“DEFEND, INDEMNIFY AND HOLD HARMLESS” CLAUSES ARE IN MANY CONTRACTS—BUT WHAT DO THEY MEAN?



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The phase “defend, indemnify, and hold harmless” is found in many, if not most, contracts with liability allocation provisions, across multiple industries. However, many parties do not have a complete understanding of what, exactly, these words mean. The meaning of all three terms varies on a state-by-state basis. Some states require an indemnitor to defend an indemnitee. Some states view the duties to defend and indemnify as wholly separate. Understanding the meaning of this common phrase goes a long way toward ensuring that the parties’ risk allocation choices (and, ultimately, their economic deal) are respected, which is important in the best of times, and vital in the worst.

Indemnification

The concept of indemnification imposes an obligation on one party, the indemnitor, to pay or reimburse another party, the indemnitee, for losses covered in the indemnification provision. The obligation to reimburse or pay arises when an actual loss or liability has occurred. Generally, indemnification arises in two ways: through an express contractual provision or implied in the law. When contained in a contract, the courts will honor its plain meaning and the intent of the parties. Generally, if there happens to be any ambiguity surrounding an indemnity clause, including what it means or its scope, it is typically construed by courts against whomever is seeking indemnification.

As to indemnity implied by operation of law, many states including New Jersey, hold that, absent anything to the contrary in a contract, a person is entitled to an implied indemnity when the implied indemnitor is not at fault and still incurs liability due to the wrongful conduct of another. See Cartel Cap. Corp. v. Fireco of New Jersey, 81 N.J. 548, 566 (1980). In Alten v. Ellin & Tucker,

Chartered, 854 F. Supp. 283, 288-89 (D. Del 1994), the District Court for the District of Delaware also noted that without an express contractual indemnification provision, a party may still rely on implied indemnity where appropriate, such as where there is a contractual relationship between the parties. Importantly, the party seeking to rely on implied indemnity to recover cannot be at fault.

Defend

The duty to defend triggers an obligation to act when a claim, which is covered by the indemnification provision in the contract, is brought by a party against the indemnitee. Polarome Int'l, Inc. v. Greenwich Ins., 404 N.J. Super. 241, 272 (App. Div. 2008). The independent obligation to defend requires the indemnitor to actually defend, finance a defense, or reimburse the indemnitee against any claim brought against it, regardless of the merits of the claim or the outcome. The differences between the duty to indemnify and to defend, while nuanced, are critically important. The obligation to indemnify arises once a judgment has been entered, whereas the obligation to defend is triggered as soon as a claim is filed against the indemnitee.

Most states, including New Jersey, consider the duty to indemnify and to defend to be distinct obligations.

Hold Harmless

The inherent meaning of "hold harmless" is subject to interpretation. The prevailing interpretation is that "hold harmless" and "indemnify" are synonymous. However, under the minority view, "hold harmless" requires payment of both actual losses and potential liabilities, while "indemnify" protects against incurred losses only. The main difference is that "hold harmless" may require a party to protect against actual losses as well as potential losses while indemnification protects against actual losses only.

In New Jersey courts have generally interpreted the obligations to "hold harmless" and "indemnify" as synonymous. See, e.g., Miller v. Hall Bldg. Corp., 210 N.J. Super. 248, 320 (Law. Div. 1985).

Similarly, certain other states, including Ohio, Colorado, Louisiana and Delaware, hold that "indemnify" and "hold harmless" are synonymous. Alternatively, California sees the two concepts as distinct as shown in Queen Villas Homeowners Assn v. TCB Prop. Mgmt., 149 Cal. App. 4th 1, 9 (Dist. Ct. App. 2007). There, the court categorized the obligations to indemnify and hold harmless as offensive
and defensive rights. Indemnification, according to the court, is "an offensive right—a sword—allowing the indemnitee to seek indemnification." Id. On the other hand, hold harmless is a defensive measure providing "[t]he right not to be bothered by the other party itself seeking indemnification." Id. Under this view, hold harmless shields one party from being sued for liability that the other party may incur.

Concerns in the Current Market

Current market conditions have emphasized the importance of ensuring that risk allocations are understood. Whether the obligations that arise under the contractual terms "defend, indemnify and hold harmless" offer meaningful protection, when a party defaults or does not have the financial ability to honor them, creates risk that must be considered at the time of contract. Whether the provisions hold up through bankruptcy and dissolution are also concerns. It is important to realize that the duty to indemnify may not survive bankruptcy as demonstrated recently in Texas. The U.S. Bankruptcy Court for the Northern District of Texas, in In re Superior Air Parts, Inc., 486 B.R. 728, 740 (N.D. Tex. 2012) held that contractual indemnity provisions give rise to a dischargeable claim. In New Jersey, courts consider the nature of the indemnification obligation to determine whether the debt is dischargeable in bankruptcy proceedings. See, e.g., Winegarden v. Winegarden, 316 N.J. Super. 52, 61 (App. Div. 1998).

How can parties in a contract protect their indemnification claims? One option is to insure against the claims. Representation

and Warranty Insurance, Director and Officer Insurance and contingent liability policies have becoming increasingly common vehicles that can provide a financial backstop for risk allocation choices. Being knowledgeable about how defend, indemnify and hold harmless provisions are interpreted and applied is crucial in today's market. A lack of clear understanding about how an indemnification clause will operate may have long lasting and a significant impact. Consider these benefits and risks when drafting your next agreement.

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