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Passing the Risk to the Responsible Party: Indemnity 101

The majority of the issues relating to indemnity in the retail context are between manufacturers and retailers. However, indemnity provisions may be included in any contract between a retailer and type of vendor or transportation service. Indemnity provisions should be considered each and every time a retailer enters into a contract with another party. Thus, it is important to understand the significance of indemnity.

What is Indemnity?

Indemnity may be defined as the obligation resting on one party to make good on a loss or damage another party has incurred.[1] While indemnity generally is created by contract, it may also arise by implication as the result of equitable considerations.[2] Traditionally, a retailer has been able to obtain complete indemnification from a manufacturer/vendor under circumstances where the retailer (without fault on its part) has become subject to liability by virtue of injury to a third person occasioned by a defectively designed or manufactured product.[3]

As with most legal concepts, indemnity has unique terminology. When there are two parties to a contract, one party is referred to as an "indemnitor" and the other is referred to as an "indemnitee." An "indemnitor" is "the person who is bound, by an indemnity contract, to indemnify or protect the other."[4] On the other hand, an "indemnitee" is "the person who, in a contract of indemnity, is to be indemnified or protected by the other."[5]

Furthermore, sometimes indemnity provisions in contracts, especially between landlords and tenants are referred to as a "hold harmless agreement." Hold harmless agreements are contractual agreements whereby one party assumes the liability inherent in a situation, thereby relieving the other party of responsibility.[6] The purpose of these provisions is to transfer

liability from the landlord to the tenant.

In summary, an indemnity provision is a risk allocation device.

Types of Indemnity

The California courts have traditionally held that there are three basic types of indemnity agreements.[7] The first type of agreement, Type I indemnity, entitles the indemnitee to indemnification from the indemnitor for all claims or losses, except those which are the sole negligence of the indemnitee.[8] Under this scenario, a retailer would be entitled to indemnity from a vendor/manufacturer for all losses, except those which are the sole negligence or willful misconduct of the retailer. The second type of indemnity, Type II, entitles the indemnitee to indemnification for all loss regardless of each party's negligence.[9]

The third type of indemnity, Type III, entitles the indemnitee to indemnity from the indemnitor for indemnitee's liabilities caused by the indemnitor.[10] Type III is limited in that it does not require that the indemnitor indemnify the indemnitee for the indemnitee's liabilities which are the result of anyone other than the indemnitor.[11] Furthermore, under this type of provision, any negligence on the part of the indemnitee, either active or passive, will bar indemnification against the indemnitor irrespective of whether the indemnitor may also have been a cause of the indemnitee's liability.[12]

Interpretation of an Indemnity Provision

Historically, California courts interpreted indemnity provisions, especially Type II and Type III provisions, by analyzing whether the indemnitee was actively or passively negligent at the time of the loss. However, the California Supreme Court in the seminole case of Rossmoor Sanitation, Inc. v. Pylon, Inc., held that the "active-passive rubric is no longer wholly dispositive, but that instead the **enforceability of an indemnity agreement** shall primarily turn upon a **reasonable interpretation of the intent of the parties**."[13] According to the Rossmoor decision, the application of an indemnity provision should be based on the intent of the indemnitee and the indemnitor at the time they entered into the contract. In other words, when the parties knowingly bargain for the protection at issue, the courts will afford the protection.[14]

Public Policy Considerations

Indemnity provisions may be limited by public policy considerations. The following is an example of a contractual provision that was deemed unenforceable because it would violate public policy. A hardware store sold toluene-containing glue to a minor, contrary to a statute prohibiting such sale and designed to protect minors.[16] The purchaser's friend, also a minor, intentionally sniffed the glue and died as a result.[17] Despite the terms of an express contract requiring indemnity, the court disallowed contractual indemnity from the manufacturer, as well as contribution, holding that: "Any agreement which relieves the defendants of the consequences of the violation of the public duty imposed by statute, is against public policy."[18]

Accordingly, although contracts require indemnity, the provisions will not be enforced where it is determined that it violates public policy.[15]

Bargaining Power

Not all retailers have the same bargaining power. For example, "mom and pop" retailers may not be able to demand the same contractual terms from manufacturers as large volume retailers, such as Best Buy, Sears, Wal-Mart, etc.

A manufacturer understands that in order to do business with the larger big box stores, a condition will be the requirement of an indemnity provision. A manufacturer will weigh the risk allocation with a larger store against the volume of business. Whereas, with smaller retailers, the manufacturer will not be as inclined to include broad indemnification provisions, since the volume of business will be much less.

Accordingly, the extent of indemnity coverage which may be available may be determined by the bargaining positions of the parties and the scope of products involved.

Additional Protection

In addition to indemnity provisions, one of the ways a manufacturer can induce retailers, distributors, wholesalers, and vendors to sell its products is to provide vendors with additional insured status under the protections of liability coverage of the manufacturer's commercial general liability (CGL) insurance.[19] Additional insured status is akin to indemnity provisions in that it achieves similar results. Some of the primary motives for including insurance provisions which mandate additional insured status are as follows:

- It may reinforce risk transfers otherwise accomplished through indemnity provisions which may be invalidated by the courts or by statute;[20]
- It may allow one party to transfer liability arising from its sole negligence to other party's insurer;[21]
- It provides additional insured with direct defense coverage that applies in addition to limits without requiring that host of conditions be met; and[22]
- It may increase the chances of cooperation between the indemnitor and indemnitee in the event of a claim or suit because the indemnitor's insurance carrier will be providing the indemnitee with a defense and possibly indemnity in a lawsuit.[23]

Additional insured status is generally achieved by obtaining from the manufacturer's insurance carrier a document referred to as a "Vendor Endorsement." For reference, attached please find a copy of a standard form, Additional Insured Endorsement for Vendors. The form is promulgated by the Insurance Services Office ("ISO") and is referred to in the insurance industry as form number CG 20 15 (07/04). Endorsement CG 20 15 requires that the vendor be specifically named, and that the named insured's [manufacturer] products handled by the vendor/retailer also be listed. Note the endorsement contains exceptions to coverage and should be reviewed carefully.

In addition to contractual provisions requiring that the manufacturer maintain liability insurance, there may be a provision specifically addressing additional insured status that provides as follows:

> Retailer shall be named by endorsement as additional insureds under Manufacturer's general liability coverage. The additional insured endorsement must be on ISO Form CG 20 15 (07/04) or an equivalent acceptable to Retailer, with such modifications as Retailer may require.

It is strongly recommended that in order to obtain the most protection, a retailer should include in all vendor contracts an insurance requirement provision as well as an indemnity provision.

Application of an Indemnity Provision

The following hypothetical situation demonstrates the application of an indemnity provision: Wet Deal, a large international clothing retailer, operates over 5,000 retail locations worldwide. Wet Deal enters into various contracts. One such contract is with Forever 12 to manufacture its spring line of women's shirts. The agreement contains a provision which requires Forever 12 to indemnify Wet Deal for any injury or damage arising from the sale or use of the product. The agreement contains the following Type I indemnity provision:

> Forever 12 [Indemnitor] agrees to **defend**, **indemnify** and hold Wet Deal [Indemnitee] and its officers, directors, employees and agents harmless from and **against all liabilities, losses, claims, damages** and expenses of any nature, including reasonable **attorneys' fees and costs**, that are reasonably incurred by Wet Deal arising out of the performance of the Services hereunder, **except** where such liability, loss, claim, damage or expense shall have been caused by Wet Deal's **sole negligence or willful misconduct** in the performance of its duties and responsibilities hereunder.

The shirts manufactured by Forever 12 are a huge success and as result are in high demand. In order to ensure she is at the forefront of fashion, Kim buys three of the shirts manufactured by Forever 12 and sold by Wet Deal.

Eager to wear the stylish shirts, Kim decides she is going to wear one of tops out of the store. Upon exiting the store, Kim runs into her friend Paul, who is smoking a cigarette. Paul accidentally ashes his cigarette onto Kim's new shirt. Kim's shirt immediately bursts into flames. As a result, Kim suffers severe burns to her torso.

Kim files a lawsuit against Wet Deal for products liability for their sale of what she alleges is an unsafe product. The issue then becomes what role the indemnity provision will play in the lawsuit filed by Kim against Wet Deal.

Immediately upon receipt of the lawsuit, Wet Deal should tender the Kim lawsuit to Forever 12 to pay for its defense. The indemnity agreement provides that Forever 12 agrees to "defend" Wet

Deal against all liabilities, losses, claims, damages" which arise out of the services provided in the contract. Under this hypothetical, the services would be the manufacturing of the shirts. Pursuant to the contract language, Wet Deal could tender or formally request that Forever 12 pay for the defense of the Kim lawsuit. This would include all reasonable attorneys' fees and costs associated with the defense of the action. This provision could save Wet Deal hundreds of thousands of dollars.

Second, the provision states that Wet Deal is entitled to indemnity from Forever 12 for all acts except those which are the "sole negligence of or willful misconduct" of Wet Deal. In this hypothetical, Wet Deal did nothing more than merely sell the shirts manufactured by Forever 12. Wet Deal was not involved in the manufacturing process of the tops. Accordingly, the allegations of products liability against Wet Deal may be "passed along to the responsibility party" Forever 12, since Wet Deal cannot be found to be solely negligent for the production of the tops. Therefore, Wet Deal, pursuant to the terms of the indemnity provision, may be able to require Forever 12 to indemnify Wet Deal for a judgment obtained by Kim in her lawsuit.

Lastly, the provision provides Wet Deal with contractual grounds to file suit based upon contract against Forever 12 for the damages which may be incurred in the lawsuit. However, hopefully the necessity of a lawsuit can be avoided, if Forever 12 agrees to participate in the action.

Conclusion

Indemnity provisions are a necessity and should be required in each and every contract. The general perception is indemnity provisions are only necessary with manufactures. However, indemnity provisions should be included in all types of contracts (e.g. with the transportation services, cleaning services, landlords, etc.). Furthermore, to ensure the most protection, a retailer should also request additional insured coverage.

By having an indemnity provision, a retailer will be able to spread its risk of loss among those who are actually responsible.

1 Sammer v. Ball, 91 Cal.Rptr. 121, 123 (1970).

2 Id.

3 Huizar v. Abex Corp., 203 Cal. Rptr. 47, 50 (1984) citing Rest.2d Torts, § 886B, com. d; Rest., Restitution, § 93(1).

4 Blacks Law Dictionary 769 (6th ed. 1990).

5 Blacks Law Dictionary 769 (6th ed. 1990).

6 Blacks Law Dictionary 731 (6th ed. 1990).

7 MacDonald & Kruse, Inc. v. San Jose Steel Company, Inc., 105 Cal. Rptr. 725, 728 (1972) (In general, all contractual indemnity provisions fall within one of three classifications…)

8 MacDonald & Kruse, Inc. v. San Jose Steel Company, Inc., 105 Cal. Rptr. 725, 728 (1972) citing Vinnell Co. v. Pacific Elec. Ry. Co., 340 P.2d 604, 607 (1959) (The first type of provision is that which provides "expressly and unequivocally" that the indemnitor is to indemnify the indemnitee for, among other things, the negligence of the indemnitee. Under this type of provision, the indemnitee is indemnified whether his liability has arisen as the result of his negligence alone (citations omitted), or whether his liability has arisen as the result of his co-negligence with the indemnitor (citations omitted).)

9 Goldman v. Ecco-Phoenix Elec. Corp., 396 P.2d 377, 380-381 (1964).

10 MacDonald & Kruse, Inc. v. San Jose Steel Co., 105 Cal.Rptr. 725, 728 (1972) citing Goldman v. Ecco-Phoenix Elec. Corp., 396 P.2d 377, 380-381 (1964).

11 Id.

12 Id.

13 Rossmoor Sanitation, Inc. v. Pylon, Inc., 532 P.2d 97, 104 (1975). (Emphasis Added.)

14 Id.

15 Robert A. Sachs, Product Liability Reform and Seller Liability: A Proposal for Change, 55 Baylor L. Rev. 1031, n.145 (2003). (For example, contractual indemnity can be disallowed, however, where it would be against public policy.)

16 Zerby v. Warren, 210 N.W.2d 58, 60-61, 64 (Minn. 1973).

17 Robert A. Sachs, Product Liability Reform and Seller Liability: A Proposal for Change, 55 Baylor L. Rev. 1031, n.145 (2003) citing Zerby v. Warren, 210 N.W.2d 58, 60-61, 61 (Minn. 1973).

18 Robert A. Sachs, Product Liability Reform and Seller Liability: A Proposal for Change, 55 Baylor L. Rev. 1031, n.145 (2003) citing Zerby v. Warren, 210 N.W.2d 58, 60-61, 64 (Minn. 1973).

19 Donald S. Malecki, et al. The Additional Insured Book, International Risk Management Institute, Inc. 5th Ed. (2004).

20 Id.

21 Id.

22 Id.

23 Id.

24 Insurance Servs. Office, Inc., Additional Insured Endorsement—Vendors Form CG 20 15 (reprinted with permission from Insurance Servs. Offices, Inc.)