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What's Wrong With This Picture? Five Questions to Ask for Improving Contractual Indemnification Provisions

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You know those puzzles where you look at a picture and you're supposed to find all the little things that are wrong, like a bear driving a car or a pedestrian with two different colored shoes? Let's play the same game and see how many problems you can find with this contract provision:

Section 4. Indemnification.

To the fullest extent allowed by law, Vendor agrees to defend, indemnify and hold Customer harmless from all claims, losses, liabilities, damages and expenses (including reasonable attorneys' fees and costs) resulting from negligence or more culpable conduct.

Before we start parsing Section 4, let's make clear that indemnification is a valuable opportunity for contracting parties to specify who bears what risk, to what extent and in what manner. Far from boilerplate to be plugged into a contract without thought, indemnification provisions can and should help advance the business purposes of the contract by specifying how the parties will manage certain problems that may arise. Thus, these risk allocation sections can help the parties avoid litigation between themselves and continue working together under the contract.

Keeping in mind the risk allocation purpose of indemnification provisions, let's ask ourselves five questions to identify some of the ways we might improve our hypothetical Section 4.

1. **Does the indemnity cover claims between the parties or only claims by third parties?**

Many people think of indemnity as applying to third-party claims. But Section 4 includes nothing that specifically limits it to third-party claims. Indeed, some courts hold that indemnity can apply to claims solely between the parties. See, *e.g., Bainbridge St. Elmo Bethesda Apts., LLC v. White Flint Express Realty Group LP*, 164 A.3d 978 (Md. 2017); *Hot Rods, LLC v. Northrup Grumman Sys. Corp.*, 242 Cal. App. 4th 1166 (Cal. Ct. App. 2015). There's nothing inherently wrong with having an indemnity that can apply to claims between the parties—if that's what the parties intend. But if the parties want the indemnity to apply only to third-party claims, they can say so in the contract. For example: "… from all third-party claims, losses…"

2. Will the indemnitee be indemnified for its own negligence?

Section 4 ties the indemnity to “negligence or more culpable conduct,” but it doesn’t specify whose negligence or more culpable conduct can trigger the indemnity. If the parties intend to refer only to the Vendor’s conduct, they can easily write “Vendor’s negligence or more culpable conduct.”

If the parties intend that the customer would be indemnified for its own negligence, they should so specify. Indeed, a party can be legally limited or prohibited from being indemnified for its own negligence. Further, gross negligence, recklessness, and willful misconduct cannot be indemnified under the law of many states.

In light of such limitations, there is a tendency to read the introductory phrase “…to the fullest extent allowed by law…” as ensuring that the rest of Section 4 must be good and does not need to be reviewed. Try to resist that temptation. If anything else in Section 4 is unenforceable under applicable law, the opening phrase will not cure the illegality. Nor will the phrase remedy ambiguity. At most, the phrase is an aid to construction of the contract language, and that aid will be used only in close cases to indicate that the parties intend to give the indemnitee the broadest rights that can be found in the indemnity, right up to but not exceeding the legal limit.

3. What if the indemnitor isn’t at fault?

One case involved a provision indemnifying a contractor for anything “arising out of or in connection with Subcontractor's work performed for Contractor.” The court held that the subcontractor had to indemnify the general contractor, regardless of whether the subcontractor was negligent or did anything to cause the damage. See *Amberwood Dev., Inc. v. Swann’s Grading, Inc.*, 2017 WL 712269 (Ariz. App. 2/23/17).

In Section 4, the words “defend” and “claims” might signal that mere allegations of negligence could be enough to trigger the Vendor’s obligations. Also, Section 4 uses the phrase “resulting from.” It doesn’t specify proximate cause or even “but for” causation.

4. What does “defend” mean?

Any new third-party claim subject to an indemnity implicates several questions about how the claim will be handled, including who controls the defense and what happens if some but not all aspects of the third-party claim are indemnifiable.

In Section 4, the word “defend” implies that the indemnitor will take full control of the indemnitee’s defense, including choice of counsel and the decision to settle. The parties could insert additional language modifying or detailing how the indemnitor will defend. For example, the contract can allow the indemnitor to choose defense counsel, subject to the indemnitee’s consent, which shall not be unreasonably withheld. The contract also could give the indemnitor power to settle, as long as the indemnitee is fully released and pays nothing.

A potentially thorny issue is how to handle a third-party claim where, for example, only one of four counts falls within the scope of the indemnity. In some states, the indemnitor generally has to defend only the covered count. See, *e.g., 933 Van Buren Condo. Ass’n v. West Van Buren, LLC*, 2016 IL

App (1st) 143490. Thus, the indemnitee would have to defend itself against the three non-indemnifiable claims. In other states, the indemnitor may be required to defend the uncovered as well as the covered counts, but the indemnitee may have to reimburse the costs of defending the non-indemnifiable counts. See, *e.g., Crawford v. Weather Shield Mfg., Inc.*, 44 Cal. 4th 541 (2008). If the parties to the contract would rather avoid default rules like these, they can address this situation in the indemnity provision. Perhaps they might specify that the indemnitor has the option to defend the non-indemnifiable counts, having no right to reimbursement of the defense costs, with the indemnitee financially responsible only for its actual liability to the third-party claimant on the non-indemnifiable counts.

5. **Would a form contract be better?**

Several years ago, a federal appeals court ruled in my client's favor, based on the indemnification provision of a trade association form contract. The result was good, but it's unfortunate that we had to litigate through appeal to accomplish the client's desired result. Forms can be very helpful, for example, by showing some of the types of issues that can be addressed in a contract and how someone else tried to address those issues. But forms can have inherent problems, and even the best form can't anticipate and adequately address every issue.

Even sophisticated businesspeople and experienced lawyers may look past indemnification provisions and focus almost exclusively on other parts of a contract. Doing so may mean missing an opportunity to make a rational allocation of risk and to streamline the process of managing claims that arise from those risks. Like the bear driving a car or the pedestrian with two different colored shoes, maybe the next time you're working on a contract, you'll be better able to find what's wrong with the indemnification picture.

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