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A Setback For Insurers Seeking Reimbursement of Defense Costs Incurred In Construction Defect Cases Based on Equitable Subrogation: Court of Appeal Affirms Judgment in Favor of Subcontractors Who Had Not Participated In Underlying Construction Defect Lawsuit

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With the advent of indemnity reform in California, subcontractors, by contract, are only required to defend and indemnify a developer or general contractor (at least with contracts signed after January 1, 2013) for their own negligence, and are not required to defend or indemnify for the active negligence of any developer or general contractor. California Civil Code section 2782(c). Nevertheless, there is still substantial litigation ongoing in the courts in regard to reimbursement of defense fees incurred to defend developers and general contractors. And one of the major areas of exposure involve cases where insurers of one or more subcontractors accept the defense of the developer or general contractor, settle the litigation and then sue the subcontractors who did not participate in the developer or general contractor defense based on equitable subrogation.

In the June 2020 article of The Morrison Law Journal, we discussed the California Court of Appeal, Fourth District opinion in Pulte Home Corporation v. CBR Electric, Inc. (2020) 50 Cal.App.5th 216 ("CBR Electric case") where the Court of Appeal held that, in the context of an equitable subrogation case against non-participating subcontractors, the costs incurred in the defense of actions arising from the non-participating subcontractors' work constituted a loss for which those subcontractors were each partly liable and the balance of the equities supported making the non-participating subcontractors bear the defense costs (the silver lining for the non-participating subcontractors being the Court's holding that there should be an equitable division of fees based on the subcontractors' scope of work).

Addressing a similar, but not identical situation, the California Court of Appeal, First District appears to have arrived at a somewhat different conclusion in ("Carter case") which it published on July 23, 2020. Based on what it perceived to be the issue before the trial court as presented by plaintiff in subrogation counsel, the Court of Appeal in the Carter case ruled that the non-participating subcontractors were only required to defend a general contractor from claims arising from their own work and the plaintiff insurer was not in a superior equitable position to the non-participating subcontractors regarding the entirety of defense costs.

In the Carter case, Pulte Home Corporation ("Pulte"), a residential developer and general contractor, was sued for construction defects by owners of 38 homes in two housing developments in Northern California. Many of the subcontractors which worked on the projects worked under contracts requiring the subcontractor to indemnify Pulte and to name it as an additional insured on the subcontractor's commercial general liability insurance (the contracts required each subcontractor to indemnify Pulte against "all liability, claims, judgment, suits, or demands for damages to person or property arising out of, resulting from, or relating to [that] contractor's performance").

Travelers Insurance Company ("Travelers"), the insurer for four of the subcontractors, accepted Pulte's tender and provided a defense at substantial expense. Pulte eventually settled the homeowner's claims. Travelers ultimately paid $320,491.82 for Pulte's defense. Travelers then pursued in subrogation the subcontractors that had declined to defend Pulte in the underlying litigation. Travelers received $164,400 in settlements from certain non-participating subcontractors, but went to trial with seven subcontractors for the balance which it paid, being $156,091.82.

At trial, Travelers framed its case as an all-or-nothing claim against the non-participating subcontractors - jointly and severally. After initially agreeing that a claim of equitable subrogation required joint and several liability and, on that basis granting Travelers' in limine motion excluding evidence relevant to the non-participating subcontractors' individual liability in the underlying lawsuit, the trial court changed its position and found it inequitable to shift the entire cost of the developer's defense to the non-participating subcontractors and then refused to entertain Travelers's request to allocate damages proportionally among the subcontractors. This issue became crucial as Travelers' expert witness admitted at trial that he could not match up the claims of the homeowners with the scopes of work of the subcontractors who had not provided a defense (and some of the non-participating subcontractors did not even work on all of the 38 homes in question). Because Travelers framed its case as all or nothing, and because Travelers could not match up the claims of the homeowners with the scopes of work of the subcontractors who had not provided a defense, the trial court granted a judgment in favor of the subcontractors.

In a lengthy holding on Appeal, the Court of Appeal affirmed the trial court's determinations. In footnote 13 to the Opinion, the Court acknowledged the holding in CBR Electric but held that Carter was distinguishable because Carter dealt with "primacy of liability for the *entire* cost of the defense." (emphasis supplied). And the Court discussed at lengthy the equities of holding non-participating subcontractors for all defense costs, particularly where, as in that case, questions clearly existed as to the scope of work of the subcontractors and whether there were actually any claims by any homeowners which involved their scope of work.

While any distinction between the issues raised in CBR and Carter could be debated, what the holding in Carter does demonstrate is that any claim for equitable subrogation will not be an all or nothing proposition AND there should be some evidence as to whether there is a tie between the scope of work of the non-participating subcontractor and the claims by the underlying plaintiffs.

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