BEST PRACTICES

Sharing the Blame

construction indemnity agreements

By Luke J. Farley and Dixie T. Wells

One theory of construction contract law is that a construction contract is less about spelling out in detail each party's specific rights and obligations and more about allocating risk in case something goes wrong. Under this theory, the particular safety rules a contractor must follow on a jobsite are less important than which party will bear the financial risk of a jobsite accident, and risk allocation is the key function of the contract. One of the most important tools for risk allocation is an indemnity clause. This article gives a brief overview of indemnity obligations in the construction industry.

WHAT IS INDEMNITY?

At its simplest, an indemnity is a promise to reimburse someone for the losses they suffer. Construction contracts commonly include the phrase "defend, indemnify, and hold harmless." While usually lumped together, these terms mean different things and should be considered separate obligations. A promise to "defend" means that the contractor must pay for a lawyer to defend the owner if the owner gets sued for any claims that fall within the scope of the indemnity clause. If you have ever caused a car accident and your insurance company hired a lawyer to defend you, you have gotten the benefit of a promise to defend—a lawyer was provided at no cost to you (except, of course, your insurance premiums). An obligation to "indemnify and hold harmless" is a step beyond paying for a lawyer to defend a lawsuit and obligates the contractor to reimburse the owner for any losses the owner suffers within the terms of the indemnity clause. So, as an example, if the contractor damaged a car parked near the jobsite and the owner of the car sued the owner of the project and won a judgement for $50,000, the contractor would be obligated to reimburse the owner for the $50,000 loss as part of the contractor's promise to "indemnify and hold harmless" the owner. In short, indemnity clauses shift the risk of certain losses (including the cost of a lawsuit) from one party to another, making those clauses key contractual terms for risk allocation.

WHAT LOSSES DO INDEMNITY CLAUSES TYPICALLY COVER?

Indemnity clauses can be broad or narrow. On the one hand, a contractor can agree to indemnify an owner for something narrowly focused, like "acts of negligence causing death, bodily injury, or property damage." Under that indemnity obligation, the contractor must indemnify the owner if the contractor's negligence hurts someone or damages property. On the other hand, a contractor can assume a much broader indemnity obligation, like a promise to indemnify the owner "for all acts or omissions of the Contractor arising out of or related in any way to the performance of the Work of the Contract." This type of indemnity obligation would go beyond just the contractor's negligence, and essentially include anything

the contractor did related to performing the work which caused the owner a loss.

Contractors should resist broad-form indemnity and seek to limit their obligations to negligence causing personal injury or property damage. Contractors should also seek to make indemnity obligations mutual. Owners will often seek to make indemnity a one-way street—the contractor must indemnify the owner but not the other way around. Contractors should push to revise indemnity clauses so that the owner must also indemnify the contractor for the owner's acts or omissions, especially failure to provide accurate or timely information about the project during construction.

ARE THERE LEGAL LIMITS ON INDEMNITY OBLIGATIONS?

Most states have laws limiting indemnity in some way. Because indemnity is such a powerful tool for risk allocation, it can be abused by owners. The most common abuse requires the contractor to indemnify the owner for the owner's own negligence—in other words, making the contractor pay for something the owner did wrong. As an example, consider a situation where the owner negligently fails to obtain required environmental approvals. The contractor begins work and the authority having jurisdiction issues fines to the owner for violating environmental regulations. Under a broad indemnity clause where the contractor must indemnify the owner for the owner's own negligence, the contractor would be required to reimburse the owner for the fines, even though the fines were the result of the owner's negligent failure to obtain the required permits. The unfairness is obvious.

To address this problem, the majority of states have passed "anti-indemnity" laws. These laws limit or void contract provisions that require the contractor to indemnify the owner for the owner's negligence. The laws fall generally into two categories (and can be further divided into those that apply only to public or private projects).

In states like Michigan, New Jersey, South Carolina, and Virginia, the anti-indemnity statute voids provisions which require the contractor to indemnify the owner for the owner's sole negligence. In other words, if the owner was the sole cause of the loss, the owner cannot be indemnified for that loss by the contractor. If, however, the owner and the contractor share responsibility in any degree, then the contractor can be obligated to indemnify the owner for the entire loss.

In a larger group of states including California, Florida, New York, and Texas, the law is more stringent and prohibits a contractor from indemnifying an owner for any of the owner's negligence, whether sole or partial. Under these statutes, if the owner and the contractor share responsibility, the contractor can be required to indemnify the owner for the contractor's share of the loss, but not the share of the loss caused by the owner.

CLOSING THOUGHT

Indemnity clauses are one of the key ways parties can allocate risk in a construction contract. Contractors should seek to negotiate clauses that are narrowly tailored to address only the contractor's negligence. Narrow clauses can also benefit the owner, as they will ensure enforceable indemnity obligations that do not run afoul of any anti-indemnity laws. ■

This article is not legal advice and does not create an attorney-client relationship.

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