

Indemnification Agreements

Senate Bill 555

by Jay Wiley
Research Fellow &
Bill Peacock
Director, Center for
Economic Freedom

Background

Indemnification clauses in contracts between general contractors and their subcontractors are commonly used in the construction industry to allocate risk. The language of indemnification clauses generally maintain that, should an accident or damage to property occur, the subcontractor will hold the general contractor blameless for the damage. These agreements are not exotic or unusual and reflect a freely contracted arrangement between willing parties in order to allocate risk among the parties involved. Without those contractual terms, liability may be allocated much later by a jury on uncertain grounds. Fixing risk at the time of the contract allows the parties to eliminate much of this uncertainty, anticipate the scope of their responsibilities, and plan for an accurate cost of the project.

Purpose

Controversy has developed over the proper scope of indemnity offered through these contract clauses. Indemnity clauses are intended to properly shift liability to the party deemed more responsible, with subcontractors generally indemnifying general contractors for acts for which the general contractor is less than wholly responsible. However, some subcontractors and their insurance companies do not like the shifting of liability and have sought relief through SB 555.

SB 555 bars voluntary contractual risk-shifting agreements between general contractors and subcontractors in which the subcontractor agrees to hold the general contractor harmless from liability for accidents or other wrongdoing.

Consequences

The consequences of this legislation go beyond the indemnification issue. SB 555 limits the ability of parties to freely contract with each other.

Contracts insure that agreements between parties last longer than their changeable states of mind and serves as a mechanism by which those parties can stabilize the future. Voluntary assumption of respon-

sibility between parties is essential to a free market and has been used in the contracting industry to create efficiencies and lower costs to property owners, tenants, and consumers.

Restrictions on contractors and subcontractors' ability to freely contract liability for damage with each other would result in more defendants to lawsuits. When contractors and subcontractors are prohibited from freely entering into contracts limiting liability, the result is more defendants to lawsuits. The complexity and inefficiency of litigation means more complex and protracted litigation, with additional counterclaims, cross-claims, joinders of party, impleaders, and so forth. The protraction of the lives of lawsuits and a lack of incentive to negotiate out-of-court settlements, which courts depend upon in order to manage their overburdened dockets, means a court system less accessible to truly injured parties. The costs of this inefficiency eventually make their way to taxpayers and consumers in the form of higher taxes and higher construction costs.

Additionally, the removal of indemnification clauses in construction contracts minimizes incentive for general contractors to appropriately manage the project and increases the likelihood of unsafe conditions.

Texasans are interested in streamlined litigation in our clogged courts and lower litigation costs. SB 555 accomplishes neither and, in fact, exacerbates the problem of frivolous suits.

Recommendation

Contractors and subcontractors are commercial parties who use indemnification agreements to voluntarily enter into agreements shifting risk to reduce uncertainty and increase efficiency. Statutorily limiting parties' ability to contract in their own interests has an adverse effect on the courts, taxpayers, and consumers in Texas. It would be bad business, and bad for the Texas economy, for the Texas Legislature to make the changes proposed in SB 555. Indemnification agreements should continue to be allowed. 