

Construction Practices

NEWSLETTER

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[Highlighting notable court decisions and trends]

Indemnitees Need Not Tender Defense to Recover Attorney's Fees Under Indemnity Agreement

City of Watsonville v. Corrigan ((2007) 149 Cal.App.4th 1542) addresses whether an indemnitee is required to tender its defense to the indemnitor before it is entitled to recover defense costs. The court ultimately holds that no tender is required.

The assumption that an indemnitee must tender its defense to the indemnitor as a prerequisite to the recovery of attorney's fees and costs is based primarily on Calif. Civ. Code § 2778, which sets forth rules that guide the construction of indemnity contracts and "are as much a part (of an indemnity agreement) as those set out therein, unless a contrary intention appears." (*Gribaldo, Jacobs, Jones & Ass.'s v. Agrippina Versicherungen A.G.* (1970) 3 Cal.3d 434, 442.) In relevant part, § 2778 provides that:

[3] [I]ndemnity ... embraces the costs of defense ...;

[4] 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;

[5] If, after request, the person indemnifying neglects to defend the person indemnified, a recovery against the latter ... is conclusive in his favor against the former;

[6] If the person indemnifying ... is not allowed to control (the person indemnified's) defense, judgment against the latter is only presumptive evidence against the former ...

Based upon these provisions, and in particular upon subsection 4, the *Corrigan* indemnitors argued that where an indemnitee chooses to defend an action without first tendering its defense, it effectively waives the right to recover from the indemnitor its attorney's fees and costs incurred thereby. Indemnitors supplemented their argument by analogy to insurance law, in which no duty to defend arises until tender of defense.

After discussing the inherent difference between the duties of an insurer and a typical (non-insurer) indemnitor, *Corrigan* concludes that principles applied in interpreting indemnity agreements within insurance policies are not applicable to interpretation of non-insurance indemnity agreements, because insurers are routinely held to stricter standards than parties to non-insurance contracts. Accordingly, insurance law principles do not inform interpretation of non-insurance indemnity agreements.

Thus, the indemnity agreement itself, supplemented only by the provisions of § 2778, govern interpretation of indemnity agreements. The *Corrigan* court stated: "Nothing in (§ 2778) obligates the indemnitee to tender defense to the indemnitor; and the election to conduct its own defense (for any reason) does not supplant the interpretative rule in subdivision [3] that indemnification 'embraces' the costs of the indemnitee's defense." The language of the indemnity agreement does not *specifically require* the indemnitee to tender its defense – or otherwise obtain the indemnitor's permission to incur fees and costs, as in *Gribaldo* (3 Cal.3d at p. 434) – as a prerequisite to recovery, an indemnitee may choose to conduct its own defense and still recover attorney's fees and costs for

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matters within the ambit of the indemnity agreement.

An important exception in which defense fees and costs may not be recoverable is where a defense is *offered by the indemnitor*. To be recoverable, attorney's fees and costs must be "reasonable"; an indemnitee's "unreasonable" refusal to accept the indemnitor's offer of defense precludes recovery of duplicative attorney's fees. (See *Buchalter v. Levin* (1967) 525 Cal.App.2d 367, 371.) Additionally, although tender is not required, it is advisable for an indemnitee to *provide* notice to the indemnitor of the claim(s) embraced by the indemnity agreement, as failure to provide notice to the indemnitor changes the burden of proof and imposes upon the indemnitee the necessity of again litigating and establishing all the actionable facts. (*Eva v. Andersen* (1913) 166 C 420, 425.)

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Draft Clause Carefully to Avoid Recovery of Attorney's Fees in Tort

A defendant who is bound by a contractual attorney's fees provision oftentimes faces a considerable risk that he or she may get left "picking up the tab" for plaintiff's attorney's fees, even if the plaintiff recovers only a nominal sum at trial. That defendant may have minimal exposure and what appears to be a palpable chance to settle the lawsuit without the expense of trial. Many of us have been faced with a scenario where plaintiff's attorney's fees potentially exceed the value of the claim and the plaintiff has incentive to "roll the dice," with the hope of recovering his or her attorney's fees, rather than negotiating a reasonable settlement. When the claims against the defendant are not limited to contract but include breach of common law duties, the outcome may be laden with uncertainty because the standards governing liability in tort are not always clearly defined. The careful drafting of attorney's fees clauses to avoid fee recovery on the tort causes of action can help eliminate added risk and level the playing field for settlement.

Two "rules of thumb" apply to circumvent the fee recovery:

1. Keep the subject matter of the attorney's fees clause narrowly tailored to the contract. Clauses that provide for the recovery of attorney's fees in an action to "enforce the contract" or in the event of "breach of" or "default

Draft attorney's fees clauses so that it is unilateral in your or your client's favor. Although the unilateral fee clauses will be treated as reciprocal in contract, reciprocity will not apply in tort.

under" the contract will be narrowly construed to avoid recovery. Avoid phrases such as "arising out of" or "related to" the agreement, which will broaden the fee clause and make it applicable to noncontract claims.

2. Draft the attorney's fees clause so that it is unilateral in your client's favor, rather than in favor of the "prevailing

party." Although unilateral fees clauses will be treated as reciprocal in contract, reciprocity will not apply in tort.

Limit the Focus of the Clause to Contract Claims

Calif. Civ. Code § 1717 governs the award of contractual attorney's fees and costs to the party who prevails in "any action on a contract." The court in *Hsu v. Abbata* ((1995) 9 Cal.4th 863, 873-874) noted that § 1717 was amended in 1987 to replace the term "prevailing party" with the term "party prevailing on the contract," to emphasize that a party's success on a noncontract claim was irrelevant to the determination of the prevailing party.

With § 1717 as a reference point, the drafter may avoid having the attorney's fees clause spill over to the tort causes of action if it is drafted narrowly to apply only to the contract claims. For example, in 1979, the court in *Reynolds Metals Co. v. Alpherston*, 25 Cal.3d 124, 129, held that a clause in a promissory note that provided for the recovery of attorney's fees in the event of a "default" would apply to the claims on the promissory note but not the tort claims.

In contrast, more recent courts have concluded that broadly worded fee clauses that provide for recovery by the prevailing party in any action "arising out of" or "related to" the contract permit an award of attorneys' fees in tort under § 1021 of the California Code of Civil Procedure. (See *Xuereb v. Marcus &*

Millichap, Inc. (1992) 3 Cal.App.4th 1338, 1341-1343; *Palmer v. Shawback* (1993) 17 Cal.App.4th 296; *Lerner v. Ward* (1993) 13 Cal.App.4th 155 and *Wilshire Blvd. Bldg. v. W.R. Grace & Co.* 990 F.2d 487 (9th Cir. 1993).)

Take advantage of the limitations afforded by § 1717 and draft the attorney's fee clause to clearly state that it

applies only to actions to "enforce the contract" for "breach of contract" or "default" under the contract.

Give Your Client a Unilateral Right to Attorney's Fees

Although § 1717 operates to transform a unilateral attorney's fees clause into "reciprocal" right on contract claims, unilateral fee clauses still retain utility in tort. *Moallem v. Coldwell Banker Commercial Group* (1994) 25 Cal. App.4th 1827, confirms that the "reciprocity" afforded by § 1717 applies in contract only, and it breathes life into unilateral fee clauses. Plaintiff Moallem was the assignee of an owner who had entered into a brokerage agreement with Coldwell Banker. Coldwell successfully defended against plaintiff's breach of contract claim arising out of the owner's forfeiture of a warehouse property. But Coldwell had sublet the property in violation of the owner's lease. The trial court entered judgment against Coldwell in plaintiff's favor on his negligence and breach of fiduciary duty causes of action.

The brokerage agreement between Coldwell and the owner contained a unilateral attorney's fees clause in Coldwell's favor that provided: "If broker is required to institute legal action against owner relating to this schedule or any agreement of which it is a part, broker shall be entitled to reasonable attorneys' fees and costs." Both parties moved for attorneys' fees under Civ. Code § 1717. The trial court determined that there was no "prevailing party on the contract" and denied both parties' requests for attorney's fees. Coldwell appealed.

On appeal, the court acknowledged Moallem's position that the term "relating to" in the fee clause was broad enough to include his tort causes of action under *Xuereb, supra*, and its progeny. However, because the fee clause was unilateral and named Coldwell as the recipient, rather than the "prevailing party," the court held that only Coldwell was entitled to recover attorneys' fees, as no reciprocal right was afforded to plaintiff on the tort causes of action. The outcome

would have been different had Coldwell not been unilaterally designated as the party to recover attorney's fees.

Whenever your client has the opportunity to leverage a unilateral fee clause, it can provide added protection against an opponent's ability to recover attorney's fees in tort.

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Killer Bond Forms and Contract Provisions—A Series

Recently, property owners and general contractors are rewriting the performance bond forms and contract provisions that they are requiring from their contractors and subcontractors. The surety industry considers many of these rewrites onerous and, in some cases, alter the standard legal responsibilities of the construction and surety industry. For example, there is a concern that the rewrites could eliminate the fact that surety is a form of guaranty. Guaranty means that the bonding company should have no liability unless the bonded contractor has liability. There is also a concern that the higher tier of the contractual relationship, i.e., the owner versus the general contractor or the general contractor versus the subcontractor, is attempting to place increasingly more responsibility upon the lower-tier entity.

This feature will be an ongoing series in Sedgwick's Construction Practices Newsletter setting forth examples of new bond and contract provisions and providing commentary as to their meaning and impact.

Bonding Company Declaration re: Bonding Capacity During Bidding Process

Sample Provision:

Provide the following declaration on bonding company's stationery and include in the submittal to owner:

The undersigned declares under penalty of perjury that contractor is able to provide 100% payment and

performance bonds. This declaration is made with the acknowledgment that future work and commitments may impact the bonding capacity of contractor.

It is unclear why a governmental entity is requiring the above statement from the bonding company that provides a bid bond on behalf of a bidder. Indemnity agreements between the bonding company and the contractor typically provide that the bonding company is not bound to provide the final bonds (payment and performance) when it provides the bid bond and that it can refuse to provide any bonds, including the final bonds, for any reason or no reason at all. Arguably, this clause does not alter that state of affairs because it

Recent changes in performance bond forms and contract provisions may alter the standard legal responsibilities of the construction and surety industry.

simply says that the contractor is "able" to provide payment and performance bonds. It further says that that "bonding capacity" could change as a result of future work and commitments.

Whether this statement could have the further effect of somehow binding the bonding company to issue the final bonds if the owner awards the project to the contractor is another question. Presumably, if the owner can make a case that the bonding company issued the bid bond with no intention of issuing the final bonds, at a minimum, the owner would have some kind of claim against the bonding company.
To Be Continued....

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Liability for Nothing: The Controlling Employer Doctrine

In a disappointing decision for prime contractors, the California Court of Appeals upheld an administrative decision that found that a prime contractor was liable for its subcontractor's Cal/OSHA violations on a multi-employer construction site. Moreover, the

appellate court affirmed that the prime contractor was liable even without agency proof that the prime contractor had failed to exercise reasonable diligence to discover and prevent its subcontractor's violation.

In *Overaa Construction v. California Occupational Safety and Health Appeals Board* (Department of Industrial Relations, Division of Occupational Safety and Health, Real Party in Interest) (2007) 147 Cal.App.4th 235, the California Court of Appeal affirmed the trial court's judgment, which denied prime contractor Overaa Construction's petition for writ of administrative mandamus to overturn the Division's Appeals Board. The Division penalized Overaa as a "controlling employer"

under Cal. Lab. Code § 6400, et. seq., and Cal. Code Regs. tit. 8, § 336.10, et. seq., for violation of a Cal/OSHA safety regulation.

This Cal/OSHA penalty arose from a public works contract that Overaa entered into with the Dublin San Ramon Services District. The contract required construction of improvements to a wastewater treatment plant. Overaa subcontracted the electrical work to Cra-Tek.

Overaa's contract with the District provided that Overaa was responsible for all work safety at the site, including subcontractors' work, which included shoring for excavations. Moreover, the prime contract deemed all of Overaa subcontractors' employees to be Overaa's employees. Overaa designated its superintendent under the Cal/OSHA regulations to supervise work safety.

After an inspection in 2001, a Division inspector issued a "citation and notification of penalty" to Overaa only, alleging a "serious" violation of regulation designed to prevent excavations from collapsing. He added that Overaa knew of the unprotected excavation for more than a week and took no action.

When the inspection occurred, only a subcontractor Cra-Tek employee was working in the trench.

Generally, under the Cal. Lab. Code § 6432, Cal/OSHA violations are classified as “serious” or “general.” A “serious” violation is defined as involving a substantial probability that death or serious physical harm could result from the violation if an accident occurred. However, the statute expressly deems that a “serious” violation does not exist if the employer can demonstrate that it did not, and could not with the exercise of reasonable diligence, know of the presence of the violation. At the Agency hearing, despite the incentive and opportunity to do so, Overaa did not assert its reasonable diligence as an affirmative defense to “serious” violation, but only that there was no violation and that the “serious” classification was incorrect.

The Division cited Overaa as a “controlling employer.” Generally, under Cal/OSHA regulations, an employer of those employees who were exposed to the hazard is an “exposing employer.” An employer who actually created the hazard is a “creating employer.” The employer who is responsible, by contract or by actual practice, for safety and health conditions on the worksite, who had the authority to ensure that the hazardous condition was corrected, is a “controlling employer.” An employer that had the responsibility to actually correct the hazard is a “correcting employer.” Ultimately, before the Agency appeals board, the administrative law judge found Overaa in violation as a “controlling employer,” but reduced the citation from “serious” to “general.”

The Court of Appeals upheld Cal/OSHA regulations creating liability upon a “controlling employer” on multi-employer worksites, and it rejected the requirement that the agency must prove a lack of employer diligence as a condition to liability. However, also critically, this case did not decide whether multiple employers may be cited for the same violation. Thus, whether a “controlling employer” may claim such a “duplication” defense is

still uncertain and left to determination in future cases.

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Stephen A. Schram, editor of this newsletter, concentrates his practice in design, construction, and class actions involving construction products and toxic tort (alleged exposure to fungal spores) in Northern California. Mr. Schram’s practice includes all aspects of private or public construction, such as bids, bid challenges, contracts, construction dispute resolution, and construction litigation, as well as evaluating claims against design professionals and defending against such claims in litigation.

Mr. Schram owns and is restoring a 100 year old house in San Francisco, one interior room per year and a major system upgrade every few years. It’s a long project!

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Construction Practices Group

About Us

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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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