive damages?	
• **Specified types of losses** caused or contributed to by the indemnified party?	
• **Losses caused by a third party,** either fully or partially?	
• **Losses resulting from intentional, willful, wanton and/or reckless misconduct** by the indemnified party?	

Major Considerations	Findings and Comments
Before including an indemnification provision in a contract, consider the following questions, in consultation with legal counsel: (continued)	
Does the provision permit the insurer to impose a monetary cap on liability and/or shorten the duration of potential exposure?	
Does the provision require the indemnified party to mitigate damages, e.g., by taking all reasonable steps to curtail losses after becoming aware of an event that may reasonably result in a claim?	
Does the provision contain a notice process, enabling both parties to defend themselves against a claim or other liability?	
Does the provision obligate the indemnified party to cooperate in planning and implementing legal defense efforts?	

Disclaimer: This resource serves as a reference for healthcare organizations seeking to evaluate risk exposures associated with indemnification provisions and subrogation waivers in vendor contracts. The content is not intended to represent a comprehensive listing of all actions needed to address the subject matter, but rather is a means of initiating internal discussion and self-examination. Your organization and risks may be different from those addressed herein, and you may wish to modify the activities and questions noted herein to suit your individual organizational practice and patient needs. The information contained herein is not intended to establish any standard of care, or address the circumstances of any specific healthcare organization. It is not intended to serve as legal advice appropriate for any particular factual situations, or to provide an acknowledgement that any given factual situation is covered under any CNA insurance policy. The material presented is not intended to constitute a binding contract. These statements do not constitute a risk management directive from CNA. No organization or individual should act upon this information without appropriate professional advice, including advice of legal counsel, given after a thorough examination of the individual situation, encompassing a review of relevant facts, laws and regulations. CNA assumes no responsibility for the consequences of the use or nonuse of this information.

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