

Defending and Indemnifying a Client

A professional service firm is responsible for rectifying any harm to its client that is the result of the firm's negligence. Such responsibility is a basic tenet of U.S. law, and it's the basis of professional liability insurance coverage. However, firms are increasingly facing demands from clients that exceed this responsibility.

Clients may request contractual provisions that extend their right to recover for losses and damages. Clients usually want to be indemnified for any costs incurred when a suit by a third party simply mentions the possible negligence of the professional service firm. Some clients may also want to shift defense and subsequent costs to design firms for any claims that have any relationship to the professional service firms' services.

Indemnity Obligations May Implicitly Require Claims Defense

In some jurisdictions, the obligation to provide defense is implied in any obligation to indemnify for a loss. For example, the California Supreme Court has held that under California statutory law, unless the parties to a contract agree otherwise, a party having an indemnity obligation under the contract is also obligated, upon request, to provide defense for the protected party. Without a "contrary intention" being expressed, the entire defense can be tendered based simply on an indemnity commitment. In California and in other states

that infer defense from indemnity commitments, it is prudent to state contractually that the professional firm has no obligation to defend the client and that the firm's obligations regarding the client's defense only include the reimbursement of reasonable attorneys' fees and expenses recoverable under applicable law, but only to the extent incurred due to a negligent act, error, or omission of the design firm in the performance of professional services. Such a "contrary intention" statement should be confirmed with local legal counsel.

Professional Liability Insurance is a Specific Coverage

It does not cover contractual obligations except the obligation to carry out duties according to the professional standard of care. Assuming a contractual obligation to defend and indemnify a client against claims from third parties goes beyond the scope of coverage. Most insurers will indemnify a policyholder's client for reasonable defense costs that are recoverable under applicable law or that are clearly identified in litigation as damages to the client resulting directly from the negligence of the policyholder. However, no professional liability policy is priced to include the cost of defending a client against any claims that might have some relationship to the services provided by the insured firm. Such an extremely broad contractual obligation is clearly not covered by insurance.

Contractual Obligation to Indemnify Clients Extends Exposure of Policyholders

In some states—those with contributory negligence theories for tort claims—a firm may not be responsible to a client for damages caused by the firm’s negligence if the firm can show that the client’s negligence was the primary or a significantly contributing factor in causing the harm. Thus, an indemnity provision creates risk beyond the normal scope of liability. In most states, statutes of limitations and repose cut off the exposure for claims resulting from construction-related services. However, a contractual obligation to defend a client and to indemnify a client for harm may extend exposure indefinitely.

Indemnity Agreements May Hinder Resolution of Disputes

Arguments over coverage and the extent of harm are typical. Agreeing to defend a client can exacerbate coverage and cost issues. This may result in tremendous expenditures of time and money by policyholders in their attempts to defend claims. Some of the issues that arise whenever a defense obligation is assumed by a design firm include the following:

- **Can the firm afford to defend the client?** Any allegation triggers a cost to the firm payable from the firm’s assets. Any cost that might be paid as an insurance expense erodes policy limits. The firm may want to collect a fee from its client to fund its internal and insurance costs.
- **How open-ended is the commitment?** The language of defense and indemnity provisions is extremely jurisdiction-specific and should be reviewed by local legal counsel. In application, the commitment is case- and client-specific, causing defense attorneys to modify the defense depending on the circumstances of the claim.
- **Does the provision mean that the client can be reckless?** Clients have a duty to act responsibly so forcing someone else to defend clients may take away an incentive to be a reliable part of the design process.

Clients Need to Understand Limitations of Professional Liability Coverage

When firms discuss an indemnity provision that includes an up-front defense obligation or requires defense irrespective of fault, they should make sure their clients know the following:

- A professional liability policy covers the insured firm for its wrongful acts that are based on an unmet standard of care for professional services. Coverage is only for the firm’s negligence in performing professional services to the client.
- The defense by the insurer of a policyholder does not extend to the defense of the policyholder’s client.
- Nothing in a professional services agreement expands the duty an insurer has to a policyholder; that duty is based on the contract of insurance. Onerous contract language usually produces nothing but an illusory sense of protection for the client.

Contractual Commitments Can Distort Normal Legal Relationships

A contractually assumed indemnity agreement that includes a defense obligation puts a design firm at great risk. When assessing any contractual obligation that extends beyond normal professional liability exposure or risks covered by other insurance policies, a firm should analyze what risk-funding allowance should be built into its fees. This is especially true whenever a client shifts defense to the firm. The defense commitment could be a significant expense that depletes a firm’s assets.

Basically, a firm can feel confident that the contractual commitment assumed by signing a contract with an indemnification provision does not extend beyond the professional liability insurance coverage if the following are clearly expressed about the indemnity obligation:

- It relates to the professional services being provided by the firm or the firm’s subconsultants.
- It is tied to the indemnification of a cost, loss, or damage that was caused by the failure of the firm to meet the standard of care for professional services. (Using the word “negligence” helps to accomplish this.)
- It is proportional so that the contractual liability of the firm is only to the extent that the cost, loss, or damage was within the scope of responsibility of the firm.
- It has some time limitation either by contract, the statute of limitations, or the statute of repose.
- No defense obligation is stated. In those states where defense is implied in any agreement to indemnify, consult your legal counsel regarding appropriate language specifically excluding the defense obligation from the agreement.

Sample Contractual Indemnity Language Must Meet State Law

Each party should be willing to be responsible for losses and claims to the extent that they are caused by the party's negligence. Few clients, however, are willing to contractually commit to paying for harm they cause. While reciprocal obligations make sense, a one-sided commitment that is narrow in scope commits the professional service firm to financial responsibility to the extent that the firm is determined negligent. Such an obligation usually tracks with the firm's normal legal liability. One example of a contractual indemnity obligation that attorneys have suggested as being within the scope of professional liability insurance coverage is the following:

Sample provision: To the fullest extent permitted by law, Consultant shall indemnify Client, its officers, directors, partners, employees, and representatives from and against losses, damages, and judgments arising from claims by third parties, including reasonable attorneys' fees and expenses recoverable under applicable law, but only to the extent they are found to have been caused by a negligent act, error, or omission of Consultant or Consultant's officers, directors, members, partners, agents, employees, or subconsultants in the performance of services under this Agreement.

Inform Clients That the Firm is Not Assuming Any Obligation for Defense

The firm should communicate in the contract that the firm's obligation regarding the client's defense only includes the reimbursement of reasonable attorneys' fees and expenses recoverable under applicable law. Such an obligation is only to the extent that costs are incurred due to the firm's negligent act, error, or omission. This makes it more likely that a firm's contractual obligation tracks with its legal duty as a professional.

A firm's professional liability insurance broker or carrier can provide a statement that clearly indicates that a contractual indemnity obligation, with or without a stated defense obligation, triggers the contractual exclusion in the policy, and therefore is a business risk for which the firm should be compensated. A firm's insurer, however, cannot provide legal advice. It is essential that contractual commitments such as assumed defense and indemnity obligations be reviewed with legal counsel.

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Victor Insurance Managers Inc. (fka Victor O. Schinnerer & Company, Inc.) recently filed in all U.S. jurisdictions to re-brand and change its name. This name change has become effective in almost all states while still pending in several states, which we expect will complete their approval processes shortly.

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