

## Shifting of Liability Nixed by New California Contractor's Law

by John R. Heisse, Robert A. James, and Christopher R. Rodriguez

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*After January 1, 2013, under new California law, "Type I" indemnity provisions covering the indemnitee's concurrent active negligence will no longer be enforceable, and owners' and contractors' ability to shift the costs of defense to downstream subcontractors and suppliers will be limited.*

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On October 9, 2011, California Governor Edmund G. Brown, Jr. signed into law Senate Bill 474, which relates to indemnity provisions in commercial construction contracts. The new law, which will apply to construction contracts entered into on and after January 1, 2013, broadens the class of indemnity provisions that are unenforceable under California law. It also imposes stricter limitations upon the ability of contractors to require their subcontractors and suppliers to cover the costs of defense in litigation.

### Prohibition of Certain Type I Indemnity Provisions

Under existing law, provisions in construction contracts whereby a downstream contractor or subcontractor indemnifies an owner or upstream contractor against liability caused by the upstream indemnitee's "sole negligence or willful misconduct" are unenforceable. See Cal. Civ. Code § 2782(a). Additionally, provisions in construction contracts on public projects are unenforceable if they impose on the contractor, or relieve the public agency from, liability for the public agency's own "active negligence." Cal. Civ. Code § 2782(b).

Given these standards, it has become increasingly common on construction projects for owners and general contractors to include "Type I" indemnity provisions in contracts with downstream contractors and subcontractors. Under a "Type I" indemnity provision, the downstream contractor/subcontractor agrees to indemnify the owner or contractor, even against liability caused by the upstream owner/contractor's own "active negligence." On private construction projects, such indemnity provisions are enforceable under California law as long as the alleged liability does not arise from the "sole negligence or willful misconduct" of the upstream owner/contractor.<sup>1</sup>

<sup>1</sup> There are exceptions under existing law for, among other things, agreements to indemnify made with professional engineers involving liability for design defects. See Cal. Civ. Code § 2782.5. Additionally, existing law sets forth different requirements and prohibitions for residential construction contracts entered on or after January 1, 2009.

Under the new law, such "Type I" indemnity provisions will no longer be enforceable. Newly added California Civil Code section 2782.05 provides that contract clauses that purport to require a subcontractor to "insure or indemnify" a contractor, construction manager or other subcontractor against claims for damages that relate to the active negligence or willful misconduct of the indemnitee, or for defects in design, or against claims that do not arise out of the scope of work of the indemnitor, are unenforceable. Furthermore, although section 2782.05 expressly does not apply to direct contracts with public agencies or direct contracts with owners of privately owned real property, public agencies and private owners are already prohibited from including Type I indemnity provisions in their direct contracts. See Cal. Civ. Code § 2782(b)(2) and 2782(c)(1) (newly added under SB 474). The new law expands the coverage of that prohibition to include downstream subcontractors and suppliers of goods.

### Restrictions on Allocation of Defense Costs

Another key change in the law is that, under section 2782.05, contractors will no longer be able to broadly force downstream subcontractors/suppliers to pay for the costs of defending against claims in litigation. Under existing law, contract provisions requiring downstream subcontractors and suppliers to pay for the costs of defending against claims—other than claims for the "sole negligence or willful misconduct" of the indemnitee—are enforceable. Thus, owners and general contractors are, to a significant extent, able to allocate the costs of litigation to subcontractors and their insurers. Such indemnities, by which the downstream party assumes the burden of handling the entirety of claims that arise at least in part from the performance or negligent performance of work by that party, are a near universal aspect of real property development. When a claim is tendered, one party is responsible for responding to the plaintiff and for disposing of the matter—rather than having an owner, a financier, a tenant, a developer, a general contractor and other professionals all having to hire lawyers and participate in the process. The exposure is handled by arranging for insurance at each level, and the cost of that insurance is passed along in the bids and prices for the indemnitor's work.

Under the new law, however, owners and contractors will have a far more limited ability to allocate the costs of defense to downstream subcontractors and suppliers. The restrictions contained in section 2782.05 prohibiting indemnity for one's own active negligence specifically extend to the "costs to defend" claims in litigation. Although the new law *does* allow contractors, subcontractors and suppliers to make agreements concerning coverage of defense costs, such agreements are strictly governed by section 2782.05(e). Among other things, section 2782.05(e) provides that a subcontractor owes no defense or indemnity obligation to a general contractor unless and until the general contractor has provided a written tender of the claim, including (a) information from the claimant relating to the claims caused by that subcontractor's scope of work and (b) a written statement explaining how the reasonable allocated share of fees and costs was determined. The subcontractor also has the opportunity to present information to the general contractor showing that another party is responsible for the claim. The subcontractor is not required to pay more than "a reasonable allocated share" of the general contractor's defense fees and costs.

The new restrictions governing the allocation of defense costs do not apply to direct contracts with public agencies or private owners. Thus, although the law prohibits all "Type I" indemnity clauses, public agencies and private owners may continue to require contractors to cover the costs of defending claims in litigation, as is customary under existing law.

Accordingly, the new law places general contractors—i.e., those that contract directly with public agencies or private owners—in a potentially precarious position. If a public agency or private project owner requires a general contractor to agree to an indemnity provision that allocates the costs of defense to the general

contractor, that general contractor will not be able to fully allocate that risk to its downstream subcontractors and suppliers. Rather, any indemnity provision in the general's contract with its subcontractor will be limited by section 2782.05 and subject to the specific requirements of section 2782.05(e). Specifically, although general contractors will only be able to force their subcontractors/suppliers to cover a "reasonable allocated share" of defense costs and subcontractors/suppliers will have statutory mechanisms for challenging allocations, public agencies/private owners may be able to force the general contractors to pay up-front for all defense costs and general contractors will have no available mechanisms for challenging the public agency/private owner.

General contractors should therefore make the public agencies and private owners with whom they contract aware of this nuance in the law. Where possible, they should seek to negotiate indemnity provisions that are consistent with the indemnity provisions they will be allowed to negotiate with subcontractors and suppliers. However, public owners typically contract using public procurement procedures that offer no opportunity for bidders to negotiate. Therefore, contractors should encourage their industry groups to (a) lobby public owners to address these issues in advance in the contracts for which they are soliciting bids or (b) lobby government officials to amend the law in order to remove the burdens placed upon contractors.

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If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work or the authors of this alert.

John R. Heisse [\(bio\)](#)  
San Francisco  
+1.415.983.1543  
[john.heisse@pillsburylaw.com](mailto:john.heisse@pillsburylaw.com)

Robert James [\(bio\)](#)  
San Francisco  
+1.415.983.7215  
[robert.james@pillsburylaw.com](mailto:robert.james@pillsburylaw.com)

Christopher Rodriguez [\(bio\)](#)  
Sacramento  
+1.916.329.4720  
[christopher.rodriguez@pillsburylaw.com](mailto:christopher.rodriguez@pillsburylaw.com)

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