

ISA Industry Issues Committee White Paper for Sub and Trade Contractors:
Tips and Best Practices relating to Indemnification
in Construction Contracts

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I. Contractual Risk Transfer

"Contractual risk transfer" is the shifting of responsibility from one party to another in a construction contract. It can be a valuable risk management tool. However, there are deadly traps for the unwary trade contractor or supplier. These concerns are particularly significant for contractors in Indiana because courts enforce unambiguous contract language -- they do not attempt to interpret contracts to get to what the parties "really" meant unless the language is unclear. That means it is really important for subcontractors to read and to understand contracts before they sign them.

Contractors and trade suppliers often view construction contracts as simply invoices or job orders that describe what is being provided, what those materials and services cost and when the project is to be completed. However, contracts are also insurance and indemnification agreements -- they dictate which party is responsible for the risks that arise in every project.

In general, agreements regarding responsibility concerning risk need to be balanced and multilateral. Ideally, each party involved in a project -- owner, design professional, general contractor, and subcontractors -- should be responsible those matters for which the party has direct responsibility and control. Oftentimes, however, risk transfer agreements evolve into a one-way, downstream assignment of risk that ends up piling on the subcontractors.

A. Differing Risk Management Perspectives

Each party to a project has distinctly different risk management concerns and priorities. It is critical to understand the perspective and agenda of each party to the project to best evaluate the manner and extent of risk management and shifting. Understanding the control and influence that each party can bring to bear on the project and on the documents that define risk assignment is also essential to effectively assess contract documents.

1. Owner

The owner in a project is the paying customer and has the greatest control and influence over risk transfer agreement. Many owners want a no-risk proposition with their project. However, while owners can insist on complete protection, the other parties being asked to assume this liability (in particular, subcontractors) must understand and factor in those costs in bids, i.e., allow for the possibility that there will be liability. Demanding no-risk necessarily creates additional project costs if the risk realignment is being properly evaluated.

One way to address these concerns is through insurance. There are many kinds of insurance products that help insulate against different kinds of risks -- a good independent insurance consultant can provide direction about available insurance coverage (if it exists for certain kinds of liability).

Some risk is uninsurable. For this kind of exposure, the smart contractor has to build that risk into the bid or pass on the project.

2. Architects & Construction Managers

The design professionals often draft and manage contracts in a project. Design professionals are committed institutionally to limiting their risk on projects. The newest AIA forms provide, in unedited form, even more protections and limitations on liability for architects, to the extent that contractors' organizations are now refusing to endorse. In terms of risk management, responsibility for design errors or the architect's errors or delays should start with the architect and then flow to the owner.

Look out for provisions that require a subcontractor to report design errors to the general contractor or owner.

Look out for provisions that allow the architect to interpret conflicting designs, plans or spec's -- the architect can shift liability on to the contractor for the architect's failure to properly detail a project.

3. General Contractors

General contractors are typically responsible for everything related to project delivery as it relates to the project owner. Many general contractors attempt to transfer responsibility to subcontractors -- even for matters that are out of the subcontractors' control. General contractors are under intense and increasing pressure from owners to assume risk for project outcomes and results. One way to do that and to cut costs is to attempt to shift liability on to subs.

4. Subcontractors

Many subcontractors are contractually responsible for the part of the project that they perform. As to the work for which they have primary responsibility, the contractor is typically liable to indemnify everyone. That makes sense.

Where risk lurks, however, is when subcontractors are asked to assume responsibility for matters outside their control. Because many subcontractors have little or no power to alter contract terms, it is important to understand the risk that the subcontractor assumes. The unwary subcontractor may learn -- after the fact of a claim -- that the contractor has inadequate insurance or other resources to address contractually assumed risk.

B. Key Contract Risk Transfer Provisions

1. Indemnification / Hold Harmless Agreements

Indemnification sounds bad and it should. Technically, indemnification means that a party agrees to assume liability that the law would otherwise impose on someone else. Why would a party agree to do this? Indemnification commitments are particularly risky if there is a possibility that liability will not be covered by insurance. Some of the new AIA contract language leaves open the question of whether the contractually accepted risk is covered by standard insurance. Non-standard indemnification provisions that have not been interpreted or tested are also particularly risky. **Show any indemnification agreement to your insurance consultant or broker if you have questions or concerns about effect on coverage.**

a. Broad Form Indemnification Agreements

A broad form indemnification agreement may contain language providing that the subcontractor agrees to "pay any and all damages, costs, expenses..." Without some qualification, there are few, if any, limitations on exposure. The contractor could be found to have assumed liability arising solely from the negligence of the owner. Again, it is key to remember that Indiana courts, unlike some jurisdictions, enforce contracts as written. Moreover, it is difficult for a commercial and industrial trade contractor to argue that plain language is unenforceable or unconscionable -- they are viewed as sophisticated contracting parties.

An exception to broad form indemnification is for intentional wrongful acts or gross negligence by the owner or the general contractor. However, there are frequently disputes that spawn litigation about who is at fault and what the degree of fault is.

Broad form indemnification agreements are particularly risky where a party assumes liability for consequential damages -- damages that arise out of loss of productivity, income, revenue, or profits. Broadly worded, indemnification can open the door to this kind of liability. Imagine consequential damages on a casino project -- a month's lost profits can exceed the net worth of even large scale contractors.

b. Limited Form Indemnification Agreements

A "limited form indemnification agreement" typically provides that a party will "pay to the extent of own negligence. . . ." The agreement is limited in scope, typically reserved "for bodily injury and property damages. . . ." In essence, each party is responsible for their own actions. Provisions of this nature are found to be equitable and likely to be enforced. Provisions like these are likely to be acceptable because risk allocation is reciprocal and bilateral. Moreover, the exposure consists of more easily identifiable (and insurable) amounts and categories.

2. Contractual Liability Insurance Coverage

"Contractual Liability" insurance is a category of coverage available to cover certain kinds of indemnification or risk that the contractor agrees to assume contractually, **which the contractor would otherwise not have**. Like all insurance, this coverage is subject to the terms, conditions, limitations, exclusions, and coverage limits defined in the policy. Therefore, it is essential to read and to understand this coverage to insure that the coverage is for the intended purpose and not illusory in nature.

One example of such coverage in a standard general liability policy covers "Bodily Injury" or "Property Damage" for which the insured is legally liable and is fairly broad contractual liability coverage. Similarly, a standard automobile liability policy covers contractual liabilities arising out of the use of automobiles or other covered vehicles. In contrast, worker's compensation, professional and pollution liability policies usually contain limited or no contractual liability coverage. One reason for these limitations is that these sorts of statutory liabilities cannot be assigned away as a matter of law and public policy.

Certain **contractual** liabilities are excluded from coverage in general liability policies, including:

- the *contractor's work* -- meaning, defective work performed by the contractor is not covered by this coverage;
- the contractor's *breach of contract*, i.e., the contractor's failure to perform contractual obligations with respect to materials, project completion, etc.; and
- a contractor's *assumption of professional design liability*.

Accordingly, there are "new" contractual liability limitation endorsements available for contractors wishing to limit or better define contractually defined and assigned risk. Before obtaining this kind of additional coverage, it is important to understand whether the provision is enforceable under the applicable state and federal law. Moreover, beware of provisions that require the contractor to notify a general contractor or construction manager regarding design defects -- a contractor can inadvertently become responsible for design flaws if the contract requires the contractor to notify of defect in plans or designs. Indiana already has a softer version of this, but affirmatively assuming more can do harm to a potential claim arising from flawed designs. As a general proposition, the devil is in insurance contract details: read and understand what is and what is not covered or have someone do that for you.

3. Waivers of Subrogation

Waiver of subrogation provisions are significant risk management and assignment contract provisions. Subrogation is the right to assume another's rights in exchange for some sort of consideration. Insurers have subrogation rights as to their insured's rights up to the amount of payment by the insurer. Many insurance carriers will not pay a claim unless they are subrogated to the insured's rights against another party.

Waiving subrogation rights while simultaneously agreeing to indemnify a general contractor or owner can be risky. Agreeing to one-way acceptance of risk may render the subcontractor's own insurance invalid -- the subcontractor's insurer will want the opportunity to pursue the party who ultimately caused the loss and the policy may be rendered void if this right is waived by the insured subcontractor. Even if the insurance carrier pays a claim without subrogation rights, it may render the contractor uninsurable in the future.

Waivers executed by the general contractor or an upstream subcontractor can apply broadly even to parties with whom the contractor is not in privity of contract. That means that a waiver can bar a claim against other contractors, owners, and design professionals even if the party barred from bringing the claim.

For all these reasons, a contractor should only agree to waive subrogation rights carefully and after serious consideration. The extent of waiver is defined by waiver language, so certain claims may survive waiver if the waiver does not explicitly address. Waivers can be executed bilaterally -- meaning that the upstream contracting party also agrees to waivers -- so there are instances when a waiver enures to a subcontractor's benefit.

Putting the contractor's insurer on notice of the contract containing waiver of subrogation rights is important. If the insurer does not object in a timely fashion, an insurer on notice of the waiver

of subrogation may not be able to dispute coverage based on the waiver. Courts assume that the insurer has taken notice of the lack of subrogation in its underwriting analysis.

Frequently Used Risk Transfer and Indemnity Provisions

American Institute of Architects

The indemnity provision for bodily injury and property damage in AIA A201, Section 3.18.1, reads as follows:

3.18.1 To the fullest extent permitted by law, the Contractor shall indemnify and hold harmless the Owner, Architect, Architect's consultants, and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Section 3.18.

3.18.2 In claims against any person or entity indemnified under this Section 3.18 by an employee of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, the indemnification obligation under Section 3.18.1 shall not be limited by a limitation on amount or type of damages, compensation or benefits payable by or for the Contractor or a Subcontractor under workers' compensation acts, disability benefit acts or other employee benefit acts.

AIA A201 does not specifically provide indemnity to an upstream party, like an owner, for that party's own negligence. The language in Section 3.18.1, however, does provide that the contractor's indemnity is triggered "regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder." This language suggests that the owner may be able to seek indemnity from the contractor where both the owner and the contractor are at fault for causing the injury. It is not bilateral, meaning that the contractor has no corresponding right to indemnification from the owner.

Section 3.18.2 also may present problems based on the interplay between the exclusive remedy of workers' compensation statutes and contractual indemnity obligations.

AIA A201 takes no chances on this matter. Section 3.18.2 provides that if the party found primarily liable for a personal injury is the injured worker's employer, the obligation to indemnify is not limited by the employer's liability under workers' compensation laws. Section 13.8.2 may be unnecessary: an agreement to indemnify operates to waive the employer's limitation of liability under the workers' compensation statute in defense to an action for contribution, although it may not entitle the indemnitee to fully enforce the indemnity.

ConsensusDOCS

ConsensusDOCS 200 provides:

10.1.1 To the fullest extent permitted by law, the Contractor shall indemnify and hold harmless the Owner, the Owner's officers, directors, members, consultants, agents and employees, the Architect/Engineer and Others (the Indemnitees) from all claims for bodily injury and property damage, other than to the Work Itself and other property insured under Subparagraph 10.3.1, including reasonable attorneys' fees, costs and expenses, that may arise from the performance of the Work, but only to the extent caused by the negligent acts or omissions of the Contractor, Subcontractors or anyone employed directly or indirectly by any of them or by anyone for whose acts any of them maybe liable. The Contractor shall be entitled to reimbursement of any defense costs paid above Contractor's percentage of liability for the underlying claim to the extent provided for under Subparagraph 10.1.2.

10.1.2 To the fullest extent permitted by law, the Owner shall indemnify and hold harmless the Contractor, its officers, directors, members, consultants, agents, and employees, Subcontractors or anyone employed directly or indirectly by any of them or anyone for whose acts any of them may be liable from all claims for bodily injury and property damage, other than property insured under Subparagraph 10.3.1, including reasonable attorneys' fees, and costs and expenses that may arise from the performance of work by Owner, Architect/Engineer, or Others. The Owner shall be entitled to reimbursement of any defense costs paid above Owner's percentage of liability for the underlying claim to the extent provided for under Subparagraph 10.1.1.

10.1.3 NO LIMITATION ON LIABILITY In any and all claims against the Indemnitees by any employee of the Contractor, anyone directly or indirectly employed by the Contractor or anyone for whose acts the Contractor may be liable, the Indemnification obligation shall not be limited in any way by any limitation on the amount or type of damages, compensation or benefits payable by or for the Contractor under Workers' Compensation acts, disability benefit acts or other employment benefit acts.

In general, the comments to AIA A201 bodily injury and property damage indemnification provision apply here. Unlike the AIA A201, however, ConsensusDOCS 200 provides for *mutual* indemnity obligations between the owner and the contractor in which each party indemnifies the other for losses that the party causes. While there is not an express duty to defend a claim brought against an innocent party because of the acts or omissions of another, the parties can recover defense costs to the extent they are beyond their respective levels of negligence.

Engineers Joint Contract Documents Committee

EJCDC C-700 provides:

6.20 Indemnification

A. To the fullest extent permitted by Laws and Regulations, Contractor shall indemnify and hold harmless Owner and Engineer, and the officers, directors, members, partners, employees, agents, consultants and subcontractors of each and any of them from and against all claims, costs, losses, and damages (including but not limited to all fees and charges of engineers, architects, attorneys, and other professionals and all court or arbitration or other dispute resolution costs) arising out of or relating to the performance of the Work, provided that any such claim, cost, loss, or damage is attributable to bodily injury, sickness, disease, or death, or to injury to or destruction of tangible property (other than the Work itself), including the loss of use resulting therefrom but only to the extent caused by any negligent act or omission of Contractor, any Subcontractor, any Supplier, or any individual or entity directly or indirectly employed by any of them to perform any of the Work or anyone for whose acts any of them may be liable.

B. In any and all claims against Owner or Engineer or any of their officers, directors, members, partners, employees, agents, consultants, or subcontractors by any employee (or the survivor or personal representative of such employee) of Contractor, any Subcontractor, any Supplier, or any individual or entity directly or indirectly employed by any of them to perform any of the Work, or anyone for whose acts any of them maybe liable, the indemnification obligation under Paragraph 6.20.A shall not be limited in any way by any limitation on the amount or type of damages, compensation, or benefits payable by or for Contractor or any such Subcontractor, Supplier, or other individual or entity under workers' compensation acts, disability benefit acts, or other employee benefit acts.

C. The indemnification obligations of Contractor under Paragraph 6.20.A shall not extend to the liability of Engineer and

Engineer's officers, directors, members, partners, employees, agents, consultants and subcontractors arising out of:

1. the preparation or approval of, or the failure to prepare or approve maps, Drawings, opinions, reports, surveys, Change Orders, designs, or Specifications; or
2. giving directions or instructions, or failing to give them, if that is the primary cause of the injury or damage.

EJCDC C-700 contains a similar casualty indemnification clause to that of AIA A201 and ConsensusDOCS 200. The comments to those documents apply here as well. The EJCDC does not extend the contractor's indemnification to professional services, which is generally consistent with the limitations of the standard CGL policy that a contractor might use to insure this risk.

Alternative Contract Language

These are provisions that may be added to forms and that a party to a construction project may see these kinds of provisions in request for proposals or draft contracts. A party may seek to include or to exclude the provisions. The first two alternative clauses are contractor-sided. The last alternative is owner-sided and broadens the scope of indemnity beyond that required in the standard form agreements. Many contractors resist inclusion of this type of language.

Limit the Liability of the Contractor or Subcontractor to Its Insured Limits Required Under the Contract Documents

The liability of the Contractor under this provision shall not exceed the limits of insurance coverage required to be carried by the Contractor under the Contract Documents.

If the claim exceeds the a contractor's insurance, the indemnitor is in a bet-the-business situation in accepting this obligation. The contractor is self-insuring the excess liability from its net worth -- not a very good idea for most contractors. The contractor risks insolvency if a claim exceeds the applicable insurance coverage. Ideally, the claim that exceeds the contractor's limits will not, except in rare circumstances, exceed the insurance available to the indemnitee because the indemnitee's policy provides excess coverage under the indemnity or additional insured agreement. The indemnitee's risk of limiting coverage to the amount of the indemnitor's insurance is having its carrier pay the excess portion of the claim. The cost to the indemnitee may be that of paying slightly higher premiums on its own policies for a few years. That is exactly the same result that occurs if the indemnitor goes out of business so there are arguments that this contract provision enures to the benefit of all the parties to the contract.

Exclude Indemnification for Certain Acts or Omissions of the Design Professional That Are Not Insurable

Notwithstanding anything contained within the Contract Documents, Contractor shall not indemnify the Owner or Design Professional for injury or damage arising out of (1) preparing,

approving or failing to prepare or approve maps, shop drawings, opinions, the preparation or approval of, or the failure to prepare or approve, maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; or (2) giving directions or instructions, or failing to give them, if that is the primary cause of the injury or damage.

An "insured contract" typically does not include indemnification for preparing, approving, or failing to prepare or approve maps, shop drawings, opinions, the preparation or approval of, or the failure to prepare or approve, maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; or giving directions or instructions, or failing to give them, if that is the primary cause of the injury or damage. Accordingly, these items must specifically be excluded from the contractor's indemnification obligations or the contractor risks carrying uninsured indemnification obligations relating to another party's work. The EJCDC includes this exclusion, but the AIA and ConsensusDOCS agreements do not. Most contractors do not factor in providing independent evaluation and assessment of project designs and specifications when they prepare a bid. Unless a contractor is prepared to affirmatively take this kind of obligation on, it is likely prudent to exclude this kind of liability from the contractor's indemnification obligation.

**Require the Contractor to Defend and Indemnify the Owner for All Claims
Arising Out of the Work Even if Such Claims Are Economic Losses**

To the fullest extent permitted by law, Contractor shall defend, indemnify and hold harmless Owner, its agents, representatives, and employees ("Indemnitees") from and against all claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from or in connection with the performance of the Work, provided that any such claim, damage, loss or expense is caused in whole or in part by any act or omission of Contractor, anyone directly or indirectly employed by it or anyone for whose acts any of them may be liable. Such obligation shall not be construed to negate, abridge, or otherwise reduce any other right or obligation of indemnity or contribution which would otherwise exist as to any party or person described in the Contract Documents.

This provision is broader than the indemnity clauses in the AIA, ConsensusDOCS, and EJCDC forms. This provision requires indemnity for any claims arising out of the work, even those that may involve purely economic losses. While this may not be a fully insured indemnity, an owner may insist on such an indemnity for a high-profile, high-risk project with a large, well-capitalized contractor that can manage this risk. Most trade contractors are not in a position to assume this kind of obligation and may find it prudent to do so. This kind of indemnity provision may be affected by any applicable liquidated damages provision, limitation of liability clause, or waiver of consequential damages.

It is significant that, absent the contractual limitations just mentioned, this provision permits recovery of consequential and economic loss damages. Making an incorrect estimate or having an unbonded contractor go bankrupt can cause significant financial losses, but in all probability they will not cripple a financially-sound contractor. However, even established contractors can go out of business after being destroyed by consequential damages — for example, reimbursing the owner for lost income that the owner would have received if the work had been completed on time. Consider, for example, a casino where the owner's monthly profits approximate or exceed most contractors' entire net worth -- a project delay of even a few days can be catastrophic. Accordingly, managing consequential damage exposure is a high priority for contractors.

This provision also imposes a duty to defend on the contractor, which means that the contractor is responsible for the costs of defending a claim brought against the owner even if, in the end, neither the contractor or the owner is found liable for this kind of claim. The language "To the fullest extent permitted by law" is an attempt to preserve the indemnity provision, or at least the portion that can be preserved, against attack under any applicable anti-indemnity statute.