

New Legislation Affecting Allocation Of Risk In Residential Construction Contracts

This article explains how risk may be allocated among parties to a construction contract through indemnity provisions, and how new legislation places constraints on the use of such provisions under certain circumstances involving residential construction.

1. Allocating Risk in Construction Contracts Through Indemnity Provisions

California Civil Code section 2772 provides a formal definition of indemnity: "Indemnity is a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person." In other words, indemnity is an agreement by which – under specified circumstances – one agrees to pay for the losses and/or liability of another. Like insurance provisions, indemnity provisions are a primary means of allocating risk among the parties to a construction contract.

One of the key features of any indemnity clause is the issues of fault. How does the fault of the indemnitee (the indemnified party) affect the obligation of the indemnitor (the indemnifying party)? For several decades, it has been common practice to classify an indemnity clause as "Type I," "Type II" or "Type III"¹ depending on how the clause deals with the indemnitee's negligence, whether active or passive.²

A Type I indemnity clause is one in which the indemnitor agrees to indemnify the indemnitee even for the latter's active or passive negligence (see important exception described below). Under a Type I clause, the indemnitor may be liable for all losses suffered by the indemnitee even where there is little or even no negligence on the part of the indemnitor -- so long as there is some nexus between the indemnitee's loss and the indemnitor's work. See, e.g., Centex Golden Construction Co. v. Dale Tile Co., 78 Cal. App. 4th 992 (2000), Continental Heller Corp. v. Amtech Mechanical Services, Inc., 53 Cal. App. 4th 500 (1997). A Type II indemnity clause is one in which the indemnitor agrees to indemnify the indemnitee for the latter's passive negligence, but not for his or her active negligence. Type II indemnity is

¹ Some courts have avoided using this nomenclature, most notably the California supreme court in Rossmoor Sanitation, Inc. v. Pylon, Inc., 13 Cal. 3d 622 (1975). However, it continues to be widely used among the construction bar.

² Active negligence arises when one "personally participates in an affirmative act of negligence, or is physically connected with an act or omission by knowledge of or acquiescence in it, or fails to perform some duty in connection with the omission which he may have undertaken by virtue of his agreement . . ." MacDonald & Kruse, Inc. v. San Jose Steel Co., 29 Cal. App. 3d 413, 424 (1972), quoting Morgan v. Stubblefield, 6 Cal. 3d 606, 625 (1972). In contrast, passive negligence occurs when one fails to perform a duty of care imposed by law, but does not actively participate in the act of negligence that is the cause of harm. Rossmoor, 13 Cal. 3d at 629.

sometimes referred to by the courts as "general indemnity." If a clause is silent respecting the negligence of the indemnitee, it generally will be held to afford Type II indemnity. See, e.g., Heppler v. J.M. Peters Co., 73 Cal. App. 4th 1265 (1999). And a Type III indemnity provision is one in which the indemnitor is not obligated to indemnify the indemnitee for the latter's active or passive negligence. (Type III indemnity basically sets up a comparative fault paradigm.) Whether an indemnity agreement is Type I, II or III under a MacDonald & Kruse analysis turns on the explicit language of the contract pertaining to the indemnitee's negligence.

Where an indemnity agreement does not fall neatly into one of these three categories (Type I, II or III), the courts will apply ordinary contract interpretation. Heppler v. J.M. Peters Co., 73 Cal. App. 4th 1265, 1276 (1999). The California supreme court has stated that "the question of whether an indemnity agreement covers a given case turns primarily on contractual interpretation, and it is the intent of the parties as expressed in the agreement that should control. . . . This requires an inquiry into the circumstances of the damage or injury and the language of the contract; of necessity, each case will turn on its own facts." Rossmoor Sanitation, Inc. v. Pylon, Inc., 13 Cal. 3d 622, 633 (1975). Under either a MacDonald & Kruse analysis or ordinary contract interpretation, the wording of an indemnity clause with respect to the indemnitee's fault is critical to its interpretation.

2. **Existing Carve-out for Sole Negligence and Willful Misconduct**

Parties have always been free to negotiate indemnity provisions in construction contracts with one important exception: an agreement whereby a party is required to indemnify another party for the latter's sole negligence or willful misconduct is void. Cal. Civ. Code § 2782. Thus, even the broad remedy afforded by Type I indemnity will be unavailable if the loss is caused entirely by the indemnitee.

3. **New Legislation Creates Additional Carve-out Regarding Indemnity Available to Builders in Original Residential Construction**

Legislation effective January 1, 2006 (AB 758) creates a further exception to parties' ability to negotiate indemnity terms in construction agreements. AB 758 has been touted as addressing the "insurance crisis" being experienced by residential subcontractors.³ Some opine that, viewed in conjunction with SB 800 (Civil Code, Title 7, "Requirements for Actions for Construction Defects"), it prohibits builders from pushing down their strict liability obligations onto subcontractors through indemnity agreements. Others maintain that it basically deals with an issue of fairness, i.e., whether liability is fairly imposed on subcontractors for damages beyond their control as to which they would otherwise not be liable.⁴

³ Insurance companies have allegedly withdrawn from the California residential market due to construction defect litigation and especially in light of the Presley Homes ruling. However, the role of Type I indemnity agreements in that pull-out is debatable.

⁴ Critics of the new legislation complain that private parties should be freely allowed to negotiate and agree to allocate risk as they see fit, noting that risk, after all, is built into the contract price. Moreover, as between the owner and subcontractors, and even as between the general contractor

Attorneys and commentators are already complaining that the new statutory language is unclear, and vigorous debate has ensued. Thus, the scheme outlined below is the author's interpretation only of new statutory language untested by the courts.

3.1 **What the New Legislation Says**

AB 758 amends California Civil Code Section 2782 to generally limit subcontractors' indemnity obligations to builders in connection with construction defect claims. The affected portions of section 2782, as amended, are as follows:

(c) For all construction contracts, and amendments thereto, entered into after January 1, 2006, for residential construction, as used in Title 7 (commencing with Section 895) of Part 2 of Division 2, all provisions, clauses, covenants and agreements contained in, collateral to, or affecting any such construction contract, and amendments thereto, that purport to indemnify, including the cost to defend, the builder, as defined in Section 911, by a subcontractor against liability for claims of construction defects are unenforceable to the extent the claims arise out of, pertain to, or relate to the negligence of the builder or the builder's other agents, other servants, or other independent contractors who are directly responsible to the builder, or for defects in design furnished by those persons, or to the extent the claims do not arise out of, pertain to, or relate to the scope of work in the written agreement between the parties. This section shall not be waived or modified by contractual agreement, act, or omission of the parties. Contractual provisions, clauses, covenants, or agreements not expressly prohibited herein are reserved to the agreement of the parties.

(d) Subdivision (c) does not prohibit a subcontractor and builder from mutually agreeing to the timing or immediacy of the defense and provisions for reimbursement of defense fees and costs, so long as that agreement, upon final resolution of the claims, does not waive or modify the provisions of subdivision (c). Subdivision (c) shall not affect the obligations of an insurance carrier under the holding of *Presley Homes, Inc. v. American States Insurance Company* (2001) 90 Cal. App. 4th 571. Subdivision (c) shall not affect the builder's or subcontractor's obligations pursuant to Chapter 4 (commencing with Section 910) of Title 7 of part 2 of Division 2.

and subcontractors, the latter typically exercise the most control over the construction, both in terms of safety and the integrity of the finished product.

Although the new legislation is touted as doing away with Type I indemnity for builders, the language appears to preclude builders from obtaining either Type I or Type II indemnity from subcontractors as it refers only to "the negligence of the builder" and does not differentiate between active and passive negligence.

3.2 **When the Legislation Applies**

The new legislation applies to construction contracts entered into after January 1, 2006. Arguably, the legislation also applies to change orders entered into after that date -- even change orders to previously executed construction contracts. Cal. Civ. Code § 2782(c) ("For all construction contracts, and amendments thereto, entered into after January 1, 2006 . . .") (emphasis supplied).

3.3 **To what the Legislation Applies**

3.3.1 **Original Residential Construction Only**

The new legislation applies only to residential construction as defined in section 895, *et seq.* of the Civil Code. Civil Code section 896 defines residential construction as "original construction intended to be sold as an individual dwelling unit." Thus, the new legislation does not apply to condominium conversions or apartment construction, nor does it apply to any commercial construction. However, arguably, it does apply to mixed use projects in which single family units are included.

3.3.2 **Construction Defect Claims Where Builder is Negligent**

The legislation only applies to indemnity for construction defect claims. It does not, on its face, apply to indemnity for personal injury, wrongful death or real property damage, for example. (But query whether it applies to property damage stemming from construction defects?) Nor does it appear to preclude indemnity for construction defects "arising out of" a subcontractor's work so long as there is no negligence by the builder or its agents.

3.4 **To Whom the Legislation Applies**

3.4.1 **Applies to Builders, Including Affiliated General Contractors**

The legislation applies to "builders" as that term is defined by section 911 of the Civil Code. Civil Code section 911 defines a "builder" as "any entity or individual, including, but not limited to a builder, developer, general contractor, contractor, or original seller, who, at the time of sale, was also in the business of selling residential units to the public . . . or was in the business of building, developing, or constructing residential units for public purchase . . ." The term "builder" does not include general contractors who are "not a partner, member of, subsidiary of, or otherwise similarly affiliated with the builder."

3.4.2 Does NOT Apply to "Unaffiliated" General Contractors

Builders arguably can still require Type I indemnity from general contractors even for residential construction.⁵ However, general contractors cannot require subcontractors to give the owner Type I indemnity. But general contractors who are not "builders" apparently can still obtain Type I indemnity for themselves from subcontractors for residential construction.

3.5 Defense Obligations

The new legislation expressly recognizes a residential builder's right to require that subcontractors provide an immediate defense against construction defect claims, but only so long as such a contract term provides for reimbursement of defense fees and costs to the extent of the indemnitees' proportional liability, i.e., on a comparative fault basis.

4. Interplay with Insurance

The new legislation expressly preserves the holding of Presley Homes v. American States, 90 Cal. App. 4th 571 (2001). In that case, the builder was an additional insured on two subcontractors' commercial general liability policies, both issued by American States. After a homeowner sued for construction defects, the insurer sought to limit its obligation to defend the builder to claims relating to the work of the two subcontractors. But the court held that the duty to defend extends to all of the claims brought in a single lawsuit, even if only one or some are potentially covered by that lawsuit.

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⁵ Note that under section 911 of the Civil Code, general contractors are "treated the same as subcontractors" for purposes of Title 7. But there is no similar definition for Title 12, in which the new legislation appears. Thus, whether a general contractor will be treated like a subcontractor in connection with AB 758 is unclear.