"To the Extent Permitted By Law"
Indemnification Provisions in Contracts with Special Districts

Jeffrey E. Erb, Esq.
Seter & Vander Wall, P.C.

Negotiating a contract between a private entity and a Colorado special district presents unique issues. One issue is whether to include an indemnification provision in the contract. In its most basic sense, an indemnification provision is a clause in which a party agrees to compensate another party for a loss or damage sustained.[1] Although common in contracts among private entities, an indemnification provision in a special district contract is problematic because the provision may create an open-ended obligation on the use of public money. Recognizing this problem, indemnification provisions in which a special district agrees to indemnify a private entity often begins with the words, "To the extent permitted by law." This language should alert the private entity that there may be a problem with the provision's enforceability.

The enforceability of an indemnification provision in a contract with a special district has not been addressed in Colorado. However, based on the language of the Colorado Constitution, Colorado statutes, and the treatment of substantially the same question in other states, it is highly likely that an indemnification provision in a contract between a private entity and a special district is unenforceable.

Colorado Constitution Article XI, sections 1 and 2

Two sections of the Colorado Constitution suggest that an indemnification provision in a contract between a special district and a private entity is unenforceable.

Article XI, section 1 states:

> Neither the state, nor any county, city, town, township or school district shall lend or pledge the credit or faith thereof, directly or indirectly, in any manner to, or in aid of, any person, company or corporation, public or private, for any amount, or for any purpose whatever; or become responsible for any debt, contract or liability of any person, company or corporation, public or private, in or out of the state."

This section has been "construed as prohibiting a town or city by its own voluntary corporate act from pledging its credit to, or becoming responsible for, any debt, contract or liability in aid of a third party."[2]

Article XI, section 2 states, in part:

> Neither the state, nor any county, city, town, township, or school district shall make any donation or grant to, or in aid of, or become a subscriber to, or shareholder in any corporation or company or a joint owner with any person, company, or corporation, public or private, in or out of the state[.]

Although Colorado courts have not applied these sections to the question of whether an indemnification provision in a contract between a special district and a private entity is enforceable, other states with similar constitutional restrictions on the mingling of public money with private enterprise have indicated that such provisions are unenforceable.

In 1984, the Florida Attorney General considered whether the City of Chiefland may enter into a contract whereby the city agreed to indemnify a private, for profit health care center for financial losses the center might suffer over a two-year period.[3] Relying in part on article VII, section 10 of the Florida Constitution, which states, "Neither the state nor any county, school district, municipality, special district, or agency of any of them, shall become a joint owner with, or stockholder of, or give, lend or use its taxing power or credit to aid any corporation, association, partnership or person," the Attorney General concluded that such an arrangement is prohibited because it would "impose a new financial obligation upon the municipality which would create a municipal debt for the benefit of a private enterprise," and would "primarily serve a private as opposed to a public interest[.]"[4]

The reasoning used by the Florida Attorney General is persuasive in Colorado because the language of article XI, sections 1 and 2 is very similar to the language of article VII, section 10 of the Florida Constitution. By entering into a contract with an indemnification provision, a special district would essentially pledge its credit in aid of a private entity, a violation of article XI, sections 1 and 2.

There is one exception to the prohibition on the use of public money in aid of a private entity: the public purpose exception. The public purpose exception is a judicially recognized exception to the prohibitions set forth in article XI, sections 1 and 2. Although not specifically defined in Colorado, a public purpose that will justify the expenditure of public money generally

means “an activity as will serve as a benefit to the community as a body and which, at the same time, is directly related to the functions of government.”[5]

Application of the public purpose exception to an indemnification provision presents a fundamental problem: the public purpose exception has only been applied to determine whether an entire project is for a public purpose and not to determine if a particular provision in a contract is permitted. Arguably, if the contract serves a valid public purpose, the indemnification provision could be included as part of the public purpose. However, even if an indemnification provision did fall under the public purpose exception, it would likely still run afoul of other Colorado legal requirements.

TABOR

The Taxpayer’s Bill of Rights (”TABOR”), article X, section 20 of the Colorado Constitution, limits the amount of money the state or any local government can receive as revenue in any given year. Section 20(4)(a) of TABOR requires voter approval if the state or a local government wishes to create a multi-year direct or indirect debt or other financial obligation without adequate present cash reserves pledged irrevocably and held for payments in all future fiscal years.[6]

No Colorado court has applied TABOR to determine the validity of an indemnification provision in a contract with a special district. However, the New Mexico Attorney General concluded that indemnification provisions are not permitted for reasons that likely would also invalidate an indemnification provision under TABOR.

In New Mexico, Pepsi-Cola Co. (“Pepsi”) and the City of Rio Rancho (the “City”) entered into a contract that gave Pepsi exclusive rights to sell its products on City premises, including athletic fields, concession stands, parking lots, and vending areas in City buildings.[7] The contract contained a clause where the City agreed to:

> indemnify and hold [Pepsi], its subsidiaries, affiliates or assigns harmless from and against any and all suits, actions, claims, demands, losses, costs, damages, liabilities, fines, expenses, and penalties (including reasonable attorney’s fees) arising out of: (i) its breach of any term or condition of this Agreement; and/or (ii) the negligence or willful misconduct of the City of Rio Rancho[.]

The attorney general concluded that this clause violated New Mexico's constitutional provisions prohibiting a municipality from (1) contracting for any debt unless the municipality ultimately receives voter approval for the debt and (2) obligating itself to pay out of general revenues beyond the current fiscal year.[8]

Similar to the two reasons relied upon by the New Mexico Attorney General to invalidate the contract clause, TABOR also prohibits the imposition of debt and multi-year financial obligations without voter approval. Thus, applying the reasoning set forth by the New Mexico Attorney General, TABOR would likely render an indemnification provision between a special district and a private entity unenforceable.

Colorado Statute

Section 24-91-103.6(1), C.R.S. states:

> No public entity shall contract with a designer, a contractor, or a designer and contractor for the construction, the design, or both the construction and design of a public works project unless a full and lawful appropriation when required by statute, charter, ordinance, resolution, or rule or regulation has been made for such project.

Section 24-91-103.6(1) has not been applied to indemnification provisions in Colorado. Nevertheless, it may prohibit a special district from entering into a contract with an indemnification provision because the amount of money a special district may be required to spend to comply with the indemnification provision is unknown. As a result, a special district will be unable to appropriate funds to cover the potential cost of its indemnification obligation.

Utilizing similar reasoning, the Oklahoma Attorney General issued an opinion in 2001 analyzing a contract provision limiting the liability of a private vendor providing goods or services to the State of Oklahoma by (1) holding the vendor harmless for his action and (2) limiting the State's legal rights by capping the amount the State could receive as damages due to the vendor's negligence.[9] The Attorney General opined that such a provision was not permitted because "a State agency may not enter into a procurement contract limiting the liability of a private vendor, because a contingent obligation would arise for which no appropriation had been made[.]"[10]

Together, the language of § 24-91-103.6(1) and the reasoning used by the Oklahoma Attorney General suggest that because an indemnification provision creates an unknown financial obligation, it may be unenforceable.

Conclusion

The foregoing is a brief discussion of some reasons that a special district's agreement to indemnify a private entity may be unenforceable. A special district should strive to utilize these arguments to persuade private entities to eliminate indemnification provisions from public contracts. By having the indemnification provision removed, the special district may be able to avoid subsequent litigation regarding its obligation to indemnify the private entity. However, until the validity of an indemnification provision with a special district is addressed by Colorado courts, special districts will continue to alert the private entity that the indemnification provision is only enforceable to the extent permitted by law.

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[1] *See* Black's Law Dictionary (8th ed. 2004).
[2] *Town of Valverde v. Shattucket, et al.*, 19 Colo. 104, 116 (1890).
[3] Fl. Att'y Gen. Op. No. 84-103 (1984).
[4] *Id.*
[5] Sanda M. Stevenson, Antieu on Local Government Law § 67.04[1] (2d ed. 2003) (citing *Visina v. Freeman*, 89 N.W.2d 635, 643 (Minn. 1958)).
[6] Article X, section 20(4); § 1-41-101, C.R.S.; *Nicholl v. E-470 Public Highway Authority*, 896 P.2d 859 (Colo. 1995).
[7] N.M. Att'y Gen. Op. No. 00-004 (2000).
[8] *Id.* at 3-4.
[9] Ok. Att'y Gen. Op. No. 01-002 (2001).
[10] *Id.*