



Are You My Type (I, II, III)?



Do you know your "Type"? At least in relation to your commercial construction contract?

On October 9, 2011, California Governor Jerry Brown signed Senate Bill 474 ("SB 474") into law effective January 1, 2013. SB 474 eliminates "Type I" indemnity agreements contained in most commercial construction contracts entered into on or after January 1, 2013. Before reviewing what is allowable under SB 474 (see chart on page 4), it is important to look at the definitions of some key terms.

Continued

Definitions

- “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. *Civil Code* §2772.
- “Indemnitee” means the person who is to be protected, saved, or made whole.
- “Indemnitor” means the person who is to protect, save, or make whole the other.
- “Negligence” means the failure to exercise the care that a reasonably prudent person would exercise under like circumstances.
- “Active negligence” means participation in some manner by the person seeking indemnity in the conduct or omission which caused the loss beyond the mere failure to perform a duty imposed by law.
- “Passive negligence” means a failure to act or a failure to perform a duty imposed by law.
- “Type I” indemnity is the broadest type available, in which the indemnitor agrees to indemnify the indemnitee for its active or passive negligence. *MacDonald & Kruse, Inc. v. San Jose Steel Co.*, (1972), 29 Cal. App. 3d 413 at p. 419.
- “Type II” indemnity is when the indemnitor agrees to indemnify the indemnitee for all losses arising out of the indemnitor’s work under the contract, including passive losses caused by others, with the exception of those arising from the indemnitee’s active negligence. *MacDonald & Kruse, Inc. v. San Jose Steel Co.*, (1972), 29 Cal. App. 3d 413 at p. 419.
- “Type III” indemnity is when the indemnitor agrees to indemnify the indemnitee only for the indemnitor’s active negligence. *MacDonald & Kruse, Inc. v. San Jose Steel Co.*, (1972), 29 Cal. App. 3d 413 at p. 420.

Civil Code §2782

Before discussing SB 474, which adds §2782.05 to the Civil Code, it is important to consider provisions already contained in Civil Code §2782, which was previously passed by the legislature. Subdivision (a) of §2782 stated that any construction contract that purports to indemnify the indemnitee or its agents, servants, or its independent contractors that are directly responsible to the promisee, for bodily injury or property damage for its sole negligence or willful misconduct or for defects in design furnished by those people, was void. This prohibition applied to all persons (indemnitees) and was not limited to a particular class of contractor.

Subdivision (b) of §2782 stated that any construction contract with a public agency that purports to impose on the contractor the responsibility for, or relieve the public agency for, the active negligence of the public agency, was void.

Subdivision (c) applies to all construction contracts entered into after January 1, 2009, for residential construction and prohibited a subcontractor from indemnifying a builder or general contractor for construction defects to the extent the claim arises out of the negligence of the builder or

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general contractor or their agents, servants or independent contractors who are directly responsible to the builder or general contractor.

Subdivision (d) stated that the provisions of subdivision (c) did not prevent the parties from agreeing on the timing or immediacy of the defense of the indemnitee, as long as it didn’t violate the provisions of subdivision (c).

Notably, §2782(c) only limits the extent of indemnity agreements with regard to construction defect claims. Other than the limitation found in §2782 (a) for sole negligence and willful misconduct, there is no further limitation on indemnity for all other liabilities such as bodily injury and other property damage claims.

What Does SB 474 Do?

What, exactly, is the goal of this legislation? The legislators stated in Section 1 of SB 474 the intent as follows:

“The Legislature finds and declares that it is in the best interest of this state and its citizens and consumers to ensure that every construction business in the state is responsible for losses that it, as a business, may cause.”

Simply put, SB 474 now applies to all construction contracts, and does not limit itself to residential construction, as did §2782 (c). Moreover, it is not limited to construction defect claims but limits indemnity to all bodily injury and property damage claims. Ironically, §2782.05 does not mention construction defect claims specifically, but those would presumably fall under a claim for property damage. Finally, §2782.05 only limits the obligation of a subcontractor to indemnify a general contractor or builder. It does not place any other limitation on other non-contractor parties. As such, it now requires that contractor parties entering into commercial construction contracts on or after January 1, 2013, be accountable for their own actions as to all types of claims. Be prepared for a fight over whether the builder/general contractor’s alleged negligence is merely passive or arguably active.

Also, SB 474 applies to both public and private commercial construction contracts entered on/after January 1, 2013. Further, SB 474 applies California law if the property to

which the construction is performed is located in California, regardless of any choice-of-law provisions or place of execution of the contract.

So, whereas before SB 474, a general contractor ("GC") could require that a subcontractor indemnify it for its active and passive negligence on a commercial construction project; after passage of SB 474 a GC can require a subcontractor to indemnify it only for its passive negligence. This will significantly change the way construction contracts are entered into from the perspective of the GC, subcontractor and sub-subcontractors. What should GCs, subcontractors and sub-subcontractors do in light of SB 474?

GCs now need to be even more diligent when selecting subcontractors. GCs need to ask if the subcontractors are financially stable. Does the subcontractor have the appropriate insurance coverage and additional insured endorsements?

Exceptions

As with any law, there are exceptions. SB 474 does not apply to Controlled Insurance Programs (commonly known as Wraps), nor does it apply to contracts with design professionals. The new law does not apply to direct contracts with public agencies that already fall under the companion §2782(b). In addition, the new law does not apply to direct contracts with the owners of privately owned land that is to be improved, and that already fall under the companion §2782 (c); as such, §2782.05 attempts to neither overlap nor contradict §2782 (c).

Will the direct contract exception cause more private owners to contract directly with trade contractors, thereby eliminating their protected status as a subcontractor? If so, how will this affect the GCs business? Will the design professional exception cause more GCs to contract with design professionals so they can still obtain Type I indemnity?

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Also, SB 474 does not apply to provisions in construction contracts that require the subcontractor to procure insurance for its own acts or omissions, or to include the GC as an additional insured with respect to liability arising out of the subcontractor's acts or omissions. While SB 474 prevents GCs from requiring subcontractors to procure insurance that extends coverage to the GC's active negligence, these same limitations do not apply to the direct insurers of the builder and general contractor.

Where an insurer issues a policy with an additional insured endorsement that attempts to limit coverage to liability arising out of [the named insured's] acts/omissions, and excludes liability for [the additional insured's] active negligence, if the allegations include damages caused by both the named insured and the additional insured's conduct, then the insurer must assume the [additional insured's] defense of the entire action. The insurer does have a right to seek reimbursement for defense fees solely relating to defense of claims from the [additional insured's] active negligence. In practice however, an allocation of the [additional insured's] active versus passive negligence may be difficult to achieve, especially if the claim is resolved without a final adjudication.

Tenders & Duty to Defend

The new law provides the GC with a statutory scheme to trigger a subcontractor's defense obligations. The GC must:

- make a written tender of claim and
- include in the written tender of claim a statement regarding how the subcontractor's reasonable share of fees/costs was determined.

Upon receipt of a written tender, a subcontractor can respond in two ways:

1. assume the general contractor's defense and appoint counsel, but it is only obligated to defend claims that are alleged to arise from the subcontractor's scope of work or
2. pay a reasonable allocated share of the general contractor's defense fees/costs, regardless of whether the general contractor has tendered the claim to other subcontractors, and whether any other subcontractors agree to participate in the general contractor's defense.

§2782.05 does not discuss whether the obligations of an insurer are any different following a tender by an additional insured. How is a subcontractor's insurer likely to respond to a tender received by its additional insured? Insurers are likely to respond by trying to use option (2) above and pay a reasonable allocated share of the general contractor's defense fees and/or costs. A subcontractor's (or possibly its insurers') refusal to accept a tender allows the general contractor express rights to pursue compensatory or consequential damages, interest on defense fees and/or costs, and attorney's fees to pursue recovery.

Fortunately, SB 474 now provides subcontractors a statutory right to request reallocation of fees and/or costs once a final settlement or judgment has been rendered. While SB 474 does not refer to the California Supreme Court’s decision in *Crawford*, the reallocation rights appears to be an attempt to clarify its effect.

As discussed above, because design professionals are exempt, one would expect a greater scrutiny of the contracts with design professionals by GCs (or its insurers) for potential avenues of Type I indemnity.

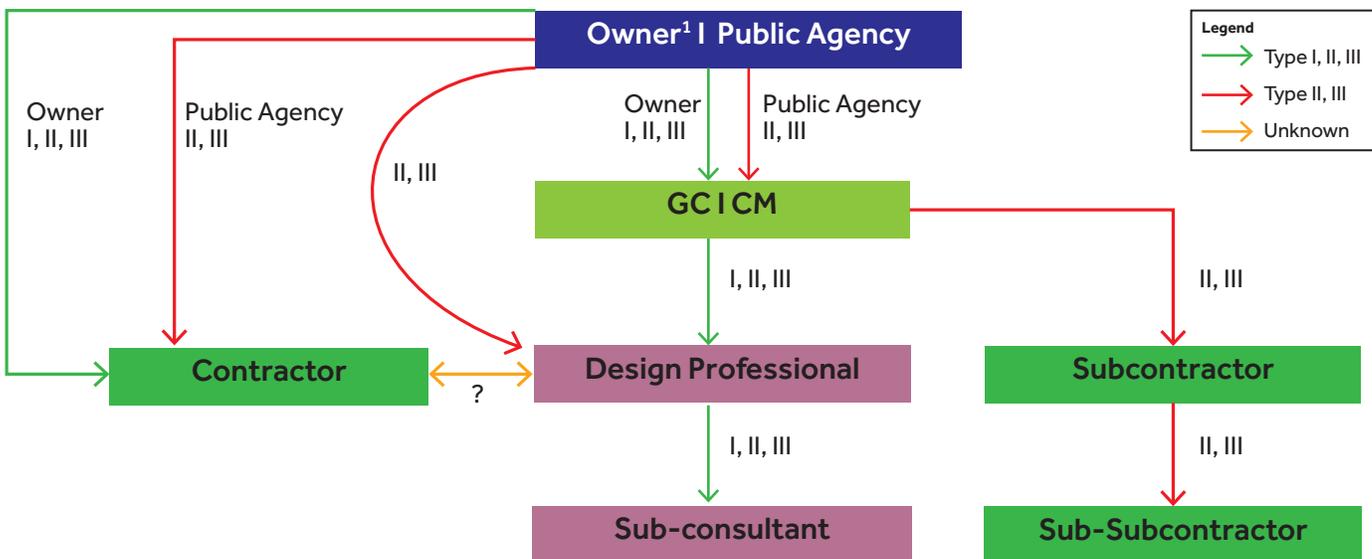
What's Next?

SB 474 will certainly be tested in the courts. Unfortunately it may take a long time for the right case(s) to test the multiple issues present in SB 474, followed by publication by an appellate court.

Until such time, all parties (and their advisors) entering into commercial construction contracts on or after January 1, 2013, that could be subject to the provisions of SB 474 should carefully read the indemnity provisions contained in those contracts.

XL’s North American Construction team stands ready to help our contractors understand these legal changes, reduce their risk, and improve their businesses.

SB474 Allowable Indemnity Commercial Construction Contracts*



* Commercial construction contracts entered into on/after January 1, 2013
 1 If Owner is not a builder.



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john.kha@xlgroup.com

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