

## SPECIAL REPORT

### NOT AT FAULT YET STILL LIABLE FOR MILLIONS: THE POWER OF CONTRACTUAL INDEMNIFICATION AS A RISK MANAGEMENT TOOL

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#### Introduction

It is routine for businesses to enter into contracts with both vendors and customers. These agreements can transfer liability to or assume liability of other parties. Such indemnity and hold harmless provisions in contracts differ widely, but where properly drafted, can be a boon or a blessing to the company entering into them.

It is also common in this technological age for such contracts to include assumptions of liability relative to intellectual property liability such as copyright, trademark or patent infringement.

The extent of insurance coverage to pay for such indemnification and hold harmless obligations varies among insurance carriers but typically is not as broad as the liability assumed in the contract.

#### 2008 Case: \$4.9M of Liability Where Not At Fault

In a December 2008 decision, the Michigan Court of Appeals determined that a crane company, which a jury determined to be not at fault in a construction accident, was nonetheless responsible for paying millions toward an adjusted verdict of \$4,900,000.

In this construction agreement, the crane company agreed to indemnify and hold harmless a subcontractor which hired it to perform services on a construction site. Such provisions are very common in the construction

arena and, in Michigan, are allowed except where one party is assuming the sole negligence of another party which is prohibited by statute.<sup>1</sup> This limitation is typically applicable only to construction contracts.

The Michigan Court of Appeals held that this agreement was to be read separately from any finding by the jury that there was no negligence by the crane company and found that this was not assuming liability for the sole negligence of the other parties. Further, even though the contract was only between the crane company and the subcontractor that hired it, the court determined that the crane company had to indemnify the general contractor as well under the language of the contract.

The \$8,100,000 verdict, which was reduced to \$4,900,000 by the court, was ultimately found to be the responsibility of two subcontractors who had agreed to indemnify the other parties including the general contractor.

### **The Power of Contractual Indemnification as Risk Management Tool**

The power of contractual indemnification provisions cannot be overstated. Courts will typically enforce clear and unambiguous language of any such agreement, separate and aside from any insurance coverage that may exist.

As a practical matter, it is likely that this loss was covered by the insurance coverage of the crane company as general liability insurance policies typically cover contractually assumed liability. However, some policies can limit this coverage, and all coverages for indemnity agreements should be closely reviewed.

Notably, such indemnity provisions are not limited to construction agreements and instead are found in lease agreements, and many other contracts. In one example of an indemnification provision in a lease, the lease stated:

“The Tenant agrees to indemnify and hold harmless the Landlord of and from liability, claims or demands arising out of or related to the injuries or damage occurring on or about the demised premises.”

In the above example, a trial court reviewed this language and held that even though an injury occurred in a parking lot and not in the tenant's space, the tenant was still obligated to indemnify the landlord given the language in the lease "on or about the demised premises." Notably, the word "defend" was not used, so there was an argument that that the tenant did not have to pay for the defense of the landlord.

Businesses should carefully review not only the precise language of agreements the company which other parties have agreed to indemnify it, but should also confirm that the insurance coverage backing up such indemnification provisions exists with adequate limits. As can be seen from the 2008 case mentioned above, a simple contract provision between two subcontractors ultimately resulted in the responsibility for millions of dollars in damages.

Correspondingly, businesses should look to see what coverage they have for liability of others they assume in contracts. Not all insurance coverage is alike in this area. Most insurance companies will only cover liability assumed in an indemnification agreement for "bodily injury" and "property damage." There are endorsements available that can broaden this to include assumed liability pertaining to libel, slander, defamation and other non-bodily injury claims. Some other carriers will add a contractual liability limitation which can significantly limit and/or remove coverage for such indemnification provisions.

As to intellectual property liability claims of violation of copyright, trademark and patent, coverage is typically nonexistent and this should be carefully considered from a risk management standpoint. For example, if services your business provides to another company are determined to violate a copyright or trademark, there is usually no coverage not only for the direct liability of your business but also for any liability you have assumed in an agreement with your customer.

***The following are some drafting considerations for either transferring or assuming liability in contracts:***

#### **A. When Transferring the Liability**

1. Require words "actual or alleged" liability.

2. Use “in whole or in part” when possible as this is absolute. Avoid “to the extent” as this is a comparative fault concept that could limit the indemnity.
3. Define “property damage” to include real property, personal property and data as tangible property.
4. Negligence and willful misconduct is not the best language. Use “any act, error or omission.”
5. Make any disclaimer of liability of consequential damages provision inapplicable to the indemnity provision. Otherwise, the indemnifying party could attempt to limit contractual liability for consequential damages or may try to invoke the limitation of liability provision.
6. Apply failure of the product to the indemnity obligation if possible.
7. Avoid “insurance only” general indemnity recourse on pure financial loss. If not negotiable, add language requiring your review of the errors and omissions insurance of the indemnifying party.
8. Require the assuming company to maintain e-business and Internet liability coverages.
9. As to breach of privacy claims, add language that the indemnity obligation applies to third parties and customers and their employees.
10. Avoid limiting general indemnity to third parties as this would otherwise take out indemnity for pure financial loss of your company.
11. As to breach of privacy claims, make indemnity obligation applicable to unauthorized access *and* unauthorized use.
12. Include words “hold harmless” and “defend” to avoid arguments that there is only an obligation to indemnify adjudicated liability.
13. Avoid requiring that you be listed as additional insured on the errors and omissions policy of the indemnifying party given insured versus insured exclusions which are common in such policies. This could

also apply to general liability policies where there is an endorsement added that is called a cross-suits exclusion.

14. Closely review selection of counsel and control of defense provisions to be sure that you are included in the defense of the claim.
15. Is the intellectual property liability indemnity obligation limited to only statutory claims? Attempt to add common law claims as well.
16. As respects intellectual property liability indemnity provisions, require that in the event of an infringement, that the vendor be required to continue providing services in a non-infringing manner so as to avoid nonperformance of contract.

## **B. When Assuming the Liability**

1. Limit general indemnity provisions to third party claims so as not to pick-up an indemnity obligation directly to the client or its employees.
2. Limit general indemnity provisions to bodily injury and property damage if possible.
3. Avoid assuming liability for the sole negligence of another party.
4. Exclude data from the definition of “property damage” assumed liability.
5. Avoid breach of contract as part of general indemnity obligation as otherwise you can be picking up breach of privacy and pure economic loss of the party you are indemnifying.
6. Avoid “any act, error or omission” language if possible. Consider “negligence and willful misconduct” as alter-native language that is less broad.
7. Avoid inadvertently assuming pure financial loss and privacy claims by limiting the indemnity obligation to bodily injury and property damage.

8. If possible, limit the assumption of liability to the amount covered under the E & O policy under the general indemnity provision.
9. Limit assumption of intellectual property liability to the amount covered under the media liability policy.
10. Place a dollar cap on the amount of indemnity for pure financial indemnity and/or intellectual property liability.
11. Include an exception to indemnity for misappropriation when transmitting information to the other party via the Internet.
12. Add selection of counsel and control of settlement provisions in the event of the application of the indemnity provision.
13. There should be a separate indemnity provision that applies in your favor. The indemnity obligation should not be one-sided.
14. Limit the indemnity obligation to statutory claims of infringement of intellectual property liability or alternatively, U.S. IP rights.
15. Add an exception for indemnity where your product is made to specifications.
16. Add an exception to indemnity where unauthorized alteration by the other party causes the infringement of any copyright, trademark or patent.
17. Add an exception to indemnity where an unauthorized combination of your product with another product causes the infringement of any copyright, trademark or patent.

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<sup>1</sup> MCL 691.991

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