PROFESSIONAL LIABILITY UPDATE

A Loss Prevention Newsletter for the Design Profession

MSP AEE 07/00: "Indemnities — Again Part I"" July, 2000

Indemnities — Again

Part I

The following material is provided for informational purposes only. Before taking any action that could have legal or other important consequences, speak with a qualified professional who can provide guidance that considers your own unique circumstances.

Indemnification originated in the construction industry to hold owners harmless from problems that arose during construction. The basic concept is rooted in fairness: since the contractor has 100% control of the site, the contractor should indemnify (i.e., hold harmless) the owner for any site-related problems that arise.

Over time, however, the fairness concept behind indemnification has been altered. Architects and consulting engineers now are often required to assume a large portion of the owners' risk – not because design professionals have control of the construction site, but rather as the price to be paid for the privilege of doing the client's work.

In the carefully crafted contract language prepared by a client's attorney, probably lurks one, two or more clauses requiring you to indemnify the client. The language may be short and innocuous sounding, but it spells trouble just the same.

Many design professionals concede that they have largely themselves to blame for this development. They have encouraged the use of onerous terms and conditions by accepting them so readily. *"The design firm down the street doesn't object to the language,"* an architect or engineer is told. And, fearing that the other firm might get the work, the designer disregards better judgment and signs an indemnity-laden contract.

Before you sign on the dotted line

- Client-drafted indemnities typically ask you to pay for the client's negligence. Ask yourself: without the indemnity, whose risk would it be? Al-

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most invariably it would be the client's.

- Most client-drafted indemnities are uninsurable. If you sign a client's indemnity that is not limited to just your negligence, you are accepting liability beyond that required by law. Your professional liability policy likely includes a clause with language such as: "This insurance does not apply to liability assumed by you under any contract unless you would have been liable in the absence of such contract."
- Client-drafted indemnities frequently contain onerous, overreaching language. For instance, a client may ask for indemnity for your "intentional acts." Unfortunately, a crafty attorney could interpret virtually any of your acts as "intentional."
- Client-drafted indemnities frequently ask you to defend the client. This provision could be interpreted as an obligation on your part to retain an attorney for your client and pay for his or her defense – even before liability for negligence has been established – an obligation most professional liability insurers are not willing to assume.
- Client-drafted indemnities may include inappropriate parties as *indemnitees* (parties to be indemnified). You should never agree to indemnify a client's agent, contractor, attorney, contract employee, lender, volunteer or anyone else who is not directly part of the client entity.

Types of Indemnities

Client-drafted indemnities used in the design and construction industry can be separated into three general types: broad-form, intermediate-form and limited-form.

Broad-Form Indemnities

Of the three types of client-drafted indemnities, the broad-form type creates the most problems. It can make a design firm responsible for almost any problem that befalls its client during the project, whether or not the designer was negligent. A typical broad-form indemnity reads as follows:

"***Indemnification***

"Consultant agrees to hold harmless and indemnify Client from any and all liability, including cost of defense, arising out of performance of the services described herein."

Note that this clause does not limit the indemnification to liability that is a consequence of the design professional's negligent acts, errors, or emissions. Obviously, such an all-encompassing blanket indemnification creates enormous and largely uninsurable liabilities.

Case in point: A town retained a consulting civil engineer and contractor for a relatively simple project. Construction was suspended during the rainy season and the locality retook control of the site, erecting a temporary fence around it. An unsupervised toddler crawled through the fence, fell into a puddle and drowned.

The engineer, contractor and jurisdiction all were sued for negligence by the child's parents. Both the engineer and the contractor obtained dismissals from the case and the jurisdiction was found negligent. Once the project was complete, however, the jurisdiction split its bill for defense and judgment 50-50 between the engineer and contractor.

Both parties claimed they were required to pay nothing, since they were not negligent in any way. A judge disagreed. True, they were not negligent, the judge noted. But just as true, they had agreed to hold the jurisdiction harmless from *"any and all liability… arising out of performance of the services...."*

In some states (California for example), broad-form indemnification has been made illegal by virtue of court decisions or anti-indemnification statutes. But even in states where such indemnities are illegal, a judge might still rule that a given clause will be enforced when the parties to the contract have enjoyed relatively equal bargaining strength and the clause is written so clearly that its intent is unmistakable. And, of course, even if a court rules in your favor, litigation always means you have lost valuable time, goodwill, peace of mind and dollars.

Intermediate-Form Indemnities

An intermediate-form indemnity is not much better than a broad-form one, but it is legal in the

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majority of jurisdictions (including California). It provides that a design professional will cover the client's risk whenever the design professional shares some of the liability due to negligence. A typical intermediate form indemnity reads as follows:

> *"**Indemnification***
>
> *"Consultant agrees to defend, hold harmless and indemnify Client from any and all liability arising out of Consultant's performance except for the sole negligence or willful misconduct of Client."*

Given a clause such as this, the client could be 99% at fault and, as long as the designer is at least 1% at fault, the design professional would pick up 100% of the tab. In the event of a project problem, there is a very good likelihood that a designer would be held partly at fault. In fact, only an incompetent attorney would be unable to convince most juries that a design professional had at least a minor role in a project problem.

In this example, design professionals would have coverage under most professional liability policies for the portion of the damages attributable to their negligence (1 - 99%), but not that attributable to the client's negligence (1% - 99%).

Limited-Form Indemnities

The limited-form indemnity reflects what common law requires in any event; i.e., if you're 20% at fault, you will pay 20% of the damages. A typical limited-form indemnification may read as follows:

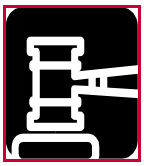
> *"**Indemnification***
>
> *"Consultant agrees to hold harmless and indemnify Client from and against liability arising out of Consultant's negligent performance of services."*

This type of indemnity is covered under most professional liability policies.

Making Your Stand

So how do you handle a potential or existing client who asks you to sign an unacceptable indemnity clause? Your first step should be to educate the client regarding the unfairness, illegality and/or ineffectiveness of such a clause. Specifically:

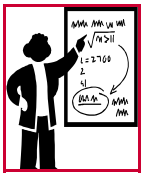
- Know the Law – Find out whether your state has anti-indemnification statutes on the books. If so, what do they say? How have they been interpreted by the courts? Ask your attorney and insurance broker for assistance in this area.

  Be aware that the law in your state may not apply in every instance. Client-drafted contracts frequently require that disputes be settled in the jurisdiction where the client is located and/or where the work is performed. This may be an out-of-state location where indemnities are enforceable.

  Also, do not assume that, because your state has anti-indemnification statutes in place, you can accept a broad-form indemnity because it would be struck down later. Having to defend a claim is costly in any event – rarely does anyone come away from the experience a winner. Besides, as already noted, a court may decide that, for whatever reason, the indemnification is enforceable in your case.

- Educate the Client – The best tactic in getting rid of an unfair indemnity is to demonstrate to the owner the ineffectiveness of such a contractual stipulation. Point out any anti-indemnification statutes on the books in your state or the jurisdiction where any dispute would be tried. Explain that any indemnification that expands your liabilities will be uninsurable. Point out that you are already liable for your errors and omissions without an indemnification clause and therefore such a clause is unnecessary and may even cloud the issue of your legal responsibilities. Your insurance broker should be willing to help you address these issues with your client.

- Negotiate for Fairness – Finally, appeal to your client's sense of fairness. Explain that to hold you legally responsible for another's li-

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ability is simply unjust. Reaffirm your willingness to accept responsibility for your own errors and omissions but your unwillingness to be liable for the mistakes and oversights of others. Explain that the theory of indemnities applies to contractors on the construction site since they assume control over the work site. Explain how it is unfair to hold a design firm responsible for liabilities that are completely out of its control.

Convincing an owner that an indemnification would be unenforceable and/or unfair can be difficult when the client has paid an attorney to draft the contract and the client has been told that another design firm will agree to the provision. What do you do when basic fairness does not work? There are still some options that while not ideal, are far better than accepting an uninsurable client-drafted indemnity.

Next issue, Part 2 of this two-part report will address those alternatives. In addition, we will examine certain cases where you might want to request indemnities from a client. ✧

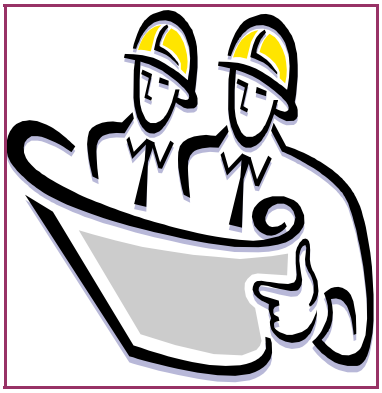
Disclaimer: *This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

The Growth of Project Specific Professional Liability Coverage

Courtesy of © RA&MCO Insurance Services, 1999

Project specific professional liability insurance is becoming more common today as owners are requesting it as part of their project specifications. Some of the reasons owners are requiring project coverage include the need for:

- Covering all of the appropriate design firms/ professional firms under a single policy
- Providing a multi-year policy limit of insurance dedicated only to the owner's project
- Having one insurer coordinate any claims (which avoids the typical dispute between insureds and multiple insurance carriers as to which firm is at fault)
- Providing vicarious liability indemnity coverage to an owner by endorsement to the policy
- Enabling the owner to proactively "control" the professional liability and risk management issues by assuring that a project specific professional liability policy is in effect for the period covering the design and construction phases of a project with an extended "claims reporting" period following construction completion



The major benefit of the "project-specific" insuring approach is that it normally includes as insureds all members of the design/ professional team under one dedicated project policy limit. Adversarial relationships between design team members may be reduced if claims arise because the firms are provided with a united de-

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fense controlled by only one insurer. This fosters a cooperative environment among the insured team to resolve the claim without having to prove the other firm or its insurer should pay. Since the team is covered, there are not the potential problems of some professional firms having inadequate limits of insurance, or the possible impact or erosion of their various professional liability policy limits by claims unrelated to the project.

The project policy is typically arranged so that retroactive coverage is granted to cover any preliminary design services rendered prior to inception of the policy. The policy period will then run until the end of the construction, after which an Extended Reporting Period (up to five years and occasionally longer) is typically provided in which claims can be reported allegedly arising from the negligent acts of the professionals on the completed project.

After the Extended Reporting Period has passed, the probability of claims activity will have been greatly reduced. New claims made subsequent to the end of the Extended Reporting Period would then typically be subject to each firm's practice policy. However, you should verify this with your practice policy insurer.

Normally, the deductible on a project specific policy is paid by the policyholder/lead design entity but it can be paid by the owner, design/build contractor or shared by the insured design team.

Professional firms covered under a project specific policy should be aware that their fees received on a project insured separately under a project policy can be removed from their practice policies' premium calculations since the coverage afforded by the project policy applies in lieu of a practice policy until such time that the coverage afforded by the project policy ceases.

In addition, there are often additional exclusions which further restrict coverage.

Project specific professional liability policies are an integral part of the owner's risk management/insurance plans. They are generally beneficial to all parties involved due to the reduction in claims handling expenses, the dedicated insurance for the project, the reduction in potential coverage gaps between the parties, and the multi-year and post-construction completion claims reporting periods.

Project specific professional liability policies are highly desirable, additional financial resource to assist in achieving a successful project. ✧

Important!

An "OCIP" policy is *not* a Project Professional Liability policy!

Don't confuse a general liability-based "Owner Controlled Insurance Program" (OCIP) with a project professional liability policy.

If an OCIP even includes the design team, it usually only covers either bodily injury or property damage, and would not extend to any economic or consequential damages. ✧

Hmmm...

- "While we are postponing, life speeds by." — *Seneca (3 BC-65 AD)*
- "I find that the harder I work, the more luck I seem to have." — *Thomas Jefferson (1743–1826)*
- "Opportunities multiply as they are seized." — *Sun Szu (570? BC-490? BC)*
- "Do, or do not. There is no 'try.'" — *Yoda ("The Empire Strikes Back")*
- "I have not failed. I've just found 10,000 ways that won't work." — *Thomas Alva Edison (1847-1931)*
- "Obstacles are those frightful things you see when you take your eyes off your goal." — *Henry Ford (1863-1947)*
- "Argue for your limitations, and sure enough, they're yours." — *Richard Bach*
- "Success usually comes to those who are too busy to be looking for it." — *David Henry Thoreau (1817-1862)* ✧

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