

Indemnification Clauses in Retainer Agreements and Guidelines: Why Law Firms Should Say “No”

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A GROWING NUMBER of corporate and governmental clients are asking their law firms to agree to indemnification or “hold harmless” clauses in outside counsel guidelines, retainer agreements, or requests for proposals. Clients are asking to be indemnified against various risks, costs, and losses that might arise in connection with their legal matters. E-discovery vendors, litigation consulting firms, and even expert witnesses also are asking law firms to indemnify them against future losses.

Law firms agree to such clauses at their peril. Although indemnification clauses can be a sensible tool for allocating risks in some commercial contexts, they are ill-suited to the attorney-client context. They are unnecessary given the many legal and ethical protections that already exist for clients and third parties. Further, such clauses impose catastrophic risks on law firms *and their clients*, most notably the risk of jeopardizing the law firm's malpractice or other insurance coverage. This article discusses the reasons law firms should say “no” when a client or vendor tries to bind the firm to indemnification language. It also suggests steps law firms should take to lessen their risk in the rare situation where the law firm decides to run the risk of agreeing to some form of indemnification.

THE INDEMNIFICATION FAD • Twenty years ago, it would have been rare for a client, vendor, or expert to request indemnification language. Within the last decade,

however, a small but growing number have begun including such language in their (often voluminous) outside counsel guidelines, form retainer agreements, or requests for proposal. See Gilda T. Russell, *Dealing with Client Outside Counsel Guidelines and Other Non-Standard Client Engagement Terms* (Paragon Brokers, 2016) (http://www.paragonbrokers.com/wp-content/uploads/2016/01/Outside_Counsel_Guidelines_Article_PDF.pdf). This trend is partly a by-product of larger trends: the expanded use of outside counsel guidelines; the growing prevalence of written retainer agreements (now required by many states' ethics rules); the perception of a "buyer's market" for legal services; increased switching of law firms by clients; a shift towards viewing lawyers as mere vendors rather than advisors; the use of "procurement" personnel to hire outside counsel; client personnel who sometimes do not appreciate U.S. lawyers' professional obligations of loyalty, diligence, and competence; the growing size of in-house counsel's offices, litigation consulting firms, and e-discovery vendors; and the ready availability, through publications and internet sources, of boilerplate contract language and guidelines. See Rob Thomas & Bernadette Bulacan, *Outside Counsel Retention Agreements* (Association of Corporate Counsel Sept. 16, 2011) (calling on "corporate legal departments to re-tool their relationships to ensure that they receive more value from their outside counsel") (<http://www.acc.com/legalresources/quick-counsel/ocra.cfm?makepdf=1>).

In-house counsel who utilize indemnification to allocate risk in corporate or commercial contexts have sought to transplant indemnification language and concepts into their employers' outside counsel guidelines, retainer agreements, or requests for proposals, regardless of its suitability in the attorney-client context. Merri A. Baldwin & John Steele, *Contracting Ethics? Legal Representation Contracts between Large Corporate Clients and Law Firms* 4 (ABA Prof'l Resp. Conf. May 2014) ("Often, the client's use of an indemnity clause appears to

be simply a matter of copying the clauses it uses in its commercial vendor relationships.") (http://www.americanbar.org/content/dam/aba/events/professional_responsibility/2014/05/40th-aba-national-conference-on-professional-responsibility/session13_final_article_re_contracting_ethics.authcheckdam.pdf). Indemnification clauses often are buried in lengthy guidelines that are not provided to law firm personnel until after an attorney-client relationship or engagement has begun. Helen W. Gunnarsson, *Some Corporate Clients Are Going Too Far With 'Guidelines' for Counsel, Speaker Says* (Mar. 6, 2015) (ABA BNA Lawyers' Manual on Professional Conduct Mar. 12, 2015) (<http://www.bna.com/corporate-clients-going-n17179923966/>). Clients may take the position (or the guidelines may state) that continued work after receipt of the guidelines constitutes an acceptance of their terms.

At the broadest extreme, clients ask law firms to indemnify, defend, and hold harmless the client and its personnel from and against any and all costs and losses relating to the law firm's (or its subcontractors') performance of an engagement. One governmental client sought (and obtained) its outside counsel's agreement to the following provision in a retainer agreement:

[Law Firm] agrees to indemnify, hold harmless, release and defend (even if the allegations are false, fraudulent or groundless), to the maximum extent permitted by law, and covenants not to sue, the City, its City Council and each member thereof, and its officers, employees, commission members and representatives, from any and all liability, loss, suits, claims, damages, costs, judgments and expenses (including attorney's fees and costs of litigation) which in whole or in part result from, or arise out of, or are claimed to result from or to arise out of any performance under this Agreement, or any acts, errors or omissions (including, with-

out limitation, professional negligence) of [Law Firm], its employees, representatives, subcontractors, or agents in connection with the performance of this Agreement. This Agreement to indemnify, hold harmless, release and defend includes, but is not limited to, personal injury (including death at any time) and property or other damage (including, but without limitation, contract or tort or patent, copyright, trade secret or trademark infringement) sustained by any person or persons (including, but not limited to, companies, or corporations, [Law Firm] and its employees or agents, and members of the general public).

Legal Services Agreement Between the City of Richmond & Bickmore Risk Services ¶ 17 (Mar. 1, 2013) (<http://www.ci.richmond.ca.us/Document-Center/View/26913>).

Such broad indemnification language could subject the law firm to strict liability for any number of circumstances that develop during an engagement through no fault of counsel or its vendors. For example, if a law firm that had agreed to the foregoing indemnification language filed a lawsuit on behalf of its client, and the client's opponent responded by filing counterclaims against the client, the client could argue that the law firm is required to defend the client (at the law firm's cost) and pay any settlement or judgment connected with the counterclaims. As another example, if a law firm made a reasonable judgment on a tactical matter (i.e., whether to call a particular witness at trial), the client could argue that the law firm is financially responsible, under the indemnification clause, for negative consequences that allegedly flowed from that judgment. If a law firm's electronic document-hosting vendor were "hacked" and a client's due diligence files or other data compromised, the law firm arguably could be liable even though it had selected a reputable vendor with state-of-the-art

computer security. See LogikCull, *eDiscovery is the next frontier for hackers, as major law firms now know* (Mar. 30, 2016) (<http://logikcull.com/blog/ediscovery-next-frontier-hackers-major-law-firms-now-know/>).

As a final example, imagine a law firm does first-rate legal work drafting a commercial contract for its client to use with a potential customer. The law firm warns the client that the potential customer is notorious for filing frivolous lawsuits against its suppliers and others. The client decides to run the risk of doing business with the litigious customer, which later sues the client alleging breach of the contract. Even if the client ultimately prevails over its supplier, or pays only a nuisance settlement, the client plausibly could contend that the law firm is responsible to pay all of the client's legal fees and the settlement amount. After all, the law firm agreed to indemnify and "hold harmless" the client from and against any and all costs arising out of or relating to its engagement.

For their part, vendors, litigation consulting firms, and even individual expert witnesses have sought similarly broad indemnification language in their retainer agreements, or have sought language to limit prospectively their liability to the amount of fees paid—with the law firm effectively bearing the risk of any additional losses resulting from the vendor's actions. See Julia Brickell, Mark Cowing et al., *Contracting with the E-Discovery Vendor* (<http://www.shb.com/~media/files/professionals/cowingmark/contractingwiththeediscoveryvendor.pdf?la=en>).

A SOLUTION IN SEARCH OF A PROBLEM

- Historically, an indemnifying party agreed (in exchange for compensation) to be financially responsible for possible future losses—losses for which it would not otherwise be liable. See Eugene L. Grant, *Avoiding the Risks: Subrogation, Indemnification, and Exculpation in the Context of Commercial Leases*, 21 Real Est. L.J. 255, 257 (1993). The classic example of an indemnifying party is an insurer, which agrees

(in exchange for premium payments) to pay the insured for losses caused by third parties or acts of God. An indemnifying party typically receives significant compensation for assuming the risk of events beyond its control.

In most contexts, a party's agreement to indemnify against *its own* breaches of legal or contractual duties would be largely superfluous, because the party already would be liable for its own acts or omissions under tort or breach of contract theories. Parties already have incentives, regardless of indemnification, to use reasonable care to prevent losses for which they would be liable. Moreover, an indemnification clause generally will not ensure much additional financial protection for a party that already has a right of recovery through tort or contract claims.

The lawyer-client relationship does not fit the traditional indemnitor-indemnitee model. For one thing, law firms are not compensated like insurers. Law firms are paid fees, usually on an hourly basis, to provide legal services. They are not compensated to assume risks of events beyond their control and, for this reason, they do not maintain the financial reserves necessary to cover such risks. Indeed, they are not compensated to assume any risks beyond the risks they assume in the ordinary course of representing a client.¹ We are aware of no instance in which a law firm and client have negotiated the "price" of a law firm's indemnification obligation. Indeed, indemnification language is sometimes included in client guidelines that are not sent to the law firm until after an engagement is already underway.

¹The Rules of Professional Conduct provide a non-exclusive list of "factors to be considered in determining the reasonableness of a fee . . ." Model Rules of Prof'l Conduct R. 1.5(a) (Am. Bar Ass'n 2016). Although the Rules likely would not be interpreted to forbid consideration in rate-setting of risks the client is asking the law firm to assume, they do not expressly contemplate that lawyers will base their fee on insuring outcomes or events (except to the extent they contemplate traditional contingency fee arrangements).

Clients already are amply protected without indemnification clauses, and law firms already have powerful incentives to protect their clients' interests. Lawyers and law firms are legally and ethically bound to comply with a complex legal and regulatory framework that has evolved primarily for the protection and benefit of clients:

The attorney's obligations . . . transcend those prevailing in the commercial market place. The duty to deal fairly, honestly and with undivided loyalty superimposes onto the attorney-client relationship a set of special and unique duties, including maintaining confidentiality, avoiding conflicts of interest, operating competently, safeguarding client property and honoring the clients' interests over the lawyer's.

Johnson v. Proskauer Rose LLP, 9 N.Y.S.3d 201, 211 (N.Y. App. Div. 2015) (citations, emphasis, and quotation marks omitted). Law firms face potential malpractice liability if they breach their fiduciary duties or if their work falls below a national standard of care. Lawyers also face discipline and possible malpractice liability if they run afoul of the Rules of Professional Conduct. Those Rules, in particular, constitute a detailed regulatory regime for the protection of clients, imposing multitudinous obligations concerning lawyers' diligence, candor to clients, avoidance of conflicts of interest, and protection of clients' confidences, among others. *See, e.g.*, Model Rules of Prof'l Conduct R. 1.1 (Competence); *id.* at 1.3 (Diligence); *id.* at R. 1.4 (Communications); *id.* at R. 1.6 (Confidentiality of Information); *id.* at R. 1.7 (Conflict of Interest: Current Clients); *id.* at R. 1.15 (Safekeeping Property); *id.* at R. 1.16 (Declining or Terminating Representation). In addition, clients are protected by client-friendly legal doctrines, such as the "continuous representation doctrine," which can extend statutes of limitations for the benefit of a law firm's client. *See, e.g.*,

Shumsky v. Eisenstein, 726 N.Y.S.2d 365, 368 (N.Y. 2001).

To graft onto this comprehensive legal and regulatory regime the additional legal obligations of an indemnification clause adds little value and has huge downsides for both the law firm and its client, as discussed below.

Similarly, it almost never makes sense for a law firm to indemnify an e-discovery vendor, litigation consulting firm, or expert witness. Vendors and consulting firms can purchase insurance to cover the very risks they are asking law firms to bear through indemnification. *E.g.*, Insureon Home Page (<https://consultants.insureon.com/small-business-insurance/cyber-liability/120>) (marketing “Cyber Liability/Data Breach Insurance for Consultants” who are “privity to a wealth of client information”). Insurance companies are paid handsomely to bear risks that vendors and consulting firms effectively are asking law firms to insure for free. In addition, these third parties, by definition, face liability only where they have violated their legal obligations—an occurrence they are better-positioned to avoid than the law firms that hire them. The risk of loss should remain with the actor better-positioned to avoid the loss. Further, in a situation where someone seeks to blame an e-discovery vendor, litigation consulting firm, or expert witness for an error or omission that is the fault of the law firm, legal doctrines such as comparative fault and contribution exist to protect the wrongly accused and to shift liability where it belongs. Here, too, indemnification from the law firm adds little real value to the party seeking an indemnification clause.

It is true that an indemnification clause could give an indemnified party the right to payment of attorneys’ fees (ordinarily not recoverable under the American Rule) and to bring a stronger, simpler claim than might be available at common law. These advantages to the indemnified party are relatively small, however, and the disadvantages far outweigh them.

PROBLEMS POSED BY INDEMNIFICATION CLAUSES •

One obvious problem with indemnification clauses in this context is that they impose potentially catastrophic risks on the law firm for events beyond the law firm’s reasonable control or traditional duties—for no compensation. Consider a hypothetical scenario where Russian gangsters “hack” a law firm’s chosen e-discovery vendor’s computer system and obtain the client’s confidential data. The client could face sizable losses if its trade secrets or business plans are made public, if individual consumers’ credit card or social security numbers are obtained, or if government authorities commence investigations. A law firm that has indemnified the client against such an occurrence could face massive liability despite having complied with all of its professional obligations, and despite having used care in selecting a well-respected e-discovery vendor with top-notch security. A law firm could face losses exceeding its ability to pay. Although indemnification could devastate the law firm, it may be of little actual value to the client, which likely will have purchased commercial insurance to cover this very risk.

A less obvious (but extremely serious) problem with indemnification clauses is that they can undermine the law firm’s malpractice insurance. *See Russell, supra*, at 1. Many malpractice insurance policies cover the law firm only against malpractice claims. Many such policies exclude breach of contract claims from coverage. Indemnification is a creature of contract. If the law firm has agreed to be contractually liable to the client for certain events, the malpractice insurer could deny coverage because the claim is a contract claim rather than a tort (malpractice) claim, and the law firm has contractually agreed to be strictly liable. Some malpractice policies cover only “wrongful acts” by the law firm, and indemnification can create liability even in the absence of a wrongful act as defined in a policy. In addition, insurers may take the position that their policies do not apply when the law firm has agreed

to expand its own common law tort liability or to undermine defenses that would have been available absent the indemnification clause. For example, a contractual indemnification claim could have a longer statute of limitations than a common law malpractice claim. An insurer could deny coverage for claims that would have been untimely but for the indemnification clause. Further, many other potential defenses to a malpractice claim—in *pari delicto*, lack of proximate causation, comparative fault, assumption of risk—could be unavailable if the law firm has indemnified the client. In addition, malpractice insurance policies can require the law firm not to interfere with the insurer's subrogation rights, which an indemnification clause arguably could do. A law firm that agrees to an indemnification clause thus risks catastrophic, uninsured liability. It will almost never make sense to “bet the firm” for the sake of representing a particular client or undertaking a particular engagement.

If a client succeeds at forcing a law firm to accept a broad indemnification clause, the client could find, when some error or omission by the law firm or its agents harms the client months or years later, that the indemnification clause renders unavailable the insurance money that otherwise could have made it whole. This is bad news for both the law firm and its client. Malpractice insurance benefits clients as well as lawyers, as reflected by the requirement in several states that lawyers disclose their insurance coverage (or lack thereof) to clients. *See State by State, Mandatory Malpractice Disclosure Gathers Steam*, 28 Bar Leader No. 4 (Am. Bar Ass'n March-April 2004) (http://www.americanbar.org/publications/bar_leader/2003_04/2804/malpractice.html).

Oregon even requires lawyers to purchase malpractice insurance for the protection of their clients. *Id.* “Malpractice insurance is essential to . . . protect the client's interests in the face of a credible claim.” Virginia State Bar Special Committee on Lawyer Malpractice Insurance, *A Guide to Purchasing Lawyer's*

Professional Liability Insurance in Virginia (August 2008) available at <https://www.vsb.org/site/members/>

Clients that insist on indemnification clauses from their law firms typically have not carefully analyzed these issues. Indeed, some client guidelines, retainer agreements, and requests for proposals require law firms to maintain certain malpractice insurance coverage amounts for the clients' protection, but then, elsewhere in the same document, impose indemnification obligations that could invalidate that very insurance coverage! *E.g.*, Legal Services Agreement Between the City of Richmond & Bickmore Risk Services, *supra*, at ¶ 17. A client is generally better served by having access to a law firm's insurance money than by having an uninsured law firm that is organized as a limited liability partnership as an indemnitor.

In addition, indemnification clauses could distort law firms' incentives in a manner that may not serve clients' interests. To continue the hacking example, a law firm could have incentives to resist taking possession of client data if it has agreed, in effect, to be strictly liable for the security of that data. The law firm could have incentives to insist that client personnel host the data on the client's own servers, regardless of the inefficiencies and other problems that could present in litigating the case for which the client retained the law firm. Law firms would have incentives to insist that their clients directly hire vendors, litigation consulting firms, or expert witnesses—entities the law firm might otherwise have retained itself—rather than risk becoming strictly liable for the conduct of “subcontractors.” Law firms subject to indemnification clauses also could have incentives to give their clients different (and inappropriate) advice if the law firms are insuring outcomes; they could have incentives to steer clients away from even modest risks, regardless of the potential rewards to the client. Indemnification clauses also could affect *clients'* incentives in a manner harmful to the attorney-client relationship or the client itself.

Indemnification clauses in vendors' and experts' retainer agreements pose these same problems: they unfairly impose risks for which the law firm is not compensated, they risk the law firm's insurance coverage, and they distort incentives. In addition, in the case of expert witnesses, indemnification clauses in retainer agreements could create a fruitful new ground for opposing counsel to cross-examine the witness (e.g., "You insisted on an indemnification clause in your engagement agreement because you lack confidence that your opinions are correct, right?"), thereby harming the credibility of the witness, counsel, and client.

WHAT SHOULD LAW FIRMS DO? • A law firm's best move when asked to agree to indemnification language is to say "no." Most sophisticated clients ultimately will agree that such language is unnecessary, unfair, and contrary to the client's best interest—especially when they learn they may lose the protection of the law firm's malpractice insurance. A law firm asked to agree to indemnification language also might seek assistance from its malpractice insurer in negotiating with the client. Some malpractice insurers are willing to speak directly to clients about the significance the insurer will give the indemnification clause if a claim is made. If a client still insists on indemnification (they almost never do), the law firm should decline the engagement.

Vendors, litigation consulting firms, and expert witnesses also generally agree to remove indemnification language from their retainer agreements if asked. If one of these entities insists on indemnification, it is usually easy to find an equally qualified replacement that will not insist on it.

In the unusual case where a client insists on indemnification, and a law firm nonetheless determines it is willing to risk proceeding with an engagement, the law firm might attempt to negotiate any or all of the following:

- To limit the law firm's indemnification obligation to a monetary amount lower than the deductible on the law firm's insurance policies;
- To limit the indemnification obligation to circumstances where the law firm already would be liable at common law (e.g., for the law firm's negligent acts);
- To exclude any liability for errors or omissions by subcontractors or other third parties;
- To exclude liability for events the law firm could not reasonably have prevented;
- To eliminate any obligation to "defend" or "hold harmless" the client, or to pay its legal fees or costs;
- To limit the indemnification obligation to particular enumerated circumstances; or
- To provide that the indemnification obligation does not apply to the extent its enforcement would limit the availability of the law firm's insurance coverage. Also, the law firm might attempt to work with its malpractice insurer to tailor indemnification language in a manner that is less likely to jeopardize the insurer's willingness to cover a claim.

Finally, law firms should implement a centralized process for reviewing retainer agreements and client "guidelines," and for objecting to inappropriate terms. One law firm's general counsel has reported that he searched his firm's document management system for outside counsel guidelines and found "hundreds of them." Gunnarsson, *supra*. Firm management "had no idea" that individual lawyers had exposed the law firm to so many "bombs waiting in our files." *Id.* Individual lawyers should not be permitted to bind the law firm to indemnification clauses or other problematic contract terms, or to assent (through inaction or otherwise) to onerous provisions in client-provided guidelines. Given the risks to the law firm, and the incentives of individual lawyers to maintain client relationships, a decision to indemnify a client or vendor should be a law firm decision, not an individual lawyer's decision. Prudent law firms will institute a policy requiring all firm lawyers to forward client guidelines (e.g., to the firm's general counsel or new business committee) for centralized review and decision-making.