Some clients are requiring consultants to agree by contract to “defend” the client. Our advice: just say no.

If you’ve noticed increasingly alarming language in client-written contracts lately, you’re not alone. Architects and engineers have seen a disturbing uptick in indemnities that impose defense obligations. For example, a clause in a contract with a municipality might read:

The Engineer agrees to indemnify and hold harmless, and upon receipt of the City’s written notice, protect, insure and defend the City from any and all allegations and claims arising out of or in connection with the acts, errors or omissions of the Engineer.

Look carefully at the language used. Courts may interpret this as an obligation by the engineer to retain an attorney for the client and mount a defense on the client’s behalf—long before any legal liability on the engineer’s part has been established. Not only would the defense obligation be triggered as soon as the claim is made, but the engineer might still have to pay for the city’s defense even if the engineer is later found to be not negligent. Worse still, professional liability policies do not cover the cost of the client’s defense. (See sidebar, “Professional Liability Insurance and Contractual Obligations.” Also see the Trend Alert: UDC vs. CH2M Hill)

Growing Client Demands

According to Nancy Rigassio, Executive Claims Counsel and Assistant Vice President for XL Group’s Design Professional unit, many clients have become increasingly aggressive in their contract demands. “Maybe they think that design firms are so eager to get back to work that they’ll accept anything,” she says. “Some clients—public agencies especially—even expect the consultant to purchase an endorsement or a separate policy to cover the defense of the owner.”

© 2013, X.L. America, Inc. All rights reserved.
Rigassio says public agencies aren’t the only ones requiring defense obligations—large developers and corporate entities are also pressuring designers. “They can be pretty stubborn,” she says. One developer agreed to delete some of the more egregious language in an indemnity, only to insist on adding the following:

The Architect’s indemnity obligations set forth herein shall remain in effect, however, even in circumstances in which the Owner is concurrently negligent.

Translated into English, this sentence means that even if the developer and architect were both found to have some responsibility for causing damages (and even if the architect was only 10% liable and the developer 90%), the developer would still look to the architect to pay 100% of its attorneys’ fees in defending the claim.

Dealing with Defense Obligation Demands

Assuming you can’t persuade the client to delete the entire indemnity or agree to a reasonably worded mutual indemnity, you might be able to agree to the client’s indemnity, if it’s been scrubbed of all its onerous and uninsurable language. And that requires careful review and wordsmithing.

Remember, you need to limit the indemnity to apply only to “damages” caused by your negligence; otherwise the clause could be interpreted as obligating you to hire a lawyer for your client and pay for the client’s defense up front—before your legal liability, if any, has been established. What’s more, the contract should clearly state you are not assuming a defense obligation. You have no responsibility for paying the client’s defense costs if you’re found not negligent.

In general, you’ll want to strike any “duty to defend” language. But watch out for “stealth” terms—those “pre-determination” nouns such as claims, demands, allegations and lawsuits—that courts have decided imply the existence of a defense obligation. Remember, anyone can allege or claim anything, and almost anyone can file a lawsuit. You don’t want that allegation triggering a defense obligation.

Be aware, too, that in a few jurisdictions the contractual duty to indemnify includes the obligation to defend, regardless of whether or not negligence is proven. In those jurisdictions, your indemnity should expressly exclude—not just line out—any defense obligation, unless and until your negligence is determined by a court.

If the client objects to your changes, explain why holding you legally responsible for another’s action is simply unfair, e.g., “This clause would have me pay for your defense at the outset even if I’m not at fault.” Also tell the client that because such clauses aren’t covered by your professional liability insurance, you’d have to pay these costs out of pocket. (See “Negotiating Client-Written Indemnities” in the April 2012 issue of Communiqué.)

Indemnities are very complex and have immense liability implications.

You can find sample clauses and additional information in the “Indemnities” chapter of the Contract eGuide. Also, speak with your attorney and professional liability agent or broker, or consult your insurance company.

Split the Difference?

Rigassio believes that many public owners’ insistence on a defense obligation comes from their wish to “privatize” all risk, even that of a slip-and-fall injury or a contractor’s demand for change orders allegedly caused by errors or omissions. Their attorneys explain that they’re just trying to insulate their clients from any liability; in other words, they’re trying to push as much liability as they can onto design professionals.

You could suggest a bifurcated, or split, indemnity that is broader for general liability claims and narrower, but insurable, for professional liability damages.

“For instance, one indemnification clause would apply to claims that fall within coverage of a general liability policy, which can be endorsed to name the owner as an additional insured,” Rigassio says. That clause could include a defense obligation because the owner is an insured under the policy that would respond to the claim. “A second, much narrower indemnity would be aligned with the coverage of professional liability policies, and would not contain a defense obligation,” she says.

“It isn’t an ideal solution, but at least the parties are limiting the language to what’s covered by the design professional’s respective insurance policies,” Rigassio says, adding that the wording of such split indemnities must be precise, that the existence of the two indemnification clauses could create another dispute about insurance coverage and that the claim might not be covered by either policy. (Make sure you discuss this with both your professional liability insurer and general liability insurer ahead of time.)

Endorsements and Escrows

Clients who fail to get defense obligations included in indemnities often ask why the architect or engineer can’t just purchase an endorsement or a separate policy that will cover
the defense of the owner. Rigassio explains that it’s not an option. “Such a product doesn’t exist in today’s market,” she says.

To satisfy their clients’ demands for a defense obligation, a few design firms have asked if they should increase their fees to allow them to escrow funds to pay for the owner’s defense in the event of a claim. Rigassio says that establishing such an escrow is strictly a business decision only the firm can make. She cautions that negotiating such an arrangement with the owner would require that careful thought be given to the amount of the escrow, the jurisdiction in which the project is located, the ability to require the owner to increase or replenish the amount, the scope of the project, the length of time to keep the escrow and what to do with the escrow after project completion. Keep in mind that having an escrow does not eliminate the professional liability insurance coverage problem created by the defense obligation.

Indemnities are very complex and have immense liability implications. “Before you sign on the bottom line, have your lawyer look at any indemnity language with respect to the laws of the governing jurisdiction,” Rigassio says, “and work with your agent or broker to make sure the indemnity is insurable.”

### Professional Liability Insurance and Contractual Obligations

Your professional liability policy is intended to cover your negligent acts, errors and omissions, and it probably contains an exclusion similar to this: “This insurance does not apply to liability assumed by you under any contract; but this exclusion does not apply if you would have been liable in the absence of such contract due to your own negligent act, error or omission...”

If you sign a client’s indemnity that is not limited to just your negligence (holding the client harmless from “any act” or for “all claims arising from the project,” for example), you’re accepting more liability than the law would otherwise require—and that additional liability may not be insurable.

Because the duty to defend a client against third-party claims can only arise out of a contractual obligation, it is excluded from coverage. Remember, your professional liability policy can’t be endorsed to identify the owner as an additional insured. This means that the professional liability policy will not provide a defense to the owner.

When faced with an uninsurable indemnity, Rigassio suggests that design firms ask themselves: “We pay a lot for our professional liability coverage. Why would we agree to take on responsibility that no professional liability policy will cover? Will we really make so much profit from this project that we can afford to bear this risk?”

---

### The Value Deficit

Could the biggest barrier to delivering more value to your clients be the inefficiency in your own processes? That’s certainly where the evidence points.

In 2004 the U.S. National Institute of Standards and Technology (NIST) released a report entitled, “Cost Analysis of Inadequate Interoperability in the U.S. Capital Facilities Industry.” The NIST study identified over $15 billion in waste due to delays, inefficiencies and requests for information during the construction process. Design professionals were responsible for 7% of this amount, stemming primarily from the planning, engineering and design phases.

In 2005 XL Group’s Design Professional unit conducted a small focus group of our insureds, which included both architects and engineers with a mix of specialties and revenues. The focus group study found that designers were writing off between 5% and 7% of total project profit due to scope and schedule creep.

Late last year, Navigant’s Construction Forum released its study titled, “The Impact of Rework on Construction & Some Practical Remedies.” The study does an excellent job of summarizing the available literature on rework.

© 2013, XL America, Inc. All rights reserved.

Continued
losses in construction. Navigant’s own data estimates that the median direct costs of rework are 5.04% of the total construction budget and the median indirect costs are 9.07% of the total construction budget. Navigant’s study goes further in breaking down the components of rework. Navigant also concludes from their review of past studies that this rework factor is increasing over time.

These three studies bring to light an endemic problem in the construction and design sector: despite all the advances in materials and methods, the rise of computers, AutoCad™ and 3D imaging, most of the project delivery processes in design and construction haven’t changed much in 50 years.

The chart in Fig. 1, from the U.S. Department of Commerce, tracks non-farm productivity against construction productivity in 1964 constant dollars, removing all the effects of inflation. As you can see, while non-farm productivity has increased by more than 200% since 1964, construction productivity has actually fallen. The studies described above, along with this chart, explain much of the owner dissatisfaction with the overall design and construction experience. Your firm may provide excellent design services, but in the context of an entire system that is inefficient, the owners’ needs are not well served.

The 2004 NIST study was itself responsible for the adoption of BIM on large federal projects. Navigant’s conclusions point to BIM and integrated project delivery, constructability reviews and change order reviews as ways to control this process. In addition, our Risk Drivers study concluded that more designer-centric approaches are needed, such as improving communication with clients, writing realistic scopes of services and educating clients on scope and schedule creep.

These are all ways your firm can take on the challenge of delivering more value to owners in the construction process. The first design and construction firms that truly take this information to heart and begin to address the demonstrated value deficit will profit immensely while leaving their competitors wondering what happened.