

The Contractor's Approach to Risk Allocation II: Indemnity Clauses

This article continues the series of discussions about risk allocation and the manner in which contractors can use various contract clauses to more equitably assign risks inherent in the industry to parties best suited to accept risk. One clause that receives a lot of attention is indemnity. This clause appears in most sophisticated construction contracts and has been a source of significant court and legislative action in recent years.

The Indemnity Clause:

At its core, an indemnity clause provides one party security against a legal obligation and protection from a loss or financial burden. Indemnity clauses have been widely used in the construction industry throughout Texas for shifting risk in construction contracts, typically downstream.

Until 2011, Texas law allowed the use of broad-form indemnity clauses in construction contracts. In that year, the Legislature moved Texas towards a majority of other states in prohibiting broad-form indemnity in all but a few situations. A broad-form indemnity clause is one where a party being indemnified, the protected party, could cause harm that was subject to the protection of the indemnity clause, even if the protected party was solely negligent and caused the harm.

Since the passage of that statute, parties to construction contracts have been renegotiating and modifying the indemnity provisions in their contracts. In addition to the statute's effect, contracting parties have become more aware of the inequities of broad-form indemnity. As a result, these provisions are being modified to better allocate the risk-shifting effect of the clause.

While Texas law has, for the most part, prohibited broad-form indemnity, it still allows intermediate-form and narrow-form indemnity clauses. Intermediate-form indemnity shifts risk to an indemnitor, the party who is accepting the indemnity obligations, as long as any amount of fault for a loss lies with that party. Narrow-form indemnity is the most equitable form of indemnity.

Narrow-form indemnity requires an indemnitor to protect the indemnitee, the party receiving the protection of the indemnity obligations, in only those cases where the indemnitee was not a cause of the protected loss or harm.

Intermediate and narrow-form indemnity clauses are enforceable in Texas. However, Texas courts will only enforce these obligations if the clause contains a clear and unambiguous expression of the parties' intent to transfer risks. Additionally, courts require these clauses pass two fair-notice requirements: 1) the express negligence rule and 2) conspicuousness. That is to say, the clause cannot contain ambiguities about assignment of risk for negligence and it must be made obvious to the contracting parties that the clause appears in the contract. The conspicuousness rule is the reason that many contracts have indemnity provision in bold and all capital letters. Historically, courts look at indemnity clauses with more scrutiny than other risk-shifting clauses because indemnity clauses have been considered to be among the most extreme risk-shifting clauses in construction contracts.

It's important to note that many other risk-shifting clauses that courts are currently enforcing do not have the same historic prejudices associated with them as indemnity. However, in the manner that many of these modern risk-shifting provisions are written and enforced, they can be as inequitable as indemnity provisions.

The comments above cover the basics of indemnity and enforceability of indemnity clauses. Now, in furtherance of this series of columns addressing equitable allocation of risk, the following discussion will address the equities of indemnity and its effect, in practice, on the relationships in construction.

Allocation of Risk with Indemnity:

Indemnity provisions shift risk downstream. In most situations, the indemnity provision only addresses financial risk, in that it deals with economic risks rather than performance risks associated with the work of a contract. Also, in many

situations where an indemnity obligation might arise, the financial burden can be extreme. In deciding how strongly and broadly to word the indemnity clause, the contracting parties need to consider the very basic question of whether the indemnitor can actually bear the risk and financial burden of the clause.

When deciding on whether and how broadly to word one's indemnity clauses, consider that many construction contracts currently require downstream parties to provide indemnity for a broad range of losses – whether caused by negligence, breach of contract, or other acts. This broadening of the clause has greatly expanded the allocation of risk beyond the traditional role of indemnity for personal injury or property damage in the event of negligence.

When drafting and negotiating your indemnity provisions, consider the actual value of the indemnity. If the downstream indemnitor lacks the resources to actually indemnify you for certain losses, then the provision might provide false security. Likewise, an overly harsh provision might cause a downstream party to raise its pricing, even if its ability to honor the indemnity obligations is compromised. In this case, the indemnitee ends up paying more to shift risk and might be in a position of essentially paying for nothing.

In the situation described above, consider limiting the scope of the indemnity to losses resulting in personal injury or property damage. In this event, an indemnity provision would not allocate risk for collateral damages associated with delay, for example, that an indemnitor might not be able to pay anyway. However, it would provide protection for



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losses covered by the indemnitor's insurance. In such a situation, the indemnitee could recover costs associated with a covered loss and should be able to recover those as the indemnitor would have the assistance of insurance coverage to pay for the loss and associated costs.

Even if an intermediate or narrow-form indemnity clause is used in a contract, the value and cost of that clause should be weighed in light of the project and the party providing the indemnity. Consider the equitable considerations and consequences of extending the indemnified losses beyond property damage and personal injury. If the costs and value of the clause might outweigh the likely benefits, then a narrowing of the clause might be warranted. ❖



A Balanced Approach to Construction Law.

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