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Indemnification Provisions in Incentives Agreements: Best Practices and Special Public Entity Issues

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Indemnification provisions are an important part of the fine print of many contracts. These clauses generally operate to protect one party against the other party's actions or failures to act that lead to a loss claimed by a third party (not a party to the contract). A common example is the indemnification provisions (or entire agreements) used in the rental car setting. Before you drive off the lot, the rental car company will require you indemnify (or protect) it against a third party (not you) bringing a claim due to you being in an accident.

Similarly, most incentive agreements contain one-way indemnification provisions, requiring the incentive recipient to indemnify and hold harmless the public entity against any possible risk and for any liability that could befall the public entity because of your project. The incentive provider will usually inform you that the indemnification provision cannot be mutual, is non-negotiable, and often includes provisions that go beyond traditional indemnification. Sorting through the legalese in these terms and conditions is a challenge in non-incentive contracts, and adding a public or quasi-public entity can make them more complicated.

The first step in negotiating these provisions is to determine exactly what the indemnification section of the agreement requires. Second, determine if there is room to negotiate any protective provisions limiting indemnification. Third, try to re-define the boundaries of your indemnity. Finally, review the negotiated provision to re-assess the risk and determine if any additional mitigation is appropriate.

Parsing Indemnification Provisions

Indemnification provisions are notoriously hard to read. These sections should not be treated as boilerplate and can also include more than the traditional concept of protecting the counterparty if you do something that creates liability for it. In the context of a real estate development incentive transaction, we recently reviewed a proposed indemnification from a city (City) that was four paragraphs (and a full page) long. When you see an indemnification provision, it is critical to parse it out and closely read each section.

For instance, the City required that the developer (Developer) or other incentive recipient "indemnify, hold harmless and defend" the City. That same provision then stated that the incentive recipient "assumes all liability and responsibility of the City" for any claims against the City from the project. The incentive recipient was then to release the City from any liability under the contract or performance of the contract. Finally, the City required the recipient have all of its contractors and subcontractors agree to include a release and indemnity on the same terms for the City.

It may look like the City simply let their attorneys keep adding their preferred language, but such provisions encompass different concepts. In the incentives context, expect your counterparties to require an indemnification provision because their counsel will tell them that, although they may have never actually seen it used in the incentives context, it does not hurt to make it clear that if someone gets upset about the project or get injured on the project and tries to blame the City/County/State, the developer or company will take responsibility to indemnify, hold harmless and defend City/County/State and its employees and agents for claims arising out of the incentive agreement or the underlying project.

In addition to the typical indemnification, it is important to try to negotiate limitations or restrictions to each subsection of such a provision.

Typical Negotiated Limitations

When negotiating indemnification provisions between private parties, it is often feasible to simply have the provisions operate mutually. If either party acts in a way that causes the other party to face a claim by a third party, the acting party will be responsible for any losses it causes to its counterparty. By having the same terms apply to both parties, reasonable limitations and protections can be negotiated since they operate both directions.

However, public entities, such as the City, generally will not mutually indemnify, and will take the position that they cannot do so under state law. This is because an indemnification is a contingent claim in an unknown dollar amount. For a public sector entity to incur such a contingent liability, many jurisdictions will require that amount be budgeted. Without creating the authority to make an expenditure, such obligations are often unenforceable.

So if the City will not delete the provision, and will not negotiate a mutual indemnification, what limits are reasonable to seek?

At a minimum, negotiate a carve-out from indemnification for intentional misconduct by the governmental entity. An example of such language is:

Except as otherwise specifically provided herein and except in cases in which City is found to be grossly negligent, to have engaged in willful misconduct or engaged in criminal or unlawful activity, Developer agrees to indemnify and hold harmless City . . .[.]

Similarly, some political subdivisions will agree to a limitation for any liability resulting from the sole negligence or fault of the City, or if due to the joint or concurrent fault of the City and the Developer, then the indemnity will be apportioned. Such provisions help mitigate any risk of an inadvertent waiver of comparative negligence.

Two additional common revisions to indemnification provisions are: (1) no settlements; and (2) a right to defend in any litigation. In these situations, the developer will seek to mitigate risk by being able to engage in the indemnification process. Examples of these clauses are:

Developer will not be required to indemnify City for any settlements reached with respect to a third party claim unless Developer has provided its prior written consent for such settlement, not to be unreasonably withheld or delayed . . .

and

In case any claim or demand is at any time made, or action or proceeding is brought, against the City in respect of which indemnity may be sought hereunder, the City will give prompt written notice of that action or proceeding to the Developer, and the Developer upon receipt of that notice will have the right, but not the obligation, to assume the defense of the action or proceeding.

Structural Approaches to Indemnification Provisions

While each of these limitations is helpful, the most effective way to protect against an overly broad indemnification provision is to limit its applicability.

First, try to limit indemnification to a breach of the agreement. If the Developer is only indemnifying the City against a breach of an incentive agreement, there are few circumstances in which the Developer's failure to make an investment or create a certain number of jobs at a certain wage will generate a third party claim.

Second, if your counterparty will not limit the indemnification to breaches, then try to limit it to claims arising out of the incentives agreement. This approach narrows indemnification and may limit indemnifying the City from ordinary operating claims that could arise many years in the future, or from employee claims beyond worker's compensation (for instance, by an employee of the political subdivision injured on public property that is being developed as part of the project).

Third, try to limit the kitchen sink approach that some public entities use by asking about each separate concept within the indemnification provision. For instance, broadly releasing the City from any liability under the contract or performance of the contract may contradict the City's other obligations under the agreement. Similarly, it may not be feasible or reasonable to have all of the Developer's contractors and subcontractors agree to include a release and indemnity the City. They are not parties to the incentive agreement, and such a provision may limit the parties willing to perform work to timely complete the

project.

Lessons Learned

Indemnification provisions often get little attention when incentives contracts are reviewed. While the governmental entity will likely require the provision, there are small changes that can mitigate your risk. Limiting the indemnification to a breach of the incentive agreement is optimal, but as we identified above there are several other modest changes that will limit potential unforeseen future exposure. Finally, with any accepted changes, review the indemnification provision again and determine if there is any other risk mitigation needed, such as insurance or specific indemnification provisions from your own subcontractors.