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PACIFIC NORTHWEST DESIGN PROFESSIONAL LEGAL UPDATE

WASHINGTON OREGON ALASKA IDAHO

SPRING 2009

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INDEMNITY ISSUES REVISITED:
Consultant agrees to *DEFEND, INDEMNIFY AND HOLD HARMLESS*

These few words in design professional contracts (and the phrases of the contract that always follow) remain a source of major risk for design professionals. They also continue to generate a great deal of confusion.

We have written about these issues many times, yet indemnification provisions lie at the core of many disputes between design professionals and their clients. Spotting these pesky clauses and addressing them in contract negotiations are key ingredients to successful risk management.

The words *DEFEND, INDEMNIFY AND HOLD HARMLESS* mean very different things and generate very different risks.

The Duty to Defend

The *duty to defend* usually arises when a client is presented with a claim from a contractor or a third party and the client contends the design professional should take on the burden of the client's defense of that claim because the contract puts the obligation of defense on the design professional.

There are many types of claims for which clients may demand a defense from the design professional. The remainder of the "*defense, indemnity and hold harmless*" clause usually describes the kinds of claims for which a defense obligation may apply. Common claims for which the *duty to defend* may apply are: construction claims brought by the construction contractor against the owner; property damage claims brought by third parties against the owner; personal injury claims brought by injured workers or members of the public against the owner; claims arising out of the discovery or mishandling of hazardous waste; or lien claims asserted by subcontractors or suppliers.

The most common claim faced by design professionals arises out of a contractor claiming extra compensation before the job is finished.

Assume the design professional agreed to contract language under which the design firm promised to:

> ***Defend*... the owner against any and all claims arising out of the professional services provided under this Agreement....**

While the job is still in progress, the contractor seeks a large change order from the owner, claiming the contractor's cost overrun is due to a combination of defects in the plans and specifications and delays by the design professional in responding to contractor RFIs and in reviewing and processing the contractor's submittals. This is a very typical claim scenario.

The design professional (and possibly also the owner) recognizes that the contractor may have under-bid the work and is trying to be made whole with an unjustified, yet massive change order request. Nevertheless, the contractor presses ahead with the claim and has

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filed a lawsuit or demanded arbitration against the owner, seeking to be compensated for the value of the contractor's claim.

This *duty to defend* clause may well require the design professional to defend the owner against this claim, even though the design professional may be ultimately successful in defeating the claim and in establishing that the design professional was not negligent.

In Washington, the *duty to defend* and *the duty to indemnify* arise at different times. The *duty to indemnify* does not come into play until the underlying liability becomes fixed and absolute. This usually means that the party seeking indemnity (here, the owner) is legally obligated to pay damages to the contractor in an amount that has been finally determined. This *duty to indemnify* may not arise until the lawsuit is over, all appeals have been exhausted and a final judgment has been entered.

As a practical matter, the *duty to defend* can arise much earlier. The *duty to defend* can be invoked as soon as the owner can review the claim and reasonably conclude that the owner risks liability, the claim arises out of the services provided by the design professional, and the design professional agreed in the contract to provide a defense.

Also as a practical matter, the underlying claims of this type are rarely black and white situations. Frequently, contractors will allege errors by the design professional as well as errors or interference by the owner, raising the issue of whether the design professional's duty to defend extends to the entire contractor lawsuit or just to certain claims. It will take much money, time and effort to pull together a defense of the claim before parties are willing to negotiate a final resolution. This means that a *duty to defend* clause in a contract with a client puts the design professional at risk for a very expensive defense of a possibly unjustifiable contractor claim. Given that design professionals typically do not have the ability to select the contractor for any particular project in advance, the risk can be great if the contractor selected by the owner has a reputation for underbidding projects and over-litigating change orders.

Is the duty to defend an insurable risk?

Professional liability insurance policies provide coverage for professional negligence and not for contractual liability. Depending on the phrasing of the contract, the *duty to defend* the owner in a particular case may well be a contractual undertaking between the design professional and the owner that is unrelated to the duty to comply with the professional standard of care. The design professional can be stuck without insurance coverage for the costs of defense.

To add insult to injury, the refusal to accept the tender of defense can expose the design professional to an independent claim for breach of contract, since *the duty to defend* is an independent contractual undertaking. The measure of damages for such a claim may well be the owner's costs of defense under circumstances where the design professional had no control over the costs or the management of the defense.

How should the design professional manage this risk?

- ◊ Train all personnel who negotiate and review contracts to spot any *duty to defend* clauses;
- ◊ These clauses should be removed from all design professional contracts;
- ◊ If the client is adamant that some *duty to defend* remain, the nature and extent of that duty should be limited and specifically negotiated.

The Duty to Hold Harmless

The duty to hold or *save harmless* often appears in these clauses, along with the *duty to indemnify*. This phrase is redundant as the *duty to hold harmless (or save harmless)* can mean the same thing as the *duty to indemnify*. To *hold harmless* means to make good or repay the other party to the agreement in the event of a specified loss.

Under some circumstances, the *duty to hold harmless* can be construed as a stand-alone release from liability of the party who is benefited by the clause. In this case, the blanket *hold harmless* provision may be uncoupled from the remainder of the provisions in the clause that spell out the more limited circumstances under which the *duty to indemnify* may apply. A stand-alone *hold harmless* clause or a *hold harmless* clause that can be construed as release of all liability can greatly expand the exposure being undertaken by the design professional.

We have enough difficulties negotiating narrowly crafted and fair indemnity clauses without cluttering them up with the concepts of providing a defense and granting a pro-

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spective release of all liability to a client. It is better to make the indemnity clause as clear and as simple as possible, so that it can be readily understood by the parties to the contract and to any court that may be later faced with discerning the intent of the contracting parties. The indemnity concept should not be cluttered up with other risk-shifting concepts.

How should the design professional manage this risk?

◊ The *hold harmless* provision in the contract probably adds nothing to the legitimate indemnity undertakings. It should be removed.

The Duty to Indemnify

The *duty to indemnify*, in its basic form, is an agreement to pay or insure another party against specified loss. As explained above, the *duty to indemnify* arises when the actual loss becomes known.

Any proposed *duty to indemnify* clause should trigger the following questions:

- What does the proposed indemnity clause actually mean?
- Is the proposed indemnity clause permissible under the state's anti-indemnity statutes and case law?
- Does the clause shift unacceptable risks to the design professional?
- Are the risks covered by the proposed clause insurable?

Unfortunately, these are not always easy questions to answer. More times than not, we find that our clients do not know what risks may be buried in the indemnity clause.

The clause should be parsed to determine its intended meaning. Questions include:

(1) To whom does the indemnity protection extend? Who is obligated to provide the protection? Indemnity protection often extends to others besides the party with whom the design professional is considering entering into a contract. For example, we frequently see indemnity clauses that extend the indemnity protection to other consultants and contractors who have contracted directly with the owner or to lenders and third party financial institutions providing funding for the project.

(2) What kinds of claims and other losses fall within the indemnity protection - economic losses, personal injury, property damage, injury to workers, environmental damage, intellectual property claims, etc.? The Washington anti-indemnity statute, which applies in a construction setting, limits the permissible reach of an indemnity obligation for claims arising out of damage to property or injury to persons. The general concepts embodied in this important statute are: i) the party receiving the benefit of the indemnity protection cannot be indemnified for its sole negligence; and ii) the extent of the indemnity obligation should be limited to the percentage of fault on the part of the party providing the indemnity protection. However, many owners argue that for claims arising out of purely economic losses, as in the claim hypothetical above, the limitations in the Washington anti-indemnity statute do not apply. For this reason, it is increasingly common to see very long and complex indemnity clauses that impose broader indemnification obligations for economic loss claims than for claims arising out of damage to property or injury to persons.

(3) What conduct triggers the indemnity obligation – professional or other negligence, breach of contract, any conduct arising out of the services provided, anything relating to the project, etc.?

(4) If professional or other negligence triggers the indemnity obligation and there is comparative negligence, is the indemnity obligation limited by the extent of the comparative fault of the party providing the indemnity protection?

(5) If there is a waiver of immunity under the workers' compensation statute, does the waiver comply with the requirements of the anti-indemnity statue? Is the waiver mutual or one-sided?

The persons reviewing contracts should be able to pose and answer these questions. Many professional liability insurance brokers and carriers will assist their insureds in reviewing proposed contracts to evaluate these issues. Anyone reviewing such a clause must be able to answer this simple question: Do I fully understand what indemnity obligations I am agreeing to, if I approve this clause?

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If this question cannot be answered with confidence, it is time to ask for help from the firm's professional liability insurance broker, insurance carrier or counsel.

What can you do if the client insists on an unfair indemnity clause?

We have discovered that more times than not, a party insisting on a particular indemnity provision does not know what the clause actually means. Sometimes a sensible conversation is enough to obtain a modification of the clause so that it is both enforceable and at an acceptable level of risk. On occasion, it can be useful in these negotiations to have a professional liability carrier or broker intercede in the negotiations to inform the party demanding the indemnity protection that the particular clause is not insurable.

In public works contracts, Washington municipal bodies have become increasingly aggressive in demanding over-reaching indemnity clauses. Often these clauses protect only the municipal body and provide no protection to the design professional. Some of this heavy-handed insistence appears to be instigated by the various municipal risk pools that insure governmental bodies. Many firms have been told these clauses are a "take it or leave it" proposition.

In some circumstances, organizations like ACEC have been successful in addressing these over-reaching clauses with municipal attorneys and upper-echelon procurement officers.

Some comfort can be found in the contracting practices of the Washington Department of Transportation. The Wash -DOT Local Agency Guidelines, Standard Local Agency Agreement, Section XI – Indemnity, offers alternative clauses that are at least in conformance with the state anti-indemnity statute.

There is also guidance from the Washington Office of Financial Management on this subject. See Policy 16.20.15f, accessible online at www.ofm.wa.gov/policy/16.20.htm.

Owners of large commercial projects are also increasingly demanding onerous indemnity clauses and are often unwilling to negotiate more balanced and reasonable indemnity provisions. When faced with an overreaching owner of a private project, reference to industry standard clauses, especially those that have had input from owner's organizations, can sometimes be helpful in convincing a private owner that the clause being offered is unacceptable.

Many of the industry-standard form contracts, such as those offered by the EJCDC and ConsensusDocs, etc. offer reasonably balanced indemnity clauses. However, these clauses should be reviewed for conformance with local law requirements before being used in a particular jurisdiction.

Conclusion

Indemnity clauses continue to generate unacceptable risk for design professionals. We strongly advise firms to invest the necessary time to train their personnel on these issues and remain vigilant in avoiding unacceptable levels of risk. The willingness to accept an overreaching clause can lead to very unfortunate results.

William J. Bender