



A RISK RETENTION GROUP

RISK MANAGEMENT ADVISORY

CONCERNS PRESENTED BY THE WORD “DEFEND” IN AN INDEMNITY PROVISION

April 10, 2004

USE LIMITATIONS

The following pages provide an overview of an issue that frequently arises during contract negotiations and that concerns the coverage provided by professional liability insurance. This Advisory serves to help engineers and their clients better understand how to draft an agreement that stays within the coverage available under professional liability insurance and to avoid creating uninsured risks for both the engineer and its client.

If an engineer uses the following pages with its client, both client and engineer should understand that it is provided as general information and does not represent legal advice, which both parties should seek only from an attorney licensed in the jurisdiction where the parties intend to perform the agreement.

This Risk Management Advisory is not legal advice. TERRA INSURANCE recommends that for legal questions concerning your contracts and services you should consult with a qualified attorney who practices in your jurisdiction and who is familiar with design and construction law.

RISK MANAGEMENT ADVISORY

CONCERNS PRESENTED BY THE WORD “DEFEND” IN AN INDEMNITY PROVISION

April 10, 2004



A RISK RETENTION GROUP

Overview

The word “defend” in the indemnity provision of an engineer’s professional services agreement exposes the engineer to liability beyond the coverage provided by its professional liability (E&O) insurance. Furthermore, clients do not need “defend” provisions to recover their legal defense costs as “damages” *to the extent* that they result from the engineer’s negligence. But recovery before a client can recover defense costs from an engineer, it must first know to what extent the engineer’s negligence actually caused the client to incur the costs.

If a client insists on keeping the word “defend” in an indemnity provision, the engineer can mitigate its risk by limiting that defense obligation so that it applies *only to the extent* that the engineer’s negligence caused the client to incur the defense costs. But such a strategy is not without risk, since a court could give broader meaning to the “defend” promise and require that the engineer cover some, or all, of the client’s defense *in advance* of any liability determination. And any such broader interpretation is beyond the coverage of E&O insurance.

Problem with “Defend”

E&O insurance only covers harm actually caused by the engineer’s professional negligence; it will not advance the cost to defend other parties *before* anyone establishes the engineer’s negligence. But “to defend” means to provide the defense against such allegations *in advance of* a liability determination. That includes paying defense costs even if the engineer has done nothing wrong and has no liability, since the defense occurs before a liability determination. Thus, in an indemnity, the word “defend” obligates the engineer to assume responsibility for the client’s defense costs on a mere allegation of negligence on the engineer’s part. And that is a liability that the engineer’s E&O insurance will not cover.

In essence, the word “defend” attempts to turn the engineer into an insurer for the client’s defense costs, regardless of whether the engineer is actually negligent. The promise to “defend” the client obligates the engineer to pay the client’s separate legal defense expenses – even if the engineer proves that neither it nor the client caused a third party claimant’s injuries. Since the engineer’s E&O policy does not cover parties other than the engineer itself, then the engineer – and not its E&O insurer – pays for the client’s defense.

An Engineer’s Insurance Will Reimburse Other Parties’ Defense Costs If the Costs Constitute Damages Caused by the Engineer’s Negligence

E&O insurance does reimburse the client’s costs for defending against a claim *to the extent that* the client’s damages arise as a result of the *actual* engineer’s negligence. The existence and

This Risk Management Advisory is not legal advice. Terra Insurance recommends that for legal questions concerning your contracts and services you should consult with a qualified attorney who practices in your jurisdiction and who is familiar with design and construction law.

RISK MANAGEMENT ADVISORY
“DEFEND” IN INDEMNITY PROVISIONS

Page 2 of 3

extent of the engineer’s liability remain unknown until the parties resolve the claim, at which time defense costs and proportionate liability become known. Only then, with the parties’ proportionate responsibility established, can the engineer and client allocate liability. Once they establish the extent of the engineer’s fault, its E&O insurance will reimburse the client for those defense costs incurred as a result of the engineer’s negligence.

Thus, engineers should delete the word “defend” from indemnity provisions. If requested by the client, they can make their responsibility for their own negligence clear by including “reasonable attorney’s fees” and other necessary defense costs in the list of damages covered by the indemnity to the extent of the engineer’s negligence.

Deletion of the Word “Defend” Results in a Fair Allocation of Risk

Clients should recognize the fairness inherent in replacing the word “defend” with a definition of damages that includes those defense costs incurred due to the engineer’s negligence. Such a provision will protect the client *to the full extent* that it incurs defense costs due to the engineer’s negligence. But for a client to require more – such as a defense without regard to fault, as implied by the word “defend” – requires that the engineer pay the client’s costs incurred through no fault of the engineer. Such a requirement unfairly burdens the engineer with risks that it cannot control.

The deletion of “defend” is also fair from a risk/reward perspective. Engineers receive a limited profit on each project. Their fee is a small percentage of the total project, and their profit a small percentage of that fee. In exchange for this limited upside potential, the engineer should not have to assume the large downside risk of its client’s defense costs – *even when the engineer is without fault*. Such costs could dwarf the engineer’s entire compensation on most projects. In contrast, clients receive all the benefits of a successful project, and can obtain their own insurance to cover unproven allegations from third party claimants. Therefore, absent actual liability on the engineer’s part, the risk of defending against third party claims should remain with each party until they can determine actual liability.

Limiting Exposure If a Client Insists on Retaining “Defend”

If a client insists on including “defend” in an indemnity provision, an engineer can limit its uninsured exposure by including “to the extent” language. Adding that qualification to the indemnity language limits the “defend” obligation to those damages caused by the engineer’s negligence.

But this approach is not without risk, since often the client and engineer will have different understandings of the provision. If the agreement has both a requirement that the engineer “defend” the client and qualifies that obligation with “to the extent” language, it is likely that engineer and client have different understandings of what happens in case of a third party claim. In most instances, a client may think that the agreement provides it with an immediate defense to

RISK MANAGEMENT ADVISORY
“DEFEND” IN INDEMNITY PROVISIONS
Page 3 of 3

all third party claims that *allege* negligence by the engineer. In contrast, the engineer will understand that the promise only covers damages caused by its *actual* negligence, and will refuse to defend the client as long as the engineer’s negligence remains undetermined. Indeed, the engineer generally will deny any negligence at the onset of litigation. Based on that denial, the engineer can properly argue that its contractual obligation to “defend” matches that 0% extent of its proportional fault. Even if the claimant later establishes negligence by the engineer, the defend obligation should apply only to the portion of defense costs actually attributable to the engineer’s proven negligence.

Such differing understandings by client and engineer could expose the agreement to potential adverse interpretation by a court. It is never good practice to have an agreement where one or both of the parties believe that the other party understands the agreement differently. So, while most jurisdictions disfavor indemnity provisions, and thus would most likely favor the engineer’s limited interpretation, a court could regard the engineer as having engaged in a deliberate deception. If that were the case, the court could require that the engineer pay the client’s entire defense cost *regardless of liability* if the court finds that the engineer knew that the client believed that was what the promise meant. Thus, while “to the extent” language should limit exposure for the client’s defense costs, leaving the word “defend” in the indemnity poses some risk that a court might decide otherwise. And in the event of such an adverse decision, the engineer cannot turn to its E&O insurance to pay the client’s defense before a liability determination, nor for the client’s defense cost beyond the extent that the engineer’s fault caused the client to incur defense costs.