# Are You Defenseless Against the Duty to Defend?

By: Jean A. Weil, Esq.[i]

## Indemnity and Defense Clauses

Perhaps you have been watching the slow-motion drama unfold related to the recent California Court of Appeal decision, UDC-Universal Development, LP v. CH2M Hill 2010 DJDAR 794. If so, you should be asking yourself three questions: 1) How many employees did you have three years ago? 2) How many employees do you have today? 3) If you had to pay out-of-pocket your client's defense costs in a lawsuit, could you afford to do so?

We are hoping that the California Supreme Court keeps these three questions in mind when they decide whether to hear an appeal on the UDC decision or, whether to depublish the opinion so that it cannot be cited as valid case authority going forward. As it stands right now, the deck is stacked against you.

Historically, architects 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. Sometimes, an architect may even have secured a limitation of liability clause that would cap damages to a specific sum, including any damages owed for the defense of their client.

These kinds of contractual protections also created a safe harbor under an architect's insurance policy. Professional liability insurers will cover liability and damages that flow from an architect's negligent acts. However, professional liability insurers exclude from their policies, coverage for liability that architects assume by contract, except to the extent that such liability is otherwise required by law. Thus, your insurer does not cover your contractual obligation to defend your client in the event of a claim.

Assume for the moment the following scenario. You submit a proposal for a new project that is right up your alley. You negotiate a bare bones fee knowing that there are ten architects behind you that will take the project for less. You receive your client's one-side boiler plate standard form agreement, which requires you to defend, indemnify and hold your client harmless from everything and the kitchen sink. You dare not modify your client's standard contract because those same ten architects will surely sign the same piece of &#!* from your client. You need the work to keep the lights on. You cross your fingers, sign the contract and hope for the best.

Further assume that shortly after the project is completed, a third-party makes a claim against your client for generic "design and construction defects". The client immediately tenders the defense and indemnity of the claim to you citing your contract. You balk because there is no real allegation that you did anything wrong. The whole case smacks of a shake down. Not only do you fervently believe that you did a great job, you probably let your client cut your fee even further due to disputed change orders or other problems during construction. But, since "no good deed goes unpunished" you are now faced with the untenable decision whether to run for the hills or belly up to the bar. You turn to your insurer and lawyer for help.

Sadly, under the current state of the law, and particularly if the UDC decision is not reversed or depublished, both your insurer and lawyer have limited options.

Your insurer's first option will likely be to issue a reservation of rights letter politely reminding you that your policy does not cover your contractual obligation to defend your client. Your lawyer will likely scrutinize every word of your contract to find language to support an argument that the parties did not "intend" that you would pay your client's defense costs unless you were found negligent. Your lawyer may also quickly evaluate liability, damages and exposure and try to settle the case before your client's defense costs mount potentially into the seven figures. If those efforts fail, your lawyer may also offer to "defend" your client, but only as to those specific issues which involve your scope of work. If your client is not satisfied, your lawyer may also have to try to stave off a summary judgment motion by your client whereby your client's lawyers seek an early judicial ruling that the defense obligation is due and payable immediately and continues throughout settlement or verdict.

If successful, such a court ruling against you may mean that you now have to "turn off the lights" that you so desperately tried to "keep on" when you entered into that contract in the first place. On our hypothetical project, you may have garnered a whopping $250,000 fee, from which you enjoyed a $25,000 profit. In exchange for that $25,000 profit, you may have taken on an obligation to defend your client for over $1 million of attorneys' fees and costs. Few if any architects practicing today could shoulder such a devastating blow. You ask yourself, how could this have happened? How could this be fair?

The answer is, it does happen and it's not fair.

# Are You Defenseless Against the Duty to Defend?

By: Jean A. Weil, Esq.[i]

While the defense obligation has been a hot topic for decades, the issue became magnified with the California Supreme Court's decision in Crawford v. Weather Shield Manufacturing. Inc. (2008) 44 Cal 4th 541. In Crawford, a subcontractor entered into a contract with broad indemnity and defense language, which had no limitation requiring finding of negligence [ii]. 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 [iii]. In analyzing and applying this statute, the Supreme Court noted that unless a contrary intention appears, a contractual promise to "defend" another against specified claims "connotes an obligation of active responsibility, from the onset." That duty "necessarily arises as soon as such claims are made" and continues until they have been resolved. *Id* at 553-54. Further, an agreement to indemnify implicitly "embraces the costs of defense" against such claims. Thus, the defense obligation is implied with "respect to matters embraced by the indemnity." *Id* at 554. 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. *Id*.

The Crawford decision sent shock waves through the construction industry. The decision overruled an earlier case, Regan Roofing v. Superior Court (1994) 24 Cal.App.4th 425 wherein the rule was that there could be no defense obligation without a finding of fault. In the wake of Crawford, architects received renewed tenders from their clients seeking to impose a

Crawford-type defense obligation on the architect. Fortunately, since most owner/architect contracts have indemnity provisions that are tied to negligence, insurers and lawyers have been able to distinguish those indemnity clauses from the one at issue in Crawford. 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. On January 15, 2010, the Court of Appeal published its decision. Arguably, UDC has changed the playing field considerably and applied a Crawford analysis to a contract that contained the previously safe words "negligent act or omission".[iv]

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! You ask, how did this happen? How can this be fair?

It did happen and it's not fair. In order to try and fix this untenable decision, multiple organizations, including AIA California Council, joined together to endorse an Amicus Curiae letter brief to the Supreme Court in support of CH2M Hill's Petition for Review, or in the alternative, in support of CH2M Hill's Request for Depublication of the opinion[v].

Additionally, through a grass-roots letter writing campaign, well over 200 letters from individual architects, engineers and land surveyors have been lodged with the Supreme Court urging the Supreme Court to either accept review or to depublish the opinion.[vi] Fortunately, these letters personalize how the UDC decision will adversely affect these firms. In short, for the vast majority of these firms, being forced to shoulder the up-front defense obligation for any one of their clients will put them out of business. The Amici Curiae letter briefs and many of the letters from the individual firms focus on the following arguments:

- The Court of Appeal did not properly interpret and apply the contractual defense obligation in the parties' contract, which was in fact tied to a finding of negligence.
- The Court of Appeal's decision requires design professionals to provide an immediate defense for which professional liability insurance carriers exclude coverage.
- The Court of Appeal's decision imposes a significant risk to design professionals with disproportionately low economic reward in their contracts.
- Unless the Supreme Court reverses (or depublishes) the Court of Appeal's decision, the decision may well put many design professionals out of business and cause irreversible damage to the design and construction community, which is already in trouble.

So, what can you do to protect yourself from falling into the defense trap so that you are not "defenseless against the duty to defend"? Please consider these following precautions:

- **Do not sign a client's one-sided contract that forces you to take on risk that is out of whack with 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, 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 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.**

With luck, the Supreme Court will make a decision to either accept review or depublish the UDC decision within the next 30-60 days. Until then, please recognize that all contracts you have entered into in the past decade and potentially beyond, if such projects go into litigation, could result in tenders of defense and indemnity that may well force you to confront these difficult issues.

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[ii] Specifically, the clause read: "Contractor does agree to indemnify and save Owner harmless against all claims for damages to persons or to property and claims for loss, damage and/or theft of homeowner's personal property growing out of the execution of the work, and at his own expense to defend any suit or action brought against Owner founded upon the claim of such damage or loss or theft…"

[iii] The relevant portions of *Civil Code* Section **2778 state:** In the interpretation of a contract of indemnity, the following rules are to be applied, *unless a contrary intention appears*:

1. Upon an indemnity against liability, expressly, or in other equivalent terms, the person indemnified is entitled to recover upon becoming liable;
2. Upon an indemnity against claims, or demands, or damages, or costs, expressly, or in other equivalent terms, the person indemnified is not entitled to recover without payment thereof;
3. An indemnity against claims, or demands, or liability, expressly, or in other equivalent terms, embraces the costs of defense against such claims, demands, or liability incurred in good faith, and in the exercise of a reasonable discretion;
4. The person indemnifying is bound, on request of the person indemnified, to defend actions or proceedings brought against the latter in respect to the matters embraced by the indemnity, but the person indemnified has the right to conduct such defenses, if he chooses to do so;

Emphasis added.

[iv] The full text of the indemnity and defense provision reads as follows: "Consultant [CH2M Hill] shall indemnify and hold Owner, Developer, and their respective officers, directors, employees and agents free and harmless from and against any and all claims, liens, demands, damages, injuries, liabilities, losses and expenses of any kind, including reasonable fees of attorneys, accountants, appraisers and expert witnesses to the extent they arise out of or are in any way connected with any negligent act or omission by Consultant, its agents, employees or guests, whether such claims, liens, demands, damages, losses or expenses are based upon a contract, or for personal injury, death or property damage or upon any other legal or equitable theory whatsoever. *Consultant agrees, at its own expense and upon written request by Developer or Owner of the Subject Property, to defend any suit, action or demand brought against Developer or Owner on any claim or demand covered herein*. Notwithstanding the above, Consultant shall not be required to indemnify Developer or Owner from loss or liability to the extent such loss or liability arises from the gross negligence or willful misconduct by Developer, Owner, or agents, servants or independent contractors who are directly responsible to Developer or Owner, or for defects in design furnished by such person." UDC at 796. Emphasis in original.

[v] The participating Amici Curiae include the following organizations: ASFE/The Geoprofessional Business Association, The American Council of Engineering Companies of California, The American Council of Engineering Companies, The National Society of

Professional Engineers, The Design Professionals Coalition of the American Council of Engineering Companies, American Society of Civil Engineers, The California Land Surveyors Association and American Institute of Architects, California Council. Jean Weil and Trevor Resurreccion authored the two letter briefs on behalf of the Amici.

[vi] Weil & Drage served as the clearinghouse to collect and serve these letters on the Supreme Court, Court of Appeal, Trial Court and counsel for UDC and CH2M Hill. It is not too late to write a letter to the Supreme Court. Contact Kurt Cooknick at kcooknick@aiacc.org or Jean Weil at jweil@weildrage.com

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