

# Risk Allocation and Insurance in Real Estate Transactions

## An Overview Regarding Sometimes Incompatible Bedfellows

by David S. Gordon

Lawyers and clients should understand the value of risk allocation, and how insurance can play a critical but sometimes seductively misleading role in the process of contractual risk allocation. In real estate-related transactions there are two primary types of insurance: property insurance under which the insured is covered directly for damage to its property, and liability insurance under which the insured is defended and indemnified by the insurance carrier against claims of and liabilities to third parties.

**T**his article focuses on liability issues, and how the parties can allocate risks to protect their respective economic expectations. It will address indemnification provisions to allocate risk, including risk arising from a party's own negligence, and contractual liability insurance coverage and additional insured liability insurance coverage under which the parties attempt to protect themselves from economic loss. These two constructs—indemnity and insurance—are powerful tools in the allocation of risk, but only if they are carefully crafted and coordinated.

### Indemnification

An indemnification provision is a commonly used method of allocating risk, a contractual obligation under which one party (the indemnitor) assumes the responsibility to defend against and pay for claims of third parties. The purpose of such a provision is to protect a party, who may or may not have liability insurance coverage, against third-party claims arising during or as a result of the contractual relationship, whether it is a lease, construction contract or subcontract, easement or agreement regarding some other contractual undertaking.

An indemnity provision, by contractually allocating the responsibility for a risk, can effectively increase the amount of insurance available to respond to a claim and reduce claims experience, which in turn can reduce insurance costs.<sup>1</sup> The indemnifying party (indemnitor) is always required to indemnify against the results of its own negligence, and frequently against the negligence of the indemnified party as well.

An agreement by an indemnitor to indemnify another (the indemnitee) against the results of the indemnitor's negligence is fairly straightforward. The ability to shift risk that is a result of the indemnitee's own negligence, however, requires specific and explicit language in the indemnification clause.<sup>2</sup>

New Jersey courts have repeatedly stated that indemnification against a party's own negligence will only be enforced where there is unequivocal language in the contract requiring that result. The cases of *Azurak v. Corporate Property Investors*, *Mantilla v. N.C. Mall Associates*, and *Ramos v. Browning Ferris Industries of South Jersey, Inc.*<sup>3</sup> set the basic framework for the unequivocal language rule.

In *Ramos* and *Mantilla*, the Appellate Division and the Supreme Court established a bright line rule that a contract will not be construed to provide protection to the indemnitee

against losses resulting from its own negligence unless such an intention is expressed in “unequivocal terms.”<sup>4</sup> Stated another way, a court will not uphold an indemnification for a party’s own negligence unless the contract contains an unequivocal expression of an intention to so indemnify.<sup>5</sup>

The cases following *Azurak*, *Mantilla*, and *Ramos* illustrate that the language of the indemnification clause needs to be both specific and unambiguous to clearly convey the intent to indemnify against the party’s own negligence.

In *Englert v. Home Depot*,<sup>6</sup> the parties entered into a contract containing an indemnification provision and conflicting indemnification language in a rider to the contract. The Appellate Division held that ambiguities within the indemnification provision, and inconsistencies between the contract and a rider to the contract, did not “demonstrate the required clear and unequivocal intention for Raimondo to be indemnified for its own share of negligence.”<sup>7</sup>

The U.S. District Court for the District of New Jersey, in a case involving an indemnification in favor of New Jersey Transit, held that for indemnification language to be deemed clear and unequivocal, the clause shifting the risk must not be subject to alternative interpretations.<sup>8</sup> The indemnification clause, which stated that “the provisions of this Article shall apply regardless of negligence or fault,” was found by the court to be ambiguous, and therefore ineffective in achieving the intended transfer of risk.

The district court held that the language failed to meet the New Jersey Supreme Court’s “requirement of specifically referring to indemnification for the indemnitee’s own negligence,” and that while the phrase “regardless of negligence or fault” could be construed to manifest intent to indemnify against New Jersey Transit’s own negligence, it could also be construed that the indem-

nitor agreed to indemnify New Jersey Transit only if the indemnitor was found to be at fault. Because there was “ambiguity in [the] phrasing,” the scope of the indemnity did not include the results of New Jersey Transit’s own negligence.<sup>9</sup>

In addition to specifically referencing the negligence or fault of the indemnitee, the facts of the underlying claim must conform with the unambiguous terms of the agreement. In *Taylor v. The Port Authority of N.Y. and N.J.*,<sup>10</sup> the court held that the indemnification agreement was specific and explicit enough to be upheld, but was so specific that it did not apply to the underlying suit. The indemnification clause encompassed only negligent acts in the port authority facility, while the accident happened outside the facility.

The court examined the component parts of the indemnification agreement to determine its scope. Emphasizing that absent an express obligation requiring the indemnitor to indemnify against the port authority’s own negligence outside the premises, the indemnification obligation was not applicable.<sup>11</sup>

The lesson of this case is that not only does the indemnification provision need to be clear and unequivocal regarding the intention to include the indemnitee’s own negligence, but it must anticipate which risks are to be allocated and state the intent to include them.

While a court will not expand an indemnification provision, and will strictly construe the terms stated, it will uphold a very broad indemnification agreement as long as it is unambiguous and clearly expresses the intent of the parties. In *Hertz Corp. v. Zurich American Ins. Co.*,<sup>12</sup> a federal court applying New Jersey law upheld an “extraordinarily broad” indemnification agreement because it found the language was clear and unambiguous.

The case involved a Hertz equipment

agreement that included a broad but detailed indemnification agreement.<sup>13</sup> Hertz sought a declaratory judgment that the indemnity provision was enforceable and applicable to the underlying action instituted when a construction worker was killed, possibly due to Hertz’s negligence. The court found that the indemnification clause unambiguously obligated the rental customer to defend and indemnify Hertz for all claims brought by anyone having anything to do with rental equipment, even if such liability resulted from Hertz’s ordinary negligence.<sup>14</sup>

Instead of facing an expensive defense of the claim and a possible judgment, the indemnification agreement allowed Hertz to shift its liability risk to the indemnitor/lessee demonstrating that a specific and unambiguous indemnification clause is a very powerful risk avoidance tool.<sup>15</sup>

## Insurance Coverage

The following section will explore the interplay between an indemnification agreement and insurance requirements, which may require the indemnitor to maintain contractual liability insurance coverage and/or to name the indemnitee as an additional insured<sup>16</sup> under the indemnitor’s liability insurance policy. Both requirements are intended to enhance the credit of the indemnitor.

An agreement of indemnification is worth no more than the financial strength and stability of the indemnitor, which may change during the course, or following the completion, of the contract. Accordingly, to provide a ‘deep pocket’ or credit enhancement, the parties frequently include requirements for insurance. This generally takes two forms: first, requiring the indemnitor to maintain a contractual liability endorsement to a liability insurance policy under which the insurer will cover the liability assumed by the indemnitor under the contract, and second, requir-

ing the indemnitor to name the indemnitee as an additional insured on the indemnitor's liability insurance policy.

While these are seemingly simple requirements, there are many issues associated with them.<sup>17</sup>

The most serious issue is that the only way to ascertain whether the coverage is actually in effect, and if it is maintained from year to year, if applicable, is to obtain, review and understand the terms of the indemnitor's insurance policy and the endorsements to the policy. The parties cannot rely on a certificate of liability insurance, because the certificate by its express terms "is issued as a matter of information only," and "confers no rights on the certificate holder," and further "does not amend, extend or alter the terms of the policy."<sup>18</sup>

The insurance certificate neither confers coverage nor confirms additional insured status. The terms of a liability insurance policy may allow certain categories of parties to be added as additional insured without an endorsement, but that is not the case with all policy forms, and the certificate of liability insurance specifically warns the certificate holder that an endorsement to the policy may be required to provide the desired additional insured coverage.<sup>19</sup> Additionally, the form of the endorsement providing the additional insured status may not be correct in the context of the contractual relationship.

The Insurance Services Organization (ISO), which promulgates forms for use by the insurance industry, has in excess of 35 different forms of additional insured endorsements. The parties (and counsel) are well advised to engage an insurance consultant in the process of reviewing both the indemnity and insurance provisions of the agreement, and the related insurance certificates and endorsements.<sup>20</sup>

Additional issues arise by virtue of the fact that nearly every liability policy, and many additional insured endorse-

ments, have an "other insurance" provision, which states, in this context, that if the indemnitee is named as an additional insured on the indemnitor's policy, but the indemnitee has other insurance available to it, the insurance of the indemnitee will be primary and the additional insured coverage provided by the insurance of the indemnitor will be secondary or excess. This would be contrary to the intention of the parties, but can be overcome by careful drafting that specifies under what circumstances the indemnitor's policy is intended to provide primary coverage.

The court will generally refer to the contract to determine if an additional insured will receive primary or excess coverage under an insurance agreement. For example, in *Englert* the court looked to the express terms of the contract to determine whether the defendant was the excess or primary insured.<sup>21</sup> The policy read, "this insurance is excess over...any other *primary* insurance available to you covering liability for damages arising out of the premises or operations for which you have been added as an additional insured." The policy provided one million dollars in liability coverage for each occurrence. Further, the contract specified that "[w]ith respect to the insurance afforded to Additional Insured...this insurance is *excess* over any valid and collectible insurance *unless* you have agreed in a written contract for this insurance to apply on a primary or contributory basis."

The requirement that the indemnitor provide insurance as financial security for the indemnification obligation does not mean the indemnitor's insurance company will necessarily agree to provide defense or coverage. The indemnitee is in no better position than the indemnitor with regard to a claim subject to the exclusions of the applicable insurance policy, and the many defenses that may be raised by the insurance carrier. Unlike indemnification provisions, for

example, the current forms of additional insured endorsement generally require that for the additional insured indemnitee to be provided with coverage there must be some negligence on the part of the indemnitor. Thus, in the case where the parties have negotiated that the indemnitor will be responsible for the negligence of the indemnitee, the addition of the indemnitee as an additional insured may be illusory.

Wholly different rules of law apply to the construction of an indemnification agreement versus an insurance policy.<sup>22</sup> New Jersey courts have adopted a "broad and liberal" view in construing ambiguities found in insurance policies in favor of the insured.<sup>23</sup>

In *Harrah's Atlantic v. Harleysville*, the issue was whether the insurer was required to defend and indemnify Harrah's in a personal injury suit when Harrah's was an additional insured under a general liability policy issued to its tenant. The lease agreement required the tenant purchase general liability insurance "in the name of and for the benefit of" Harrah's. The lease also contained an indemnification clause in favor of Harrah's.

The court found that the indemnification was too vague to be enforced, but upheld the lease agreement that required the additional insured coverage. Even though the lease provision was vague and subject to possible different interpretations, the court found the tenant's insurance company had the duty to defend Harrah's where the plaintiffs were injured when they left the tenant's stores and walked to the parking lot. Thus, Harrah's liability "arose out of the risk generated by [the tenant's] business on the premises."<sup>24</sup>

It was unreasonable of the insurer to argue that it did not foresee such an accident arising in the course of "conduct by an invitee of [the tenant]."<sup>25</sup> Harrah's liability arose as a result of a breach of duty on the tenant's part, and

so the accident was in the “landscape of risk” that Harrah’s could reasonably expect to be insured against.<sup>26</sup>

As compared to the strict interpretation of indemnification clauses:

The inquiry...is whether the occurrence which caused the injury, although not foreseen or expected, was in the contemplation of the parties to the insurance contract, a natural and reasonable incident or consequence of the use of the leased premises and, this, a risk against which they may reasonably expect those insured under the policy would be protected.<sup>24</sup>

While courts may be more liberal in construing an insurance policy, counsel must still be careful to make the intent of the contract clear. If the intent is unclear, the court will sometimes read an additional insurance obligation to name the indemnitee as an additional insured as co-extensive, with the indemnity burden contractually assumed by indemnitor. In *Pennsville Shopping Ctr. Corp. v. American Motorists Ins. Co.*,<sup>25</sup> the court held that where the lease agreement, including an indemnification provision, expresses the intent of the parties, the insurer was not required to defend the indemnitee as an additional insured.

The parties had provided that the tenant would indemnify the landlord “from loss or liability for damages occurring on the demised premises except for those due to Landlord’s negligence.”<sup>30</sup> The tenant also named the landlord as an additional insured. The court distinguished this set of facts from *Harrah’s* and *Franklin*, because the parties expressly agreed they were not responsible for the landlord’s negligence. The court wrote that while the policies of insurance are to be construed in favor of the insured, “here the lease agreement...clarifies the [intent] of the

parties in apportioning responsibility and providing for insurance coverage.”<sup>26</sup>

## Conclusion

Shifting and allocating risk is an important part of real estate-related agreements, yet lawyers, and perhaps clients, frequently exhibit a hostile or skeptical approach to risk allocation provisions. When examined in the light of the anticipated and accepted economics of a transaction, however, many, if not most, risk allocation structures are not unreasonable. Where the parties have already considered the cost of providing insurance, and the policy limits are at least adequate to the clients’ needs, a well-drafted risk allocation provision does nothing other than shift the financial burdens that may arise from an insured risk to the party (*i.e.*, the insurance company) that charges a fee for accepting that risk. A clear, explicit agreement combining indemnification and insurance has the potential to save clients vast amounts of money, but care must be taken in consideration of the available options and the different rules of interpretation when negotiating and drafting for risk allocation.<sup>27</sup> ⚡

## Endnotes

1. Indemnification clauses must be crafted so as not to exceed the lawful scope or level of indemnification (see endnote 2). Attorneys may treat the indemnification and insurance provisions as boilerplate, and be tempted to merely copy these provisions from a document used in a previous transaction. These provisions, however, are far from standard. They should always be analyzed anew, and it is strongly suggested they be reviewed by professional insurance or risk management personnel.
2. Where indemnification against the indemnitee’s own negligence is concerned, some jurisdictions have spe-

cific statutory or case law prohibitions or specific language/notice requirements that must be met. In New Jersey, indemnification against a party’s sole negligence is unenforceable as against public policy in certain circumstances as provided in N.J.S.A. 2A:40A-1 and N.J.S.A. 2A:40A-2, which provide:

N.J.S.A. 2A:40A-1. Construction, alteration, repair, maintenance, servicing or security of building, highway, railroad, appurtenance and appliance; invalidity

A covenant, promise, agreement or understanding in, or in connection with or collateral to a contract, agreement or purchase order, relative to the construction, alteration, repair, maintenance, servicing, or security of a building, structure, highway, railroad, appurtenance and appliance, including moving, demolition, excavating, grading, clearing, site preparation or development of real property connected therewith, purporting to indemnify or hold harmless the promisee against liability for damages arising out of bodily injury to persons or damage to property caused by or resulting from the sole negligence of the promisee, his agents, or employees, is against public policy and is void and unenforceable; provided that this section shall not affect the validity of any insurance contract, workmen’s compensation or agreement issued by an authorized insurer.

2A:40A-2. Architect, engineer, surveyor of agents for damages, claims, losses or expenses arising out of preparation or approval of maps, opinions, change orders, designs or specifications, or giving of or failure to give directions or instructions; invalidity

A covenant, promise, agreement

or understanding in, or in connection with or collateral to a contract, agreement or purchase order, whereby an architect, engineer, surveyor or his agents, servants, or employees shall be indemnified or held harmless for damages, claims, losses or expenses including attorneys' fees caused by or resulting from the sole negligence of an architect, engineer, surveyor or his agents, servants, or employees and arising either out of (1) the preparation or approval by an architect, engineer, surveyor or his agents, servants, employees or invitees, of maps, drawings, opinions, reports, surveys, change orders, designs or specifications, or (2) the giving of or the failure to give directions or instructions by the architect, engineer, surveyor or his agents, servants or employees; provided such giving or failure to give is the cause of the damage, claim, loss or expense, is against public policy and is void and unenforceable.

3. *Azurak v. Corporate Prop. Investors*, 175 N.J. 110 (2003); *Ramos v. Browning Ferris Indus. of S. Jersey, Inc.*, 103 N.J. 177 (1986); *Mantilla v. NC Mall Assocs.*, 167 N.J. 262 (2001).
4. *Ramos*, 103 N.J. at 191; *Mantilla*, 167 N.J. at 272.
5. *Azurak v. Corporate Prop. Investors*, 347 N.J. Super. 516 (App. Div. 2002).
6. 389 N.J. Super. 44 (App. Div. 2006).
7. *Id.* at 48. ("The question before us is whether the language of the indemnification provision in the Raimondo-Weir contract meets the *Ramos-Mantilla-Azurak* standard, that is, 'whether it express[es] in unequivocal terms,' the intention for Weir to indemnify Raimondo for his own negligence." *Id.* at 53. Here, the "regardless of" language in Article 11 is inconsistent with Rider D. Rider D lacks both of the critical phrases that appear in Article 11, and does not satisfy the required

unequivocal expression of intention to obligate Weir to fully indemnify Raimondo for damages resulting from its own negligence.

8. *Darcy v. N.J. Transit Rail Operations, Inc.*, No. 04-5907, 2007 U.S. Dist LEXIS 33989 at \*5 (D.N.J. May 8, 2007).
9. *Id.* at \*9.
10. No. A-4005-06T3, 2008 N.J. Super. Lexis 971 (App. Div. July 1, 2008).
11. *Id.* at \*9-10.
12. 496 F. Supp. 2d 668 (E.D. Va. 2007).
13. *Id.* at 678.
14. *Id.* at 670.
15. *Id.* at 671. (Indemnification Language: For an in additional consideration of providing the Equipment herein, customer will defend, indemnify and hold harmless HERC [Hertz Equipment Rental Corp.], its subsidiaries, parent company and its and their officers, agents and employees, from and against all loss, liability, claim, action or expense, including reasonable attorney's fees, by reason of bodily injury, including death and property damage, sustained by any person or persons, including but not limited to employees or customer, as a result of the maintenance, use, possession, operation, erection, dismantling, servicing or transportation of the equipment or motor vehicle or customer's failure to comply with the terms this agreement, even if such liability results in any part from the ordinary negligence of HERC, its agents or employees; Customer will, at its expense, comply with all federal, state and local laws and regulations affecting the equipment and its use, operation, erection, design, and transportation, including without limitation licensing and building code requirements and will defend, indemnify, and hold HERC harmless from all loss, liability or expense resulting from

actual or alleged violations or any such laws, regulations, or requirements.)

16. For more cases dealing with indemnification clauses, see *Marsdale v. J.F. Creamer & Sons*, 2007 N.J. Super. LEXIS 2772 (App. Div. 2007) (holding that *Mantilla* and *Azurak* did not preclude indemnification under facts of case. Moreover, the indemnification agreement satisfied bright line test described in those cases); *Nagim v. N.J. Transit*, 369 N.J. Super. 103 (Law Div. 2003) (Unless specifically provided for in contractual language, an indemnitor cannot be held responsible to indemnify an indemnitee for the negligence of the indemnitee.); *Carpenter v. Jersey Shore Univ. Med. Ctr. & Meridian Health*, 2009 U.S. Dist. LEXIS 29838 (D.N.J. 2009) (Although indemnity contracts are usually interpreted in accordance with the rules governing the construction of contracts, when the clause's meaning is ambiguous, it should be strictly construed against the indemnitee).
17. The correct term for this coverage is "additional insured." Care should be taken not to use the terms "named insured" or "additional named insured."
18. For example, the date of completion of the contractual performance is not the date by which the indemnity and insurance are measured. Insurance Service Organization [known as ISO, this is an insurance industry enterprise that promulgates standard forms of policies, endorsements and other documentation, such as insurance certificates, for industry] standard liability policies are triggered only when there is an occurrence which may be after completion of the contract. When the indemnification includes post-completion liabilities related to the indemnitor's completed opera-

tions, there is a special ISO endorsement that must be used, and the endorsement must be carried forward to successive policies, if applicable. This underscores the need to engage knowledgeable insurance professionals in the drafting, review and monitoring of the indemnification and insurance provisions.

19. Until several years ago, the form of certificate titled *Evidence of Commercial Property Insurance* that was used in connection with first-party property insurance coverage expressly stated that it “is evidence that [the policy] has been issued, is in full force and effect and conveys all rights and privileges afforded under the policy.” Certificates regarding commercial property insurance now carry the same disclaimers as do the certificates of liability insurance, and the courts have uniformly held the disclaimers are effective and really do mean what they say. See, e.g., the unpublished Appellate Division opinion in *Porowski v. Rehm, et al*, No. A-4039-7T3, 2008 N.J. Super. LEXIS 2031, and cases cited therein.
20. Non-standard or ‘manuscript’ policies may require both an additional insured endorsement and the issuance of a certificate of liability insurance to vest the additional insured with coverage.
21. As a practical matter, it may not be realistic to request or expect copies of insurance policies, but obtaining a copy of the endorsement is critical. Note, however, that endorsements can be long lead time items and require both specialized knowledge and monitoring (see endnotes 1 and 18).
22. 389 N.J. Super. at 58.
23. See generally *Harrah’s Atlantic v. Harleysville*, 288 N.J. Super. 152 (App. Div. 1996).
24. *Id.* at 159.
25. *Id.*

26. *Id.* at 158 (quoting *Weedo v. Stone-Elbrick, Inc. Co.*, 275 N.J. Super. 335, 341 (App. Div. 1994)).
27. For a discussion of indemnity and insurance issues in construction risk management, see Hickman, Effective Contractual Risk Transfer in Construction, *Construction Risk Manager*, [www.irmi.com/newsletters/#irmicrm](http://www.irmi.com/newsletters/#irmicrm).

**David S. Gordon** is a shareholder in the Woodbridge office of Wilentz, Goldman & Spitzer, P.A. He is a member of the commercial real estate, land use and redevelopment practice groups. The author acknowledges the assistance of Vanessa Brochin, Seton Hall School of Law, a 2009 summer clerk with Wilentz, Goldman & Spitzer, P.A., and Annemarie Terzano, a first-year associate with Wilentz, Goldman & Spitzer, P.A., in preparing this article.