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CALIFORNIA'S NEW SUBCONTRACTOR DEFENSE REGIME FOR NON-RESIDENTIAL PROJECTS: CREATING ORDER OR CHAOS?

As explained in a recent *Commentary* (*available at* http://www.jonesday.com/navigating__treacherous__waters/), California's recently enacted and amended anti-indemnity statutes have expanded the bar against one construction participant forcing another to indemnify the first participant for its own "active negligence." As discussed in this *Commentary*, these statutes have also created a new regime governing how subcontractors, having contractually agreed to defend the general contractor or construction manager, will share that defense duty.

In a nutshell, under California Civil Code section 2782.05(e), which governs most non-residential projects, a general contractor ("GC") or construction manager ("CM") may only allocate a reasonable share of its defense to each subcontractor. In response, each subcontractor may elect either to defend the GC or CM or to reimburse a reasonable share of the GC's or CM's defense costs. The new regime also provides a mechanism to re-allocate defense shares after final resolution of the claim and for ensuring compliance with its provisions.

As with the recent amendments barring indemnity for a participant's active negligence, California's new subcontractor defense regime may raise more questions than it answers. Construction participants attempting to navigate the requirements of section 2782.05 may find themselves in murky waters without a clear course to avoid disputes and litigation. This commentary analyzes the recently added subcontractor defense regime and flags some of the uncertainties and risks it may create.

THE NEW REGIME FOR SUBCONTRACTOR DEFENSE DUTIES ON NON-RESIDENTIAL PROJECTS

In the past, some GCs, having contractually bound their subcontractors to indemnify them against claims arising from the project, have demanded

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that each subcontractor pick up the whole tab for the GC's defense against a claim by the owner or other claimant. Now, for contracts and amendments entered into on or after January 1, 2013, a new regime has been created under section 2782.05(e) to govern the allocation and performance of defense obligations by and among subcontractors on non-residential projects, both public and private. This new regime draws from the nearly identical pre-existing defense rules for residential projects under California Civil Code section 2782(e) (governing contracts entered into after January 1, 2009). While section 2782.05(e) should be consulted in connection with any request for defense or indemnity, a summary of the new rules follows.

PROJECTS SUBJECT TO THE NEW REGIME

The new subcontractor defense rules under section 2782.05(e) apply to any indemnity provision subject to subdivision (a) of section 2782.05, which governs "any construction contract and amendments thereto entered into on or after January 1, 2013 that purport to insure or indemnify, including the cost to defend, a general contractor, construction manager, or other subcontractor, by a subcontractor against liability for claims of death or bodily injury to persons, injury to property, or any other loss, damage, or expense. Section 2782.05(a) invalidates any clause in such a contract that seeks to require the subcontractor to indemnify or insure the GC, CM, or other subcontractor (a) for that other party's active negligence or willful misconduct, (b) for defects in the project's design provided by that other party to the subcontractor, or (c) for claims arising outside the scope of the subcontractor's work. §2782.05(a).

However, the defense-duty regime under section 2782.05(e) does not apply to the following circumstances enumerated in section 2782.05(b):

1. Contracts for residential construction that are subject to any part of Title 7 (commencing with Section 895) of Part 2 of Division 2;
2. Direct contracts with a public agency that are governed by subdivision (b) of section 2782;
3. Direct contracts with the owner of privately owned real property to be improved that are governed by subdivision (c) of section 2782;
4. Any wrap-up insurance policy or program;
5. A cause of action for breach of contract or warranty that exists independently of an indemnity obligation;
6. A provision in a construction contract that requires the promisor to purchase or maintain insurance covering the acts or omissions of the promisor, including additional insurance endorsements covering the acts or omissions of the promisor during ongoing and completed operations;
7. Indemnity provisions contained in loan and financing documents, other than construction contracts to which the contractor and a contracting project owner's lender are parties;
8. General agreements of indemnity required by sureties as a condition of execution of bonds for construction contracts;
9. The benefits and protections provided by the workers' compensation laws;
10. The benefits or protections provided by the governmental immunity laws; and
11. Provisions that require the purchase of any of the following: (i) owners and contractors protective liability insurance; (ii) railroad protective liability insurance; (iii) contractors all-risk insurance; and (iv) builders all-risk or named perils property insurance.

Some of these exceptions are not as clear on their face as others. Unfortunately, section 2782.05 offers no further guidance as to the meaning or scope of these exceptions. This lack of guidance may, at best, create uncertainty and, worse, could result in disputes and litigation.

While residential projects are exempted from these subcontractor defense rules (see the first exception above), certain residential projects are subject to nearly identical subcontractor defense rules by virtue of pre-existing section 2782. Specifically, section 2782(d), which applies to contracts entered into after January 1, 2009, prohibits a "builder" as defined in Civil Code section 911[1] from requiring a subcontractor to indemnify the builder for its negligence in connection with construction defect claims, for defects in design furnished to the subcontractor, or to the extent a claim arises outside of the subcontractor's scope of work.[2] Section 2782(e) then provides defense rules nearly identical to those in section 2782.05(e), as discussed below.

THE NEW REGIME ALLOWS A SUBCONTRACTOR TO CHOOSE HOW TO SATISFY ITS DEFENSE DUTY

A subcontractor owes no duty to defend or indemnify a GC or CM unless and until the GC/CM tenders a claim to the subcontractor in writing along with any information provided by the claimant relating to the claims resulting from the subcontractor's scope of work. The GC/CM must provide a reasonable allocation of defense costs to that subcontractor along with a written explanation as to how that allocation was determined. §2782.05(e).

If and when the GC/CM properly tenders a claim to a subcontractor, the subcontractor may elect to perform one of two options, either of which satisfies the subcontractor's defense duty:

Option 1—Defend the claim: If the subcontractor makes this election within a reasonable time and not later than 30 days after receiving a tender from the GC/CM, the subcontractor may defend the claim with counsel of its choosing and control the GC/CM's defense as to any claim to which the subcontractor's defense duty applies. The subcontractor must provide a complete defense of all claims to the extent alleged to be caused by its conduct, including the vicarious liability of the GC/CM due to the subcontractor's scope of work, but not as to claims resulting from the scope of work, actions, or omissions of the GC/CM or any other party. Any vicarious liability imposed on the GC/CM for claims caused by the subcontractor shall be enforceable against the subcontractor by the GC, CM, or claimant. The subcontractor must provide the GC/CM with any information, documentation, or evidence relating to the subcontractor's assertion that another party is responsible for the claim. §2782.05(e)(1).

Option 2—Pay a reasonably allocated share of the GC's or CM's defense costs: Alternatively, the subcontractor may pay, within 30 days of receiving an invoice from the GC/CM, a reasonable allocated share of the GC/CM's defense fees and costs. This must be performed on an on-going basis during the pendency of the claim, but it is subject to reallocation upon final resolution of the claim, either by settlement or judgment. The GC/CM must allocate to itself a share of its defense costs to the extent the claim is alleged to be caused by its work, actions, or omissions, and must allocate shares to each of the subcontractors regardless of whether the GC/CM actually tenders a claim to those subcontractors and regardless of whether those subcontractors are participating in the GC/CM's defense. Any amounts not collected from any particular subcontractor cannot be collected by the GC/CM from any other subcontractor. §2782.05(e)(2).

THE NEW REGIME IMPOSES MEASURES TO ENSURE COMPLIANCE WITH ITS RULES

Ensuring subcontractor compliance: If a subcontractor fails to timely and adequately perform its duties under section 2782.05(e)(1) above (i.e., fails to defend the claim per option 1), the GC/CM can pursue a claim against the subcontractor for any resulting compensatory damages, consequential damages, and reasonable attorney's fees. §2782.05(f). If a subcontractor fails to timely perform its duties under section 2782.05(e)(2) above (i.e., fails to pay defense invoices per option 2), the GC/CM can pursue a claim against the subcontractor for any resulting compensatory damages, consequential damages, interest on defense and indemnity costs at 2 percent per month from the date incurred, and reasonable attorney's fees incurred to recover those amounts. §2782.05(f). The GC/CM bears the burden of proving the subcontractor's failure to perform its duties under these two options, as well as the resulting damages to the GC/CM. §2782.05(f). The GM/CM can seek equitable indemnity for any claim governed by this section. §2782.05(j).

Ensuring GC/CM compliance: If a subcontractor requests re-allocation of its defense cost share, and the GC/CM fails to re-allocate within 30 days after final resolution of the claim, the subcontractor can pursue a claim for any resulting compensatory damages with interest at 2 percent per month from the date of final resolution of the underlying claim against the GC/CM. §2782.05(f). The subcontractor bears the burden of proving the GC/CM's failure to re-allocate defense costs, as well as the subcontractor's resulting damages. §2782.05(f). The subcontractor can seek equitable indemnity for any claim governed by this rule. §2782.05(j).

Despite these rules for ensuring subcontractor and GC/CM compliance with this regime, the statute does not prevent

the parties from agreeing to reasonable contractual terms for damages in the event any party fails to perform its obligations. §2782.05(f).

THE NEW REGIME ALLOWS PARTIES SOME FLEXIBILITY TO MODIFY THE TIMING OR CERTAIN OTHER DETAILS OF THE DEFENSE DUTY

Subdivision (a) of section 2782.05 states that "[t]his section shall not be waived or modified by contractual agreement, act, or omission of the parties," but that "[c]ontractual provisions, clauses, covenants, or agreements not expressly prohibited herein are reserved to the agreement of the parties." Subdivision (e) states that "Subdivision (a) does not prohibit a subcontractor and a general contractor or construction manager from mutually agreeing to the timing or immediacy of the defense and provisions for reimbursement of defense fees and costs, so long as that agreement does not waive or modify the provisions of subdivision (a) subject, however, to paragraphs (1) and (2)" (discussing a subcontractor's two options for defending the GC or CM).

It appears that while section 2782.05 is intended to prevent the waiver of its protections against subcontractor indemnities, the timing or details of the subcontractor fulfilling its defense duty can be negotiated between the parties, as long as it does not conflict with subdivision (a), and as long as it remains "subject to" subdivisions (e)(1) and (e)(2), a qualification that is not defined in the statute. It is not entirely clear when a particular negotiated agreement affecting the subcontractor's defense duty will be enforceable or barred by subdivision (a)'s non-waiver provision or subdivision (e)'s "subject to" qualification. Any such uncertainty should be considered by the parties in negotiating any such agreement.

THE NEW SUBCONTRACTOR REGIME MAY RAISE MORE QUESTIONS THAN IT ANSWERS

This new regime governing a subcontractor's performance of its contractual defense duty on non-residential projects may raise more questions than it answers. Some of the questions that construction participants may have to grapple with include the following:

- What factors should a GC consider in making a "reasonable" allocation of the defense duty among the various subcontractors?
- Each targeted subcontractor has the option to "[d]efend 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." §2782.05(e)(1). Which subcontractor "controls" the GC's defense where multiple subcontractors are alleged to have jointly contributed to the same harm? Do the relative sizes of the allocated defense shares have a bearing on who controls the defense? Will multiple law firms, appointed by multiple subcontractors, simultaneously defend the GC?
- What does it mean for a subcontractor to "control" the GC's defense? What input into decision-making and strategy do the subcontractors and the GC have where each has been allocated a share of the GC's defense? Is the degree or nature of a party's input affected by the relative size of its allocated defense share?
- The GC has until 30 days after final resolution of a claim to re-allocate defense shares upon request by a subcontractor. §2782.05(f). Does a subcontractor, which has been allocated what it believes is an unreasonably large defense share, have any recourse before final resolution of the claim?
- The statute appears to permit modification of payment and timing of the defense duty owed by the subcontractor, but then appears to provide that such modifications are "subject to" the provisions on payment and timing of defense under section 2782.05(e)(1) and (2). If parties wish to modify the timing of the subcontractor's defense duty, to what extent can they do so without violating those timing provisions?
- How would the GC's defense burden be allocated among subcontractors if the GC entered into certain subcontracts in 2012 and certain subcontracts in 2013 all tied to the same work (i.e., where some of the subcontracts are governed by the former rules and some by the new rules)?
- If a subcontractor nonetheless insures the GC contrary to section 2782.05(a) (e.g., for claims based on the GC's active negligence), what standing, If any, does the insurer have to try to use section 2782.05(a) to invalidate its duty to cover the GC?

- What is the impact on the allocation of defending the GC if one of the subcontractors were to settle with the GC or a third party claimant during the underlying action?

Although the new regime under section 2782.05(e) is nearly identical to the regime under section 2782(e) (governing certain residential contracts entered into after January 1, 2009), few if any appellate cases have tackled any of these questions. This may be due to an insufficient amount of time for disputes raising these questions to percolate up through the appellate courts.

In any event, given the uncertainty created by the new regime, some construction participants may choose to negotiate specific provisions to define their rights and obligations with regard to a subcontractor's defense of the GC or CM. But even then, participants must grapple with the question of which aspects of the defense-duty regime can be modified by the parties' agreement, and which would be considered a prohibited waiver or modification of the regime's non-waivable or non-modifiable provisions. See §2782.05(a) (contractual provisions "not expressly prohibited herein are reserved to the agreement of the parties.").

PARTING THOUGHTS

With the enactment of Civil Code section 2782.05, the California Legislature has created a new regime to govern a subcontractor's duty to defend a general contractor or construction manager on most non-residential projects. While this new regime appears intended to benefit construction participants by equitably spreading among the various subcontractors the burden of defending a GC or CM, the lack of guidance on a number of issues will likely result in disagreements and even litigation among the participants. Adding to this uncertainty is the fact that, while section 2782.05 allows the parties to address certain defense-related matters through negotiation, other matters cannot be waived or modified, and the line between what is permitted and what is prohibited is not distinct.

It remains to be seen how construction participants, and likely the courts, will address and resolve the disputes that will almost certainly arise out of the new subcontractor defense regime. In the meantime, parties should be careful to consider the impact of the new laws, and consult legal counsel as appropriate, when negotiating or modifying their construction contracts after January 1, 2013.

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ENDNOTES

1 Section 911 defines a "builder" as "any 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 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."

2 Section 2782.05(a) also states that it shall not alter the obligations of an insurance carrier (a) under *Presley Homes, Inc. v. American States Ins. Co.*, 90 Cal. App.4th 571, 573-576 (2001), which held that a subcontractor's liability insurance carrier is required to provide a full and complete defense to all claims, covered and uncovered, brought by a third party against an additional insured under that insurance policy, or (b) under *Buss v. Superior Court*, 16 Cal.4th 35, 39 (1997), which held that insurance carriers may seek reimbursement of certain defense costs for claims that are not even potentially covered by the policy, and bear the burden of proving the right to reimbursement of any such defense costs.

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