



CONTRACT CONCERNS

Indemnification Clauses, Part 2* Case Summaries Addressing Indemnification or Limitation of Liability

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Case 1:

Indemnification Clause Unenforceable if Negligent Parties Are Indemnified

Where an indemnification clause in a construction subcontract was so broad as to require the subcontractor to indemnify a project owner and construction manager for their own negligence, a court held the clause could not be enforced during a summary judgment motion requested by the indemnities. The clause could only be saved if it were proved that the indemnitees were not themselves negligent, and that determination would have to await the outcome of the trial on the facts.

In *Lanarello v. City University of New York*, 774 N.Y.S. 2d 517 (2004), the court considered the enforceability of an indemnification clause that required the subcontractor to "indemnify the owner and construction manager [Morse Diesel] for any and all losses they sustain as a result of any or all injuries to any and all persons arising out of or occurring in connection with [subcontractor's] work, excepting only injuries that arise out of faulty designs or affirmative acts of the owner or construction manager committed with the intent to cause injury." The court concluded that this clause would indemnify the owner and construction manager for their own negligence and therefore "runs afoul of General Obligations Law section 5-322.1(1) of New York.

Morse Diesel, the construction manager ("CM") was asking the court to enforce the indemnity clause by way of a summary judgment motion to grant it judgment against the subcontractor. It argued that to the extent that the clause did not require the subcontractor to indemnify the CM for the CM's own negligence the clause would be saved by another clause in the contract providing that "each and every provision of law and clause required by law to be inserted in the Contract shall be deemed to be inserted therein." In rejecting that argument, the court stated "Such language is not equivalent to language in the indemnification clause itself limiting a subcontractor's indemnification obligation 'to the extent permitted by law.'"

The Motion court that denied the summary judgment motion found that Morse Diesel had more than a mere general supervisory authority with regard to one of its subcontractor's who had responsibility for cleaning up debris and providing temporary protection around openings. Since negligence in those respects may have contributed to the accident, it would be necessary to allow the matter to go to trial so that it could be determined based on all the facts whether or Morse Diesel was negligent or not.

Practice Note: It is important to include a "survival" or "saving clause" directly inside the indemnification article so that if for any reason a court finds the indemnity language to be in violation of public policy or a state anti-indemnity statute, the article will nevertheless survive as language that falls back to that which is permissible under public policy and state law. This is often accomplished by introducing the article with language such as, "To the fullest extent permitted by law, the Contractor shall indemnify the Client" This may be more persuasive with a court than was the general saving clause that the court declined to apply in this particular case.



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Case 2:

Limitation of Liability Clause Protecting Owner is Not Voided by Owner's Breach of Contract or Alleged Bad Faith

A Limitation of Liability (LoL) clause in a contract was upheld by a court notwithstanding allegations that the project owner had acted in bad faith in its treatment of the contractor. It was held to apply, however, only to the damages that would be awarded under the contract and not to limit additional damages for interest, attorneys fees, and other costs that were imposed under state statute.

Where a painting contractor and the project owner, Sun Company, could not agree on inspection standards and whether the contractor's paint stripping met the contract specifications, the contractor left the job and Sun eventually issued a letter to cancel the contract. Sun offset its costs of re-procurement and completion of the paint job against the balance claimed by the contractor for work it had performed. The contractor filed suit to recover the balance of what it thought was due for the work that had been performed. The trial court rejected Sun's claim that any remedies were subject to the contract's LoL clause because it found Sun had acted in bad faith.

In reviewing the matter, the appellate court stated that LoL provisions are not disfavored by the state and that such clauses are binding on parties unless they are unconscionable. Regardless of whether there was an unjustified breach of contract, the court explained that by their contract language parties may agree to waive remedies that they would otherwise have under contract law. The court's decision suggests that this could be applied to both statutory and common law remedies if the LoL clause was clearly drafted to express that intent.

In determining the impact of Sun's breach of its implied duty of good faith inspection on the contract's other provisions (such as the LoL clause) the court reviewed the contract as a whole. It found significant the fact that the contract contained multiple provisions permitting Sun to "terminate," "cancel," or "suspend" the contract at its sole discretion for any reason -- or for no reason whatsoever. The appellate court concluded that Sun had the right to terminate the contract and was not required, as the trial court had wrongly concluded, to try to work out with the contractor its dispute over the inspection and the quality of the work being performed. Nevertheless, the court found that the trial court's error was harmless in that the contractor was indeed entitled to recover its costs and fees under the contract - even as terminated, and that the award of the trial court had been within the amounts permitted under the LoL clause which limited contractor recovery to the total contract price. *John B. Conomos, Inc. v. Sun Company, Inc.*, 831 A.2d. 696 (Pa. 2003).

Risk Management Comment: The court's discussion of the interpretation and enforceability of the LOL clause in the contract demonstrates several points for consideration when drafting LOL clauses. These clauses are often enforced even in the face of difficult facts or allegations when both parties are commercial enterprises as was the situation here. The clauses can limit recovery that would otherwise be permitted under the law of the state but to do so, they must clearly express that intent. In this case, the clause did not expressly state that interest and attorneys fees would be affected by the clause and the court declined to apply it to these remedies that were imposed by statute rather than by the contract. As a general matter, it may be prudent to keep the LoL clause separate from an Indemnification clause. Whereas state anti-indemnity statutes may restrict the use of an indemnification clause, the same statute might not restrict the use of an LoL clause. A court that may be inclined to find an indemnification clause to violate public policy may be less likely to find fault with an LoL clause that parties bargained for and that only affects their rights as against one another.



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Case 3:

Indemnity Clause Requires Subcontractor to Indemnify Prime for Injuries Arising out of the Prime's own Negligence

Where the indemnity clause of a contract expressly exculpated a prime contractor from the consequences of its own negligence that resulted in injury to a subcontractor's worker, the prime was entitled to be indemnified by the subcontractor because the claim arose out of the performance of the contract.

In *Spawglass, Inc. v. E.T. Services, Inc.*, 143 S.W.3d 897 (Tex. 2004), the appellate court reversed a summary judgment that had been granted by the trial court in favor of the subcontractor. The contractor, SpawGlass Construction Corporation had subcontracted with E.T. Services, Inc. ("ETS") for ETS to perform structural steel erection for a high school. An employee of ETS, Brian Sanders, was working as a welder on the site. While he was rolling up an oxygen hose, he was struck by a sheet of plywood that blew off of the roof during a sudden storm. Sanders sued SpawGlass for negligence. SpawGlass in turn sought indemnity from ETS pursuant to the indemnity provisions of the contract.

SpawGlass contended that the contract clearly and unambiguously required ETS to indemnify SpawGlass for claims of injury to ETS's workers attributable to SpawGlass's negligence. ETS, in contrast, contended that the indemnity provision applied only to injuries resulting from ETS's performance. Flying plywood, says ETS, did not arise out of ETS performance. ETS argued that the indemnity may only be triggered if the incident arose out of its performance, not its mere presence on the site.

The appellate court rejected ETS's argument completely. First, the court found that the indemnity provision was clear and unambiguous with regard to meeting what is known as the "express negligence rule." That rule requires that the intent of the party seeking indemnity from the consequences of its own future negligence must be expressed in unambiguous terms within the four corners of the contract. In this case, the court held that the language clearly required that ETS would indemnify SpawGlass from the consequences of SpawGlass's own negligence that resulted in injury to ETS's worker.

With regard to whether the injury arose during ETS' "performance", the court held that despite ETS's argument that the injury arose from SpawGlass's *performance* completely unrelated to the work that ETS and its employee were hired to perform, the injury occurred while all the parties were "engaged in the construction of a high school auditorium." Thus, the court concluded, "The claim asserted by Brian Sanders arises out of the *performance* of ETS's contract with SpawGlass. For these reasons, the appellate court reversed and remanded the trial court decision.

Comment - Based on the reasoning of this decision, it is important for parties that are negotiating indemnity provisions in contracts to carefully determine what they want to be indemnified and to craft the language to accomplish that. As explained in this case, the "express negligence rule" that is applicable in most states means that if you want to be indemnified for your own negligence, you need to clearly state that intent in the contract. The contract in this case accomplished that for the prime contractor.

It is also not uncommon to see language like that in the contract at issue here which states that the indemnity applies to injuries or damages arising out of "performance of the contract." This does not necessarily mean that the injury has to arise directly out of the performance of the work performed by the party that is the Indemnitor. As explained in this case, just the fact that the worker was on the site because his employer was performing work for the primer under a contract was enough to trigger the

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indemnity obligation - and it didn't matter whether the employee or his employer had anything to do with causing the plywood to blow off the roof.

If you want to limit the indemnity to apply only to damages and injuries caused by your own performance, you can clearly state this in the contract. For example, if you are a design professional, you might state something to the effect that you will only indemnify the other party for damages "to the extent that they arise from the negligent acts, errors or omissions of the design professional." If you are a contractor, you might not be able to limit your indemnity to negligence based acts, but you might nevertheless limit your indemnity to apply only to damages "to the extent that they are caused" by you.

Case 4:

Anti-Indemnity Statute does not Void Additional Insured's Coverage

Where a construction contractor signed a contract containing an indemnification clause agreeing to indemnify the project owner for all claims arising under the contract, including those caused by the owner's negligence, a court held that a liability insurance policy that had been purchased by the contractor naming the owner as an additional insured was enforceable against the insurance company to recover for personal injuries that were caused by the owner's negligence despite a state statute precluding a project owner from requiring a contractor to indemnify the owner for damages arising out of the owner's own negligence.

In *Chrysler Corp. v. Merrell & Garaguso*, 796 A.2d 648 (Del.Supr. 2002), an injury was sustained by an employee of Merrell and Garaguso ("Merrell"), the contractor, as a result of the alleged negligent operation of a forklift by an employee of Chrysler, the project owner. The Merrell employee sued Chrysler for his injuries, and Chrysler, in turn, brought a third party action against Merrell pursuant to the terms of the indemnification provisions of the Merrell contract. The issue in this reported case arises out of cross motions for summary judgment on the extent of Merrell's duty to defend Chrysler against the injured worker's claim. The trial court ruled that the indemnification provision was unenforceable because it was contrary to the statutory prohibition against being indemnified for one's own negligence. The court also ruled that the provision of the contract requiring Merrell to obtain insurance naming Chrysler as an additional insured was "void as an indirect requirement to indemnify." According to the trial court, even if the contractual duty to provide insurance has been satisfied, the resulting coverage is unenforceable.

On appeal, Chrysler argued that the public policy purpose of the anti-indemnity statute did not extend to the insurance aspect of indemnification. As asserted by Chrysler, although the statute in its first paragraph makes void a contract clause that requires indemnification for a party's own negligence, the second paragraph of the statute provides "(b) Nothing in subsection (a) of this section shall be construed to void or render unenforceable policies of insurance issued by duly authorized insurance companies and insuring against losses or damages from any causes whatsoever." In sorting out the interplay between the two sections of the statute, the appellate court found that there has been no consistency in the courts of the various state jurisdictions that have considered similar statutes. The court was impressed, however, with a decision by the Maryland Court of Appeals addressing similar statutory language and holding that liability insurance, once issued, may create coverage for one's own negligence under an indemnity agreement, "even if the wrong party paid the premiums."



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The Maryland holding, as described by the Delaware court, "reflects a practical accommodation of the insurance savings provision with the right of a party to a construction contract to refuse, ab initio, and directly, to indemnify another party for that party's own negligence." In support of enforcing the insurance savings provision, the court noted that this was beneficial from the viewpoint of the injured worker. And the court further stated that if, in fact, the insurer issues an endorsement to cover the actions of a third party and charges a premium for that coverage, the insurer should not be permitted to create an illusion that insurance exists and then deny coverage. In conclusion, the court stated: "The savings provision has meaning only if it cannot be used as a shield by insurers to decline coverage for insurance once purchased and duly issued to any insured, however identified or designated." For these reasons, the court affirmed the trial court ruling to the extent that it relieved Merrell of any direct obligation to indemnify Chrysler for that firm's own negligence, and it reversed the trial court as to the rights Chrysler may be able to assert under Merrell's insurance policy.

Risk Management Note: The court states that there is separate litigation going on between the insurance carrier and Chrysler concerning the matter of what, if any, coverage Chrysler may be entitled to under the policy. The issues in that litigation are not described in this decision. It is worth noting, however, that insurance companies appear to be rethinking the availability of additional insured status for project owners on a contractor's policy. And on professional liability errors and omissions policies, insurance companies rarely, if ever, agree to make a project owner an additional insured. It would be prudent for parties that are executing contracts containing language requiring additional insured status of project owners should obtain advice of their insurance agent and concurrence of the insurance company in advance of signing such contracts.

Thirty nine states have enacted some form of anti-indemnity statute. The details vary widely from state-to-state. It is advisable to have counsel familiar with the laws of the jurisdiction applicable to any specific contract review the indemnification clause of the contract to evaluate how it may be interpreted and applied within the relevant jurisdiction.

Case 5: Contractor Required to Indemnify Negligent Party

Pursuant to the indemnity clause of its lease agreement with a landowner (Washington Street Investments (WSI)), the Goettl Air Conditioning Company (Goettl) agreed to indemnify WSI for all damages caused in whole or in part by Goettl's negligence. When one of Goettl's employees (Cunningham) fell through a skylight while on the roof of the building, that employee recovered workers compensation and then sued WSI for additional damages.

WSI demanded that Goettl defend it per the indemnity agreement but Goettl refused to do so. WSI and Cunningham settled the case, and WSI assigned its indemnity rights to Cunningham who then sued Goettl to recover the damages. At trial, the court granted summary judgment to Cunningham, concluding that Goettl was required by the terms of what it deemed to be a "general indemnity agreement" to indemnify WSI. This decision was reversed by the first appellate court on the basis that the court believed that the indemnity did not apply where the damages were caused by the indemnitee (WSI's) own negligence. Specifically, the court found that WSI's failure to conduct site inspections recommended by its engineer created a material question of fact as to whether WSI was actively negligent. Presumably, the court believed that if WSI was actively negligent, the indemnification requirement would not apply.



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This decision was reversed by the Arizona Supreme Court which found that even if the indemnitee had been actively negligent, the indemnity requirement still applied. The indemnity provision in question reads as follows:

Lessor (WSI) shall not be liable to Lessee (Goettl] ... for any injury ... resulting from the condition of, or any defect in, the Premises. Lessee hereby agrees to indemnify and hold Lessor harmless from and defend Lessor against any and all claims ... arising out of or in connection with ... any accident ... in or about Premises, when such injury ... shall be caused in whole or in part by... any act or negligence of Lessee....

Because the indemnity clause did not specifically state what would result if the indemnitee (WSI) was itself negligent, the court found it to be a "general indemnity." As a general rule, an indemnitee under such an agreement is only entitled to indemnity from the consequences of other parties' negligence as well as its own passive negligence, but is not entitled to indemnity against its own active negligence. But where there is clear and unequivocal language demonstrating that the indemnitee is to be indemnified despite its active negligence, the clause will be enforced as written.

In this case, the court found that the language was clear and unambiguous, and that Goettl was, therefore, required to indemnify WSI (and now Cunningham) for the damages.

An interesting aspect of the case was that when Goettl refused to participate in the defense, WSI settled the matter directly with Cunningham, without input or participation from Goettl. Because Goettl had ample notice by WSI of these proceedings and circumstances, the court ruled that the settlement was binding against Goettl. The rule is that so long as the indemnitor (Goettl) had reasonable notice of the action and an opportunity to assume or participate in the defense, the judgment against the indemnitee is binding against the indemnitor. *Cunningham v. Goettl Air Conditioning, Inc.* No. CV-97-0511-PR, 1999 Ariz. LEXIS 67, 1999 WL 312544 (Ariz. May 19, 1999).

Case 6:

Liquidated Damages Clause and Waiver of Consequential Damages Clause Effectively Cap Damages Available against Design-Builder

Contracts requiring a design-build engineering firm to supply "basic engineering packages" for licensing and technology transfer agreements for the design and construction of a processing plant for sodium hydroxide (caustic soda) contained a liquidated damages clause capping the engineer's liability at 10 percent of its fee, and also contained a waiver of consequential damages clause waiving "special, indirect, incidental, or consequential damages of any kind." In response to the project owner's suit against the engineer for failure of the plant to achieve commercial production, the court enforced these clauses to limit the available recovery.

The plaintiff's complaint against the contractor alleged breach of contract, misrepresentation and fraud. With regard to the counts of the complaint alleging misrepresentation and fraud, the court dismissed these because they were barred by the two year statute of limitations. In response to the defendant's argument that the breach of contract claim should also be dismissed based upon the Waiver of Consequential Damages and the Liquidated Damages clauses, the plaintiff argued that the clauses should not be enforced because the clauses were unconscionable, were based on material misrepresentations, and were the product of mutual mistake.



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The Waiver clause provided: "Article XV Waiver of Consequential Damages. In no event shall Seller [contractor] be liable to [owner] whether in contract, warranty, tort (including negligence or strict liability) or otherwise for any special, indirect, incidental or consequential damages of any kind or nature whatsoever."

The liquidated damages clause provided: "Article VIII Liquidated Damages. In the event that the Caustic Prill Unit fails to produce Caustic Soda beads during the performance test even though all the conditions described in Article VII hereof have been satisfied and despite [contractor's] efforts to correct said failure, for each 5 percent or part thereof shortfall below the level warranted in Article VII, hereof, [contractor] will pay to [owner] an amount equal to 5 percent of the lump sum fee received by [contractor] for the failed Caustic Prill Unit. However, [contractor's] maximum limit of liability under the Agreement as to any failed Caustic Prill Unit shall be 10 percent of the Lump sum fee received by [contractor] for the failed Caustic Prill Unit. These payments are the exclusive remedies provided to [owner] under this Agreement. Except as provided in the Article VII, Contractor shall have no other liability whether in contract, warranty, tort, or otherwise."

The plaintiff, project owner, tried to get around the liquidated damages clause by arguing that it only applied in the event that the Unit failed the performance test. Since there was never a performance test, it argued the limitation clause had no effect. In interpreting the contract on this matter, the court explained that "the intention of the parties is a paramount consideration." Intent must be ascertained from the contract document itself when the terms are clear and unambiguous. The court concluded that the clause makes clear that although the five percent cap appears to apply in the event of a performance test failure, the ten percent cap applies to any claim under the Agreement regardless of whether or not performance tests were performed. The court emphasized that "When combined with the extremely strong liability-limiting language of the entire clause, these phrases make clear that the intention of the parties was to limit [owner's] recover under any circumstance to ten percent of the fee it paid to [contractor]."

The court also rejected the project owner's argument that the clauses were "unconscionable" and should not be enforced. The court said that the test under Pennsylvania jurisprudence for unconscionability is "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." It further explained that the principle underlying the concept is to prevent oppression and unfair surprise but that it is not intended to disturb the "allocation of risks because of superior bargaining power." In other words, just because a party has greater bargaining power and negotiates a more favorable and even onerous deal does not make the deal unconscionable in the absence of oppression and unfair surprise. In commercial settings, explains the court, a limitation of damages clause will rarely be found unconscionable.

In this case, the owner claimed that it was a small unsophisticated Indian company that trusted "an American behemoth" when its president flew to Philadelphia to sign the deal. It made no changes to the contract and did not seek counsel to assist with its negotiation. Although the court described this as a "sympathetic picture," the court concluded that the scenario did not suggest any lack of meaningful choice. In its conclusion with regard to this issue, the court said, "There is nothing in the record to suggest unfair surprise.... The clauses were not hidden boilerplate. The one point which gives this Court pause is whether a ten percent cap creates an adequate incentive to perform. However, there is no indication that the profit margin was any higher than ten percent. Therefore, [owner] has not demonstrated unconscionability." *Mistry Prabhuda Manji Eng. Pvt. Ltd. v. Raytheon Engineers & Constructors, Inc.*, 213 F.Supp.2d 20 (U.S D.C., Massachusetts, 2002).



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Risk Management Note: This case provides valuable insight into the judicial interpretation and application of contract clauses that purport to limit liability of engineers and contractors. There is a striking similarity in the project owner's arguments with those that have been raised in so many other reported cases. This decision should be a reminder to every commercial entity entering a contract for the design or construction of a project that, generally speaking, courts will enforce the terms of the contract that result from arms-length negotiations between two commercial entities. This is true even if one of the parties was significantly smaller than the other and did not have equal bargaining clout.

The key, as explained by this court, is whether the damage limitations would be unconscionable. In my own legal practice, I have had more than one client tell me that they wanted to ignore my advice and sign onerous contracts in which they would be giving away substantial rights to the other party - with the expectation that they could convince a court that they signed the contract as a result of duress, coercion or unequal bargaining position and that the clause should be void as against public policy or as unconscionable. My advice has been that a court would not be impressed with their arguments for much the same reasons stated by the court in this case. Plus, my clients have had competent legal assistance with their contracts and this makes their chances of getting a court to let them out of a bad deal even more unlikely.

Note, however, that the court provides significant pointers in drafting an enforceable limitation of liability clause, when it states that the clause in this case was not "hidden boilerplate" and that the question of whether a ten percent cap creates an adequate incentive to perform gave the court pause. I typically advise clients to make clauses such as indemnification, limitation of liability (LoL), and waiver of consequential damages clear and pronounced in the contract.

If an LoL clause might be subjected to close judicial scrutiny it may even be advisable to have your client separately initial or sign their name beside the clause so they cannot later claim they were surprised to learn of its presence in the contract. In addition, you should be careful to make the LoL amount reasonable. If it is too small in comparison to the size of the fee or the significance of the potential damages that could occur, a court may refuse to enforce it. Most important of all, the decision of this court demonstrates the value of seeking contract language where appropriate to limit the liability or the types of damages that can be recovered.

Indemnification Clauses is presented in a three parts discussing the analysis of indemnification clauses in contracts. Future editions of Contract Concerns will provide the remaining parts.

Part 1 begins with "Issue" and ends with "Conclusion" and is re-printed from a/e ProNet's Risk Management & Contract Guide for Design Professionals by J. Kent Holland, © 2006.

Part 2 is a series of case notes by Mr. Holland, summarizing developments in the law concerning the application of indemnification clauses and limitation of liability clauses.

Part 3 contains comments by Mr. Holland on a number of indemnification clauses reviewed from actual contracts. These are offered only for general education purposes and are not to be considered legal opinion or advice. Assistance of qualified counsel and insurance professionals should be sought concerning negotiations of contracts containing indemnification provisions.



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NOTE: The comments presented are general in nature, and are not intended to be a legal review or legal opinion. Neither a/e ProNet, Kent Holland, or any organization with whom Mr. Holland may be hereby providing legal services. Any opinions stated herein are solely those of Mr. Holland and are not to be attributed to any other party or organization. The information provided herein is for general educational purposes to assist the insured in understanding potential issues concerning the insurability of certain identified risks that may result from the allocation of risks under the contractual agreement. The insured should seek the advice of legal counsel familiar with construction law and contracts in the jurisdictions where this contract will be executed and performed.