

CALL OF DUTY TO DEFEND: Importance Of Indemnity Clause In Residential Construction Subcontracts

One of the most overlooked clauses in residential construction subcontracts is the indemnity clause. The clause is the primary method to shift the risk of loss for a third party claim from a homebuilder to the subcontractor who performs the work at issue. The clause typically provides that the subcontractor agrees to **defend** and **indemnify** the general contractor from loss, damage, suits, or claims arising out of the subcontractor's work.

While indemnity is important, it is the "duty to defend" that is of real significance. For example, assume that a homeowner sues their homebuilder for damages allegedly caused by a leaky roof. The homebuilder may have sold the house, but it did not install the roof. The homebuilder is being sued for the roofing subcontractor's allegedly defective work. The duty to defend requires the roofing subcontractor to defend the homebuilder from the suit - - whether or not the claim ultimately has merit. Absent this contractual obligation the homebuilder would have to defend the claim on its own and then later sue the subcontractor to try and recover the fees it incurred in defending the suit as well as for the money, if any, it had to pay the homeowner as a result of the leaky roof claim. The value of the duty to defend is clear; the homebuilder benefits if the subcontractor defends its own work rather than having to incur tens of thousands of dollars to defend the suit with the hope that the subcontractor will be able to reimburse it once the suit is over.

Standard Indemnity Agreements Do Not Require A Finding Of Fault

Most modern indemnity clauses are triggered by "claims" rather than "fault." This is significant. Older indemnity clauses provided that the subcontractor only had to defend and indemnify the homebuilder from loss caused by its "negligent acts" or "faulty work." The homebuilder would have to prove that the claims resulted from the subcontractor's

negligent or faulty work before the subcontractor was obligated to defend it. Only a finding of fault would trigger the defense obligation. The subcontractor could refuse to defend the homebuilder because there had been no finding that its work was negligent or faulty. If the claims were ultimately unsuccessful then the subcontractor would have no obligation to reimburse the homebuilder because its work was not found to be at fault. In that instance, the homebuilder would have to bear the entire cost of successfully defending the subcontractor's work. On the other hand, if the claims were found to have merit, the subcontractor would not only have to indemnify the homebuilder for the amount it was required to pay the homeowner for the claims, but also for the fees and costs incurred to defend the suit. In both situations, however, the homebuilder has to incur the costs of defense in the first instance.

Current indemnity clauses are drafted to avoid this situation and are "claim-based" rather than "fault-based." Typically, these clauses provide that the subcontractor agrees to defend and indemnify the homebuilder from claims and for loss "arising out of, resulting from, or related to" the subcontractors' work. It is the assertion of a claim -- not a finding of fault -- that triggers the defense obligation. The subcontractor owes a defense as soon as a claim arising from its work is made and without regard to whether the claim is ultimately found to have merit. For the subcontractor, failing to comply with this duty poses very real and significant risks.

Harsh Consequences For Failure To Comply

Oftentimes, claims can arise from the work of more than one trade. For example, a roof leak may arguably result from the allegedly deficient workmanship of the roofer or

the framer. Which trade has the obligation to defend the claim in that situation? The answer is both.

A recent Arizona Court of Appeals case demonstrates the unintended consequence of a subcontractor's failure to comply with its defense obligation in this situation. In the case of *Amberwood Development v. Swann's Grading*, Amberwood (the general contractor) was sued by 18 homeowners for various construction defect claims, including claims that arguably arose from Swann's as well as other trade's work. Amberwood ultimately settled the homeowners' claims for \$2,473,900.00. Amberwood had also asserted third party claims against each of the subcontractors whose work was implicated by the homeowners' claims. Amberwood settled with each of the subcontractors, except Swann's, for a total of \$479,400.00. Amberwood, who performed no work, was arguably out the difference (\$1,994,500), plus the fees it incurred in defending the homeowners' claims. A trial was held on the extent of indemnity Swann's owed Amberwood and the impact of Swann's failure to comply with its duty to defend Amberwood. At trial, Swann's attempted to defend whether its work was at fault and Amberwood objected.

The Court ruled that whether the claims were caused by Swann's defective work was irrelevant; what was relevant was whether the claims arose, *even partly*, out of Swann's work such that it should have defended Amberwood from the claims. Whether Swann's work was actually defective was never litigated. The Court then found that, since approximately 72% of the claims arose from Swann's work, it was obligated to indemnify Amberwood for 72% of the settlements paid to the homeowners minus the \$479,400.00 Amberwood recovered from the other subcontractors - - approximately \$1,300,000.

Swann's was also responsible for \$315,000.00 in fees and costs Amberwood incurred in defending the claims.

By failing to comply with its duty to defend Amberwood, Swann's was unable to defend its work or establish that the claimed damages resulted from the homeowners' actions or from some other subcontractor's work. Swann's was stuck with Amberwood's settlement. By agreeing to defend Amberwood, Swann's could have avoided this harsh outcome.

How does a subcontractor comply with this duty while maintaining the ability to defend itself from what it perceives are meritless claims? The subcontractor can do one of two things. First, it could hire separate counsel to defend the homebuilder from the claims arising from its work while maintaining its own counsel to defend the indemnity claim. Alternatively, and more typically, it could negotiate an agreement with the homebuilder where it agrees to pay a percentage of the homebuilder's own attorneys' fees and defense costs. By reaching an agreement early on both the homebuilder and subcontractor can agree to fairly share the risk of loss and more properly focus on their joint goal - - defending the defect claims in the first instance. Otherwise, the subcontractor is at risk for being responsible for all damages which arguably arise from its work without regard to whether those damages also arose from another cause as well.