

ORIGINAL

No. 81003-6

SUPREME COURT OF THE STATE OF WASHINGTON

CAMBRIDGE TOWNHOMES, LLC, a Washington limited liability company; POLYGON NORTHWEST COMPANY, a Washington general partnership,

Respondents,

v.

PACIFIC STAR ROOFING, INC., a Washington corporation; P.J. INTERPRIZE, INC., a Washington corporation,

Petitioner.

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SUPREME COURT
STATE OF WASHINGTON
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**SUPPLEMENTAL BRIEF OF PETITIONER
P.J. INTERPRIZE, INC.**

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TABLE OF CONTENTS

	<u>Page</u>
I. ASSIGNMENTS OF ERROR.....	1
II. STATEMENT OF THE CASE.....	3
III. SUMMARY OF ARGUMENT.....	6
IV. ARGUMENT	9
A. THE CORPORATION CAN NOT BE HELD LIABLE FOR THE SOLE PROPRIETOR'S ALLEGED DEFECTIVE WORK UNDER A SUCCESSOR LIABILITY THEORY.	9
B. THE BANKRUPTCY OF THE SOLE PROPRIETOR PRECLUDES CAMBRIDGE FROM SEEKING DAMAGES AGAINST THE CORPORATION AND ITS INSURER.	12
C. CAMBRIDGE'S CLAIMS AGAINST THE SOLE PROPRIETOR ARE BARRED UNDER RCW 4.16.326(1)(G).	13
D. THE COURT OF APPEALS MISAPPREHENDS THE ACCRUAL OF AN INDEMNITY CLAIM.	15
E. THE COURT OF APPEALS' INTERPRETATION OF THE INDEMNITY CLAUSE IS UNREASONABLE.....	16
V. CONCLUSION.....	20

TABLE OF AUTHORITIES

	<u>Page</u>
State Cases	
<i>Berg v. Hudesman</i> , 115 Wn.2d 657, 801 P.2d 222 (1990)	17
<i>Brame v. St. Regis Paper Co.</i> , 97 Wn.2d 748, 649 P.2d 836 (1982)	19
<i>Cambridge Townhomes, LLC v. Pacific Star Roofing, Inc.</i> , No. 57328-4-1	passim
<i>Cashar v. Redford</i> , 28 Wn. App. 394, 624 P.2d 194 (1981).....	10
<i>Central Wash. Refrigeration, Inc. v. Barbee</i> , 133 Wn.2d 509, 946 P.2d 760, 764-65 (1997).....	15
<i>Earley v. Rooney</i> , 49 Wn.2d 222, 299 P.2d 209 (1956)	15
<i>Fraser v. Beutel</i> , 56 Wn. App. 725, 785 P.2d 470 (1990).....	14
<i>Hall v. Armstrong Cork., Inc.</i> , 103 Wn.2d 258, 692 P.2d 787 (1984).....	9
<i>Jones v. Strom Construction Co.</i> , 84 Wn.2d 518, 527 P.2d 1115 (1974)	3, 9, 18, 19
<i>Long v. Home Health Servs. of Puget Sound, Inc.</i> , 43 Wn. App. 729, 735, 719 P.2d 176 (1986).....	10
<i>MacLean Townhomes, LLC v. American 1st Roofing & Builders, Inc.</i> , 133 Wn. App. 828, 138 P.3d 155 (2006)	18, 19
<i>Parkridge Assoc., Ltd. v. Ledcor Industries, Inc.</i> , 113 Wn. App. 592, 54 P.3d 225 (2002)	15

Smith v. Jackson, 106 Wn.2d 298, 721 P.2d 408
(1986) 15

Other State Cases

Armour-Dial, Inc. v. Alkar Eng'g Corp.,
469 F. Supp. 1198 (E.D.Wis.1979) 11

Federal Statutes

11 U.S.C. § 524(a) 1, 7, 12
11 U.S.C. § 727 5, 12

State Statutes

RCW 4.16.310 8
RCW 4.16.326 8, 13, 14
RCW 4.16.326(1)(g) 8, 13, 14
RCW 4.24.115 3, 19

Books and Other Materials

42 C.J.S., Indemnity § 44, at 137 (1991) 15
Black's Law Dictionary 321 (6th ed. 1990) 16

I. ASSIGNMENTS OF ERROR

A. The Court of Appeals erroneously concluded that the Corporation was a successor to the sole proprietor and could be held responsible for the sole proprietor's separate contractual obligations under the mere continuation exception, when there was no continuity of officers, directors, and stockholders in the selling and purchasing companies, and the Corporation did not purchase the assets of the sole proprietor. The Court of Appeals' finding that the Corporation is a mere continuation of the sole proprietor is not supported by substantial evidence.

B. Even assuming the Corporation is a successor to the sole proprietor, it can not be held responsible for the sole proprietor's contractual obligations to Cambridge which were previously discharged in bankruptcy. All debts or liabilities that the sole proprietor may have had to Cambridge relating to its work on the Project were discharged in bankruptcy. Under 11 U.S.C. § 524(a), Cambridge is enjoined from collecting the discharged debt from the debtor sole proprietor. Cambridge should also be enjoined from collecting this same discharged debt from the Corporation under a successor liability theory where the discharged debt arose

under a separate contract with Cambridge prior to the formation of the Corporation.

C. The Court of Appeals came to the erroneous conclusion that Cambridge's right to indemnity accrued on November 21, 2003, when it entered into a settlement agreement with the Cambridge Townhomes Homeowners Association which was conditional on funding by December 21, 2003. The settlement agreement was not funded by December 21, 2003, and the Cambridge Townhomes Homeowners Association subsequently filed suit against Cambridge on December 22, 2003. Cambridge failed to present any evidence that it actually paid the Association anything in settlement. The November 21, 2003 settlement agreement was only a conditional promise, and establishes only a mere potential, not actual, liability. A cause of action for indemnity does not accrue until the indemnitee suffers actual loss or damage by paying money on the obligation for which he or she seeks indemnification or the potential liabilities of the indemnitee become fixed and certain by a judgment. Cambridge did not file its complaint against the sole proprietorship within six years of substantial completion, and its claims are now barred under 4.16.326(1)(g).

D. The Court of Appeals misconstrued the indemnity clause to include any and all damages suffered by the indemnitee, including economic damages caused by construction defects, regardless of whether the loss is connected to the indemnitor's breach of its contract. The Court of Appeals' interpretation of the indemnity clause casts the indemnitor into the role of an insurer of the indemnitee's performance of its separate statutory and contractual obligations, in violation of RCW 4.24.115 and this court's decision in *Jones v. Strom Construction Co.*, 84 Wn.2d 518, 527 P.2d 1115 (1974).

II. STATEMENT OF THE CASE

Polygon Northwest Company ("Polygon") was the developer of a condominium project called the Cambridge Townhomes Condominium project. (CP 4). Cambridge Townhomes, LLC ("Cambridge") was the general contractor on the project. (CP 4). The Project was constructed in three phases. (CP 98-111 and 456).

On August 26, 1998, the sole proprietorship of Gerald Utley d/b/a P.J. Interprize ("sole proprietorship") subcontracted with Cambridge to install vinyl siding and trim on Phase II of the Project.

(CP 98-101). The sole proprietorship's work on Phase II was completed by November 1998. (CP 98-101).

Several months after the sole proprietorship completed its work on the project, the corporation of PJ Interprize, Inc. ("Corporation") was formed in January 1999. (CP 98-99). Four months later, on April 21, 1999, the Corporation entered into a separate contract with Cambridge to install the vinyl siding and trim for Phase III of the Project. (CP 98-111). The Corporation's contract contains the following indemnity agreement:

SUBCONTRACTOR shall defend, indemnify, and hold CONTRACTOR harmless from any and all claims, demands, losses and liabilities to or by third parties arising from, resulting from, or connected with, services performed or to be performed under this Subcontract by SUBCONTRACTOR or SUBCONTRACTOR'S agents, employees, subtier Subcontractors, and suppliers ***to the fullest extent permitted by law and subject to the limitations provided below:***

SUBCONTRACTOR'S duty to indemnify CONTRACTOR shall not apply to liability from damages arising out of bodily injury to persons or damages to the property caused by, or resulting from, the sole negligence of CONTRACTOR, or CONTRACTOR'S agent or employees.

SUBCONTRACTOR'S duty to indemnify CONTRACTOR for liability for damages arising out of bodily injury to person or damages to property caused by or resulting from the concurrent negligence of CONTRACTOR or CONTRACTOR'S agents or employees shall apply only to the extent of negligence of SUBCONTRACTOR'S or SUBCONTRACTOR'S agents, employees, and subtier Subcontractors and suppliers.

SUBCONTRACTOR specifically and expressly waives any immunity that may be granted it under the Washington State Industrial Act, Title 51, RCW. Further, the indemnification obligation under this Subcontract shall not be limited in any way by any limitation on the amount or type of damages, compensation, or benefits payable to or for any third party under worker's compensation Acts, Disability Benefit Acts, or other employee benefits acts.

SUBCONTRACTOR'S duty to defend, indemnify, and hold CONTRACTOR harmless as to all claims, demands, losses, and liabilities shall include CONTRACTOR'S personnel related costs, reasonable attorney fees, court costs (sic), and all related expenses.

(CP 271-275), ¶¶Q) (Emphasis ours).

In February 2004, Gerald Utley d/b/a P.J. Interprize, Inc. filed for bankruptcy in the United State Bankruptcy Court for the Western District of Washington. (CP 1183-1207). The schedules of creditors holding secured and unsecured claims list Cambridge Townhomes, LLC as a creditor. (CP 1188). On February 27, 2004, the Debtors received a Chapter 7 bankruptcy discharge under 11 U.S.C. § 727 (CP 1206-1207).

A month later, on March 24, 2004, Cambridge filed a Complaint against the Corporation, but not the sole proprietorship, for alleged deficiencies relating to the construction of the Project. (CP 237-252). The Complaint alleges causes of action against the Corporation for breach of contract, contractual indemnity, and

breach of the duty to defend. The Complaint does not allege a cause of action against the Corporation for successor liability.

On May 28, 2004, Cambridge filed a "Motion for Relief from Automatic Stay to Pursue Insurance of Debtor" in the United States Bankruptcy Court to pursue its claims against the sole proprietorship. (CP 277-283). In June 2004, Judge Thomas Glover issued an Order granting Cambridge's motion for relief from the automatic stay to pursue the sole proprietorship's insurance proceeds only. (CP 285-286).

On November 21, 2003, Cambridge entered into a settlement agreement with the Cambridge Townhomes Homeowners Association ("Association"), which was conditional on funding by December 21, 2003. (Appellant's Brief, page 6; CP 241). Cambridge concedes that the settlement was not funded by December 21, 2003, and the Association subsequently filed a Complaint against Cambridge on December 22, 2003. Cambridge presented no evidence that it actually paid the Association any amounts in settlement.

III. SUMMARY OF ARGUMENT

The Court of Appeals erroneously concluded that the Corporation is a mere continuation of and successor to the sole

proprietorship because the Corporation and sole proprietorship “performed the same work for the same contractor.” In determining whether successor liability can be imposed on the theory of “mere continuation”, there must be a common identity of officers, directors, and stockholders in the selling and purchasing companies, and sufficient consideration running to the seller. There was no continuity of shareholders, officers, or stockholders between the sole proprietorship and the Corporation, and it is undisputed that the Corporation did not purchase the assets of the sole proprietorship. Therefore, the Corporation can not be a mere continuation of the sole proprietorship.

Furthermore, all debts or liabilities that the sole proprietor may have had to Cambridge relating to its contracted work on the Project were discharged in bankruptcy. Under 11 U.S.C. § 524(a), Cambridge is prohibited from pursuing any claims against the sole proprietor for its work on the project. Cambridge should also be enjoined from collecting this same discharged debt from the Corporation under a successor liability theory.

Additionally, the Court of Appeals erroneously concluded that Cambridge’s breach of contract and indemnity claims against the sole proprietorship are not barred by the statute of limitations

finding that a November 21, 2003 settlement agreement, which was conditional on funding, meant that Cambridge was “legally adjudged liable” and that its claims “accrued” within the six year statute of repose under RCW 4.16.310. An indemnity claim accrues when the payment is actually made **or** the indemnitee is legally adjudged obligated to pay damages to a third-party. The November 21, 2003 settlement was conditional on funding by the December 21, 2003, which never occurred. A promise to pay a settlement amount “conditional on funding” is only a conditional promise, and establishes a mere potential, not actual, liability. There is no evidence in the record that Cambridge paid anything to the Association. Moreover, Cambridge was never legally adjudged liable to the Association. The Court of Appeals erred in finding that Cambridge’s indemnity claim accrued on November 21, 2003.

Even assuming Cambridge’s indemnity claim accrued on November 21, 2003, Cambridge did not file its Complaint against the sole proprietorship within six years of substantial completion of Phase II and its claims are clearly barred under RCW 4.16.326(1)(g).

Finally, the Court of Appeals disregarded the specific clauses of the indemnity agreement and relied exclusively on the

general language which this court in *Jones* ruled was unenforceable and invalid. This is not a negligent construction claim and the court can not rely exclusively on the specific clauses in the indemnity agreement to validate an indemnity claim for economic damages for a breach of contract.

IV. ARGUMENT

A. THE CORPORATION CAN NOT BE HELD LIABLE FOR THE SOLE PROPRIETOR'S ALLEGED DEFECTIVE WORK UNDER A SUCCESSOR LIABILITY THEORY.

The general rule in Washington is that a corporation purchasing the assets of another is not liable for the seller's debts.¹ This rule is subject to four limited exceptions where: (1) the purchaser expressly or impliedly agrees to assume liability; (2) the purchase is a de facto merger or consolidation; (3) the purchaser is a mere continuation of the seller; or (4) the transfer of assets is for the fraudulent purpose of escaping liability.² Washington courts have indicated that to prevail on the theory of "mere continuation", proof of ***at least two elements*** is required. The first element is "a common identity of the officers, directors, and stockholders in the

¹ *Hall v. Armstrong Cork., Inc.*, 103 Wn.2d 258, 261, 692 P.2d 787 (1984).

² *Hall*, 103 Wn.2d at 261-62, 692 P.2d 787.

selling and purchasing companies.”³ The second element is “the sufficiency of the consideration running to the seller corporation in light of the assets being sold.”⁴

The record in this case does not support the conclusion that the Corporation is a mere continuation of the sole proprietor’s discharged debts to Cambridge. The Court of Appeals articulated the following indicia of continuity: “Utlely was both the sole proprietor and the president of the corporation. The sole proprietorship and the corporation performed the same work for the same contractor”. In this case, there is no common identity of officers, directors and stockholders between the sole proprietor and the Corporation. Although Gerry Utlely was the sole proprietor and the President of the Corporation, Gerry Utlely’s family members and former employees did not have any ownership interest in the sole proprietorship. Because there was no continuity of shareholders, officers, or stockholders, the general rule, if applied according to its terms, would preclude liability as a matter of law.

The second element is “the sufficiency of the consideration running to the seller corporation in light of the assets being sold.”

³ *Cashar v. Redford*, 28 Wn. App. 394, 397, 624 P.2d 194 (1981); *accord Long v. Home Health Servs. of Puget Sound, Inc.*, 43 Wn. App. 729, 735, 719 P.2d 176, *review den’d*, 106 Wn.2d 1012 (1986).

⁴ *Cashar*, 28 Wn. App. at 397, 624 P.2d 194.

The Court of Appeals conceded that the Corporation did not purchase the assets of the sole proprietor. There was no evidence that any part of the sole proprietor or his assets or liabilities, continued on in the form of the Corporation. The Court of Appeal's mere claim that the sole proprietor and the Corporation "performed the same work for the same contractor" can not satisfy the second element. Under the common law and Washington law, the fact that the sole proprietor and the corporation performed similar types of work under separate contracts with Cambridge, does not bring this case within the "mere continuation" exception to the general rule of nonliability.

Even after termination of the business entity, the sole proprietor remains a viable defendant for suit and will remain responsible for his own acts. The sole proprietor *cannot* avoid liability through incorporation. Therefore, no equitable principle would be served in finding the Corporation to be a mere continuation of the sole proprietor.⁵

Furthermore, Cambridge never even asserted a claim for successor liability against the Corporation, and never sought to

⁵ See *Armour-Dial, Inc. v. Alkar Eng'g Corp.*, 469 F. Supp. 1198, 1202 (E.D.Wis.1979) (cited in Fletcher, § 7125 n. 6).

amend its Complaint to assert such a claim. The Court of Appeals' consideration of this claim, in effect, allowed Cambridge to amend its pleadings on appeal.

B. THE BANKRUPTCY OF THE SOLE PROPRIETOR PRECLUDES CAMBRIDGE FROM SEEKING DAMAGES AGAINST THE CORPORATION AND ITS INSURER.

Cambridge's exclusive remedy for any damages against the sole proprietor for alleged construction defects was as an unsecured creditor in the bankruptcy proceedings. The debtor sole proprietor was subsequently discharged in the Chapter 7 bankruptcy. Under 11 U.S.C. § 727(b), a bankruptcy discharges the debtor from all debts arising prior to the date of filing of the bankruptcy petition. Thus, Cambridge's claims against the debtor sole proprietor were discharged. Under 11 U.S.C. § 524(a), Cambridge is enjoined from pursuing any further effort to collect or recover the discharged debt from the debtor sole proprietor. If Cambridge is enjoined from collection of the discharged debt from the sole proprietor, Cambridge should also be enjoined from collecting this same discharged debt from the Corporation under a successor liability theory where the Corporation has taken no independent action to assume liability for this discharged debt

which arose under a separate contract with Cambridge prior to the formation of the Corporation.

On May 28, 2004, Polygon filed a motion for relief from automatic stay, requesting that the Bankruptcy Court allow it to pursue the sole proprietorship "only" to the extent of its insurance proceeds. The Bankruptcy Court granted the motion, and Cambridge was allowed to proceed against the sole proprietorship but only to the extent of its insurance proceeds. However, Cambridge never filed suit against the sole proprietorship. The Bankruptcy Court's order does not allow Cambridge to seek damages against the Corporation or its insurer. Cambridge should not be allowed to recover against the Corporation after the sole proprietor's bankruptcy was closed and a Chapter 7 bankruptcy discharge of the debtor sole proprietor was entered. This would circumvent the protection of the bankruptcy discharge of the sole proprietor and improperly impose liability on the Corporation which had nothing to do with the contracted work performed by the sole proprietor.

C. CAMBRIDGE'S CLAIMS AGAINST THE SOLE PROPRIETOR ARE BARRED UNDER RCW 4.16.326(1)(g).

RCW 4.16.326 became effective July 27, 2003 and applies

to Cambridge's claims against the sole proprietor since its complaint was filed after July 27, 2003.⁶ Under RCW 4.16.326(1)(g), an action for construction defects must be filed within six years of substantial completion of construction, regardless of discovery. The temporary certificate of occupancies for Phase II were issued on October 1, 1999. Thus, the six-year statute of limitations on Cambridge's claims against the sole proprietorship expired on October 1, 2005.

The Court of Appeals refused to address RCW 4.16.326(1)(g) and summarily concluded that the statute of limitations does not bar Cambridge's claim because the claims "accrued in early 2003". Under RCW 4.16.326(1)(g), an action for construction defects must be **filed** within six years of substantial completion of construction, regardless of discovery. The six-year statute of limitations on Cambridge's claims against the sole proprietorship expired on October 1, 2005. Since Cambridge did not file an action against the sole proprietorship by October 1, 2005, its claims are clearly barred under RCW 4.16.326(1)(g).

⁶ *Fraser v. Beutel*, 56 Wn. App. 725, 785 P.2d 470 (1990).

D. THE COURT OF APPEALS MISAPPREHENDS THE ACCRUAL OF AN INDEMNITY CLAIM.

The Court of Appeals came to the erroneous conclusion that Cambridge was “adjudged obligated to pay damage to the Association” and its right to seek indemnity accrued at the time of the purported November 21, 2003 settlement with the Association. Washington law provides that an indemnity claim does not begin to accrue until the party seeking indemnity pays or is legally adjudged obligated to pay damages to a third-party.⁷ Thus, before an indemnity claim arises (i.e., before payment is made), the claim cannot possibly be prosecuted nor can it be considered to exist.

The November 21, 2003 settlement was conditional on funding by December 21, 2003. Cambridge concedes that the settlement was not funded by the December 21, 2003 deadline and the Association filed suit on December 22, 2003. A promise to pay a settlement amount “conditional on funding” is only a conditional promise, and establishes a mere potential, not actual, liability. An indemnity claim accrues when the payment is actually made.⁸

⁷ *Parkridge Assoc., Ltd. v. Ledcor Industries, Inc.*, 113 Wn. App. 592, 598, 54 P.3d 225 (2002).

⁸ *Central Wash. Refrigeration, Inc. v. Barbee*, 133 Wn.2d 509, 516-18, 946 P.2d 760, 764-65 (1997) (citing *Smith v. Jackson*, 106 Wn.2d 298, 302, 721 P.2d 408 (1986); *Earley v. Rooney*, 49 Wn.2d 222, 228, 299 P.2d 209 (1956); 42 C.J.S., Indemnity § 44, at 137 (1991)).

Cambridge failed to present any evidence that it actually paid anything to the Association.

Furthermore, there was never an adjudication of Cambridge's liability to the Association. "Adjudged" is defined as "to pass on judicially...and implies a judicial determination of a fact and the entry of a judgment."⁹ If the indemnity is against liability, the cause of action accrues as soon as liability occurs. The mere assertion of a claim against the indemnitee does not fix and establish liability, but only subjects the party to potential liability to be determined with the outcome of the lawsuit. Thus, when the Association filed its complaint there remained a number of issues as to Cambridge's potential liability and losses. These determinations were unquestionably dependent upon the outcome of the Association's claims against Cambridge and until that time, Cambridge's cause of action for indemnity did not accrue. Without a final determination of Cambridge's liability to the Association, Cambridge's cause of action for indemnity could not have accrued.

E. THE COURT OF APPEALS' INTERPRETATION OF THE INDEMNITY CLAUSE IS UNREASONABLE.

The Court of Appeals focused exclusively on the general language in the indemnity agreement and completely ignored the

⁹ Black's Law Dictionary 321 (6th ed. 1990).

phase “**and subject to the limitations provided below**” and the remaining five paragraphs of the indemnity clause, to find that the Corporation is liable for any all damages suffered by Cambridge, regardless of whether the loss connected with the indemnitor’s breach of its contractual duties. The Court of Appeals’ interpretation of the indemnity clause virtually casts the Corporation into the role of an **insurer** of Cambridge’s own liabilities.

Contracts of indemnity are subject to the same rules of construction governing other contracts, i.e., the intent of the parties controls.¹⁰ The intent of the parties to a contract is determined not only from the actual language of the agreement, but also from “viewing the contract as a whole, the subject matter and objective of the contract, all of the circumstances surrounding the making of the contract, the subsequent acts and conduct of the parties to the contract, and the reasonableness of the respective interpretations advocated by the parties”.¹¹

The general language of the indemnity agreement ties the losses to claims ‘arising from,’ or ‘resulting from’ or ‘connected with’ the Corporation’s performance under the subcontract. The

¹⁰ *Berg v. Hudesman*, 115 Wn.2d 657, 667, 801 P.2d 222 (1990).

¹¹ *Id.*

language of the indemnification only addresses claims or losses related to “bodily injury” or “damages to property” caused by or resulting from the negligence of the Corporation. This litigation involves a breach of contract claim, and not a tort claim for bodily injury or property damage. Even if the indemnity clause covers economic damages caused by a breach of contract, there must be a causal connection between a breach by the Corporation of its subcontract and the loss to Cambridge. Cambridge failed to show any breach by the Corporation of its contractual duties under the subcontract.

The Court of Appeals’ interpretation of the indemnity clause is based on its decision in *MacLean Townhomes, LLC v. American 1st Roofing & Builders, Inc.*, 133 Wn. App. 828, 138 P.3d 155 (2006), which directly contravenes this court’s decision in *Jones v. Strom Construction Co.*, 84 Wn.2d 518, 527 P.2d 1115 (1974). In *Jones*, this court specifically rejected *MacLean’s* interpretation of the same general indemnity clause. The court considered a general indemnity provision which covered damages “arising out of, in connection with, or incident to the indemnitor’s performance of

the contract".¹² The court concluded that the indemnity clause was ambiguous and did not give rise to a duty to indemnify.¹³ This holding was subsequently affirmed in *Brame v. St. Regis Paper Co.*, 97 Wn.2d 748, 649 P.2d 836 (1982), on the basis of an identical indemnity provision.

Under RCW 4.24.115, the indemnitor may not indemnify the indemnitee for indemnitor's sole negligence.¹⁴ Moreover, in cases of concurrent negligence of the indemnitor and the indemnitee, the indemnitor only has a duty to indemnify the indemnitee to the extent of the indemnitor's negligence, and only if expressly stated in writing.¹⁵ The Court of Appeals' interpretation of the indemnity clause in *MacLean* violates the public policies expressed by the Washington Legislature under RCW 4.24.115. Regardless of the context, indemnity clauses which do not expressly limit recovery for the indemnitor's own breach of contract and purport to indemnify the indemnitee against any and all claims so long as they have some connection with the indemnitor's work, should be found void as against public policy.

¹² *Jones*, 84 Wn.2d at 521.

¹³ *Jones*, 84 Wn.2d at 521-22.

¹⁴ RCW 4.24.115 (1).

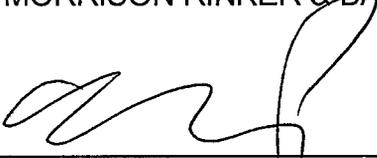
¹⁵ RCW 4.24.115 (2).

V. CONCLUSION

The Court of Appeals' unpublished decision in *Cambridge Townhomes, LLC v. Pacific Star Roofing, Inc.*, No. 57328-4-I, filed on June 11, 2007, should be reversed and this court should affirm the trial court's dismissal of Cambridge Townhomes, LLC's and Polygon Northwest Company's claims against P.J. Interprize, Inc.

DATED this 25 day of August, 2008.

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