OPINION

Onerous indemnification clauses

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GUEST SPEAKER

A critical component of effective risk management for design firms involves practicing good contract hygiene. This includes reviewing any prospective contract to evaluate the risk associated not only with the professional services to be performed, but also related to any contractual risk transfer that can create or expand liability for the architect, engineer, or construction manager.

While many provisions can shift risk (e.g., standard of care, warranties, and guarantees, etc.), one of the most important is indemnification clauses. If improperly worded, these clauses not only can shift significant risks, but do so in ways that leave design professionals exposed to potentially large claims that may not be covered under their professional liability insurance.

In assessing the potential impact of an indemnification clause, A/E firms must first recognize that their coverage under professional liability insurance policies is typically restricted to liabilities that arise from negligent acts, errors, or omissions in the rendering of, or the failure to render, their services.

> "When architects or engineers agree contractually to indemnify a client for anything unrelated to the design firm's negligence, it won't be insured."

Significantly, the policies exclude contractual assumption of liability other than "liability that would have attached in the absence of the contract." So, when architects or engineers agree contractually to indemnify a client for anything

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unrelated to the design firm's negligence, it won't be insured.

Further, in case law the issue of "privity" and the "economic loss doctrine" provide additional protection for design firms. Typically, absent a contractual commitment to the contrary, design professionals cannot be sued for economic loss incurred by a third party not in a contractual relationship with the design professional. However, when design firms agree contractually to an indemnification clause that extends to contractors, financial institutions and other third parties, this protection may be eroded.

"The first step in reducing uninsured or inappropriate risk is to understand what terms in an indemnification clause can hold the potential for uninsured exposures."

PROBLEMATIC INDEMNIFICATION WORDING ADDS RISK. While owners may have logical reasons to require indemnification, some try to protect themselves with language that is unfair, poorly worded, ambiguous, and uninsurable. For instance, consider the following example of an inappropriate indemnification clause:

> *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.*

This clause has several issues, including:

- **Duty to defend.** The word "defend" in the first line needs to be deleted, as the duty to defend can be broader than the duty to indemnify. If unchanged, this implies the design firm will provide the defense and pay the costs from the moment a suit is filed or a claim is made – regardless of any allegation of its negligence. Without a claim of negligence, the design firm has accepted a liability that would not exist without the contract and may not be insured.
- **"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 otherwise not have liability, which is an uninsured exposure. 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. So, the references should be deleted and design firms should limit indemnified parties to the client, its officers, directors, and employees.
- **"Any and all."** The wording "any and all" should be deleted. It implies application of the indemnification to claims that may not relate to negligence.
- **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 worded, makes no reference to negligence. So, the word "negligent" should be inserted prior to "acts, errors or omissions."
- **Attorney's fees.** Whenever "attorney's fees" are included in an indemnification provision, it needs to read: "attorney's fees where recoverable under applicable law on account of negligence" or something similar. Not all jurisdictions allow the recovery of a plaintiff's legal costs against the architect or engineer. In states with such laws, the fees are likely covered under a professional liability policy if the award is based on a finding of negligence, but not solely due to a contractual obligation to reimburse such fees.
- **Lack of proportional liability.** The phrase "in whole or in part" should be deleted and replaced with "to the extent caused by." If unrevised, it creates a potential uninsured exposure. A professional liability insurance policy only covers a firm for its share of the liability.

Given the revisions outlined, here's the corrected version (with deleted text in brackets and strikethrough; inserted text in bold type) of the uninsurable indemnification provision:

> *Consultant shall indemnify, [~~defend~~] and hold harmless the Client, the Client's employees, directors,* ***and*** *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.*

One other important point with regard to indemnification clauses: Be sure they "flow down" to any subconsultants the architect, engineer, or construction manager may be using on the project with wording identical to that of the primary agreement.

"While owners may have logical reasons to require indemnification, some try to protect themselves with language that is unfair, poorly worded, ambiguous, and uninsurable."

The first step in reducing uninsured or inappropriate risk is to understand what terms in an indemnification clause can hold the potential for uninsured exposures. Once these are recognized, the design firm should attempt to negotiate improvements that ensure a fair allocation of risk. Often, we find changes are possible simply by asking and explaining the unintended result of eliminating insurance coverage for a claim. Where the owner won't make necessary changes, the firm then has the information it needs to make a "business decision" about whether or not to move forward with a less than acceptable clause.

In such instances, we are aware that some design firms may add a "risk charge" to their project pricing to help minimize any potential financial impact.

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