

# Construction Practices

NEWSLETTER

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[ Highlighting notable court decisions and trends ]

## Indemnity Clause Requires Defense As Soon As Suit Filed

Under a typical “Type I” indemnity provision, does a subcontractor’s duty to defend an owner or general contractor kick in only after it has been established that the subcontractor actually was negligent? In *Crawford v. Weather Shield Manufacturing, Inc.* S141541 (July 23, 2008), the California Supreme Court finally put to rest this fundamental issue. It held that, under the provision at issue, where a claim implicates the subcontractor’s work, the subcontractor owes a duty to defend *as soon as a suit is filed*, regardless of whether it is ultimately determined that the subcontractor was negligent.

In *Crawford*, the project was a large residential development in Southern California. J.M. Peters Co. was the project’s owner and builder. Peters engaged many subcontractors, including Weather Shield, to manufacture and supply wood-framed windows for the project.

Peters drafted all the subcontracts, and each contained identical indemnification provisions. Each stated that the subcontractor promised to indemnify and hold Peters harmless “against all claims for damages [and] loss ... growing out of the execution of [the subcontractor’s] work.” They further provided that each subcontractor would, at its own expense, “defend any suit or action brought against [Peters] founded upon the claim of such damage [or] loss.”

After completion, about 200 homeowners sued Peters and certain subcontractors (including Weather Shield) for alleged construction defects under various theories. As to Weather Shield,

the homeowners alleged that, due to improper design, manufacture and installation, Weather Shield’s windows fogged and leaked, causing extensive damage to their homes.

In turn, Peters cross-complained against the subcontractors, including Weather Shield. The cross-complaint asserted that under the identical indemnification provisions, the subcontractors owed Peters a duty of indemnity and a “present duty” of defense against the homeowners’ complaints.

Thereafter, the action was settled among the plaintiffs, Peters and all subcontractors except Weather Shield and one other. The window leak issues then went to trial against Weather Shield on the negligence and breach of warranty claims. The jury found in Weather Shield’s favor.

Peters’ cross-complaint was then separately tried. In addition to seeking indemnity for the amounts it paid in settlement with the homeowners, Peters also sought, under the duty-to-defend provision of its subcontract with Weather Shield, recovery of the attorneys fees’ and expenses incurred in defending itself against the homeowners’ suit.

The trial court denied Peters’ demand for indemnity, holding that the subcontract would have obliged Weather Shield to indemnify Peters *only if* Weather Shield had been found negligent.

With respect to defense costs demands, however, the trial court ruled in Peters’ favor. The lower court held that the subcontract language made Weather Shield immediately responsible for Peters’ legal defense against

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the homeowners’ claims against Weather Shield’s windows, *regardless of whether Weather Shield was ultimately found to be negligent.*

The appellate court affirmed, and the case then went to the Supreme Court, which again affirmed the trial judge’s rulings. In its analysis, the Court noted that under Civil Code section 2778(4), absent language showing a contrary intention, every indemnity agreement carries with it a duty to defend claims with respect to matters “embraced by the indemnity.” The Court then held that this implied duty to defend is “distinct from, and broader than” an

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indemnitor's duty to reimburse an indemnitee for defense costs for a claim for which indemnity is actually found to be owed. Specifically, the Court found implicit within this duty to defend that "the duty arises immediately upon a proper tender of defense by the indemnitee."

The Court then examined the language of Weather Shield's subcontract and found that not only was there no language showing an intent to preclude a duty to defend, the subcontract language expressly confirmed this duty. The indemnity provision articulated *two distinct obligations*, namely, a duty to indemnify, and a *separate and specific promise* by Weather Shield "at [its] own expense to defend any suit or action ... founded upon the claim of such damage [or] loss." The Court held that this specific promise "to defend" another against specified claims "clearly connotes an obligation of active responsibility, from the outset, for the promisee's defense against such claims," and that the duty promised "is to render, or fund, the service of providing a defense on the promisee's behalf—a duty that necessarily arises as soon as such claims are made against the promisee, and may continue until they have been resolved."

Based on this analysis, the Court concluded that the subcontract language "expressly and unambiguously" obligated Weather Shield to defend, *from the outset*, any suit against Peters insofar as that suit was "founded upon" claims *alleging* damage or loss arising from Weather Shield's negligent role in the project.

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### **How Contract's Scope and General Scope Define Available Remedies**

No construction project ever really proceeds as planned. There are just

too many things that will unexpectedly arise that adversely impact the contractor's ability to complete the project.

Unexpected events and circumstances are those that are not contemplated by the parties when the contract is formed. In most cases, one or both parties will seek some type of adjustment in the contract's time, cost and/or requirements. Whether the contract will ultimately be adjusted, rescinded or terminated depends on: whether the unexpected events and circumstances were really unexpected (i.e., beyond the contract's scope); and whether the unexpected event and/or circumstance's risk was either expressly or impliedly allocated to a party in the contract.

As a general premise, all standard form contracts contain change provisions that authorize changes within the contract's general scope. Therefore, any contract change analysis must involve analyzing the contract's scope and general scope.

A contract's scope refers to the work, obligations and risks that a contractor assumes in exchange for the contract's price. A contract's general scope refers to things outside of the contract's scope but still within the contract's broader general scope as determined by the contract's general intent and legal concepts such as reasonableness, substantiality and materiality.

Changes within the contract's scope are presumably covered by the contract; therefore, they are not compensable. Such changes might include routine, minor and expected changes that do not impact either the contract's price or time. These types of changes result from specification clarifications, authorized product and/or material changes, field dimension clarifications, and some responses to requests for information.

Changes outside of a contract's scope but within a contract's general scope are considered non-material or partial

breaches. Remedies include compensatory damages.

Changes outside of a contract's general scope are material changes that may result in the contract's rescission or termination. Unfortunately, identifying when a change falls outside of a contract's general scope is difficult. The analysis is fact specific, and court opinions are all over the place.

Changes outside the contract's general scope are generally referred to as cardinal changes in federal work and abandonment of contract in state work. Cardinal changes are substantial contract deviations that change the nature of the bargain and alter the contract so profoundly that they constitute material contract breaches.

Factors used to analyze whether a change is a cardinal change include the dollar amount of the change compared to the original contract price and the change's impact on the contract's duration and/or complexity. In other words, when changes unreasonably alter the character of the work, unduly increase the project's cost, or constitute a radical departure from the original contract, the change is considered to be outside the contract's general scope, and therefore, a cardinal change. On public contracts, another key factor affecting the analysis is the effect the change would have had on the competitive bidding process.

The consequences of cardinal changes include: the contractor's right to pursue common-law damage and termination remedies for material breaches; the contract's procedural requirements and damage limitations becoming inapplicable; the contractor's right to abandon or terminate the contract without liability; the violation of applicable statutory bidding statutes; the application of sovereign immunity defenses to the claim; and the performance bond surety's discharge.

Most contracts specifically define and limit the remedies (i.e., costs and profits) that can be recovered for contract changes within the contract's general scope. If a change falls outside the general scope, however, the change is considered to be a material breach. In such a case, the contractual remedy limitations become inapplicable. Therefore, determining whether a change is within or outside a contract's general scope is critical to determining the available remedies.

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### **Tribes Can't Contractually Create Tax Shelter for Contractors**

In *Barona Band of Mission Indians, et al. v. Betty T. Yee, et al.*, the Ninth U.S. Circuit Court of Appeals held that a non-Indian contractor who purchases construction materials from non-Indian vendors that are delivered to a construction site on Indian land is not exempt from state sales tax.

The *Barona Band of Mission Indians* (Tribe) entered into a contract with Hensel Phelps to construct a \$75 million expansion to a casino, only five years old at the time. Hensel subcontracted with Helix Electric to perform electrical work. The prime contract and subcontracts required deliveries of materials from non-Indian vendors to occur on tribal lands and for title of the materials to transfer upon delivery. With this contract language, the Tribe intended to shield Hensel and its subcontractors from California state sales tax.

The California State Board of Equalization demanded that Helix pay the sales tax. Helix sought indemnification from Hensel, and Hensel sought indemnification from the Tribe. The Tribe sued the Board for declaratory relief. The court granted the Tribe's motion for summary judgment, finding that although the sales tax was not *per se* improper, it did fail the balancing test

set forth in *White Mountain Apache Tribe v. Bracker*.

The Board appealed to the Ninth Circuit, which reversed the district court's grant of summary judgment and remanded for judgment to be entered in favor of the Board. The Ninth Circuit agreed that the California state tax was not *per se* invalid. But the court also held that the *Bracker* balancing test did not invalidate the state tax where the Tribe invited the commercial transaction on its land to avoid the tax, which otherwise would have been paid by the subcontractor.

A state tax is unenforceable and *per se* invalid if its "legal incidence" falls on a tribe or its members for sales made on Indian land. Legal incidence is determined by who the state is taxing and where. The one who bears the legal incidence may differ from who ultimately bears the "economic burden" of the tax.

The Tribe tried to equate economic burden with legal incidence by designating the subcontractors as "purchasing agents" for the tax-exempt Tribe. The Court refused to recognize this fiction and concluded that Helix was the "consumer of materials" furnished to a client under a construction contract.

Under the *Bracker* balancing test, the court measured the state's interest in raising revenue against that of the Tribe's and federal government's interest in the Tribe's autonomy and economic self-sufficiency.

A tribe has a paramount right to autonomy within its territory and an interest in respecting its tribal sovereignty. But here, the Tribe "significantly compromised" its autonomy by inviting the transaction on its land for the sole purpose of providing a "tax shelter for non-Indian businesses." Thus, this case is factually distinguishable from cases analyzing taxation on non-Indians performing work on Indian land.

The impact to the Tribe's economic self-sufficiency carried very little weight with the court because the tax would have been incurred by Helix, not the Tribe, but for the contract language requiring the Tribe to indemnify Hensel and Helix. "[T]he state has a parallel interest in preventing the manipulation of its tax laws to aid a casino in shopping tax exemptions to local businesses who otherwise would remit sorely needed revenue to the state."

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### **Killer Bond Forms and Contract Provisions—A Series**

*This is the sixth in an ongoing series setting forth examples of new bond and contract provisions and providing commentary as to their meaning and impact.*

#### **If Obligees Completes/Carte Blanc**

**Surety shall not have the right, if Obligees completes, to object on the grounds that Obligees's successor contractor is not the lowest and best bidder or that the successor contract price is excessive unless the objection is based on demonstrated amendments to the plans and specifications made after the declared default and constituting new work.**

This type of provision on the part of bond obligees, be they project owners or general contractors, is a main reason that sureties often opt to take over a project rather than have the obligee to do so. Obligees, when completing a contract, may have the work performed on a time and material or cost plus basis, thereby risking completion costs far in excess of the original contract price. Even if the obligee does not perform the project on a time and material basis, obligees have selected a contractor or subcontractor and negotiated a contract price that is, again,

significantly greater than the cost of a competitively bid project.

Even if a surety does not decide to take over a project, a surety typically has the argument that the obligee has included betterments in its completion work for which the surety is not obligated to reimburse to the obligee. The above clause seemingly removes that argument. Essentially, the surety argues that the obligee has performed work that is outside the scope of the plans and specifications of the underlying bonded contract. The above provision, in actuality, is saying the same thing. Only if there are “amendments to the plans and specifications,” work done outside the scope of the original plans and specifications, can the surety object to the obligee’s expenditures. Thus, although the language is unusual, the provision is not significantly different from what a surety can object to when responding to an obligee’s demand for reimbursement. The problem arises when the plans and specifications may be vague or allows the contractor some discretion as to which materials or construction means and methods to use. In those cases, the surety in a takeover situation would be within its right to choose the least expensive that complies with the plans and specifications. Based on the above language, the obligee could choose the most expensive and charge it against the surety.

As to the amount of the bid or lump sum contract price, as long as the work being performed is within the scope of the plans and specifications and as long as there was no collusion between the obligee and the completion contract, a surety’s argument that the obligee did not mitigate its damages by selecting the least expensive responsible or qualified prospective completion contractor is also an uphill battle. It is more than likely that the obligee will have sufficient grounds for selecting the completion contractor that it did such that the surety will lose on this argument.

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## Construction Practices Group

### About Us

Sedgwick has established a record of successfully protecting the interests of general contractors, subcontractors, sureties, project owners and developers (commercial, public and residential), design professionals and material suppliers. The firm’s construction attorneys represent clients in matters ranging from commercial and governmental projects to private and commercial residential construction.

We handle various aspects related to construction – from the contracting, bonding, insuring and development phase; construction disputes, including terminations for default and convenience, takeovers and completion, litigation, arbitration, DRB hearings, and mediation; and post-construction issues, including impact claims, mechanic’s liens and stop notice enforcement and defense, compliance with regulatory authorities, product malfunction, construction site injuries, and construction defects. We work with specialized consultants with design and construction expertise.

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