

## **AB 2738: Will The Intended Reforms Result in Increased Litigation Costs and Possibly Create New Inequities?**

California Assembly Bill 2738 ("AB 2738"), signed into law by Governor Arnold Schwarzenegger on September 29, 2008, is being lauded by many as much needed construction industry reform, legislatively leading the industry away from a "top down" risk allocation model toward a "shared risk" model for residential construction defect claims. While few industry professionals would disagree that something should be done to decrease the cost and burden of construction defect litigation in California, AB 2738's inherent ambiguities may create new problems and actually serve to increase, rather than decrease, the overall cost and scope of construction defect litigation. This article will discuss the way AB 2738 changes existing law and the potential ramifications of those changes.

### **HOW AB 2738 CHANGES EXISTING LAW**

#### **Defense and Indemnity Obligations**

Section 1 of AB 2738 amends Civil Code § 2782 to restrict the defense obligations of a subcontractor to a builder or non-affiliated general contractor (hereinafter, "builder/GC") under a contractual indemnity provision in a residential construction agreement subject to SB 800 which is entered into after January 1, 2009. The new law clarifies that a subcontractor's defense obligations are subject to the comparative fault principles embodied in existing Civil Code § 2782(c).

Most significantly, AB 2738 adds a new subsection (d) to Civil Code § 2782 which allows a subcontractor under an applicable contract the following election upon tender by the builder/GC of a claim arising from the subcontractor's scope of work: (1) the subcontractor may defend with counsel of its own choosing and maintain control over that portion of the claim against the builder/GC to which the indemnity applies, or (2) the subcontractor may pay a portion of the builder/GC's costs which directly relate to defending the allegations made against the subcontractor's scope of work. Failure to tender or late tender will negatively impact the builder/GC's right to a defense by the subcontractor under the indemnity provision.

#### **The Subcontractor's Insurance Obligation**

AB 2738 amends Civil Code § 2782(c) to make clear that clauses in applicable contracts which require a subcontractor to "insure" a builder/GC for claims or damages arising from the subcontractor's scope of work are also subject to the comparative fault strictures of existing Section 2782(c). At the same time, the new bill expressly affirms

the holding in *Presley Homes, Inc. v. American States Insurance Company*, 90 Cal.App.4<sup>th</sup> 571, 108 Cal.Rptr.2d 686 (2001).

## **Wrap Programs and Self-Insured Retentions**

Sections 2, 3 and 4 of AB 2738 add new Civil Code §§ 2782.9, 2782.95 and 2782.96 which address the obligations of builders, contractors and subcontractors on projects that utilize wrap-up or consolidated comprehensive general liability insurance programs.

New Civil Code § 2782.9 applies to all residential construction agreements (not just those subject to SB 800) entered into after January 1, 2009 where a wrap up or consolidated comprehensive general liability insurance program is used. This section provides that all provisions in applicable agreements that require a subcontractor participating in a wrap program to indemnify, hold harmless or defend another party against any claim covered by the policy are unenforceable, and eliminates claims for equitable indemnity on those matters as well.

Civil Code § 2782.9(b) provides a formula for determining the maximum amount of deductible or SIR under a wrap program for which a subcontractor can be held responsible based upon a determination by the builder/GC of the reasonable and proportionate relationship of any potential liability arising from the participant's scope of work to the project's total anticipated potential losses due to third party claims.

## **Disclosure Obligations In Connection With Wrap Up Programs**

New Civil Code § 2782.95 provides that for any residential construction project utilizing a wrap up or consolidated insurance program that *first commences construction* after January 1, 2009, the builder/GC purchasing the insurance program must disclose the total amount or method of calculation of any credit or compensation for premium required from a subcontractor for that wrap-up program in the contract documents. Also, the builder/GC shall disclose the following in the contract documents, if and to the extent known: (1) the policy limits, (2) the scope of coverage, (3) the policy term, (4) the basis upon which the SIR/deductible is triggered, (5) the number of units covered by the wrap if it covers more than one work of improvement, and (6) a good faith estimate of the remaining limits of the policy as of the date of the disclosure. Failure to provide this information to a subcontractor at the bid stage may result in the subcontractor being allowed to re-calculate that portion of its bid which reflects its anticipated insurance costs.

New Civil Code § 2782.96 provides that for a public works project or any other project that is *not* residential construction that utilizes a wrap up or consolidated insurance program and is put *out to bid* after January 1, 2009, the total amount or method of calculation of any credit or compensation for premium must be disclosed in the bid documents. The named insured must also disclose in the contract documents (1) the policy limits, (2) the known exclusions, and (3) the length of time the policy is intended to be in effect.

## Sample Questions Raised by the New Changes

### 1. Will the New Defense Election Actually Increase The Overall Costs of Defense?

The subcontractor's right under AB 2738 to elect to defend a portion of a third party claim against the builder/GC with counsel of its own choosing and to control the defense of the portion of any tendered claim against the builder/GC which arises from its scope of work may result in several trades, each with potential conflicts with the builder/GC and cross-actions against each other, defending a portion of a third party claim against the builder/GC. Not only would such a result increase the overall cost of the litigation, it is hard to imagine how the builder/GC's interests could be adequately defended under such a scenario.

The alternative election, payment of a proportionate share of the builder/GC's defense costs during the pendency of litigation, is not without its problems as well. First, it forces the builder/GC to assign a proportionate share of liability to each of the parties, including itself, before the true nature of the claim is known. Second, the periodic payments are subject to reallocation both during the pendency of litigation and thereafter.

### 2. Does AB 2738 Limit an Insurer's Defense Obligation?

The inclusion of clauses that seek to "insure" the builder/GC against third party construction claims in the comparative fault portion of Section 2782(c) seems to suggest that the defense and indemnity obligations of a subcontractor's insurer are likewise limited to matters arising from the subcontractor's scope of work. However, the new statute expressly affirms the holding in *Presley Homes, Inc. v. American States Insurance Company*, 90 Cal.App.4<sup>th</sup> 571, 108 Cal.Rptr.2d 686 (2001), which provides that, once an insurer for a subcontractor has a duty to defend any portion of a claim, it has the obligation to defend the entire claim. This seems to be an inherent ambiguity which may lead to additional litigation.

### 3. Are Indemnity Agreements Enforceable for Matters that are Excess to the Wrap Policy?

The question here is whether a builder/GC can seek indemnification (or equitable indemnity) for claims that would otherwise be covered under the wrap if the limits are exhausted or otherwise unavailable. If the answer to that question is "no," this change in existing law is extremely problematic as there can be any number of reasons why insurance is not available under the wrap policy that has nothing to do with high deductibles, inadequate coverage or inadequate limits. What if the carrier goes out of business? What if the carrier denies coverage because the subcontractor commits fraud or engages in willful misconduct? In the latter scenario, a liability cap to the limits of insurance would leave the builder/GC without a viable remedy against the subcontractor.

## **WHAT STEPS TO TAKE NOW**

AB 2738 operates to limit the potential exposure of subcontractors on residential construction projects, but the statutory language contains many ambiguities. Builders and general contractors should carefully review their bid documents and construction contracts to make sure they will be enforceable after the new law takes effect. They should also work with coverage counsel, their insurance brokers and all parties affected by any wrap up insurance for the project to ensure that coverages and limits are acceptable to all and sufficient to cover anticipated risks. Finally, many problems may be potentially avoided if all parties discuss and attempt to resolve at the contract negotiation stage, and in a manner consistent with AB 2738, how the defense of third party construction claims will be managed.

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