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Articles of Note

How Contractual Indemnity Clauses Can Wreak Havoc on Potential Settlements in Construction Litigation

By Gary Strong

Assume a general contractor contracts with subcontractors to perform various scopes of work to complete a residential or commercial building. All of the subcontracts contain some sort of indemnity provision. After the project is completed, the general contractor is sued by the developer for damages related to a host of alleged construction defects at the property. The complaint alleges various defects in the interior and exterior of the building which implicates trades such as a stucco, waterproofing, roofing, and siding. The general contractor files a third-party complaint against most if not all of its subcontractors and alleges, among other causes of action, contractual indemnity against these subcontractors. The case proceeds for a few years and the parties are at mediation or on the doorsteps of what could amount to a several month trial and settlement is within their grasp. However, an old foe appears—the general contractor is seeking to enforce its contractual indemnity rights against the subcontractors and now wants a six or seven figure sum of money to make it whole from spending all of its legal fees and costs in defending itself in the case.

This article focuses on the basics of the contractual indemnity provisions and what strategies counsel should be armed with when he/she is forced to not only defend a complex construction defect case but also the contractual indemnity component of such a case.

Basic Rules of Interpretation for Indemnity and Defense Provisions

Construction contracts typically include an indemnity provision that requires one party (the indemnitor) to indemnify the other (the indemnitee) for claims asserted against the indemnitee which arise out of the indemnitor's work. *Cal Civ. Code § 2772; Buenz v. Frontline Transportation Co.,* 227 Ill.2d 302 (2008). The scope of the indemnity provision can range from a narrow obligation, which requires a specific finding of fault by the indemnitor before it is liable for indemnity, to a broad obligation, where the obligation to indemnify is triggered merely by the fact that the indemnitor's scope of work is implicated in the underlying action, regardless of whether the indemnitor is at fault. *City of New York v. Lead Industries Ass'n, Inc.,* 190 A.D.2d 173 (1st Dep't 1993); *Illinois Cent. Gulf R. Co. v. Deaton, Inc.,* 581 So.2d 714, 717 (1991). Under either scenario, however, the indemnity obligation generally arises only after the underlying action has been resolved.

Most typical indemnity provisions include a related duty to defend, which requires the indemnitor to defend the indemnitee against covered third-party claims. Similar to indemnity provisions, the scope of a defense obligation can range from a narrow obligation, which limits the duty to a specific claim or claims, to a broad obligation, which requires the indemnitor to defend the indemnitee against an entire action where damage is "attributed" to the indemnitor's scope of work.

The fundamental rules for interpreting contracts in general, and indemnity and defense provisions in particular, provide that the parties have great freedom to assign the rights and responsibilities in the contract as they see fit.*Englert v. Home Depot*, 389 N.J. Super. 44 (App. Div. 2006; *Hertz Corp. v. Zurich American Ins. Co.,* 496 F. Supp.2d 668 (E.D. VA. 2007). This freedom includes the right to allocate risk through indemnity and defense provisions and, if desired, to impose conditions or limitations on the applicability of those provisions. Id. The intent of the parties is to be ascertained, if possible, from the contract alone, so the key question of whether an indemnity or

defense provision applies in a given case can turn initially on the intent of the parties as expressed in the contract. It is worth noting that while general contractors and subcontractors can be considered sophisticated business entities, the reality is that the subcontractors are so desperate for work that the sign contracts with indemnity provisions that completely in the general contractors favor and leave the subcontractor with an inordinate amount of exposure.

Enforceability of Indemnification Provisions

Most, if not all states, allow language that provides an indemnitor to indemnify an indemnitee for the indemnitors own negligence. The issue becomes less clear when two parties negotiate a contract where the indemnitor is to indemnify the indemnitee for the indemnitee's own negligence. Some states have held that an agreement to indemnify another for the other party's own negligent acts does not violate public policy, but indemnity of this nature is strictly construed and not enforced unless the indemnitor's obligation to protect the indemnitee against its own negligence is expressed in clear and unequivocal terms. *Washington Elementary Scholl Dist. No. 6 v. Baglino Corp.*, 817 P.2d 3, 6 (Ariz. 1991); *Hyson v. White Water Mtn. Resorts of Connecticut*, 829 A.2d 827 (Conn. 2003); *H&H Painting and Waterproofing Co. v. Mech. Masters, Inc.,* 923 So.2d 1227 (Fla. 4th Dist. Ct. App. 2006). *Ramos v. Browning Ferris Indus. of S. Jersey, Inc.,* 103 N.J. 177 (1986); Azurak v. Corporate Prop. Investors, 175 N.J. 110 (2003). Succinctly, a court will not construe a contract to provide indemnification for damages arising from the indemnitee's own negligence, unless such an intention is stated expressly and unequivocally in the indemnification clause. Id. Indeed, the contract must specifically reference the negligence or fault of the indemnitee. *Id.*

The New Jersey Appellate Division has upheld an indemnity provision as valid and enforceable where the subcontractor agreed to indemnify the general contractor for any and all claims "arising… out of" the subcontractor's work or any breach or default of the subcontractor "whether or not any acts, errors, omission or negligence of any of the indemnities [general contractor] contributed thereto in whole or in part." *Estate of D'Avila v. Hugo Neu Schnitzer East*, 442 N.J. Super. 80, 114 (App. Div. 2015). It also upheld a separate provision in which a different subcontractor agreed to indemnify the general contractor for all claims, damages, losses, and expenses, "arising out of" its performance of the subcontract "regardless of whether or not such claim, damage, loss or expense is caused in part by the [general contractor.]" *Id.* at 115-16.

The court held that the language in both provisions was sufficiently plain and unequivocal to require the subcontractors to indemnify the general contractor for the general contractor's own negligence. *Id.* at 114–16. It further concluded that the "arising out of" language did not require proof that the injuries were proximately caused by the subcontractor's conduct. *Id.* at 115–16. Rather, "[a]pplying a common and ordinary sense to that phrase, there only needs to be proof of 'a substantial nexus' between the injury and the activities encompassed in the contract." Id.

Assuming that the duty to indemnify is clear and unequivocal, the question then becomes when does the indemnitor need to start fulfilling its contractual indemnity obligations. It can be argued that the indemnitor's indemnitee obligation can only begin once there has been a finding by the court that the indemnitor or indemnitee is negligent. *Virginia Sur. Co. v. Northern Ins. Co.*, 362 Ill. App.3d 571, 574 (3d Dist. 2005); *Hankins v. Pekin Insurance Co.,* 305 Ill.App.3d 1088, 1093, (1999); *McNiff v. Millard Maintenance Service Co.,* 303 Ill.App.3d 1074, 1077 (1999).

The Duties to Defend and Indemnify- Related But Different

As noted above, a duty to indemnify arises upon imposition of an adverse judgment requiring the payment of money. For all practical purposes then, an indemnitor's (the one who pays the indemnity's) liability on an indemnity obligation does not even arise until the underlying litigation is concluded (even though for administrative purposes, indemnity claims are commonly brought at the same time, as part of the underlying litigation, in order that all potentially responsible parties are before the court in one proceeding, saving the courts and parties from two trials on the same subjects).

Most indemnity provisions, however, also include a related duty to defend, which requires the indemnitor to defend the indemnitee against covered third-party claims and potentially first party claims depending on the language included in the provision. *Mid-Continent Cas. Co. v. Swift Energy Co.,* 206 F.3d 487 (5th Cir. 2000); *Estate of King v. Waggoner County Board of County Commissioners*, 146 P.3d 833 (2006); Similar to indemnity provisions, the defense obligation can range from a limited obligation, which limits the duty to a specific claim or claims, to a far more expanded obligation, which requires the indemnitor to defend the indemnitee against an entire action where damage

is related to or attributed to the indemnitee against an entire action where damage is related to or attribute to the indemnitor's scope of work, design, or construction administration services. *See generally Wal-Mart Stores, Inc. v. Qore, Inc.,* 647 F.3d 237 (2011).

Statutory and case law principles related to interpreting indemnity contracts and defense provisions permit wide latitude and great freedom of the contracting parties to assign rights and responsibilities in the contract. This latitude includes the right to allocate risk through indemnity and defense provisions and, if desired, to impose conditions or limitations on the applicability of those provisions. The intent of the parties is to be ascertained, if possible, from the contract alone, so the key question of whether an indemnity or defense provision applies in a given case will vary depending on the language of the provision in the contract.

The duty to defend was read quite broadly by the California Court of Appeals in *UDC v. CH2M Hill*, 181 Cal. App.4th 10 (2010). In the UDC case, developer UDC-Universal Development, L.P. entered into a contract with engineer, CH2M Hill under which CH2M Hill agreed to provide certain engineering and environmental planning services in connection with UDC's development of a residential condominium complex. *Id.* at 14. Included in the contract was an indemnity provision that required CH2M Hill to indemnify UDC for any claims, demands, injuries, etc., ". . . to the extent they arise out of or are in any way connected with any negligent act or omission" by CH2M Hill. The agreement also required CH2M Hill to defend UDC for ". . . any claim or demand covered herein." *Id.* at 19.

After the project was completed, the homeowners' association ("HOA") filed an action against UDC for allegedly defective conditions at the project. *Id.* at 10-11. Although the allegations of "defective conditions" included claims of negligent planning and design of open space and common areas, the complaint did not name CH2M Hill as a defendant and did not make any specific allegations against CH2M Hill or specifically criticize any of its services. Id. at 13-14. UDC tendered its defense to CH2M Hill in the HOA action, which CH2M Hill rejected. UDC thereafter filed a cross-complaint against CH2M Hill, alleging among other things, causes of action for negligence, breach of warranty and express contractual indemnity. *Id.*

The trial court ruled for UDC, holding that it was only CH2M Hill's indemnity obligation that was conditioned on a finding of negligence and its defense obligation arose at the time of the tender, regardless of whether any negligence was found. CH2M Hill appealed. *Id.* at 13.

The California Court of Appeal affirmed. Focusing primarily on the language that required CH2M Hill to defend UDC for ". . . any claim or demand covered herein. . .," the appellate court held that CH2M Hill's defense obligation was not conditioned on a determination of its negligence but arose simply when any claim against UDC "implicated" CH2M Hill's scope of services on the project. *Id.* at 21. Although the HOA had not alleged that CH2M Hill committed any negligent acts or omissions, and despite the fact that a jury later determined that CH2M Hill was not negligent, the court held that CH2M Hill still had a duty to defend UDC at the time it tendered its defense because the underlying HOA claims simply "implicated" CH2M Hill's work on the project. *Id.* at 21–22.

In sum, 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. In other words, the contractual duty to defend a claim may be broader than, and arise more often than, the duty to provide indemnity from a loss or judgment.

Legal Bills and Expert Bills in Connection With Contractual Indemnity Claim

More likely than not, the general contractor or developer believes their contractual indemnity claim commences once they put on notice of claim by Plaintiff. The actual lawsuit may not arise until a few years later. Nevertheless, the general contractor or developer will most likely seek to recover attorneys' fees and costs well before the lawsuit is filed. It is good practice, when sending out initial discovery demands to include a request for legal bills and expert bills. The general contractor or developer will likely balk and try and use the shield that these documents are privileged or this part of the claim is not ripe until there is a finding of liability. The argument against this deflecting nature is that these indemnity claim are part of the general contractor's affirmative claim. Essentially it is best to use the indemnity language that is being held over the subcontractor's head against the general contractor. A recent New Jersey Appellate Division case addressed this exact issue and the Court rejected the general contractor's claim that

counsel fees are traditionally addressed in post-trial applications. Marina Del Rey Associates, LLC v. Community Realty Management, Inc., 2016 WL 4197303 at *4 (App. Div. August 10, 2016). The Appellate Division stated, "[a] claim for attorney's fees pursuant to a contractual agreement is not an award of fees under R. 4:42–9. Rather, it is an element of damages which must be proved in the same manner as any other item and which must be assessed by the finder of fact as a matter of right and in the actual amount established by the proofs." *Id.*

Conclusion

The moral of the "contractual indemnity" story is to aggressively pursue these damages from the general contractor's counsel from the onset of the case. This means conducting an early analysis of the contractual indemnity provision that is in play. Next, discovery and/or deposition requests should be served so that counsel has a good idea of what fees have been accrued and/or will continue to accrue. Additionally, it may be beneficial to, for the limited purposes of defending against the contractual indemnity claims, to work with co-defendants, many of which likely have the same contractual indemnity obligations.

The key is to not let the contractual indemnity obligations torpedo a settlement. It may mean, depending on what jurisdiction the case is taking place, paying a sum of money, more than what is estimated to remediate the alleged construction defect(s), to buy peace for the client. The alternative in taking a hard-line stand on paying any money to satisfy the contractual indemnity obligation, could have dire ramifications for the client because the contractual indemnity obligations will increase with every deposition, court conference, and correspondence exchanged in the case. Another concern is that while general liability policies cover alleged negligence, these insurance policies do not necessarily cover claims for contractual indemnity.

Gary Strong *is a partner with the law firm of Seiger Gfeller & Laurie LLP. Mr. Strong focuses his practice in the defense of contractors and design professionals during construction defect litigation.*
