California Places Client Defense Burden on Design Firms

By: Jean A. Weil, Esq.

Contract provisions—especially those that limit or transfer liability—are governed by state law. Through statutes and court interpretations of the law, states can differ significantly on how provisions are construed. In California, following the recent Court of Appeal decision in UDC Universal Development, LP v. CH2M Hill, it is clear that design firms that contractually commit to indemnifying their clients may well be compelled to shoulder the cost of defending their clients even if the design firms are not at fault.

Historically, design firms have been able to protect themselves from taking on a contractual responsibility to "defend" their client from third-party claims related to a given project by either striking the defense obligation or, at a minimum, tying that defense obligation to a finding of negligence. These kinds of contractual protections also created a "safe harbor" under a design firm's insurance policy. Professional liability insurers will cover liability and damages that flow from an insured's negligent acts. However, professional liability insurers exclude from their policies coverage for liability their policyholders assume by contract, except to the extent that such liability is otherwise required by law. Thus, an insurer does not cover a contractual obligation to defend the client of a policyholder in the event of a claim.

Special Considerations Exist in California Contracts

While the contractually assumed defense obligation has been a hot topic for decades, the issue was magnified by the California Supreme Court's decision in Crawford v. Weather Shield Manufacturing, Inc. (2008). In Crawford, a subcontractor entered into a contract with broad indemnity and defense language, which had no limitation requiring a finding of negligence. The trial court found that the subcontractor had no duty to indemnify its client (since the jury found no fault on the subcontractor's part) but nonetheless allocated approximately $131,000 of the developer's defense costs to the subcontractor to pay. The Court of Appeal affirmed the trial court's ruling. In turn, the Supreme Court affirmed the Court of Appeal.

Of particular concern, the Supreme Court discussed at length Civil Code Section 2778, which is the statute governing interpretation of indemnity clauses. In analyzing the statute, the Supreme Court concluded that by virtue of the interplay of the provisions of Section 2778, unless the parties' agreement expressly provides otherwise, an indemnitor has the obligation, upon proper tender, to accept and assume the indemnitee's active defense against claims "embraced" by the indemnity provision.

As mentioned, the Crawford indemnity clause was not limited to a finding of negligence and the subcontractor had agreed to defend "any suit or action".

Then came UDC Universal Development, LP v. CH2M Hill. In UDC, the civil engineer, CH2M Hill, contractually agreed to indemnify the developer UDC from any and all claims ". . .to the extent they arise out of all or are in any way connected with any negligent act or omission by consultant." In the next sentence, CH2M Hill agreed, at its own expense to "… defend any suit, action or demand brought against developer…on any claim or demand covered herein".

The trial court, applying Civil Code Section 2778, found the defense obligation to be separate and distinct from the matters embraced by the indemnity clause (which limited indemnity to negligent acts or omissions). Thus, despite the fact that CH2M Hill was found to be not negligent at trial, the Court of Appeal affirmed the trial court's order to CH2M Hill to pay approximately $550,000 of the developer's defense costs, including the cost to prosecute the unsuccessful case against CH2M Hill.

In order to try and fix this untenable decision, multiple organizations joined to endorse an Amicus Curiae brief to the Supreme Court in support of CH2M Hill's Petition for Review, or in the alternative, in support of the firm's Request for Depublication of the opinion. On April 29 the court denied the Petition for Review and denied the Request to Depublish the decision without explanation.

The California ruling could be applied retroactively to contractual indemnity provisions design firms accepted years ago as well as for any being negotiated in the future.

Indemnity

Provisions Are Not "Boilerplate"

Firms must take action to protect from falling into the defense trap. Indemnity provisions should always be carefully examined and crafted to be as specific as possible. Legal counsel in the specific jurisdiction should be consulted to shape the provision to meet state law. This often means separating a duty to indemnify a client when the firm negligently performs professional services from other indemnity obligations. Design firms must specifically limit the duty to defend. Our law firm has recommended language such as the following be added to indemnity provisions to create what the California court would consider a "contrary intention" to the defense obligation:

> Consultant shall have no upfront duty to defend the Owner, but shall reimburse defense costs of the Owner to the same extent of Consultant's indemnity obligation herein. The indemnity obligations provided under this section shall only apply to the extent such Claims are determined by a court of competent jurisdiction or arbitrator to have been caused by the negligence or willful misconduct of Consultant. But whether a firm has a contract construed by California law or by the law of another state, consider these following precautions:

- Do not sign a client's one-sided contract that forces you to take on risk that fails to match your economic reward.
- If possible, avoid any agreement to indemnify or defend your client.
- If you must give indemnity to your client, be sure that the indemnity is clearly tied to a finding of negligence
- However, in California it is no longer sufficient to merely strike the word "defend" from the indemnity clause. You must show a "contrary intention" in the text of your contract that you do not intend to defend your client and that your indemnity obligation is limited to your proportionate share of negligence.
- If you must accept the defense obligation, be sure that your intention is clear. Indicate that both the indemnity and defense obligation is limited to your proportionate share of negligence.

- If you must agree to indemnify and defend, attempt to negotiate a limitation of liability that caps your exposure to a sum certain for all damages including those associated with both indemnity and defense.
- When in doubt, consult your lawyer and/or broker for help.

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