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Understanding Contractual Indemnity and Defense Obligations Under California Construction Law

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Although the rules for interpreting contractual indemnity and defense obligations appear to be relatively clear and straightforward, courts have struggled to apply them to often-carelessly drafted construction contracts in complex, multi-party disputes. Three California appellate and supreme court opinions that have analyzed contractual indemnity and defense provisions illustrate the confusion that courts can have when interpreting them in typical construction disputes. Although each of the three cases discussed below involve similar contract language, the courts do not appear to reach any consistent or predictable results.

In the first case discussed below, *Regan Roofing v. Pacific Scene* (1994), the appellate court applied the contractual indemnity and defense obligation very narrowly, reading a "fault requirement" into the obligations where no such express requirement was included in the contract language. Based in-part on this "implied" fault requirement, the court held that neither the duty indemnify nor the duty to defend, could be triggered until after the underlying case was resolved and a determination of the indemnitor's fault had been made. Thus, *Regan Roofing* is an example of the court reading unclear and poorly drafted indemnity and defense language more narrowly than it appears.

In the second case discussed below, *Crawford v. Weather Shield* (2008)—the controlling California Supreme Court precedent on these issues—the court focused on the basic rules of contract interpretation and, more specifically, on the rule that parties to a contract have great freedom of action to assign the rights and responsibilities under the contract as they see fit, including the freedom to limit indemnity and defense obligations. However, disapproving *Regan Roofing* on this issue, the court held that, unless the agreement expresses a contrary intention, the duty to defend is discrete and independent from the duty to indemnify and is triggered at the time the indemnitee tenders its defense. In *Crawford*, because the parties had not expressed such an intention, the duty to defend arose at the time of tender, regardless of the fact that the indemnitor was found not to be at fault or ultimately liable for indemnity.

A recent opinion of the California Court of Appeal has raised new questions with respect to how contractual indemnity and defense provisions are interpreted and applied in complex and multi-party construction litigation. In the final case discussed below, *UDC v. CH2M Hill* (2010), the appellate court purported to apply the Supreme Court's guidance in *Crawford* to imprecise and unclear indemnity and defense contract language. However, in this case, the court went to the opposite extreme from *Regan Roofing* and read the "fault requirement" out of an indemnity and defense provision that appears expressly to include it. Thus, although *Crawford* states the rule that such provisions can be limited in scope and application, the question remains how parties can articulate these limitations so they are correctly interpreted and applied by the courts.

These three cases highlight the fact that even subtle variations of contract language can have a significant effect on how indemnity and defense obligations are interpreted and applied. Therefore, the contract language used in these provisions must be drafted with care, so that the intentions of the parties are clearly and carefully stated. Indeed, as these cases demonstrate, if this language is not clearly stated, unsuspecting parties can be exposed to substantial liabilities that were not intended or contemplated at the time of contracting.

This article analyzes the three cases identified below and offers lessons for parties in drafting indemnity and defense agreements in construction contracts:

- Prior Rule for Interpretation of Indemnity (and Defense) Obligations and *Regan Roofing v. Pacific Scene* (1994)
- Recent Developments and the New Authority of *Crawford v. Weather Shield* (2008)
- New Questions and *UDC v. CH2M Hill* (2010)

General 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. The scope of these provisions 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. Under either scenario, however, the indemnity obligation generally arises only after the underlying action has been resolved.

Additionally, 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. 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. 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.

In conjunction with these general rules of contract interpretation, the California Legislature has provided guidance to courts specifically for interpreting contractual indemnity and defense obligations. As relevant here, Section 2778(4) of the California Civil Code ("Section 2778(4)") provides that unless a contrary intention of the parties is expressed in the contract, the duty to defend arises "on request of the person indemnified" (*i.e.*, upon tender). Thus, unless the parties clearly state that the duty to defend should be otherwise conditioned or limited, Section 2778 must be applied.

Despite Section 2778(4), courts in the past have held that the duty to indemnify and the duty to defend were not independent obligations but were tied together, both in the scope of their coverage and by the event that triggers the obligations. Under this interpretation, the duty to defend traditionally did not arise until after the underlying case was resolved and an ultimate determination of indemnity liability had been made. Thus, indemnitors with a potential defense obligations could systematically reject an indemnitee's tender of defense and await final resolution of the underlying case. However, as discussed in more detail below, recent California case law has changed the rule. These cases, which rely in large part on the guidance provided in Section 2778(4), hold that, unless a contrary intention is clearly stated in the contract, the duty to defend actually arises immediately upon the indemnitee's tender of defense and, in some instances, irrespective of whether the indemnitor is ultimately found liable for indemnity.

Prior Rule for Interpretation of Indemnity (and Defense) Obligations and *Regan Roofing v. Pacific Scene* (1994)

For many years, the 1994 case of *Regan Roofing Company v. Pacific Scene*,[1] was considered the controlling California authority regarding a subcontractor's contractual duty to defend. In this case, Pacific Scene, the developer/contractor of a residential condominium complex, entered into multiple subcontracts, including a subcontract with Regan Roofing, a roofing subcontractor. The subcontract contained an indemnity provision that required Regan Roofing to indemnify Pacific Scene against any liability, etc., "arising out of or in any way connected with [the] Subcontractor's performance of [the] Subcontract. . . ." Additionally, the provision stated that Regan Roofing would defend Pacific Scene in any suit brought against Pacific Scene that is "subject to the [indemnity] provision. . . ."

After the project was complete, the homeowners' association ("HOA") brought an action against Pacific Scene, arising out of alleged construction defects at the project. Pacific Scene filed a cross-action for indemnity against a number of subcontractors, including Regan Roofing, and tendered its defense to the HOA claims. Regan Roofing rejected the tender as premature. Thereafter, Pacific Scene moved for summary adjudication, in part on the issue of whether Regan Roofing owed Pacific Scene a duty to defend upon tender under the terms of their subcontract.

The trial court granted the motion, finding that, under the language in the subcontract, Regan Roofing had a contractual duty to defend Pacific Scene which arose at the time of its tender. The trial court explained that the duty to defend was independent of any eventual determination of the duty to indemnify, and that Regan Roofing had a duty to defend Pacific Scene whether or not Regan Roofing was ultimately found to be liable for indemnity. Regan Roofing appealed.

The California Court of Appeal reversed the trial court's ruling and held that the duties to indemnify and to defend were generally not "free-standing" obligations, but were tied together by both the triggering event(s) and the scope of the coverage. The appellate court held that because Regan Roofing's indemnity obligation was conditioned on a finding of its negligence, its defense obligation was similarly conditioned. Therefore, because no determination had yet been made on whether Regan Roofing had been negligent, its corresponding duty to defend had not yet arisen.

The appellate court also addressed the duty to defend a practical matter in complex, multi-party construction cases, noting that there were approximately 24 different subcontractors involved in the litigation, each of whom performed work on a different phase or area of the project. Thus, under the trial court's ruling, each subcontractor's respective duty to defend would be limited to the issues implicated by its respective scope of work. Thus, the court explained that if the trial court's ruling was correct and all of the subcontractors' duties to defend were held to arise at the time of the tender and run concurrently up to and during trial, Pacific Scene would end up with a series of fragmented defenses, which would pose a significant practical problem for both the parties and the court.

The *Regan Roofing* opinion was significant for several reasons. To start, despite the apparently broad indemnity language in the subcontract—which required Regan Roofing to indemnify Pacific Scene for any claims "arising out of its performance . . . "—the appellate court narrowly interpreted this language as requiring a finding of negligence to trigger the duty to indemnify. Thus, the court appears to have read a "fault" requirement into the indemnity and defense obligations where none existed. Additionally, and notwithstanding Section 2778.4, the court held that because Regan Roofing's duty to defend was inextricably tied to its duty to indemnify, the duty to defend could not arise until after the underlying case was resolved, either by settlement or trial, and a determination was made as to Regan Roofing's indemnity obligation. In essence, the court's holding sanctioned the "wait and see approach" that allowed indemnitors to initially reject indemnitees'

tenders of defense and "wait and see" if they were ultimately found to be liable. If no liability was found, the indemnitor would have no up-front, out-of-pocket expenses for the indemnitee's defense. If the indemnitor was found to be liable, the costs could be easily ascertained and reimbursed to the indemnitee and, if necessary, allocated between multiple indemnitors.

Recent Developments and the New Authority of *Crawford v. Weather Shield* (2008)

The California Court of Appeal's decision in *Regan Roofing* remained as generally accepted law regarding subcontractors' duties to defend until 2008, when the California Supreme Court issued its decision in *Crawford v. Weather Shield*.[2]

In *Crawford*, JMP—the developer, builder and general contractor of a large Southern California residential construction project—contracted with Weather Shield, a window manufacturer, to provide wood-framed windows for the project. The parties' contract included an indemnity and defense provision, which, similar to the language in *Regan Roofing*, required Weather Shield to indemnify JMP for all claims, damages, etc., "growing out of the execution of the [Weather Shield's] work" and to defend the JMP in any action "founded upon the claim of such damage. . . ." After the project was completed, 220 of the homeowners brought a construction defect action against JMP, Weather Shield, Darrow (the framing subcontractor that installed the windows) and other subcontractors involved in the project, alleging numerous construction defects, including improper design, manufacture and installation of the windows. JMP cross-complained against Weather Shield and others for indemnity and tendered its defense. Weather Shield rejected the tender.

All the defendants, except Weather Shield and Darrow settled with the plaintiff homeowners before trial, and the homeowners' negligence and breach of warranty claims went to trial against Weather Shield and Darrow only. A jury eventually determined that Weather Shield was free from fault and returned a general verdict against Darrow. Thereafter, JMP's cross-action for indemnity (and defense) against Weather Shield was separately tried to the court. The trial court ruled that although Weather Shield was not obligated to indemnify JMP—because the jury had ultimately found that Weather Shield was not negligent in the underlying action—its defense obligation to JMP had been triggered and arose at the time JMP tendered its defense to Weather Shield, irrespective of the fact that it had no indemnity obligation.

Addressing only the issue of Weather Shield's duty to defend— and not the trial court's holding that there was no indemnify obligation—the California Supreme Court affirmed. Agreeing with the trial court, the supreme court ruled that Weather Shield had breached its duty to defend JMP when it rejected JMP's tender. Disapproving Regan Roofing on this issue, the Supreme Court 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 Section 2778(4), the duty to defend arose at the time of tender, not after liability was ultimately resolved. Because in Crawford, the parties had not expressed an intent that was contrary to Section 2778(4), the supreme court held that Section 2778(4) was applicable and the duty to defend arose at the time of the tender.

Additionally, the supreme court noted that not only did the contract language neglect to state an intention contrary to Section 2778(4), but the duty-to-defend language was different, discrete and much broader than the indemnity language. Thus, the supreme court held that, even if the indemnity obligation was conditioned on a finding of negligence (as the trial court found), the language in the contract which addressed the defense obligation contemplated a broader and immediate duty to defend that was not conditioned on an ultimate finding of negligence, but rather required the indemnitor to defend immediately upon tender.

The supreme court appeared to go out of its way to stress that its holding was completely consistent with the general rules of contract interpretation, recognizing that parties have great freedom of action to condition or limit, or disclaim entirely, the indemnity and defense obligations. With respect to the duty to defend, the supreme court acknowledged that "[p]arties to an indemnity contract can easily disclaim any responsibility of the indemnitor for the indemnitee's defense, or the costs thereof. Short of that, they can specify that the indemnitor's sole defense obligation will be to reimburse the indemnitee for costs incurred by the latter in defending a particular claim."[3] On the other end of the spectrum, the parties can agree that the duty to defend should be broader, for instance, tied to the indemnitor's fault or even simply arising from its scope of work.

Under the prior (*Regan Roofing*) interpretation of contractual indemnity and defense obligations in the construction context, the immediate adverse effects of careless contract drafting were limited because the financial implications of incurring a defense obligation were generally deferred until after the underlying action was resolved. However, in light of *Crawford*, the potential consequences of poorly drafted contracts can expose unsuspecting indemnitors to liability for substantial defense costs that were not contemplated when the contract was negotiated. These costs can be incurred at the beginning of a case, long before—and, in some instances, regardless of whether—there are any findings of underlying liability. Moreover, some parties may have to pay these costs out-of-pocket if their insurance coverage excludes this "contractually assumed liability." Now more than ever, indemnity and defense provisions should be drafted with considerable care so that courts can give effect to the true intentions of the parties.

New Questions and *UDC v. CH2M Hill* (2010)

Although the Supreme Court appeared to settle the issue of the proper interpretation of contractual indemnity and defense obligations in its *Crawford* opinion, new questions have emerged from a recent California Court of Appeal decision in *UDC-Universal Development v. CH2M Hil*l.[4]

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. 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***."

After the project was completed, the homeowners' association ("HOA") filed an action against UDC for allegedly defective conditions at the project. 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. 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.

In January 2008, the HOA and UDC reached a settlement, and the underlying action was dismissed. UDC pursued its cross-complaint against CH2M Hill for indemnity and defense costs, as well as its claims for negligence and breach of warranty. The parties stipulated that a jury would determine the negligence and breach of warranty claims, and subsequently, the court would adjudicate the indemnity issues. The jury returned a verdict for CH2M Hill and unanimously found that it had not been negligent and had not breached its warranty. The trial court then took up the issue of CH2M Hill's defense obligation to UDC. UDC contended that, under Crawford, which was published in July 2008, CH2M Hill's duty to defend arose at the time

of the tender and applied regardless of the jury's findings on CH2M Hill's negligence. CH2M Hill maintained that under the express language in the agreement, a determination of negligence was a prerequisite to its defense obligation, and therefore, because the jury found it was not negligent, it had no duty to defend UDC.

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.

In January 2010, 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. The court reasoned that while the "negligent act or omission" language may have limited CH2M Hill's indemnity liability to the scenario in which CH2M Hill was found negligent, under Crawford and Section 2778(4), the duty to defend was much broader and arose at the time of tender, irrespective of the lack of any specific allegations (let alone proof) of CH2M Hill's negligent acts or omissions. 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.

The appellate court's opinion in *UDC* is significant because it highlights the potential perils that can arise when the duty to defend is not clearly and expressly defined in the contract. To start, and as the supreme court recognized in *Crawford*, parties to a contract have great freedom of action to assign rights and responsibilities in the contract, including the right to condition and limit the indemnity and defense obligations. In the *UDC* case, the parties appeared to have done just that, and intended to condition CH2M Hill's indemnity *and* defense obligations on CH2M Hill's negligent acts or omissions. Under the rule in *Crawford*, one may have thought CH2M Hill's defense obligation would have been limited to a finding (or at least an allegation) of its negligence, *i.e.*, claims or demands "covered herein," just as the indemnity obligation was limited. However, the appellate court seemed to not heed this language and instead interpreted a seemingly narrow defense obligation much more broadly. Indeed, in contrast to the *Regan Roofing* opinion—where the court read a phantom fault requirement into the obligation where it seemingly did not exist—here, the court read the fault requirement out of the obligation where it seemingly was expressly included.

Under the appellate court's rationale in *UDC*, a party runs the risk of being held liable for significant defense costs, long before and regardless of whether there is an indemnity obligation. Thus, the appellate court's decision potentially creates the scenario where the duty to defend entirely overshadows and may consume the duty to indemnify.

Lessons for Future Contract Drafting

Generally, these cases hold that, unless a contrary interpretation of the parties is clearly indicated in the contract, the indemnitor's duty to defend arises at the time the defense is tendered, regardless of whether the indemnitor is ultimately found liable and, in some instances, even if there are no specific allegations of fault alleged against the indemnitor in the underlying action. Generally speaking, in the first case discussed below, *Regan Roofing v. Pacific Scene*, the court appears to have interpreted the indemnity and defense provisions in the contract too broadly, reading to those obligations a negligence requirement that does not appear to exist in the contract language.

Parties may wish to consider the following factors before entering into an indemnity and defense agreement.

- Because defense obligations are interpreted more broadly than indemnity obligations, special attention may be warranted for contract language that includes a duty to defend. This language should be prudently drafted with precise terms that identifies the parties' intent, both with respect to what event triggers the duty and the scope of its coverage. Any language that is intended to condition or limit the defense obligation, or disclaim it altogether, should be unambiguous; otherwise, the obligation may be broadly interpreted.
- If the contract is a standard form contract without room to negotiate the terms, the language setting forth the defense obligation should be analyzed with extra care, in the context of applicable case law, to determine the likely interpretation of the provision should a dispute arise. Only then may parties have a clear understanding of the exposure they are assuming and perhaps not be surprised by unexpected liability.
- The language in indemnity and defense provisions should be evaluated for potential insurance-coverage issues and to determine if these "contractually assumed liabilities," including a contractual duty to defend in the absence of fault, would be covered under commercial or professional liability policies.
- It may be prudent to consult with experienced legal counsel early in the contracting process to ensure proper drafting. This may reduce the potential for adverse rulings if the meaning of the indemnity and defense language ends up in court.

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Notes

1. *Regan Roofing Company, Inc., et al. v. Pacific Scene, et al*. 24 Cal. App. 4th 425 (1994).
2. *Crawford, et al. v. Weather Shield Mfg., Inc.*, 44 Cal. 4th 541 (2008).
3. *Id.* at 560.
4. *UDC-Universal Development, L.P. v. CH2M Hill*, 181 Cal. App. 4th 10 (2010).