Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Risky Business: Pursuing Indemnity Rights

Law360, New York (September 10, 2009) -- After a long weekend away at the beach, Mr. and Mrs. Homeowner come home to find their dream house flooded because a faucet in their upstairs bathroom failed, dumping several thousand gallons of water into their home. The damage is so bad that the house must be condemned.

Mr. and Mrs. Homeowner's insurance company investigates the loss and determines that the faucet failed because of a manufacturing defect. The insurance company then asserts a claim against your client, the manufacturer of the faucet.

Because your client stands behind its product, it pays the claim. Your client's investigation, however, reveals that the failure occurred because of a defect in a component part manufactured by one of its critical business partners.

Should your client, which is self-insured, write this loss off as the cost of doing business or assert its indemnity rights against its supplier, which could destroy the business relationship?

It is not surprising that the company whose brand name appears on a product that allegedly causes personal injury or property damage to an end user is the company against whom the end user will assert his or her claim regardless of where, from a legal perspective, product liability may rest ultimately.

Indeed, the end user is often completely unaware that the defect that caused the damages associated with their product liability claim was due to a component part manufactured by an entirely separate company.

Furthermore, it is axiomatic that the customer's interest does not lie in who actually made the specific part that failed but rather, obtaining recovery of their losses by the quickest and easiest method possible. As a result, otherwise innocent manufacturers are often the ones "left holding the bag."

Companies commonly outsource the manufacture of component parts that will ultimately be incorporated into a finished product to other companies. This practice is more prevalent given that such outsourcing, particularly overseas, is generally cheaper than in-house manufacturing.

Additionally, our current economic climate forces manufacturers to seek additional measures to cut costs and increase revenue simply to stay in business.

Because the purchase of these component parts is generally conducted between two sophisticated companies for bulk amounts, these purchases are normally accompanied by a contractual agreement that contains indemnity language in the event the component part fails or does not meet specifications.

But, can your client really enforce those indemnity rights against a company with which it needs to continue to do business? Component part suppliers are frequently the sole source of the component product. Schisms within the business relationship could shut down a company's manufacturing capabilities entirely.

Imagine if your client in the case example above decided it could not stomach such a catastrophic loss and, therefore, instructed you to file suit against the component part manufacturer to enforce its indemnity rights.

Such action could easily result in the component part supplier increasing its per-unit price or, worse yet, shutting down shipments to your client all together. If your client gets to this point, there is no turning back — either the client must march forward and litigate its claim or simply walk away so that its business operations are not interrupted.

Such "bet the company" risks must be approached with extreme caution, but there is a way to counsel your client so that it can enforce its contractual rights without appearing adversarial and, consequently, without jeopardizing business relationships.

Resolve the Underlying Claim Instead of Tendering the Defense

If your client receives a claim in which liability is clear, i.e., the product your client manufactured failed causing damage to your client's customer, advise your client to resolve the claim for as close to actual cash value as possible rather than tendering the claim or defense to the component part supplier.

This approach serves two ends. First, resolving the claim directly with your client's customer fosters good customer relations and will allow you to obtain any necessary evidence (such as, insurance appraisals, receipts, photographs of the defective product, and photographs of the damages). Even more importantly, this approach will allow you to negotiate return of the defective product for analysis.

Second, in the event of a lawsuit, not making the component manufacturer a party to every claim raised serves your client's long-term interests, particularly if a full product

analysis has not been completed, i.e., your client has not determined with certainty that the failure was caused by the component part.

Determine Whether the Loss Actually Was Caused by the Component Part Supplier

Once you have custody of the product at issue or at least have been able to have your investigator photograph the product, your client must confirm that the loss was actually caused by a component part supplier's product.

To accomplish that end, enlist your client's engineering department or engage a consultant to conduct a more detailed investigative review of the product at issue (including nondestructive testing) to determine the root cause of the failure.

This review will not only allow your client to confirm that the defect was in the component product at issue, but it will isolate the specific failure scenario, which will be needed throughout the process.

Request that the investigative engineer fully document any nondestructive testing conducted, not only in a written report, but also photographically. This evidentiary collection will be critical when the time comes for your client to discuss the claims with his or her counterpart at the component part supplier.

Analyze the Contract

Presumably your client and the component part supplier will have entered into a contract manufacturing agreement setting forth each company's respective rights and responsibilities.

A good agreement should set forth the representations and warranties related to the product quality, design, specifications, inspection and testing and should also contain an indemnification provision protecting the buyer from liability for losses incurred as a result of the component part supplier's product.

Additionally, the agreement should require that the component part supplier obtain comprehensive general liability insurance coverage that expressly covers personal injury and property damage claims associated with the component parts.

If you are involved in negotiating these contracts for your client, the inclusion of provisions relating to defects, product liability insurance, and indemnification are critical as they will provide legal recourse against the supplier for breach of contract and will make it easier in the long run for your client to assert its indemnity claim against the supplier.

Is it worth it? Once a claim has been identified as involving a defective component part, your client should still consider a number of factors before determining how and whether to assert a cost recovery claim against a supplier.

This cost-benefit analysis should include consideration of the: (1) nature and extent of the contractual relationship between the client and the supplier, (2) availability of insurance coverage, (3) strength of the claim involved, (4) frequency with which such claims are received by your client (every claim may be minor, but if they occur repeatedly there could still be significant dollars involved), (5) overall financial wherewithal of the supplier, (6) potential affect on the client's business, and (7) feasibility of potentially having to institute litigation domestically or internationally.

Indeed, consideration of these factors may demonstrate that the risk of negatively affecting the business relationship substantially outweighs the reward of potentially recovering the amount of loss from the supplier.

Under such circumstances, you must be prepared to advise your client that its business interests mandate that it walk away from its otherwise valid claim. In most circumstances, however, these claims should be raised.

The Approach

If the client decides to pursue recovery, sensitive claims such as these should always start off as business-to-business communications, i.e., without the direct involvement of lawyers.

This approach is preferable because many times a lawyer's involvement signals the beginning of the adversarial process and acts to shut down further communication.

Instead, the lawyer should work "behind the scenes" with the client's business, sales or sourcing departments to first determine the most appropriate method to notify the supplier of the claim and second, to direct the client on the tenor and scope of the negotiations.

Generally speaking, the client's indemnity position can be articulated to the supplier in a written indemnity demand outlining the claim and the indemnity obligations contained in the contract.

This written demand should also include a summary of the claim and copies of all documents relating to the claim such as, proof of loss documents, your client's engineering investigative report, and photographs of the damages and the product itself.

It is also a good idea to arrange for shipment of the product to your supplier so that it can conduct its own nondestructive testing.

Ideally, the indemnity demand letter should be sent to the supplier by the client's purchasing personnel or other point of contact with whom the supplier is accustomed to negotiating purchase and sale prices.

In most instances, putting a business-to-business angle on your client's effort to recover these types of costs will more effectively keep open the door of communication. The key to this whole process is to be forthcoming rather than adversarial.

Accordingly, whereas in the litigation setting one might be tempted to withhold all documents until a proper discovery request is served, here it serves your client's interests to give up as much information as possible early in the process.

You should discuss recovery options with your client once notice has been provided and the supplier begins its investigation. The chances of the supplier having cash available to cover a catastrophic loss such as that contemplated above is minimal.

So, unless the supplier has insurance coverage that will cover the loss, you must convince your client to be flexible about the method of recovery.

Specifically, rather than rigidly expected a cash payment, perhaps credits on future invoices would be an acceptable alternative. Such an arrangement could actually foster the business relationship by making your client whole while placating the supplier by assuring it of continued business.

If the component part supplier has comprehensive general liability insurance coverage that will cover the claims, it should be urged to contact their insurance carrier to place it on notice the claim. Directly involving the lawyers is appropriate when negotiations with insurance carriers are taking place.

In sum, asserting indemnity rights against business partners can be a risky business. But, if you can work behind the scenes and guide your client through the notice and negotiation process, your client's business partners will be far more likely to treat such claims as business expenses rather than litigation expenses.

If done right, not only can you help your client recover its costs, but you can also help strengthen its relationship with its critical suppliers.

--By Matthew T. Wagman and Leianne Helfrich, Miles & Stockbridge PC

Matthew Wagman is a principal with Miles & Stockbridge in the firm's Baltimore office. Leianne Helfrich is an associate with the firm in the Baltimore office.