The Liability Implications of the Duty to Defend

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We have always advised our design professional clients not to assume the contractual obligation to defend their clients. The contractual liability coverage in a professional liability policy is narrower than the contractual coverage included in a typical general liability policy, and as such, the "obligation to defend" may not be covered by a professional liability policy.

Unfortunately, a decision by the California Supreme Court in the Crawford v. Weather Shield Manufacturing (the Crawford case) has created problems for subcontractors, suppliers, consultants or anyone else who assumes the obligation to defend an upstream party. A recent California Appellate Court decision in the UDC v CH2M Hill case reinforced this decision.

The problem is this: regardless of how the indemnity agreement is phrased, an express agreement to “defend” — even in the absence of the indemnitor’s (downstream party) negligence — can require the indemnitor to provide an immediate defense to the indemnitee (upstream party). This may not be covered by the indemnitor’s insurance program.

The Cases

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

Duty to Defend (continued on page 2)

In this issue...

Duty to Defend ................................................................. 1-5

2010 Risk Management Seminar Series ............... 2

BULLETIN! Workers Compensation Dual Wage Requirements ........................................ 5

Live Well, Work Well ......................................................... 6

Community Bulletin Board ............................................ 7
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. In a nutshell, even though Weather Shield was not at fault, it was still held responsible for the indemnitor’s (developer Crawford) 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.

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 professional engineer 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, unless the indemnitor specifically excepts itself from an immediate defense obligation.
Is the “Duty to Defend” Insurable?

General Liability

If there is a favorable Additional Insured (AI) endorsement naming the upstream party on the downstream party's CGL policy, and if the claim is tendered correctly, the downstream party’s insurer may have a defense obligation if any of the claims against the upstream party are potentially covered by downstream party’s CGL policy.

The problem is there are many different AI forms currently in use. Many insurance companies have drafted their own AI endorsements, and many of these are tied to either the partial or sole negligence of the named insured. Other AI endorsements may only extend to “ongoing operations” and not provide coverage for “completed operations.” Defense to the AI is only available if there is “coverage potential.” In the absence of “coverage potential,” there would be no coverage under a CGL policy.

A second way that defense costs might be afforded or reimbursed to an upstream party is through contractual liability coverage built in to most CGL policies. Note, however, that this would only cover the named insured for its contractual assumption of liability. In other words, if the downstream party was contractually obligated to indemnify the upstream party for its defense costs, and assuming no other provisions of the policy excluded coverage, then the downstream party’s insurer would cover the named insured for its obligation. In all likelihood, this would reduce the downstream party’s liability limits.

Professional Liability

As mentioned above, while the cost of defending the upstream party may be covered under a commercial general liability policy, it is not covered under most, if not all, professional liability policy forms. Whereas a CGL policy’s contractual liability coverage allows the insured to assume the tort liability of a third party, the contractual liability coverage under most professional liability forms is not nearly as broad.

Under most professional liability forms, contractual coverage is limited to the “non-defense” liability that the design professional would have had in the absence of the contract. 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 basic legal damages for that negligence (such as the obligation to defend the client in the absence of negligence, or other obligations arising solely from the professional services contract) would not be covered. This was made crystal clear by The CH2M case, and underscores why this decision is particularly dangerous for design professionals.

Both the Crawford and CH2M cases make it clear that unqualified express indemnity provisions that do not specifically reject an immediate defense can be problematic for any indemnitor, whether a subcontractor, supplier, design professional, or anyone else for that matter.

So What Is a Downstream Party 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:

   Indemnification

   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.

“The parties expressly agree that this indemnity provision does not include, and in no event shall the Consultant be required to assume, any obligation or duty to defend any claims, causes of action, demands, or lawsuits in connection with or arising out of this Project or the services rendered by the Consultant.”

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

Contractor 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 Contractor in the performance of professional services under this Agreement, but only to the extent that Contractor is responsible for such damages, liabilities and costs on a comparative basis of fault between the Contractor and the Client after adjudication in a Court of Competent Jurisdiction. Contractor shall not be obligated to defend or indemnify Client for the Client’s own negligence or for the negligence of others.

Option 4 may not accomplish what you want. It is conceivable that a court may interpret the duty to defend to be a broad separate duty from the duty to indemnify, and that the sub-consultant (downstream party) could be expected 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. Regardless, the wording above is better than an unqualified duty to defend.

You should also be aware that every contract is different, and any language employed in a professional services agreement must be scrutinized in light of the specific situation the downstream party is facing. There are no “cookie cutter” solutions to this complex problem.

Conclusion

From an insurance industry’s perspective, the Crawford and CH2M rulings are potentially very costly. Insurance companies never intended to provide coverage when their insureds did nothing wrong. Because of this, you can expect to see specific

Duty to Defend (Continued from page 3)
exclusions on future policies for the duty to defend in the absence of negligence of the “named insured.”

The indemnification agreement is a critically important element in any contract. It is important that entities entering into an indemnity agreement understand what type of risk they are assuming and whether or not it is insurable.

The good news is that many of your clients will understand that it makes no sense for you to assume obligations that are not covered by your insurance program or that are inherently unfair, and they will agree to the modifications outlined above. After all, if the shoe were on the other foot, would your client assume responsibility for another’s defense costs when it did nothing wrong?

Some clients may not be as reasonable. In those situations where, despite your best efforts (and the efforts of your risk manager/insurance broker and attorney) your client remains unyielding, you will have to decide whether the fee for the work is worth the massive risk of an uninsured loss.

In California, workers compensation insurance divides some construction and erection operations into two separate classifications based on an employee’s hourly wage rate.

For example, Classification Codes 5185 and 5186 both are used for workers engaged in automatic sprinkler installation. Code 5185 is used for workers earning less than $27 per hour, and Code 5186 is used for those earning more than $27 per hour. Under the workers compensation rating system, premium rates are higher for employees who are assigned to a lower wage classification.

In order to clarify the regular hourly wage and record keeping requirements for assigning “dual wage” classifications, the Workers Compensation Insurance Rating Bureau (WCIRB) proposed changes to the California Workers Compensation Uniform Statistical Reporting Plan – 1995 (USRP). These changes were adopted by the Insurance Commissioner after a public hearing, and became effective January 1, 2007.

In brief, the law states that employers are required to maintain time cards or time logs that show actual hours worked, and start and stop times for each employee for each day.

- Assignment of classifications is governed by the WCIRB, not by the insurance companies who write workers compensation insurance.
- The WCIRB requires insurance carriers to verify that their insureds maintain the required time records in order to substantiate assignment of eligible employees to the higher wage/lower premium classifications.
- The time keeping requirements apply regardless of whether the employer pays prevailing wage or has union employees.

As a result of this increased enforcement, insurance companies now routinely request copies of sample time cards/time logs for all workers compensation audits.

If your insurance company is unable to verify that the required time records have been maintained, it is required to assign dual wage class employees to the lower wage/higher premium classification, which results in increased workers compensation premium costs for the employer.

In order to be sure employees are assigned to their correct dual wage classification at your annual audit, you should have sample time cards or logs that include the required information available for the auditor.

If you have questions or would like to see samples, please contact us. We will be happy to assist you.

If you would like more detailed information concerning the dual wage classification, click on the link below:
Check Your Pressure

May is National High Blood Pressure Awareness and Prevention Month, so what better time to get your blood pressure checked and know your numbers!

High blood pressure, also known as hypertension, occurs when your resting blood pressure is consistently measured at 140/90 or greater. The higher number – your systolic pressure – indicates when the heart beats, and the lower number – your diastolic pressure – is when the heart is at rest.

The goal is to keep your blood pressure below this level – or below 130/80 if you are diabetic or have chronic kidney disease.

Because there are no symptoms of high blood pressure, it is often referred to as a silent killer. When left untreated, high blood pressure can cause heart failure, aneurysms, kidney failure or stroke. Talk to your doctor this month about how you can prevent or treat your high blood pressure.

Financial Spring Cleaning

It’s spring – time to assess, refresh and grow. But don’t think this just applies to your garden. A little spring cleaning can help you grow your finances, too.

Treat your financial statements and bills like closets. Is there anything you’re not using anymore? Could you reduce your cable package? Or eliminate your home phone? Consider what you’re not “wearing” anymore, and think about what you could eliminate.

Get rid of winter bills with the season. Still have leftover holiday debt? Now is a good time to get rid of it. To do this, consider a one-time way to make money, such as a garage sale, selling online or volunteering for overtime at work.

Consider an automatic savings plan. Go to your bank’s Web site and set up an automatic transfer from your checking to your savings each month. Already have an automatic savings plan? Set up one for something specific, such as a weekend away or a remodeling project. Even if you can only contribute $20 a month to your new account, it easily adds up.

100 Calories or Less!

Did you know that one snack-sized bag of potato chips has about the same number of calories as an apple and one cup of strawberries and one cup of carrots with low-calorie dip?

When trying to lose weight, one of the most important points to consider is eating fewer calories than you did previously. But this doesn’t mean that you necessarily have to eat less, just smarter. Filling up with healthier alternatives can satisfy your hunger while still monitoring your caloric intake.

Consider some of these healthier 100-calorie or less options, next time you’re hungry for a snack.

- 2 cups raspberries
- 1 cup blueberries
- 1 medium-sized apple
- 1 hard-boiled egg
- 6 oz. fat-free yogurt
- 1 stick string cheese
- 1 handful roasted peanuts
- 2 tbsp. hummus with ¼ cup fat-free pretzels
- 2/3 cup whole grain cereal with ¼ cup fat-free milk
Community Bulletin Board
“Neighbors helping neighbors in San Diego”

San Diego Humane Society and SPCA

- Meow Madness—June 5th
- Web Site

Downtown YMCA

- Web Site
- Summer Night on the Midway
- Questions? Contact Alicia Gettys by phone at 619-232-7451 or e-mail agettys@ymca.org

San Diego Architectural Foundation

- Design Tours
- Web Site
- Questions? E-mail info@SDAArchitecture.org

Monarch Schools

- How You Can Help
- Web Site

Senior Community Centers

Mission:
To provide quality and compassionate services for the survival, health and independence of seniors living in poverty
- New Senior Center Opens
- Web Site

San Diego Police Foundation

The San Diego Police Foundation supports the men and women who "protect and serve" by raising community awareness of important unbudgeted or "discretionary" needs that will improve crime-prevention and law enforcement efficiency. The Foundation puts your tax-deductible contributions to measureable work in local communities.
- Web Site
- Hands to Paws Canine Unit Benefit—June 5th
- For more information, contact info@sdpolicefoundation.org

Monarch Schools

Mission:
The Society for Design Administration advances management and administrative professionals in the A/E/C industry through education, networking and resources.
- Become an SDA Member
- Web Site
- For more information, e-mail vicepresident@sdasandiego.org