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Understanding the Limits on Indemnity Agreements

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Do indemnity agreements typically require payment of the indemnified party's attorney fees? Can a party cap the amount of its liability, or is doing so against public policy? Here's a look at some of the key questions that arise in indemnity contracts.

TAKEAWAYS »

- Indemnity agreements are contracts and are subject to the general rules of contract construction, which are used to discern the parties' intent from the contract language. While Illinois cases have held that the indemnification obligation is to be strictly construed against the indemnitee, each case depends on the precise language of the agreement and the facts of the dispute.
- Illinois follows the general rule that if an indemnity agreement does not expressly exclude indemnity for first-party losses, those losses are within the scope of the indemnity provided.
- Case law points to the conclusion that without reference either to a defense or to attorney fees, an "indemnify and hold harmless" clause will not impose a defense upon the indemnitor or any obligation to reimburse the indemnitee for its incurred attorney fees.

Indemnity is a staple of many business and other relationships. One party - say a contractor, aka indemnitor - promises to indemnify another - e.g., a homeowner, aka indemnitee - for any damage the contractor does in the course of the project.

The indemnity agreements define the boundaries of that promise, ideally creating

certainty and helping avoid disputes. Toward that end, attorneys typically use language both broad and specific to define the scope of exposure. But despite drafters' best efforts, disputes arise and lead to litigation.

This article focuses on three questions about contractual indemnity agreements, some of which have been addressed in Illinois cases. First, does an indemnity agreement cover first-party claims by the indemnitee, in addition to third-party claims against the indemnitee, when no specific language addresses that issue? (Answer: Usually.) Second, does an indemnity agreement encompass the indemnitee's defense costs if the agreement does not expressly say? (Answer: Not likely.) Third, is a cap on indemnity enforceable? (Answer: Probably.)

One preliminary point: Indemnity agreements are subject to the general rules of contract construction. That means parties' intent is derived from the contract language.[1]

However, while Illinois cases have held that indemnification provisions should be strictly construed against the indemnitee, the outcome of each case depends on the precise language and facts.[2] Also, courts do not apply rules of construction typically applicable to insurance policies when the indemnity agreement is between two non-insurers.[3]

Coverage for first-party claims: Draft carefully to avoid problems

In most indemnity agreements, the indemnitee requires the indemnitor to indemnify claims by others (i.e., third-party claims) against the indemnitee.[4] But what if an indemnitee suffers a loss of its own, without a claim being made against it by a third party? Are those losses within the scope of the agreement if it doesn't address that point?

Illinois follows the general rule that if an indemnity agreement does not expressly exclude first-party losses they are within the scope of the agreement. In *Water Tower Realty Co. v. Fordham 25 E. Superior, L.L.C.*, the indemnitor agreed to indemnify the indemnitee "against any and all loss...arising out of the Work," which the indemnitor conceded was broad enough to encompass first-party losses.[5]

However, the indemnitor argued that first-party indemnity was nonetheless excluded by language in the agreement imposing a duty to defend "suits or actions" against the indemnitee. That "defense" language stated, "and [we] shall defend any suit or action brought against you or any of the indemnified part[ie]s, based on any such alleged injury or damage...."[6]

The *Water Tower* court disagreed that the duty to defend clause restricted the scope of indemnity to third-party claims. The court wrote that if the parties wanted to exclude first-party claims they should have done so expressly.

The court reached a different result in *Open Kitchens, Inc. v. Gullo International Development Corp.*,[7] where the indemnity agreement was read to limit the indemnitee's protection to third-party claims against it. In *Open Kitchens,* the general indemnity language required the contractor to indemnify the owner "from and against all claims, damages, losses, expenses, liabilities, and demands, including attorneys' fees, of whatsoever kind or nature, arising out of, resulting from or connected with the performance of the Work by the Contractor or any Subcontractor."[8]

The *Open Kitchens* court stated that this language would normally be broad enough to include first-party claims. However, that sentence was modified by the next one: "Contractor shall defend at its own expense, any actions based thereon and shall pay all attorneys' fees, costs and other expenses arising therefrom."[9]

The *Open Kitchens* opinion read the words "thereon" and "therefrom" as modifying the phrase "all claims, damages, losses, expenses, liabilities, and demands." It read those two provisions together to limit the indemnity obligation to third-party claims, i.e., "the indemnity was intended to arise only in the context of liability imposed on plaintiff as a result of losses or injuries incurred by third parties."[10]

A comparison of *Water Tower* and *Open Kitchens* underscores the need for precise drafting. To avoid confusion about first-party coverage, the indemnity obligation provision should specify whether it extends to, e.g., "all loss, whether or not involving claims against Indemnitor by third parties," or only to "all loss, arising from claims against Indemnitor by third parties."

No indemnity for defense costs unless expressly mentioned

Another important question is whether an indemnitor must pay the indemnitee's attorney fees if the agreement does not mention "attorney fees" or "defense." Several Illinois cases have found no obligation to pay defense costs in that case.

In *Downs v. Rosenthal Collins Group, L.L.C.*,[11] the court interpreted the following language in an LLC's operating agreement:

> The Company shall indemnify each Member for any act performed by such Member with respect to Company matters permitted by this Agreement and/or Majority Approval, but in no event for fraud, willful misconduct, negligence or an intentional breach of this Agreement.

A member of the LLC argued that this language imposed no limits on the scope of the LLC's duty to indemnify him and thus included his defense costs. The appellate court disagreed, noting that the absence of the terms "defend" or "attorney fees" precluded any reading of the agreement as providing a defense.

Downs was followed in *Northbound Group, Inc. v. Norvax, Inc.*,[12] where the agreement used "indemnify and hold harmless" language to define the scope of the indemnity:

> [Indemnitor] shall indemnify and hold harmless [indemnitee]...from and against any and all losses, costs, third-party claims, damages, liabilities and expenses arising out of or relating to [indemnitor's] performance under this agreement or any claims arising out of [indemnitor's] operation of its business or use of the Assets following the Closing Date.

The *Northbound Group* court held that this language "contains no explicit language creating a right to reimbursement for attorneys' fees and costs."[13]

The court in *Opheim v. Norfolk & Western Railway Co.*[14] construed another "indemnify and hold harmless" clause, under which a trucking company shall

> be responsible for and shall indemnify and hold harmless Railroad Company from any and all loss, damage, liability, cost or expense resulting from injury to or death of persons (including agents,

> servants and employees of the parties hereto) arising out of, directly or indirectly, the performance or attempted performance by Contractor of the services contemplated by this agreement, unless caused by the sole negligence of the Railroad Company, its agents, employees, or servants.

Consistent with *Downs* and *Northbound Group, Opheim* held that under this language, the trucking company "does not agree to assume the defense of actions brought against" the railroad.[15] It also held that the railroad was "not entitled to demand that [trucking company] assume the defense."[16]

A related rule of construction to keep in mind: The fees the indemnitee incurs to bring suit against the indemnitor are not shifted where the agreement provides indemnity for the defense of claims.[17] "Such expenses are not by their nature a part of the claim indemnified against. Rather, they are costs incurred in suing for a breach of contract, namely the failure to make good on the indemnification clause."[18] The parties' litigation fees incurred are subject to the American Rule and are not reimbursable unless the indemnity agreement expressly makes them so.[19]

Caps on amount of indemnity? Nothing in Illinois prevents them

Many purchasers of goods and services, particularly those with strong bargaining positions, demand unlimited indemnity from their vendors or suppliers. But when the vendor is providing a limited service or product, the purchaser might be open to capping indemnity to an amount commensurate with the job.

For example, a tech vendor may want to limit its liability to clients - either in general or for particular disputes (such as, for the clients' costs of defending against costly intellectual property claims) - to the amount of the vendor's fee. Where that fee is not large, it may be commercially reasonable for the vendor to ask to limit its exposure for claims against it arising out of the work. The question for the vendor's lawyer is whether the courts will enforce such an arrangement.

The principal objection indemnitees raise to such limitation is that it violates a public policy - usually contained in a state's so-called "anti-indemnity" statute - against a party being indemnified for its own negligence.[20] However, most of the relevant cases in other jurisdictions have rejected that argument as a basis to ignore contractual caps on indemnity.[21]

No Illinois court appears to have ruled on this question directly, and none have held that contracting parties may not limit the amount of contractual indemnity. Courts elsewhere generally uphold the principle that the parties are free to limit the scope of indemnity. Weighing the scope of indemnity in light of the amount of the transaction is also consistent with Illinois authority.

In *Henry v. Waller*,[22] an attorney argued that an agreement with a bank for an Interest on Lawyers Trust Account (IOLTA) that required him to pay the bank's attorney fees for litigation involving the negotiation of checks with allegedly forged signatures was unfair as "broad," "open ended," and "unlimited." The *Henry* court noted that "no bank would willingly undertake the risk of incurring attorney fees and costs of the magnitude incurred here in return for the privilege of providing a depositor with an IOLTA account that generates a relatively small amount of bank fees."[23] It stated that parties are free to apportion risk as they see fit, and that indemnity agreements are meant to address the types of circumstances presented in that case.

In short, nothing in Illinois statutory or case law prevents parties to an indemnity agreement from capping indemnity at a dollar amount.

Conclusion

The best way to address the scope of contractual indemnity is careful drafting. But it is important to know how the cases treat the scope of indemnity, both to understand how certain terms are construed in court and to advise a client seeking to pursue or defend against a claim for indemnity. Here are specific drafting tips that address the issues raised in this article.

- Consider adding language to the general indemnity clause specifying whether the parties intend to include or exclude first-party claims from the scope of indemnity.
- If attorney fees are meant to be included in the indemnity obligation, say so by using the term "attorney fees," "defense," or both.
- When discussing the defense obligation, state clearly whether you intend to include or limit it. Address it consistent with the language of the indemnity clause (see first tip, above).
- If the parties intend to shift attorney fees in a suit for enforcement of the indemnity, state that expressly.
- Consider a dollar cap on indemnity commensurate with the risks and size of the underlying commercial transaction.

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1. See, *e.g.*, *933 Van Buren Condominium Ass'n v. West Van Buren, LLC,* 2016 IL App (1st) 143490, ¶ 42.
2. See, *e.g.*, *American Management Consultant, LLC v. Carter*, ***392 Ill. App. 3d 39***, 63 (3d Dist. 2009).
3. See, *e.g.*, *933 Van Buren Condominium Ass'n,* 2016 IL App (1st) 143490, ¶ 59.
4. See, *e.g., Board of Managers of Hidden Lake Townhome Owners Ass'n v. Green Trails Improvement Ass'n,* ***404 Ill. App. 3d 184***, 196 (2d Dist. 2010) ("In an indemnity agreement, the indemnitor agrees to protect the indemnitee from claims asserted against the indemnitee by third persons.").
5. *Water Tower Realty Co. v. Fordham 25 E. Superior, L.L.C.*, ***404 Ill. App. 3d 658*** (1st Dist. 2010).
6. *Id.* at 660.
7. *Open Kitchens, Inc. v. Gullo International Development Corp.*, ***126 Ill. App. 3d 62*** (1st Dist. 1984).
8. *Id.* at 64.

9. *Id.* at 65.
10. *Id.*
11. *Downs v. Rosenthal Collins Group, L.L.C.*, ***385 Ill. App. 3d 47***, 49 (1st Dist. 2008).
12. *Northbound Group, Inc. v. Norvax, Inc.*, ***5 F. Supp. 3d 956***, 972 (N.D. Ill. 2013).
13. *Id.*
14. *Opheim v. Norfolk & Western Railway Co.*, ***123 Ill. App. 2d 211***, 214 (1st Dist. 1970).
15. *Id.* at 218.
16. *Id.* at 220.
17. *R.R. Donnelly & Sons Co. v. Vanguard Transportation Systems, Inc.,* ***641 F. Supp. 2d 707*** (N.D. Ill. 2009).
18. *Id.* at 721.
19. *Id.*
20. See Construction Contract Indemnification for Negligence Act, 740 ILCS 35/1 (applying only to construction contracts). There is also a similar provision prohibiting landlords from obtaining indemnity from their lessees for the landlords' own negligence. Lessor's Liability Act, 765 ILCS 705/1.
21. See, *e.g.*, *Thrash Commercial Contractors, Inc. v. Terracon Consultants, Inc.*, ***889 F. Supp. 2d 868*** (S.D. Miss. 2012).
22. *Henry v. Waller*, 2012 IL App (1st) 102068.
23. *Id.* at ¶ 20.