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Construction Conjunction — How Does Indemnity Function?

Indemnity in Oregon and Washington

— *by* **Julie E. Dutton**

At a time when contractors are having a difficult time obtaining and maintaining liability insurance, it is no surprise that general contractors are looking for ways to pass their liability on to others, especially their subcontractors. The most common method of passing liability through to others is by bringing claims for indemnity. Indemnity is just another word for reimbursement. Indemnity claims can be based either on a written contract between the parties or they can be based in equity.

Because the terms of any written contract control the relationship between the parties, contractual indemnity will not be discussed in detail here. Suffice it to say that if a written contract containing an indemnity clause exists between a general contractor and its subcontractor, and a general contractor is forced to go to trial, a subcontractor who did not settle prior to trial, but who is found at fault for some or all of the plaintiff's damages, may also be required to indemnify the general contractor for some or all of its attorney fees incurred in litigating the claim. Accordingly, these contractual terms must be taken into account when evaluating a subcontractor's exposure and in determining a course of action at the outset of a claim against a subcontractor for indemnity.

Generally, a claim for equitable (implied) indemnity arises when a party can prove: (1) that he has performed a legal obligation owed to a third party; (2) that the defendant was also liable to the third party; and (3) that between the two, the obligation should have been performed by the defendant. The following is a brief analysis of when contractors in Oregon and Washington are entitled to indemnity from their subs. As with other aspects of construction defect cases, how equitable indemnity claims are treated will depend upon which side of the Columbia River you are standing on, as these claims are treated very differently in Oregon and Washington.

The Oregon Model:

First, in Oregon, building and homeowners may bring claims against contractors for negligent construction. Indemnity comes into play in the construction defect context when a general contractor who may only have been technically, or passively, negligent and at fault for damage to property has the right to shift the loss to a subcontractor who is primarily, or actively, at fault for the damage. While the character of a contractor's negligence, whether the contractor actively as opposed to passively caused damage to property, is a distinction that is often troubling, one way to explain it is that it is the difference between "actively" installing a building component as opposed to "passively" supervising the installation. (Please note that there are many other ways

for indemnity to arise between parties other than the general contractor/subcontractor relationship). If the component is installed incorrectly, both parties could be found negligent, but the passive supervisor may also be entitled to indemnity from the active installer. In fact, a finding that the passive supervisor was negligent is *necessary* in determining if it is entitled to indemnity from the subcontractor because an "indemnitee is not entitled to indemnity unless it is liable to the injured third party." Irwin Yacht Sales, Inc. v. Carver Boat Corp., 98 Or. App. 195, 198 (1989). Not only may the passive supervisor be entitled to indemnity for the amount it paid to settle the case (or the amount of a judgment awarded against it), but it may also be entitled to indemnity for the cost of defending the claim. Maurmann v. Del Morrow Construction, Inc., et al., 182 Or. App. 171, 174 (2002).

The Washington Model:

Washington follows the economic loss doctrine and simply does not recognize claims for negligent construction. Therefore, all claims arising out of the defective construction of a building must be based on the breach of a written or oral contract; but not all contracts give rise to implied contractual indemnity. Unless a written contract contains an indemnity clause, Washington courts will not interpret the contract to include one. However, in some cases, the nature of the relationship between the general contractor and its subcontractor could give rise to a right of indemnity. Express and implied warranties can create the type of relationship upon which a right to indemnity may be based. Express warranties may be relied upon by any party the defendant could expect would act upon representations made and, therefore, express warranties provide sufficient bases for implied indemnity claims.

The types of contracts that potentially create implied warranties are generally those that involve the sale of goods. This is because these contracts are governed by the UCC and, in some cases, product liability law. The UCC and product liability law imply certain warranties regarding the products that are sold and those implied warranties can create a basis for an indemnity claim.

The UCC warranties that may be implied in contracts for the sale of goods include the implied warranty of merchantability and the implied warranty of fitness for a particular purpose. However, these warranties are limited to cases where there is a claim that the product itself is defective, not just that it was installed incorrectly. Contracts for construction services alone are not are not governed by the UCC. In other words, if there is no sale of goods, or if there is no claim that any goods sold are defective, then UCC warranties do not apply and cannot provide the basis for an indemnity claim between a general contractor and its subs. Urban Development, Inc. v. Evergreen Building Products, LLC, et al., 114 Wash. App. 639, 644 (2003).

Product liability law may also provide the basis for an implied indemnity claim depending on both the nature of the injury and the manner in which it occurred. In Washington, there is no recovery under product liability law for purely economic losses. Product liability law could be applicable to a construction defect claim when a product that has been installed in a building causes physical injury to a person, or when the construction defect causes a substantial risk of harm to human life, such as the collapse of a wall. However, in the context of the usual construction defect case, where damage is done to a building due to exposure to moisture and weather over time, the Washington courts have held that this type of damage is purely economic

and product liability law, along with its implied warranties, is not applicable.

Because these UCC and product liability law warranties are not available as bases for implied indemnity claims, general contractors have shown their creativity by claiming that subcontractors impliedly warrant that they will perform their work in a workmanlike manner in accordance with industry standards. Now comes the good news, or the bad news (depending on who your insured is), the Urban Development court held that there is nothing in Washington law to suggest that a warranty of workmanlike performance is implicit in construction contracts and, therefore, it cannot provide support for an indemnification claim against a subcontractor. Id. at 646. That Court held that a claim based on such an implied warranty "would be strikingly similar to a cause of action for negligent construction, which is not recognized in Washington." Id. The underlying reasoning is that two contracting parties have adequate remedies for breach of contract and, if they choose, they can negotiate for the warranties they want and include them in the terms of their contract.

In short, when there is no written contract containing an indemnity provision, Washington law will not hold a subcontractor liable to its general contractor in indemnity unless there is something more to their relationship. What constitutes "more," includes express and implied warranties. However, warranties will not be implied against the subcontractor if there is only an oral agreement for services. If the subcontractor supplied both goods and services, warranties will not be implied if there is no claim that the goods themselves are defective.

What all this means from a litigation standpoint is that a general contractor in Oregon can bring claims for indemnity against its subcontractors more easily than in Washington. Further, the Oregon general contractor may be able to take a "wait and see" approach to the litigation, making the home or building owner prove their case first, and then passing the liability through to the appropriate subcontractor via implied indemnity claims. However, in Washington, a general contractor may have an affirmative responsibility to plead and prosecute a breach of contract claim against a subcontractor as opposed merely taking the "wait and see" approach. This is especially the case given the short 6-year statute of repose limiting indemnity claims that arise out of the construction of buildings. ❖

— If you have any questions, please feel free to contact the author, Julie E. Dutton, by phone at (503) 768-9600, or by email at julie@lerlaw.com.