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Minimizing Tort Liability With The Right Terms

Law360, New York (February 28, 2012, 12:36 PM ET) -- Contractual risk-allocation clauses can be used in various contexts to minimize tort liabilities. A recent consumer case in the U.S. Court of Appeals for the Third Circuit provides one such example.

Greenspan v. ADT Security Services Inc. involved property damage claims resulting from a fire at the plaintiffs' Pennsylvania residence.[1] The plaintiffs sued ADT for breach of contract and negligence, claiming that ADT insufficiently repaired and monitored their fire alarm system.

The district court granted summary judgment in ADT's favor, finding that the contractual risk-allocation provisions limited any potential recovery to $500, but the court disagreed with ADT's argument that ADT owed no duty in tort because all duties arose solely from the parties' contract for alarm services.

The plaintiffs appealed to the Third Circuit, arguing that the contract's risk-allocation provisions were ineffective against their claim for gross negligence. ADT cross-appealed, arguing that the plaintiffs' claims were moot because Pennsylvania's gist-of-the-action doctrine barred any tort claim, including gross negligence, because ADT's duties were solely contractual.

The Third Circuit agreed with ADT on all issues, finding the contract's risk-allocation provisions valid against all claims, including gross negligence. The court further found that the plaintiffs could recover in contract only, not tort, because the common law did not impose a separate tort duty to monitor an alarm system.

Notably, this decision settled somewhat-murky precedent by deeming the plaintiffs' gross negligence claim moot because they had no tort remedy. The clarity this opinion provides is to defeat the usual attempt to circumvent contractual provisions by simply alleging gross negligence. The strict enforcement of contractual risk-allocation provisions thus provides businesses with the ability to mitigate tort risks and litigation costs through well-drafted contracts.

Not surprisingly, the effectiveness of a contract's risk-allocation provisions depends on the contract's terms. While each contract is necessarily individualized, an effective risk-allocation framework should contain the following provisions:

- Waiver of Subrogation
- Limitation of Liability
- Limitation of Action
- Insurance Requirements
- Indemnity Clause

Waiver of Subrogation

Many states have enforced waiver of subrogation provisions even when the plaintiff alleges gross negligence and/or statutory violations.[2] Waiver of subrogation provisions, unlike other risk-allocation provisions, are not strictly construed and are favored by courts. See, e.g., Best Friends Pet Care Inc. v. Design Learned Inc., No. X06CV000169755S at * 2 (Conn. Super. Ct. July 22, 2002) (citing cases and noting that, "[a]uthority from other jurisdictions unanimously is of the view that a waiver of the subrogation clause is not an exculpatory provision.").

An effective contract spells out the expectations to ensure that the waiver of subrogation provision is deemed a true waiver of subrogation, as opposed to an exculpatory provision.

Such terms should state that the customer agrees to procure insurance for all damages that might arise in connection with the performance of the contract and then name the company as an additional insured; the customer waives all right of recovery beyond the proceeds of such insurance policy; and the customer agrees that no insurer will have any right of subrogation against the company.

Thus, the effect of these provisions is to preclude insurance companies from suing for risks they undertook in underwriting insurance coverage and making payment for a loss.

Limitation of Liability

Although this provision does not usually stand up against claims for gross negligence and statutory violations, it is generally enforceable in most states against claims for breach of contract and negligence. Annotation, Validity, Construction and Effect of Limited Liability or Stipulated Damages Clause in Fire or Burglar Alarm Service Contract, 42 A.L.R.2d 591 (Supp. 1995) (stating that "courts have been unanimous in declaring provisions [limiting liability] valid and citing cases from over 25 jurisdictions in support of this proposition.").

Enforceability, however, relies on the express intent to limit the company's liability even for its own negligence, whether active or passive. The contract should also include an "up to and including statement" that expressly states the sum of damages that the company will be liable for in the event of a breach, which ensures the provision is deemed a true limitation of liability provision as opposed to a liquidated damages provision. Avoid using the term "liquidated damages," as these provisions are disfavored by courts.

Limitation of Action

Most states require a "reasonable" time period to enforce any limitation-of-action clause, and usually enforce clauses with a one-year or greater provision. One-year provisions are generally enforceable against allegations of gross negligence and/or statutory violations.

Drafters should proceed with caution, however, because a few states require longer limitations periods. For example, contractual limitations periods cannot be less than two years in Texas.

Insurance Requirements

Insurance requirement provisions require the customer to purchase and maintain insurance coverage for the company, its affiliates, employees, agents and licensees for any claims that may arise from the other parties' performance.

Coverage should waive all rights of subrogation and include commercial general liability insurance, comprehensive automobile liability insurance and workers' compensation/employer's liability insurance.

Finally, the provision should indicate that the additional insured insurance is the primary insurance, and a certificate of insurance must be provided to the company before the start of its work.

Indemnity Clauses

Indemnity agreements are usually separated into two categories: those that indemnify against loss or damage (for actual loss suffered), and those that indemnify against liability (obligation to perform acts that prevent injury or harm to indemnitee) Am Jur Legal Forms 2d § 142:1.

Many indemnification clauses are intermixed and thus contain both indemnification against loss and indemnification against liability. An effective clause should specifically state that indemnification covers any claims arising from any act or omission by the company or the customer under the agreement, including claims for contract, warranty, tort (including but not limited to active or passive negligence), strict liability or otherwise.

The clause should also explicitly state that the company has the right to select its own counsel to represent it in any action subject to this clause.

In addition to these five elements, effective contracts should also be signed by both parties and definitively indicate if the contract contains more than one page. The customer should sign or initial each page of the contract, or acknowledge that she has read and agrees to all terms and conditions of the contract on each page. It is best to place contractual provisions under separate headings so they do not blend into other provisions making them hard to read.

Finally, document management is essential to the defensive use of a contract in litigation. Missing contracts make it difficult to assert contractual defenses and unnecessarily expose the company to significant liability.

An effective document-management system should aim to keep contracts as close to the original as possible, such as keeping the pages in the exact order as the original and ensuring that both the front and back pages of the contract are retained for two-sided contracts.

As the Greenspan decision illustrates, contracts are an effective means to mitigate tort liabilities and decrease legal spend. Inclusion of the above risk-allocation scheme as a base framework for most contracts, particularly when paired with effective field training and document retention, thus enables companies to better control on-going litigation risks and dispose more quickly of those risks when claims do arise.

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[1] Greenspan v. ADT Security Servs., Nos. 10-2901, 10-2902 (3d Cir., Sept. 20, 2011).

[2] See, e.g., Great N. Ins. Co. v. Architectural Env'ts, Inc., 514 F. Supp. 2d 139, 143 (D. Mass. 2007); City and County of San Francisco v. Factory Mut. Ins. Co., No. C 04-5307 PJH, 2007 WL 4463949, at *1 (N.D. Cal. Dec. 17, 2007); Indian Harbor Ins. Co. v. Dorit Baxter Skin Care, 430 F. Supp. 2d 183, 188-91 (S.D.N.Y. 2006); St. Paul Fire & Marine Ins. Co. v. Univ. Builders Supply, 409 F.3d 73, 85-87 (2d Cir. 2005); Lexington Ins. Co. v. Entrex Comm. Serv., Inc., 749 N.W.2d 124, 131 (Neb. 2008); Reliance Nat'l. Indem. V. Knowles Indus. Servs. Corp., 2005 ME 29, 868 A.2d 220, 226 (Me. 2005); Penn Ave. Assoc. v. Century Steel Erectors, Inc., 798 A.2d 256, 259 (Pa. Super. Ct. 2002); Behr v. Hook, 787 A.2d 499 (Vt. 2001); Glazer v. Crescent Wallcoverings, Inc., 451 S.E.2d 509 (Ga. App. 1994).