CALIFORNIA CONSTRUCTION INDEMNITY CHANGES: THE LEGISLATURE ACTS AGAIN

Contractual indemnity provisions are at the heart of a well-structured construction risk transfer program. But just as commercial construction is recovering – especially in the multi-family sector – the California legislature enacted SB 474 which restricts contractual indemnity protection for commercial project owners and general contractors, and for public agencies.

Effective January 1, 2013, SB 474 applies to privately owned construction projects and to public works projects.

Affected parties are advised to act now to modify their construction contracts and subcontracts to reflect the new legal rules and adequately protect themselves.

What Does SB 474 Do?

The new legislation affects privately owned and public construction projects with respect to contracts or amendments entered into on or after January 1, 2013.

- For private projects, SB 474 renders indemnity clauses unenforceable to the extent they require a general contractor, subcontractor or supplier to indemnify an owner for the owner's active negligence.
- Similarly, SB 474 proscribes contract provisions that require a subcontractor to indemnify a general contractor, construction manager or another subcontractor to the extent the claim arises out of those parties' active negligence, or defective design, or to the extent the claim does not arise out of the scope of work of the subcontractor indemnitor. In addition, subcontractors' defense obligations to the general contractor or construction manager are limited to claims caused by that subcontractor's scope of work.
- For public works projects, the new legislation renders unenforceable indemnity clauses that require a general contractor, subcontractor or supplier to indemnify a public agency for the agency's active negligence.

Historical Background

To understand the impact of SB 474, some background is useful.

Historically, for both residential and commercial projects, California owners and developers could pass liability to downstream parties – the general contractor, subcontractors and suppliers – via Type 1 indemnity clauses. Under a broad Type 1 clause, the owner was indemnified by the other parties for losses or claims arising out of the owner's negligence, whether active or passive. While owners were unable to obtain indemnity as to their *sole* negligence or willful misconduct, Type 1 clauses afforded significant protection for owners.

The downstream parties, as indemnitors, were obligated both to indemnify and to defend the owner or developer. When combined with additional insured status on the other parties' commercial general liability ("CGL") insurance policies and with careful contract administration, owners and developers could be relatively confident about their contractual risk transfer structure for construction projects.

Indemnity Restrictions In New Residential Construction

With the enactment of AB 2738, effective January 1, 2009, the indemnity landscape changed dramatically on for-sale residential

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projects. Promoted by subcontractor trade associations, AB 2738 radically altered subcontractors' indemnity and defense obligations on such projects.

Owners, developers and general contractors could no longer obtain Type 1 indemnity from subcontractors on residential projects as to construction defect claims. Instead, subcontractors' construction defect indemnity obligations were limited to claims arising out of the subcontractors' respective scopes of work.

Moreover, subcontractors' defense responsibilities likewise were limited. In the wake of AB 2738, subcontractors now may elect to either defend the construction defect claim arising out of its scope of work with counsel of its choice, or pay a reasonable allocated share of the builder's defense costs, subject to later reallocation.

As a result, owners, residential owners, developers and general contractors modified their construction contracts to create a bifurcated indemnification structure: Type 1 indemnity for non-construction defect claims and AB 2738-compliant indemnity for construction defect claims.

In addition, AB 2738 addressed indemnity in the context of wrap-up insurance programs. Under a wrap-up, one entity (the owner or the contractor) procures insurance for all eligible construction participants. A wrap-up may include only general liability and excess liability insurance or it may also include other coverages such as builder's risk, workers' compensation/employer's liability and contractor's pollution liability. For residential projects, subcontractors can no longer be obligated to indemnify if the claim is "covered" by the wrap-up insurance program.

Practical Implications

SB 474 represents a further limitation on contractual indemnities, this time affecting commercial projects.

We predict that SB 474 will have significant practical implications.

First, we expect to see more use of wrap-up liability insurance programs. Legislative restrictions on contractual indemnity, together with long-term erosion of subcontractors' ability to provide adequate additional insured coverage, will cause commercial owners increasingly to use owner controlled insurance programs ("OCIPs") and commercial contractors increasingly to use contractor controlled insurance programs ("CCIPs"). While owners and general contractors can no longer be contractually indemnified for their active negligence, a well-structured wrap-up insurance program affords insurance coverage – and a defense – for precisely that exposure on commercial projects.

Second, the law of unintended consequences dictates that on privately owned projects, SB 474 may result in more disputes and litigation, not less. As noted above, the new legislation attempts to bar indemnification of an owner by a general contractor, subcontractor or supplier *to the extent* of the active negligence of the owner. Use of the phrase "to the extent" means that in order to assess the parties' indemnification rights and obligations, there will need to be a determination – or a negotiated resolution – of the extent to which the claim or liability is caused by the owner's active negligence.

Conclusion

SB 474 is one element of a seismic shift now occurring in construction risk management and insurance. At the same time as contractual indemnity protection is eroding, worldwide insurance markets are in transition. We anticipate firming premium rates and potentially more restrictive terms and conditions across various lines of insurance coverage. Owners and contractors are advised to re-examine their construction risk management and insurance programs and practices in this new landscape. With appropriate risk management measures in place, owners and contractors can make themselves more attractive to insurance underwriters in the changing environment.

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