

Indemnification versus Defense

Part 2: Why the Difference Matters

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The previous article in this series (STRUCTURE, November 2018) looked at the concept of indemnification. Stated simply, to indemnify someone means to financially protect them against specified claims from third parties. The party providing the financial protection (the “Indemnitor”) can be required to pay the amount of an award or settlement for a claim in place of the party being protected (the “Indemnitee”), or reimburse the Indemnitee for amounts the Indemnitee has already paid. The indemnification clause in many engineering agreements is similar to that found in § 8.1.2 AIA C401, *Standard Form of Agreement between Architect and Consultant*.

The Consultant shall indemnify and hold the Architect and the Architect’s officers and employees harmless from and against damages, losses 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 caused by the negligent acts or omissions of the Consultant, its employees and its consultants in the performance of professional services under this Agreement.

A key point concerning indemnification is that the indemnification obligation does not arise until liability has been determined through either litigation or arbitration, or the parties agree to a settlement. This follows logically from the definition of indemnification – if it is determined that the Indemnitee is not liable for the claim, the Indemnitee will not need to pay any monies and hence will not need to be reimbursed. Likewise, if the indemnification is only to the extent the claim was caused by the negligence of the Engineer and it is determined that the Engineer was not responsible for the claimant’s injuries or damage, the Engineer would not owe a duty of indemnification.

The Defense Obligation

While the indemnification obligation does not arise until liability has been determined, if a claim is brought against a party that the Engineer has agreed to indemnify, the indemnified party will likely incur considerable costs

for attorneys’ fees, court filings, and expert witnesses before the trial or arbitration even begins.

As a result, clients may require that the indemnification clause also include a duty to defend against claims “arising from the Engineer’s services.” If the Engineer has a duty to defend the Indemnitees, the Engineer would be responsible for an Indemnitee’s costs of defense as soon as a claim is filed, even if it were ultimately found that the Indemnitee had no liability for the claim or the damage was caused by someone other than the Engineer.

Indemnification clauses requiring defense can be extremely far-reaching; for example:

To the extent permitted by law, Engineer will indemnify, defend and hold Owner and Architect harmless against and from all claims, damages, judgments, fines, penalties, and costs arising out of or in any way connected with the Engineer’s Services.

The words “arising out of or in any way connected with” the Engineer’s services can be interpreted very broadly. As long as the claim is written in such a way that it appears the claimant’s injuries arose from the Engineer’s services, the Engineer could be held responsible for the Indemnitee’s defense.

Defense of an Indemnified Party

Unless an Engineer provides services that require them to spend a considerable amount of time at the project site, virtually all claims against the Engineer will fall under its Professional Liability Insurance (PLI). In cases where the Engineer is working on site and there is an accident involving the Engineer’s tools or equipment, or instructions that the Engineer has given, the resulting claim could fall under the Engineer’s Commercial General Liability (CGL) claim. However, even in such cases, the Engineer’s CGL carrier will generally try to deny coverage, alleging that the claim arose from the Engineer’s professional services and is thus subject to the professional services exclusion of the CGL policy.



Which policy a claim falls under can be very significant – CGL insurance will cover the defense of an indemnified party; PLI will not. This is not something the Engineer can change through an endorsement to its PLI policy or by changing insurance carriers. While professional liability policies cover the defense of the insured party (the Engineer), they will not cover the defense of an indemnified party. An Engineer who agrees to a defense obligation will likely end up paying for the defense of the indemnified party out of their own pocket.

Editing the Indemnification Clause

If the Client insists that the indemnification clause include a defense obligation, the Engineer can try to edit the clause such that the Engineer is not agreeing to uninsurable liability. Two such options for editing are:

- change the word “defend” to “defend (except for professional liability claims)”;
- or,
- change the word “defend” to “defend to the extent covered by Engineer’s insurance”

If the Client does not agree to either of these changes, the Engineer can leave the word “defend” but add a sentence at the end of the indemnification clause stating:

The Engineer’s defense obligation shall not extend to professional liability claims; however, the Engineer shall reimburse the indemnified party for reasonable attorneys’ fees and legal costs to the extent such claims are caused by the Engineer’s negligence or willful misconduct.

While the above wording could leave the Engineer responsible for the attorneys’ fees that it is required to reimburse, the obligation would not arise until liability for the claim had been determined. This means that the

Engineer avoids responsibility for defense of claims where the Engineer had no liability for the damages.

The Engineer can also propose a bifurcated indemnification clause that separates indemnification for professional liability from indemnification for general liability. A simple example of such a clause would be:

7.A Professional Liability. *The Engineer shall indemnify and hold Client harmless for losses, damages, and costs arising from third-party claims to the extent such claims are caused by the Engineer's negligence or willful misconduct in the provision of its professional services.*

7.B General Liability. *Except for those claims covered under section 7.A, the Engineer shall indemnify, defend, and hold Client harmless from and against allegations and claims arising from the Engineer's acts, errors, or omissions.*

Separating the indemnification for professional and general liability also allows the Engineer to agree to a broader indemnification for claims that do not arise from their professional services. While coverage under a PLI policy is limited to the extent of the Engineer's negligence, both CGL and auto policies will cover the entire claim, provided the claim arose from the Engineer's services. This is reflected in the wording of 7.B (above), which indemnifies against "allegations and claims arising from the Engineer's acts, errors or omissions," rather than "to the extent caused by the Engineer's negligence." Although the difference in the wording may seem trivial, it can be quite significant with respect to how a court will interpret the indemnification obligation.

Reimbursement by the Client

If the client will not delete the defense obligation for professional liability claims, the Engineer can propose a requirement that the Client reimburses the Engineer if the allegations of the Engineer's negligence are false. An example would be:

Client shall reimburse the Engineer's reasonable attorneys' fees and legal costs incurred in defending the Client against professional liability claims, to the extent such claims are not caused by the Engineer's negligence or willful misconduct.

This is the least desirable of the suggested changes, as it means the Engineer will be responsible for covering the Client's defense fees until liability is established, at which point the Engineer can request reimbursement. However, it is also the hardest for the Client to argue against. If the Client has required the Engineer to defend it against a claim and the claim was not caused by the Engineer's negligence or willful misconduct,

the Engineer should not be held responsible for the Client's defense costs.

Willful Misconduct

The AIA C401 indemnification clause limits the indemnification obligation to the extent of the Engineer's negligence, which is what will be covered by the Engineer's professional liability insurance. However, like the reimbursement provision described above, many indemnification clauses also require indemnification to the extent the Engineer's willful misconduct caused the claim. Claims due to willful misconduct are not covered by professional liability insurance – professional liability insurance is designed to cover claims due to negligence (unintentional mistakes) as opposed to intentional misconduct. However, in terms of basic fairness, it is not reasonable for the Engineer to refuse to indemnify another party when the Engineer's willful misconduct caused the claim. On a positive note, claims against engineers based on willful misconduct are extremely unlikely. Although the wording of court holdings on willful misconduct can vary, depending on the circumstances surrounding the claim, a party claiming willful misconduct must generally show that the other party has intentionally acted or failed to act knowing that his or her conduct will probably result in injury or damage.

Contracts Governed by California Law

As discussed above, indemnification and defense, while related, are separate obligations. However, under California law, based on the cases *Crawford v. Weather Shield Manufacturing*, 44 Cal.4th 541 (2008) and *UDC Universal Development L.P v. CH2M Hill*, 181 Cal.App.4th 10 (2010), if a design professional agrees to indemnify another party, there is an implied duty to defend. Unless the duty to defend is explicitly disclaimed, the design professional can be required to defend the indemnified party against claims arising from the design professional's services.

The California legislature revised the code section that addresses the enforceability of indemnification requirements for design professionals (California Civil Code § 2782.8) such that, for contracts entered into on or after January 1, 2018, a design professional cannot be required to indemnify or defend another party "except to the extent the claims against the indemnitee arise out of, pertain to, or relate to the negligence, recklessness, or willful misconduct of the design professional."

Section 2782.8 also states that "In no event shall the cost to defend charged to the design professional exceed the design professional's proportionate percentage of fault."

However, the revised code section is silent on the implied duty to defend, which means the duty probably still exists. Thus, unless the duty is explicitly disclaimed, the design professional can be required to defend an indemnitee; once liability is determined, the design professional would have to seek reimbursement to the extent it was not liable for the claim. The wording of the disclaimer can be quite simple; it is enough to add the statement "The Engineer shall not be required to defend the Client against professional liability claims."

The 2017 edition of AIA C401 added an explicit disclaimer to its indemnification clause; the clause now includes the statement: "The Consultant's obligation to indemnify and hold harmless the Architect and its officers and employees does not include a duty to defend." While the addition of the disclaimer to the standard agreement is helpful when the agreement is governed by California law, it can be confusing to those who do not understand the reason for its inclusion.

Conclusion

The indemnification clause is often the most difficult clause to negotiate in a design agreement, as most clients seek to limit their exposure to claims. Although the indemnification clause is a legitimate means of allocating risk between the parties, engineers should be careful about agreeing to obligations that will not be covered by insurance. In particular, engineers should be aware that the defense of indemnified parties will generally not be covered by professional liability insurance. ■



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