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Risk Transfer for Complex Construction Cases

I. Duty to Indemnify

Indemnification occurs when one party, the "indemnitor", agrees to protect (indemnify) another party, the "indemnitee", from a legal consequence of the indemnitor's or some other party's conduct. Indemnity shifts payment or liability for payment, in whole or in part, from one party to another party, whether due to principles of fairness or equity or by express agreement between the parties. An insurance contract is the most common type of indemnity agreement, in which the insurance company agrees to indemnify the insured against another party's conduct.

"Indemnity" is commonly thought of in general terms as the indemnitor's duty to protect the indemnitee in all respects. However, one fundamental principle, the duty to indemnify does not arise unless there is an adverse finding against the indemnitee, or in practical terms a money judgment. Only then does the duty to indemnify (as opposed to the duty to defend, discussed below) arise.

Indemnity can take many forms:

- equitable indemnity (based on principles of fairness),
- implied contractual indemnity (implied from the terms of a contract), and
- express indemnity (stated within the "four corners" of a contract).

Our focus will be primarily express indemnity. Express indemnity focuses solely on the language to which parties agreed to be bound in their contracts. Accordingly, express indemnity law developed under the rules governing general contract law where the court's focus is on the expressed intent of the parties, rather than principles of fairness and equity (although express indemnity clauses will be strictly construed as narrowly as possible to prevent overreaching).

A. Equitable Indemnity

Under comparative equitable indemnity principles, each party reimburses the claimant in relatively proportionate shares, based on percentages of liability attributed to each defendant or cross-defendant. Equitable indemnification arises due to the particular considerations, or equities, of a given case, and the duty arises by operation of law (basically, a court or jury determines what is equitable or fair). In general terms, an equitable indemnity claim is the presence of two or more parties both liable in tort to the injured party. In other words, you have multiple parties who should pay damages. Absent joint liability, there is no comparative equitable indemnity and that "there can be no indemnity without liability." *Prince v. Pacific Gas & Elec. Co.* (2009) 45 Cal.4th 1151, 1159.

B. Implied Indemnity

The implied contractual indemnity doctrine is grounded upon one contracting party's failure to properly perform contractual duties owed to the other contracting party. That is, if one party did not perform as it was supposed to under the contract, that party should pay under equity theories. Under this indemnity theory, equitable considerations are brought into effect by contractual language not expressly dealing with indemnification.

C. Express Indemnity

The law of express indemnity is based upon traditional contract law principles, in which each party is expressly bound to the terms and obligations to which they have agreed. Thus, express contractual indemnity seeks to enforce the actual agreement of the parties. Under the law of contracts, contracting parties are free to voluntarily define their duties toward one another, including clauses requiring one party to pay, or indemnify, the other against certain claims or losses. The parties may even assign one party the responsibility for the other's attorneys' fees incurred in defending third-party claims.

Typically, the courts will interpret express indemnity clauses very strictly, and construe them only to the extent necessary to effectuate the parties' clear intent as set forth in the contract ***regardless of liability***. Absent fraud or some applicable overriding public policy set forth in a statute, the court will generally not be concerned with issues of fairness. Thus, precise drafting of these terms is of paramount importance. There is no requirement that there be two or more parties liable to the indemnitee. All that is required is the expression of an agreement that one party will indemnify the other party. Moreover, the terms of an enforceable express indemnity provision will generally override any obligation due under a comparative equitable indemnity claim based on the same acts for which express indemnity is sought.

D. California Anti-Indemnity Statutes

California has anti-indemnity statutes which limit the breadth of indemnity provisions in construction contracts:

- **No Indemnity for Sole Negligence or Willful Misconduct** – *Civil Code section 2782(a)*.
- **No Indemnity by Public Agencies for Active Negligence** – *Civil Code section 2782(b)*.
- **Limitations on Indemnity in Residential Construction Contracts** – *Civil Code section 2782(d)*.
- **Limitations on Indemnity by Public Agencies Against Design Professionals** - *Civil Code section 2782.8*.
- **Limitations on Indemnity in Wrap-Up Insurance Policies** - *Civil Code sections 2782.9 through 2782.96*.
- **No Indemnity for Active Negligence or Willful Misconduct** - *Civil Code section 2782.05*.
- **No Indemnity by Public Agencies for Active Negligence** - *Civil Code section 2782(b)(2)*.
- **No Indemnity by Private Builder Not Acting as Contractor** – *Civil Code section 2782(c)*.

E. Coverage Perspective

Contractual liability coverage is limited to a third party's liability in fact "assumed" by insured under an "insured contract." An indemnity agreement does not make a third party indemnitee an "insured" on the indemnitor's CGL policy. *Alex Robertson Co. Co. v. Imperial Cas. & Indem. Co.* (1992) 8 Cal.App. 4th 337. If the contractual liability coverage applies to the particular indemnity agreement, the insurer could be obligated to defend and potentially indemnify the named insured indemnitor for its liability under the agreement. However, the insurer owes no direct duty to the indemnitee.

II. Duty to Defend and Indemnify

Many construction indemnity provisions include a related duty to defend, which requires the indemnitor to defend the indemnitee against third-party claims and potentially first party claims depending on the language included in the provision. In addition, it is important to understand that the duty to defend does not depend on the outcome of the claim, whereas the duty to indemnify does not arise unless the outcome of the claim is adverse. The duty to defend and duty to indemnify are separate and distinct obligations. Because the duty to defend and the duty to indemnify are distinct obligations, the contract may impose a duty to defend the underlying claim even in the absence of a duty to indemnify. *Hollingsworth v. Chrysler Corp.* (Del. 1965) 208 A.2d 61. In other words, the contractual duty to defend a claim may be broader than the duty to provide indemnity from a loss or judgment.

A. The *Crawford* Decision

The underlying *Crawford* matter involved a group of homeowners claiming a broad spectrum of construction defects against a developer. The developer then filed cross-claims for express indemnity against its various subcontractors and design professionals. The subcontracts contained a provision under which each subcontractor/designer agreed:

> "[1] to indemnify and save [J.M. Peters] 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 [2] at his own expense to defend any suit or action brought against [J.M. Peters] founded upon the claim of such damage or loss . . ."
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> *Crawford v. Weather Shield* (2008) 44 Cal.4th 541 at 553.

The Supreme Court ruled that the subcontractors were obligated to pay its respective defense costs to the developer even though the jury had ultimately found that the subcontractors were not negligent in the underlying action. The Supreme Court went further and held that the duty to indemnify and the duty to defend were generally separate and independent obligations, and unless the agreement expressly conditioned or limited the defense obligation contrary to Civil Code Section 2778(4), the duty to defend arose at the time of tender, not after the determination of liability. *Crawford v. Weather Shield* (2008) 44 Cal.4th 541.

The California Supreme Court acknowledged that every indemnity contract embraces the duty to defend, and unless the agreement provides otherwise, a duty to assume the indemnitee's defense, if tendered, against all claims is included in the duty to indemnify. *Crawford v. Weather Shield* (2008) 44 Cal.4th 541 at 558.

B. Coverage Perspective

If the insurance policy provides contractual liability coverage, an insurance policy may ultimately respond and pay defense costs and any indemnity owed under the contract as "damages". *See Golden Eagle Insurance Co. v. Insurance Co. of the West* (2002) 99 Cal.App.4th 837. However, pursuant to *Golden Eagle*, an indemnification provision in a contract does not bind the insurance carrier to defend. In other words, the insurance carrier is not a party to the contract and owes no direct duty defend based on the indemnification provision alone.

Some changes to the contractual liability landscape may apply as a result of *California Senate Bill 474*. The new law provides that construction agreements with a subcontractor that attempt to indemnify a general contractor, construction manager, public entity or other subcontractor for liability claims (including the costs to defend) will be unenforceable to the extent of willful misconduct or if the general contractor, construction manager, etc. is actively negligent.

The effect of *SB 474* appears to be in conflict with *Crawford*. *Crawford* indicates that the duty to defend begins immediately but *SB 474* references both defense and indemnity obligations. It may be possible to argue that the defense obligation does not arise until a determination is made as to the extent of the indemnitee's negligence.

C. Additional Insured Obligation

Another form of risk transfer is the Additional Insured Endorsement (AI). The additional insured endorsement arguably provides an even stronger and more direct transfer of risk than that of the indemnity provision. In essence, additional insured endorsements obligate another's insurer to defend and indemnify even if the additional insured's liability is the sole cause of damage. An additional insured endorsement can be limited by its specific terms or can broadly extend to the named insured's contracts with its customers where it expressly covers anyone who the named insured has agreed in writing to insure. But the terms of an express indemnification provision in the named insured's contract has no bearing on the scope of coverage under an additional insured endorsement.

Given the relationship created between the additional insured and the insurer, when an insurer chooses not to use clearly limiting language, but instead grants coverage for liability arising out of the "named insured's work", the additional insured is covered without regard to whether the injury or damage was caused by the fault of the named or the additional insured.

Fortunately, as common sense would dictate, pursuant to *Patent Scaffolding Co. v. Williams Simpson Construction Co.* (1967) 256 Cal.App.2d 506, 509, an additional insured obligation trumps and fully satisfies any additional contractual obligation to defend. In other words, a developer who successfully tenders its defense to a subcontractor's insurance carrier pursuant to a valid additional insured endorsement, does not also have a continued claim against the subcontractor for those same fees and costs pursuant to an express indemnity provision. The developer is not entitled to a double recovery.

Case law in this area continues to evolve and as both contractual indemnity provisions and designations of third parties as additional insureds under an insurance policy are grounds for a third party's tender, they are separate and distinct and thus, require separate analysis.

III. Strategies

A. <u>Developer Attack Strategies</u>

- Immediately make Defense Demands based on *Presley, Crawford*, and *Civil Code § 2278*
- File cross-complaint that allows for motion for summary adjudication - declaratory relief regarding the duty to defend
- File motion for summary adjudication on the duty to defend
- Prevail on motion for summary adjudication and demand participation
- Consider second motion for summary adjudication on equal share contribution

B. <u>Subcontractor Attack Strategies</u>

Demand the following in Response to a *Crawford* demand:

- Breakdown of actual payments/assignments. *Bramalea California, Inc. v. Reliable Interiors, Inc.* (2004) 119 Cal.App.4th 468
- Copy of Joint Defense Agreement (JDA)
- Copies of All Legal Bills
- Acknowledge the duty to defend to avoid motion for summary adjudication
- Consider making good faith payments subject to settlement or court determination
- Consider a JDA or retention of separate counsel