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CONTRACT

Indemnification Agreements and Contractual Risk Transfer

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Indemnification Agreements and Contractual Risk Transfer

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	TYPES OF INDEMNITY	1
	A. Broad-form Indemnity	1
	B. Intermediate-form Indemnity	1
	C. Limited-form Indemnity	1
III.	FAIR NOTICE DOCTRINE	2
	A. The Express Negligence Test	2
	(1) “Express Intent” Rule	3
	(2) Inapplicability of the Express Negligence Rule	4
	(a) Gross Negligence	4
	(b) Past Acts and Breach of Contract	5
	B. Conspicuousness	5
	(1) Conspicuousness Standard	6
	(2) Actual Notice of Knowledge Exception	6
IV.	DETERMINING THE ENFORCEABILITY OF AN INDEMNITY AGREEMENT	7
	A. Step One: Does the Liability Arise Out of the Subject Matter of the Clause?	9
	B. Steps Two & Three: Does the Indemnity Clause Meet the Fair Notice Requirements?	9
	C. Step Four: Do Any Anti-indemnity Statutes Apply?	10

(1)	Indemnification of Architects and Engineers	10
(2)	Oil & Gas Contracts	10
(3)	State Public Works Contracts	11
(4)	Recent Trends in Anti-Indemnity: 2005 Texas Legislature (79th Regular Session)	12
V.	INTERSECTION OF INSURANCE AND INDEMNITY	15
A.	Insurance in Lieu of Indemnity	16
B.	Insurance for Indemnity Obligations	17
C.	Failure of Both Indemnity and Insurance	18
VI.	EXAMPLE INDEMNITY PROVISIONS	18
A.	Enforceable Indemnity Provisions	18
B.	Unenforceable Indemnity Provisions	21
VII.	CONCLUSION	22

INDEX OF AUTHORITIES

CASES

<i>Amoco Oil Co. v. Romaco, Inc.</i> , 810 S.W.2d 228 (Tex.App.-Houston [14th Dist.] 1989, no pet.)	19
<i>Arthur's Garage, Inc. v. Racal-Chubb Sec. Systems, Inc.</i> , 997 S.W.2d 803 (Tex.App.-Dallas 1999, no pet.)	19
<i>Atlantic Richfield Co. v. Petroleum Personnel, Inc.</i> , 768 S.W.2d 724 (Tex. 1989)	18
<i>B-F- W Const. Co., Inc. v. Garza</i> , 748 S.W.2d 611 (Tex.App.-Fort Worth 1988, no writ)	20
<i>Banner Sign & Barricade, Inc. v. Price Construction, Inc.</i> , 94 S.W.3d 692 (Tex. App.-San Antonio 2002, pet. denied)	20
<i>Boyd vs. Amoco Production Co.</i> , 786 S.W.2d 528 (Tex.App.-Eastland 1990, no writ)	9
<i>Cate vs. Dover Corp.</i> , 790 S.W.2d 559 (Tex. 1990)	6, 7
<i>Coastal Transport Co. v. Crown Central Petroleum Corp.</i> , 20 S.W.3d 119 (Tex.App.- Houston [14th Dist.] 2000, pet. denied)	7
<i>Coker v. Coker</i> , 650 S.W.2d 391 (Tex. 1983)	2
<i>Crown Cent. Petroleum Corp. v. Jennings</i> , 727 S.W.2d 739 (Tex.App.-Houston [1st Dist.] 1987, no pet.)	19
<i>Douglas Cablevision IV, Lt. v. Southwestern Electric Power</i> , 992 S.W.2d 503, 509 (Tex.App.-Texarkana 1998, pet. denied)	6
<i>Dresser Indus. v. Page Petroleum, Inc.</i> , 853 S.W.2d 505 (Tex. 1993)	2, 6, 7
<i>Emery Air Freight Corp. v. General Transp. Sys., Inc.</i> , 933 S.W.2d 312 (Tex.App.-Houston [14th Dist.] 1996, no writ)	18

<i>Enserch Corp. v. Parker</i> , 794 S.W.2d 2 (Tex. 1990)	2
<i>Ethyl Corporation vs. Daniel Construction Company</i> , 725 S.W.2d 705 (Tex. 1987)	1, 2
<i>Fisk Elec. Co. v. Constructors & Assocs., Inc.</i> , 888 S.W.2d 813 (Tex. 1994)	2
<i>Getty Oil Co. v. Insurance Co. of N Am.</i> , 845 S.W.2d 794 (Tex. 1992)	16
<i>Glendale Const. Services, Inc. v. Accurate Air Systems, Inc.</i> , 902 S.W.2d 536 (Tex.App.- Houston [1st Dist.] 1995, writ denied)	21
<i>Green Int.'l, Inc. v. Solis</i> , 951 S.W.2d 384 (Tex. 1997)	5
<i>Hernandez. v. Big 4, Inc.</i> , 241 F.Supp. 2d 715 (S.D.Tex. 2003)	2,3
<i>Houston Lighting and Power Company vs. Atchison, Topeka & Santa Fe Railway Co.</i> , 890 S.W.2d 455 (Tex. 1994)	3
<i>J. M. Krupar Const. Co., Inc. v. Rosenberg</i> , 95 S.W.3d 322 (Tex.App.-Houston [1st Dist.] 2002, no pet.)	21
<i>K & S Oilwell Service, Inc. v. Cabot Corp.</i> , 491 S.W.2d 733 (Tex.Civ. App.-Corpus Christi 1973, writ ref'd n.r.e.)	5
<i>Quorum Health Res., L.L.C. v. Maverick County Hosp. Dist.</i> , 308 F.3d 451 (5th Cir. 2002)	2
<i>Robert H. Smith, Inc. vs. Tennessee Tile, Inc.</i> , 719 S.W.2d 385 (Tex.App.-Houston [1st Dist.] 1986, no writ)	9
<i>Spawglass, Inc. v. E.T. Services, Inc.</i> , 143 S.W.3d 897 (Tex. App.-Beaumont 2004, pet. denied)	21
<i>Sun Oil Co. vs. Renshaw Well Service</i> , 571 S.W.2d 64 (Tex.Civ. App.-Tyler 1978, writ ref'd n.r.e.)	9

Tesoro Petroleum Corp. v. Nabors Drilling USA, Inc., 106 S.W.3d 118
(Tex.App.-Houston [1st Dist.] 2002, pet. denied) 18

Transcontinental Gas Pipeline Corporation v. Texaco, Inc.,
35 S.W.3d 658 (Tex.App.-Houston [1st Dist.] 2000, pet, denied) 5

U.S. Rentals, Inc. vs. Monday Service Corp., 901 S.W.2d 789
(Tex.App.-Houston [14th Dist.] 1995) 6, 7

Webb vs. Lawson-Avila Construction, Inc., 911 S.W.2d 457
(Tex. App.-San Antonio 1995, writ dismissed) 4, 5

OTHER AUTHORITIES

TEX. BUS. & COM. CODE ANN. § 1.201(10) 6

TEX. CIV. PRAC. & REM. CODE § 127.003 10

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I. INTRODUCTION

Construction contracts often contain indemnity or other risk sharing agreements. These types of agreements receive close scrutiny by courts due primarily to a concern regarding the disparate bargaining power that often exists between the parties when the agreements are entered. However, Texas courts do allow for transfer of risk between the parties when the agreements meet criteria established to ensure that the parties entered the contract with an awareness of the obligations they have agreed to assume. This paper will address the requirements of an enforceable indemnity agreement and discuss other methods of transfer of risk commonly seen in construction contracts.

II. TYPES OF INDEMNITY

Indemnity agreements are classified according to the scope of the indemnity obligation provided thereunder. These classifications include the following:

A. Broad-form Indemnity

Under this type of indemnity, the indemnitor essentially assumes an unqualified obligation to indemnify the indemnitee for any and all liability arising out of a specified subject matter (usually the indemnitor's work under the agreement), ***even if the damage, injury or claim is actually caused by the sole negligence of the indemnitee***. This form of indemnity transfers the entire risk of loss from the indemnitee to the indemnitor.

Example: Subcontractor agrees to indemnify Contractor in any matter arising from the work performed hereunder, including but not limited to any negligent act or omission of Contractor. See Atlantic Richfield Co. V. Petroleum Personnel, Inc., 768 S.W.2d 724 (Tex. 1989).

B. Intermediate-form Indemnity

This type of indemnity requires an indemnitor to indemnify the indemnitee for any and all liability arising out of a specified subject matter (usually the indemnitor's work under the agreement), even if the damage, injury or claim is actually caused by the negligence of the indemnitee, ***but specifically excludes the indemnitor's sole negligence***. Thus, so long as the indemnitor is partially at fault, the indemnitor must indemnify the indemnitee for 100 percent of the claimed damages.

Example: Subcontractor agrees to indemnify Contractor for any liabilities arising from the activities of Subcontractor in connection with work performed under this agreement, excepting only claims arising out of accidents resulting from the sole negligence of Contractor. See Crown Cent. Petroleum Corp. V. Jennings, 727 S.W.2d 739, 740-741 (Tex.App.-Houston [1st Dist.] 1987, no pet).

C. Limited-form Indemnity

This type of indemnity is sometimes referred to as “non-*Ethyl* indemnity” or “comparative fault indemnification.” Under this type of agreement, the indemnitor is obligated to indemnify the indemnitee only to the extent of the indemnitor’s own fault. These agreements probably need not meet the express negligence test set forth below.

Example: The parties agree to indemnify one another for any liability caused by the negligent act or omission of the other.

III. FAIR NOTICE DOCTRINE

Under Texas law, an indemnity agreement requiring a party to indemnify another party for its own negligence (that is, broad-and intermediate-form indemnity agreements), in order to be enforceable, must meet the fair notice requirements of **(1) the express negligence test; and (2) conspicuousness**. See *Dresser Indus. v. Page Petroleum, Inc.*, 853 S.W.2d 505,508 (Tex. 1993); *Enserch Corp. v. Parker*, 794 S.W.2d 2, 8 (Tex. 1990). Enforceability of an indemnity agreement is a question of law. See *Dresser*, 853 S.W.2d at 509; see also *Quorum Health Res., L.L.C. v. Maverick County Hosp. Dist.*, 308 F.3d 451, 459 (5th Cir. 2002). Thus, indemnity claims are fertile grounds for obtaining summary judgment.

A. The Express Negligence Test

In *Ethyl Corporation vs. Daniel Construction Company*, the Texas Supreme Court adopted the express negligence test, which requires a party seeking indemnity from the consequences of its own negligence to express that intent in specific terms within the four corners of the contract. 725 S.W.2d 705 (Tex. 1987). In order to satisfy the express negligence test, the intent of the parties must be: (1) clearly expressed; (2) set forth within the four corners of the agreement; and (3) stated in specific terms. See *id.* at 705, 708. In *Ethyl*, the Texas Supreme Court explained the purpose of the express negligence test as follows:

As we have moved closer to the express negligence doctrine, the scriveners of indemnity agreements have devised novel ways of writing provisions which fail to expressly state the true intent of those provisions. The intent of the scriveners is to indemnify the indemnitee for its negligence, yet be just ambiguous enough to conceal that intent from the indemnitor. The result has been a plethora of lawsuits to construe those ambiguous contracts. We hold the better policy is to cut through the ambiguity of those provisions and adopt the express negligence doctrine.

Id. at 707-08. Such a strict rule of interpretation is necessary in order to “reduc[e] the need for satellite litigation regarding interpretation of indemnity clauses.” *Fisk Elec. Co. v. Constructors & Assocs., Inc.*, 888 S.W.2d 813, 815 (Tex. 1994).

Thus, while valid indemnity agreements are enforceable under Texas law, an indemnity provision requiring a party to indemnify another party for its own negligence must be clear. *Hernandez v. Big 4, Inc.*, 241 F.Supp.2d 715,717 (S.D.Tex. 2003). Generally, when interpreting a traditional contract, “[t]he Court first determines as a matter of law if the contract is indeed ambiguous, and if it is, the question of the parties’ intent becomes a fact question for the trier of fact to decide.” *Id.* at 719 (citing *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983)). However, “[t]he express negligence doctrine demands that an indemnity clause requiring indemnification of a party for its own negligence, especially for its sole negligence, be crystal clear.” *Id.* at 720 (emphasis added). “If a party wishes to be indemnified for its own negligence, a party must draft an absolutely clear written provision that is doubt-free to comply with Texas law.” *Id.* The *Big 4* Court reasoned:

The Court is well aware of the real world lack of bargaining power between subcontractors and general contractors. The express negligence doctrine ensures that subcontractors are at least aware of their indemnity obligations, even if such obligations were not truly bargained for, so that they can, at least theoretically, incorporate such obligations into the bid valuation analysis.

Id. at 720-21.

(1) “Express Intent” Rule

The Texas Supreme Court has expanded applicability of the express negligence test to other types of claims, calling the test the “express intent rule.” *Houston Lighting and Power Company vs. Atchison, Topeka & Santa Fe Railway Co.*, 890 S.W.2d 455 (Tex. 1994). In the *Houston Lighting* case, a railroad employee brought suit against the railroad for personal injuries allegedly resulting from the employer’s violation of two federal statutes. The railroad filed a third-party complaint against HL&P for contractual indemnification. A jury trial ensued and the railroad was found strictly liable for the personal injuries of its employee. The indemnity agreement between HL&P and the railroad read as follows:

Notwithstanding anything contained in section 3 of Article I of Original Contract to the contrary [HL&P] agrees that it will at all times indemnify and save harmless Railway Company against all claims, demands, actions or causes of action, arising or growing out of loss of or damage to property, including said rotary dumper and appurtenances, and injury to or death of persons, including employees of Railway Company, resulting in any manner from the construction, maintenance, use, state of repair or presence of said rotary dumper and appurtenances under or adjacent to TV Tract, whether such loss, damage, injury or death be caused or contributed to by the negligence of Railway Company, its agents or employees, or otherwise
. . . .

Id. at 456.

HL&P, as the indemnitor, argued it should not be held responsible for the statutory violation [negligence per se] of the railroad since the indemnity agreement did not express an intent to require the indemnitor to indemnify for the statutory liability of the indemnitee. The Supreme Court agreed with HL&P and held that “parties seeking to indemnify an indemnitee against strict liability must expressly state that intent in their indemnity agreement.” *Id.* at 456. Justice Gonzales, writing for a unanimous Supreme Court, explained the rationale for the decision when he wrote:

Contracts indemnifying an indemnitee against the consequences of strict liability involve an extraordinary shifting of the risk and may have great financial impact on the parties. Thus, fairness dictates against imposing liability on an indemnitor unless the agreement clearly and specifically expresses the intent to encompass strict liability claims.

Id. at 458.

The “express intent rule” is the reason some indemnity agreements you see may contain a laundry list of claims for which the indemnitee seeks indemnification. While every construction project involves different risks, the following represents a list of risks that may be expressed in indemnity agreements:

- negligent act, error or omission,
- sole negligence,
- concurrent negligence,
- joint negligence,
- active or passive negligence,
- gross negligence,
- negligence per se,
- strict liability,
- patent infringement,
- copyright,
- unseaworthiness of any vessel or vessels,
- condition of property or its premises,
- latent defects,
- defects in materials,
- workmanship or design,
- workers’ compensation claims,
- disability act claims,
- employee benefit acts or claims, and
- failure to comply with any of the provisions of this subcontract or the contract documents.

(2) *Inapplicability of the Express Negligence Rule*

While drafters may list all risks intended to be transferred, some risks may be transferred by way of an indemnity agreement that does not fully meet the express intent rule.

(a) *Contract Against Strict Construction*

In *Webb vs. Lawson-Avila Construction, Inc.*, 91 S.W.2d 457 (Tex.App.-San Antonio 1995, writ dismissed), the Court of Appeals found the following indemnity agreement not only met the express negligence test, but also provided indemnification for gross negligence even though the indemnity agreement did not expressly include gross negligence:

. . . Upon request Subcontractor agrees to defend at its own cost and to indemnify and hold harmless the Contractor and its agents and employees from any and all liability, damages, losses, claims and expenses howsoever caused resulting directly or indirectly from or connected with the performance of this agreement, irrespective of whether such liability, damages, losses, claims and/or expenses are actually or allegedly, caused wholly or in part through the negligence of Contractor or any of its agents, employees or other Subcontractors.

Id. at 460.

The *Webb* decision discussed several Supreme Court decisions involving negligence and gross negligence, and concluded the term negligence included gross negligence. The court noted no exact line could be drawn between negligence and gross negligence and the difference was simply one of degree rather than of kind. While the *Webb* case does stand for the proposition that the term negligence can be interpreted to include gross negligence, the author of the particular indemnity agreement included a clause which allowed the court to apply a different standard of review. The general rule requires an indemnity agreement to be strictly construed in favor of the indemnitor. However, this particular contract included a provision stating it was the intent of the parties that the agreement was to be construed “fairly and reasonably and neither more strongly for nor against either party.” *Id.* at 461. This softer approach to interpretation may not be followed by other courts when reviewing agreements that do not contain such a favorable contract construction provision.

(b) *Past Acts and Breach of Contract*

In *Transcontinental Gas Pipeline Corporation v. Texaco, Inc.*, 35 S.W.3d 658, 668-669 (Tex.App.-Houston [1st Dist.] 2000, pet. denied), the First Court of Appeals held the express negligence rule applies only to indemnification against future acts of negligence, not past acts. 35 S.W.3d at 668-669 (*citing Green Int. 'l v. Solis*, 951 S.W.2d 384,387 (Tex. 1997)). The

Transcontinental court further held the express negligence doctrine would not apply to a provision, which shifted the risk of economic damages resulting from a breach of contract. *Id.* at 669.

B. Conspicuousness

Since 1973, Texas courts have required an indemnity provision to be conspicuous in order to be enforceable. See *K&S Oilwell Service, Inc. vs. Cabot Corp.*, 491 S.W.2d 733 (Tex.Civ. App.-Corpus Christi 1973, writ ref'd n.r.e.). Following *K&S*, various courts of appeal reached inconsistent conclusions with regards to the conspicuousness of indemnity agreements. Courts even differed on whether conspicuousness was a question of fact or of law.

(1) Conspicuousness Standard

In 1993, the Texas Supreme Court established the standard used today for determining the conspicuousness of an indemnity agreement. In *Dresser Industries, Inc. vs. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993), the court adopted the definition contained in former TEX. BUS. & COM. CODE ANN. § 1.201(10) as the standard for determining conspicuousness of indemnity agreements and releases that relieve a party in advance of responsibility for its own negligence. *Id.* at 511. Former subsection 1.201(10) read as follows:

(10) “Conspicuous: A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals (as: Non-Negotiable Bill of Lading) is conspicuous. Language in the body of a form is “conspicuous” if it is in larger or other contrasting type or color. But in a telegram any stated term is “conspicuous.” Whether a term or clause is “conspicuous” or not is for decision by the court.

The *Dresser* Court further stated, “when a reasonable person against whom a clause is to operate ought to have noticed it, the clause is conspicuous.” *Id.* at 511. On the other hand, an indemnity provision, which is “no more visible than any other provision in an agreement,” and which “does not appear to be designed to draw the attention of a reasonable person against whom the clause is to operate” is not conspicuous. *Douglas Cablevision IV, Lt. v. Southwestern Electric Power*, 992 S.W.2d 503, 509 (Tex. App.-Texarkana 1998, pet. denied).

In *Douglas Cablevision IV, Lt. v. Southwestern Electric Power*, the Court considered the enforceability of an indemnity clause, contained within one of twenty-two separately numbered paragraphs of a contract. *Id.* All numbered paragraphs were printed in the same size and type of font. *Id.* The indemnity provision was set forth in two sentences, which spanned two pages of a thirteen page document. *Id.* at 507. Applying the conspicuousness test adopted by *Dresser*, the Texarkana Court of Appeals held such an indemnity provision was not conspicuous and, therefore, did not comply with the fair notice doctrine. *Id.* at 509.

(2) *Actual Notice of Knowledge Exception*

One caveat to the Court's adoption of the Texas UCC definition for conspicuousness concerns a situation where the indemnitor has actual notice or knowledge of the existence of the indemnity agreement. The Court, in a footnote, said "the fair notice requirements are not applicable when the indemnitee establishes that the indemnitor possessed actual notice or knowledge of the indemnity agreement." *Id.* at 508 (citing *Cate vs. Dover Corp.*, 790 S.W.2d 559, 561 (Tex. 1990)).

The Court, however, did not discuss the difference between actual notice and actual knowledge. In *U.S. Rentals, Inc. vs. Monday Service Corp.*, 901 S.W.2d 789 (Tex.App.-Houston [14th Dist.] 1995), in what can only be described as the battle of the footnotes, the court wrote in footnote 8 the following:

Notably, however, the *Cate* opinion addressed only actual *knowledge*, and not actual *notice*, as an exception to the fair notice requirement. This distinction is important in that forms containing indemnity provisions are commonly signed by or on behalf of the ostensible indemnitor. To the extent such a form is signed without reading the indemnity provision, the signature might not alone evidence actual *knowledge*. See *Cate*, 790 S.W.2d at 562. However, such a signature could arguably evidence actual *notice*. Thus, if actual *notice* is also an exception to the fair notice requirement, as suggested by the footnote in *Dresser*, and if a signature on the forms signifies actual notice for this purpose, then the fair notice requirement could be thereby rendered largely ineffectual.

Id. at 793 n. 8. Later, in 2000, the Fourteenth Court of Appeals held where an indemnitor stipulated its President had read the indemnity paragraph at issue, actual *notice* of the indemnity provision existed and therefore, the Court did not have to address the fair notice requirement. *Coastal Transport Co. v. Crown Central Petroleum Corp.*, 20 S.W.3d 119, 126-27 (Tex.App.-Houston [14th Dist.] 2000, pet. denied) (noting the issue of the express negligence doctrine was not raised on appeal).

In drafting a contract, it is advisable to insert knowledge and notice provisions into signature blocks in an attempt to eliminate or at least minimize the factual contest of actual notice or knowledge after a loss occurs. Although not specifically discussed, it seems apparent that any issue dealing with "actual notice or knowledge" of the indemnity agreement would be a fact question and not a question of law for the court. In *U.S. Rentals*, the Fourteenth Court of Appeals also dealt with the issue of burden of proof for conspicuousness when the issue of actual notice or knowledge is in play. The Court, citing both *Dresser* and *Cate*, held it was the indemnitee's burden to prove (not the indemnitor's burden to disprove) actual notice or knowledge. *U.S. Rentals*, 901 S.W.2d at 793. The Court reasoned actual notice or knowledge was in the nature of an affirmative defense to a claim of lack of conspicuousness. *Id.*

IV. DETERMINING THE ENFORCEABILITY OF AN INDEMNITY AGREEMENT

While courts generally look to the Fair Notice Requirements in order to determine the enforceability of a given indemnity agreement, counsel is advised to look beyond these requirements. A four-step analysis is required to determine the enforceability of any indemnification agreement. The graphic on the following page charts this four-step analysis:

These four steps can be summarized as follows:

A. Step One: Does the Liability Arise Out of the Subject Matter of the Clause?

Step one in determining the enforceability of the indemnity agreement is whether the claim for which indemnification is sought is actually covered by the indemnity clause. A typical indemnity clause “applies to claims arising out of or relating to” the work of the contract. In *Robert H. Smith, Inc. vs. Tennessee Tile, Inc.*, 719 S.W.2d 385 (Tex.App.-Houston [1st Dist.] 1986, no writ), a tile company employee was electrocuted when he attempted to move electrical wiring. The employee sued the general contractor who in turn filed suit against the employer for contractual indemnity. The contract required the employer to indemnify the contractor for all claims “arising out of or resulting from the performance of the subcontractor’s work under the contract,” The court found there was no indemnity since there was no proof the employee’s handling of electrical wiring would have been within the scope of the subcontract involving tile work.

In *Sun Oil Co. vs. Renshaw Well Service*, 571 S.W.2d 64 (Tex.Civ.App.-Tyler 1978, writ ref’d n.r.e), the court held that an injury to an employee of a well service contractor was not an injury “arising out of, incident to or in connection with” the contractor’s performance of work under the well servicing agreement where the injury occurred after the specific well servicing work had been completed and no further work remained to be done at the well site.

In *Boyd vs. Amoco Production Co.*, 786 S.W.2d 528 (Tex.App.-Eastland 1990, no writ), a welder’s employee was injured while performing welding operations pursuant to a well servicing contract. The owner sought indemnity from the welder after paying the claim of the injured employee. The court upheld the owner’s entitlement to indemnity, rejecting the contractor’s attempt to characterize its employee’s operation of cutting anchor bolts as actually being work arising out of the owner’s operations, rather than the welding operations. The court held the welder’s employees and the owner’s employees were all working to prepare a pumping unit for removal and replacement, and the welder’s injuries arose out of the welder’s operations pursuant to the contract.

The cases illustrate that even where an indemnification agreement may be enforceable, the facts and circumstances surrounding the injury, property damage, or claim must be carefully examined to determine whether they fall within the scope of the indemnification obligation.

B. Steps Two & Three: Does the Indemnity Clause Meet the Fair Notice Requirements?

The next step is to determine whether or not the indemnity clause meets the fair notice requirements of express negligence (or express intent) and conspicuousness as discussed in Section III above. If the indemnity clause fails to meet either of these tests, it is unenforceable as a matter of law.

C. Step Four: Do Any Anti-indemnity Statutes Apply?

The final hurdle to clear before you can determine whether an indemnity agreement is enforceable is whether there is any anti-indemnity statute prohibiting the particular type of risk-shifting involved. The most common anti-indemnity statutes encountered in construction cases deal with architects and engineers (TEX. CIV. PRAC. & REM. CODE § 130.002) and oil and gas (TEX. CIV. PRAC. & REM. CODE § 127.003). In 2001, the Texas legislature enacted an anti-indemnity statute relating to state public works contracts, which was amended in 2005 (TEX. GOV'T CODE ANN. § 2252.902). A thorough reading of the anti-indemnity statutes is required in order to determine their possible application.

(1) Indemnification of Architects and Engineers

§ 130.002. Covenant or Promise Void and Unenforceable

A covenant or promise in, in connection with, or collateral to a construction contract is void and unenforceable if the covenant or promise provides for a contractor who is to perform the work that is the subject of the construction contract to indemnify or hold harmless a registered architect, registered engineer or an agent, servant, or employee of a registered architect or registered engineer from liability for damage

- (1) is caused by or results from:
 - (A) defects in plans, designs, or specifications prepared, approved, or used by the architect or engineer; or
 - (B) negligence of the architect or engineer in the rendition or conduct of professional duties called for or arising out of the construction contract and the plans, designs, or specifications that are a part of the construction contract; and
- (2) arises from:
 - (A) personal injury or death;

- (B) property injury; or
- (C) any other expenses that arises from personal injury, death, or property injury.

(2) ***Oil & Gas Contracts***

§ 127.003. Agreement Void and Unenforceable

- (1) Except as otherwise provided by this chapter, a covenant, promise, agreement, or understanding contained in, collateral to, or affecting an agreement pertaining to a well for oil, gas, or water or to a mine for a mineral is void if it purports to indemnify a person against loss or liability for damage that:

is caused by or results from the sole or concurrent negligence of the indemnitee, his agent or employee, or an individual contractor directly responsible to the indemnitee; and

- (2) arises from:
- (A) personal injury or death;
 - (B) property injury; or
 - (C) any other loss, damage, or expense that arises from personal injury, death, or property injury.

(3) ***State Public Works Contracts***

§ 2252.902. Indemnity Provisions in Construction Contracts

- (a) In this section, “construction contract” means a contract or agreement made and entered into by a state governmental entity, contractor, construction manager, subcontractor, supplier, or equipment lessor, concerning the construction, alteration, or repair, of a state public building or carrying out or completing any state public work,
- (b) Except as provided by Subsection (c), a covenant, promise, or agreement contained in a construction contract, or in an agreement collateral to or affecting a construction contract, is void and unenforceable to the extent that it indemnifies a person against all or any portion of loss or liability for damage that:

- (1) is caused by or results from the sole, joint, or concurrent negligence of the indemnitee, its agent, employee, or another independent contractor directly responsible to the indemnitee; and
- (2) arises from:
 - (A) personal injury or death;
 - (B) property damage;
 - (C) a fine, penalty, administrative action, or other action assessed by a governmental entity directly against the indemnitee, its agent or employee, or an independent contractor directly responsible to the indemnitee; or
 - (D) any other loss, damage, or expense that arises from an occurrence described by Paragraph (A), (B), or (C).
- (c) A covenant, promise, or agreement, contained in a construction contract, or in an agreement collateral to or affecting a construction contract, may provide for a person to indemnify, hold harmless, or defend another person against loss or liability for damage that is caused by or results from the sole, joint, or concurrent negligence of the indemnitee or its agent or employee and arises from the bodily injury or death of an employee of:
 - (1) the indemnitor;
 - (2) the indemnitor's subcontractor, supplier, or equipment lessor;
 - (3) any lower-tier subcontractor, supplier, or equipment lessor of the indemnitor's subcontractor; or
 - (4) any independent contractor directly responsible to a person described in Subdivisions (1)-(3).
- (d) This chapter does not affect the validity and enforceability of:
 - (1) an insurance contract;
 - (2) benefits and protections under the workers' compensation laws of this state; or
 - (3) any statutory right of contribution.

- (e) This section may not be waived by contract or otherwise.

Pursuant to this statute, only limited indemnity is permitted for construction contracts involving state public works. The statute, however, contains an exception permitting broad- and intermediate-form indemnity for third party over actions relating to worker's compensation.

(4) *Recent Trends in Anti-Indemnity: 2007 Texas Legislature (th Regular Session)*

In 2007, during its 80th Session, the Texas Legislature again considered multiple bills that would have limited the ability of parties to contract to shift risk. As discussed below, the bills considered in 2007 were re-introductions, although not in identical form, of some of reforms proposed in 2005. As was the case in 2005, none of the proposed bills were passed into law.

**SB 354 and
HB 2014**

These two similar bills were introduced in both the House and Senate within one month of each other in 2007. Although reworked, these bills were a re-introduction of SB 868 and HB 2156 respectively, which were originally introduced in 2005. The primary purpose of the bills remained the same-- to create a "consolidated insurance program" intended for a principal to provide insurance coverages bundled into one insurance program for a single construction project or multiple construction projects.

The 2005 version of this bill would have waived governmental immunity, making governmental units liable for their negligence in "the procurement and cover of insurance under a consolidated insurance program." In the 2007 versions, the waiver of governmental immunity was removed. Additionally, the 2005 versions of the bill limited its application to construction projects over \$100 million; this limitation was removed from the 2007 version. The 2007 version, like the 2005 version, would have waived the right to subrogation between the principal and a contractor, or a contractor and its subcontractor, for claims under the consolidated insurance program. However, while the 2005 version of the bills voided any "waiver of a right to subrogation contained in an insurance policy or contract separately maintained by a contractor that is of the same general type as the insurance coverage provided under the consolidated insurance program." The 2007 versions removed this language and it did not address whether such provisions would be void or not.

Indemnification. The 2005 versions contained a provision that prohibited contractors from being required to indemnify, hold harmless or defend any claim that exceeded the insurance liability limits under the consolidated insurance program, and provided that any such agreement in a

construction project contract covered by a consolidated insurance program was void. This provision is not contained in the 2007 version of the bills.

SB 346 and

HB 2262

These two bills have identical language. They were a re-introduction and rework of SB 445, originally introduced in 2005. Like the original version of this bill, the 2007 version was intended to void most types of broad and intermediate form indemnity agreements in construction contracts. The 2007 versions of the bill contains all of the provisions of the 2005 version, but had several additional provisions. The 2007 version also included a provision which stated that “[a]n insurance contract may not provide an additional insured endorsement or a waiver of subrogation that is in contravention of this chapter” and that any such endorsement or waiver would be void and unenforceable. The 2007 version also specifically stated that it would not have affected the validity or enforceability of a waiver of subrogation between contractors or between a principal and a contractor for coverage provided by a consolidated insurance program.

HB 1152

This bill was virtually identical to HB 1217, introduced in 2005. It would amend the Insurance Code Chapter 1808 to provide that a construction insurance provision would be unenforceable to the extent that it required another person, including an indemnitee under an indemnification agreement, be made an additional insured; or require an insurance policy he endorsed to provide a waiver of subrogation.

V. INTERSECTION OF INSURANCE AND INDEMNITY

The typical construction contract contains both stringent insurance requirements and indemnity obligations. Specifically, in a typical owner-contractor agreement, the owner imposes an indemnity obligation on the general contractor and requires that the general contractor have the owner named as an “Additional Insured” on the general contractor’s insurance policy. Sometimes obligated to do so by the terms of its contract, the general contractor then imposes these same obligations on its subcontractors. The intent is to pass risk to the contractor in the best position to guard against the risk or secure insurance to cover the risk. Under the construction contract, risk may be transferred to an insurance carrier through various insurance requirements, or it may be transferred to one of the contracting parties through the indemnity agreement. Although insurance requirements and indemnity agreements are often intended to describe independent contractual obligations, a poorly worded contract may result in a court holding the two provisions are “inextricably tied,” the consequences of which will be discussed in more detail

below. Finally, a contractual Flow Down Clause may implicate additional insurance policies and indemnity agreements affecting the risk transfer analysis.

For the sake of simplicity, the examples discussed in this section of the paper assume a General Contractor/Subcontractor relationship with the construction contract containing both an insurance requirement (including an Additional Insured coverage requirement) and an indemnity agreement in favor of the General Contractor.

A. Insurance In Lieu of Indemnity

An indemnity agreement alone is often insufficient to guarantee an effective risk transfer because the indemnitor may not have the financial wherewithal to satisfy its indemnity obligation. As a result, most general contractors require their subcontractors to purchase insurance coverage covering the risks transferred by the indemnity agreement. As added protection for the general contractor, the construction contract often requires the General Contractor be named as an Additional Insured in the subcontractor's policy or policies.

Although construction contracts may require the subcontractor to purchase commercial general liability ("CGL") coverage with certain minimum policy limits, many contracting parties realize the better approach is to specify the risks to be covered and the amount of coverage to be purchased, while allowing the subcontractor to choose the mix of CGL, excess, and umbrella coverage that achieves the required minimum limits in the most cost effective manner. As a result, excess and umbrella policies are often in place to cover the insurance requirements of the construction contract.

The benefits the general contractor derives from Additional Insured status under the subcontractor's policy or policies include:

- a. reduction of the uncertainty surrounding enforceability of contractual indemnity obligations, an issue discussed in greater detail below;
- b. protection of its own insurance coverage; and
- c. direct entitlement to a defense and the other obligations owed to a first party to the insurance policy.

As this paper suggests, however, the general contractor may not be successful in attaining the first two goals, no matter how diligently the intent is expressed in the construction contract and the insurance policies.

One of the primary motivations for requiring Additional Insured status is to hedge the uncertainty surrounding enforceability of the indemnity agreement. However, it does not necessarily follow that once the general contractor is named as an Additional Insured under the

subcontractor's policy, the general contractor is entitled to coverage for any loss caused by an insured peril under the subcontractor's policy, *regardless* of whether the indemnity agreement in the construction contract is enforceable under applicable state law. *Cf. Getty Oil Co. v. Insurance Co. Of N Am.*, 845 S.W.2d 794 (Tex. 1992).

B. Insurance for Indemnity Obligations

Even if the construction contract does not require the subcontractor to name the general contractor as an Additional Insured, the subcontractor's policies may still provide coverage for the indemnity agreement through "contractual liability coverage." The wording of the standard CGL general coverage agreement is broad enough to encompass the subcontractor's liability to the indemnitee (general contractor) by virtue of indemnity obligations assumed by the subcontractor in the construction contract. The issue is typically addressed in an exclusion . Sample wording from the standard ISO CGL form follows:

Standard ISO CGL Form Contractual Liability Exclusion

This insurance does not apply to:

b. "Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:

(1) that the insured would have in the absence of the contract or agreement; or

(2) assumed in a contract or agreement that is an "insured contract,"¹ provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement.

To summarize, if the construction contract contains an indemnity agreement and insurance requirement, but the insurance requirement does not require the general contractor be named as an Additional Insured, contractual liability coverage contained in the subcontractor's policy will cover the subcontractor's indemnity obligation, but only if the indemnity agreement is

¹ The term "insured contract" is defined in the standard ISO CGL form as :
That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for municipality) under which you assume the tort liability of another party to pay for "bodily injury" or "property damage" to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

enforceable and it satisfies the requirements of the CGL policy, and only to the extent of indemnification required by the construction contract.

C. Failure of Both Indemnity and Insurance

If insurance fails, parties are forced to rely on indemnity provisions in their contracts. If these are held unenforceable, parties will likely sue their lawyers who drafted the provisions.

Notably, if the contractual insurance requirement is ruled “inextricably tied” to an invalid indemnity agreement, the subcontractor may successfully defend against a breach of contract action for failing to procure the required insurance. *See Emery Air Freight Corp. v. General Transp. Sys., Inc.*, 933 S.W. 2d 312 (Tex. App.-Houston [14th Dist.] 1996, no writ). In *Emery*, Emery sued General Transport for breach of contract after General Transport failed to add Emery as an Additional Insured to General Transport’s insurance policy as required by the contract between the two. One of General Transport’s employees had already successfully sued Emery for a work related injury. Emery discovered it had not been added as an Additional Insured when it called General Transport’s carrier to report the claim. Emery then sued General Transport seeking damages in the amount of the judgment taken against Emery by the injured General Transport employee.

The *Emery* court first determined the indemnity agreement contained in the contract did not satisfy the express negligence test. The court then examined the wording of the insurance requirement and held the actual purpose of the insurance requirement was “to support the indemnity agreement.” Because the indemnity agreement did not require indemnity for Emery’s own negligence, neither did the insurance requirement require coverage for Emery’s own negligence. General Transport could therefore not be held liable for breach of contract.

VII. CONCLUSION

Given the current climate with respect to insurance coverage, having a valid indemnity clause in a construction contract is increasingly important. As such, it is a subject both contract drafters and litigators need to familiarize themselves.

