JOHNSON CONDON

Attorneys at Law P.A.

CONTRACTUAL RISK MANAGEMENT:

CONSIDERATIONS WHEN ALLOCATING THIRD PARTY LIABILITY RISK

Dale O. Thornsjo
Nadia B. Hasan
JOHNSON & CONDON, P.A.
7401 Metro Boulevard, Suite 600
Minneapolis, Minnesota 55439
Telephone: (952) 831-6544
Direct Dial: (952) 806-0498
Facsimile: (952) 831-1869
E-Mail: DOT@Johnson-Condon.com
NBHasan@Johnson-Condon.com

CONTRACTUAL RISK MANAGEMENT:

CONSIDERATIONS WHEN ALLOCATING THIRD PARTY LIABILITY RISK[1]

Business contracts allow parties to prospectively apportion third party liability risk which arises from the parties' relationship. Unfortunately, many contracts do not address all the implications involved with the parties' intent to allocate these risks. Sometimes the lack of specific language is because the parties may not have a full appreciation of the third party risks related to the transaction. The shortcoming can also come from not fully appreciating the impact of the language utilized in light of the insurance held by each of the parties. Any combination of these and other scenarios can alter or nullify the parties' liability risk allocation unless all of the risk's subtleties and implications are addressed.

Contractual risk management provides an infinite variety of ways for parties to accurately and effectively define their exposures and rewards in the business arrangement so long as each parties' obligations and risks assumed are understood by all involved with the contract. The following generically describes some of the more common points to consider when utilizing indemnification

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[1] These materials raise a variety of issues involved with contractual risk management and transference of third party liabilities. The discussions are not intended to be exhaustive of every possible scenario which could or might arise in every business contract. Instead, these materials address some of the more common situations faced, and provides general guidance in identifying and addressing the risks involved. These materials are a starting point, and not an endpoint, in determining what language to utilize in a contract. Resolution of that question requires an analysis of the particular facts and risks at issue, the desires of the contracting parties on how to allocate/transfer the risk, the availability of insurance products to cover the risks, and the skill of the contract drafter to memorialize the parties' intent.

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agreements and insurance clauses as part of the risk management planning. These materials also provide some general insight into why these points should be considered and planned for in the agreement. In addition, the following provides some practical insight into how parties may wish to prospectively craft various clauses, as well as how they analyze the issue raised after a loss is realized.

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GENERAL CLAUSES

Choice of Law: Contracts are governed by state law. Therefore, the parties' obligations under a particular contract clause may be different depending on what state law is applied to the contract. For example, a variety of states void certain types of indemnification agreements because of either public policy or statutory considerations. The most common statutory prohibitions against indemnification of an indemnitee's own fault are the Construction Anti-Indemnification Statutes now in place in well over 40 states. 3 Bruner and O'Connor on Construction Law, § 10:77, p. 917 (2002). Specific statutory prohibitions vary from state to state, and therefore the jurisdiction's statute should be consulted if the parties will be engaged in construction activities. The statutes generally either prohibit the indemnitee from assuming the indemnitor's sole negligence, limit the indemnitee's protection to only the amount of fault of the indemnitor, or contain atypical or miscellaneous limitations. Id. Minnesota's statute, for example, is uniquely formatted to prohibit a party from

indemnifying another in a construction contract unless the contract also contains a duty to procure coverage to insure the indemnification obligation. Minn. Stat. Ch. 337.

Some jurisdictions may void an indemnification contract for public policy reasons. An ambiguous clause may limit the scope of an indemnification agreement. Also, some courts look to whether, at the time of contracting, there was a great disparity of bargaining power between the parties. See e.g., Cook v. Southern Pacific Trans. Co., 623 P.2d 1125 (Or. App. 1981) (court invalidated an indemnification clause due to great disparity of ability to shoulder the burden in light of the small dollar value at issue in the contract).

In order to avoid potential unintended application of state law, the contract should have a choice of law provision such as the following:

"***This Agreement shall be governed by the law of the state of*** _____."

If the contract does not have this type of clause, the parties must determine what law will apply to the indemnification agreement and/or duty to procure insurance. If there is a dispute over what state law is to apply, a detailed and often-times muddied "choice of law" analysis is performed to answer this question.

Historically, many courts applied a "lex loci" territorial approach concept to the case's facts to determine which state law applied. The "lex loci" was the law of the place where the right was acquired or the liability was incurred which constitutes the claim or the cause of action. Gray v. Blight, 112 F.2d 696 (10th Cir. 1940). See also Huang v. D'Albora, 644 A.2d 1 (D.C. 1994);

Prudence Life Ins. Co. V. Morgan, 213 N.E.2d 900 (Ind. 1966); Naughton v. Nakkier, 691 A.2d 712 (Md. 1997); Whitten v. Whitten, 548 N.W.2d 338 (Neb. 1996).

The modern trend in many jurisdictions is to analyze the contract under the Restatement (Second) of Conflicts of Laws to determine which state law applies. The Restatement provides that courts should apply the "most significant relationship" test to determine what law governs the contract. Restatement (Second) Conflicts of Law § 188. The "most significant relationship" test considers the following:

> (1) The rights and duties of the parties with respect to an issue in the contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6 of the Restatement.[2]

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[2] Section 6 of the Restatement sets forth general "choice of law principles":

> (1) A court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law.
>
> (2) When there is no such directive, the factors relevant to the choice of the applicable rule of law include:
>
> (a) the needs of the interstate and international systems;
> (b) the relevant policies of the forum;
> (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue;
> (d) the protection of justified expectations;
> (e) the basic policies underlying the particular field of law;
> (f) certainty, predictability and uniformity of result; and
> (g) ease in the determination and application of the law to be applied.

(2) In the absence of an effective choice of law by the parties, the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:

(a) the place of contracting;
(b) the place of negotiation of the contract;
(c) the place of performance;
(d) the location of the subject matter of the contract; and
(e) the domicile, residence, nationality, place of incorporation and place of business of the parties.

These contracts are to be evaluated according to their relative importance with respect to the particular issue.

(3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189-199 and 203.

Restatement (Second) of Conflict of Laws §188. The Restatement also directs that, in insurance contracts, the principal place of the insured's risk is the most important factor. Restatement (Second) Conflict of Laws § 193.

This modern approach is not universal. Some jurisdictions apply other choice of law tests. For example, Minnesota and a few other states, primarily in the Midwest, employ a "choice influencing considerations" methodology to resolve conflict of laws issues. See, e.g., Hime v. State Farm Fire & Cas. Co., 284 N.W.2d 829, 832-33 (Minn. 1979), cert. denied, 444 U.S. 1032, 100 S.Ct. 703, 62 L.Ed.2d 668 (1980); Nodak Mut. Ins. Co. v. Wamsley, 2004 ND 174, 687 N.W.2d 226 (N.D. 2004). If there is a conflict in the application of competing states' laws, and if sufficient contacts exist as to each state to allow application of its law, then five "choice influencing" factors

originally propounded by Professor Robert A. LeFlar in the 1960s are considered to determine which state law applies to interpret the contract:

- the predictability of the result;
- the maintenance of interstate and international order;
- the simplification of the judicial task;
- the advancement of the forum's governmental interest; and
- the application of the "better rule of law."

See, e.g., Milkovich v. Saari, 203 N.W.2d 408 (Minn. 1973).

It is an understatement to say that many times these tests do not provide clear expressions to determine which substantive law applies to the contract. However, it seems the local law of the jurisdiction where the event causing liability occurred will generally apply so long as there is no choice of law clause in the contract and the indemnitor is local, unless there are significant reasons to employ another state's law. Ultimately, this analysis must be done on a case by case basis.

As will be seen below, determining what state law applies could well be the difference between being able to rely on the indemnification agreement and/or the duty to procure insurance to offload the loss, or being forced to retain the exposure arising from the incident.

Negotiation Clause: Many business contracts are based on form documents which are developed by one of the parties. While use of standard language encourages uniform application of the law to facts, utilizing "standard" contract language raises a question of whether a court will later determine that the language is ambiguous, and therefore the parties' intent needs to be determined

to enforce the language. See e.g., Transport Indem. Co. v. Dahlen Transport, Inc., 161 N.W.2d 546, 550 (Minn. 1968). If the parties' intent cannot be determined, then the court will likely construe the provision against the drafter. Restatement (Second) of Contracts § 206 (1982); ICC Leasing Corp. v. Midwestern Machinery Co., 257 N.W.2d 551 (Minn. 1977). This is in fact what occurs most of the time as "standard" clauses are never negotiated, and therefore there is no evidence of the parties' intent to construe the language.

The best approach to avoid having a clause construed against the contract's drafter is to include a provision where the parties agree that no provision is to be so construed:

> "***The Agreement has been the result of negotiated terms, and therefore the Parties agree neither the Agreement nor portions of the Agreement's language is to be construed against any one party as a drafter.***"

Insurance Policy Disclosure: Historically, contracting parties have relied on Certificates of Insurance to determine if the other party has in place the insurance contemplated by the business transaction. Unfortunately, this custom has lead to innumerable situations where the parties later encounter severe problems because the Certificate did not reflect the actual terms and conditions involved with the referenced policy.

Because of this, both parties are better served by requesting copies of the actual insurance policies contemplated by the transaction to allow them to independently confirm that the coverage intended is actually in existence. In the past, this has been problematic, mostly due to the carriers not actually having a fully assembled copy of the policy which includes the particular additional provisions

mandated by the business transaction. However, this is expected to change as more and more information is maintained electronically.

An example of a clause mandating an exchange of insurance policies is as follows:

> "***Each party agrees to provide the other party with a copy of its commercial general or other liability policy or policies referenced in this Agreement, as amended, to allow the parties to confirm that the policy or policies, as amended, provide the coverage contemplated in this agreement.***"

A word of caution is required as to this provision. Just like the business transaction itself, the insurance contracts will also be governed by state law. Specifically, coverage exists if an application of the claim's facts as applied to the insurance contract in light of the relevant state law results in a finding of coverage. The "relevant state law" is not necessarily the same state's law which applies to the business transaction. Therefore, the party receiving a copy of the other party's insurance policy must first ascertain what state law will apply to the policy before she can determine the scope of that coverage as applied to the business transaction's risk management clauses.

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INDEMNIFICATION AGREEMENTS

Indemnification agreements contractually obligate one party to indemnify, and many times defend, another against losses arising from the subject matter of the contract. Most jurisdictions interpret the construction and effect of indemnification agreements as a matter of law. See e.g., Art Goebel, Inc., v. North Suburban Agencies, 567 N.W.2d 511, 515 (Minn. 1997). "A party may

contract to indemnify another for damages or injuries caused by the negligence of the indemnitee and beyond the control of the indemnitor." Christy v. Menasha Corp., 297 Minn. 334, 211 N.W.2d 773, 777 (1973). Most courts will enforce the scope of an unambiguous indemnification agreement even if it indemnifies the indemnitee for its own negligence unless the agreement runs afoul of public policy or statutory considerations. Therefore, it is important to understand how the state law of the jurisdiction involved will interpret the provision before it is proposed in an agreement.

Is The Indemnification Agreement Enforceable Under The Applicable State Law? The concept that one party may agree to assume another's liability is well accepted in many states' common law. The question is whether that state, either by caselaw or statute, has placed certain limits or restrictions on the enforceability of the indemnification agreement. There are several legal principles a particular state may consider in determining whether, or to what extent, to enforce the indemnification agreement.

Connection Between the Project and the Liability: Typically, some nexus or connection between the liability and the project is required in order to enforce the indemnification agreement. Minnesota, for example, requires that a temporal and geographic nexus, or a causal nexus, exists between one party's work and the injuries or damages at issue in order to enforce the agreement. Anstine v. Lake Darling Ranch, 305 Minn. 243, 249, 233 N.W.2d 723, 727 (1975), overruled on other grounds, Farmington Plumbing & Heating Co. v. Fischer Sand and Aggregate, Inc., 281 N.W.2d 838, 840 n. 4 (Minn. 1979). A temporal nexus exists between the party's work and the injury when a worker's injury, for example, occurs while the worker is preparing for work, or in the

process of working, but not after the work is complete. Fossum v. Kraus-Anderson Const. Co., 372 N.W.2d 415, 418 (Minn. App. 1985). A geographic connection exists between the injury and the party's work if the injury is sustained on the job site, regardless of its cause. Id. at 417-18. Alternatively, a causal nexus exists when, "but for" the work, the injury would not have occurred. National Hydro Systems v. M. A. Mortenson, 528 N.W.2d 690, 693 (Minn. 1995).

Other states employ a variety of approaches to determine whether the indemnification agreement is enforceable under the circumstances. See e.g., Arthur's Garage, Inc. v. Racal-Chubb Security Systems, Inc., 997 S.W.2d 803, 814 (Tex. Ct. App. 1999)(citing Dresser Indus, Inc. v. Page Petroleum, Inc., 853 S.W.2d 705, 708 (Tex. 1987)) (indemnity provisions are valid and enforceable so long as the agreement meets the "fair notice" requirements of unambiguous terms and conspicuous terms); Burlington Northern Railroad Co. v. Pawnee Motor Serv., Inc., 171 Ill. App. 3d 1043, 525 N.E.2d 910(Ill. App., 1st Dist. 1988) (indemnity agreements are strictly construed).

Statutory or Other Public Policy Limitations: Indemnification agreements, and especially those which seek to indemnify a party for its own negligence, may be void or unenforceable either because of public policy or statutory considerations. The most common statutory prohibition against indemnification for one's own fault are the Construction Anti-Indemnification Statutes referenced above. Specific statutory prohibitions vary from state to state, and therefore the jurisdiction's statutes should be consulted if the parties' contract addresses construction activities. These statutes generally prohibit one party from assuming another's sole negligence, or limit the party's protection to the amount of fault imposed on the indemnitee, or contain atypical or miscellaneous limitations. Id.

The following are examples of various state's statutes which may impact this analysis. Minnesota's Anti-Indemnification Statute is uniquely formatted to prohibit an indemnitor from indemnifying another in a construction contract unless the indemnitor obtains insurance to cover the obligation. Minn. Stat. Ch. 337. One Arizona statute bars an indemnification obligation if the indemnity sought involves the sole liability of the indemnitee in certain types of claims, but does not enforce this limitation if the indemnitee is merely allowing the contractor access to the land to allow the project to be performed for another. Ariz. Rev. Stat. §§ 32-1159; 34-226; 41-2586. A Texas statute bars a party's indemnification of another for the other's sole or joint negligence unless the injury is to the indemnitor's employees or agents and involves public works projects. Tex. Govt. Code. § 2252.902. One California statute bars enforcement of an agreement which indemnifies another for his or her sole negligence, Cal. Civ. Code. § 2782(a), although this prohibition does not apply to indemnification agreements where the indemnitee allows the indemnitor an accommodation access through the indemnitee's property to perform work for a third party. Cal. Civ. Code. § 2782.1. Illinois has a similar statute barring indemnification of the indemnitee's own negligence when the contract "deal[s] with construction, or for any moving, demolition or excavation;" 740 ILCS 35/1; however, the statute does not necessarily apply to an agreement seeking access through a railroad right-of-way because the right-of way access is not work "dealing with construction, or for any moving, demolition or excavation." Winston Network, Inc. v. Indiana Harbor Belt R. Co., 944 F.2d 1351 (7th Cir. 1991). Often times, a particular state will have several statutory provisions which could impact whether the indemnification provision is enforceable.

Some jurisdictions may void an indemnification agreement because of public policy reasons. Some courts look to whether, at the time of contracting, there was a great disparity of bargaining power between the parties. For example, in Cook v. Southern Pacific Trans. Co., 623 P.2d 1125 (Or. App. 1981), a court invalidated an indemnification clause where the agreement was on a form prepared by the railroad, did not specifically allocate risk of third-party negligence (the cause of the injury to the railroad's employee), and the railroad was under a broad duty of care pursuant to the Federal Employers Liability Act ("FELA"). Despite these "legal" reasons, it appears what motivated the court was the fact the contractor was financially unable to actually perform the indemnification obligation. The contractor was an individual who took on a job to demolish and remove an abandoned station house for the sum of $1,500.00. Assuming what in effect was the railroad's liability under FELA was just too great of an obligation and reflected too great of a bargaining disparity between the parties to allow the court to enforce the agreement.

In California, an indemnification agreement will also be struck down if it is considered unconscionable. Marin Storage & Trucking, Inc. v. Benco Contracting and Engineering, Inc., 89 Cal.App.4th 1042 (Cal. Ct. App. 2001). In order to determine whether an indemnification provision is unconscionable, the court will consider the clause procedurally and substantively. Id. At 653. The procedural element focuses on "oppression" and "surprise." Id. Oppression arises from an inequality of bargaining power which results in no real negotiation and an absence of meaningful choice. Id. Surprise involves the extent to which the supposedly agreed-upon terms are hidden in a pre-printed form drafted by the person seeking to enforce the agreement. The substantive element has to do with