

STATE AND LOCAL PROCUREMENT LIABILITY ALLOCATION: CONSTITUTIONAL AND STATUTORY LIMITATIONS

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This paper summarizes common constitutional and legislative limitations¹ on the liability allocation approaches in state and local government contracting.

Requests by contractors for indemnification or hold harmless provisions² often are opposed by governments based on constitutional principles. Other liability allocation techniques, such as warranty disclaimers, damage exclusions, ceilings on contractual damages or other liability, usually are not analyzed in terms of constitutional provisions. These clauses do not create liability of the state flowing to the contractor or a third party, but they limit possible damages that can be claimed against a contractor.

This paper highlights common themes in analyzing the legality of these provisions.

CONSTITUTIONAL LIMITATIONS

State governments are creatures of state constitutions. Local governments and other political subdivisions are usually created by state statutes, although some entities other than traditional executive branch agencies can be created by constitution. Public higher education institutions, for example, sometimes have powers and authorities that are derived from a combination of constitutional and statutory provisions.

But many aspects of a state's constitution limit the powers of all public entities. The most common powers implicated in state and local government contracting – the power to commit public funds – are constrained by constitutional provisions.

In Colorado, for example, revenues are limited by a constitutional provision known as the Taxpayer's Bill of Rights, or TABOR Amendment, an initiated measure passed by the voters in the early 1990s. Indirectly, expenditures and the ability to commit funds through contracting are restricted as well. TABOR applies to all indirect and direct debt incurred by state and local

¹ The term *legislation* will be used to distinguish between state statutes and legislation by local governments that is in a variety of forms, ordinances and charters for example.

² Indemnification provisions contractually require one party to pay the damage awards and defense costs suffered as a result of actions by the other contracting party. A contractual provision that "holds harmless" another party against certain claims similarly creates potential liability of state and local governments and are treated the same as indemnification clauses for purposes of analysis.

governments and generally limits the ability of governments in the state of Colorado to enter into multiyear financial transactions.

While that particular provision is peculiar to Colorado, other common state constitution provisions limit the ability of governments to pledge credit and engage in practices that favor individual companies. But in general, state and local governments draw distinctions between affirmative indemnification obligations and the limitation of on damages or the liability of contractors.

Constitutional Debt and Other Provisions Limiting the Pledging of State Credit

The Colorado Constitution, art. XI, Section 3, is typical. It provides, “The state shall not contract any debt by loan in any form . . .” States have varying approaches to limitations placed on debt or extending state credit that are implicated in financing transactions such as lease-purchase. In Colorado, discretionary or contingent obligations generally are not constitutional debt. To constitute debt in the constitutional sense, one legislature, in effect, must obligate a future legislature to appropriate funds to discharge the debt created by the first legislature. For the most part, Colorado state contracts having non appropriation clauses are not considered unconstitutional debts that bind future legislatures.³

Some states analyze indemnification clauses as *debt*. In New Mexico, for example, an indemnification provision implicates the constitutional debt limitations because it is considered a contingent liability, the amount of which is uncertain at the time of the agreement.⁴ Some states – Colorado included – construe the no-debt provisions more narrowly. For example, where a clause can be drafted to reflect existing liability, there would be no lending of credit, donation, or assumption of liability.⁵ In Colorado, the presence of a non appropriation clause solves the problem of *debt* in a constitutional sense for apparently multiyear obligations.⁶

Prohibition on Donations, Grants and Aids to Corporations

Constitutions may prohibit donations or grants to corporations. In the Western states, these constitutional provisions were an outgrowth of special relationships that developed with the railroads in the latter nineteenth century.

³ See, for example, *Gude v. City of Lakewood*, 636 P.2d 691 (Colo. 1981). In Colorado, any commitment voucher that provides that the financial obligations of the state in subsequent fiscal years are contingent upon funds for that purpose being appropriated, budgeted, and otherwise made available are not deemed to create a state multiple-fiscal year direct or indirect debt or other financial obligation for purposes of section 20(4)(b) of article X of the state constitution. Section 24-30-202(5.5), C.R.S.

⁴ See N.M.Op. Att’y Gen. 00-04 (2000). See also Okla. Op. Att’y Gen. 06-07 (2006).

⁵ See, e.g., Tex. Att’y. Gen. Op. LO-90-107 (1990).

⁶ *Gude*, *supra* note 3.

A literal application of the rule would preclude most economic incentive programs in states that provide tax breaks or other incentives for corporate relocation or even sports stadium construction. The Colorado Attorney General has concluded that recent analysis of these provisions now focuses upon whether the public entity received some benefit in return for the benefit conferred on the private corporation and whether a "public purpose" exists to justify the legislation.⁷

Public Purpose Doctrine

The Colorado Attorney General has said that for all intents and purposes the public purpose doctrine is an exception that has swallowed the constitutional rules limiting donations and grants in aid to corporations.⁸ A legislative declaration of a "valid public purpose" makes the prohibitions on pledge of credit and aid to corporations inapplicable.⁹ Other states also have indicated that adequate consideration for the totality of the contractual obligation satisfies the *public purpose* exception.¹⁰ The *public purpose* doctrine is not applied as an exemption to prohibitions on general obligation debt.

No Disbursement Except Upon Appropriations Made by Law

Constitutions commonly include limitations on disbursements, requiring them to be based on appropriations by the legislature. If one goes back to the early days of state contracting, one can find small disbursements authorized by specific legislative appropriations. Over time, though, the practical realities of government and the growing complexity of financial transactions resulted in broad delegations of contracting authority, often coupled with approval requirements by named officers, like controllers.¹¹

⁷ Colo. Att’y Gen. Op. No. 91-4 (1991) (Proposed tax incentive legislation concerning construction of a new United Airlines aircraft maintenance facility was constitutional based among other reasons on the ‘public purpose’ doctrine), *citing* McNichols v. City and County of Denver, 131 Colo. 246, 280 P.2d 1096 (1955) (city contribution to police pension fund for distribution to pensioners was not a donation where there was a public purpose served by pensions for public employees)

⁸ Colo. Att’y Gen. Op. No. 91-4 (1991), *supra* note 7.

⁹ Interrogatories re: House Bill No. 1247, 193 Colo. 298, 566 P.2d 350 (1977)(en banc). Ginsberg v. City and County of Denver, 164 Colo. 572, 436 P.2d 685, 689 (1968) (scheme involving City revenue bonds and sale and lease-back contract, by which City acquired Mile High Stadium, held not an unconstitutional debt and in furtherance of a valid public purpose -- recreation).

¹⁰ *See, e.g.*, Ohio Att’y Op. Gen. No. 96-060, (1996); 78 Ops. Cal. Atty. Gen. 238 (1995) (presuming consideration was adequate for the risk indemnity).

¹¹ In Colorado state contracting, the Controller examines commitment vouchers to determine whether the prices or rates are “fair and reasonable.” Section 24-30-202(2), C.R.S. State contracts are also reviewed by the Attorney General for legal sufficiency.

The Oklahoma Attorney General squarely grounds its prohibition of indemnification provisions in the appropriation sections of the Oklahoma constitution. In response to a request about authority to indemnify the Department of Defense for claims arising out of use of DoD-provided equipment under the counter drug program, the Oklahoma Attorney General found the indemnification to be a violation of the balanced budget provisions of the Oklahoma constitution. The opinion reasoned that the amount of the contingent liability was uncertain in amount and for an indefinite term, with the possibility of a financial obligation in excess of the unencumbered amount of the cash on hand.¹²

STATUTORY AND OTHER LEGISLATIVE LIMITATIONS

In general, no public officer can enter into a valid contract without first having been delegated that power by the legislative body. Apart from requisite authority, state and local governments have broad discretion to set contract terms and conditions. But the competing principle is that payments are subject to the appropriation authority of the legislative body. Yet, an official authorized to enter a contract on behalf of a state or local agency necessarily has broad authority to agree to terms that are reasonably related to the bargain.

Express Legislative Authority

Colorado does not constitutionally prohibit indemnification. Some indemnification provisions are expressly authorized by state statutes – without having to encumber funds to pay the potential liability. On the one hand, the existence of statutory authority supports a conclusion that the prohibition is not a constitutional one. By the same token, though, specific legislative authorization suggests that the authority to indemnify must be expressly granted.

For example, various Colorado statutes authorize a limited “hold harmless” provision for state leases when approved by the state risk manager, indemnification of civilian defense workers, indemnification of livestock owners for outbreaks of infectious disease, indemnification by the hospital authority of the Regents of the University of Colorado upon transfer, and water system/facility entities to ‘justly indemnify’ property owners or others affected for any losses or damages incurred, including reasonable attorney fees, or that may subsequently be caused by such corporations.

In the face of such specific legislative authority, one has difficulty finding implied authority for indemnification. Synthesis of Colorado case law leads to the conclusion that an

¹² Okla. Att’y Gen. Op. No. 96-007 (1996). *See also* N.D. Att’y Gen. Op. No. 2002-L-21 (2002) (finding statutory authority for indemnification, but requiring inclusion of a non appropriation clause and identification of the funds to fulfill the indemnification obligation). In Texas, the Attorney General found legislative authority, and although the “hold and save harmless” provision created an indeterminate future liability to a third party, the county could agree to it if it levied the tax and established the sinking fund required by the constitution. Tex. Att’y Gen. Op. GA-1076 (2004).

agency has no authority to agree to an indemnification provision that is 1) a contingent liability, 2) not merely incidental to the transaction, and 3) without legislative authorization.¹³

The contracting policy in Colorado reflects this basic prohibition on indemnification of contractors by the state. The *Colorado Contract Procedures and Management Manual* says, with respect to indemnification, that agencies “may not promise anything on behalf of the state, which may create a claim against funds held by the state unless you have an appropriation to pay for it.”¹⁴

In general, affirmative indemnification (and hold harmless provisions) are not permitted by the states.¹⁵ Some prohibitions are grounded in constitution, others on statutes, and others by the practical difficulty of complying with the legal prerequisites: use of a non appropriation clause and set aside or identification of appropriated funds sufficient to discharge the liability. Colorado permits indemnification provisions in specified circumstances (leases, for example), but there is no statute granting general authority to indemnify contractors in state contracts.

Indemnification and Other Liability Limitation Provisions Distinguished

Apart from indemnification provisions, generally one does not find constitutional and statutory analysis of other limitation of liability provisions in state attorney general opinions. Colorado’s contract manual was developed with attorney general participation and includes model liability allocation provisions: warranty disclaimers, damage exclusion provisions, and recommended intellectual property indemnification clauses (that provide some defense control to the contractor).¹⁶

In Colorado, the form of commitment vouchers (i.e. state contracts and purchase orders) is regulated by the State Controller. The Fiscal Rules set forth a limitation of liability policy:

¹³ Reimer v. Town of Holyoke, 93 Colo. 571, 27 P.2d 1032 (1933); Johnson v. McDonald, 97 Colo. 324, 49 P.2d 1017 (1935). *See also* Montgomery v. City and County of Denver, 102 Colo. 472, 80 P.2d 434 (1938)(approving city’s ordinance requiring city to satisfy bond deficiencies); City of Trinidad v. Haxby, 136 Colo. 168, 315 P.2d 204 (1957).

¹⁴ *Colorado Contract Procedures and Management Manual*, p. 6-57 (2d Ed. 2005), available on-line at www.colorado.gov/dpa/dfp/sco, hyperlink to Alphabetical Index, Contract Procedures and Management Manual.

¹⁵ Some attorney general opinions suggest a limited rationale for justifying contingent liabilities. *See, for example*, 71 Md. Op. Atty. Gen. 274 (1986) (limited indemnity of vendor for damage associated with use of product, consistent with commercial practice, might be permissible); City of Big Spring v. Board of Control, 404 S.W.2d 810 (Tex. 1966) (permissible where duration and extent of liability controlled by agency).

¹⁶ Chapter 6, Appendix A, of the *Colorado Contract Procedures and Management Manual*, *supra* note 14.

State agencies and institutions of higher education may agree to commercially reasonable limitation of liability/remedies provisions, or exclusion of consequential damages, so long as in the case of transactions in goods involving tangible risk from the nature of the goods, and in the case of all services, limitations of liabilities or exclusion of consequential damages exclude from their provisions damages and claims arising out of bodily injury (including death) and damage to tangible property.¹⁷

The contrast between the states of Oklahoma and Colorado is informative. In 2006, the Oklahoma Attorney General issued an opinion that restricted the authority, not only to indemnify and hold harmless, but to agree to other limitation of liability provisions as well.¹⁸ The opinion confirmed Oklahoma's historical prohibition on indemnification. But the opinion went on to embrace damage exclusions and limitations of liability as well. The attorney general opinions of other states cited in the Oklahoma opinion likewise prohibited indemnification of contractors by state and local governments. But those opinions did not go so far as to prohibit liability allocation techniques such as consequential and special damage exclusions and ceilings on contract damages.

The Oklahoma opinion did not explain how the analysis of potential liability *of* the state was analogous to the questions of liability limitation with respect to actions against the contractor, although a previous referendum on the issue may explain the opinion.¹⁹ Indemnification and hold harmless provisions create affirmative financial obligations; they impose potential financial liability of governments that flow to contractors. Limitation of liability provisions, on the other hand, limit or cut off potential claims by a government against a contractor. But they do not impose an obligation in the sense that an appropriation would be required to support a subsequent payment of money by the state or local governments to a contractor or third party.

Considerations of Sovereign or Governmental Immunity

The 2006 Oklahoma opinion combines principles of tort liability and contract liability. The opinion begins by noting that the contract provisions under consideration require the state to bear the risk of the vendor's intentionally wrongful acts or negligence in addition to the State's own. At least under Colorado practice, this kind of a liability allocation likely would not have been accepted during contract review by the Attorney General's office. Provisions are

¹⁷ Colorado Fiscal Rule 2-2, p. 21, 1 CCR 101-1.

¹⁸ Okla. Att'y Gen. Op. 06-017 (2006).

¹⁹ Oklahoma had a referendum on the issue of liability allocation. In 2002, a measure was referred by the Oklahoma legislature to the people. The referendum specifically asked the people to authorize limitation of liability clauses. The measure was defeated, posing a challenge for anyone to then argue that there was implied authority to agree to limitation of liability provisions.

traditionally tailored so the contractor is responsible at least for claims arising out of its own negligent or intentional acts.

The Oklahoma opinion intertwines notions of negligence in liability allocation – a tort concept – with contract breach principles. Other liability limitation clauses typically do not condition their operation on “negligence” of the contractor. Normally, one does not want the intentional or negligent nature of performance to enter into contractual liability allocation and performance remedies.

Analysis of these provisions is complicated by the existence of governmental immunity. It is common for state statutes to waive sovereign immunity of state and local governments for a narrow range of torts. Federal Constitutional torts aside – that are not limited by states’ government immunity statutes – states commonly waive immunity for common torts like claims arising out of negligent operation of government motor vehicles or dangerous conditions of public roads and buildings. On the other hand, the states often do not waive immunity for torts like defamation and infliction of emotional distress.

Indemnification provisions are often included in public contracts for the benefit of the government. The provisions require the contractor to assume liability (including defense costs) for claims and damages arising under the contract. These provisions typically are carefully drafted so they are not construed as a waiver of government or sovereign immunity. They are intended to require the contractor to provide a defense and satisfy any resulting liability if the underlying basis for the action arose from the contractor’s performance.

Even where these provisions exist, state and local governments remain protected by sovereign immunity concepts.²⁰ So, for example, if a local government is sued for an automobile accident in which a contractor employee is driving, the state may have defenses. The effect of a contractual indemnity is to shift to the contractor responsibility for the costs of pleading that defense and satisfying the subsequent judgment if one is entered against the state. On the other hand, a claim against the state (and contractor) based on the tort of business defamation likely would be subject to dismissal under most state government immunity statutes. Nevertheless, there are costs incurred by a government in defending such an action, and the indemnity shifts the defense costs to the contractor, even if the only cost is the preparation of a motion to dismiss.

Occasionally public entities agree to include *fault* conditions into otherwise broad indemnification provisions written for their benefit. Contractors do not favor strict liability, obviously. Negotiating *fault* standards into an indemnification provision may help a contractor insure against tort risk and possibly avoid an insurer’s claim that the contract expanded the nature of the liability that is not covered by otherwise available insurance. Of course, there are

²⁰ This is not to minimize the possible of issues of intent that can arise through use of these provisions. Third parties may argue that an indemnification clause represents a waiver of sovereign immunity under third party beneficiary principles. There may be an issue about whether the clause was intended as a waiver to the extent of available insurance coverage. These are important issues that should be addressed by careful drafting of contract language.

some kinds of performance where strict liability may more reasonably be assumed by a contractor, who may be in a better position than the public entity to assume the risk. Inherently hazardous activities (like blasting) may be an example under some state laws where strict liability standards apply to the activity. In that kind of contract, one would not want to limit indemnification to “negligent or intentional acts” of the contractor.

Traditionally, these kinds of considerations are the subject of negotiations. The Colorado State Controller places a caveat on the state’s limitation of liability policy. Colorado limits the operation of the clauses to damages and claims “other than bodily injury (including death) and tangible property damage.” That way, indemnity for the common damages and claims that are waived under its governmental immunity statutes is preserved. Any deviation from that policy requires approval by the attorney general’s office.

In many ways, the Oklahoma opinion mirrored common approaches to negotiation of limitation of liability provisions by state and local attorneys. For example, the opinion spotted an inadvisable limitation of liability clause in the context of a software contract. The proposed limitation of liability clause limited its applicability to claims of “tangible personal property damage” but then defined that term to exclude software, data, and other types of property that may have been likely candidates for claims of damage given the nature of the performance. In that case, because the definition excluded a likely type of damage that might flow from the contract performance, other states’ attorney generals probably would have found the definition objectionable as well and in need of further negotiation. But the Oklahoma Attorney General’s outright prohibition on negotiating limitation of liability provisions is unusual.

Drafting Around the Limitations “to the Extent Authorized by Law”

In the Oklahoma request-for-opinion, the agency asked whether the prohibitions could be avoided by conditioning liability limitation provisions with a provision along the lines of, “to the extent authorized by law.” The opinion seemed to invite this approach, “This statement is not prohibited in state contracts, but is superfluous.” At least one Oklahoma agency has drafted around the apparent limitations on use of traditional liability allocation techniques.²¹

¹⁸ A recent contract provision found on the internet illustrates the impact on Oklahoma contracting from drafting around the apparent limitation on authority imposed by the Attorney General Opinion:

Limitation of Liability. Vendor's aggregate liability under this Agreement shall be limited to the maximum amount paid under this Agreement during its initial term. In no event shall the vendor be responsible for any indirect, incidental, special, punitive or consequential damages. The foregoing limitation shall not apply to negligence, intentional misconduct, or claims related to infringement of intellectual property rights of third parties. On April 14, 2006, the Attorney General of Oklahoma issued Attorney General Opinion No. 06-11 that, among other things, opined that under the Oklahoma State Constitution contractual limitation of liability provisions

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Other states that have considered the technique disapprove it.²² These attorney opinions find the provisions void, even with the disclaimers.

Yet, sometimes insertion of the term “to the extent authorized law” may be negotiated to reflect the belief that the liability allocation provision – even indemnity – is warranted and intended to be effective by the parties, except that there is an apparent limitation on authority to agree to the provision.

Copyright indemnity may be a good example. Governments have the ability to control the risk of infringement from piracy and unauthorized use of software and other works. They also can control the extent of damages by directing cessation of offending uses once they receive notice.²³ Where third party software is provided under a contract, and the contractor wants some assurances that it will not be liable for license rights infringement, an indemnity provision may be commercially reasonable. If a contracting officer negotiated a commercially reasonable provision to cover statutory penalties and other copyright damages, subject only “to the extent authorized by law,” and the parties clear intent was to have the provision effective to the extent it could be enforced, then it is unclear what effect the provisions would have: whether the attorney general would have an obligation to press for voiding the provisions, what effect a court would

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contained in agreements with State agencies are void and unenforceable unless the amount of liability the State assumes is certain and budgeted for. While the Parties to this contract acknowledge the Attorney General's Opinion, the Parties further recognize that Contractor disagrees with the Attorney General's Opinion and contends that contractual limitation of liability provisions such as the one contained in this contract are enforceable and do not violate the State Constitution. As a result in the event that Parties to this contract have a dispute in which the enforceability of a contractual limitation liability clause is relevant, then Parties agree that either Party may initiate suit in the State District Court for Oklahoma County seeking a declaratory judgment or any other relief available in law or equity regarding, among other things, the enforceability of a contractual limit of liability. Further the Parties shall have the right to appeal any ruling from the District Court to the extent permitted by applicable law.²¹

To the extent any limitation of liability contained herein is construed by a court of competent jurisdiction to be a limitation of liability in violation of Oklahoma law, such limitation of liability shall be void.

²² S. C. Att’y Gen. Op., Oct. 20, 1971 (no authority to indemnify with condition “insofar as it lawfully may”). *See also* Ohio Att’y Gen. Op. No. 2005-007 (2005); Miss. Att’y Gen. Op. No. 2002-0488 (2002).

²³ Higher education institutions have special challenges in purchasing software for student use.

give the provision, etc. Given the uncertainty, these to-the-extent-authorized-by-law provisions are not very good solutions.

CONCLUDING OBSERVATIONS

For the most part, state and local procurement accommodates common commercial approaches to liability allocation. The Oklahoma attorney general opinion may have been an aberration explained in part by the fact that a referred measure on limitation of liability authority was defeated by Oklahoma's citizens in 2002.

In the case of indemnification by governments in particular – generally considered to violate constitutional or statutory limitations -- there is significant time and effort expended in negotiating these provisions. In some cases – intellectual property infringement is an example – the ability to agree to limited indemnification by a government would be consistent with commercial practices and easily harmonized with governmental immunity statutes.

Most attorney general opinions would approve of a statutory scheme that overtly recognizes authority to agree to indemnification and other contingent liabilities. Such legislation could provide general standards (e.g. consistency with commercial practice), prescribe a process, and grant approval authority to an official (the attorney general, controller, or purchasing director for example). Such legislative authorization would go a long way to making the contracting process more efficient.

In the case of local governments and political subdivisions, they would legislate to grant authority to their officials. But state action would at least eliminate the concerns that there are constitutional impediments in those states where the constitution is not interpreted as an obstacle to commercially reasonable liability allocation provisions.

Further, express statutory authorization would avoid the often creative, less-than-constructive methods that are being used to get contracts executed.

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