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Chinese Manufacturers vs. U.S. Distributors: Contractual Indemnity and Insurance Coverage Governing Product Liability

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Companies typically rely upon indemnity and insurance provisions in their contracts to dictate who in the supply chain is responsible for litigation arising out of their products. Negotiating these terms is a standard part of the business done between manufacturing entities in China and their U.S.-based distributors.

The distributors often do everything they can to shift potential product liability to the manufacturer via an indemnity clause in the supply contract. The distributor also typically requires the manufacturer to have in place an insurance policy that insures the liability assumed via the indemnity agreement. A careful distributor will also require the manufacturer to name the distributor as an "additional insured" on its insurance policy, which grants the distributor the same benefits under the insurance policy as the manufacturer.

Each of these three elements has a distinct purpose, and it is important for all parties involved to understand the interplay between them. The parties must accurately spell out their intentions via the terms of their contracts and insurance policies, because the addition or omission of a few words could shift the responsibility for millions in legal fees and liability. This article distills some of the key best practices for manufacturers and distributors to keep in mind.

Drafting Effective Indemnity Provisions

A contractual indemnity provision is simply the statement of one party agreeing to pay for the liability another incurs. Generally, a product manufacturer agrees to indemnify distributors and retailers of its product for liability caused by its own acts or omissions. Indemnity provisions will typically not cover liability caused solely by the negligence of the distributor or retailer. This is known as a "risk sharing" indemnity clause, and the provision needs to be clear on who retains liability for what. As a general matter, indemnity provisions will not be interpreted to indemnify a party against liability resulting from its own negligent acts unless that intention is expressed in clear and unequivocal terms.

Of course, liability can arise from strict liability as well as negligence. Therefore, it is in the interest of distributors to ensure that the indemnity provision specifies that the manufacturer is to indemnify the distributor for all liability arising out of the product's manufacturing or design defects, whether arising under negligence or strict liability theories. The manufacturer, on the other hand, seeks to minimize the scope of its liability and should disclaim any responsibility for the distributor's negligence.

Here, the manufacturer has the helping hand of anti-indemnity statutes and case law that operates to override overly-broad indemnification provisions in certain jurisdictions. That being said, it is always better to draft a crystal-clear indemnity provision in the first instance.

The result of an effective indemnity agreement is that the manufacturer will have a legal obligation to pay for the liability (and usually legal defense costs) incurred by the distributor related to the manufacturer's product. However, when dealing with small manufacturers who may not have significant assets, or overseas manufacturers where enforcing the contractual rights in court may be difficult, the U.S. distributor does not want to rely upon the contractual indemnity provision alone. This is where an insurance provision becomes essential.

Contract Terms Governing Insurance Coverage

A U.S. distributor who is indemnified by a China-based manufacturer should contractually require the manufacturer to insure its indemnity obligation. It is also wise for a distributor to require that the manufacturer provide proof of compliance with the insurance provision before the distributor begins importing the product. The insurance policy may be either a commercial general liability insurance or, more commonly, a policy that is specific to product liability (and often specific to the line of products the distributor is importing from the manufacturer). Most policies come in standard form, but when the insurer is based in China, it is worth checking how the policy terms compare to standard U.S.-based policies.

The interplay between contractual indemnification provisions and insurance policies can be complicated, and sometimes lead to unexpected problems. One major pitfall is that the manufacturer's policy may exclude liability assumed in a contract, which can include liability assumed through the very indemnity provisions discussed above. Standard CGL policies often have a "Contractual Liability" exclusion, which excludes liability for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. However, to confuse matters further, the standard forms also state that this exclusion does not apply if the liability arises from an "insured contract."

In order to ensure that the indemnity provision in the parties' supply contract is interpreted as an "insured contract," the indemnity provision should mirror the terms in the standard definition of an "insured contract", including that it covers "tort liability" to another party for "bodily injury" or "property damage" "caused, in whole or in part, by [indemnitor] or those acting on [indemnitor's] behalf", "including but not limited to strict liability". To remove all doubt, an express statement in the contract that the indemnity obligation is to be interpreted as an "insured contract" should do the trick.

Another potential problem with contractual insurance provisions arises when the insurance company claims that the benefits of the parties' indemnity clause extends to it. In other words, the insurer argues that the parties' contractual indemnity agreement is primary, and the manufacturer must pay for the liability first, while the insurance policy only provides excess insurance, and needn't pay until the manufacturer has extinguished its obligation. To avoid this outcome, the parties can expressly state in their contractual indemnity provision that the indemnification is intended for the benefit of the named indemnified parties only. It may also help to expressly state that the indemnification is not intended to relieve a primary insurer of its coverage obligations.

Even where both an indemnity provision and an insurance provision are fully enforceable and clear, a U.S. distributor will want a bit more: direct rights under the manufacturer's insurance policy.

The Importance of 'Additional Insured' Status

Perhaps the most important goal of the U.S. distributor is to be added as an "additional insured" under the manufacturer's insurance policy. The critical benefits of doing so include the right to tender a claim directly to the insurer, the right to demand the insurer fulfill its defense obligation, and the right to sue the insurer for breach of contract should the insurer not defend the additional insured or pay for any settlement or judgment. In other words, being named an "additional insured" gives the distributor many of the same rights as the manufacturer that obtained the policy has.

For a distributor to enjoy the rights of an additional insured, the parties must meet a few requirements. First, the parties should make sure the policy contains an Additional Insured Clause. If there is no Additional Insured Clause in the policy, courts might not enforce an addendum to the policy that simply lists the distributor as an additional insured. The distributor should thus request a copy of the policy to ensure there is an Additional Insured Clause, or at least that the policy does not expressly prohibit additional insureds.

Next, the distributor will want the manufacturer to endorse it as an additional insured by written contract, but the manufacturer will only want to do so with respect to liability for which the manufacturer is responsible. This limits the distributor's additional insured coverage to the same scope of liability that the manufacturer assumed through its contractual indemnification of the distributor. Without such a limitation, the manufacturer and insurer risk covering the distributor for liability outside the scope of the indemnity agreement.

Finally, the manufacturer will need to submit (and update when needed) its additional insured endorsement to its insurance policy. These "vendor endorsements" identify the names of all additional insureds (distributors, retailers, etc.), and the specific product to be covered by the policy. If all of this is done, the distributor will have the same rights as the manufacturer under the policy, limited to the manufacturer's liability under the contract. For a U.S. distributor working with a China-based manufacturer, this allows the distributor to request a defense from the insurer directly, and avoids the challenges of bringing a China-based manufacturer into litigation in the U.S.

Conclusion

A U.S. distributor of products manufactured in China wants an enforceable indemnification agreement with the manufacturer, an insurance policy in place that insures the manufacturer's indemnity obligation, and also an enforceable additional insured provision on the manufacturer's policy. This combination provides “belt and suspenders” protection from U.S. product liability claims based on good manufactured in and imported from China. The distributor then has the ability to seek indemnification from the manufacturer, but also the right to seek insurance coverage under the manufacturer's insurance policy. For all parties involved, it is important to understand and properly draft indemnity and insurance provisions in their contracts in a way that clearly spells out the scope of obligations both sides intend.