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## California Change to Construction Contracts Could Increase Litigation

By Patricia-Anne Tom  
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California Gov. Arnold Schwarzenegger has approved legislation affecting indemnity for construction defect claims in contracts in residential construction — a decision that could increase litigation when resolving construction defect claims and could increase the defense limits needed in wrap-up policies.

Assembly Bill 2738, which was signed by the governor on Sept. 27, 2008, states that for construction contracts entered into after Jan. 1, 2009, "if a builder or contractor tenders a claim, or a portion thereof to a subcontractor, the subcontractor shall be entitled to either defend the claim with counsel of its choice or pay, within 30 days of receipt of an invoice from the builder or general contractor, no more than a reasonable share of the builder's or general contractor's defense fees and costs. The bill provides that a builder, general contractor or subcontractor has the right to seek equitable indemnity for construction defect claims." And the subcontractor can maintain control of the defense for any claim or portion of the claim to which the defense obligation applies.

Additionally, the bill states that any builder's wrap-up insurance policy that requires an enrolled and participating subcontractor or other participant to indemnify, hold harmless, or defend another for any claim or action covered by that program arising out of the project is unenforceable. This also would apply to workers' compensation claims in which coverage is provided by the wrap-up.

And, the bill requires that "for wrap-up insurance policies or other consolidated insurance program, the owner, builder or general contractor that obtained the policy or program to disclose the total amount or method of calculation of any credit or compensation for premium required from a subcontractor or other participant for that policy or program."

Similar disclosure requirements would apply if an owner, builder or general contractor obtains a wrap-up insurance policy or other consolidated insurance program for a public work, or any other project other than residential construction that is put out for bid after Jan. 1, 2009.

Wrap-up insurance policies generally are purchased by the construction project owner or general contractor to cover himself or herself as well as subcontractors working on the project, rather than have each subcontractor provide his or her own insurance.

The California Professional Association of Specialty Contractors (CALPASC) applauded the signing of the bill, saying the new law will "reduce the defense costs of lawsuits filed against trade contractors in construction defect claims. It also will ensure that builder-controlled insurance policies are fair and equitable, and include adequate limits to protect trade contractors and consumers in construction defection situations," the association said in a statement.

Subcontractors generally believe the law gives them more power and reduces their risk to address construction defect claims.

"If a builder's wrap-up policy indemnifies subcontractors, it means the wrap-up policy is working," according to the CALPASC. "Unless a builder knows it has an under-funded wrap-up policy, there is no need to require indemnity from subcontractors in this context. Builders can still request an indemnity for non-general liability claims, such as delays, etc."

The drawback, according to DBH Resources, a risk management consultancy that provides wrap-up administration services, is that the law will "increase litigation costs of resolving construction defect litigation; force builders to indemnify subcontractors for subcontractors' own negligence or fault, even though negligence is no longer the standard in construction defect cases; create chaos in the wrap-up administration process by removing the ability of subcontractors and builders to negotiate fair contributions to wrap-up premiums; and cause litigation and delay in claims handling under wrap-up policies."

Explaining why he believes litigation will increase, DBH Resources CEO George Dale stated, "The bill states that if a builder tenders a claim to a subcontractor, as allowed by contract and the remainder of the bill, the subcontractor shall be entitled to control the defense of the claim and choose its own counsel for this purpose. Under this scenario, if a construction defect claim has, for example, five claimed defects with 10 potentially responsible subcontractors, there would be 10 subcontractors attempting to control that portion of the builder's liability with potentially 10 separate counsel all representing the builder."

"Reducing the number of attorneys involved in litigation, creating fair allocation of indemnity for claims created by subcontractors and builders, and promoting the use of well-administered wrap-up policies are all good public policy," Dale added. The legislation, he noted, "will cause the costs and delays associated with litigation to increase and will result in incredible uncertainty in the creation and administration of wrap-up insurance policies."

In the past, wrap-up policies tried to answer the question, "whose fault is it?" in construction defect claims that it's the entire project's fault, said Treacy Duerfeldt, strategic development specialist for the **Western States Contractors' Alliance**. Under the new law, every subcontractor is entitled to his own defense. So determination of fault will cost money because there will more litigation, he agreed.

Another concern regarding the new law involves the disclosure requirement, according to Kevin Gillispie, partner at Wood Smith Henning & Berman LLP, which analyzed how the law will impact construction defect cases in the future. The requirement to disclose to enrolled subcontractors the key terms and conditions of coverage under any wrap-up insurance policy covering a project is difficult to conform to because a lot of wraps are tied to multiple projects and the law requires disclosures be made prior to the time the participant/subcontractor submits a bid, he explained.

"The purpose of the requirement is to allow enrolled subcontractors to learn some of the more important terms of coverage in sufficient time to negotiate the contract prior to the beginning of the project," he said. However, builders can't just say they have a \$10 million policy, they must say how much has been used up before, how much is tied to closing, etc., which builders are having a real difficult time with," especially given the fact that wraps may cover multiple projects. Given the disclosure requirement, builders are going to have to take care that they don't disclose they have a certain amount to cover a project then run out of money when the wrap is tied to multiple projects, he said, noting builders are likely to more carefully scrutinize the amount of insurance coverage they have.

Nevertheless, CALPASC believes that the new regulations represent a compromise between trade contractors, home builders and insurance brokers that "will allow the parties involved in a construction defect lawsuit to quickly and efficiently manage and resolve the alleged defective claims," said Brade Diede, CALPASC executive vice president.

Given the new law, Duerfeldt, recommended insurance agents and brokers make sure to discuss and offer customers adequate limits on their wrap-up policies. "Be extra sure adequate limits are contemplated and offered, as the subcontractors are entitled to their own defense costs in addition to the developer. Multiple defense costs means there's a need for higher limits," he said.

"For those builders that are relying on wrap-up insurance policies as their only insurance coverage, and are without excess coverage, careful attention to the viability of the insurance carrier, the policy limits, and whether the limits are exhausted by defense fees and costs will be critical," said Gillispie and Steve Henning, also of Wood Smith Henning & Berman LLP. "If the insurance carrier is unable to respond to the claim due to solvency or limits issues, under the changes included in AB 2738, a builder will not be able to use express indemnity provisions as a means of transferring the risk over and above the coverage limits of the wrap policy. Whether this will result in a significant decrease in the use and desirability of wrap policies, or whether builders will obtain more excess insurance in addition to coverage from wrap policies remains to be seen."

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