

RAILROAD CONTRACTOR LITIGATION & OUTSOURCE LIABILITY COVERAGE:

PRACTICAL CONSIDERATIONS WHEN ADDRESSING INDEMNIFICATION AND ADDITIONAL INSURED ISSUES.

A Johnson & Condon White Paper

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**CONTRACTOR LITIGATION & OUTSOURCE LIABILITY COVERAGE:
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Railroad risks and losses are unique. Endless liability potentials abound, largely because railroad rights-of-way intersect thousands of non-railroad-owned properties and thoroughfares. Risks and potential losses associated with railroad properties themselves are equally endless due to the unique nature of the industry. The risks are compounded when a railroad allows contractors to access railroad property, or outsources its activities to third parties. Railroad property access occurs when the contractor performs work for the railroad, or when a contractor must access or traverse railroad properties or rights-of-way in order for those contractors to perform work for others. Outsource liability can also occur in a variety of ways.

Railroads are, for the most part, self-insured, and thus highly motivated to offload exposures in as many ways as possible. *Commercial Liability Insurance* (International Risk Management Institute, Inc.), at VI.R.1 (July 2002). Railroad risk management is most effective when it can prospectively offload its risk to another. Risk mitigation is most effective when the professional handling the claims arising out of contractor and outsource activities can effectively communicate to and persuade contractors and their carriers to assume the railroad's risks as they promised before the

¹ These materials are intended to educate, inform, and encourage discussion. A professional handling an actual claim involving these issues should analyze the facts of the case as applied to the various contracts and/or policies which may be involved in light of the particular applicable state law. The views expressed herein are not necessarily those of Johnson & Condon, P.A. or its clients.

accident. Risk management and risk mitigation are equally important bookends to effectively contain the railroad's risks.

Insightful risk containment includes the following strategies to offload potential liabilities related to contractors or the outsourcing of operations:

- Procurement of Railroad Protective Liability (“RPL”) coverage if possible to initially address railroad liabilities because of certain Contractor operations:
 - This protection provides direct primary occurrence coverage to the Railroad for risks which may otherwise be excluded under commercial general liability policies, and to provide possible first-line of defense in claims against the Railroad because of the Contractor operations;
- Indemnification agreements coupled with the obligation that the Contractor's Commercial General Liability (“CGL”) policy insures the indemnification obligation:
 - This protection insulates the Railroad against claims brought by others by, at a minimum, indemnifying the Railroad for the Contractor's fault in causing injury to the third person, or, if permissible, to indemnify the Railroad for the Railroad's own fault in causing the loss.
- Additional Insured status under the Contractor's CGL policy:
 - This protection, if available, provides the Railroad with direct primary insurance coverage for the loss at issue if the RPL coverage does not apply.

These materials overview each of these strategies, discuss how each separate tool can provide effective (and sometimes duplicative) protection for Railroad contractor and outsource exposures, and provide some considerations for risk managers and claims professionals handling contractor and outsource issues.

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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 the contractual provision requires the Contractor to indemnify the Railroad for the Railroad’s own negligence unless the promise 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 indemnification agreement.

Choice-of-Law Considerations: What state law applies to the contract containing the indemnification agreement? Given that contract interpretation is a matter of state law, different states employ a variety of rules or law to determine whether or to what extent these agreements are enforceable. Therefore, risk containment professionals need to know exactly how the state law at issue applies to the agreement in order to determine if the indemnification obligation is enforceable as intended by the Railroad.

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Prospectively, this is handled best by adding a clause in the agreement which identifies what state law will apply to the Railroad/Contractor agreement. An example of such a clause is as follows:

“This Agreement shall be governed by the law of the state of _____.”

If the contract does not have this type of clause, the claims professional must determine what law will apply to the indemnification agreement. If there is a dispute over what state law is to apply, a detailed and often-times muddled “choice of law” analysis needs to be performed to answer this question. This is essentially the same analysis a court will employ if the matter proceeds to a lawsuit.

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 what 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

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the most significant relationship to the transaction and the parties under the principles stated in § 6 of the Restatement.²

- (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.

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.

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 their 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 express guides to determine which substantive law applies to the contract. However, the local law of the jurisdiction

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where the event causing liability occurred will generally apply so long as there is no choice of law clause in the contract and the Contractor 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 to offload the loss, or being forced to retain the exposure arising from the incident.

Is the Indemnification Agreement Enforceable Under the Appropriate 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 have considered 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, between the contractor's work and the injuries or damages at issue exist 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 contractor's work and the injury when the worker's injury occurs while the worker is preparing for work, or in the process of working, but not

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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 contractor'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 similar 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 such as a Railroad 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 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 statutes should be consulted if the Contractor will be engaging in construction activities. These statutes generally prohibit the Contractor from assuming the Railroad's

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sole negligence, or limit the Railroad's protection to the amount of fault imposed on the Contractor, or contain atypical or miscellaneous limitations. Id.

One statute in Minnesota, for example, is uniquely formatted to prohibit a Contractor from indemnifying a Railroad in a construction contract unless the Contractor obtains insurance to cover the indemnification obligation. Minn. Stat. Ch. 337. One of Arizona's statutes 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. One of Texas' statutes bars a Contractor's indemnification of the Railroad for the Railroad's sole or joint negligence unless the injury is to the Contractor's employees or agents and involves public works projects. Tex. Govt. Code. § 2252.902. One of California's statutes 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 Railroad would allow the Contractor an accommodation access through the Railroad'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).

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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 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 it 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.

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