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The Voice of the Defense Bar

The Critical Path
The Newsletter of the Construction Law Committee

Volume 18 Issue 4 December 2014

Impact of California's Anti-Indemnity Legislation on Construction Litigation: Is the Value of Additional Insured Coverage Eroded Under the New Extension?

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California's newest extension of its anti-indemnity legislation under *Civil Code* § 2782.05 is convoluted, difficult to follow and hard to digest even for those actively engaged as practitioners in the construction industry, leaving many to scratch their heads, as they attempt to wade through the legal maze left in its wake. While there are numerous aspects of *Civil Code* § 2782.05 that require discussion, questions have been posed by those in the industry as to whether the new statute serves to erode the value of additional insured coverage provided to upstream parties in construction litigation? Part and parcel of this discussion really must commence with an understa nding that there are two separate and distinct obligations of an insurer: (1) the duty to defend; and (2) the duty to indemnify. *Montrose Chemical Corp. v Superior Court,* 6 Cal.4th287 (1993). In the state of California, it is well settled that these two duties are separate and distinct. *Id.*

While there is a duty to indemnify component that exists under additional insured coverage, the duty to indemnify in construction litigation is typically absorbed by the downstream entity's other contractual indemnification obligations arising out of that downstream entity's scope of work. While insurers have been self-limiting the scope of indemnity under manuscripted additional insured endorsements for years, one of the largest hurdles they have had difficulty circumventing is the broad obligation that an insurer has to defend its insured. The California Supreme Court has averred that while the duty to indemnify is more limited, the duty to defend is broad and complete. An insurer has a duty to defend the insured if the "potential for coverage" exists at the time of the tender. *Montrose, supra.* As further defined by the California Supreme Court, "to defend meaningfully, the insurer must defend immediately. To defend immediately, the insurer must defend entirely, including both covered and non-covered claims. The insurer cannot parse the claims dividing those that are at least potentially covered from those that are not." *Buss v. Superior Court*, 16 Cal.4th 35, 39 (1997). Thus, it is the "duty to defend" that is sought so avidly by upstream entities in a construction action. It is the obligation of an insurer's duty to defend in construction cases that is not eroded by *Civil Code* § 2782.05. *Civil Code* § 2782.05(a), citing *Presley Homes, Inc. v. American States Insurance Company*, 90 Cal.App.4th 571 (2001).

California anti-indemnity legislation stems as far back as 1967, when California enacted *Civil Code* § 2782, which served to bar indemnity for a party's own "sole negligence" or "willful misconduct." While anti-indemnity legislation has been on the books in California for over 45 years, the subsections of *Civil Code* § 2782 have been rearranged and labeled differently throughout the course of the amendments, which has added to the complexity of this provision and the difficulty in interpreting this Statute.

The history of anti-indemnity in California is significant, because it reflects how the industry has responded and how it has been interpreting these issues through the normal course of doing business, through legislative amendments and via court decisions. For example, under the notable 2005 amendment to *Civil Code* § 2782, all *residential construction contracts entered into after January 1, 2006* were prohibited from containing Type I indemnity clauses. This was defined as:

> indemnity agreements by a subcontractor to indemnify a builder against **liability for claims that 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 were directly responsible to the builder.

(Emphasis added). *Civil Code* § 2782 makes no distinction between active and passive negligence, in contrast to *Civil Code* § 2782.05. Rather, C*ivil Code* § 2782 encompasses both active *and* passive negligence and is thus even more restrictive than the new Statute in its limitation of indemnity to an upstream entity.

Moreover, in 2008, the Supreme Court of California held that even within the confines of anti-indemnity legislation, if a downstream party has specified contractual language triggering its obligation to defend an upstream entity as set forth in the *Crawford v. Weather Shield Mfg.,* 44 Cal. 4th 541 (2008) decision, and assuming the upstream meets its other obligations under the Statute, even if the downstream party defenses its case at trial and is found to bear no liability to plaintiffs, the court may find that the downstream party is still responsible to the upstream party for the upstream party's defense which arose out of the downstream party's scope of work. The *Crawford* Court held that Weather Shield owed a duty to defend an upstream developer against claims "founded upon" damage or loss caused by Weather Shield's negligent performance of its work, pursuant to its subcontract, imposing such duties on Weather Shield as soon as a suit was filed against the developer that asserted such clams, and *regardless of whether it was ultimately determined that Weather Shield was actually negligent.* While *Crawford* is not an insurance coverage decision, parties will argue that defense fees and costs awarded under *Crawford* are arguably damages as defined under a standard ISO form commercial general liability policy. Thus, even in the midst of anti-indemnity legislation, the obligation to defend has continued to be interpreted broadly and be a pervasive player in the construction litigation arena.

Following the *Crawford* decision, in 2008, Governor Schwarzenegger signed Assembly Bill 2738, thereby further amending California *Civil Code* § 2782. *Civil Code* § 2782(d) amended the Statute, applying to*residential construction contracts entered into after January 1, 2009*. One of the primary purposes of this amendment was to further define contractual *defense* obligations.

> For all construction contracts, and amendments thereto, entered into after January 1, 2009, for *residential* construction, …. , all provisions, clauses, covenants, and agreements contained in, collateral to, or affecting any construction contract, and amendments thereto**, that purport to insure or indemnify, including the cost to defend, the builder**, …, or the general contractor or contractor not affiliated with the builder, … 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 contractor or the builder's or contractor'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. . .

Civil Code § 2782(d) (Emphasis added). Additionally, *Civil Code* § 2782 was amended to incorporate more structure within which the upstream party was required to notify the downstream party of its tender of the defense obligation. "… A subcontractor shall owe no defense or indemnity obligation to a builder or general contractor for a construction defect claim unless and until the builder or general contractor provides a written tender of the claim …." *Civil Code* § 2782(e). This provision further defined what constituted a "valid tender" by setting forth certain requirements that must be met by the builder when issuing the tender to a downstream party.

While *Civil Code* § 2782 serves to limit the type of contractual indemnity obligation which an upstream can seek of a downstream party, *Civil Code* § 2782 specifically articulates that it does not serve to alter an insurer's obligation to defend an upstream party as an additional insured as held under *Presley Homes, supra.* This is significant as the *Presley Homes* case held that a downstream party's liability insurance carrier is required to provide a full and complete defense to all claims, covered and uncovered, brought by a third party against an additional insured under that insurance policy.

Most recently in 2011, Governor Brown signed Senate Bill 474, further amending California *Civil Code* § 2782 by adding § 2782.05. This legislation essentially extended the 2005/2008 anti-indemnity legislation to include *commercial construction contracts*. Under the new Statute, contractual indemnity obligations (including the cost to defend) arising out of the *active negligence* or *willful misconduct* of the indemnified party are void and unenforceable.

> . . . provisions, clauses, covenants, and agreements contained in, collateral to, or affecting any construction contract and amendments thereto entered into **on or after January 1, 2013**, that**purport to insure or indemnify, including the cost to defend, a general contractor**, construction manager, or other subcontractor, by a subcontractor against liability for claims of death or bodily injury to persons, injury to property, or any other loss, damage, or expense **are void and unenforceable to the extent the claims arise out of, pertain to, or relate to the *active negligence* or*willful misconduct* of that general contractor**, construction manager, or other subcontractor, or their other agents, other servants, or other independent contractors who are responsible to the general contractor, construction manager, or other subcontractor, or for defects in design furnished by those persons, **or to the extent the claims do not arise out of the scope of work of the subcontractor pursuant to the construction contract.**

Civil Code § 2782.05(d) (Emphasis added). While both *Civil Code* § 2782 and *Civil Code* § 2782.05 share similar language throughout the various provisions, unlike *Civil Code* § 2782, *Civil Code* § 2782.05 does not broadly extend to negligence but rather makes a distinction between active and passive negligence. Active negligence has generally been interpreted in the State of California to include one's act or omission to act, while passive negligence has been viewed more as mere nonfeasance, such as the failure to discover a dangerous condition or perform a duty otherwise imposed by law. *Rossmoor Sanitation, Inc. v. Pylon, Inc.*, 13 Cal.3d 622, 629 (1975). However, California Courts have also asserted that the determination of active and passive negligence should be taken on a case by case basis as the facts present. *Id*. at 634. While the lines of active and passive negligence are often blurred, in the State of California, the potential for coverage is not confined to the four corners of the pleadings, as extrinsic evidence is permissible to give rise to the defense duty. *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal.4th 1076, 1086 (1993). Accordingly, parties on both sides of the proverbial table have become well adept at pleading to coverage and the law and it is anticipated that they will quickly adjust to anticipated arguments that the pleadings, as asserted, allege "active" negligence versus the permitted "passive" negligence indemnification of an upstream party.

While *Civil Code* § 2782.05(a) preserves an insurer's rights to reserve under the California Supreme Court decision of *Buss, supra,* which held that an insurer may seek reimbursement of certain defense cost that are not even "potentially" covered by the policy, but not for the claims that are "potentially" covered, both Statutes make an overt effort to further enforce a carrier's obligation to provide a full and complete defense as established in the *Presley Homes, supra,* decision. Significantly, as does *Civil Code* § 2782(d), *Civil Code* § 2782.05(a) specifically calls out that it does not affect the additional insured obligations of an insurance carrier under *Presley Homes*. In *Presley*, an additional insured endorsement in a policy issued to a subcontractor, which amended the policy to add the general contractor as an insured ". . . but only with respect to liability arising out of 'your work' for that insured by or for you," required the insurer to provide the additional insured with a full and complete defense, not just for the claims related to the subcontractor's work. *Presley Homes, supra,* at 573-576.

Additionally, as if to attempt to draw further clarity to ensure maintenance of a broad defense obligation, the Statute specifically excepts and does not apply to:

> A provision in a construction contract that requires the promisor to purchase or maintain insurance covering the acts or omissions of the promisor, including additional insurance endorsements covering the acts or omissions of the promisor during ongoing and completed operations.

Civil Code § 2782.05(b)(6). Accordingly, *Civil Code* § 2782.05 does not apply to preclude an upstream party from contractually requiring a downstream entity to provide primary insurance coverage with additional insured endorsements in favor of the upstream entity, which would serve to provide coverage for that downstream party's acts or omissions during both ongoing and completed operations. Once such additional insured coverage is provided, and assuming that the claim against the additional insured fits within the coverage afforded under the confines of the policy issued to the primary named insured, the Statute forecloses on any ambiguity of an insurer's defense obligation by specifically asserting that an insurer's obligation to its additional insured will not be affected and will be held to the standards of the law set forth in*Presley Homes*. *Civil Code* § 2782.05(a). Thus, while the contractual obligations of downstream entities have been narrowed under the Statutes, the obligations of insurers to defend their additional insured remain consistently broad.

As practitioners have already found with *Civil Code* § 2782, the new *Civil Code* § 2782.05 will undoubtedly lead to litigated disputes over validity of tenders to downstream parties by upstream parties, proper allocations of defense under *Crawford* and perhaps even more problematic under *Civil Code* § 2782.05 than *Civil Code* § 2782, disputes over the distinction between active and passive negligence under the statute and the law. However, California's legislators have seemingly made a point to be clear that while contractual indemnity may be limited under the Statute, the obligation of an insurer to defend an additional insured has not been eroded.

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