AB 2738: More Restrictions on Residential Construction Subcontracts (The Legislature Again Jumps in the Middle of Private Contract Negotiations)

By Jay W. Deverich

I. INTRODUCTION

AB 2738[1] amends existing California law to further limit subcontractors' indemnity, defense and insurance obligations in residential construction contracts. It also establishes procedural requirements for tendering a demand to a subcontractor for indemnity and defense and adds disclosure and other requirements in connection with "wrap-up"[2] insurance policies.

Although the law is generally effective January 1, 2009, various provisions are subject to different grandfather rules for existing projects and agreements. Suggested action for builders and general contractors are listed in section VIII at the end of the article.

II. BACKGROUND

With AB 758[3] in 2005 (effective in 2006), the California Legislature enacted certain protections benefitting residential subcontractors (Subcontractor). That law made *unenforceable* all provisions and agreements in contracts for "residential construction"[4] that require a Subcontractor to indemnify and defend a builder for claims of construction defects: (1) to the extent they relate to the builder's negligence or the negligence of the builder's other agents or independent contractors, or for defects in design furnished by those persons; or (2) that do not relate to the scope of work in the written agreement between the builder and Subcontractor.

Two years later, with SB 138[5] (effective in 2008), the Legislature closed a technical loophole in AB 758 by adding section 2782(e)[6] in order to protect Subcontractors from having to indemnify and defend a "general contractor or contractor that is not affiliated with the builder" under circumstances that parallel those applicable to the indemnity of a builder in the paragraph above.

Assembly Bill 2738, enacted in late September 2008, further modifies sections 2782(c) and (d), entirely replaces section 2782(e), adds new sections 2782(f) through (h), and adds new sections 2782.9, 2782.95, and 2782.96. The new law re-organizes the existing statutory indemnity and defense limiting provisions, but applies a common effective date of January 1, 2009 for section 2782(c). It also imposes new rules for tender and acceptance of Subcontractors' indemnity and defense obligations, as well as prescribes rules to allocate the sharing of defense costs. Finally, it imposes requirements governing the disclosure and use of "wrap-up" insurance policies that cover Subcontractors.

The new law introduces a number of ambiguities and raises various issues that will need to either be addressed by clean up legislation or resolved by judicial interpretation. Following is a summary of AB 2738's key provisions and a discussion of corresponding issues.

III. THRESHOLD DEFINITIONAL ISSUES

Some uncertainty created first by AB 758 and now continuing in AB 2738 arises from undefined or ill defined statutory terminology. Key statutory terms repeatedly used include "subcontractor," "residential" or "residential construction," and "builder."

A. Subcontractor

Curiously, the 2006 version of section 2782(c) codified by AB 758 used but did not define the term "subcontractor." That omission persists in the current version of section 2782(c) codified by AB 2738 and may lead to a distinction the Legislature may not have intended. In fact, a limited review has uncovered only one definition of "subcontractor" in the entire California Civil Code.[7] Landowners typically construct improvements either by hiring a general contractor, who then hires subcontractors, or by hiring trade contractors directly under the "owner builder" exception,[8] in which case the trade contractors are generally referred to as "prime" contractors since there is a direct rather than indirect (*e.g.*, a subcontract) relationship. Since section 2782(c) prohibits specified risk shifting to a "subcontractor," an owner hiring trade contractors directly could certainly argue that no "subcontractor" is involved and, consequently, section 2782(c) does not reach that relationship. That argument is bolstered by the fact that the Legislature presumably knows how to define statutory terms when it wants to and must have intended for "subcontractor" to have its common meaning of someone contracting with a general contractor rather than directly with an owner—even if "residential construction" is involved and even if the owner is a "builder" otherwise subject to section 2782(c).

B. Residential

The key term "residential" appearing in various AB 2738 provisions is sometimes defined by a simple cross reference to its use in the Right to Repair Law[9] (also known as SB 800 or the "Fix It" Law), and sometimes is used without definition.[10] Unfortunately, while the Right to Repair Law uses the term "residential" several times, it does not expressly define it. However, since section 896 states that the Right to Repair Law applies to "original construction intended to be sold as an individual dwelling unit," logic suggests the term "residential" is intended to have that meaning. Although a detailed examination of the Right to Repair Law is beyond the scope of this article, it is generally understood to address defects in dwelling units, and clearly applies to all aspects of vertical for-sale residential construction and underlying soil issues.[11] However, the description of some residential defects arguably includes, perhaps uninten-

tionally, certain infrastructure work that master developers (as opposed to home builders) frequently install in a master planned community. For example, the Right to Repair Law covers irrigation systems and drainage systems,[12] retaining and site walls,[13] plumbing, sewer and utility systems,[14] electrical systems,[15] and exterior pathways, driveways, hardscape, sidewalls, and sidewalks.[16] It also covers any improvements on common areas.[17]

C. Builder

Although the term "builder" is used throughout AB 2738, it is defined only once in section 2782(c) by reference to its definition in section 911, which is part of the Right to Repair Law. Section 911 first defines "builder" by what it is and then by what it is not. In section 911(a) "builder" means:

> [a]ny entity or individual, including, but not limited to a builder, developer, general contractor, contractor, or original seller, who, at the time of sale, was also in the business of selling the residential units to the public for the property that is the subject of the homeowner's claim or was in the business of building, developing or constructing residential units for public purchase for the property that is the subject of the homeowner's claim.

Next, section 911(b) states that a "builder" does *not* include:

> [a]ny entity or individual whose involvement with a residential unit that is the subject of the homeowner's claim is limited to his or her capacity as general contractor or contractor and who is not a partner, member of, subsidiary of, or otherwise similarly affiliated with the builder.

Even though the focus of the Right to Repair Law is homebuilders, the definition of "builder" is both expansive and ambiguous enough to potentially include a typical master developer of a master planned residential community.[18] Thus, based on its incorporation of key definitions in the Right to Repair Law described above, AB 2738 may apply at least to grading work done on residential lots by master developers and also may reach other types of master infrastructure work traditionally done by master developers in residential projects. It is unknown whether the Legislature intended this result.

IV. LIMITS ON INDEMNITY, DEFENSE, AND INSURANCE

As modified by AB 2738, section 2782(c) now makes *unenforceable* all provisions and agreements in construction contracts for residential construction that require a Subcontractor to insure or indemnify (including the cost to defend) builders, general contractors or other contractors not affiliated with builders (Builder Parties) for claims of construction defects to the extent the claims: (1) arise out of, pertain to, or relate to the negligence of the builder or contractor[19] or their specified affiliated parties, or for defects in design furnished by those persons; or (2) do not arise out of, pertain to, or relate to the scope of work in the written agreement between the parties. The provisions of this section 2782(c) are effective for any construction contract or amendment entered into after January 1, 2009, and cannot be waived by the parties.[20]

The Legislature's articulated motivation underlying these restrictions favoring Subcontractors was to "put an end to alleged abuses of so-called "Type I" [21] indemnification clauses in contracts imposed on subcontractors by builders."[22]

The new law also imposes the same limits on insurance Subcontractors may provide. Post-AB 758, a builder (and later, under SB 138, a general contractor) could no longer shift the risk of its own or others' negligence to Subcontractors via an indemnity, but nothing stopped a builder from contractually requiring Subcontractors to carry insurance covering that risk—essentially an "end run" around the statute. The new law now *prohibits* a Subcontractor not only from indemnifying and defending against residential construction defect claims, as described above, but also from *insuring* Builder Parties against that liability, and this change is presumably designed to stop risk shifting to Subcontractors' insurers.

Although the above limitation on Subcontractors' ability to indemnify, defend, and insure Builder Parties in residential construction is very broad, that limitation does *not* apply to *all* indemnity, defense, and insurance provisions. So, assuming it can be negotiated, a Subcontractor should still be able to contractually agree to broadly indemnify, defend, and insure Builder Parties for claims *other than* the claims of residential construction defects now limited by the statute.

V. TENDERING CLAIMS—NO WRAP-UP POLICY

In addition to making additional modest changes to the existing sweeping section 2782(c) limitations on indemnity and defense, AB 2738 adds procedural requirements for tendering construction defect claims to Subcontractors.[23] Before a Subcontractor will owe an indemnity or defense obligation for a construction defect, the indemnified party(ies)[24] must make a written tender to the Subcontractor containing the information specified in new section 2782(d) and such written tender has the same force and effect as a notice of commencement of legal proceeding.[25] Upon receiving a compliant tender, the Subcontractor can elect either to (1) defend the claim with its counsel; or (2) pay its "reasonable allocated share" of the Builder Parties' defense fees and costs, either of which will satisfy the Subcontractor's defense obligations.

If the Subcontractor elects to defend the claim, it must notify the tendering party within a "reasonable time period" not exceeding 90 days. This election gives the Subcontractor complete control of the defense which means, presumably, that the Subcontractor will use its own defense counsel.[26] Section 2782(d)(1) then continues and states, in part, that:

> *[c]onsistent with subdivision (c)*, the defense by the subcontractor shall be a complete defense of the builder or general contractor of all claims or portions thereof to the extent alleged to be caused by the subcontractor, including any vicarious liability claims against the builder or general contractor resulting from the subcontractor's scope of work, but not including claims resulting from the scope of work, actions, or omissions

of the builder, general contractor, *or any other party*. (Emphasis added.)

The intent of this sentence seems to be that the claims Subcontractor is permitted to defend under section 2782(d) are the very same claims as Subcontractor is permitted to indemnify under section 2782(c). However, section 2782(d)'s description of what section 2782(c) means is simply wrong. Section 2782(c) prohibits a Subcontractor from indemnifying Builder Parties for their own negligence—it says nothing about the "any other party" limitation contained in section 2782(d)(1). So, notwithstanding this conflicting language in section 2782(d)(1), presumably, a Subcontractor *can* indemnify Builder Parties for residential construction defect claims relating to the Subcontractor's scope of work that are caused by third parties who are *not* Builder Parties.

The new law does not specify how or when a Subcontractor makes an election to pay its share of defense fees and costs.[27] One would presume that if a Subcontractor does not timely elect to defend, then it would be deemed to elect payment, the only remaining option, but the statutory language is silent about any deemed election. In any event, the payment option requires the Subcontractor to pay its share of fees and costs within thirty days of receiving an invoice from the Builder Parties.

These new procedural requirements raise practical issues and potentially introduce uncertainty and confusion into the process of defending construction defect claims. First, a Subcontractor is obligated to defend claims only to the extent alleged to have been caused by the Subcontractor, and that obligation expressly excludes "claims resulting from the scope of work, actions, or omissions of the builder, general contractor, or any other party." Since construction defect suits often involve work touched by many different trades, it seems, at a minimum, impractical and inefficient and, in reality, even impossible, to require that each implicated Subcontractor separately defend only its slice of the defect issues, especially since the parties are unlikely to agree about the nature and size of that slice early in the litigation.[28] Naturally, a Subcontractor and Builder Parties will view the scope of the Subcontractor's defense obligation quite differently. The Subcontractor will want to define it narrowly and the Builder Parties will want to define it broadly. Even though that difference of opinion can ultimately be determined by separate litigation, the Builder Parties must mount a complete defense of the lawsuit since the implicated Subcontractor will likely be willing to handle only its portion of that defense, as defined by the Subcontractor.

If the Subcontractor elects to pay its share of defense fees and costs, and the Subcontractor and Builder Parties are unable to agree on the Subcontractor's allocation, the Subcontractor will probably pay what it thinks it owes and defer determination of the proper allocation, in the words of section 2782(d)(2), to the "final resolution of the claim, either by settlement or judgment."

One of the most significant impacts of these required procedures is the Builder Parties' loss of control.[29] Once a Builder Party tenders a claim to a Subcontractor, the Subcontractor then gets to elect whether to assume the defense or pay its share of defense costs. Although Builder Parties may view the "pay" option as acceptable, they may hesitate taking the chance the Subcontractor will elect to defend given the undesirable multiple party defense scenario mandated by the new statutory requirements discussed in this section V above. These difficult issues will need to be weighed at the time the Builder Parties anticipate tender as a possibility for a claim or expected claim not covered by a wrap-up policy.

VI. TENDERING CLAIMS—WRAP-UP POLICY

Since "wrap-up" insurance is typically structured to cover the Builder Parties and all or almost all Subcontractors involved in a given project, the wrap-up insurer defends all of those parties and that defense typically eliminates any reason for the Builder Parties to tender the claim to Subcontractors. Thus, the section 2782(d) tender requirements discussed above will apply as a practical matter only to projects with a traditional insurance structure where Builder Parties and Subcontractors each carry their own insurance. Assuming that is how section 2782(d) is interpreted and applied, a project using a "wrap-up" insurance policy should avoid the difficult tender requirements and issues discussed in Section V above.[30]

With "wrap-up" insurance, each Subcontractor often agrees to pay to the Builder Party sponsoring the "wrap-up" policy a "contribution" to defray the self insured retention (SIR)[31] incurred by the Builder Party for each claim and the "wrap-up" insurer would then take over the defense of all insureds involved. As described in section VII below, however, a Subcontractor's required SIR contribution must now meet reasonable allocation requirements under section 2782.9(b).

VII. STATUTORY RESTRICTIONS FOR WRAP-UP INSURANCE

The law adds new sections 2782.9 and 2782.95 that address issues applicable to "wrap-up" insurance or "other consolidated insurance program" in a "residential construction project." Finally, the law adds section 2782.96 which applies to a "wrap-up insurance policy or other consolidated insurance program for a public work . . . or any other project other than residential construction."

A. Overlapping Indemnity

Section 2782.9 addresses a situation where a construction subcontract for a "residential construction project"[32] contains a Subcontractor indemnity under which the Subcontractor must "indemnify, hold harmless, or defend" another for liabilities already covered by a "wrap-up" policy in which the Subcontractor was enrolled and participating. In other words, this provision addresses overlapping coverage of the same risk, *i.e.*, a Subcontractor's indemnity that covers the same, or a portion of the same, liability covered by "wrap-up" (or other consolidated) insurance.[33] Under AB 2738, new section 2782.9(a) declares *unenforceable* all "contracts, provisions, clauses, amendments, or agreements contained therein entered into after January 1, 2009" with such an overlap. Although the probable intent of this provision is to protect Subcontractors from having to provide an indemnity to the extent of "wrap-up" insurance coverage, the literal language of the provision can be read to declare the *entire contract* unenforceable in that situation rather than just the overlapping aspect of the indemnity.[34]

B. SIR Contributions

Section 2782.9(b)[35] permits Builder Parties to require Subcontractors and other "wrap-up" policy participants to pay a "reasonably allocated contribution" towards an applicable "wrap-up" policy SIR if three requirements are met:

1. the contract discloses the maximum amount and method of collection of the SIR contribution;
2. the SIR contribution is reasonably limited so that each "wrap-up" participant will make some SIR contribution towards claims alleged to be caused by that participant's scope of work; and
3. the SIR contribution bears a reasonable and proportionate relationship to the alleged liability arising from the claim or claims 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, a Subcontractor is not required to pay its SIR contribution until the SIR is incurred by the Builder Parties and the Subcontractor receives written notice of the amount and basis for the contribution. Not surprisingly, the total contributions collected from "wrap-up" participants cannot exceed the actual SIR payable by the Builder Parties for an applicable claim, *i.e.*, the Builder Parties cannot make a profit on the SIR contributions.

C. Wrap-Up Disclosure—Private Residential Projects

The statute mandates disclosure of specified terms of a "wrap-up" insurance policy or other consolidated insurance program covering a "private residential"[36] work of improvement that "first commences construction" after January 1, 2009.[37]

Under section 2982.95, the owner, builder or general contractor[38] obtaining the "wrap-up" policy must disclose the total amount or manner of calculation of any credit or compensation for premium required from a Subcontractor or other participant. The contract documents must also disclose the following, if and to the extent known:

1. The policy limits.
2. The scope of policy coverage.
3. The policy term.
4. The basis upon which the deductible or occurrence is triggered by the insurance carrier.
5. If the policy covers more than one work of improvement, the number of units, if any, indicated on the application for the insurance policy.
6. A good faith estimate of the amount of available limits remaining under the policy as of a date indicated in the disclosure obtained from the insurer.

The statutory language acknowledges that the disclosures in items (5) and (6) are made as of a point in time and may change in the future. These disclosures are presumptively made in good faith if the item (5) disclosure matches information in the insurance application and the "wrap-up" insurer or broker provided the item (6) information. Upon request, any participant is entitled to a copy of the policy that reflects items (1)-(4) above or, if the policy is unavailable, at least a copy of the insurance binder or declaration of coverage.

If the owner, builder, or general contractor obtaining the "wrap-up" insurance does not disclose to a bidder prior to the bid the total amount or manner of calculation of a required "wrap-up" insurance bid credit, the bid will not be binding unless the bidder has the right to increase its bid by up to the amount the actual required "wrap-up" bid credit exceeds the bid amount for "wrap-up" insurance, if any. However, this pre-bid disclosure is not required if the Subcontractor does not have to provide any "wrap-up" bid credit.

D. Wrap-Up Disclosure—Public Works & Private Non-Residential Projects

As a final matter, section 2782.96 specifies certain disclosures by owners, builders, or general contractors which obtain a "wrap-up" or other consolidated insurance program for a "public work"[39] (potentially residential or non-residential) *or* "any other project other than residential construction"[40] that is put out to bid after January 1, 2009. Thus, this required disclosure seems to apply to *every type of construction other than* the "private residential" covered by section 2982.95.

For affected projects, the "wrap-up" policy disclosure requirements are as follows:

(1) the bid documents must clearly set forth the total amount or manner of calculation of any credit or compensation for premium required from a Subcontractor or other participant.

(2) to the extent known, the named insured must disclose to the Subcontractor or other participant in the contract documents: (a) the policy limits, (b) the known exclusions, and (c) the length of time the policy is intended to remain in effect.

Upon request, any participant is entitled to a copy of the policy or, if the policy is unavailable, at least a copy of the insurance binder or declaration of coverage.

VIII. CONCLUSION

AB 2738 is poorly drafted, dense, ambiguous, and raises a number of questions the Legislature will need to clarify or the courts will have to answer. The statute primarily affects owners, builders or general contractors involved in "residential" construction, but also impacts *any* developer utilizing a "wrap-up" insurance policy to cover construction participants.

A. Action Suggested for Private Residential Projects

AB 2738 impacts *every* private residential developer and general contractor that is still in business. Suggestions on how to respond follow.

1. *Check Contract Language*: Developers and general contractors should review residential subcontract language and revise it, as necessary, to conform to the new law.
   - Conform contractual indemnity and defense provisions applicable to residential construction defects, perhaps by using carveout language, to the maximum scope allowed under section 2782(c) and (d).

- To the extent negotiable, expressly provide that the Subcontractor's defense obligation is immediate, subject to the statutory restrictions.
- For any new residential construction contracts, or existing residential contracts amended after 2008, review the contract language to identify the possibility of section 2782.9(a) overlap between a Subcontractor indemnity and "wrap-up" insurance coverage. It may be best to insert a savings clause in all such contracts or amendments that defines the scope of indemnity so that it *cannot* overlap the scope of "wrap-up" coverage.
- If Subcontractors are contractually obligated to make an SIR contribution towards a construction defect claim, the section 2782.9(b) requirements that the contribution must be reasonably allocated, etc., may apply. Unfortunately, since section 2782.9(b) does not include an express effective date, it is unclear whether it applies only to new contracts, or also to post-2008 amended contracts or to any post-2008 contributions by Subcontractors.

2. *Consider the Effect of Amendments*: Since amending existing subcontracts may destroy "grandfather" protection enjoyed by the original subcontract, consider that ramification carefully before executing an amendment. Such an amendment would need to include the conforming statutory changes. In certain cases, it may be advisable to execute a new contract rather than amend an existing one.

3. *Be Aware of New Tender Requirements*: The new tender requirements (probably) apply to any post-2008 tender of a residential construction defect claim to a subcontractor for indemnity and/or defense. Since the effective date of section 2782(d) is not specified, developers and general contractors should consult with legal counsel prior to making any demand on a Subcontractor that could be construed as such a tender.

4. *"Wrap-Up" Policy Disclosures*: The "wrap-up" policy disclosures under section 2982.95 will apply to any project that "first commences construction" after January 1, 2009, and contract bid documents will need to be modified accordingly.

B. Action Suggested for Public Works and Private Non-Residential Projects

AB 2738's impact on construction *other than* private residential projects is limited to specified "wrap-up" insurance disclosure requirements in bid and contract documents for projects put out to bid after January 1, 2009, and all such developers utilizing "wrap-up" insurance need to conform their documents accordingly.

Mr. Deverich is a partner at Deverich & Gillman LLP in Irvine, CA. He represents public company and private developers, property owners, investors and master planned communities in real estate, development, construction and joint venture transactions. He received an undergraduate degree in accounting and finance from Brigham Young University and a law degree from Boalt Hall School of Law (UC Berkeley).

ENDNOTES

1 Chapter 467, Statutes of 2008, signed by the Governor and filed with the Secretary of State on September 27, 2008.

2 "Wrap-up" insurance is defined by reference to CAL. INS. CODE § 11751.82(b) quoted below:
"For the purposes of this section, a 'wrap-up insurance policy' is an insurance policy, or series of policies, written to cover risks associated with a work of improvement, as defined in section 3106 of the California Civil Code, and covering two or more of the contractors or subcontractors that work on that work of improvement."

3 Chapter 394, Statutes of 2005, signed by the Governor and filed with the Secretary of State on September 29, 2005.

4 The meaning of this and other key terms used in the statute is discussed in detail in Section III of this article.

5 Chapter 32, Statutes of 2007, signed by the Governor and filed with the Secretary of State on July 6, 2007.

6 Unless otherwise indicated, all Section references in this article are to the California Civil Code.

7 CAL. CIV. CODE § 3104, which is located in the portion of the Civil Code dealing with mechanics' liens and stop notices, defines "subcontractor" as "any contractor who has no direct contractual relationship with the owner." That particular definition was not intended to apply beyond that limited context. CAL. CIV. CODE § 3082.

8 *See* BUS. & PROF. CODE § 7044(b). Interestingly, even that statute refers to an owner contracting with a licensed "subcontractor" although such a contract would be a direct (or prime) contract and not a subcontract. The California Business & Professions Code also omits any definition of subcontractor.

9 Chapter 722, Statutes of 2002, signed by the Governor and filed with the Secretary of State on September 20, 2002. That law added Title 7 to Part 2 of Division 2 of the Civil Code (CAL. CIV. CODE § 895-945.5).

10 The AB 2738 instances of "residential" or "residential construction" that expressly adopt Right to Repair Law usage are sections 2782(c), 2782.95 and 2782.96. The term "residential construction project" is used in Section 2782.9 without definition.

11 Section 896(c) covers soils issues and engineered retaining walls.

12 *See* section 896(a)(9).
13 *See* section 896(a)(12).
14 *See* section 896(a)(14).
15 *See* section 896(f).
16 *See* section 896(g)(1).
17 Section 897 states: "The standards set forth in this chapter are intended to address every function or component of a structure." Section 895 then defines "structure" as "any residential dwelling, other building, or improvement located upon a lot or within a common area."
18 A master developer is arguably "in the business" of "developing . . . residential units for public purchase" by virtue of its master grading and installation of various types of infrastructure discussed above.
19 The statute does not define this use of term "contractor" which leaves the reader to surmise that it may mean the "general contractor" and/or "contractor not affiliated with the builder" used earlier in the same sentence.
20 Although AB 758 utilized identical effective date language with a January 1, 2006 effective date, the language is inherently ambiguous and raises questions about the effect of a post-2008 amendment to an existing pre-2009 contract. Does the modified statute apply somehow *just* to the scope of the amendment and not to existing unamended portions of the contract, or does *any* post-2008 contract amendment bring a pre-existing contract under the new provisions of the law? What about an amendment as innocuous as changing an address in the notices provision? Must the amendment involve the substantive issues covered by the statute such as indemnity, insurance, etc., to justify nullifying the "grandfather" protection otherwise afforded to a pre-2009 contract? Until these questions are answered, the safest assumption must be that *any* amendment to an existing contract subjects that *entire contract* to the application of the new statute.
21 California courts have traditionally classified a contractual indemnity clause as either "Type I," "Type II," or "Type III" depending on how the indemnitee's negligence is handled. *See, e.g., MacDonald & Kruse, Inc. v. San Jose Steel Co.*, 29 Cal. App. 3d 413, 419 (1972). However, this traditional approach may be evolving slowly from a three-category analysis to simple contract interpretation of the precise text of the indemnity provision. *St. Paul Mercury Ins. Co. v. Frontier Pacific Ins. Co.*, 111 Cal. App. 4th 1234, 1246 n.6 (2003). In a "Type I" indemnity, the indemnitor "expressly and unequivocally" indemnifies the indemnitee for the indemnitee's own negligence (active and passive), while a "Type II" indemnity only covers the indemnitee's own passive (but not active) negligence. 29 Cal. App. 3d at 419. On the other hand, in a "Type III" indemnity, the indemnitor indemnifies the indemnitee for liabilities *caused by* the indemnitor but not for liabilities caused by anyone else. *Id.* at 420. With the changes imposed by the Legislature, a Subcontractor is now permitted to provide an indemnity that is closer to, but still broader than, a "Type III" indemnity because it can cover not only the negligence of the Subcontractor and strict liability arising from the Subcontractor's work, but also liability arising from the Subcontractor's scope of work that is caused by third parties who are not Builder Parties.
22 AB 2738, 2007-2008 Session, Bill Analysis, Concurrence in Senate Amendments, as amended August 18, 2008, at 2 (Cal. 2008).
23 Since there is no effective date associated with section 2782(d), it probably applies to all applicable tenders made after 2008.
24 Almost certainly, the Builder Parties will be the ones who are indemnified.
25 Apparently, some insurers take the position that the "Calderon" notice required under the Right to Repair Law is not a "suit" under policy language that triggers the insurer's defense obligation. This provision seems designed to make a tender under the new procedure the equivalent of filing suit and, therefore, obligate insurers to defend.
26 With encouragement from AB 2738, a Subcontractor may view defense counsel as its "own" attorney under Subcontractor's control. However, any attorney trying to represent both the Subcontractor on one hand and Builder Parties on the other will most likely face an impossible conflict of interest that the Builder Parties will not waive. *See* Cal. Rules Prof'l Conduct R. 3-310(C). As a result of the conflict, the Subcontractor (or its insurer) will almost certainly end up hiring separate counsel to defend the Builder Parties and the Subcontractor will thereby lose all practical ability to "maintain control of the defense" promised by section 2782(d)(1).
27 According to section 2782(d), a subcontractor and builder/general contractor can mutually agree to the "timing or immediacy" of the defense and provisions for reimbursement of defense costs and fees, provided that those agreements are in accordance with section 2782(c) and (d).
28 Interestingly, faced with a similar situation in a recent residential construction defect case, the California Supreme Court acknowledged the "practical difficulties of sorting out multiple, and potentially conflicting, duties to assume the active defense of litigation then in progress." *Crawford v. Weather Shield Mfg. Inc.*, 44 Cal. 4th 541, 565, n.12 (2008). In response to such difficulties, the *Crawford* Court then discussed approvingly the parties' deferral of indemnity and duty to defend issues until the end of the underlying construction defect case. *Id.* Unfortunately, the new AB 2738 approach will almost certainly return litigants to the finger pointing among multiple counsel that experience has shown is so time consuming, costly, and inefficient.
29 Of course, as discussed in note 26 *supra*, concern about a loss of control is somewhat lessened as a result of the ethical constraints imposed on counsel by the conflicts of interest rules. As a practical matter, Subcontractor

control of defense makes more sense in a case involving *just one* trade Subcontractor, but it certainly does not work in cases involving multiple trade defendants. Regardless, the notion of tendering complete control of defending Builder Parties to a Subcontractor having a primary goal of limiting its own liability is somewhat offensive.

30 This assumes the insurer does not reserve its rights as to any significant issue, *e.g.*, mold claims.

31 An SIR is a dollar amount specified in an insurance policy that must be paid by the insured before the insurance policy will respond to a loss. Although an SIR is conceptually similar to an insurance deductible, there are important technical distinctions beyond the scope of this article. Even though it is called self *insurance*, that is a bit of a misnomer because an SIR is not really insurance at all – in fact, it is "repugnant to the [very] concept of insurance." *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 72, n.20 (1997) (citing cases).

32 This term is not defined in this portion of the statute, but logic suggests that "residential" should have the same meaning assigned elsewhere in the statute.

33 On its face, the statute does not allow for the possibility that the overlapping "wrap-up" coverage may ultimately be exhausted. Presumably, even under that circumstance, this provision still prohibits a Subcontractor from indemnifying Builder Parties, *even for the Subcontractor's own negligence*, because "wrap-up" insurance was once applicable to the project. Although that result seems to fly in the face of the Legislature's concern underlying AB 2738 that Subcontractors' liability be limited to their own negligence, Builder Party sponsors of a "wrap-up" policy should be forewarned to obtain ample coverage or be prepared to shoulder themselves all liability for Subcontractors' negligence after "wrap-up" coverage is exhausted.

34 Section 2782.9(b) allows a party to pursue an equitable indemnity claim in cases where "any contractual provision is deemed unenforceable pursuant to this section" unless the wrap policy provides coverage for that claim. This reference to a contractual "provision" suggests that section 2782.9(a) intends to make unenforceable *only* the specific offending indemnity *provision* and not the *entire contract*, but that is by no means clear. If the entire contract is rendered unenforceable, that may cause other problems for all concerned including the Subcontractors.

35 Although section 2782.9(a) is expressly applicable only to "contracts, provisions, clauses, amendments, or agreements contained therein entered into after January 1, 2009," it is unknown whether that effective date language also applies to the separate provisions in section 2782.9(b). Thus, depending on how it is interpreted by the courts, section 2782.9(b) may apply *only* to new contracts entered into after 2008, or possibly also to existing contracts amended after 2008, or even to *any* post-2008 SIR contributions by Subcontractors, without regard to the applicable contract date.

36 As in certain other provisions in the statute, the term "residential" as used in section 2982.95 is defined by reference to the Right to Repair Law. However, the term "private residential" is not used in the Right to Repair law. In the absence of enlightenment by the statutory language, logic suggests that a "private residential" work of improvement means a "residential" work of improvement built with private as opposed to public funds.

37 The phrase "work of improvement that first commences construction" defines the effective date of section 2982.95, but not without raising questions. First, it is entirely possible that the *contract* for a subject "work of improvement" was executed prior to 2009, but the *construction* of that work of improvement does not commence until after January 1, 2009. In that case, does the statute intend to force amendment of the contract to include the wrap disclosure? Second, the term "work of improvement" is not defined. It could be defined broadly, such as an entire tract of residences, more narrowly, as an individual residence within a tract of residences, or even on a very narrow basis, such as the retaining wall component for a residence. Each of these possibilities would change the application of the statute.

38 Sections 2982.95 and 2982.96 apply to an "owner, builder, or general contractor." The term "Builder Parties" first used in section IV of this article is a very similar concept utilized as shorthand for the "builder . . . general contractor or contractor not affiliated with the builder" language used in section 2782(c). Although both groups are likely to be identical, the statutory language is inconsistent and this article intentionally preserves the differing statutory terminology.

39 In this case, "public work" is defined to mean any "public works" under CAL. LAB. CODE § 1720. The "public works" definition is very complex, but primarily includes projects paid for in whole or part from public funds.

40 For the meaning of "residential construction" the statute again adopts the same use as the Right to Repair Law which, as explained in section III above, does not expressly define the term.