Contractual indemnities — the downside of effective clauses

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In the May 2013 edition of this journal, David Gerber and Craig Hine wrote of the need to exercise care in drafting contractual indemnity clauses.[1]

They (correctly) identified the reality "that the scope of cover under … particular insurance policies may not align with what is covered under the indemnity".[2] The issue of a contractually assumed liability was identified as an example of a liability that may be excluded under certain policies and thus leave that liability uninsured.

This article considers the issue, from a practical perspective, of the effect that indemnity clauses within contracts executed by "professionals" have on coverage under their professional indemnity insurance policy. In this context, a professional is one who has a professional indemnity insurance policy: common examples include the various design professionals such as architects and engineers.

These days it is relatively common to find in a professional's contract of engagement clauses to this effect:

> (a) the consultant will indemnify the client and the owner in respect of
> (i) personal injury to, disease or death of any person;
> (ii) any noncompliance with the contract documents;
> (iii) any claim by a third party in relation to the consultant's services;
> (iv) any act or omission of a subconsultant;
> (v) loss of use or damage to property, including property of the owner and third parties;
> (vi) actual or threatened pollution;
> (vii) "Loss" (which is very broadly defined)
> (b) the proportionate liability legislation is excluded…

The practical effect of an indemnity clause of this kind is that the professional will cover (ie, "hold harmless") the loss and damage suffered by the client for the stated events.

The courts have interpreted an indemnity as giving rise to an obligation in two alternative respects. The first, being an obligation to prevent the loss or harm covered by the indemnity to the client from occurring.[3] Under this obligation, the client is then entitled under the indemnity to make a claim in damages for breach of contract against the professional. Such a claim can be made (and succeed) absent tortious fault.

The second obligation is to compensate the client for the event, resulting in a debt.[4] Under this obligation, the client is then entitled under the indemnity to make a claim for recovery of that debt as distinct from damages for the breach of contract. Again, such a claim can succeed absent tortious fault.

The legal effect of contracting out of the proportionate liability legislation is that the professional agrees to be responsible for the acts and omissions of others who may have a liability, be they subcontractors or third parties, instead of only the portion of loss that the professional would have otherwise been liable for under the legislation.

It is also common to see in professionals' engagement contracts clauses in which the professional provides a range of warranties. For example, a common express warranty within a design and construct contract is that the materials and equipment called up by the professional and incorporated into the construction will be proper, functional and in accordance with the design (ie "fit for purpose"). The effect of such a warranty is that the professional gives a contractual undertaking, to follow the example, that the construction will be "fit for purpose" and should it not be, for reasons that may have little to do with the professional but a lot to do with the builder and a clerk of works, it allows the client to claim from the professional damages for breach of contract (but not so far as to terminate the contract).[5]

The problem with all clauses of the kind discussed is that in the event of a claim against the professional, the professional indemnity insurer will almost certainly point to a policy exclusion which might say something like:

> There is no indemnity available under this policy in respect of:
> (a) any contractually assumed warranty, guarantee or undertaking, unless that liability would have existed in the absence of such contractual warranty, guarantee or undertaking;
> (b) any circumstance where a right of contribution or indemnity has been given up;

(c) any circumstance where the insured has agreed to limit the right to obtain contribution or indemnity from another party.

Why then is it that so many contracts presented to a professional for signature include provisions that will fall foul of a common professional indemnity policy exclusion, with the result being the very last thing the client wishes to see, namely a professional who is effectively uninsured in respect of a claim?

Perhaps it is because as a profession, we lawyers are too used to slavishly following precedents and do not give adequate thought to what we are calling for in the contracts we draft. Perhaps some of the commercial lawyers who draft such contracts are not familiar with the provisions of professional indemnity insurance policies. Clearly, Messrs Gerber and Hine are very familiar with the issue, because they specifically refer to it. However, I am not at all confident that it will be easy to persuade an insurer to amend its policy wording so that it "aligns" with the breadth of the professional's potential liability where the engagement includes obligations of the kind described earlier.

Insurance is a means of guarding against the unexpected: it is not a means of guarding against a certainty. Professional indemnity insurers are not in the business of undertaking to pay money when an insured has contractually accepted a liability that would not attach to the insured, *but for the contract*. The professional indemnity insurer is prepared to indemnify his/her insured for that insured's inadvertent civil liability; he/she is not prepared to indemnify the insured for a liability that arises not from some error on the part of the insured, but rather from the insured's contractual promise to make sure that the client suffers no loss, whatever the circumstances giving rise to, or the nature of, that loss

By means of clauses of this kind, the client is seeking to transfer to the professional's insurer responsibility for making good loss suffered by the client, notwithstanding the fact that the professional has not caused or contributed to the loss. It is little wonder that professional indemnity insurers will not accept that position.

It is frequently the case that a claim against a professional is put on at least two bases. Firstly, the pleaded claim alleges breach of the contract of engagement to exercise due care and skill, along with a claim for breach of duty (ie, a negligence claim in tort). These claims are of the kind that one would expect to fall within the scope of cover under a professional indemnity policy. Secondly, however, there is commonly also a claim for indemnity, pleaded on the basis of one or more of the provisions referred to above. Such a claim is likely to fall foul of an exclusion for contractually assumed liability.

Pleading the second basis for claim also gives rise to very real difficulties in the claims handling process, including these:

a) the insurer may decline to grant indemnity altogether, even in respect of the first basis for claim. Depending on the circumstances, the insurer may take the view that as it is very likely the insured will be found liable under an indemnity or warranty, the policy does not respond at all, even in respect of dealing with the (say) breach of duty aspect of the claim. In such a situation, the insurer may leave it to the insured to defend the entire claim, at the insured's own cost. This can result in a dispute between the insurer and the insured, one practical consequence of which is that attention is diverted from dealing with the merits of the principal claim;
b) the insurer may decide to conduct the defence of the claim, but on a fully rights reserved basis. In other words, there is no grant of indemnity by the insurer and although the insurer may meet defence costs as the claim is dealt with, there is no certainty that at the end of the day, the policy will respond or that the insured professional will not be required to reimburse the insurer in respect of those costs; and
c) the insurer may decide to grant indemnity in respect of the breach of duty aspect of the claim, conduct the defence and meet defence costs in respect of that aspect, but deny policy coverage in respect of the contractual indemnity claim(s) and require the insured to meet costs associated with that aspect of the claim. Clearly, this is not an ideal position and gives rise to potential conflict issues.

None of these possibilities work to the benefit of the insured professional's client: each almost invariably results in delay, difficulty and extra cost in dealing with the claim in question.

An actual example of how a claim was dealt with by a professional indemnity insurer might assist. Under a design and construct deed, an engineer agreed to design a roof for a client (the first deed). The engineer then prepared the bulk of the design for the roof. Under a later design and construct deed, a builder agreed to assume the liability for the design of the roof and also the further design, documentation and construction of the roof for the client (the second deed). The roof collapsed during a storm. The builder was sued by the client for damages for breach of contract and for negligence. The client also sought a declaration that the client was entitled to be indemnified under the second deed. Under the second deed, the builder had assumed full responsibility for the design of the roof even though

the bulk of the design has been done by the engineer, prior to the second deed: thus the builder had taken on an express obligation in contract it would otherwise not have had. The normal exclusion for assumption of liability in contract applied under the builder's professional indemnity policy.

As could be expected, the professional indemnity insurer declined to admit indemnity and reserved its rights pending final judgment (and thus a decision on the effect of the second deed). The court determined the matter on the basis of the second deed and found the builder liable. The insurer applied the exclusion and the builder was uninsured in respect of its judgment liability. As the builder could not fund that liability, the client received nothing.

It is accepted that risk allocation during contract negotiations is common practice. It is often the case that professionals feel they have no option but to accept what has been put in front of them by the client, notwithstanding the potential effect on their professional indemnity coverage. To the client, the perceived ability to recover 100% of any loss from the insured professional is prima facie attractive. However, if the effect of what the client is calling for is that there may be no cover, where is the real world advantage for the client?

Gerber and Hine identify three consequences of there being an effective indemnity which, one presumes, commercial lawyers see as advantageous for their clients:

(a) an indemnity may permit the client to recover damages that the common law would regard as too remote;[6]

(b) an indemnity may have the effect of extending an otherwise applicable limitation period;[7] and

(c) an indemnity may mean that the client does not have an obligation to mitigate the loss.[8]

It is accepted that these are *possible* consequences of a legal nature which may flow to the client as a result of the existence of an indemnity, but the real question is this: are those possible consequences of such material benefit to the client as to offset the risk of the professional's professional indemnity policy not responding to the claim?

Put another way, how often is it that a claim based on mere breach of contract, or negligence, does not result in a plaintiff recovering, from an insured professional, an adequate amount?

In our experience, this question will in most circumstances be answered in the negative.

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Footnotes

1. David Gerber and Craig Hine, "Contractual indemnities — drafting effective clauses" (2013) Vol 16 No 7 Inhouse Counsel Bulletin, p 115.
2. Above, n 1, at p 116.
3. *Firma C-Trade SA v Newcastle Protection & Indemnity Association (The Fanti)* [1991] 2 AC 1; [1990] 2 All ER 705; [1990] 3 WLR 78; [1990] 2 Lloyd's Rep 191.
4. *Caledonia North Sea Ltd v Norton (No 2) Ltd (in liq)* [2002] All ER (D) 85 (Feb); [2002] UKHL 4; [2002] 1 All ER (Comm) 321; [2002] 1 Lloyd's Rep 553.
5. *Associated Newspapers Ltd v Bancks* (1951) 83 CLR 322; 25 ALJR 77; BC5100060.
6. Above, n 1.
7. Above, n 1.
8. Above, n 1.