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# Indemnification Clauses: Uninsurable Contractual Liability

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Professional consultants are judged by whether or not they satisfied the professional standard of care (i.e., were not negligent in the performance of their services). That is what is covered under a professional liability policy; therefore, it is critical that the indemnification obligations be limited to damages to the extent caused by the consultant's negligence. Anything more is barred from coverage pursuant to the contractual liability exclusion of the professional policy. By agreeing to more than that, the consultant effectively agrees to a higher standard of care that is uninsurable. Under the common law of the states, the professional consultant is not held to a standard of perfection, but instead is required only to meet the generally accepted standard of care. Language is sometimes buried deep within the insurance article of a contract that states the consultant must provide insurance with contractual liability coverage for the indemnity agreement. This is not acceptable for professional liability, as those policies do not provide such contractual liability coverage for defense costs. Additionally, they will not cover damages within the indemnity costs other than what would have been incurred in the absence of the contractual indemnity provision.

### Strike Any "Duty to Defend" Language

There is no common law duty of a consultant to defend its client against third-party actions. That duty can only arise as a result of a contractual liability created through the indemnification clause of the contract. Since this is a contractual liability, it is excluded from coverage pursuant to the contractual liability exclusion of the errors and omissions policy.

Courts interpreting indemnification provisions that include "duty to defend" language have explained that this means the consultant must defend its client (i.e., pay legal fees on behalf of) as the litigation is ongoing. It cannot wait until the conclusion of the litigation to determine whether the consultant is found to have negligently performed services and therefore owe a separate duty to indemnify. The courts see the duty to defend and the duty to indemnify as two separate and unique duties. The professional liability insurance policy only covers damages to the extent they are caused by the consultant's negligence — and that determination can only be reached at the conclusion of the case or by settlement to which the carrier agrees.

Although it is theoretically possible that the damages awarded by a court might include some attorney's fees if there is a statute that requires

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the same, attorney's fees are generally not awarded as part of a judgment in the American system of justice. Therefore, a clause stating that the consultant will defend (pay on behalf of) or indemnify (pay attorney's fees after judgment is rendered) may create uninsurable liability. Agreeing to defend on behalf of a client, however, is the far worse situation. The consultant would be paying out of its own pocket its client's attorney's fees as they are incurred to defend against a third-party claim. Ultimately, that claim might not even be found to have been caused by the consultant's negligence.

Typical advice to professional consultants from risk managers and insurance professionals is that any duty to defend the client pursuant to an indemnification clause, or other provision of the contract, is uninsurable pursuant to the contractual liability provision of the contract. Therefore, it should be struck from the contract language accordingly.

It is not good enough that the contract states that the duty to defend and indemnify is limited to damages resulting from the negligent performance of professional services. Even where the trigger is limited to "negligent performance," a court could reasonably interpret the duty to defend to be such a broad duty that the consultant could be expected to begin defending a claim on behalf of its client (paying attorney's fees as they are incurred) as soon as any allegations of negligence are made. This could be true regardless of whether those allegations are frivolous and ultimately disproved.

Although the results vary by state, it is generally the case that the duty to defend that is agreed to as part of an indemnification clause is comparable to the duty to defend that an insurance carrier has pursuant to an insurance company. An insurance company doesn't wait to see if you are negligent before defending you. Rather, the company defends you as the battle is being waged in the hope of proving you are not negligent. Waiting until negligence has already been proven before starting the defense would be like waiting until the war has been lost before deciding to join the battle. The same principle applies to defense duties assumed by a consultant in an indemnity clause.

## Court Decisions Enforcing the Duty to Defend

A California Supreme Court decision in the case of *Crawford v. Weather Shield* provides a clear analysis of how the duty to defend differs from the obligation to indemnify. The trial court in the underlying case determined that since the jury found Weather Shield was not negligent, the indemnification obligation was not triggered. On the other hand, the court found that the duty to defend was triggered by the initiation of the lawsuit insofar as claims concerned the windows supplied by Weather Shield, regardless of whether a jury ultimately found Weather Shield was not negligent. This decision was affirmed on appeal to the California Supreme Court, which stated:

We focus on the particular language of the subcontract. Its relevant terms imposed two distinct obligations on Weather Shield. First, Weather Shield agreed "to indemnify and save [its client] harmless against all claims for damages to persons or to property and claims for loss, damage and/or theft ... growing out of the execution of [Weather Shield's] work." Second, Weather Shield made a separate and specific promise "at [its] own expense to *defend any suit or action* brought against [its client] *founded upon* the claim of such damage, ... loss, ... or theft." (Italics added.)

We agree with the Court of Appeal majority that, even if strictly construed in Weather Shield's favor, these provisions expressly, and unambiguously, obligated Weather Shield to defend, from the outset, any suit against [its client] insofar as that suit was "founded upon" claims *alleging* damage or loss arising from Weather Shield's negligent role in the Huntington Beach residential project. Weather Shield thus had a contractual obligation to defend such a suit even if it was later determined, as a result of this very litigation, that Weather Shield was not negligent.

The court further stated:

A contractual promise to "defend" another against specified claims clearly connotes an obligation of active responsibility, from the outset, for the promisee's defense against such claims. The duty promised is to render, or fund, the service of providing a defense on the promisee's behalf — a duty that necessarily arises as soon as such claims are made against the promisee, and may continue until they have been resolved. This is the common understanding of the word "defend" as it is used in legal parlance [citations omitted]. A duty to defend another, stated in that way, is thus different from a duty expressed simply as an obligation to pay another, after the fact, for defense costs the other has incurred in defending itself.

The court concluded that the defense obligations contained in California civil statute “are deemed included in every indemnity agreement unless the parties indicate otherwise.” This means that for many California contracts, it is not sufficient to merely strike out the “duty to defend” language from the indemnification clause. Rather, it is necessary to insert words to the effect that “Consultant shall not defend” the indemnitees.

Since *Crawford v. Weather Shield*, other court decisions in California have followed the holding, including a Court of Appeals decision in the matter of *UDC v. CH2M Hill* that interpreted and applied an indemnification clause requiring a design professional to defend its client even though a jury found no negligence on the part of the professional. The court’s conclusion was based on the fact that the professional services agreement between the parties provided that the consultant would “defend any suit, action or demand brought against Developer or Owner on any claim or demand covered herein.” The engineer argued that under the contract, it had a duty to indemnify UDC only if it was found negligent in performing its work and had a duty to defend only when the third-party suit alleged a claim that directly implicated it. Because a jury found that the engineer was not negligent, the appellate court agreed that the “negligent act or omission” language shielded the consultant from a duty to indemnify, but held that the engineer nevertheless had a duty to defend the indemnitee against the claim.

### **Agreeing to Pay Reasonable Attorney’s Fees as Part of Indemnification May Create Uninsurable Loss**

A question that is asked with increasing frequency is whether attorney’s fees incurred pursuant to an indemnity clause are insurable where they are not incurred due to a duty to defend (i.e., paid on behalf of the indemnitee) but are instead paid after the litigation is complete and the indemnitor (e.g., engineer) is found liable for damages due to its negligence. The short answer is that unless the court would have awarded the attorney’s fees against the engineer in the absence of the contractual obligation created by the indemnification provision, the attorney’s fees will not be covered by the professional liability policy. The contractual liability exclusion of the policy applies to such a contractually created attorney’s fees obligation.

A typical indemnification clause that includes payment of attorney’s fees as part of indemnification rather than as part of a duty to defend is as follows:

### **INDEMNIFICATION**

“The Consultant shall indemnify and hold harmless Owner, its parent, affiliates and their respective directors, officers and employees (“Indemnitees”) from and against any and all claims, suits, actions, judgments, demands, losses, costs, liability, damages, and expenses, of any kind (including reasonable attorney’s fees) for injuries to persons (including but not limited to death) or damage to property to the extent any of the foregoing are caused by any negligent act, error, or omission of Consultant, its officers, employees, agents, representatives, and persons for whom Consultant is legally responsible in the performance of the Services.”

Although this clause may look innocuous in that the indemnification is limited to negligence, it may nevertheless create uninsurable loss by virtue of the attorney’s fees that are included in the indemnification. Under *American Jurisprudence*, the courts do not award attorney’s fees to the prevailing party unless the contract creates such a duty or unless there is some legal basis such as a civil statute that would establish the basis for the award.

To avoid contractual liability for legal fees under the above-quoted clause (which would not be covered by insurance), it may be necessary to revise the final sentence to read something like the following:

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

Unless the award is limited to the sum “recoverable under applicable law on account of negligence,” the indemnity of legal costs may not be fully insured. Specifically, an award of legal costs in favor of the indemnitee against the engineer that is based on the contractual indemnity alone is excluded from coverage by the contractual liability exclusion of the policy. The award amount made under applicable law, respecting recovery of plaintiff’s legal costs and apart from the contractual indemnity, could be covered depending upon terms and conditions of the policy.

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**Unless the award is limited to the sum “recoverable under applicable law on account of negligence,” the indemnity of legal costs may not be fully insured.**

In other words, if a state has a law for recovery of plaintiff's legal costs against the engineer, an award under that law based upon negligence might be covered under the professional liability policy. However, any part of an award of attorney's fees that results only from a contractual indemnity obligation to indemnify a plaintiff's legal fees will run afoul of the contractual liability exclusion of the policy and, therefore, be excluded from coverage.

**...agreeing to reimburse the indemnitee for attorney's fees will likely create an uninsurable risk...**

As previously stated, in the United States, the laws of the individual states do not routinely provide for an award of plaintiff's legal costs. That is the genesis of contractual indemnity of legal costs.

Contractual indemnity "fills in" what the law does not otherwise order. Likewise, that is the reason the engineer would limit the contractual indemnity to the sum that the state law would award. The "fill in" to enforce the contractual indemnity is not a liability that would have attached to the "insured" in the absence of such contract, warranty, guaranty or promise, to quote from the contractual liability exclusion contained in a typical insurance carrier's policy. For the reasons explained in this article, a party that agrees to indemnify another should beware that agreeing to reimburse the indemnitee for attorney's fees will likely create an uninsurable risk where those fees would not have been awarded by a court in the absence of the contractual obligation.

### Spotting the Uninsurable Risks in an Onerous Indemnity Clause

An example of a problematic indemnity clause is presented below. It is an issue because although the indemnification requirement only applies to damages ultimately caused by negligence, the defense obligation is immediate and is not limited by the language of the clause concerning negligence.

INDEMNIFICATION (example of problem clause)

The Consultant covenants to save, defend, hold harmless, and indemnify the County, and all of its elected and appointed officials, officers, employees, agents, departments, agencies, boards, and commissions (collectively the "County"), and contractors working for the County, from and against any and all causes of action, proceedings, claims, losses, damages, injuries, fines, penalties, costs (including court costs and attorney's fees), charges, liability, or exposure, however caused, resulting from, arising out of, or in any way connected with the

Consultant's acts, errors, or omissions, recklessness or intentionally wrongful conduct of the Consultant in performance or nonperformance of its work called for by the Contract Documents.

There are several uninsurable risks in this clause that should be easily spotted. If I were reviewing this clause, I might recommend changes such as the following:

- Line 1 – Delete the word "defend."
- Line 2 – The number of indemnitees is too expansive.
- Line 7 – Delete the words "causes of action, proceedings, claims."
- Line 11 – Delete the words "however caused, resulting from, arising out of, or in any way connected with" and replace with "resulting from third-party claims to the extent caused by."
- Line 13 – Delete the words "Consultant's acts" and replace with "Consultant's negligent acts."
- Line 14 – Delete the word "recklessness." (This is an ill-defined term.)
- Line 14 – Delete the words "intentionally wrongful conduct" and replace with "willful misconduct." (Note that this states the intent more clearly. But beware that "willful misconduct" is not insurable. Nevertheless, it is difficult to argue against indemnifying a client for one's willful misconduct.)

### An Attempt to Draft a Reasonable Indemnity Clause

Consider the clause below in which the consultant attempts to make it clear that there will be no defense duty, and that the indemnity is limited to costs and damages the indemnitee is legally obligated to pay to third parties.

"Indemnification. Notwithstanding any clause or provision in this Agreement or any other applicable Agreement to the contrary, Consultant's only obligation with regard to indemnification shall be to indemnify (but not defend) the Client, its officers, directors, employees and agents from and against damages arising out of third-party claims that Client is legally obligated to pay as a result of the death or bodily injury to any person or the destruction or damage to any property, 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."



Note that in this example clause, the author went beyond deleting the defense obligation, but went the next step to affirmatively state that there would be no duty to defend. This affirmative statement is necessary in some California contracts to avoid the automatic imposition of a defense duty as part of an indemnity clause pursuant to statute and court holdings. The duties have also been limited to damages from third-party claims.

Historically, it was understood that indemnification clauses pertained only to third-party claims and not to the first-party claim of the client directly against the indemnitor. Indeed, since the client could bring a breach of contract action against the consultant for damages caused by the acts and omissions of the consultant, the indemnification clause would serve no additional purpose unless it was for third-

party claims against the client. Increasingly, however, project owners are drafting these clauses so broadly that they go beyond third-party claims and enable the owner to recover first-party damages for basic breach of contract. To avoid any confusion on this matter, it may be appropriate to affirmatively narrow the scope of the indemnity provision so that it expressly applies only to third-party claims for bodily injury and property damage. Recent cases such as *Wal-Mart Stores, Inc. v. Qore, Inc.*, 647 F.3d 237 (5th Cir. 2011) have held that the language of an indemnity clause allowed recovery of attorney's fees expended by a project owner in first-party actions against an engineer.

**...narrow the scope of the indemnity provision so that it expressly applies only to third-party claims for bodily injury and property damage.**

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## Conclusion

As noted by the cases discussed herein, responsibility for paying attorney's fees incurred by another party can arise by the express contractual indemnity language despite the fact that they would not otherwise be recoverable under state common law or statutory law. If that happens, those attorney's fees are not recoverable under a professional liability policy. When negotiating indemnification clauses in design professional contracts (as well as other types of contracts), it is important to carefully craft the clause so that the obligation to indemnify is limited to the extent of damages caused by the indemnitor's negligence. It is also important to make the clause applicable only to damages arising out of third-party claims against the indemnitee. It is generally assumed that an indemnity clause is only intended to respond to legal liability the indemnitee incurs as a result of third-party claims. In view of recent case law, that may be a bad assumption. It may be prudent to expressly state that the indemnity applies only to damages arising out of third-party claims.

**If the only legal basis for recovery of damages against the design firm is the contractual indemnity clause, then the contractual liability exclusion of the insurance policy will bar coverage for those damages.**

Design professionals should also be aware that the contractual liability exclusion in their professional liability policy states that there is no coverage for liability assumed under indemnification clauses that would not have been imposed by law (meaning either state common law or statutory law). If the only legal basis for recovery of damages against the design firm is the contractual indemnity clause, then the contractual liability exclusion of the insurance policy will bar coverage for those damages. Likewise, if the only basis for imposing attorney's fees against the design professional is the contractual indemnification language, there is no insurance coverage for those fees since they are not "damages" that would be awarded by the court in the absence of the contract language. Therefore, they are barred by coverage pursuant to the contractual liability exclusion.

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