

GUEST ESSAYS

Indemnification: Limit it to Damages Resulting from “Tort” Claims

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A recent court decision requiring an engineer to indemnify and defend its client, a project owner, against a routine contractor claim is a wakeup call to further clamp down on indemnification language so that only those damages resulting from tort claims against the indemnitee based on the negligence of the design professional will be indemnified, and that there will be no duty whatsoever to defend such claims.

In the case of *Penta Corporation v. Town of Newport v. AECOM Technical Services, Inc.*, No. 212-2015-CV-00-011 (Merrimack, New Hampshire Superior Court, 2016), the trial court held that the engineer owed its client, the town, a defense against a contractor suit that alleged that the plans and specifications prepared by the engineer and provided by the town to the contractor for bidding and construction were defective. It was a routine breach of contract claim by the contractor against the project owner, but the court concluded the indemnification agreement in the engineer’s agreement with the town was broad enough to obligate it to defend the town against the contractor’s claim.

Some Questions to Consider

When an indemnification clause includes an obligation to “defend,” what exactly does that mean? If the defense is limited to claims arising out of the negligence of the indemnitor, does that mean a finding of negligence must be made and then the indemnitor will reimburse the indemnitee for its attorneys’ fees? Or, does it create a distinct and broader duty, separate and apart from the indemnification obligation, that requires the indemnitor to defend a claim “on behalf of the indemnitee” as soon as the claim is made, even if there is never a determination of negligence? Finally, what constitutes a “claim” that must be defended – does it include a run of the mill change order request from a contractor that subsequently becomes a complaint in court against the owner?

This court decision is an eye opener, and the answers it gives to the above questions will perhaps be a shocker to many who are reading this.

Facts of the Case

The contractor filed suit against the town to recover payments it alleged were owed it under its construction contract. It included counts for breach of contract and negligent misrepresentation. Its complaint asserted that it completed the construction in accordance with the plans and specifications of the town’s engineer, which called for a specific brand of disc filters for a wastewater treatment facility. It further alleged that the reason the constructed facility failed to meet the required effluent limits was because the design specifications prepared by the engineer were incapable of handling the required flow of wastewater, which was a condition outside of its control.

Upon receipt of the suit, the town sent the engineer a demand for a defense against the contractor’s suit pursuant to the terms of the indemnification clause in the contract between the engineer and the town and the engineer. The engineer responded to the town’s demand, stating it would not defend (or indemnify) the town because the allegations of the contractor were not directed at the engineer.

Getting Around the Spearin Doctrine and Effectively Holding Design Professional to a Standard of Perfection Instead of Normal Standard of Care

Before going further with this analysis, it is important to note, based on the facts presented in the court’s decision, the dispute between the contractor and the town is essentially of the type of dispute one typically sees on many projects – with a contractor alleging it is entitled to additional compensation due to problems it (allegedly) encountered with the plans and specifications prepared by the project designer.

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Under basic principles of common law, the project owner grants an implied warranty of the adequacy of the project plans and specifications to the contractor when it gives those plans and specifications to the contractor. The contractor is entitled to rely upon the accuracy of the documents so that if it builds according to the documents, the work will be successful and the project will function as intended. This is called the Spearin Doctrine, and is based on the seminal decision of *United States v. Spearin*, 248 U.S. 132 (1918).

This means that the contractor is entitled to a change order or equitable adjustment from the owner if different or more costly work is necessitated because of flaws in the plans and specifications. And that is so regardless of whether the design professional satisfied the standard of care when preparing the documents.

Although the project owner owes a warranty of the plans and specifications to the contractor pursuant to the Spearin Doctrine, under the common law, the design professional owes no such warranty to the owner. Consequently, an owner can get caught “holding the bag.” It must pay the contractor a change order for the contractor’s extra costs caused by the defective plans and specifications, yet it cannot recover those costs from its design professional absent proof that the design professional was negligent in preparing the documents. That requires expert testimony to prove what the standard of care was and that the design firm failed to meet that standard.

What the decision in *Penta* case demonstrates is a clever (shall we say devious) way that a project owner can make its design firm liable for contractor change orders without ever having to prove negligence by way of expert testimony. The project owner, in a manner of speaking, makes the engineer liable for perfection and effectively eviscerates any standard of care clause that might have been in the contract by requiring the engineer to “step into the shoes” of its client and provide the client with a defense upon the mere allegation that the engineer’s plans and specifications were somehow defective.

Duty to Defend is Triggered as Soon as Claim is Made

The engineer argued that any duty it had with regard to the town’s defense was only a duty to reimburse the town’s attorneys’ fees if and when a final determination was rendered that the engineer owed the town indemnification as result of the engineer’s negligence. The court rejected that argument. It stated:

Generally, to “defend” means “[t]o do something to protect someone or something from attack,” “[t]o deny, contest, or oppose,” or “[t]o represent (someone) as an attorney; to act as legal counsel for someone who has been sued or prosecuted.” *Black’s Law Dictionary* 508 (10th ed. 2014). Based on this definition, it has been observed that a contractual duty to defend “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.” *Crawford v. Weather Shield Mfg. Inc.*, 187 P.3d 424, 431–32 (Cal. 2008). The general meaning of a duty to defend is therefore “different from a duty expressed simply as an obligation to pay another, after the fact, for defense costs.”

In a footnote, the court commented that parties to a contract “are free to contract around any presumed scope of the duty to defend....” The court quoted a Maryland decision for the proposition that “[u]nless the parties’ agreement expressly provides otherwise, a contractual indemnitor has the obligation, upon proper tender by the indemnitee, to accept otherwise, a contractual indemnitor has the obligation, upon proper tender by the indemnitee, to accept and assume the indemnitee’s active defense against claims encountered by the indemnity provision.”

The Indemnity Clause

In this case, the court concluded that the language of the indemnity provision established a duty to defend that was broader in scope than the duty to indemnify, based on the relevant language of the clause, which provided that the engineer:

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shall indemnify, exonerate, protect, **defend (with counsel acceptable to the Town . . .)**, hold harmless and reimburse the Town . . . **from and against any and all** damages (including without limitation, bodily injury, illness or death or property damage), losses, liabilities, obligations, penalties, **claims (including without limitation, claims predicated upon theories of negligence, fault, breach of warranty, products liability or strict liability), litigation**, demands, defenses, judgments, **suits**, proceedings, costs disbursements, or expenses of any kind or nature whatsoever, including without limitation, attorneys' and experts' fees, investigative and discovery costs and court costs, **which may at any time be** imposed upon, incurred by, **asserted against**, or awarded against **the Town . . . which are in any way related to the Engineer's performance under this Agreement** but only to the extent arising from (i) any negligent act, omission or strict liability of Engineer, Engineer's licenses, agents, servants or employees of any third party, (ii) any default by the Engineer under any of the terms or covenants of this Agreement, or (iii) any warranty given by or required to be given by Engineer relating to the performance of Engineer under this Agreement.

Duty to Defend Applied to "ALL" Claims – Not Just Tort Claims

The court noted that the duty to defend applies to "claims," "litigation," and "suits" that are "asserted against" the town and related to the engineer's negligent contract performance.

Significantly, the court concluded, "This language anticipates unproven allegations, meaning the duty to defend would necessarily arise prior to any factual finding as to [the engineer's] negligence or breach." The court said, "If [the engineer's] duty to defend only required it to reimburse the Town for the cost of a defense following adjudication of [the engineer's] negligence or breach, then the Town would necessarily have to choose its own counsel, thus rendering the [choice of counsel language in the clause] meaningless."

It is important to note that the indemnity clause was applied to all claims, losses and damages of the town without regard to whether a third party made a tort claim such as a negligence-based claim against the town. The contractor here merely made a breach of contract claim against the town. The town, in turn, had a potential breach of contract claim against the engineer if it could prove, via expert testimony, that the engineer violated the professional standard of care. Yet, in the absence of any property damage, bodily injury, or tort claim by any third party, the court found sufficient language in the contractor's claim to trigger a duty to defend prior to any determination regarding the engineer's alleged negligence.

"Arising Out Of" is Very Broad Term

The engineer argued that the language of the clause reading "but only to the extent arising from" served as a strict limitation on the engineer's responsibility. The court rejected that argument, stating, "The phrase 'arising out of' has been construed as a 'very broad, general and comprehensive term' meaning 'originating from or growing out of or flowing from'." The phrase, according to the court, "indicates intent 'to enter into a comprehensive risk allocation scheme.' 'Arising out of' does not mean that any losses or claims must have been caused by [the engineer's] negligence or breach. Nor does it necessarily require an action for negligence or breach. A claim merely has to involve an alleged negligent act or omission in the performance of the contract."

Thus, the court concluded that the engineer's assertion that adding the words "to the extent" in front of "arising from" did not alter the broad intent of the words "arising from."

Contractor's Complaint Against Town Sufficiently Alleged Claims Involving Engineer

The contractor stated in its complaint that it completed construction in accordance with the engineer's plans and specifications. It alleged that the wastewater plant failed to meet the regulatory requirements due to the filters specified by the engineer. "These claims," said the court, "clearly arise from [the engineer's] contract performance, and the factual

allegations necessarily characterize [the engineer's] performance as negligent or in breach of its contractual obligation to design the project to achieve the promised phosphorous levels." For these reasons, the court found that the complaint alleged claims against the town within the scope of the duty to defend provision, and thereby triggered the engineer's duty to defend the town.

Comment on Drafting the Indemnification Clause

Historically, indemnification was only for tort claims for property damage and bodily injury claims made against the indemnitee. Breach of contract claims and first party claims by a project owner were not intended to fall within the context of indemnification. Over the years, we have seen the language of indemnification clauses increasingly broadened to cover all claims, damages, and losses incurred by the indemnitee that "arise out of" the indemnitor's work or services. This creates an uninsurable liability that we attempt to correct by modifying such clauses so that the design professional does not indemnify against "claims" at all but rather indemnifies the owner for damages "arising out of claims". We have further endeavored to limit claims to "third party claims." As a party to its contract with the design professional, the client does not need a contractual right to indemnity in order to assert its claims against its design professional.

The need to add "third party" as a modifier of "claim" was revealed in the decision of *Wal-Mart Stores v. Qore, Inc.*, 647 F.3d 237 (5th Cir., 2011) in which a court concluded that Wal-Mart could make a first party claim against Qore to recover losses incurred on the project even though no third party claim was ever made against Wal-Mart. Moreover, that decision imposed attorneys' fees on Qore by concluding that the defense obligation in the indemnification clause meant that Qore was responsible for the attorneys' fees incurred by Wal-Mart in prosecuting a claim against the engineer and contractor. After reading that decision, risk managers sought to avoid first party claim indemnity by specifically limiting indemnity to damages from "third party" claims only.

That revision is apparently no longer good enough because a contractor change order claim against an owner might be considered a "third party claim." The solution is to add the word "tort" so that indemnity is only for "third party tort claims." With regard to the defense obligation, there are several viable solutions. Consider (1) adding a sentence stating, "The duty to defend shall not apply to professional liability claims," (2) deleting the word "defend," or if necessary deleting the word "defend," but offering somewhat of a compromise by stating, "Consultant agrees to reimburse Owner for reasonable defense costs, provided however that such obligation is limited to the portion of such costs equal to the percentage of Consultant's liability as determined to be caused by the intentional misconduct or negligence of Consultant using principles of comparative fault."

A Sample Clause for Your Consideration

The following sample clause seeks to address the issues highlighted in this article:

Consultant shall indemnify and hold harmless (but not defend) the Client, its officers, directors, and employees, from and against those damages and costs that the Client is legally obligated to pay as a result of third party tort claims, including the death of or bodily injury to any person or the destruction or damage to any tangible property, to the extent caused by the negligence of the Consultant or anyone for whom the Consultant is legally responsible, subject to any limitations of remedies or liability contained in this Agreement.

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