The "Duty to Defend" Your Client

Implications of Two Recent California Court Decisions and the Impact of SB 972

April 2011

By Jeffrey W. Cavignac, CPCU, ARM, RPLU, CRIS
President/Principal, Cavignac & Associates

Introduction

An indemnification agreement contractually transfers risk from one party to another. In typical owner/ design professional agreements, owners require design professionals to hold them harmless and indemnify them. On many occasions owners will also request a defense. We have always counseled our design professional clients not to accept the express obligation to defend, since in the absence of proven negligence this is not considered insurable under typical professional liability policies offered to architects and engineers.

This issue was brought to bear in two recent California Court decisions. Both these cases reiterated that the express "duty to defend" was separate from the "duty to indemnify," and that a downstream indemnitor could be responsible for paying the upstream indemnitee's legal fees even if the downstream party was determined to have done nothing wrong!

The Cases

The Crawford Case

The California Supreme Court decided the Crawford case in July of 2008. Crawford, a developer, contracted with Weather Shield to provide windows for a project. In the contract between the two parties, Weather Shield was obligated to not only indemnify and hold Crawford harmless, but also to *"defend any suit or action brought against Crawford founded upon the claim of such damage...."*

Several years after the project was completed, some homeowners filed suit against Crawford, alleging, among other things, that the windows were defective. Crawford incurred legal fees to defend the claim, and ultimately settled with the homeowners and all the cross-defendant subcontractors except for Weather Shield (and one other party).

Crawford then brought an indemnity action against Weather Shield, attempting to recover what it paid for indemnity as well as its legal costs for the window issues in the homeowner litigation. The lower court ruled that even though Weather Shield was found not negligent, the firm still had an obligation to pay Crawford's legal fees. The rationale was that the "obligation to defend" was a separate issue from the "obligation to indemnify." The California Supreme Court upheld the decision.

The "Duty to Defend" Your Client

The Cases (continued)

The Crawford Case (continued)

In a nutshell, even though Weather Shield was not at fault, it was still held responsible for the indemnitee's (developer Crawford's) legal defense fees for the homeowner litigation. This is problematic for any contractor, subcontractor, supplier, consultant, or anyone else who agrees to "defend" an upstream party. Not only is it unfair; it may not be covered by commercial general liability (CGL) policies, and it is definitely not covered by a professional liability policy.

The CH2M Hill Case

A similar case was tried by a California Appellate court in early 2010. *UDC v CH2M Hill* (the CH2M case) was the first litigation to interpret a design professional's duty to defend subsequent to the Crawford case.

CH2M Hill was retained by the developer (UDC) to provide engineering and planning services in connection with a residential development. CH2M Hill was contractually obligated to *"indemnify ... Developer ... from and against any and all claims…to the extent they arise out of or are in any way connected with any negligent act or omission by Consultant...."* Furthermore, *"Consultant agrees, at his own expense, and upon written request by Developer or Owner of the Subject Property, to defend any suit, action or demand brought against Developer or Owner on any claim or demand covered herein."*

After construction was completed, the homeowners association sued the developer, UDC, for various construction defects. UDC cross-complained against numerous subcontractors, including the engineering firm CH2M Hill. Ultimately, UDC settled with all of the subcontractors except CH2M Hill. This case went to trial. The jury ruled unanimously that CH2M Hill was not negligent and had not breached its contract. Relying on the Crawford case, however, the jury ruled that, despite the fact that CH2M Hill was not negligent, it was still liable for UDC's defense costs.

Under the court's interpretation, the duty to defend began when the homeowners association made claims implicating CH2M Hill's work. The UDC case, in essence, demonstrates that the Crawford case holding will be applied to virtually anyone who enters into an express indemnification agreement that includes the duty to defend.

California Civil Code Section 2782

The court in Weather Shield also clarified how the duty to defend was to be interpreted under California Civil Code Section 2782. The court clarified that the duty to defend is inherent to the duty to indemnify. In other words, there does not have to be an "express" requirement for defense; rather, it is built in to the indemnity obligation. Rule 4 of Section 2782 states *"the indemnitor is bound on request of the indemnitee to defend actions or proceedings brought against the indemnitee in respect to the matters embraced by the indemnity."* In other words, if there is no express statement that the indemnitor is not providing a defense, then the duty to defend exists.

The "Duty to Defend" Your Client

Senate Bill 972

Senate Bill 972 was signed into law by Governor Arnold Schwarzenegger on September 29, 2010. SB 972 was an effort by the American Council of Engineering Companies of California (ACED California) and others to reverse the decisions in both the Crawford and CH2M Hill cases.

As originally written, the bill tied the design professional's obligation to defend or reimburse legal fees to the design professional's proportionate negligence. Unfortunately, as is so often the case, the final bill is substantially different from the original.*

As signed, the new law makes it illegal to *"... require a design professional to indemnify (including the duty and cost to defend a public agency except for claims that arise out of, pertain to, or relate to the negligence, recklessness, or willful misconduct of the design professional."* The phrases "arise out of," "pertain to," and "relate to" are vague. If an upstream party alleges that a design professional was negligent, is that enough to trigger an immediate duty to defend? It is unclear, and opinions vary. Ultimately, these questions will probably be answered by the courts, but this, however, may take some time.

** A copy of SB 972, including the Legislative Counsel's Digest, follows this article*

Insurability

Professional liability policies written for design professionals all have contractual exclusions built into the policy form. A typical exclusion reads:

> *This policy excludes claims that are related to liability assumed by you under any "contract." This exclusion does not apply if you would have been liable in the absence of that "contract" due to your error, omission, or negligent act."*

In other words, a design professional can agree to hold harmless and indemnify a third party for the consequences of the design professional's negligence, but anything that goes beyond the design professional's negligence is not covered. The obligation to defend the client in the absence of the design professional's negligence or other obligations arising solely from the professional services contract would not be covered. Note that if it is ultimately determined that the design professional is negligent, then the defense costs incurred by the upstream indemnitee would be covered.

A question commonly asked by design professionals is, "*Why can't we buy insurance for this?"* Putting aside the fact that it is terribly unfair to ask the design professional to be responsible for defending the client for anything "related to or arising out of" a design professional's work, it is something the insurance industry is simply not willing to take on, nor should design professionals want it to. If the obligation to fund a defense up front was insurable, anything remotely related to the design of the project would be tendered to the design professional. Loss costs would go through the roof, premiums would sky rocket, and the deductible burden foisted on to the design professional would be massive.

The "Duty to Defend" Your Client

So What Is a Downstream Party to Do?

What is clear is that the immediate obligation to defend, whether it is express or implied, is uninsurable under professional liability policies written for design professionals. So what is a downstream indemnitor to do?

If possible, all problematic contract provisions need to be negotiated out of the agreement. In order of priority, you should seek the following:

1. Try to avoid contractual indemnity provisions.
2. If you must agree to contractual indemnity, seek to make it reciprocal.
3. If you must agree to a unilateral indemnity, make certain that it is tied to your negligence; also be sure that there is an express rejection of the obligation to defend. You might consider something like this:

   Notwithstanding any clause or provision in this Agreement or any other applicable Agreement to the contrary, Consultant agrees to indemnify and hold harmless (but not defend) the Client, its officers, directors and employees from and against damages and costs (including reasonable attorneys fees and cost of defense) that Client is legally obligated to pay, to the extent caused by the negligent act, error or omission of the Consultant or anyone for whom the Consultant is legally responsible, subject to any limitations of liability contained in this Agreement.

   Consultant shall have liability for reasonable and necessary defense costs incurred by persons indemnified to the extent caused by Consultant's negligence herein and recoverable under applicable law on account of negligence.

4. If the "obligation to defend" cannot be deleted, then seek to tie it to a negligence standard. Consider the following example:

   Consultant agrees, to the fullest extent permitted by law, to defend, indemnify and hold Client harmless against damages, liabilities and costs caused by the negligent acts, errors or omissions of Consultant in the performance of professional services under this Agreement, but only to the extent that Consultant is responsible for such damages, liabilities and costs on a comparative basis of fault between the Consultant and the Client after adjudication in a Court of Competent Jurisdiction. Consultant shall not be obligated to defend or indemnify Client for the Client's own negligence or for the negligence of others.

Option 4, while better than an unqualified express obligation to defend, may not accomplish your objective. It is conceivable that a court may interpret this clause to mean that a separate duty to defend exists in addition to the duty to indemnify, and that the sub-consultant (downstream party) is required to begin defending the client (upstream party) as soon as a claim is tendered by the client, even if no determination of negligence has been rendered.

The "Duty to Defend" Your Client

Final Comments

The decisions in both Crawford and Weather Shield as well as the interpretation of California Civil Code section 2782 could have far reaching implications. Even though courts in other states are not bound by California law, many states look to California for precedent.

When negotiating with your clients, it is important that they understand that you are not trying to relegate your responsibility. You are trying to keep the clause insurable. If you make a mistake for which you are responsible (and probably insured), you should not be responsible for someone else's mistakes, nor can you insure for this. The fact is that clients will probably be better off defending themselves as opposed to relying on a joint defense provided by your firm. Also, if a design firm can't afford to fund its clients' defense costs out of pocket up front, the client will have to pay these costs anyway.

Many clients will have a "take it or leave it" attitude when it comes to amending their indemnity provisions. They will say, *"This is legal, and it is what our attorneys recommend."* Regardless, you should always make the effort to amend the contract so it is fair and insurable. Your client might say, *"Everyone else signs it"* (which, by the way, probably isn't true). Your response might be, *"If we make a mistake, if our performance falls below the standard of care required by the law, we will pay for it. However, we try to avoid assuming responsibility for mistakes made by others for which we are not insured. We take risk seriously, both yours and ours."*

Many clients are not going to change their stance, and tough business decisions will have to be made. You should also be aware that every contract is different, and any language employed in a professional services agreement should be scrutinized by your legal and risk management advisors in light of the specific situation the downstream party is facing. There are no "cookie cutter" solutions to this complex problem.

Note: Cavignac & Associates are not attorneys and do not provide legal advice. Any proposed contractual provisions or alterations should be reviewed by legal counsel.

Senate Bill 972

with Legislative Counsel's Digest

Senate Bill No. 972

CHAPTER 510

An act to amend Section 2782.8 of the Civil Code, relating to indemnity.

[Approved by Governor September 29, 2010. Filed with Secretary of State September 29, 2010.]

LEGISLATIVE COUNSEL'S DIGEST

SB 972, Wolk. Indemnity: design professionals.

Existing law provides, for all contracts, and amendments to contracts, entered into on or after January 1, 2007, with a public agency for design professional services, all provisions, clauses, covenants, and agreements contained in, collateral to, or affecting these contracts, that purport to indemnify, including the cost to defend, the public agency by a design professional against liability for claims against the public agency, are unenforceable, except for claims that arise out of, pertain to, or relate to the negligence, recklessness, or willful misconduct of the design professional.

This bill would provide, with respect to contracts and amendments to contracts entered into on or after January 1, 2011, with a public agency for design professional services, that all provisions, clauses, covenants, and agreements contained in, collateral to, or affecting these contracts or amendments to contracts that purport to require the design professional to defend the public agency under an indemnity agreement, including the duty and the cost to defend, are unenforceable, except for claims that arise out of, pertain to, or relate to the negligence, recklessness, or willful misconduct of the design professional. The bill would provide that all contracts and all solicitation documents between a public agency and a design professional are deemed to incorporate these provisions by reference.

The people of the State of California do enact as follows:

SECTION 1. Section 2782.8 of the Civil Code is amended to read:

2782.8. (a) For all contracts, and amendments thereto, entered into on or after January 1, 2007, with a public agency for design professional services, all provisions, clauses, covenants, and agreements contained in, collateral to, or affecting any such contract, and amendments thereto, that purport to indemnify, including the duty and the cost to defend, the public agency by a design professional against liability for claims against the public agency, are unenforceable, except for claims that arise out of, pertain to, or relate to the negligence, recklessness, or willful misconduct of the design professional. The duty to indemnify, including the duty and the cost to defend, is limited as provided in this section. This section shall not be waived

or modified by contractual agreement, act, or omission of the parties. Contractual provisions, clauses, covenants, or agreements not expressly prohibited herein are reserved to the agreement of the parties.

(b) All contracts and all solicitation documents, including requests for proposal, invitations for bid, and other solicitation documents, between a public agency and a design professional, are deemed to incorporate by reference the provisions of this section.

(c) For purposes of this section, the following definitions apply:

(1) "Public agency" includes any county, city, city and county, district, school district, public authority, municipal corporation, or other political subdivision, joint powers authority, or public corporation in the state. Public agency does not include the State of California.

(2) "Design professional" includes all of the following:

(A) An individual licensed as an architect pursuant to Chapter 3 (commencing with Section 5500) of Division 3 of the Business and Professions Code, and a business entity offering architectural services in accordance with that chapter.

(B) An individual licensed as a landscape architect pursuant to Chapter 3.5 (commencing with Section 5615) of Division 3 of the Business and Professions Code, and a business entity offering landscape architectural services in accordance with that chapter.

(C) An individual registered as a professional engineer pursuant to Chapter 7 (commencing with Section 6700) of Division 3 of the Business and Professions Code, and a business entity offering professional engineering services in accordance with that chapter.

(D) An individual licensed as a professional land surveyor pursuant to Chapter 15 (commencing with Section 8700) of Division 3 of the Business and Professions Code, and a business entity offering professional land surveying services in accordance with that chapter.

(d) This section shall only apply to a professional service contract, or any amendment thereto, entered into on or after January 1, 2007.

(e) The amendments made to this section by the act adding this subdivision shall apply to services offered pursuant to a design professional contract, or any amendment thereto, entered into on or after January 1, 2011.

(f) Nothing in this section shall abrogate the provisions of Section 1104 of the Public Contract Code.

O

