

ProNetwork News

Risk Management Tools for the Design Professional



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An Unfair Duty to Defend

By Samuel Greengard

No engineering project is without risk. Somewhere between the goal of designing the best bridge, building or water treatment facility and running a profitable business lurks the ever-present possibility of litigation. A legitimate disagreement can occur, a company can make a mistake, or a firm or government entity—or a member of the public—can file a lawsuit that forces the firm to defend itself and its work. “A lot of risks exist and they’re not necessarily related to the quality of the work performed,” says John Moossazadeh, a senior vice president at Kleinfelder in San Diego.

Engineering firms often take jobs that knowingly expose the firm to legal risk. But how much risk is too much?

That’s a question that more and more engineering and design firms are asking when confronted with contracts that contain controversial “Duty to Defend” language.

A contractual Duty to Defend provides that the engineering firm will pay for attorney’s fees and costs incurred in a client’s defense of a claim. Depending on the contract language and the governing jurisdiction, this duty may be immediate from the time the claim is made, and may exist regardless of whether the engineer is found to be negligent. Although basic indemnification and defense clauses are common, and they typically assign risk to the negligent party, a growing number of developers and agencies request—and, in some cases, demand—that the consultant or firm in charge of the project defend any suit or other legal action brought against the developer or owner, and sometimes even irrespective of whether the claim is related to the engineer’s services.

Duty to Defend provisions are therefore criticized because a consultant or engineer who signs such an agreement could be legally required to bear the cost of defending against any project-related claim, even when the claim has nothing to do with the services performed by the firm, and there’s zero evidence of negligence. “It forces engineers to take responsibility for far more than the work they’re being paid to do and what their insurance covers,” explains P. Douglas Folk, principal at Folk & Associates in Phoenix.



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Fighting Back

Recent court rulings have put A/E/C firms at greater risk, extending the express or implied defense obligations contained in indemnity clauses. Many firms, meanwhile, say they've had enough.

Because of concerns about the scope of Duty to Defend language in new project contracts, engineering and design firms have attempted to strike such provisions from deals or write in protections. Firms that cannot negotiate such protection or reduce their overall liability have been forced to turn down work. The industry, meanwhile, has attempted to enact laws that offer a more balanced assumption of risk for engineers and their clients. "Duty to Defend is a very serious obligation with potentially disastrous consequences. Unless it is carefully limited, it can be fundamentally unfair," says Paul Meyer, executive director of ACEC/California.

Courting Disaster

Over the years, indemnity clauses have emerged as a standard fixture in engineering and construction contracts. The typical goal is to assign responsibility for third-party claims to the party that is responsible for negligent acts or omissions underlying the claims. Most of these contracts contain language that states that the person or firm in charge of the project will indemnify the other party for damages to the extent arising out of or relating to that person's or firm's negligence.

However, these indemnity provisions often include in their scope an express or implied Duty to Defend obligation. This Duty to Defend may force the design professional to retain or pay for attorneys to defend the client against claims, even if the claims are merely alleged to arise out of services performed by the design professional and even if it is determined that the services in question met the professional standard of care—in other words, even if the design professional was not negligent.

Most professional liability insurance (PLI) policies do not cover the cost of legal fees paid to defend a client. Moreover, PLI typically only covers the firm that obtains the policy and only applies to damages resulting from negligence. "Anything more is barred from coverage," explains J. Kent Holland Jr., an attorney who heads Construction Risk Counsel, a Tysons Corner, Va.-based consulting firm.

It's no small problem. "Duty to Defend extends the defense obligation and the costs associated with the law-suit without consideration for the party that is actually negligent," says Karen Erger, vice president and director of practice risk management at Lockton Companies in Kansas City, Mo., a provider of insurance and risk management services for the design, engineering and construction industries. "For those who agree to a Duty to Defend clause, there is a huge unfunded liability and a significant level of financial risk."

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A project that represents \$25,000 in revenues for a firm can end up costing the same firm more than \$1 million in legal defense fees. Given the litigious culture we live in, those claims can come from just about anywhere—an unhappy homeowners association member, a citizens' rights group that takes issue with the project or believes that some aspect of the work was improperly done, etc. "There is no way to predict who might file a lawsuit for a reason that has nothing to do with quality of the services or, if it is a legitimate claim, whether it has anything to do with negligence on the part of the firm that winds up having to defend the suit," Holland says.

Over the years, courts have stripped away protections once afforded to A/E/C firms. In a bench-mark 2008 California case, *Crawford v. Weather Shield*, the state's Supreme Court ruled that a contractual indemnity clause compelled a subcontractor to pay legal fees of the general contractor as part of a third-party suit, even though the subcontractor was not found negligent. The net effect: A subcontractor must defend a builder regardless of whether the subcontractor is required to indemnify the builder or found at fault in any way. Translation: Duty to Defend is implied in a contract unless otherwise stated.

More recent court rulings have under-scored such risks. In 2010, a California appellate court ruled in *UDC-Universal Development v. CH2M HILL* that the engineering firm had a duty to pay the defense expenses of its client, UDC-Universal Development, from the commencement of the claim, even though CH2M HILL was eventually found not negligent.

The court's decision was based on the conclusion that the engineer's work was "implicated" by the plaintiff homeowners association's claims, and that the professional services agreement between both parties provided that the engineer contractually agreed to "defend any suit, action or demand brought against Developer or Owner on any claim or demand covered herein," Holland explains.

In recent years, clients and agencies seeking engineering services have put pressure on competing firms to sign Duty to Defend clauses. A tougher business climate made it easier for clients to dictate terms to smaller companies. "There are those who say, 'If you don't sign the agreement with a Duty to Defend clause, we will find another company willing to accept the terms,'" Erger says. As a result, "firms—especially smaller businesses—are forced into an extremely tough decision. They either have to risk losing the work or taking on the risk and defending any third-party claims."

We Will Not Rest

ACEC, along with other industry advocates, continues to push for laws and policies that would reduce the liability burden that Duty to Defend language places on engineering and design firms.

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“There’s a growing focus on taking the issue to state legislatures and amending laws,” Meyer says. In California, S.B. 972, which became law in September 2010, amended California Civil Code section 2782.8 to limit the enforcement of indemnification clauses on design professionals working for local public agencies. Under the law, which was backed by ACEC, indemnity and Duty to Defend obligations in contracts between design professionals and public agencies are limited to those situations in which the design professional is negligent.

Last year in Washington state, Gov. Chris Gregoire signed H.B. 1559, which limits the enforceability of indemnification agreements involving design professionals by more expressly defining what is and is not protected under the law.

The revised statute expressly applies to contracts for “architectural, landscape architectural, engineering and land surveying services.” It also limits a firm’s Duty to Defend and voids provisions that require design professionals to defend a client for claims that arise out of client or third-party negligence. The previous statute applied to “construction” contracts but it was unclear whether that definition included contracts with design professionals, such as those between owners and architects.

Bill Garrity, president and CEO of ACEC/Washington, says the change represents an important and welcome shift in policy. The contractor’s liability for indemnification and defense is now limited to the extent of the contractor’s negligence, but only if it is expressly stated in the contract. “The revised statute should reduce the number of uninsurable risks created by indemnity provisions in professional services agreements,” he says, adding, “This should allow design professionals and their clients to better allocate risk.”

With ACEC taking the lead, other states—Colorado, Florida, Nevada, Oregon and Texas, among them—also have taken steps to reform existing indemnity laws. Engineers in Arizona are also advocating for indemnity changes in public works projects. ACEC/Arizona sponsored S.B. 1231, which passed the Arizona Senate and awaits passage in the House. It, too, changes the way indemnities are handled—so that design professionals and contractors are liable only for their own errors or omissions.

But Legislative Reform Is Not The Only Option

A/E/C firms can take several steps during contract negotiations to reduce the risk associated with indemnification. Kleinfelder often asks clients to remove risky Duty to Defend clauses—and in some cases, the firm has turned down work from clients that refuse to budge on the issue.

Moossazadeh says his firm will some-times insert language into contracts that says Kleinfelder is not responsible for any Duty to Defend specified in the contract absent “evidence of negligent performance by our firm.”

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Beyond specific contract language, Erger says engineers would benefit by better educating clients about indemnity. "The idea that anything bad that happens should be paid by the design or engineering firm is completely unreasonable and not conducive to a healthy and robust industry," she says.

Folk says that firms should either use an ACEC standard contract or have an attorney review a contract to limit the possibility of creating inadvertent liability. He adds that those who sign away their rights should understand that they have assumed an uninsurable risk.

Despite the industry's best efforts, it's unlikely that overly broad indemnification and defense demands will disappear any-time soon. That's why "when negotiating indemnification clauses, 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," Holland says. The clause should also at a minimum specify that any obligation to defend commences only after the design professional is found negligent. "It is also important to make the clause applicable only to damages arising out of third-party claims against the indemnitee." Holland goes on to say, "Those that sign away their rights are putting their firm and their livelihood on the line."

BROKER'S NOTES



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