Information Alert
July 2011

Insights on Developments and Issues for Architects, Engineers and Construction Professionals

AMES & GOUGH

Why Worry So Much About Indemnification Clauses?

Architects, engineers, and construction managers hear constantly from their risk advisors about the importance of practicing good "contract hygiene." Typically, this refers to taking the time to carefully review proposed contracts, evaluate problem provisions, and negotiate improved wording. While more firms are working to manage risk through reasonable and fair contracts, we are still asked: "Why are Ames & Gough and our professional liability insurer so worried about the language of indemnification clauses?"

The answer is simple — because such clauses have the potential to shift to design professionals many significant risks that may not be covered under their professional liability insurance (PLI) policy. In this InfoAlert, we discuss this issue and provide some common-sense advice to help reduce the worry associated with inappropriate indemnification clauses.

What Are Indemnification Clauses Intended to Do?

Simply put, indemnification clauses are utilized to shift risk from one party to another. Commonly, the service provider (in this case, an architect, engineer, or construction manager) is asked to assume the liability of the client/project owner for claims and expenses arising from the service provider's work undertaken for the client. In concept, this seems reasonable in that the party performing the services should bear the risk related to their negligent performance of the work. However, in practice, some owners seek to shift additional risk that is beyond the control of the design professional or that extends beyond basic negligence-based liability.

Why Are Indemnification Clauses Written with Such Inappropriate Clauses/Language?

It is helpful to understand why indemnification clauses for architects, engineers and other construction professionals are often written with so many problematic provisions. The over-arching issue is that they are written with contractors in mind. This, in turn, has three aspects to it:

1. Contractors are often less risk-averse. This is related not only to their personality, but also to the risk/reward trade-off – contractors risk more because they can make more. Design professionals don't have the same "upside" potential and therefore shouldn't be expected to take the same level of downside risk.
2. Contractors historically have been required to provide warranties and guarantees. As the ultimate builders of the "end product"—the building or structure—contractors have long been expected to "guarantee" their work.
3. Contractors' General Liability (GL) policies provide much broader coverage than that provided by a design firm's professional liability insurance policy. For example, the typical contractor GL policy includes an exclusion for contractual liabilities, but then goes on to state: *"…This exclusion does not apply to liability for damages…assumed in a contract or agreement that is an 'insured contract'… provided the 'bodily injury' or 'property damage' occurs subsequent to the execution of the contract or agreement. Solely for the purposes of liability assumed in a [contract], reasonable attorney fees and necessary litigation expenses incurred by or for a party other than an insured are deemed to be damages because of 'bodily injury' or 'property damage'…"*

Of course, even beyond the issue of modeling language according to what would be acceptable to contractors, is the reality that some owners and their attorneys simply want to push all risk off on other parties, as opposed to fairly allocating risk.

Understanding the Coverage Granted Under Your Professional Liability Insurance Policy

In order to understand why indemnification clauses can create such issues for architects, engineers and other construction professionals, it is important to review a few basics of coverage under your professional liability insurance policy:

- Coverage is granted only for negligent acts, errors or omissions in the rendering or failing to render professional services. While the actual policy wording will vary, the intent is clearly to cover you for your **negligence.** This has, in turn, been interpreted by the courts (in light of the 'standard of care' doctrine) to not require perfection, but only that you perform in a manner that is consistent with other professionals under similar circumstances.

- **Contractual assumption of liability is excluded, except for** "liability that would have attached in the absence of the contract." So, for example, if an architect or engineer were to agree to indemnify their client for anything not related to the design firm's own negligence, there would be no coverage under the professional liability policy. This is because the firm contractually assumed liability that would not have existed otherwise.

Another concept not found directly in the policy wording, but carried forward in case law, is the issue of "privity" and the so-called "economic loss doctrine." In most instances, absent some contractual commitment to the contrary, a design professional cannot be sued for economic loss by a third-party not in a contractual relationship with the design professional. This doctrine often prevents direct claims by contractors and others against design professionals. By agreeing to an overly-broad indemnification clause that extends to contractors, financial institutions and other third parties, there is some concern that this may erode the protection of the economic loss doctrine.

Bad Indemnification Wording Adds Risk

While there are logical reasons for owners to require indemnification, far too often they attempt to achieve the protection they are seeking with language that is unfair, poorly worded, or ambiguous, as well as uninsurable. An example of an inappropriate indemnification clause is:

> *Consultant shall indemnify, defend and hold harmless the Client, the Client's employees, directors, officers, agents, representatives, subsidiaries, affiliated companies, and lenders from and against any and all liability, costs and expenses including, but not limited to, attorney's fees, that occurred in whole or in part, as a result of the Consultant's acts, errors or omissions.*

As you might imagine this clause is rife with issues. Let's take a look at some of them.

Issues to Consider

- **Duty to Defend** — Let's start with the word "defend" in the first line of the indemnification provision. This needs to be deleted because the so-called *duty to defend* can be broader than the *duty to indemnify*. What does that mean? Simply, that an agreement on the Consultant's part to defend a client means you are both providing the defense and paying the costs of the defense from the moment a suit is filed or a claim has been made, without knowing whether there is any alleged negligence on your part. If there is no claim of negligent actions or errors against the Consultant, this means you've agreed to liability that goes beyond "liability that would have attached in the absence of the contractual commitment." Therefore, you may not have insurance coverage. In addition, no professional liability policy is priced to include the cost of defending a client against claims that might have some relationship to the services provided by a design firm, but are not be related to your negligence or potential negligence.
  - ➢ **The Fix** – Delete the word "defend."

- **"Agents, representatives, subsidiaries, affiliated companies, and lenders**" — Agreeing to indemnify these additional parties can create two problems. First, you may be indemnifying parties for whom you would not have liability in the absence of this contractual commitment, thereby

creating an uninsured exposure under your professional liability insurance. Second, this language could be interpreted as creating a contractual relationship (i.e., "privity") with these parties, thereby increasing the odds that a suit for economic loss against your firm will be upheld.

  - **The Fix** – Delete any references to "agents, representatives, subsidiaries, affiliated companies, and lenders." Limit Indemnified Parties to your client, its officers, directors, and employees.

- **"Any and All"** – The wording "any and all" is too broad and implies application of the indemnification to claims that may not relate to negligence.
  - **The Fix** – Delete: "… any and all."

- **Lack of Negligence Standard** – In order for any indemnification provision to be insurable, it must be tied to the Consultant's negligence. The provision, as currently worded, makes no reference to negligence and is, therefore, too broad.
  - **The Fix** – Insert "negligent" prior to "acts, errors or omissions."

- **Attorney's fees** – Whenever "attorney's fees" are included in an indemnification provision, it needs to be modified to read, "attorney's fees where recoverable under applicable law on account of negligence." This is important as not all jurisdictions allow for the recovery of a plaintiff's legal costs against the architect or engineer as a matter of law. Attorney's fees awarded in a state with such a law are likely covered under your PLI policy if the award is based on a finding of negligence. However, any part of an award of attorney's fees that results only from a contractual indemnification obligation (i.e., not due to your negligence) to indemnify a plaintiff's legal fees will be subject to the contractual liability exclusion discussed earlier.
  - **The Fix** – Insert "where recoverable under applicable law on account of negligence" after "attorney's fees."

- **Lack of Proportional Liability** – The phrase, "in whole or in part," should be deleted because leaving it in creates a potential uninsured exposure. It makes the Consultant potentially responsible to indemnify the Client 100%, even if the Consultant is "in part" negligent by only 1%. Your professional liability insurance policy only covers you for your share of the liability. Anything beyond that is an assumed contractual liability excluded under your professional liability policy since it goes beyond your responsibility under a common law standard of negligence**.**
  - **The Fix** – Delete "in whole or in part" and add in "to the extent caused by."

The corrected version of this uninsurable indemnification provision (with changes tracked) would read as follows:

> *Consultant shall indemnify, ~~defend~~ and hold harmless the Client, the Client's employees, directors, officers~~, agents, representatives, subsidiaries, affiliated companies, and lenders~~ from and against ~~any and all~~ liability, costs and expenses including, but not limited to, attorney's fees* ***where recoverable under applicable law on account of negligence*** *~~that occurred in whole or in part, as a result of~~* ***to the extent caused by*** *the Consultant's* ***negligent*** *acts, errors or omissions.*
>
> (Note: Inserted text in **bold red** type.)

A Preferred Indemnification Clause

An example of a preferred indemnification provision is as follows:

> *The Consultant agrees, to the fullest extent permitted by law, to indemnify and hold harmless the Client, the Client's employees, officers and directors against damages, liabilities and costs where recoverable by law but only to the extent caused by the negligent acts, errors or omissions of the Consultant in the performance of Professional Services under this Agreement.*

As you can see, this clause, in its simplicity, addresses many of the issues presented by the "problem" clause described earlier. One enhancement present in this language that we and attorneys representing architects and engineers often recommend is the addition of the phrase

"…to the fullest extent permitted by law…" Many would consider this to be "belt and suspenders" protection against the possibility that a contractual commitment in an indemnification clause goes beyond the common law negligence a design firm would otherwise have.

Other Indemnification Issues

- **Flow Down** – A reminder that you should "flow down" any indemnification provisions you accept to your sub-consultants. You should use the same wording that exists in the primary agreement in the subcontractor agreement as well.
- **Mutual Indemnifications** – In an ideal world, you would get mutual indemnification from the client. This means you would indemnify the owner/client to the extent claims are caused by your negligence and then you would receive a "mirror" indemnification to the extent the client's negligence caused potential liability or defense costs for you. This may be difficult to achieve, but definitely worth requesting.
- **Indemnification from Contractors** – A bit different from a mutual indemnification is the indemnification of the design professional by the contractors working on the project as part of their agreement with the owner/client. Often, the architect on a project can steer this issue as part of preparing a bid package. This contractor indemnification can be invaluable in cases of employee or third-party bodily injury or property damage claims. Typically, in these instances, the design firms on the project are also named in a suit and have to expend defense costs to extricate themselves – even if they had nothing to do with the incident or with jobsite safety. We've seen situations where these costs can run into the tens of thousands of dollars, all of which could have been (and should have been) the responsibility of the contractor under an indemnification clause.

Conclusion

The key message is the importance of understanding the risks inherent in indemnification clauses and taking the time to thoroughly evaluate such clauses. While ideally you will be able to negotiate improvements that ensure a fair allocation of risk, at the very least you want to be aware of whether or not a particular contract holds the potential for uninsured exposures. Many firms find it necessary to make the "business decision" to move forward even with poor contract wording. This is, of course, always an option, albeit not a recommended one given the real possibility of uninsured exposures. In such instances, we've seen clients add a "risk charge" to their project pricing to help minimize any potential financial impact.

Indemnification clauses are a fact of life for architects, engineers, and other construction professionals. Understanding the risks these clauses can bring and how to address these concerns can go a long way to reducing stress and avoiding unnecessary costs.

For additional information, please call the Ames & Gough office nearest you:

Washington, D.C.
8300 Greensboro Drive
Suite 980
McLean, Virginia 22102-3616
Phone: (703) 827-2277
Fax: (703) 827-2279

Boston
859 Willard Street
Suite 320
Quincy, Massachusetts 02169-7469
Phone: (617) 328-6555
Fax: (617) 328-6888

Philadelphia
1781 Hunters Circle
West Chester, Pennsylvania
19380-6643
Phone: (610) 547-0663
Fax: (703) 827-2279

www.amesgough.com