

Surety & Construction Law Alert:

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Brace for Impact? The new California Labor Code Section 218.7's implications**SUMMARY OF NEWLY ENACTED CALIFORNIA LABOR CODE SECTION 218.7:**

The passage of California Assembly Bill 1701 (now codified as Section 218.7 of the California Labor Code) has caused a ripple to run through the California construction industry. This legislation holds direct (general) contractors liable for unpaid wages, including fringe benefits and interest, owed by subcontractors to their employees on *private works* contracts entered into after January 1, 2018. The California Labor Commissioner, joint labor-management cooperation committees, and third parties (such as labor unions) may bring actions to enforce the new provisions. Notably, individual wage claimants have no private right of action. Claims must be brought within 1 year after recordation of a notice of completion or cessation, or actual completion of the work. Direct contractors may request payroll records and other project information from subcontractors and withhold payments as disputed if such information is not timely provided. Following trial, a direct contractor's property may be attached to pay for a judgment entered pursuant to the new provisions.

REVIEW OF NEW REQUIREMENTS:

- The new provisions apply to private works contracts that are entered into "on or after January 1, 2018". (Labor Code Section 218.7 (a)(1)).
- They do not "apply to work performed by an employee of the state, a special district, a city, a county, a city and county, or any political subdivision of the state." (Labor Code Section 218.7(e)).
- The statute imposes liability on "direct contractors" for "any debt owed to a wage claimant or third party on the wage claimant's behalf, incurred by a subcontractor at any tier acting under, by, or for the direct contractor for the wage claimant's performance of labor included in the subject of the contract between the direct contractor and the owner". (Labor Code Section 218.7(a)(2)).
- For purposes of the new provisions, a direct contractor is a contractor who has a direct contractual relationship with the project owner as provided in California Civil Code Section 8018. (Labor Code Section 218.7(g)). Accordingly, general contractors are "direct contractors".

- The direct contractor’s liability “shall extend only to any unpaid wage, fringe or other benefit payment or contribution, including interest owed but shall not extend to penalties or liquidated damages”. (Labor Code Section 218.7(a)(2)).
- A later section ambiguously states however that “the obligations and remedies provided in this section shall be in addition to any obligations and remedies otherwise provided by law, except that nothing in this section shall be construed to impose liability on a direct contractor for anything other than unpaid wages and fringe or other benefit payments or contributions including interest owed.” (Labor Code Section 218.7(h)).
- The new law permits “a direct contractor or subcontractor at any tier from establishing by contract or enforcing any otherwise lawful remedies” against lower tier subcontractors whose nonpayment of wages and fringe benefits create liability for the direct contractor or upper tier subcontractor. (Labor Code Section 218.7(a)(3)).
- The new provisions do not create a private right of action for individual wage claimants. Labor Code Section 218.7 (b)(4) ensures that enforcement rights do not extend beyond the class of claimants listed in sub-sections (b)(1), (2) and (3) of this section of the statute, none of which includes individual laborers. This section (4) indicates that that “[n]o other party may bring an action against a direct contractor to enforce the liability created by subdivision (a)”, that is, no one other than the listed entities may enforce the statutory provision that creates this cause of action.
- For enforcement purposes, the statute authorizes the California Labor Commissioner to bring civil or administrative actions against the direct contractor for “unpaid wages including interest” (Labor Code Section 218.7 (b)(1)).
- In addition, a “joint labor-management cooperation committee established pursuant to the federal Labor Management Cooperation Act of 1978 (29 U.S.C. Sec. 175a)” may sue a direct contractor or subcontractor for wages they owe directly to a wage claimant or for “unpaid wages owed by the direct contractor, pursuant to subdivision (a)” of the new provisions. The committee is required to provide at least 30 days notice to the direct contractor or subcontractor prior to filing an action and, in such an action, the court shall award a prevailing plaintiff its reasonable attorney’s fees and costs, including expert witness fees. (Labor Code Section 218.7(b)(3)).
- A third party (such as a labor union) that is “owed fringe or other benefit payments or contributions on a wage claimant’s behalf may bring a civil action against a direct contractor” and the prevailing party is entitled to recover its reasonable attorneys fees and costs, including expert witness fees. (Labor Code Section 218.7(b)(2)).

- Wage claims must be brought within 1 year after recordation of a notice of completion or cessation, or actual completion of the work, whichever event occurs first. (Labor Code Section 218.7(d)(1-3).
- Direct contractors are entitled to request subcontractors to provide payroll and other subcontractor project information and to withhold payments as “disputed” if the subcontractor(s) do not timely provide the requested information. (Labor Code Section 218.7 (f)(1) and (2), and (i)). However, the subcontractor’s failure to provide the information does not relieve the direct contractor of its obligations under Section 218.7. (Labor Code Section 218.7(f)(3)).
- Following trial, the property of the direct contractor may be attached to pay for any judgment that is entered against it. (Labor Code Section 218.7(c)).

WOULD A SURETY PAYMENT BOND BE SUBJECT TO LIABILITY FOR WAGE CLAIMS UNDER CALIFORNIA LABOR CODE SECTION 218.7?

California Labor Code Section 218.7 applies to private works contracts that are entered into on or after January 1, 2018 and imposes liability on general contractors for wages and fringe benefits owed to subcontractor employees at any tier who provided “labor” for the project. Private works payment bonds in California are governed by Sections 8600-8614 of the California Civil Code. Pursuant to Section 8608, claimants cannot recover against a general contractor’s payment bond on a private project “unless the claimant provided “work” to the general contractor “either directly or through one or more subcontractors”. Under Section 8400, persons who provide “work” on the project for purposes of filing liens include “(a) Direct contractor, (b) Subcontractor, (c) Material supplier, (d) Equipment lessor, (e) Laborer, [and] Design professional”.

While subcontractor payment bonds are not specifically mentioned in the California Civil Code Sections which address private works contracts, they are specifically authorized in those code sections dealing with public works contracts (Section 9554(d)) and are widely used and recognized in California for both public and private works projects.

Accordingly, both general contractor and subcontractor payment bonds will likely be subject to the liability imposed by California Labor Code Section 218.7 on general contractors for wages and fringe benefits that are owed to subcontractor employees who provided labor for the project.

DOES CONTRACTOR DEFAULT INSURANCE COVER DIRECT CONTRACTOR LIABILITY FOR WAGE CLAIMS UNDER CALIFORNIA LABOR CODE SECTION 218.7?

Contractor default insurance (also referred to as subcontractor default insurance) is an insurance policy that provides catastrophic loss protection to the general contractor (or owner) for subcontractor (and supplier) performance default by reimbursing the general contractor (or owner) for the direct and indirect costs it incurs in completing the subcontractor's work under a covered subcontract following default and termination. The contractor is responsible for the policy deductible which may be several hundred thousand dollars or more per loss as well as co-pays after the deductible has been reached. Also, unlike surety bonds, the policy does not provide payment benefits to lower tier subcontractors and suppliers who are not paid by the subcontractor whose performance is insured.

California Labor Code Section 218.7 imposes liability on general contractors for wages and fringe benefits that are owed by subcontractors at any tier to their employees and third parties (such as unions) for work that has been performed on the project that is the subject of the general contract.

While contractor default insurance will reimburse the general contractor for the direct and indirect costs incurred in completing performance of covered subcontracts, it will not pay for wage claims arising out work that has already been performed prior to default and termination. It also will not cover wage claims that originate from lower tier subcontractors who simply are not covered by the policy. In addition, it seems likely that many claims under California Labor Code Section 218.7 would be made after a covered subcontractor's performance was completed or the project itself was finished. Under those circumstances (where performance is complete), contractor default insurance would not provide any coverage.

Furthermore, even if previously incurred wage costs were covered by contractor default insurance, reimbursement would be subject to the significant deductible and co-pays associated with the policy. Accordingly, we believe contractor default insurance will not cover the liability imposed by California Labor Code Section 218.7 unless the language of the policies was specifically modified to cover labor costs previously incurred and owed by covered subcontractors before default and termination as a cost of completing the subcontract performance. Moreover, even if the policy language were modified to cover pre-existing labor costs, contractor default insurance still would not cover wage claims originating from the employees of lower tier subcontractors and reimbursement under the policy would still be subject to significant deductibles and co-pays.

RECOMMENDATIONS TO LIMIT EXPOSURE UNDER CALIFORNIA LABOR CODE SECTION 218.7:

We believe the following actions may help to mitigate the increased risk created by Labor Code Section 218.7:

- General contractors should require their subcontractors to provide payment bonds on private works projects.
- In lieu of a payment bond, general contractors could require major subcontractors to provide a letter of credit to satisfy claims under Labor Code Section 218.7.
- General contractors could broaden existing defense and indemnity provisions to include claims made under Labor Code Section 218.7 and require that such provisions flow down to lower tier subcontracts.
- General contractors could require that payroll records for subcontractors be provided for each pay period (coupled with conditional releases or other acknowledgment of payment from subcontractor employees) and have those provisions flow down to lower tier subcontracts.
- Similarly, general contractors could request on a regular basis during the course of the project that unions provide acknowledgments fringe benefit payments have been received from subcontractors on behalf of employees at every tier.
- General contractors could include audit provisions that mirror the information they are allowed to request under Labor Code Section 218.7(f) and withhold payments (or back charge subcontractors) if the information is not provided within a specific time frame pursuant to subsection (i).
- General Contractors could also require the owners of major subcontractors to provide personal guarantees to satisfy claims made under Labor Code Section 218.7.
- General contractors could tie release of retention to written proof that subcontractor employees at all tiers have been paid.
- For subcontractors who work for the general contractor regularly on multiple projects, the general contractor could consider broadening the set off language in its subcontracts to specifically include claims that might arise under Labor Code Section 218.7.
- To the extent that contracts can be signed before the January 1, 2018 effective date of Labor Code Section 218.7, general contractors should do so.

CONCLUSION

Future litigation will shape how, and to what extent, this statute will impact the construction industry. For now, a general contractor's options are to: (1) review and revise its subcontracts to address the risks attended to the passage of this statute; (2) examine its subcontractor qualification process and make revisions as necessary to ensure the selection of subcontractors with a low risk profile; (3) enhance its field and payment practices to collect payroll records and audit subcontractors; and (4) consider requiring subcontractor performance and payment bonds.



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