Traps for the Unwary: Hold Harmless Clauses

Overview of California's Statutory Framework Concerning Indemnification Affecting Construction Projects

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I. Introduction

Inherently, construction projects involve risks. For most projects, cost and schedule are the two risks of paramount concern; severe consequences can be suffered by all construction participants (i.e., owner, contractors, design professionals, and others) if a project is not completed within budget and on schedule. Besides cost and schedule, there are other risks that greatly impact the success of a project. For example, accidents at jobsites are not uncommon, and structural failures can similarly be tragic.

The hold harmless indemnity clause is one of the most critical clauses in both the construction contract and the professional services agreement. At its most basic level, an indemnity clause shifts risk. It requires one party (i.e., the indemnitor) to protect another (i.e., the indemnitee) when a third party asserts a claim against the indemnitee and the claim falls within the scope of the indemnity clause. By and large, the protection is of two forms. First, the indemnitor must pay the third party's claim on behalf of the indemnitee, assuming the covered claim is meritorious. Second, even if the covered claim is not meritorious, the indemnitor may be required to defend the indemnitee in any litigation filed by the third party. If the indemnitor fails to provide a defense, the indemnitor may be forced to reimburse the indemnitee for its attorney's fees and other litigation costs in defending the claim. Often times, the defense obligation is more costly than the indemnity obligation.

Traditionally, the law allowed the parties to a contract a substantial amount of freedom to negotiate the allocation of risks between them. However, within the past several years, California has enacted several laws that significantly limit the ability of the party with the superior bargaining position (normally, the owner vis-à-vis the contractor, architect or engineer, or the contractor vis-à-vis its subcontractors) to require the indemnitor to agree to an indemnity clause that unduly favors the indemnitee.

Just this past year, California enacted a new statute—commonly referred to as SB 474—that provides further limitations on indemnity clauses in construction contracts. This paper provides a summary of the indemnity limitations included within SB 474, and it concludes with an overview of the statutory framework now existing in California concerning indemnity clauses affecting the construction industry.

II. Senate Bill 474

Senate Bill 474 is California's latest intervention in the parties' ability to freely negotiate indemnity clauses in prime contracts and subcontracts. Underlying the new legislation, which generally becomes effective for contracts entered into after January 1, 2013, is the Legislature's finding that "it is in the best interests of [California] and its citizens and consumers to ensure that every construction business in the state is responsible for losses that it, as a business, may cause." The primary sponsors of the legislation were subcontractor trade associations. They argued that "emerging and small businesses simply cannot grow or survive in an environment where they are required to pay for the accidents and mistakes created by other larger companies. Additionally, these contract provisions are leading to a decline in jobsite safety. … Without liability reform legislation for commercial and industrial construction contracts, [general contractors, who have the overall responsibility to keep construction jobsites safe], lack incentive to ensure that all safety measures are in place and enforced because they are not financially responsible for any accidents."

SB 474 accomplishes three major results in regards to hold harmless clauses. First, subcontractors can no longer be required to hold a general contractor, owner, or construction manager harmless from the indemnitee's active negligence. (Civil Code Section 2782.05(a).) Generally, "active negligence" occurs when the party either actively participates in the negligent act or fails to fulfill a specific statutory or contractual duty. By comparison, "passive negligence" generally occurs when a party unreasonably fails to act and such failure is one of the causes of the loss at issue.

Second, for public works contracts, SB 474 expands the current prohibition against a public agency shifting its liability for the agency's active negligence. Now, under SB 474, subcontractors and suppliers of goods or services are treated identically to the prime contractor. Civil Code Section 2782 has been amended to provide that a public agency cannot hold a contractor, subcontractor or supplier responsible for the agency's active negligence. (Civil Code Section 2782(b)(2).) Therefore, with the new legislation, a public agency cannot require a general contractor, a subcontractor, or supplier to indemnify the public agency for the agency's active negligence.

Third, for most private projects, SB 474 similarly prohibits an owner from shifting its liability for its active negligence. In other words, private owners are now treated similarly to public agencies for public work projects: the private owner cannot require a contractor, subcontractor, or supplier of goods or services to be responsible for the active negligence of the private owner. (Civil Code Section 2782(c)(1).) This rule is subject to the following two exceptions. The first exception is that the new rule does not apply if the owner is acting as the prime contractor. And the second exception is that, for home improvements for an owner's single-family dwelling, the owner can require the contractor, subcontractors, and suppliers to protect the owner from its active negligence.

III. California's Statutory Framework Regarding Hold Harmless Clauses

The following provisions summarize California's various indemnity limitations that apply for different types of construction projects. Note that the cited statutory sections have different effective dates, depending on when the contract was entered into. One should consult with his or her legal advisor for these particulars.

A. Public Works

For public works, the relevant statutory provisions are Civil Code Sections 2782, 2782.05, and 2782.8.

From a public works owner's standpoint, in its contract with the prime contractor, the maximum indemnity protection is that the owner can be protected from claims of passive negligence, as well as claims where the owner was not at fault. The owner cannot seek indemnity from the prime for the owner's sole negligence or willful misconduct or for furnishing a design with defects. (Civil Code Section 2782(a).)

Also, as discussed above with regard to SB 474, the public works owner cannot impose on the prime contractor or its subcontractors and suppliers any liability for the owner's active negligence. (Civil Code Section 2782(b).)

A public works owner also cannot seek indemnity from a design professional unless the design professional is guilty of negligence, recklessness or willful misconduct. (Civil Code Section 2782.8.) It is immaterial as to whether the owner is actively or passively negligent or is guilty of willful misconduct. A design professional has no obligation to indemnify a public works owner unless the design professional is at fault.

With regard to a subcontract between the prime and its subcontractors, the prime is not allowed to require the subcontractor to either insure or indemnify the prime for the prime's active negligence or willful misconduct or for furnishing a design with defects. (Civil Code Section 2782.05(a).) Similarly, an indemnity clause contained in a subcontract is not enforceable to the extent the prime is guilty of sole negligence. (Civil Code Section 2782(a).)

B. Private Works

1. Home Improvements to Single Family Home

If an owner is conducting a home improvement at his house, the owner cannot seek indemnity from the prime for the owner's sole negligence or willful misconduct or for furnishing a design with defects. (Civil Code Section 2782(a).) However, the owner can obtain indemnity from the prime, its subcontractors and suppliers even if the owner is actively negligent, since SB 474 does not apply to homeowners performing their own home improvement projects. (Civil Code Sections 2782(c)(3).)

There are no statutory restrictions on the owner's right to seek indemnity from a design professional with regard to a home improvement project.

For home improvement projects, the prime is not allowed to require the subcontractor to either insure or indemnify the prime for the prime's active negligence or willful misconduct or for furnishing a design with defects. (Civil Code Section 2782.05(a).) Similarly, an indemnity clause contained in a subcontract is not enforceable for a home remodel project to the extent the prime is guilty of sole negligence. (Civil Code Section 2782(a).)

2. For Sale Single Family Homes

There are special rules that apply to construction defects relating to single family home projects that are intended for sale. An owner cannot seek indemnity from either the prime or the subcontractors for any defects in the design or for the owner's sole negligence or willful misconduct. (Civil Code Section 2782(a) and 2782(d).) Additionally, the owner cannot impose liability on the prime, its subcontractors and suppliers for the owner's active negligence (Civil Code Section 2782(c).)

There are no statutory restrictions on the owner's right to seek indemnity from a design professional with regard to a project involving the construction of for sale single family homes.

Subcontractors, for this type of project, cannot be required to either insure or indemnify the prime contractors for any type of prime contractor negligence, whether active or passive. (Civil Code Section 2782(d).) This prohibition also

applies for the prime's furnishing the subcontractor with a design containing defects. (Civil Code Section 2782(d).)

3. Other Private Projects

For commercial projects and residential projects not discussed above (e.g., apartment projects), the owner cannot obtain indemnity from the prime for the owner's sole negligence or willful misconduct or for furnishing a design with defects. (Civil Code Section 2782(a).) It also cannot impose liability on a prime, subcontractor or supplier for the owner's active negligence (Civil Code Section 2782(c).)

Regarding design professional agreements, there are no statutory restrictions on the owner's right to seek indemnity from a design professional with regard to projects that fall within this category (i.e., commercial projects or non for sale single-family home projects).

With regard to subcontracts between the prime and its subcontractors, the prime is not allowed to require the subcontractor to either insure or indemnify the prime for the prime's active negligence or willful misconduct or for furnishing a design with defects. (Civil Code Section 2782.05(a).) Similarly, an indemnity clause contained in a subcontract is not enforceable to the extent the prime is guilty of sole negligence. (Civil Code Section 2782(a).)

IV. Conclusion

SB 474 has created additional limitations on the enforceability of indemnity clauses affecting the construction industry. The limitations depend on whether the indemnitor is a prime contractor, subcontractor, supplier, or design professional. They are further dependent on whether the project involves a public work, a home remodel, a "for sale" single family home, or a commercial or other type of residential project. Consulting with your legal advisor is recommended before executing any contract that includes a hold harmless clause.

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