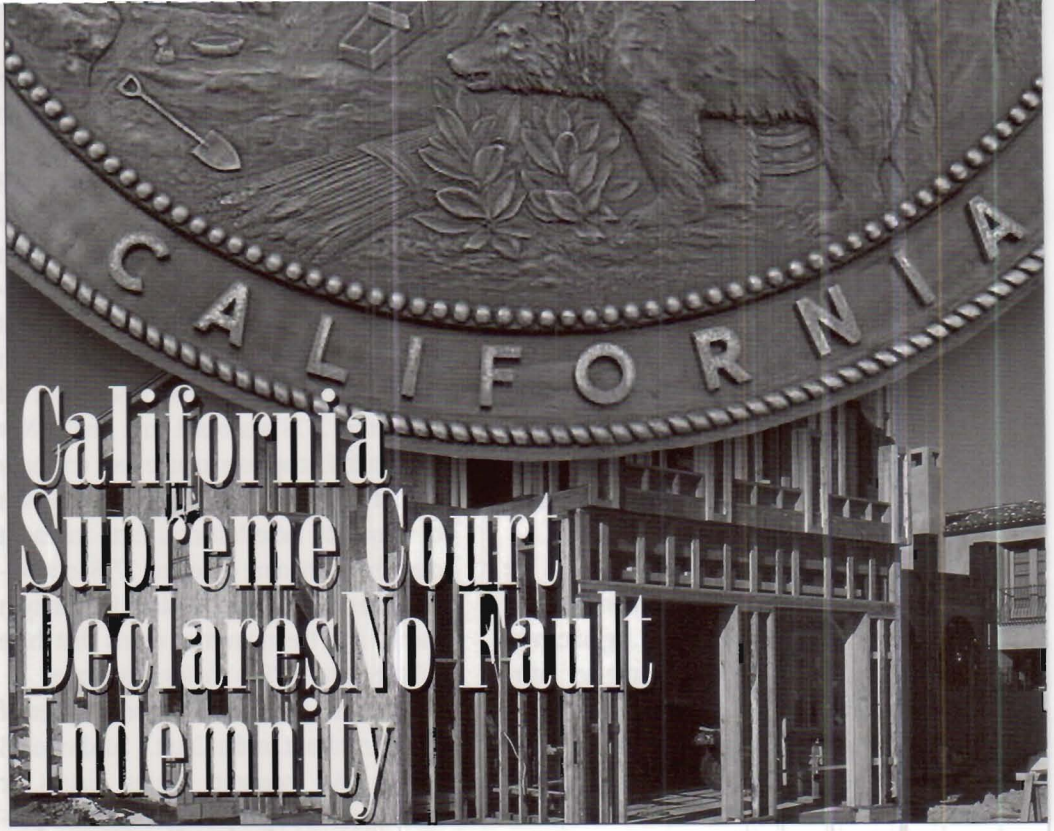

California Supreme Court Declares No Fault Indemnity

by Daniel Lee Jacobson

Last summer the California Supreme Court issued a unanimous opinion in an Orange County case that could have profound implications on construction litigation for years to come. The Court ruled that, unless there is an express statement to the contrary, pre-2009 residential general contractor/subcontractor construction contract indemnity agreements create in the subcontractor-indemnitor a duty to defend the general contractor/developer-indemnitee – even if the subcontractor has no substantive liability.

In issuing its opinion, the Court overruled *Regan Roofing v. Superior Court* (24 Cal.App.4th 425 (1994)) which has been held as an icon by the construction defect bar since its issuance. Because lawsuits alleging latent construction defects may be filed as late as 10 years after a home is built (*Code of Civil Procedure* Section 337.15), a ruling that affects pre-2009 residential construction contracts necessarily affects numerous yet-to-filed lawsuits.

Crauford v. Weather Shield (44 Cal.4th 541 (2008)) is a consolidated construction defect case wherein a group of homeowners filed construction defect lawsuits against the general contractor/developer which had built and sold their homes. The homeowners also sued the subcontractors for construction defects. The general contractor/developer, J.M. Peters Co. ("JMP"), cross-complained against the subcontractors for indemnity. One of those subcontractors was Weather Shield which manufactured and supplied JMP with windows for installation in the homes.

At trial in Orange County Superior Court the jury completely exonerated Weather Shield, finding that it had done nothing wrong in its manufacture and supply of the windows. The indemnity cross-complaint was then tried to the court. The issue was whether Weather Shield, which had no substantive liability, nonetheless owed JMP money for the attorney's fees that JMP had spent defending the Weather Shield issues. The trial court sided with JMP, finding that the JMP/Weather Shield contract created in Weather Shield a duty to defend notwithstanding its complete lack of liability.

Weather Shield appealed to the Fourth District Court of Appeal, Division 3 in Santa Ana, contending that, since it was not negligent (which it wasn't), it couldn't owe JMP a defense. In a 2-1 decision the Fourth District sided with JMP, upholding the trial court's ruling with a finding that the language of the contract, as interpreted with the aid of *Civil Code* Section 2778, required Weather Shield to defend JMP notwithstanding Weather Shield's lack of substantive liability.

Weather Shield finally appealed to the Supreme Court. In agreeing with the Fourth District's interpretation of the JMP/Weather Shield contract, the Court quoted the indemnity clause contained in that contract, and cited *Civil Code* Section 2778.

As to the indemnity clause language, the Supreme Court observed: "Weather Shield promised (1) 'to indemnify and save [JMP] harmless against all claims for damages . . . loss, . . . and/or theft . . . growing out of the execution of [Weather Shield's] work,' *and* (2) 'at [its] own expense to *defend any suit or action* brought against [JMP] *founded upon* the claim of such damage.'" [Italics added by the Court.] (*Crauford v. Weather Shield,* 44 Cal.4th 541, 547-548.) Both the Supreme Court and the Fourth District's majority found that this wording created in Weather Shield a duty to defend JMP without regard to Weather Shield's liability. That finding was aided by *Civil Code* Section 2778. The Supreme Court noted, "*Civil Code* Section 2778 . . . sets forth the general rules for the interpretation of indemnity contracts, 'unless a contrary intention appears.'"

The Supreme Court began its analysis with a recitation of some of its insurance law jurisprudence. Citing *Buss v. Superior Court* (16 Cal.4th 35 (1997)) and *Montrose Chemical Corp. v. Superior Court* (6 Cal.4th 287 (1993)), the Court explained, "[An] insurer's duty to defend is broader than its duty to indemnify. The latter duty runs only to claims that are actually covered by the policy, while the duty to defend extends to claims that are merely potentially covered." Quoting *Montrose,* the Court further stated:, "The [insurer's] defense duty is a continuing one, arising on tender of defense and lasting until the underlying lawsuit is concluded . . ., or until it has been shown that there is *no* potential for coverage . . . ." (Italics in original.) (6 Cal.4th 287, 295 (1993).)

The Court pointed out that *Crawford* was not an insurance case, explaining: "Here, however, we address issues concerning the contractual duty to defend in a *noninsurance* context. We consider whether, by their particular terms, the provisions of a pre-2006 residential construction subcontract obligated the subcontractor to defend its indemnitee – the developer-builder of the project – in lawsuits . . . insofar as the plaintiffs' complaints *alleged* construction defects arising from the subcontractor's negligence even though (1) a jury ultimately found that the subcontractor was not negligent, and (2) . . . [assuming] . . . that [the subcontract] gave the builder no right of *indemnity* unless the subcontractor was negligent."

(Italics in original.) (44 Cal.4th 541, 547.)

Although the Supreme Court referred to "pre-2006 residential construction subcontract[s]," its analysis will apply to all pre-2009 such subcontracts because, since publication of the Supreme Court's decision, the Legislature has changed the start date of *Civil Code* Section 2782(c) and (d) from 2006 to 2009. Those subsections significantly modify what is indemnifiable in post-January 1, 2009 residential construction subcontracts, and were the apparent reason for the Supreme Court's restriction of its analysis to pre-2006 contracts.

The Court explained that the "rules for interpreting . . . [indemnity agreements and insurance policies] differ significantly. Ambiguities in a policy of insurance are interpreted against the insurer . . . In noninsurance contexts however, it is the *indemnitee* who may often have the superior bargaining power, and who may use this power unfairly to shift to another a disproportionate share of the financial consequences of its own legal fault." Thus, when interpreting noninsurance indemnity agreements, "language on the point [of indemnity] must be particularly clear and explicit, and will be construed strictly against the indemnitee." The interpretation of indemnity agreements in general is aided by *Civil Code* Section 2778.

By its plain terms *Civil Code* Section 2778 requires that "[i]n the interpretation of a contract of indemnity, the . . . [rules stated in Section 2778] are to be applied, unless a contrary intention appears." The statute's words do not limit themselves to insurance contracts. However, an *amicus curiae* in the *Crawford* case pointed out that Section 2778 was based on a similar New York statute that appears to have been originally aimed at insurance contracts only. The Court was not swayed by these historical facts; instead it noted the positioning of Section 2778 in a portion of the *Civil Code* that legislates indemnity in general, and the numerous courts that have applied Section 2778 to noninsurance cases.

Subdivisions 3 and 4 of Section 2778 were of particular interest to the Court. Subdivision 3 provides, "An indemnity against claims, or demands, or liability, expressly, or in other equivalent terms, embraces the costs of defense against such claims, demands, or liability incurred in good faith, and in the exercise of a reasonable discretion." Subdivision 4 says, "The person indemnifying is bound, on request of the person indemnified, to defend actions or proceedings brought against the latter in respect to the matters embraced by the indemnity, but the person indemnified has the right to conduct such defenses, if he chooses to do so."

Thus, the Court concluded that, "subdivision 4 . . ., by specifying an indemnitor's duty 'to defend' the indemnitee upon the latter's request, places in every indemnity contract, unless the agreement provides otherwise, a duty to assume the indemnitee's defense, if tendered, against all claims 'embraced by the indemnity.'" (*Crawford v. Weather Shield* 44 Cal.4th 541, 557.)

The Court was impressed by the timing of the duty to defend, perhaps harkening to an insurer's duty to defend when an action is first brought, so long as the potential for indemnity exists. (See *Montrose*, supra at 295.) "The duty 'to defend' expressly set forth in Weather Shield's subcontract . . . clearly contemplated a duty that arose *when* such a claim was made." [Italics added.] (*Crawford v. Weather Shield* 44 Cal.4th 541, 558.) The Court reviewed the subcontract's duty to defend language to determine the timing of the duty to defend. "[T]he duty to defend arose, as it logically must, as soon as a 'suit or action' was brought against JMP that was 'founded upon' a covered claim . . . . Necessarily, a duty expressed in this manner did not require a final determination of the issues, including the issue of Weather Shield's negligence." (*Crawford v. Weather Shield* 44 Cal.4th 541, 558.)

Once the Court found that the duty to defend began at the time of the making of the allegations, the Court had no problem deciding that the duty was owed notwithstanding any negligence or other fault on the part of the indemnitor. After all, at the time of the making of the allegations no one even knew if the indemnitor was negligent.

The subcontractor arguments were best stated in the Fourth District's dissenting and concurring opinion. Penned by Justice Kathleen O'Leary, that opinion would have found that the contract's indemnity language called for the provision of a defense only if Weather Shield had been substantively liable. Justice O'Leary explained, "the starting point of my analysis of the [contract's] indemnity provisions is the Civil Code. Section 2778 begins by stating, 'In the interpretation of a contract of indemnity, the following rules are to apply, unless a contrary intention appear[s].'" Two of those rules were key to Justice O'Leary's position. Citing Section 2778, subdivision 4, which "discusses the mechanism used to trigger

the duty to defend," Justice O'Leary noted: "First is the simple requirement of a 'request' . . . . There is no language mandating when this request should be made. The second component requires the request to concern an action involving 'matters embraced by the indemnity[.]' The latter component obviously requires an inquiry into both the circumstances of the claim at issue, and the scope of indemnity protection agreed upon in the contract." (*Crawford v. Weather Shield* 136 Cal.App.4th 304, 374.)

Justice O'Leary cited *Continental Heller Corporation v. Amtech Mechanical* (53 Cal.App. 500 (1997)), as well as *Heppler v. J.M. Peters* (73 Cal.App. 1265,1278), for the proposition that, "unlike insurance contracts, an expansive indemnity obligation in a subcontract must be articulated with 'specific, unequivocal contractual language to that effect.'" (*Crawford v. Weather Shield* 136 Cal.App.4th 304, 375, quoting *Heppler, supra* at 1278.)

That brought the dissenting and concurring opinion to the words of the one-sentence indemnification provision, the first part of which provided that Weather Shield would indemnify JMP for Weather Shield's negligence. The second part of the sentence provided for the defense of JMP "founded upon the claim of *such* damage." [Italics added.] Justice O'Leary reasoned that the reference to "such damage" in the latter part of the same sentence which referred to damage caused by Weather Shield's negligence necessarily meant that the defense obligation only arose if there was damage caused by Weather Shield's negligence. (*Crawford v. Weather Shield* 136 Cal.App.4th 304, 377.)

But, Justice O'Leary's logic did not carry the day in the Court of Appeal or at the Supreme Court.

Notwithstanding the Supreme Court's distinction between insurance contracts and other indemnity contracts, the practical result of the *Crawford* analysis seems to be to impose on subcontractors a defense obligation similar to that of insurance companies. To reach this result the *Crawford* Court injected vitality into a statute (*Civil Code* Section 2778) that some had thought was meant only for insurance companies, distinguished a relatively recent Court of Appeal case (*Mel Clayton Ford v. Ford Motors Co.*, 104 Cal.App.4th 46 (2002)), and overruled part of the long-standing *Regan Roofing Co. v. Superior Court* (24 Cal.App.4th 425 (1994)).

The Court expressly did not decide whether the duty to defend "would *continue* even if, during the progress of the third party proceeding against the indemnitee, all claims potentially subject to the contractual indemnity obligation were eliminated, or if the promisor otherwise conclusively established that the claims were not among those 'embraced by the indemnity.'" (*Crawford v. Weather Shield* 44 Cal.4th 541, 554, Footnote 4.) Even insurance companies can recover from their insureds defense costs spent on claims that ultimately turned out to be not covered. (*Buss v. Superior Court* 16 Cal.4th 35, 50-51 (1997).)

Another issue left expressly undecided is whether an appropriate request for a defense can be made in a cross-complaint. That is how JMP made its request of Weather Shield. The parties did not argue about this issue, so the Court left it undecided. (*Crawford v. Weather Shield*, 44 Cal.4th 541, 548, fn. 2.)

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