Understanding Indemnification Clauses

By Gail S. Kelley, P.E., Esq.

When design professionals review proposed contracts with their risk management consultants, they are invariably told that they should look closely at provisions that could create uninsurable risk and negotiate better language. One issue that often arises is the language of the indemnification clause. The reason for this is simple – indemnification clauses can shift significant risks to the design professional, and these risks may not be insurable.

The Purpose of an Indemnification Clause

The purpose of an indemnification clause is to shift risk from one party to another. One party (the Indemnitor) agrees to financially protect the other party or parties (the Indemnitees) against specified claims and expenses. This can include both reimbursing an Indemnitee for the amounts it has had to pay on account of the specified claims, or paying these amounts in place of the Indemnitee. Often, a service provider such as a design professional is asked to indemnify its client for claims and expenses arising from the work that the service provider has undertaken for the client. On its face, the concept seems reasonable in that the party performing the services should bear the risks for its negligent performance. In practice, owners may try to shift risk that is beyond the control of the design professional or that extends beyond negligence-based liability.

Indemnification Clauses in Design Contracts

While it is not unreasonable for owners to require indemnification from the design professional, they sometimes try to obtain the protection they are seeking with language that is completely inappropriate. One reason for this is that many design contracts are based on the AIA agreements and, historically, the AIA agreements have not included an obligation for the designer to indemnify the owner. As a result, owners who want to require indemnification from the design professional often just copy the indemnification provision from the construction contract.

There are significant differences between how contractors and design professionals handle risk, however:

- Contractors tend to be less risk-averse. This may be partly due to the personalities of the individuals involved but is also due to the risk/reward trade-off. Contractors may take projects that are significantly larger or different from their previous projects because of the financial incentives. Design professionals do not have the same "upside" potential in their projects and therefore shouldn't be required to assume the same level of risk.
- A contractor's work involves following a set of plans and specifications to create the building or structure. While contractors are almost always required to provide warranties and guarantees, design professionals are not required to guarantee their work. Like doctors and lawyers, they are judged by the professional skill and care ordinarily provided by firms practicing in the same or similar locality under the same or similar circumstances.
- The liabilities that a contractor is required to provide indemnification for are covered under its Commercial General Liability (CGL) policy. Typical CGL policies provide much broader coverage than professional liability policies for liabilities assumed in a contract.

Coverage Under a Professional Liability Policy

It is helpful to review the basics of professional liability insurance to understand why indemnification clauses can create issues for design professionals:

- Coverage is only granted for the insured's negligent acts, errors or omissions in the rendering of, or failing to render, professional services.
- Contractual assumption of liability is excluded, except for "liability that would have attached in the absence of the contract." In the absence of a contract stating otherwise, the design professional would only be liable for its own negligence. If a design professional agrees to indemnify its client for claims not caused by its negligence, there will be no coverage under its professional liability policy.

Indemnification Clauses Can Create Uninsurable Risk

Even beyond the issue that the indemnification clause may be based on language written for contractors is the reality that some owners simply want to transfer as much risk as they can to other parties, rather than allocating the risk fairly. The following is an example of a clause creating uninsurable risk for the design professional:

> *Consultant shall indemnify, defend and hold harmless the Client, the Client's employees, directors, officers, agents, representatives, and lenders from and against any and all liability and expenses including, but not limited to, attorney's fees that occurred, in whole or in part, as a result of the Consultant's acts, errors or omissions.*

Suggested revisions to this wording:

- **Delete** the word "defend." This is the most significant issue. While professional liability insurance covers defense when a claim is filed against the insured, it does not cover defense of an indemnified party. An agreement to defend means the design professional will be paying the costs of defense from the moment a claim is made, even if it is ultimately determined that the design professional was not negligent. Thus, the design professional will agree to

liability that goes beyond "liability that would have attached in the absence of the contract."

- **Delete** "agents, representatives." The terms "agents" and "representatives" are extremely broad. The client should identify the specific entities it wants indemnified by either name or function.
- **Delete** "any and all." The wording "any and all" implies indemnification of claims that may not relate to negligence.
- **Insert** "negligent" before "acts, errors or omissions." For the indemnification obligation to be insurable, it must be based on the insured's negligence.
- **Insert** "where recoverable under applicable law on account of negligence" after attorney's fees. Not all states allow a plaintiff to recover its legal costs in a negligence claim as a matter of law. Attorney's fees will generally not be covered under a professional liability policy unless entitlement is provided by state law.
- **Replace** "in whole or in part" with "to the extent caused by." The words "in whole or in part" makes the design professional liable for the entire amount of the claim, even if it was only partly responsible. Professional liability insurance policies only cover the insured for its share of the liability.

The revised version of this indemnification provision (with inserted text in bold type) would be as follows:

> *Consultant shall indemnify, ~~defend~~ and hold harmless the Client, and the Client's employees, directors, officers, ~~agents, representatives,~~ and lenders from and against ~~any and all~~ liability and expenses* ***arising from third-party claims****, including attorney's fees* ***where recoverable under applicable law on account of negligence****, ~~that occurred in whole or in part, as a result of~~* ***to the extent caused by*** *the Consultant's* ***negligent*** *acts, errors or omissions.*

The final version would read:

> *Consultant shall indemnify and hold harmless the Client, and the Client's employees, directors, officers, and lenders from and against liabilities and expenses arising from third-party claims, including attorney's fees where recoverable under applicable law on account of negligence, to the extent caused by the Consultant's negligent acts, errors or omissions.*

Conclusion

Indemnification clauses are a fact of life for design professionals, and they may find it necessary to make a "business decision" to proceed even with poor contract wording. While ideally a design professional will be able to negotiate a fair allocation of risk, at the very least it should be aware that a contract holds the potential for uninsurable exposure.▪

Gail S. Kelley is a LEED AP, as well as a professional engineer and licensed attorney in Maryland and the District of Columbia. Her practice focuses on reviewing and negotiating design agreements for architects and engineers. She is the author of Construction Law: An Introduction for Engineers, Architects, and Contractors, *published by Wiley & Sons. Ms. Kelley can be reached at* ***Gail.Kelley.Esq@gmail.com****.*

Disclaimer: The information in this article is for educational purposes only and is not legal advice. Readers should not act or refrain from acting based on this article without seeking appropriate legal or other professional advice as to their particular circumstances.