

Contents

Oklahoma Voids General Contractor's "own negligence" Provisions in General-Sub Contracts

Excess Insurance and the "Selective Tender" Rule—Illinois Appellate Court Addresses Issues of First Impression in Two Recent Opinions

Setting the Record Straight: A Solution to Undiscoverable Previous Construction Defect Claims

When is an Indemnity Agreement Not an Insured Contract? — Contractual Contribution and the Construction Contract Conundrum

May 14, 2007

I would like to welcome all DRI Construction Law Committee members to the first 2007 installment of The Critical Path. In this edition, we have case notes from `xml:namespace prefix = st1 ns = "urn:schemas-microsoft-com:office:smarttags" />`Illinois and a legislative update from Oklahoma. We also have two articles which I believe you will find both useful and informative.

As many of you know, the August edition of For the Defense will feature the Construction Law Committee. The issue will be published just in time for the annual meeting of the Construction Law Committee on September 6 – 7, 2007 in Scottsdale, Arizona. Sean Martin is the editor for this project. Sean can be reached at sean.martin@leitnerfirm.com.

Also, the deadline for submission of materials for publication in the next edition of The Critical Path is June 8, 2007. Articles, case notes, and legislative updates for the next edition should be submitted to me at mhaynes@tillerlawgroup.com.

Once again, thanks to all our contributors to the first 2007 edition of The Critical Path. I hope you enjoy the edition.

J. Matthew Haynes, Jr.

Editor, The Critical Path

C. William Daniels, Jr.
Committee Chair, Program Co-Chair
cwd@bowronlatta.com

Chris E. Ryman
Committee Vice-Chair
cryman@coatsrose.com

May 14, 2007

Oklahoma Voids General Contractor's "own negligence" Provisions in General-Sub Contracts

Recently, the Oklahoma Legislature passed legislation that greatly affects contractual agreements between general contractors and subcontractors. OKLA. STAT. TIT. 12, § 221, which became effective November 1, 2006, states that any provision in a construction agreement that requires an entity to indemnify, insure, defend or hold harmless another entity for any liability arising out of the negligence or fault of the indemnitee (or its agents or subcontractors) is void and unenforceable as against public policy. This means that a construction contractor may no longer require a subcontractor to agree to indemnify and hold harmless the contractor for the contractor's own negligence. Numerous other jurisdictions, such as Ohio, Illinois, and New York, among others, have had similar statutes on the books for quite some time. However, Oklahoma did not, and prior to the enacting of this statute, contractors were free to include such language in their agreements, so long as they met certain requirements—and most construction contracts did contain such language.

Oklahoma case law has long recognized that exculpatory contracts may be valid and enforceable, so long as certain requirements were met:

- (1) the intent to exclude a party for its own negligence is expressed in clear, definite and unambiguous language;
- (2) the agreement is made at arm's length with no vast disparity of bargaining power between the parties; and
- (3) the exculpation is not contrary to statute or public policy.

It should be noted that Part C of section 221 does provide that agreements to indemnify for the subcontractor's own negligence are not affected by the statute, but the indemnification may not exceed the percentage of negligence or fault attributable to that subcontractor. Further, Part D of the statute provides that it does not apply to construction bonds or contract clauses requiring an entity to purchase a project-specific insurance policy, project management protective liability insurance, or builder's risk insurance.

One additional note is that, while the statute does not specify that it would apply retroactively, it is likely that it will have a retroactive effect. While there is not yet any case law construing the statute, section 221 does not limit itself to contracts entered into (or renewed) after the effective date of the statute. It is difficult to conceive of an Oklahoma court ruling that a "contractor's own negligence" exculpatory clause is enforceable after November 1, 2006, even if the contract was signed prior to that date. Otherwise, such clauses could conceivably be valid in perpetuity in certain situations—such as where a contract may be automatically renewed yearly or perhaps a contract with a thirty-year term. Therefore, this statute should be treated as if it invalidates all such provisions as of November 1, 2006—because in all likelihood, it does.

With the enactment of Okla. Stat. tit. 15, § 221, therefore, it would be advisable to contact any clients who do work in Oklahoma, have contracts with Oklahoma companies or individuals, or plan to do work in Oklahoma in the future. Any existing contracts will need to be examined for "contractor's own negligence" clauses, or broader provisions that would potentially include the contractor's own negligence. Oklahoma has now joined a number of other jurisdictions in prohibiting these provisions, and will be necessary to inform your affected clients of this fact so that they can plan accordingly.

May 14, 2007

Excess Insurance and the "Selective Tender" Rule—Illinois Appellate Court Addresses Issues of First Impression in Two Recent Opinions

In virtually all construction settings, the general contractor or other higher level contractors maintain their own general liability insurance and are also named as additional insureds on subcontractors' policies. This creates a situation where a defendant in an action brought by a third party may be insured by two or more carriers who may be obligated to respond to the loss. xml:namespace prefix = st1 ns = "urn:schemas-microsoft-com:office:smarttags" /> Illinois courts have adopted the selective, or "target," tender rule, which allows an entity insured under two or more policies to select which carrier it wishes to respond to the loss. *John Burns Construction Co. v. Indiana Ins. Co.*, 189 Ill.2d 570, 727 N.E.2d 211 (2000).

The Illinois First District Court of Appeals recently decided two cases addressing issues of first impression with respect to application of the selective tender rule. In *Kajima Construction Services, Inc. v. St. Paul Fire and Marine Ins. Co.*, 856 N.E.2d 452 (1st Dist. 2006), the appellate court held that a general contractor's selective tender did not extend to excess insurance provided by the subcontractor's carrier, finding that the general contractor's own primary insurance must first be exhausted under the doctrine of horizontal exhaustion. In *The North River Ins. Co. v. Grinnell Mutual Reinsurance Co.*, 2006 Ill. App. LEXIS 1128 (Ill. App. 1st Dist. December 8, 2006), the appellate court addressed a situation where all concurrent primary policies had been exhausted. In that case, the court held that an insured may "target tender" an excess carrier.

A. The Selective Tender Rule Does Not Supersede the Horizontal Exhaustion Doctrine
"urn:schemas-microsoft-com:office:office" />

Kajima Construction Services, Inc. v. St. Paul Fire and Marine Ins. Co., 856 N.E.2d 452 (1st Dist. 2006).

Kajima Construction Services, Inc. ("Kajima") entered into a subcontract with Midwestern Steel Fabricators, Inc. ("Midwestern") requiring that Midwestern obtain general liability coverage with \$1 million primary coverage and \$5 million umbrella coverage. The subcontract also required that Midwestern name Kajima as an additional insured on Midwestern's insurance policies. In accordance with the subcontract, Midwestern obtained a \$2 million primary policy and a \$5 million umbrella policy from St. Paul Fire and Marine Ins. Co. ("St. Paul"). Kajima maintained its own general liability coverage with Tokio Marine and Fire Ins. Co. ("Tokio").

During the construction project, an employee of Midwestern's subcontractor was seriously injured. The employee subsequently filed a personal injury lawsuit against Kajima and Midwestern, alleging that his injuries were caused by their negligence. Following receipt of the lawsuit, Kajima made a "targeted tender" to Midwestern and St. Paul, requesting a defense and indemnity to the personal injury lawsuit. St. Paul agreed to defend Kajima under a reservation of rights. During the trial of the personal injury action, the parties settled the case for \$3 million, with St. Paul paying its primary limit of \$2 million and Tokio paying its primary limit of \$1 million. St. Paul had previously refused Kajima's request that it pay the entire \$3 million settlement.

Kajima and Tokio subsequently filed a declaratory judgment action against St. Paul seeking reimbursement of Tokio's contribution to the settlement. Kajima and Tokio asserted that Tokio was not obligated to contribute any amounts to the settlement because of Kajima's targeted tender to St. Paul. In response, St. Paul argued that Illinois law required that all primary policies be exhausted prior to reaching any excess policies. The circuit court agreed with St. Paul and entered summary judgment in its favor. Kajima and Tokio appealed.

On appeal, Kajima and Tokio contended that the selective tender rule supersedes the "horizontal exhaustion" doctrine argument advanced by St. Paul. Under this doctrine, an insured covered under multiple primary and excess policies is required to exhaust all primary policies (including uninsured and self insured periods) before invoking any excess policies. *Illinois Emcasco Ins. Co. v. Continental Casualty Co.*, 139 Ill.App.3d 130, 487 N.E.2d 110 (1st Dist. 1985). In contrast, vertical exhaustion allows an insured to seek coverage from an excess carrier so long as any primary policies immediately beneath the excess policies have been exhausted, regardless of whether other primary policies may apply. *United States Gypsum Co. v. Admiral Ins. Co.*, 268 Ill.App.3d 598, 643 N.E.2d 1226 (1994). Vertical exhaustion is not favored by Illinois courts.

Kajima asserted that it exercised its right to selectively tender the defense and indemnity to St. Paul. Accordingly, Kajima and Tokio argued that St. Paul alone must respond to the claim and exhaust both its primary and excess policies before Tokio's primary policy was implicated (vertical exhaustion). In contrast, St. Paul contended that, while the selective tender rule is recognized by Illinois courts, it applies only to concurrent primary policies, and not to successive primary or excess policies where additional primary coverage is available (horizontal exhaustion).

In its analysis, the appellate court noted that Kajima and Tokio cited no authority to support their assertion that an excess policy could be activated by a selective tender prior to exhausting all primary coverage. In addition, the court emphasized the difference between primary and excess policies (intentions of the contracting parties, premiums paid, conditions to coverage), noting that the general rule in Illinois is that, with certain exceptions, excess coverage cannot be activated until all underlying primary coverage is exhausted. The court declined to apply vertical exhaustion in this case, finding that the selective tender rule should be applied only to circumstances where concurrent coverage exists for additional insureds. Accordingly, to the extent that defense or indemnity costs exceed the primary limits of the selected insurer, the deselected insurer or insurers' primary policies must respond to the loss before invoking coverage under an excess policy. (On January 24, 2007, the Illinois Supreme Court granted a petition for leave to appeal this case).

B. An Insured May Use Selective Tender Rule and Direct Excess Insurer To Pay Indemnity So Long As All Underlying Primary Insurance Exhausted

The North River Ins. Co. v. Grinnell Mutual Reinsurance Co., 2006 Ill. App. LEXIS 1128 (Ill.App. 1st Dist. December 8, 2006).

In this case, Kajima, the general contractor, entered into a subcontract with Shelco Steel Works, Inc. ("Shelco") for a construction project. Shelco, in turn, subcontracted with American Miscellaneous Steel, Inc. ("AMS"). During the project, one of AMS' employees sustained injuries when he was hit by an iron bar joist. The employee filed suit against Kajima, Shelco and others, alleging his injuries resulted from their negligence.

Kajima maintained a \$1 million in primary and \$2 million excess coverage with Tokio. Shelco was covered by a \$1 million primary policy issued by North River Insurance Company ("North River") and a \$2 million excess policy issued by United States Fire Insurance Company ("U.S. Fire"). AMS was covered by a \$1 million primary policy and \$2 million umbrella policy issued by Grinnell Mutual Reinsurance Company ("Grinnell"). Kajima was an additional insured on the Shelco and AMS policies.

After receipt of notice of the personal injury lawsuit, Kajima tendered its defense and indemnity to North River and Grinnell. Both ultimately accepted the tender and shared the costs of Kajima's defense. As the lawsuit proceeded, it became apparent that the lawsuit would exceed the combined limits of the primary policies issued by North River and Grinnell. Consequently, North River asked Tokio to contribute \$500,000 towards a settlement package. Tokio refused. The lawsuit settled for \$4 million during trial, with North River and Grinnell contributing their \$1 million primary policies, and U.S. Fire contributing \$2 million from Shelco's excess policy. Tokio did not contribute to the settlement.

U.S. Fire subsequently sought declaratory relief against Tokio alleging that Tokio was obligated to exhaust its primary policy before U.S. Fire was obligated to contribute on Kajima's behalf. In response, Tokio argued that it was not obligated to contribute to the settlement because its policy was not "available," given Kajima's selective tender to Shelco, AMS and their respective insurers, including U.S. Fire. Like St. Paul in *Kajima Construction Services, Inc. v. St. Paul Fire and Marine Ins. Co.*, 856 N.E.2d 452 (1st Dist. 2006), U.S. Fire contended that it

was not obligated to contribute until all primary policies had been exhausted. U.S. Fire also argued that Kajima and AMS's excess insurers were also obligated to equally contribute to the loss at an excess level due to the policies' mutually repugnant "other insurance" clauses.

The trial court granted summary judgment in favor of U.S. Fire and against Tokio with respect to U.S. Fire's claim that the horizontal exhaustion doctrine exempts the selective tender rule. The trial court also ruled that the selective tender rule applies to multiple excess policies, and because Kajima selectively tendered its defense and indemnity to its subcontractors' insurers, Tokio's excess policy was not available for indemnity until the targeted insurers exhausted their policy limits. Tokio appealed and U.S. Fire cross-appealed the judgment of the trial court.

Based on its ruling in the *Kajima* case discussed above, the appellate court reiterated that the selective tender rule does not entitle an insured to vertically exhaust consecutive insurance policies. Deselected primary insurers must answer for a loss before an excess insurance policy is activated. Thus, the appellate court found that Tokio should have contributed its primary policy towards the settlement before any excess policy.

The appellate court addressed the issue of whether the selective tender rule applies to excess insurers, assuming all underlying insurance is exhausted, in U.S. Fire's cross-appeal. U.S. Fire sought equitable contribution from Grinnell and Tokio's excess policies in its declaratory judgment action (Grinnell settled with U.S. Fire for \$500,000, which was paid out of the excess policy). The appellate court held that once an insured has exhausted its concurrent primary insurance coverage, it may selectively tender its indemnity to concurrent excess carriers.

In reviewing the extensive body of case law discussing the insured's "right" to select one insurer, to the exclusion of all other insurers, the appellate court noted that nothing in those cases limited the right only to primary carriers. Central to the appellate court's reasoning, is the fact that the selective tender rule may be applied only to concurrent, and not consecutive, policies. Accordingly, the appellate court maintained the distinction between primary and excess policies, which was of paramount concern in the *Kajima* opinion. Similarly, the appellate court found that the fact that an excess policy contained an "other insurance" clause did not preempt the selective tender rule. The appellate court explained that the purpose of an "other insurance" clause is to apportion liability between properly triggered concurrent policies. The appellate court noted that whether the excess policies contained "other insurance" clause was irrelevant because the deselected policy was never "triggered." Thus, U.S. Fire could not seek contribution from Tokio's excess layer.

Scott D. Braun is special counsel with Sedgwick, Detert, Moran & Arnold, LLP, in Chicago, Illinois and a member of DRI. Mr. Braun's insurance coverage practice includes the nationwide management and oversight of professional liability lawsuits. In addition, Mr. Braun has successfully defended contractors and manufacturers in complex construction and products liability cases involving catastrophically injured plaintiffs. Mr. Braun has also represented general contractors, owners and architects in claims arising out of the construction process.

May 14, 2007

Setting the Record Straight: A Solution to Undiscoverable Previous Construction Defect Claims

Developers and general contractors in California are finding themselves in the unenviable position of defending themselves against construction defect claims for which releases have been previously executed, sometimes years before. Should the California Legislature allow settlement agreements or notices of claim to be recorded against a property, not only will the time and expense of defending against these meritless claims be prevented, it will circumvent the problems of sellers' inadequate disclosure in the first place. California home buyers are discovering the existence of defects and prior defect litigation involving their homes that the sellers failed to disclose.

As California courts have sagely noted, "[c]onstruction defect litigation seems as common as crabgrass. . . ." *Padgett v. Phariss*, 54 Cal. App. 4th 1270, 1275 (1997). The proliferation of construction defect suits has given rise to an equally large number of issues peculiar to construction law requiring the attention of the California legislature. As early as 1971, the legislature recognized the need to "protect contractors and other professionals and tradespeople in the construction industry from perpetual exposure to liability for their work," *Sandy v. Superior Court*, 201 Cal. App. 3d 1277, 1285 (1988), and accordingly enacted a ten year statute of limitations on construction defect claims with the Code of Civil Procedure § 337.15. The statute reflected the legislature's concern that "expanding concepts of liability could imperil the construction industry unless a statute of limitations was enacted." *Id.*

Today, a newer threat to the construction industry is rearing its head within the ten year statute of limitations. With the relatively quick dispatch of defect claims within the first five years after the completion of construction, initial homeowners are selling homes to subsequent purchasers with plenty of time still remaining in the statute of limitations. When subsequent purchasers have not received notice of the previous litigation and/or settlements involving their homes, they are often quick to initiate suits regarding claims identical to those of their predecessors. Unaware of the existence of a release of these claims, the subsequent homeowners are bringing duplicative and meritless suits requiring developers to face the formidable task of determining whether the home has been involved in litigation, and, if so, the result. The resulting inefficiency and waste of resources in processing these claims requires legislative attention once again.

Mum's The Wordxml:namespace prefix = o ns = "urn:schemas-microsoft-com:office:office" />

The following scenario is all too common in the construction litigation morass of California: a developer completes construction of a

residential project containing dozens, or even hundreds, of homes. In the active California real estate market, these homes are quickly purchased by eager homebuyers. During the first two years of ownership the homeowners are approached by the plaintiff bar in ever increasing "door-to-door" solicitations of new developments. The homeowners join other property owners within the development in bringing suit against the developer contractor for any alleged construction defects in the home. Primarily, these suits are settled out of court in exchange for a release of claims executed by the homeowners for the benefit of the developer, general contractor and subcontractors. While the homeowners insist they will use the settlement amount to repair the defects, very often they do not. Instead, they use the settlement money for something else and live with the defects. After four or five years have elapsed from the time of purchase, the homeowners are ready to sell and move elsewhere. That is when the subsequent buyers come in.

Although homeowners are responsible for disclosing construction defects or lawsuits involving their home to subsequent buyers pursuant to Civil Code § 1102, too often they simply do not. As a result, when the subsequent purchasers discover the pre-existing defects, they are unaware that a settlement or litigation has already occurred involving the very same defects. They are equally unaware that a release of claims has been executed by the former homeowners regarding the defects. Therefore, when a plaintiffs' firm begins the door-to-door solicitation process through the development anew, and within the statute of limitations, the subsequent purchasers are quick to join suit against the developer because they are unaware their only legitimate cause of action lies against the former homeowners for failure to disclose.

Where is the Waiver ?

It is in the best interest of developers to create and maintain accurate records regarding their properties involved in defect litigation. However, this is a time consuming process that is generally only seen by larger self-insured developers. Because they are self-insured, they bear the risk and expenses associated with the possibility of defending repeat claims. Generally, smaller development companies who insure through independent insurers do not share the same concerns. Since their interests are guarded by insurance companies, smaller developers do not have the same incentive to maintain expensive systems of detailed and accurate records of litigation involving properties they have sold.

However, by allowing developers to record settlement agreements or notices of claims regarding a construction defect on a particular home, the problem is solved. Not only can developers, general contractors, subcontractors and their respective insurance carriers gain access to this valuable information quickly and inexpensively, but potential subsequent buyers can learn about litigation or defects affecting a home that the sellers may not disclose.

Current State of California Recording Laws

"A county recorder is obligated to accept for recordation only those documents which are 'authorized or required by law to be recorded.'" *Ward v. Superior Court*, 55 Cal. App. 4th 60, 64 (1997) (quoting Cal. Gov. Code § 27201 et seq. (2006)). Under current California law, "any instrument or judgment affecting the title to or possession of real property may be recorded." Cal. Gov. Code § 27280 (a) (2006). "The term 'instrument' as used in the Government Code § 27280 is defined in § 27279 (a), as 'a written paper signed by a person or persons transferring the title to, or giving a lien on real property, or giving a right to a debt or duty.'" *Ward v. Superior Court*, 55 Cal. App. 4th 60, 64 (1997) (quoting Cal. Gov. Code § 27279(a)(2006)). Therefore, three categories of instruments may be recorded: those that 1) transfer title, 2) give a lien, or 3) give a right or duty. See *Ward v. Superior Court*, 55 Cal. App. 4th 60, 64 (1997).

Neither settlement agreements nor notices of claim currently qualify as instruments or judgments affecting title or possession of real property. Settlement agreements and notices of claim addressing construction defects in a residence are not judgments rendered by a court. Notices of claim are simply documents giving notice of pending construction defect claims against a particular property. Settlement agreements are documents outlining a waiver of future claims against the developer for the defects at issue in return for the agreed upon settlement amount. As such, neither type of document has the effect of transferring title to the property at issue, granting a lien, or giving a right or duty with regard to the property. Therefore, neither settlement agreements or notices of claim in construction defect cases are currently recordable under California law.

However, the California legislature has created special provisions for recording other documents that do not meet the criteria listed above in order to limit liability and exposure to litigation of developers and general contractors. For instance, California Civil Code § 3235 allows a general contractor to file an original contract for a private work of improvement in the office of the county recorder. Cal. Civ. Code § 3235 (2006). By recording the contract and a bond that inures to the benefit of the lien claimants before construction commences, the general contractor is able to cap the amount of recovery under a mechanics' lien to the amount of the contract.

The legislature enacted the provision in order to provide a means of limiting the amount of recovery under mechanics' liens on a property. See *Patten-Blinn Lumber Co. v. Francis*, 166 Cal. App. 2d 196, 203 (1958). While recordable under the provision, the contract itself is not a judgment or instrument affecting title to or possession of real property. However, the mechanic's liens that the contract contemplates would be considered such instruments. Another example of the Legislature's decision to broaden the range of instruments that may be recorded in order to protect a developer's interest is found in California Civil Code § 3093. Cal. Civ. Code § 3093 (2006). This provision allows a notice of completion to be filed within ten days after work on a project is complete in order to trigger both a thirty-day time limit in which to file a mechanics' lien and the ten year statute of limitations on construction defect actions. *Id.* So long as the owner records a timely notice, he is able to obtain the benefit of a shorter lien filing period, even though there is no general statutory requirement for the filing of notices of completion. *Id.*

Again, a notice of completion is not an instrument affecting title to or possession of real property. Rather, it is simply a document the legislature deemed recordable in order to shorten the time for filing of mechanics' liens and commencing the running of the

statute of limitations, thereby limiting both the liability and exposure to litigation of the developer.

Circumstances Require Extension of Recording Policy

Current circumstances, including the abundance of suits resurrecting previously settled claims, require the legislature to extend the recording policy to allow settlement agreements or notices of claim in construction defect cases to be recorded. Such a move would be in keeping with the policies behind allowing other types of instruments to be recorded, such as those instruments contemplated by Civil Code §§ 3235 and 3093. By allowing settlement agreements or notices of claim in construction defect cases to be recorded, the legislature would be furthering policies it has recognized to be important: the limitation of a developer's liability and exposure to litigation, and the streamlining of claims within the ten year statute of limitations for construction defect cases. The recorded settlement agreement will protect the developer/contractor from multiple construction defect actions relating to the same defects in the same residence.

In addition, providing for such an extension will not be unfairly adverse to the homeowners who have executed the recorded settlement agreements. A recorded settlement agreement will not limit transferability or cloud title to the property. It will simply serve the important purpose of providing notice that the home was involved in prior litigation—notice the selling homeowner is already required to give by law. Allowing settlement agreements or notices of claim in construction defect suits to be recorded is a logical extension of the stated legislative intent to "protect contractors and other professionals and tradespeople in the construction industry from perpetual exposure to liability for their work." *Padgett v. Phariss*, 54 Cal. App. 4th 1270, 1275 (1997).

May 15, 2007

When is an Indemnity Agreement Not an Insured Contract? — Contractual Contribution and the Construction Contract Conundrum

Indemnity agreements are common in construction contracts, and typically take one of three basic forms: (1) those that obligate a contractor to indemnify another only for its own negligence; (2) those that obligate a contractor to indemnify another for all liability except for the other's sole negligence; and (3) those that obligate a contractor to indemnify another for all liabilities, including for its own negligence.

Many jurisdictions regulate indemnification agreements in construction contracts with anti-indemnity statutes, which render unenforceable those agreements that require indemnification for a contractor's own negligence. Under anti-indemnity statutes, only contracts which obligate a contractor to indemnify another for its own negligence are enforceable. In effect, the statutes render indemnification agreements in construction contracts mutual or reciprocal, since neither party can be compelled to indemnify another for the other's negligent acts. A typical agreement for "partial indemnity" might provide:

"To the fullest extent permitted by law, the subcontractor shall indemnify and hold harmless the owner and contractor from and against any claims, damages, losses, and expenses, including but not limited to attorney's fees, arising out of or resulting from performance of the subcontractor's work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death or to injury to or destruction of tangible property, which is caused in whole or in part by negligent acts or omissions of the subcontractor, the subcontractor's subcontractors, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, loss, or expense is caused in part by a party indemnified hereunder."

In addition, workers' compensation laws prohibit employees from suing their employers directly for workplace injuries, and grant some form of limited immunity from third party claims for contribution by owners and general contractors. Statutes and judicially-created doctrines often permit limited recovery by owners and contractors against employers in the form of third party actions for contractual indemnification, "partial indemnification," and other forms of relief. In New York, for example, third party claims against employers are limited to claims for contractual indemnification, unless the employee has sustained a grave injury, in which case claims against employers for contribution are permitted. Nevertheless, courts have enforced contractual provisions that restore rights of contribution, often characterized as claims for "partial indemnification."

The interplay between anti-indemnity statutes and workers' compensation immunities raise questions about the scope of coverage under the "insured contract" provisions of standard general liability policies for claims for workplace injuries premised upon indemnity provisions in construction contracts. Commercial general liability policies typically exclude coverage for employer's liability and indemnification claims unless the liability is assumed by an insured in an "insured contract," a term that is usually defined as including, among other agreements:

"That part of any other contract or agreement pertaining to your business ... under which you assume the tort liability of another party to pay for 'bodily injury' or 'property damage' to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement."

See standard general liability policy promulgated by Insurance Organizations, Inc.

Two recent decisions, *Lubrizol Corp. v. Nat'l Union Fire Ins. Co.*, 2006 WL 2986396, No. 05-3280 (6th Cir. (Ohio) Oct. 17, 2006) and *Virginia Sur. Co., Inc. v. Northern Ins. Co. of New York*, ___ N.E.2d ___, 2007 WL 121161, No. 102036 (Ill. Jan. 19, 2007), warrant close examination of the scope of coverage available for third party claims for "partial indemnity" in workplace injury suits where anti-indemnity

statutes and employer immunities are at play.

In *Lubrizol Corp.*, an insured entered into an equipment purchase agreement with Valvoline, pursuant to which the insured's employees were required to replace used equipment on Valvoline's premises. The contract contained a mutual indemnity agreement, in which the parties agreed to indemnify one another for claims by their respective employees arising from injuries suffered while work was performed. The insured's employee was injured while working at the site, and filed a workers' compensation claim against the insured, and a negligence claim against Valvoline. Pursuant to the indemnity agreement, Valvoline tendered the claim to the insured, and the insured informed its umbrella carrier of the suit. The carrier declined coverage for the claim, which was then settled with the plaintiff.

In the declaratory judgment action that ensued, the court first considered whether the indemnity agreement was enforceable under Ohio law, concluding it was not because it did not contain an express statement waiving the insured-employer's immunity from workplace injury suits. Next, the court considered whether the indemnity agreement, had it been enforceable, would have been covered by the policy. The court concluded that the indemnity agreement was not an "insured contract," and, therefore, would not have been covered by the policy. The court reasoned that an "insured contract" was one in which the insured "assumes the tort liability of another party to pay for bodily injury ... to a third person or organization." Because the insured was required to indemnify Valvoline only for damages resulting from the insured's own negligence, and, in cases of joint negligence, each party would be responsible for its allocable share, the indemnity agreement did not require the insured's assumption of Valvoline's liability. Consequently, the claim was not covered by the insured's general liability policy.

Similar reasoning was employed by the Illinois Supreme Court in *Virginia Sur. Co., Inc.* There, an insured-subcontractor's employee was injured while working at a construction site. Like in *Lubrizol Corp.*, the insured worker filed a workers' compensation claim against the insured, and a negligence claim against the general contractor. The general contractor then filed a third party action for contribution against the insured subcontractor. The subcontractor tendered the third party claim to its Workers' Compensation and Employer's Liability carrier, Virginia Surety, which accepted the tender. The subcontractor also tendered the claim to its general liability carrier, Northern, who denied coverage for the claim. Virginia Surety then commenced a declaratory judgment action seeking defense and indemnity from Northern.

Resolving conflicting decisions in the state's appellate districts (see *Hankins v. Pekin Ins. Co.*, 305 Ill.App.3d 1088 (5th Dist.1999); *West Bend Mut. Ins. Co. v. Mulligan Masonry Co.*, 786 N.E.2d 1078 (2nd Dist. 2003); *Michael Nichols, Inc. v. Royal Ins. Co. of America*, 748 N.E.2d 786 (2nd Dist. 2001), and *Christy-Foltz, Inc. v. Safety Mut. Ins. Cas. Corp.*, 722 N.E.2d 1206 (4th Dist. 2000)), the Illinois Supreme Court held that, under the plain language of Northern's general liability policy, the agreement between the general contractor and subcontractor could not have been an "insured contract" within the meaning of its general liability policy. The agreement required only that the subcontractor indemnify the general contractor for the subcontractor's own negligence.

The court reasoned that these agreements are not true indemnity agreements, in that the subcontractor has not assumed the general contractor's tort liability. Instead, they seek only to enforce a right of contribution. While labeled an indemnity agreement, the court concluded "the effect of the provision is nothing more than a simple anticipatory waiver of an affirmative defense in a contribution action." In this regard, the court observed that both parties are liable at common law for their own negligence, and, while the employer enjoyed the option of limiting its common law liability by asserting immunity under the state's Workers' Compensation Act up to the amount it paid in workers compensation benefits, under Illinois law an employer may waive these protections. A waiver, however, does not shift liability as an indemnity agreement is intended to do. Instead, the employer chooses to remain liable by not asserting an affirmative defense. Thus, the agreement was not a true indemnification clause—it did not transfer liability from the indemnitor to the indemnitee. The court also rejected assertions that the employer "assumes" the joint and several liability of the non-employer sufficient to bring it within the definition of "insured contract." Joint and several liability is pre-existing and imposed by operation of law, not "assumed" by the insured through contract.

Other courts have considered this issue, with conflicting results. See, e.g., *Certain London Market Ins. Cos. v. Pennsylvania Nat'l Mut. Cas. Ins. Co.*, 106 Fed.Appx. 884 (5th Cir. (Miss.) 2004) (holding that contract between owner and contractor was not "insured contract" where state's anti-indemnity statute precluded contractor from assuming indemnity for owner's negligence); *Truck Ins. Exch. v. BRE Props., Inc.*, 81 P.3d 929 (Wash. Ct. App., Div. 1, 2003) (holding that subcontractor's agreement to indemnify contractor was "insured contract" under policy, notwithstanding state's anti-indemnity statute, and citing *West Bend Mut. Ins. Co. v. Mulligan Masonry Co.* (overruled by Virginia Surety)).

These cases beg two related questions—in states where anti-indemnity statutes have been enacted, can indemnification agreements in construction contracts ever qualify as "insured contracts" for which coverage is afforded under a general liability policy, and which policies are intended to cover these claims?

There are three common workplace injury scenarios under which this issue arises: (1) where the plaintiff is employed by a subcontractor from whom indemnification is sought by an owner or general contractor; (2) where the plaintiff is not so employed; and (3) where the subcontractor has agreed to indemnify the owner and general contractor for another contractor's or subcontractor's negligence.

Applying *Lubrizol* and *Virginia Surety* reasoning to the first and most common scenario, general liability policies would not afford coverage to subcontractors for their partial indemnification obligations, that is, obligations to reimburse owners and general contractors for the subcontractor's allocation of fault. Because such agreements, perhaps best described as "contractual contribution," would not constitute "insured contracts," the Employer's Liability exclusion typically found in general liability policies would bar coverage for these claims. While expressly excluded from a CGL policy, however, claims for "contractual contribution" might be covered under Workers' Compensation and Employer's Liability policies, which typically afford coverage for damages for which the insured is liable to a third party by reason of a claim against such third party as a result of injury to the insured's employee. The Employer's Liability coverage typically excludes "liability assumed under a contract;" however, under *Lubrizol* and *Virginia Surety*, claims for "partial indemnity" or "contractual contribution" would not necessarily qualify as assumed liabilities within the meaning of such exclusions.

Under the second scenario, coverage would be available under general liability policies for third party claims against subcontractors in the event the plaintiff was not an employee of the subcontractor. This is so because the Employer's Liability exclusion typically found in such policies would not apply, and because it would be unnecessary to rely upon the "insured contract" exception of the

Contractual Liability exclusion. The Contractual Liability exclusion is stated to apply in the first instance only to "bodily injury" claims for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. For the same reason that a "partial indemnity" agreement would not qualify as an "insured contract," it also would not come within the terms of the Contractual Liability exclusion.

Finally, the third scenario is unaffected by the *Lubrizol* and *Virginia Surety* analysis, as such agreements contemplate the insured's assumption of liability for the negligence of others, which would not violate anti-indemnity statutes, and, therefore, are true indemnification agreements.

Regardless of how they might be labeled, indemnification clauses in construction contracts should be examined closely to determine whether they truly effect a transfer or shifting of liability, such that they qualify as assumed liabilities within the contemplation of the "insured contract" provisions of general liability policies. This is especially important in jurisdictions with anti-indemnity statutes, in which attempts to transfer liability are not permitted. Indemnification clauses drafted to comply with anti-indemnity statutes often only preserve contribution rights, which might otherwise be limited by employer immunities under workers compensation laws. Under *Lubrizol* and *Virginia Surety*, such agreements do not represent an assumption of liability necessary to implicate the "insured contract" coverage of general liability policies, and coverage for such claims may be relegated to Workers' Compensation and Employer's Liability policies.

Kevin T. Merriman and Richard J. Cohen
Goldberg Segalla, LLC
Buffalo, New York
kmerriman@goldbergsegalla.com
rcohen@goldbergsegalla.com

June 01, 2007



Teleconference on Tuesday, June 26!xml:namespace prefix = o ns = "urn:schemas-microsoft-com:office:office" />

Discovery of Disaster Recovery, Legacy & Inaccessible Data

Presented by DRI's Electronic Discovery Committee: With the recent Federal Rules amendments, new attention is focused on electronic information that is "not reasonably accessible because of undue burden or cost," in the words of new Rule 26(b)(2)(b). Aggressive litigants are turning their attention to non-current media that are not within arm's reach, such as disaster recovery back-up tapes, ancient legacy data from obsolete computer systems, and even deleted or fragmentary data. All clients need advice on how to handle this entirely new discovery issue. This teleconference will recommend valuable pre-discovery data reduction strategies. It will also offer suggestions on how to best defend against unreasonable discovery requests and detail what resources are available to assist you when discovery becomes unavoidable. **To register, [click here](#), or call KRM Information Services atxml:namespace prefix = st1 ns = "urn:schemas-microsoft-com:office:smarttags" /> 800.775.7654.**

Published by DRI Happenings
Copyrights © DRI