JANUARY 2012

CALIFORNIA CONSTRUCTION LAW: IMPORTANT CHANGES AHEAD

A number of significant changes to California construction statutes take effect over the next year. The first group of changes caps the amount of retention that can be withheld on public projects and shortens the time in which progress payments to subcontractors must be statutorily made on public and private projects, both of which took effect January 1, 2012. Second, sweeping modifications to California law governing mechanics' liens and stop notices become effective July 1, 2012. Third, subcontractor interest groups championed major modifications to California's "anti-indemnity" statutes—modifications that are generally very protective of subcontractors. The ramifications are so far reaching that these changes do not go into effect until January 1, 2013. Contract forms and contract administration need to be adjusted in light of each of these changes to avoid inadvertent forfeiture of important rights and unenforceable contract provisions.

RETENTION AND PROMPT PAYMENT: CHANGES EFFECTIVE JANUARY 1, 2012

Senate Bill 293 ("SB 293"), signed by Governor Edmund G. Brown, Jr., on October 9, 2011, made two notable changes—establishing a five percent cap on retention on public contracts and shortening from 10 days to seven days the time by which subcontractors must be paid after receipt of progress payments.

Retention Cap on Public Contracts. SB 293 adds Section 7201 to the Public Contract Code, which caps the retention that may be held on a public works contract. Section 7201 applies to contracts entered into on or after January 1, 2012, between a "public entity"[1] and an original contractor,[2] between an original contractor and a subcontractor, and between subcontractors and lower-tier subcontractors relating to construction of any public work of improvement. Section 7201 provides new limits on retention, including five percent of any payment and an overall cap on total retention of five percent of the contract price.

Previously, public agencies could hold more than five percent of the contract price as retention as there was no statutory cap on what a public owner could specify as the retention percentage. Prior to establishment of this cap, public owners in California typically specified a 10 percent retention. Some competitively bid projects might specify a lower retention rate or provide for a step down from 10 percent to five percent once the project reached 50 percent completion. Similarly, on an increasing number of public contracts awarded by means other than competitive bidding (*e.g.*, best value awards where statutorily permitted), lower retention rates had become more common. The new law now mandates a retention rate no higher than five percent. For general contractors, this is good news as public owners will generally not be able to withhold more than five percent in retention. However, general contractors and subcontractors on public works projects need to be mindful that, absent one of the exceptions discussed below, this five percent cap applies to their contracts as well and not just to the contract between the general contractor and the public owner.

Many public entities opposed SB 293 on the grounds that additional retention may be needed to ensure prompt, on-time completion of important projects and to protect taxpayers. Contractors argued that reduced retention was necessary, particularly in the current economy, to provide sufficient cash flow and ensure contractors are able to perform. Contractors prevailed in this battle. However, the final legislation includes a sunset date of January 1, 2016. Additionally, several statutory exceptions exist, including a procedure whereby the public entity, after a proper hearing, can find a particular project to be "substantially complex" and specify a retention amount greater than five percent in the bid documents for that project. No definition is provided for "substantially complex," and disputes may arise between owners and contractors as to how broadly this exception may be applied.[3]

Prompt Payment. SB 293 also amends various prompt payment statutes to expedite payments to subcontractors. Business and Professions Code Section 7108.5 and Public Contract Code Section 10262.5 now provide seven days for payments to subcontractors after the prime contractor receives each progress payment from the owner rather than 10 days under prior law. These changes apply to both private and public construction projects. As with the changes to the anti-indemnity statute discussed below, the new law benefits subcontractors and is another legislative victory for groups representing subcontractor interests. The statutory remedies for prompt payment violations remain the same, including a penalty of two percent of the amount due per month for every month that payment is not made and the award of attorneys' fees and costs to the prevailing party.

MECHANICS LIENS AND STOP NOTICES: CHANGES EFFECTIVE JULY 1, 2012

Senate Bill 189, signed by Governor Brown on September 30, 2010, set forth a series of changes to the California mechanics' lien and stop notice statutes (collectively "Mechanics Lien Law") based upon recommendations from the California Law Review Commission. These recommendations were intended to modernize and simplify the Mechanics Lien Law, which the Commission felt had become "unduly complex and impenetrable as the result of piecemeal amendments over the years." Both mechanics liens (private projects) and stop notices (private and public projects) are highly technical tools used to secure payment by those who provide, for example, labor or materials to a project. Under SB 189, some of the recommended changes took effect in January 2011, but most were deferred until July 1, 2012. Further legislation was passed this year (Senate Bill 190, approved by the governor on June 29, 2011) to clean up some of the changes in SB 189 and facilitate the new statutory scheme.

Effective July 1, 2012, the existing Mechanics Lien Law (commencing with Section 3082 of the Civil Code) will be repealed and replaced with new provisions in three titles relating to: (i) works of improvement generally (commencing with Civil Code Section 8000); (ii) private works of improvement (commencing with Civil Code Section 8170); and (iii) public works of improvement (commencing with Civil Code Section 9100). Although many provisions are renumbered without substantive changes, new terminology is used throughout to attempt to modernize and clarify the statutes. For example, stop notices are now referred to as "stop payment notices," and the term "original contractor" is changed to "direct contractor."

In addition, substantive changes were made in a number of areas, including:

- Standardized contents and procedures for giving notice and standardized notice periods;
- "Completion" no longer includes "acceptance by an owner," which may affect the time for recording a lien or filing a stop notice;
- New required releases and forms, such as mandatory conditional and unconditional waiver and release forms (*see*, *e.g.*, Civil Code Sections 8132 and 8134);
- The amount of lien release bonds has been reduced from 150 percent of the lien amount to 125 percent of the lien amount, making it easier to obtain such bonds;
- Both direct contracts (contracts directly between the owner and a contractor) and subcontracts must provide for identification of any construction lenders, and the owner must give notice of the name and address of the lender if a construction loan is obtained later in the project;
- Direct contractors, including general contractors, must now give a preliminary notice to a construction lender;
- If there are multiple direct contracts, the owner may record separate notices of completion, and the owner has 15 days to do so instead of 10;
- Separate design professional lien laws (Civil Code §§ 3081.1, *et seq.*) have been repealed, and design professional liens are now included in the new Mechanics Lien Laws.
- The limit on attorneys' fees that can be recovered by a successful owner who challenges a stale lien (which had been capped at only $2,000 under Civil Code Section 3154) has been removed.

Despite SB 189's goal of simplifying the Mechanics Lien Law, the repeal of these long-standing statutes and enactment of a new statutory scheme is likely to lead to more confusion (at least in the short run). Some parties are sure to continue to use their outdated forms and file liens and stop notices based upon statutes that are no longer on the books. Careful planning is needed to ensure that important rights are protected and that notices are given in the time, manner, and form required by the new statutes. In the case of mechanics liens and stop notices, the devil truly is in the details, and those seeking to protect their rights need to make sure that they adjust to the new requirements. Similarly, transactional lawyers involved in deals attaching lien release forms that are contractually specified for use need to make sure that current statutory forms are used or specify that the "attached form or such other form as consistent with applicable law" shall be used.

INDEMNITY AND DEFENSE COSTS: CHANGES EFFECTIVE JANUARY 1, 2013

Senate Bill 474, signed by the governor on October 9, 2011, broadens the types of indemnity provisions related to construction contracts that are unenforceable under California law. Due to the broad ramifications of this law and the need for ample lead time, these changes to California's "anti-indemnification" statute do not become effective until January 1, 2013. This new law is part of a growing national movement by subcontractors to secure legislatively mandated restrictions on the scope of indemnification obligations that can be imposed on subcontractors. For example, on January 1, 2012, a new Texas law supported by subcontractor interests became effective; it significantly restricts indemnification agreements in construction contracts in a state that allowed substantial freedom of contract as to such matters.

By way of overview, Senate Bill 474 makes three primary changes to California's anti-indemnity statute. Each of these changes essentially makes unenforceable "Type I" or "broad" form indemnity that extends to "active" negligence and makes clear that subcontractors cannot be required to provide indemnity against another's active negligence, whether on public or private contracts. Subject to certain exceptions, California's anti-indemnity statute has for years made unenforceable true broad form indemnity in connection with construction contracts by prohibiting a party from obtaining indemnity against its own sole negligence or willful misconduct or "for defects in design furnished" by such party. Cal. Civ. Code § 2782(a).[4] The new law makes clear that an indemnity for active negligence is also generally unenforceable.

The first place where this change is implemented concerns public contracts. Although the existing law made indemnity provisions in construction contracts for public projects unenforceable where the indemnity purports to shift liability

for the active negligence of a public agency from the government to the "contractor," this limitation did not expressly extend to subcontractors and suppliers. See Cal. Civ. Code § 2782(b). Under SB 474, a new subsection is added for public contracts entered into on or after January 1, 2013 that expressly extends this prohibition to "any contractor, subcontractor or supplier of goods and services." Cal. Civ. Code § 2782 (b)(2). In other words, a prime contractor on a public works project may not require that a subcontractor provide an indemnity against liability for the active negligence of the public agency.

Second, SB 474 further extends this limitation on indemnifications for active negligence to owners of private construction projects. For contracts entered into on or after January 1, 2013, a new provision is added making indemnity obligations on private contracts unenforceable if they purport to relieve the owner from its active negligence. Cal. Civ. Code § 2782(c).[5]

Third, the new law is not limited to indemnity obligations that run in favor of the owner. SB 474 also adds a new section that applies to indemnity obligations by subcontractors in favor of general contractors, construction managers, or other subcontractors on both public and private projects.

For contracts entered into on or after January 1, 2013, indemnity obligations extending to the active negligence of the general contractor, construction manager, or subcontractor are void and unenforceable. Cal. Civ. Code § 2782.05 (a). This new section also prohibits terms that would require indemnity (including costs to defend) by subcontractors for claims that "do not arise out of the scope of work of the subcontractor pursuant to the construction contract." *Id.* This limitation is meant to address what subcontractors believed were overbroad indemnities that by their terms extended beyond the scope of the subcontractor's own work. Additionally, this section proscribes imposing an indemnity obligation on subcontractors for defects in design furnished by the contracting party. The new section also specifies how the indemnification obligation is satisfied (modeled after an existing section applicable to residential construction) and sets forth a number of statutory exceptions. Cal. Civ. Code § 2782.05(b). The exceptions, among other things, specify that this new section protecting subcontractors does not apply to wrap-up insurance policies, indemnity agreements required by sureties, and contracts with design professionals.[6]

The overall intent of SB 474 is to "ensure that every construction business in the state is responsible for losses that it, as a business, may cause." SB 474 applies to construction performed on property located in California even if the parties have attempted to opt out of these changes or have agreed to a non-California choice of law provision in their contract. Cal. Civ. Code §§ 2782.05(c), (d). In other words, the statute limits the ability of parties to contract out of this law by incorporating a choice of law provision of another state like Nevada that does not prohibit indemnification for active negligence.

SB 474 will require careful analysis by owners, contractors, construction managers, and subcontractors as to risk allocation on a project and reexamination of standard contract terms, including indemnity and insurance provisions. A number of groups have expressed concerns with various aspects of this legislation and may seek clarifying amendments or other changes before it becomes effective on January 1, 2013.

This brief summary of the new law is meant to heighten awareness so that parties can take advantage of the lead time afforded by the legislature to adjust contracts, contract administration, and risk management programs. We will be issuing a *Commentary* shortly that addresses in greater detail the many ramifications of Senate Bill 474.

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ENDNOTES

1 "Public entity" is broadly defined in new Section 7201 to mean "the state, including every state agency, office, department, division, bureau, board or commission, the California State University, the University of California, a city, county, city and county, including charter cities and charter counties, district, special district, public authority, political subdivision, public corporation or nonprofit transit corporation wholly owned by a public agency and formed to carry out the purposes of the public agency." Pub. Cont. Code § 7201(a)(3).

2 Section 7201 uses the term "original contractor" to include general contractors. Other statutes, discussed below, specifically refer to general contractors and/or prime contractors. Each of these terms is used interchangeably herein.

3 Even if an exception does not apply, Section 7201 expressly makes clear that it does not limit the ability of a public entity to withhold 150 percent of the value of any disputed amount of work from final payment as permitted in Public Contract Code Section 7107(c). Section 7201(a)(2) further provides that "in the event of a good faith dispute, nothing in this section shall be construed to require a public entity to pay for work that is not approved or accepted in accordance with the proper plans or specifications."

4 The general limitation on indemnity in Section 2782 does not prevent agreements between the owner and the contractor as to "allocation, release, liquidation, exclusion, or limitation as between the parties of any liability (a) for design defects, or (b) of the promisee to the promisor arising out of or relating to the construction contract." Cal. Civ. Code § 2782.5.

5 This provision does not apply to a homeowner performing a project on a single family dwelling. Cal. Civ. Code Section 2782(c)(3).

6 Design professionals previously received some protection from indemnity obligations on public contracts under SB 972. SB 972 does not apply to private projects. *See* Cal. Civ. Code § 2782.8(e).