New Law Affects Indemnification in Construction Contracts

by Thad Armstrong

On June 17, 2011, Texas governor Rick Perry signed a new law declaring void and unenforceable any provision in a construction contract that requires a contractor to indemnify another person against a claim caused by the other person's negligence. The new law, which became effective on January 1, 2012, upends a long-held principle in Texas that, subject to a few exceptions, parties to a contract may freely agree to allocate risks between them through broad, unlimited indemnities. The new law also established similar rules with regard to one person's status as an additional insured under an insurance policy. The following, however, will focus on the new law as it respects indemnities.

Indemnity Basics

An indemnity is a lot like an insurance policy. In its most basic form, an indemnity is one person's agreement to protect another person from claims and lawsuits and to pay for the other person's covered losses. The person providing the indemnity is often referred to as the "indemnitor," and the person receiving the benefit of the indemnity is often referred to as the "indemnitee." If the indemnitee incurs a loss covered by the indemnity, the indemnitor must pay. An indemnity often requires the indemnitor to provide the indemnitee with a defense against claims and lawsuits that could result in a loss covered by the indemnity. In other words, the indemnitor must also pay for the indemnitee's legal fees in defending a claim or lawsuit covered by the indemnity.

Why Indemnify?

Risk is inherent in any construction project. In fact, a saying exists in the construction industry: "Allocate now or litigate later." Put another way, rather than fight over which person should bear liability after a loss has occurred, an owner and a contractor can simply decide ahead of time which of them will bear the risk in the event of a loss. This ability to clarify risk responsibility is why indemnities exist; many lawyers refer to this principle as an "allocation of risk" or the "transfer of risk." In a perfect world, an owner and a contractor would allocate a project-related risk to the person best suited to control it. In the context of a construction project, this person is often the contractor.

Prior Law – Negligence Allowed

Before January 1, 2012, owners and contractors were free to allocate between them as much or as little as they desired of the liability for project-related risks. This range included broad, unlimited indemnities that covered 100 percent of the liability for any given risk—even if the loss was the fault of the person being indemnified. In the context of a project-related injury, such an arrangement meant that a contractor could be required to cover the legal fees of the owner and any resulting liability of the owner even if the injury was caused by the owner's own negligence. To many, this type of indemnity appears fundamentally unfair. Why should one person be required to pay for an injury caused by another person's negligence? But fairness is not the guiding principle behind most indemnities. As stated before, the goal of most indemnities is to allocate risk now rather than argue

over who was at fault later. Determining fault can require years of litigation and tens of thousands of dollars in legal fees, and often fault is ultimately apportioned among several people.

Recognizing that persons agreeing to a contract are (mostly) free to agree on whatever they desire, Texas courts have upheld this type of broad indemnity. Throughout the years, however, the Texas Supreme Court has established a few nuances that affect whether this type of broad indemnity is enforceable. One such nuance, called the "express negligence rule," requires this type of broad indemnity actually to state that it is intended to cover the negligence of the person being indemnified. Another such nuance, called the "conspicuousness rule," requires this type of broad indemnity to be conspicuous within the text of the contract, which is why indemnities are commonly written in all capitalized letters and/or boldface type. These drafting rules are well-known by lawyers, which means that broad indemnities are routinely inserted into contracts and are upheld and enforced by the courts.

Many states, however, have recognized the burden that broad indemnities place on contractors and lower-tier subcontractors and have thus enacted legislation prohibiting or restricting a person's right to be indemnified for the person's own negligence.

New Law – Negligence Not Allowed

Effective January 1, 2012, Texas joined several other states in enacting legislation to prohibit a construction contract from requiring one person to indemnify another person for the other person's own negligence. The new law specifically states that, subject to an exception discussed below, a provision in a construction contract is void and unenforceable to the extent that it requires a person (the "indemnitor") to indemnify another person (the "indemnitee") against a claim caused by the negligence or fault of the indemnitee, the indemnitee's employee, or anyone other than the indemnitor who is under the control or supervision of the indemnitee. The new law broadly defines the term "construction contract" to include any contract, subcontract, or agreement entered into by an owner, architect, engineer,

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contractor, construction manager, subcontractor, supplier, or material or equipment lessor for the design, construction, alteration, renovation, remodeling, repair, or maintenance of—or for the furnishing of material or equipment for—a building, structure, or other improvement to or on public or private real property, including moving, demolition, and excavation.

The new law cannot be waived in a contract. Therefore, an owner cannot require a contractor to waive the applicability of the new law in order to skirt its prohibitive effect on a broad indemnity. The new law does not apply, however, to contracts entered into before January 1, 2012.

This article has addressed the subject of indemnity within the context of an owner and a contractor, but it must be noted that the new law is broad; it covers, for instance, subcontractors and architects. A general contractor cannot require a subcontractor to indemnify the general contractor for the general contractor's own negligence. Likewise, an owner cannot require an architect to indemnify the owner for the owner's own negligence.

An Important Exception

The new law creates an important exception in the case of an injury suffered by the contractor's own forces, specifically stating that it does not apply to claims for the bodily injury or death of an employee of the contractor, the contractor's agent, or the contractor's subcontractors of any tier. Therefore, an owner and a contractor may still agree to a broad indemnity covering the owner's own negligence under these circumstances.

The new law also contains other exclusions, but they are beyond the scope of this article because each applies to a very narrow, specific situation (e.g., loan and financing documents) rather than to construction contracts in general.

Compliance

Although the new law has not been challenged or tested in the courts, one risk of non-compliance could be the unintended consequence of a void or unenforceable indemnity clause. Many construction contract forms, including so-called "standard" forms such as those published by AIA, will need to be modified in order to bring them into compliance with the new law and its exceptions and exclusions. N

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