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Legal Pipeline

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Beware of the Indemnification Imbroglia

Welcome to the wacky world of construction law for contractors and subcontractors, predicated on Saturday morning cartoon shorts from the 1970s to keep things interesting. The purpose of this article? To provide the contracting professional with a quick dose of current events in construction law, while offering an informative (and hopefully entertaining) glimpse into a legal topic that is the subject of a contracts or torts class in the first year of law school.

This article will follow the same informal format and style of the "Legal Pipeline" column that ran in from 2005 through 2011. Like those columns, this article will not be offering any legal advice as per the full disclaimer included. Rather, it will discuss current cases and fact patterns that may sound familiar and possibly prompt the reader involved in construction situations to seek out formal legal advice from a qualified attorney.

For this month's adventure, we turn to the case of Miller-Davis Company v Ahrens Construction, Inc., decided by the Supreme Court of Michigan in 2014. The project at issue, the Sherman Lake YMCA Natatorium project, was particularly contentious, with the parties fighting in court and arbitration proceedings for almost ten years. In this latest incarnation of the parties' fracas, the dispute focused on the natatorium roof and the contractor's claim against its subcontractor for indemnification.

Definition of Indemnification

Before we go any further, it is important to understand precisely what "indemnification" or an "indemnity" provision in a contract actually means. According to Black's Law Dictionary (17th ed.), indemnification, as set forth in the ditty above, is, "[t]he action of compensating for loss or damage sustained."

A staple in written construction contracts, an indemnity provision, generally speaking, is designed to protect a party from the financial consequences that may result from the work performed by another party. Indemnity clauses are frequently between general contractors (indemnitors) and subcontractors (indemnitees), who may very well be liable to the project owner.

In the subject case, Miller-Davis Company was the "at-risk" contractor for the natatorium project. (In other words, Miller-Davis had a contractual obligation to the project's owner (the YMCA) to meet its subcontractors' obligations in the event that the subcontractors defaulted.) Miller-Davis hired Ahrens Construction, Inc. as its subcontractor to install a roofing system on the natatorium. As part of Ahrens's subcontract, Ahrens agreed to indemnify Miller-Davis from and against any liabilities, claims, damages, losses, actions and expenses arising out of the subcontract.

At the conclusion of the first winter season following construction of the natatorium, the facility experienced massive condensation – so much so that it appeared to be raining inside the natatorium. Miller-Davis notified Ahrens

of this "natatorium moisture problem," and Ahrens returned to the project in a futile attempt to perform remedial work. After further investigation, the project architects learned that Ahrens' installation of the roofing system was defective and not in accordance with the approved plans, specifications and manufacturer's requirements.

Ultimately, Miller-Davis declared Ahrens in default and made a claim under its performance bond. After the bonding company failed to perform, and Miller-Davis performed the corrective work itself, Miller-Davis commenced a lawsuit against Ahrens and its bonding company for breach of contract, damages under the bond and indemnification. Ahrens lost at a bench (nonjury) trial in Kalamazoo Circuit Court, and the judge awarded Miller-Davis almost \$350,000 in damages. Ahrens appealed from the judgment and after a series of intermediate appeals involving the statutes of repose and limitations (topics for another article altogether), the matter made its way back up to the highest state court in Michigan.

Application of Indemnification Clause

After discussing the lengthy procedural history of the parties' dispute, followed by the timeliness of Miller-Davis' claim under the applicable statute of limitations, the Supreme Court of Michigan addressed the issue of indemnification. Specifically, the Court looked at whether the indemnification clause in the Miller-Davis/Ahrens contract applies and if so, whether Miller-Davis is entitled to collect any damages from Ahrens as a result of a breach of that indemnification clause.

By way of introduction, the Court explained that an indemnity contract creates "a direct, primary liability between the indemnitor and the indemnitee that is original and independent of any other obligation." Under Michigan law, parties have wide latitude to enter into indemnification agreements with one notable exception (that is common in many jurisdictions, including New Jersey): a subcontractor does not have to indemnify a contractor for the sole negligence of the contractor. This exception did not apply to the Miller-Davis case.

Plain language of subcontract

To evaluate the applicability a contractual provision, a Court first analyzes the plain language of the provision. The pertinent part of the indemnification clause in the subject subcontract provided, in pertinent part:

"You [Ahrens] as Subcontractor/Supplier agree to defend, hold harmless and indemnify Miller-Davis Company . . . from and against all claims, damages, losses, demands, liens, payments, suits, actions, recoveries, judgments and expenses including attorney's fees, interest, sanctions, and court costs which are made, brought, or recovered against Miller-Davis Company, by reasons of or resulting from, but not limited to, any injury, damage, loss, or occurrence arising out of or resulting from the performance or execution of this Purchase Order and caused, in whole or in part, by any act, omission, fault, negligence, or breach of the conditions of this

Purchase Order by the Subcontractor/Supplier, its agents, employees, and subcontractors regardless of whether or not caused in whole or in part by any act, omission, fault, breach of contract, or negligence of Miller-Davis Company. The Subcontractor/Supplier shall not, however, be obligated to indemnify Miller-Davis Company for any damage or injuries caused by or resulting from the sole negligence of Miller-Davis Company."

(Emphases added.)

The Court found that the above indemnification was properly "inclusive," noting the use of the words "all" and "any." Thus, under the above provision, the Court found that Ahrens had "the broadest possible obligation to indemnify."

It further found that this language was clear and unambiguous. One may ask: if everything was so clear and unambiguous, why was there a dispute about this indemnification provision in the first place? The twist here, as noted by the Court of Appeals (the intermediate appellate court), was that, "no one had brought a claim or demand against [Miller-Davis] within the meaning of the indemnification clause."

Claims, damages, losses or demands trigger indemnity

The Michigan Supreme Court said that this interpretation by the appellate court was too cramped, given the breadth of the clause itself. Specifically, the Court found that the clause also triggered liability when, "damages, losses, demands" or "expenses" result from "any act, omission, fault, negligence, or breach..."

The Court further found that the YMCA made a written claim or demand against Miller-Davis when the parties entered into their Agreement for Corrective Work (pursuant to which Miller-Davis fixed the roof itself). As the Supreme Court explained:

"A straightforward reading of the Agreement for Corrective Work confirms that [the] YMCA possessed a claim or demand against Miller-Davis that was resolved – at Miller-Davis's expense – by this settlement between them. That [the] YMCA and Miller-Davis succeeded in resolving their dispute without resort to legal action does not alter Ahrens's obligation to indemnify Miller-Davis for the corrective work that it was required to undertake in light of Ahrens's default. The indemnity provisions do not require [the] YMCA to prove liability or initiate a lawsuit or arbitration proceeding against Miller-Davis for Miller-Davis to seek indemnification from Ahrens for the corrective work it performed under the Agreement, not do we see any question regarding the reasonableness of that agreed-upon work or Miller-Davis's liability to [the] YMCA for it. As a result, we hold that the indemnity clauses of the subcontract apply to Miller-Davis's corrective work."

Establishing causation

After determining that the indemnification clause is applicable, the Supreme Court determined that Miller-Davis established "causation of damages" (i.e., that to the extent Ahrens was required to indemnify Miller-Davis for the cost of its corrective work, its failure to do so caused Miller-Davis' damages). The Supreme Court noted that the Court of Appeals misconstrued the causation element by looking

at whether Ahrens's defective work caused the natatorium moisture problem. Such an inquiry is irrelevant, according to the Supreme Court.

The terms of the indemnification provision (set forth above) do not require Miller-Davis to prove that Ahrens caused the moisture problem. All that is needed, the Supreme Court noted, is a "claim" or "demand" brought against Miller-Davis as a result of the work or performance under the subcontract by Ahrens. The Court found that this occurred here, and that Miller-Davis presented sufficient evidence to prove that Ahrens breach of the indemnification provision in the subcontract caused Miller-Davis to sustain losses in remediating Ahrens's defective work.

Lessons learned

The Miller-Davis case offers a textbook example of a claim for contractual indemnification. The clause in the Ahrens subcontract is not atypical. It is pretty standard fare, however many of its terms may be subject to negotiation, depending on the relative bargaining strength of the parties at the table. The Ahrens example is a very broad, yet enforceable clause, providing the contractor with solid indemnification protection by the subcontractor. It also notes, by way of the last sentence, the public policy exclusion for indemnity provisions (in Michigan, anyway).

Given the complexity of the provision itself, and the ramification of paying significant damages (including attorneys' fees) in addition to those damages caused as a result of the underlying breach of contract, indemnification clauses provide an excellent reason why an attorney is needed to review a construction contract and help the contracting parties evaluate their respective risks and financial exposures – before signing the subcontract to perform work at the project. ■

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