CATLIN

Contractual Defense Obligations

In our last newsletter, we provided a step-by-step approach to contract review. Now we are focusing on the defense obligation - a provision that is frequently found in onerous client-written indemnities - and we offer some ways to deal with this uninsurable risk. *

The Issue

Our insureds are increasingly asked to sign contracts with complicated indemnity provisions - risk allocation clauses that require the design professional to pay money to the client if something goes wrong. These provisions often include a defense obligation, which usually requires the design professional to pay for a lawyer to defend the client for claims that might arise from the design professional's scope of work.

Why not agree to this? After all, how else are you going to get the project?

According to Brett Stewart, Risk Manager of Catlin's Design Professional team, agreeing to onerous provisions - like the duty to defend your client - is rarely a good idea, especially if it creates an uninsured exposure. "Catlin sees too many claims where bad contracts dictate how a case is litigated and a claim is resolved," he says.

How Your Policy Works

"When it comes to contracting," Stewart says, "a basic rule of thumb is to have your insurance policy cover as much as possible of the liability you might incur on a project."

"In general terms, your insurance policy covers your liability under what is called common law, which is that body of law developed from court decisions rather than by statutes. Under common law, if you make a mistake (in other words, if you do something that falls below the standard of care for your profession and someone suffers damages) you have to pay for it. And, in very basic terms, that's what your insurance policy covers," Stewart explains.

However, your policy doesn't cover everything. "Virtually all professional liability policies contain an important exclusion: the contractual liability exclusion. This exclusion basically says that you are not covered for anything you agree to by contract unless you would otherwise be liable," he says.

The Defense Obligation

So what about agreeing to defend your client? Is that covered by your policy? "Ask yourself whether you would owe that obligation in the absence of a contract," Stewart says. "That is, does common law require you to hire an attorney for your client? The short answer is 'no.'" The law doesn't require one party to hire an attorney for another party unless they promised by contract to do so. In other words, if there is a dispute, it's up to each party to hire its own attorney.

So why would anyone agree to hire an attorney up-front for the client? "Usually, the reason is market pressure," Stewart says. "Clients often have the upper hand in negotiations, and if design firms don't agree to clients' contractual requirements, often the competition will."

Introducing the Specified Defense Cost Exception

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There is some good news, however. Recognizing that our insureds continue to face a tough contracting environment, Catlin has developed a way to provide some relief when it comes to dealing with the onerous defense obligation that so many clients seem to want.

While it seems like a mouthful, the specified defense cost exception is a carve-out to the contractual liability exclusion. In other words, it adds coverage back to the policy if your contract with your client provides for reimbursement of your client's reasonable defense costs based on principles of comparative fault.

How Does It Work?

Let's assume you are involved in a dispute in which the claim settles for $1 million. Several parties are involved, but your share of the settlement is $250,000, or one-fourth of the total settlement. Let's also assume that your client spent $200,000 in legal fees. Provided that you have a contract that says you will reimburse your client for its reasonable defense costs based on principles of comparative fault, then the reimbursement of one-fourth of these legal fees, or $50,000, would be covered under the Catlin policy.

Wouldn't This Be Covered Anyway?

"Many folks believe that if their client's defense costs are tacked on to the end of a claim as a form of reimbursement, then they are covered under a professional liability policy, because these costs are an element of the client's damages," Stewart says. "Stated another way, some think that so long as they don't agree to an immediate cost of defense for their client, their insurance will pay the client's fees since they are 'damages.'"

Unfortunately, this isn't the case. "The question shouldn't be whether your client can claim legal fees incurred as a result of your alleged error or omission are 'damages,' but whether your client can even recover those 'damages' in the absence of a contract." The key is whether the right to recover fees is based on a contract, Stewart says. "Except in rare circumstances, a party to a lawsuit is never entitled to its attorneys' fees merely because it incurred the costs. The way a party recovers its attorneys' fees is through a contractual obligation."

"Ninety-nine percent of lawsuits resolve late in the day at mediation," Stewart says. "By two o'clock in the afternoon, the facts have been thrown out the window, and the parties are merely dealing in dollars. Often, attorneys' fees are wrapped up in the negotiation and ultimately rolled into the overall settlement. However, most carriers will reserve the right not to pay attorneys' fees. At the end of the day, this is an uncovered exposure for you."

Why Doesn't the Insurance Industry Just Agree to Cover the Defense Obligation?

Many wonder why the insurance industry doesn't just cover the defense obligation. After all, the thinking goes, clients tend to dig in over this issue, and it would be easier for everyone if it were covered by insurance. "At first blush, this may make sense," Stewart agrees. "But if insurance companies offered to pay for your client's attorneys' fees when you agree to do this by contract, we would see a shift in how claims are portrayed. It wouldn't take long for claimants and clients to realize that there are deep pockets, so long as the claim is based on 'defective design,' thus triggering the contractual duty to defend the client. As a practical matter, any dispute between an owner and a contractor would necessarily involve a 'defective design' that would force the design professional to first pay its deductible to cover the client's attorneys' fees, and then the professional liability carrier would start to pay money. Since the client is having its defense fully funded and no longer has any 'skin in the game,' the client would have little incentive to settle cases." he says.

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The result: your insurer pays exorbitant amounts toward attorneys' fees, which will erode your policy limits and drastically increase the cost of insurance.

Using the Specified Defense Cost Exception

Stewart says that Catlin recognizes that many clients are reluctant to negotiate their hard-fought indemnity provisions and will tell design firms that if they don't sign, there are ten other design professionals lined up in the wings who will. "But it's important to raise the issue," he says. "Design firms need to know that they are about to sign a contract with an uninsured exposure. And it's important for their clients to know that if there is a problem on this project, there is no insurance to pay for the attorneys' fees."

"Your goal should be to have your insurance company pay for the entire loss," Stewart tells design professionals. This goal should be shared by the client. "Explain to your client that you want to make sure that if you make a mistake, your insurance company will be there to make the client whole. If the client will agree to an indemnity provision that allows you to reimburse your client for reasonable defense costs based on principles of comparative fault, then they will actually recover that money based on the wording in the Catlin policy. If they demand an immediate defense in the contract, there is no coverage for it, and you likely cannot pay for it."

Stewart acknowledges that this approach isn't quite the much-needed panacea for tough contracts. "Many clients will want you to have some uncovered exposure, thinking that you'll step up your game and perform better than you would otherwise. However, if you don't ask, the answer is always no," he says. "If you are going to bet the company, at least know you are doing it."

* In some jurisdictions, including California, the contractual obligation to defend a client may be presumed in any contractual indemnity, unless specifically excluded. While this certainly creates a contracting pitfall, the analysis in this article remains the same. Be sure to talk to your attorney and insurance company or agent before agreeing to any indemnity.

Note: There is no substitute for local expertise, and we encourage you to review the general advice in this newsletter with your local experts including lawyers, risk managers, brokers and underwriters. Nothing in this newsletter is intended to constitute legal advice.