California Professional Association
of Specialty Contractors

AB 2738 – A Common-Sense Approach To Construction Risk Management!

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The CALPASC-sponsored bill, AB 2738 addresses several significant problem areas in the construction industry. The bill makes great strides towards a more balanced allocation of risk while providing a platform for a more collaborative effort in defending construction defect claims. By developing a consensus on these issues, it is hoped that this legislation will significantly reduce the costs of risk for all parties.

WHAT AB 2738 DOES:

Section 1: Defense & Indemnity. AB 2738 clarifies that the defense obligations are also subject to the comparative fault principles embodied within Section 2782 (c). Those provisions state that a subcontractor[1] cannot be required to indemnify or defend claims that are beyond its "scope of work." The bill adds the word "insure" at Section 2782 (c) in order to restrict a builder's[2] ability to require a broad Additional Insured ("A/I") endorsement (along the lines of an 11 85) that is not available in the marketplace and also deletes the phrase "upon final resolution of the claim" currently contained in Subsection (d) of 2782. Under AB 2738, a subcontractor's obligation to defend contractor and/or owner will cease upon the resolution of all issues within subcontractor's scope of work. Many builders have in their contracts a provision to tender the entire defense of a claim or lawsuit to a single subcontractor, who could be reimbursed "upon the final resolution of the claim." However, AB 758 limited a subcontractor's defense obligation to claims arising out of its scope of work. Therefore, pursuant to statute, a builder's tender of the entire defense would be unenforceable. Additionally, the reality is that extremely few claims ever get to a final resolution. Almost all construction defect claims settle at some point, which makes it nearly impossible for the subcontractor to recoup any amounts allocated beyond that which was the subcontractor's responsibility.

Additionally, the bill allows the subcontractor to pay for one attorney to defend the claim or lawsuit, not two. The legislation does so by adding a provision in Subsection (d) of 2782, allowing that if a builder "tenders a claim, or portion thereof, to a subcontractor, … the subcontractor shall be entitled to defend the claim with counsel of its choice, and the subcontractor shall maintain control of the defense for any claim or portion of claim to which the defense obligation applies." Subsection (d) of 2782 also provides that, if a builder wants a trade contractor to provide a defense of its scope of work, the builder must: (1) give a clear written tender requesting that defense; and (2) that tender must include all claim information the builder has received.

[1] For purposes of this article, the term "Subcontractor" shall include "trade contractor" and "participant" as each is used in the language of the bill.
[2] The term "builder" shall also include "general contractor" and "owner" as each is used in the language of AB 2738.

Trade contractors have two options to respond to the tender. They may either: 1) defend the builder for the trade's scope of work, at the trade's own expense, with the trade contractor controlling the defense; or 2) pay a portion of the builder's defense costs, which costs directly relate to defending the allegations made against the trade contractors' scope of work. There are clear parameters in the bill for the builder to follow in setting up a reasonable allocation of defense costs.

There are also provisions in this Subsection that allow for collection of damages from parties who don't perform their obligations in a timely fashion. These cumulative changes should dramatically lower the cost of defending claims, and speed up the claim process, as there will be much less infighting. Since the principles of AB 758 do not allow a builder to transfer its or its agent's negligence to subcontractors, the defense should simply be a factual discussion, not a posturing or leveraging one. *Section 1 takes effect for new contracts, or amendments to existing contracts; that are entered into on or after January 1, 2009.*

Section 2: Wrap Programs & Self Insured Retentions (SIR). Most builders require trade contractors to enroll in the wrap program as a condition to being awarded the job and performing the work. The majority of trade contractors' own CGL policies have specific exclusions for work performed on projects covered under a wrap. If a claim involving the trade contractor's work involves homes or units covered under the wrap, the wrap is the sole insurance policy covering the trade contractor. If the wrap would have covered the claim, but is otherwise unavailable, such as in cases of a high SIR, carrier liquidation or exhaustion, the trade contractor is faced with a potentially enormous risk, including contractual obligations to the builder, without any insurance to cover the claim. This result is especially burdensome when the trade relied solely on the builder to procure a policy with suitable coverage, adequate limits and a reasonable SIR or deductible.

AB 2738 requires that the purchaser/creator of a wrap-up insurance policy, who has the complete control/discretion to buy adequate limits and coverage for all participants, not be allowed to require indemnity for claims from the subcontractors who are intended to be covered by that wrap-up policy. This is a fair and reasonable proposition, in that a wrap-up insurance policy should "wrap up" coverage for all construction participants. A wrap policy is supposed to replace the subcontractor's own coverage, thereby covering its negligent acts. This intent is achieved in the bill by adding new Section 2782.9 to the California Civil Code. This Section states that for residential construction projects only, that are insured by a wrap-up, subcontractors cannot be required to "indemnify, hold harmless, or defend another for any claim or action covered by that program." The same provision would hold true for Workers' Compensation claims, to the extent that coverage is provided by the wrap-up.

The bill also provides a formula for the builder when determining the maximum amount of SIR or deductible under a wrap program and provides a reasonable method for collection of such by adding language at Subsection (b) of 2782.9. First, the maximum amount and method of collection must be disclosed in the subcontract. Second, the SIR/deductible shall be reasonably limited[3] so

[3] Factors to look at when determining if builder's SIR allocation is "reasonable."

1) Was the SIR disclosed at time of contract?
2) Was the SIR reasonably limited so that each "participant" has some financial obligation in the event of a claim alleged to be caused by the trade contractor's scope or work?
3) Was the SIR collected as incurred by the builder in an amount that bears a reasonable and proportionate relationship to the alleged liability arising from the claim?
4) Builder's request for contribution must be in writing and show basis for request.
5) Compare trade contractor's own CGL SIR to the requested wrap SIR amount. In no event shall the total amount of contributions collected from trade contractor exceed the amount of any SIR due and payable by the builder for the claim.

that each participant may have some financial obligation in the event of a claim alleged to be caused by that participant's scope of work. Third, the builder is only able to collect the portion of the SIR which bears a reasonable and proportionate relationship to the alleged liability arising from the claim(s) alleged to be caused by the participant's scope of work, when viewed in the context of the entirety of the alleged claim or claims. Finally, the participating trade is only responsible to pay the SIR as that obligation is incurred by the builder and after written notice to the trade of the amount of and basis for the contribution. *Section 2 takes effect for new contracts, or amendments to existing contracts; that are entered into on or after January 1, 2009.*

Note: A sentence from AB 758 has been inserted into AB 2738 for clarification. That sentence is included in new Section 2782.9 of the California Civil Code, and reads, "This section shall not be waived or modified by contractual agreement, act, or omission of the parties." The identical language was included in Section 2782 (c) by AB 758 because of the significant disparity in bargaining power between builders and subcontractors in residential construction.

Section 3 & 4: Disclosure. Section 3 of the bill (added Section 2782.95) provides that for any wrap insuring a residential work of improvement that first commences after January 1, 2009, the builder shall disclose in the *contract documents* (if not prior to then), to the extent the builder knows, the: (1) wrap policy limits; (2) scope of the coverage; (3) policy term; (4) the basis upon which the SIR/deductible is triggered (i.e. on an occurrence or per claim basis); (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.

Along with receiving adequate information about the policy that the trade contractor will be insured under, it is important that the subcontractor knows when preparing his or her bid, what amount the builder expects to receive for contribution to the wrap program. Many subcontractors have presented a bid for a project, and then been told the project is being constructed under a wrap program, or even if the existence of the wrap was disclosed, they are later told what the expected bid credit is, oftentimes 3 or 4 times what the subcontractor pays for general liability insurance. Subsection 2782.95(d) addresses this negative scenario by allowing the trade contractor to increase its bid up to the amount equal to the difference between the amount originally included in the bid for insurance and the amount of the actual bid credit required by the builder. *Section 3 applies to wraps that insure residential projects that first commence construction after January 1, 2009*.

Section 4 of the bill requires similar information to be given at the time the project goes out to bid, for commercial wrap programs. *Section 4 takes effect for commercial wrap projects that are put out to bid after January 1, 2009*.

AB 2738 is the product of consensus and the parties' recognition that the status quo is unsustainable. Without this legislation, unduly burdensome risk shifting would likely have caused the demise of the very trade contractors which builders have come to rely on to build quality homes.