



1-1-2008

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Recommended Citation

39 McGeorge L. Rev. 407

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Chapter 32: Bringing Down the Hammer on Type I Indemnity Agreements in Construction Contracts

Brett E. Bitzer

Code Section Affected

Civil Code § 2782 (amended).
SB 138 (Calderon); 2007 STAT. Ch. 32.

I. INTRODUCTION

The year is 1995, and subcontractor *A* has just submitted a bid to waterproof decks at a new condominium development.¹ The project involves many parties, including an architect, developer, general contractor, and many other subcontractors.² The general contractor selects subcontractor *A*'s bid, contingent on the fact that subcontractor *A* signs a contract indemnifying the general contractor against all liability.³ Subcontractor *A*, in need of the business, agrees to indemnify the general contractor and adds the contractor as an additional person insured on her insurance policy.⁴ Nine years later subcontractor *A* is sued.⁵

The owners of the condos file suit against the general contractor "for various construction defects related to the structural components, decks, and balconies of the condos."⁶ The complaint, however, does not allege any specific defects or problems arising from subcontractor *A*'s work. Unfortunately, the general contractor brings subcontractor *A* into the lawsuit as a third party defendant through the previously signed indemnity clause.⁷ Even though there were many other subcontractors that worked on the condominium project and signed indemnification contracts, the general contractor has chosen subcontractor *A* because he is "one of the few subs still in business and able to be located and also because . . . [subcontractor *A* has] one of the best insurance policies."⁸ After discovery, the evidence establishes subcontractor *A* is not at fault for the

1. Trisha Strode, Comment, *From the Bottom of the Food Chain Looking Up: Subcontractors Are Finding That Additional Insured Endorsements Are Giving Them Much More Than They Bargained For*, 23 ST. LOUIS U. PUB. L. REV. 697, 698 (2004) (providing a hypothetical scenario where a subcontractor is forced to sign an agreement that requires the subcontractor to name various individuals as additional insureds on the subcontractors liability policy). This hypothetical has been altered from dealing with additional insureds to dealing with an indemnity contract.

2. *Id.*
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*

construction defects. However, because subcontractor A signed a contract with an indemnification clause, he is still forced to pay for the general contractor's defense costs.⁹

In 2005, California subcontractors won a major victory when Governor Schwarzenegger signed Chapter 394 into law.¹⁰ Chapter 394 banned Type I indemnity agreements in residential construction contracts, which allow subcontractors to be held liable for the sole negligence of general contractors and other subcontractors.¹¹ Some law firms interpreted the new legislation as narrowing the scope of parties who could use Type I indemnity agreements rather than banning them altogether.¹² Chapter 32 responded to this analysis by clarifying that all parties in the residential construction industry are banned from entering into Type I indemnity agreements.¹³

II. LEGAL BACKGROUND

The Supreme Court of California has defined indemnity as “the obligation resting on one party to make good a loss or damage another party has incurred.”¹⁴ The right to indemnity is based on principles of equity,¹⁵ and “[t]he right depends upon the principle that everyone is responsible for the consequences of his own wrong, and if others have been compelled to pay damages which ought to have been paid by the wrongdoer, they may recover from him.”¹⁶ In construction contracts, indemnity issues usually arise when a plaintiff is injured in an accident on a construction site or through defective construction.¹⁷ “The owner, developer, general contractor and subcontractors are normally joined into the litigation

9. *Id.*

10. Ned Barnett, California Contractors Win Liability Reform: AB 758 Limits Type 1 Indemnity, http://www.nvconstructionzone.com/Cal_Contractors_Win_Liability_Reform_Winter_2005.htm (last visited July 27, 2007) (on file with the *McGeorge Law Review*).

11. *See id.* (explaining AB 758 (Chapter 394) and stating that it “applies if the construction defect arises out of the builder’s negligence, another subcontractor’s negligence, design negligence or from issues beyond the ‘scope of work’ of a given subcontractor”).

12. *See* Candace L. Matson, New Legislation Affecting Allocation of Risk in Residential Construction Contracts 5, <http://www.realestateandconstructionlawblog.com/Candace%20Matson%20article%20for%20blog.pdf> (last visited on July 27, 2007) (on file with the *McGeorge Law Review*) (providing that “apparently” general contractors who were not “builders” could still obtain Type I indemnity contracts from subcontractors for residential construction).

13. SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 138, at 2 (Mar. 13, 2007).

14. *Rossmoor Sanitation, Inc. v. Pylon Inc.*, 13 Cal. 3d 622, 628, 532 P.2d 97, 100 (1975).

15. *See Herrero v. Atkinson*, 227 Cal. App. 2d 69, 74, 38 Cal. Rptr. 490, 493 (1st Dist. 1964) (“The duty to indemnify may arise, and indemnity may be allowed in those fact situations where in equity and good conscience the burden of the judgment should be shifted from the shoulders of the person seeking indemnity to the one from whom indemnity is sought.”).

16. *Id.*

17. Richard D. Brown & Mara E. Fortin, *An Introduction to Interpretation of Express Contractual Indemnity Provisions in Construction Contracts under California and Nevada Law*, 32 MCGEORGE L. REV. 1019, 1019 (2001).

either as defendants or as third-party defendants.”¹⁸ The California Appellate Court for the Fourth District has stated that “parties to an indemnity contract have great freedom of action in allocating risk, subject to certain limitations of public policy.”¹⁹

Indemnity contracts generally fall within one of three classifications²⁰: “the limited form indemnity [Type III], the intermediate form indemnity [Type II], and the broad form indemnity [Type I].”²¹ A Type I contract is

that which provides “expressly and unequivocally” that the indemnitor [subcontractor] is to indemnify the indemnitee [general contractor] for . . . the negligence of the indemnitee [general contractor]. . . . [T]he indemnitee [general contractor] is indemnified whether his liability has arisen as the result of his negligence alone or whether his liability has arisen as the result of his co-negligence with the indemnitor [subcontractor].²²

In a Type II indemnity contract “the indemnitee [general contractor] is indemnified from his own acts of passive negligence that solely or contributorily cause his liability, but is not indemnified for his own acts of active negligence that solely or contributorily cause his liability.”²³ Lastly, in a Type III indemnity contract

the indemnitor [subcontractor] is to indemnify the indemnitee [general contractor] for the indemnitee’s [general contractor’s] liabilities caused by the indemnitor [subcontractor], but [the contract] does not provide that the indemnitor [subcontractor] is to indemnify the indemnitee [general contractor] for the indemnitee’s [general contractor’s] liabilities that were caused by other than the indemnitor [subcontractor].²⁴

Thus under a Type III indemnity contract “any negligence on the part of the indemnitee [general contractor], either active or passive, will bar indemnification against the indemnitor [subcontractor] irrespective of whether the indemnitor may have also been a cause of the indemnitee’s [general contractor’s] liability.”²⁵

18. *Id.*

19. *Heppler v. J.M. Peters Co.*, 73 Cal. App. 4th 1265, 1277, 87 Cal. Rptr. 2d 497, 508 (4th Dist. 1999).

20. *MacDonald & Kruse, Inc. v. San Jose Steel Co.*, 29 Cal. App. 3d 413, 419, 105 Cal. Rptr. 725, 728 (2d Dist. 1972).

21. *Strode*, *supra* note 1, at 700; *see also* *McCrary Constr. Co. v. Metal Deck Specialists, Inc.*, 133 Cal. App. 4th 1528, 1536-37, 35 Cal. Rptr. 3d 624, 630 (1st Dist. 2005) (explaining Type I, II, and III indemnity provisions).

22. *MacDonald & Kruse, Inc.*, 29 Cal. App. 3d at 419, 105 Cal. Rptr. at 728 (citation omitted).

23. *Id.* at 419, 105 Cal. Rptr. at 729.

24. *Id.* at 420, 105 Cal. Rptr. at 729.

25. *Id.*

Courts have upheld the limited and intermediate forms of indemnity, but Type I indemnity “has been held unenforceable in construction contracts by many courts and state statutes on the ground that it violates public policy.”²⁶ The U.S. Supreme Court stated that “[a] contractual provision should not be construed to permit an indemnitee to recover for his own negligence.”²⁷ Justice Brennan, writing for the majority in *United States v. Seckinger*, remarked that “[t]he traditional reluctance of courts to cast the burden of negligent actions upon those who were not actually at fault is particularly applicable to a situation in which there is a vast disparity in bargaining power and economic resources between the parties.”²⁸

A. Existing California Law

California Civil Code section 2782 invalidates certain types of indemnity clauses in construction contracts as being against public policy.²⁹ The purpose of the statute is “to prevent [the] enforcement of indemnity clauses that require the subcontractor to indemnify the ‘builder’ for negligent acts of the builder or third parties.”³⁰

Section 2782 limits indemnity clauses in construction contracts in three specific ways.³¹ First, it invalidates any provision that attempts to indemnify the indemnitee for any type of liability (death, bodily injury, property damage, etc.) arising from the negligence of only the indemnitee or an agent of the indemnitee.³² In enacting this section, the Legislature did not want to “affect the validity of any insurance contract, workers’ compensation, or agreement issued by an admitted insurer.”³³ Second, section 2782 invalidates any type of agreement between a contractor and a public agency that relieves the agency of liability for its negligence.³⁴ Third, it invalidates any provision in a residential construction contract that requires the subcontractor to indemnify the builder for claims that arise out of the builder’s own negligence, for defects in design created by the builder, or for claims that are outside the scope of the subcontractor’s work.³⁵

26. Strobe, *supra* note 1, at 700.

27. *United States v. Seckinger*, 397 U.S. 203, 211-12 (1970) (footnote omitted).

28. *Id.* at 211-12 (citation omitted).

29. See CAL. CIV. CODE § 2782(a) (West 1993 & Supp. 2007) (“[P]rovisions . . . affecting any construction contract and that purport to indemnify the promisee against liability for damages for death or bodily injury to persons . . . or any other loss, damage or expense arising from the sole negligence or willful misconduct of the promise . . . are against public policy and are void and unenforceable . . .”).

30. John E. Sebastian, *Recent Legislation Affecting the Construction Industry*, CONST. LAW., Fall 2006, at 39, 39.

31. See CAL. CIV. CODE § 2782(a)-(c).

32. *Id.* § 2782(a).

33. *Id.*

34. *Id.* § 2782(b).

35. *Id.* § 2782(c).

The Legislature expressly stated that the provisions in section 2782, relating to indemnity clauses in residential construction contracts, “shall not be waived or modified by contractual agreement, act, or omission of the parties.”³⁶ However, the statute “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 they do not violate or modify any of the indemnity prohibitions.³⁷ Also, section 2782 does “not affect the obligations of an insurance carrier under the holding of *Presley Homes*,”³⁸ or the obligations that a builder or subcontractor has under the California Civil Code³⁹ for handling complaints.⁴⁰

Shortly after section 2782 was enacted, the law firm of Sheppard, Mullin, Richter & Hampton analyzed the new legislation and put its conclusions on its website.⁴¹ The law firm stated that the legislation applies to “builders,”⁴² which section 911 of the Civil Code defines 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.”⁴³ The law firm then went on to note that “[t]he term ‘builder’ does not include general contractors who are ‘not a partner, member of, subsidiary of, or otherwise similarly affiliated with the builder.’”⁴⁴ This exposed a potential loophole in the legislation that might allow nonaffiliated contractors⁴⁵ to obtain Type I indemnity from subcontractors in residential construction.⁴⁶ Chapter 32 clarifies that certain indemnity agreements between subcontractors and nonaffiliated builders are unenforceable.⁴⁷

36. *Id.*

37. *Id.* § 2782(d).

38. *See Presley Homes, Inc. v. Am. States Ins. Co.*, 90 Cal. App. 4th 571, 575, 108 Cal. Rptr. 2d. 686, 689 (4th Dist. 2001) (“[W]here an insurer has a duty to defend, the obligation generally applies to the entire action, even though the suit involves both covered and uncovered claims, or a single claim only partially covered by the policy.”).

39. *See CAL. CIV. CODE* §§ 910-938 (West 2007) (stating the procedures, rights, and obligations that each party has when a homeowner makes a claim for relief).

40. *Id.* § 2782(d).

41. *See Matson, supra* note 12 (providing Candice Matson’s, a partner at Sheppard Mullin’s in their construction practice group, analysis of SB 138).

42. *Id.* at 4.

43. *CAL. CIV. CODE* § 911(a).

44. *Matson, supra* note 12, at 4 (quoting *CAL. CIV. CODE* § 911(b) (West 2007)).

45. Nonaffiliated contractors are persons or entities “whose involvement with a residential unit that is the subject of the homeowner’s claim is limited to his or her capacity as general contractor or contractor and who is not a partner, member of, subsidiary of, or otherwise similarly affiliated with the builder.” *CAL. CIV. CODE* § 911(b).

46. *Matson, supra* note 12, at 5.

47. SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 138, at 2, 5-6 (Mar. 13, 2007).

III. CHAPTER 32

Chapter 32 invalidates three types of indemnity clauses between a non-affiliated contractor and a subcontractor if contained in residential construction contracts executed after January 1, 2008.⁴⁸ First, Chapter 32 declares that any indemnity agreement holding a subcontractor liable for claims arising from the negligence of a nonaffiliated contractor are unenforceable.⁴⁹ Second, Chapter 32 invalidates any indemnification by the subcontractor liable for design defects of the nonaffiliated contractor.⁵⁰ Third, Chapter 32 voids any indemnity clause that holds the subcontractor liable for claims that “do not arise out of, pertain to, or relate to the scope of work in the written agreement between the parties.”⁵¹

Chapter 32 further provides that the prohibition against these types of indemnity agreements “shall not be waived or modified by [a] contractual agreement . . . of the parties.”⁵² However, the parties can contract about the “timing or immediacy of the defense and provisions for reimbursement of defense fees and costs,” as long as their agreements do not violate any of the three prohibitions on indemnity agreements.⁵³ Chapter 32 also leaves untouched the requirement announced in *Presley Homes, Inc. v. American States Insurance Company* that an insurance company provide a full defense of an insured in an entire action “even though the suit involves both covered and uncovered claims, or a single claim only partially covered by the policy.”⁵⁴ Lastly, Chapter 32 does not affect “builder’s, nonaffiliated general contractor’s, nonaffiliated contractors, or subcontractors obligations” under the California Civil Code.⁵⁵

IV. ANALYSIS

In the construction industry, subcontractors need protection from being forced to execute a Type I indemnity agreement and insure the builder against its own negligence.⁵⁶ In this type of agreement, even if the builder is ninety-nine percent negligent and the subcontractor is one percent negligent, the subcontractor must indemnify the builder against the whole loss.⁵⁷ Without

48. See CAL. CIV. CODE § 2782(e)(1) (amended by Chapter 32) (invalidating an indemnity contract where the nonaffiliated contractor seeks indemnity from a subcontractor for the negligence of the nonaffiliated contractor, for defect in designs by the nonaffiliated contractor, or for claims that do not arise out of the work in the written agreement between the nonaffiliated general contractor and the subcontractor).

49. *Id.* (amended by Chapter 32).

50. *Id.* (amended by Chapter 32).

51. *Id.* (amended by Chapter 32).

52. *Id.* (amended by Chapter 32).

53. *Id.* § 2782(e)(2) (amended by Chapter 32).

54. *Presley Homes, Inc. v. Am. States Ins. Co.*, 90 Cal. App. 4th 571, 575, 108 Cal. Rptr. 2d 686, 689 (4th Dist. 2001); CAL. CIV. CODE § 2782(e)(2) (amended by Chapter 32).

55. CAL. CIV. CODE § 2782(e)(2) (amended by Chapter 32).

56. SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 758, at 5-6 (July 12, 2005).

57. *Id.* at 6.

section 2782 of the California Civil Code, builders could use their superior bargaining power to force the subcontractor to either indemnify or find another job.⁵⁸ Builders typically coerce subcontractors into Type I agreements because “[u]nder California law, a builder is strictly liable for construction defects, while subcontractors are liable for their own negligence and misconduct.”⁵⁹ The major problem is that it is difficult to prove who is responsible for a defect when there are multiple parties involved, such as in the construction setting.⁶⁰

Chapter 32 was enacted to close a potential⁶¹ loophole in section 2782 exposed by a law firm “opining that so-called ‘non-affiliated’ general contractors are not ‘builders’ under AB 758 [section 2782(c)-(d)], and thus may enter into Type 1 indemnity agreements with subcontractors, which the builder is prohibited from doing.”⁶² Both supporters and the author intend Chapter 32 to clarify that the prohibition of Type I indemnity provisions applies to all residential construction contracts between a builder, general contractor, contractor, or subcontractor, affiliated or nonaffiliated.⁶³

Specifically, Chapter 32 seeks to prevent any action in the residential construction industry that would avoid section 2782 through “[a] narrow interpretation or misuse of the definition of ‘builder.’”⁶⁴ Chapter 32 holds each party responsible for its own negligent acts and prevents contractors from using a “straw man” to get around the rule “by simply hiring another general contractor or contractor to act in the builder’s stead in contracting with subcontractors.”⁶⁵ Chapter 32 also avoids a situation in which the general contractor forces a subcontractor into a Type I agreement by “dubbing him, her, or itself ‘unaffiliated’ with the builder.”⁶⁶

58. *See id.* at 6 (explaining that, prior to legislation prohibiting Type I indemnity agreements, if a subcontractor did not agree to sign the Type I indemnity agreement, the contractor would find another subcontractor, “essentially shopping for a willing participant”).

59. *Id.* at 2.

60. *Id.* at 3.

61. The author of Chapter 32 believes that a loophole in the law never really existed. *See SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 138*, at 2 (Mar. 13, 2007) (“The author and supporters intend for this bill to clarify that AB 758 [section 2782(c)-(d)] was and is intended to apply to all residential construction contracts between builders/general contractors/contractors and subcontractors.”).

62. *Id.*

63. *Id.* Numerous construction associations located all over California support Chapter 32 and there is no registered opposition to the statute. *Id.* at 8-9.

64. *Id.* at 5 (alteration in original).

65. *Id.* at 5, 7.

66. *See id.* at 6 (stating that the author of the bill never intended “that a person or entity directly associated with the builder on a residential construction contract could attempt to circumvent the law” in such a way).

V. CONCLUSION

Chapter 32 ensures that a builder will not be allowed to circumvent the law by arguing that there is a distinction between “affiliated” and “nonaffiliated” contractors.⁶⁷ Chapter 32 expresses the Legislature’s distaste for Type I indemnity agreements by declaring them void as against public policy.⁶⁸ Subcontractors are no longer at the mercy of general contractors or builders that, without Chapter 32, would try to exploit their bargaining power by forcing subcontractors to indemnify for the builder’s negligence.⁶⁹ Now every party in the residential construction industry has an incentive to maintain their standard of care in order to avoid being held liable for any accidents or defects that result from their work.⁷⁰

67. *Id.* at 5-7.

68. See SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 138, at 5 (Mar. 13, 2007) (“[T]he [bill’s provisions amending CC section 2782] . . . prevent a builder from circumventing the fairness and equity of each party being responsible for its own actions and negligence” (second alteration in original)).

69. See SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 758, at 6 (July 12, 2005) (explaining that, prior to legislation prohibiting Type I indemnity agreements, if a subcontractor did not agree to sign the Type I indemnity agreement, the contractor would find another subcontractor, “essentially shopping for a willing participant”); SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 138, at 5-7 (Mar. 13, 2007) (explaining that Chapter 32 is intended to prevent contractors from circumventing the prohibition against Type I indemnity agreements).

70. See SENATE JUDICIARY COMMITTEE, COMMITTEE ANALYSIS OF SB 138, at 5 (Mar. 13, 2007) (“[T]he [bill’s provisions amending CC Section 2782] would prevent a builder from circumventing the fairness and equity of each party being responsible for its own actions and negligence” (second alteration in original)).