

Contract Information

Understanding Indemnification Agreements

by Jeffrey W. Cavignac, CPCU, ARM, RPLU, CRIS, Cavignac & Associates

As a matter of course, design professionals should have their insurance representative review client contracts before signing them. While a number of different provisions of a contract need be scrutinized, by far the most critical from a risk management and insurance perspective is the indemnification clause.

An indemnity agreement is a risk-transfer mechanism in which one party is transferring risk to another party. In an indemnity agreement, one party, the "indemnitor," agrees to "indemnify" the other party, the "indemnitee," for things spelled out in the indemnity clause. Unfortunately, it is common for design professionals to be asked to indemnify their clients not only for their own negligence, but for the clients' negligence as well. This is not only unfair, it is also uninsurable under a professional liability policy.

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 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 omissions. Obviously, such an all-encompassing blanket indemnification creates enormous and largely uninsurable liabilities.

In some states (California, for example), broad form indemnification has been made illegal by virtue of court decisions or anti-indemnification statutes. 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 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 the 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.

Unfortunately, this contractual assumption of risk is not covered under a professional liability policy. Your professional liability policy covers you for your negligent acts, errors, and omissions. It does not cover you for the negligence of others that you assume contractually.

- *Limited Form Indemnities.* The limited form indemnity reflects what common law requires in any event – i.e., if you are 20% at fault, you will pay 20% of the damages. A typical limited form indemnity reads 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.

The Problems

Most client-drafted indemnities ask design professionals to be responsible for more than their own negligence.

- Client-drafted indemnities often require design professionals to indemnify the owner for everything except the owner's "sole" negligence; as mentioned above, this is not insurable.
- Client-drafted indemnities often are based on "intentional acts" or "performance" as opposed to "negligent acts, errors, or omissions."
- Client-drafted indemnities often require the design professional to indemnify not only the client, but also the client's agents, contractors, attorneys, and other unrelated parties that the design professional does not want to indemnify.
- Client-drafted indemnities often require design professionals not only to indemnify the client, but also to defend the client. A design professional

should avoid the obligation to defend at all costs. A 2008 California Supreme Court Case (the Crawford Case) made it clear that the obligation to defend was separate from the obligation to indemnify, and the indemnitor could be responsible for the indemnitee's defense costs – even if it were ultimately determined that the indemnitor was without fault.

The Dilemma

What should a design professional do when faced with an indemnity that is unfair and uninsurable? The only real option is to negotiate the agreement.

- *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, don't assume that, because your state has anti-indemnification statutes in place, you can accept a broad-form indemnity because it would be struck down in court. 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 in which 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 liability is simply unjust. Reaffirm your willingness to accept responsibility for your own errors and omissions, but your unwillingness to be held liable for the mistakes and oversights of others. Explain how it is unfair to hold a design firm responsible for liabilities that are completely out of its control.
- *Offer Alternatives.*
 - Propose a reciprocal indemnity in which each party agrees to hold harmless and indemnify the other for their respective negligence.
 - Propose a unilateral, but insurable, indemnity that only obligates you to indemnify the owner from the consequences of your negligence.
 - Propose a bifurcated or split indemnity that is broader for general liability claims (general liability policies provide broader contractual liability coverage) and narrower, but insurable, indemnity for professional services (the City of San Diego uses such a provision).

Conclusion

Some clients will understand that the risk they are asking you to assume is unfair, and will change their agreements to make them acceptable. Others, however, will not. They will tell you that "everyone else signs it" and if you don't want the job, other qualified firms are waiting at the door.

At this point, you have a tough decision to make. Do you walk away from the job and forego a nice fee? Or do you close your eyes, sign the

agreement, and hope the job goes off without a hitch? This is a decision only you can make.

•••