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California Enacts Sweeping Changes That Limit a Subcontractor's Obligation to Defend and Indemnify Contractors and Developers In Connection With Residential Construction Defect Claims

Monday's enactment of California Assembly Bill 2738 means that subcontractors working on new residential construction may no longer be forced to pay a disproportionate share of the damages or attorney fees in construction defect lawsuits. "Payment in proportion to fault" becomes the new rule for a subcontractor's liability to contractors and developers under express indemnity agreements (also called "hold harmless" clauses) entered after January 1, 2009.

Under former rules, a developer or general contractor could compel a subcontractor to fully indemnify them against construction defect claims, and pay all of their attorney fees, even though the subcontractor was only partially at fault. In what are known as "Type 1" indemnity clauses, a subcontractor could be compelled to pay 100% of a developer or general contractor's liability for a construction defect claim, and 100% of their attorney fees, even if the subcontractor were only 1 percent at fault. Statutes effective January 1, 2006, and January 2, 2008, began restricting the enforceability of those Type 1 clauses.

AB 2738 now enacts sweeping reforms affecting indemnity for construction defect claims in contracts for new residential construction (including construction of new single family homes and condominiums but not apartments) entered after January 1, 2009. Highlights are: Defend the claim with counsel of subcontractor's choice. The subcontractor controls the defense as to that portion of the claim involving the subcontractor's work. The defense extends to the developer and general contractor's vicarious liability, but does not include defense of claims to the extent of the developer, general contractor, or any other party's scope of work, actions, or omissions.

o Alternately, the subcontractor must pay its reasonably allocated share of the developer or general contractor's defense costs on an ongoing basis, and the share must be reallocated upon final resolution of the claim. The developer and general contractor must allocate shares to themselves to the extent the claims are alleged to be result from their actions. Shares must be allocated to every subcontractor implicated in the claims, even if that subcontractor is not participating in the defense. Developers and general contractors may not collect orphan shares from any other subcontractor.

· The developer or general contractor is awarded its attorney fees if it has to sue a subcontractor who does not defend. Subcontractors may recover attorney fees from developers or general contractors who do not reallocate at the final resolution.

AB 2738 also regulates Wrap insurance for residential construction. Key provisions are:

· With respect to claims covered by the Wrap, indemnity agreements, including the obligation to defend, are not enforceable against subcontractors enrolled in the Wrap. To the extent the claim is not covered by the Wrap, any party may pursue claims for equitable indemnity against the other.

· Subcontractors may be required to pay a reasonably allocated portion of any deductible or self-insured retention, based on the party's share of alleged responsibility.

· Significant details regarding the Wrap, including its pricing and scope of coverage must be disclosed to subcontractors.

· Under certain circumstances, a subcontractor is entitled to revise its bid after acceptance to adjust for an offset that is charged the subcontractor for its share of the

premium.

Finally, AB 2738 requires certain disclosures be made regarding Wrap programs in bidding documents for public works projects.

Comment: Care must be taken with contract language, so that provisions in prime contracts and subcontracts do not run afoul of these regulations. Different rules apply to contracts entered before 2006, between 2006 and 2008, in 2008, and after 2008, so that will impact the enforceability of indemnity clause should you become involved in residential construction defect litigation. We're here to help.

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