

Greetings from the Editor

Bell, Rosenberg & Hughes greets the official new millennium with a new partner, Eric Phillips, and new associate Dan Weisenfeld. This issue of *News in Brief* focuses on several new cases that will have substantial impact on construction and real estate development in California. As always, we welcome your comments and suggestions for future articles.

Please remember to join us on **March 21, 2001** for our next *BR&H Breakfast Forum* where Andrew B. Fremier, Caltrans District 4 Division Chief, will discuss Bay Area roadway and bridge projects now under construction and those planned for the future. —RMH

In this issue:

- The Wizards of Aas
Dorothy may have a negligence claim for cracks in the yellow brick road, but California homeowners do not.
- U.S. Supreme Court Reviews Statute Authorizing Withhold, Without Notice or Hearings, For Prevailing Wage Violations
- San Jose's Minority Outreach Program Violates Prop. 209
- An Update on Arbitration Clauses in Employment Contracts
- An Introduction to The California Family Rights Acts
- Court Watch
New Case Notes

THE WIZARDS OF AAS

Dorothy may have a negligence claim for cracks in the yellow brick road, but California homeowners do not.

The California Supreme Court recently ruled in *Aas v. William Lyon Company*, 00 D.O.S. 9607, that homeowners cannot sue for economic losses in construction defect cases where no property damage or personal injury has yet occurred.

Justice Kathryn Werdegar led the 5 to 2 majority in navigating the "nebulous and troublesome" terrain between tort and contract law, ultimately concluding that construction defects unaccompanied by actual harm do not satisfy the requirements for pursuing a negligence claim. The Court's decision stems from two lawsuits filed by more than 160 homeowners seeking damages for repairs of alleged structural defects and building code violations. Although most of the code violations had not yet caused physical damage or injury, the homeowners sued to recover the cost of repair and for diminution in the value of their homes.

The Court's opinion reviewed more than four decades of construction defect cases before concluding that construction defects that have not ripened into property damage—or at least into some form of out-of-pocket loss—do not give rise to a negligence claim. How will this decision affect the construction industry, and in particular, construction defect claims in California?

First, do not be fooled into thinking that construction defect litigation in California will cease to exist. Plaintiffs have other available causes of action such as breach of contract and breach of warranty for those claims that do not involve actual personal injury or property damage. Contractors and subcontractors will continue to have exposure under indemnity clauses in prime contracts and subcontracts.

While the construction industry is trumpeting this decision as a victory for "the good guys," the real winners may be the insurance companies. Historically, most owners, general contractors, and subcontractors have relied on their insurance companies to protect their interests in construction defect litigation. In turn, insurance companies generally agreed to hire an attorney to defend their insureds in construction defect lawsuits and contribute money to settle those cases, even when coverage issues exist.

Now, with the *Aas* decision, the insurance industry is in a better position to argue that there is no coverage under the liability policy unless there is evidence of resulting property damage caused by an unplanned or unforeseen event, generally identified as an occurrence in the policy language. Because the plaintiffs are

Continued on page 2

BR&H BREAKFAST FORUM

welcomes

Andrew B. Fremier

of Caltrans

Date: March 21, 2001

Location: Clarion Suites
Lake Merritt Hotel
1800 Madison Street
Oakland, California 94612
Terrace Room

Time: 7:00 a.m. Continental Breakfast
7:30 a.m. Presentation

BELL, ROSENBERG & HUGHES LLP IS PLEASED TO announce **Andrew B. Fremier** as our guest speaker at our popular BR&H Breakfast Forum. Mr. Fremier will discuss recent developments and future Bay Area roadway and bridge projects.

Mr. Fremier is Caltrans' District 4 Division Chief, Construction. The Division Chief is responsible for the contract administration of all Caltrans projects in the 9 Bay Area counties. Mr. Fremier was graduated from Cal Poly, San Luis Obispo with a BSCE in Civil Engineering and lives with his wife and 2 children in Marin County.

We anticipate that this will be a very well-attended session, so PLEASE reserve your place early by contacting Sheila Garvey at 510-832-8585 or by e-mail at SKG@BRHLAW.COM.

THE WIZARDS OF AAS

Continued from page 1

now precluded from bringing a negligence claim unless there is actual resulting property damage, the insurance companies can assert that they are not obligated to hire an attorney to defend their insured because there is no coverage under the policy.

Since the *Aas* decision, our experience is that insurance companies are becoming more aggressive and limiting their settlement contributions to the costs of repairing only what is deemed to be resulting property damage as opposed to other aspects of the claim, such as the defects themselves. More importantly, we expect the insurance companies to use the *Aas* decision as a basis for refusing to hire attorneys to defend their insured, unless there are clear allegations of an occurrence with resulting property damage. So, what initially looked like a win for the construction industry may actually be more costly in the long run.

Because of the risks to homeowners, we expect some refinement to the *Aas* decision either in the courts or through the legislature. As Chief Justice Ronald George stated in his dissent, no one will agree "that a negligently constructed home must first collapse or be gutted by fire before a homeowner may sue in tort." Because the defects referred to in the *Aas* decision did not pose a direct risk of personal injury or property damage to the homeowners, there is a good chance that another court will issue a different decision in a case where the defects are more serious. Otherwise, the legislature will likely act to protect homeowners in California.

Depending on who you are, with the Supreme Court's decision in *Aas*, remember to be careful when either building or traveling on the yellow brick road. If you have any questions regarding the implications of this decision, please feel free to call our office. **-JHB ❖**

U.S. SUPREME COURT REVIEWS STATUTE AUTHORIZING WITHHOLD, WITHOUT NOTICE OR HEARINGS, FOR PREVAILING WAGE VIOLATIONS

In an important case for all public works contractors in California, a subcontractor successfully sued the California Labor Commissioner to challenge the constitutionality of California Labor Code provisions authorizing the state, without notice or hearing, to withhold money and impose penalties for alleged prevailing wage violations.

The U.S. District Court in Los Angeles ruled that the challenged provisions are unconstitutional and, on appeal, a divided panel of the U.S. Court of Appeals for the Ninth Circuit agreed. The majority judges held that the California Labor Code provisions authorizing the state to seize money and to impose penalties for a subcontractor's alleged prevailing wage violations ran afoul of the Fourteenth Amendment's due process clause because the statutory scheme afforded no hearing when state officials directed that payments be withheld.

The U.S. Supreme Court vacated the Ninth Circuit decision and remanded the case to the appellate court for further consideration in light of an earlier Supreme Court case, *American Manufacturers Mutual Insurance Company v. Sullivan* (1999) 526 U.S. 40, which involved a due process clause challenge to the withholding of payments for medical treatment by insurance companies under Pennsylvania's workers compensation statutes.

On remand from the Supreme Court, the same Ninth Circuit panel addressed two key issues: First, whether—under the California statutory scheme—there is “state action” when a prime contractor—a private actor—withholds payment from its subcontractor following an order by the state labor commissioner directing the public entity to withhold payment. Second, whether the withholding amounts to a deprivation of a constitutionally protected property interest. The same majority reinstated its earlier judgment:

G&G's due process rights were violated...not because it was denied immediate payment, but because the California statutory scheme afforded no hearing at all when state officials directed that

payments be withheld...Nor can there be any doubt whether the action at issue here was compelled by the State...The withholding here was specifically directed by State officials in an environment where the withholding party has no discretion at all.

A strongly worded dissent argued that the prime contractor's withhold—even though authorized and encouraged by one statute—was not “state action” requiring due process under the Fourteenth Amendment. The dissenting judge also concluded that a subcontractor has “no property interest in being paid for work that has not been shown to satisfy the contractual condition that it be completed in accordance with prevailing wage requirements” requiring constitutional protection.

Interestingly, California recently changed its procedures in prevailing wage cases to give public works contractors and their subcontractors a right to be timely heard on the issue of whether the withholding is justified. Nevertheless, the concerns expressed by two of the three Ninth Circuit justices go far beyond California's scheme for enforcing its prevailing wage statutes. Increasingly, local municipalities and other public agencies are resorting to withholding contract payments and penalties as a means of enforcing various local socio-economic policies, for example, programs promoting local employment. While these programs may have underlying objectives that are laudable, the public agencies' methods of enforcing compliance often results in contractors being deprived of earned contract proceeds for indefinite periods without notice or an opportunity to be heard on the underlying allegations. There is a significant risk that if local public officials have unbridled power to seize or withhold contract payments, power may be abused by those same officials for illegitimate reasons, such as to gain leverage to compel the waiver or reduction of a contractor's meritorious claim after work is completed. *G & G Fire Sprinklers, Inc. v. Bradshaw* (9th Cir. 2000) 204 F.3d 941, cert. granted, Oct. 10, 2000, __ U.S. __ (Docket No. 00-152) -HGC ♦

SAN JOSE'S MINORITY OUTREACH PROGRAM VIOLATES PROP. 209

IN A LONG-AWAITED decision, the California Supreme Court ruled that San Jose's "Nondiscrimination/Non-preferential Treatment Program" unconstitutionally discriminates in favor of subcontractors on the basis of race or sex by requiring bidders for most city public works contracts to demonstrate either that they attempted to obtain subcontract bids from minority-owned business enterprises ("MBE") and women-owned business enterprises ("WBE") or to prove the adequate use of such subcontractors in city projects. This case marks the first time that California's high court has interpreted the controversial Proposition 209.

In the November 1996 general election, the voters approved Proposition 209 which, in part, added a section to the California Constitution prohibiting discrimination or preferential treatment:

The state shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting.

Before the voters passed Proposition 209, San Jose instituted a program that required bidders for city construction projects to demonstrate that they did not discriminate in the award of subcontracts by documenting their efforts to obtain MBE and WBE subcontract bids or to list an adequate number of MBE/WBE participants in their bid. The city rejected bids that failed to document the requisite "outreach" or "participation" efforts.

In the wake of Proposition 209, San Jose modified its previous outreach program somewhat, but retained both the "outreach" and "participation" components. When, in 1997, Hi-Voltage Wire Works submitted a public works bid that failed to document either its "outreach" efforts or the requisite MBE/WBE "participation," the city summarily rejected the Hi-Voltage bid as "non-responsive" and found that Hi-Voltage was not a "responsible" bidder. Hi-Voltage sued the city, asserting that its program required preferences in favor of minorities and women in violation of Proposition 209, and prevailed in both the Superior Court and the Court of Appeals.

The city sought the California Supreme Court's review,

arguing that the program's "evidentiary presumption" is not discriminatory or preferential because its purpose is only to screen for discrimination and that the program was necessary to discharge the city's affirmative duty to eradicate discrimination against subcontractors on public works projects.

All seven justices disagreed with the city, holding that the program is unconstitutional because it affords preferential treatment to minority and women subcontractors by requiring bidding contractors to either utilize a specified percentage of minority subcontractors or to document their efforts to include them in the bidding process. The majority opinion, adopted by four justices, summarily rejected the City's arguments:

Because the City rejects any bid that fails to comply with one or the other requirement, both of which are race and sex based, the essential structure of the Program discriminates on an impermissible basis against prime contractors that neither engage in outreach nor meet the evidentiary presumption, and it grants preferential treatment to those that do...[¶] The outreach component requires contractors to treat MBE/WBE subcontractors more advantageously by providing them notice of bidding opportunities, soliciting their participation, and negotiating their services, none of which they must do for non-MBE's/WBE's. The fact that prime contractors are not precluded from contacting non-MBE's/WBE's is irrelevant. The relevant constitutional consideration is that they are compelled to contact MBE's/WBE's, which are thus accorded preferential treatment within the meaning of [Proposition 209]...[¶] The participation component authorizes or encourages what amounts to discriminatory quotas or set-asides, or at least race- and sex-conscious numerical goals. . . .

Although *Hi-Voltage* is a significant victory for Proposition 209 proponents, the Supreme Court did not rule out other, non-targeted outreach efforts. Writing for the majority, Justice Janice Rogers Brown acknowledged "that outreach may assume many forms, not all of which would be unlawful" but stopped short of describing what might be considered lawful outreach efforts.

Since Proposition 209's passage, some public owners—most notably the City and County of San Francisco—have

continued to defend their MBE/WBE contracting programs in the face of mounting legal challenges. Most recently, one Bay Area legal journal quoted San Francisco City Attorney Louise Renne as saying she was disappointed with the *Hi-Voltage* decision but that her office would study the similarities and differences between San Francisco's program and San Jose's. *Hi-Voltage Wire Works, Inc. v. City of San Jose* (Nov. 30, 2000) –HGC ❖

AN UPDATE ON ARBITRATION CLAUSES IN EMPLOYMENT CONTRACTS

TWO RECENT CASES dealing with arbitration provisions in written employment agreements will be of interest to all employers. The first, *Martinez v. Scott Specialty Gases* (2000) 83 Cal.App.4th 1236, held that an employee's refusal to acknowledge receipt of and agree to an arbitration clause in an employee handbook did not release him from his acceptance and acknowledgment of an earlier version of the handbook. In the second case, *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, the California Supreme Court held that an arbitration clause in an employment agreement was contrary to public policy and unlawful.

In *Martinez*, the employee acknowledged an arbitration agreement in a 1997 employee handbook. The employer issued a new handbook in 1998. The cover letter stated that the new handbook was an "update," while the acknowledgment and receipt provided that it "superceded" earlier handbooks. The employee refused to sign the acknowledgment of the second handbook and, after his termination, argued that he was not bound by the arbitration agreement. The court found that it was illogical to find that the second handbook truly superceded the earlier handbook and was not effective until signed because that resulted in a hiatus during which no policies were in effect, including those pertaining to benefits. The court found the employee was still bound by his original agreement to arbitrate.

Although this case resulted in the court upholding the employee handbook's terms, it points out a potential peril when the policies are updated or changed. Rather than stating that an entire new handbook "supercedes" a prior one, an employer should probably simply note specific changes in policy and when they are effective.

At least one case has held that an employee who

continued his employment after being told of a change in the terms accepted the new terms despite his refusal to acknowledge them in writing. *DiGiacinto v. Ameriko-Omserv Corp.* (1997) 59 Cal.App.4th 629. That case rests in part on the fact that the new terms were clear. As a result, the court was willing to view the change as an offer of employment on modified terms that the employee accepted.

In *Armendariz*, the California Supreme Court found a mandatory arbitration provision unlawful on several grounds.

First, the agreement covered statutory claims relating to sexual harassment or discrimination under the fair employment statutes, but required that the employee waive certain statutory remedies by limiting recovery to lost wages. Second, the fact that the arbitration clause required the employee, but not the employer, to arbitrate disputes was unconscionable.

In reaching its decision, the court also examined the potential right to discovery under the agreement and the potential cost to the employee. In *Armendariz*, the court found that the agreement, by incorporating certain provisions of the Code of Civil Procedure, provided for adequate discovery. It avoided the cost issue by interpreting the clause as requiring the employer to pay costs unique to arbitration, such as the arbitrator's fees.

The Supreme Court went to lengths to point out that it did not intend to refute the state's long-standing policy favoring arbitration. Rather, it intended to clarify that when an agreement to arbitrate is a condition of employment, it must be fair:

Given the lack of choice and the potential disadvantages that even a fair arbitration system can harbor for employees, we must be particularly attuned to claims that employers with superior bargaining power have imposed one-sided, substantively unconscionable terms as part of an arbitration agreement. *Armendariz, supra*, page 115.

Armendariz sets forth a list of factors to be considered in determining if an arbitration provision in an employment agreement is enforceable. If you have such a clause or are considering adding one, you should contact us to make sure that your contract addresses the court's concerns. –TJM ❖

AN INTRODUCTION TO THE CALIFORNIA FAMILY RIGHTS ACT

MOST EMPLOYERS ARE AWARE of the California Family Rights Act and its precursor at the federal level, but many are not aware that the Act imposes certain obligations of investigation and presumed knowledge on employers in addition to the statute's express requirements.

Among other things, the Act expressly requires employers to give notice of the Act's benefits to employees, provide up to 12 weeks of unpaid leave to employees who qualify, refrain from disciplining employees who take covered leave, reinstate employees to the same or an equivalent job, and continue the employee's health care during covered leave.

It is logical, therefore, that courts have held that in a civil action a plaintiff must plead and prove that he or she was an entitled employee, that the plaintiff or a family member had a "serious medical condition," and that he or she properly notified the employer of the need for leave.

What may not be as logical are the obligations of investigation and presumed knowledge that the courts have imposed.

BASIC DEFINITIONS

The Act includes several defined terms that don't necessarily comport with everyday usage:

Qualified Employees

To be a qualified employee, a plaintiff must have worked for the employer for at least 1,250 hours during the preceding year, have worked for the employer for at least one year and the company must employ fifty or more people within 75 miles of the employee's job site. Thus, the Act doesn't apply to part-time employees or to small companies.

Serious Medical Condition

The phrase "serious medical condition" encompasses illness or injuries that result in certain periods of incapacity. Thus, an illness, injury, impairment, or physical or mental condition involving a period of incapacity due to inpatient care, a period of incapacity resulting in an absence of more than 3 days plus continuing medical treatment or supervision, or continuing treatment for a chronic condition that if not treated, would result in a period of incapacity of more than three days, all qualify as "serious medical conditions."

In addition to taking leave for him or herself, the employee is entitled to take leave to "care" for a family member. When an employee takes leave to care for a family member, "care" includes physical and psychological care.

The Employer's Notice Requirement

The Act requires that specific information be posted for employees. As a general rule, an employee cannot seek relief because an employer fails to meet the Act's posting requirements. Under some circumstances, however, the failure to post can constitute an interference with the employee's rights. Also, an employer who fails to post cannot take adverse action against an employee for failing to give advance notice of his or her intent to seek protection under the Act.

In addition to the posting requirement, when an employee gives adequate notice of the need for leave under the Act, the employer must give additional written notice of the employee's rights and obligations under the Act.

The Employee's Notice Requirement

This is the most problematic aspect of the Act for employers, because the courts have held that an employee need not specifically refer to the Act to be entitled to its protection. This requires employers to take a proactive approach.

In general, the Act requires 30-day notice of the employee's intent to take covered leave, unless the treatment requires leave to be in less than 30 days, in which case, "the employee shall provide such notice as soon as is practicable." No specific form of notice is required and there is no reference to a specific form of notice for unforeseeable leave. The notice must be "sufficient" to make the employer "aware" that the employee needs qualifying leave and of the anticipated timing and duration. These are very subjective terms.

The Act puts the burden on the employer to designate the leave as qualifying and to question the employee if the latter doesn't provide enough information for the employer to make the determination. The employee requesting leave does not have to specifically assert or even mention the Act.

For example, at least one court held that, where an employer knows that an employee has an ill family member and is notified that the employee's absence is related to the family member, the burden is on the employer to determine if the employee qualifies for protection under the Act by ascertaining the nature of the illness and whether the employee's participation was necessary. If

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COURT WATCH

CORPORATIONS

Minority shareholders' inability to participate in operation of close family corporation, breakdown of relationship with majority shareholder and continuing losses of one division did not provide sufficient basis for involuntary dissolution of corporation.

Two sisters owning the majority of non-voting stock sued to involuntarily dissolve the corporation, after their brother, owner of the majority of voting stock, excluded them from continuing to participate in the corporate management. The sisters argued that the corporation should be dissolved because their disagreements with their brother had deteriorated to the point that only dissolution would protect their interests. The Court of Appeal affirmed the trial court's decision not to dissolve the corporation and noted that involuntary dissolution is a drastic remedy. The court also found that the sisters' inability to participate in the corporation's operation, the breakdown of the relationship with their brother, and continuing losses from the corporation's furniture manufacturing operation were not, by themselves, sufficient bases for dissolution. *Stuparich v. Harbor Furniture Manufacturing, Inc.* (Second Appellate District, Sep. 28, 2000).

CALIFORNIA FAMILY RIGHTS ACT

Continued from preceding page

the employer wants verification of the family member's condition, it is to look to the health care provider for information and formally request certification.

In that case, the employee's child was HIV positive and the employee said he had to stay home because the child had a fever. The court held that the employer should have found out if the fever was related to the "serious medical condition."

In light of the holdings, employers must be diligent in keeping track of absences, illnesses and medical conditions of employees that might trigger the Act so that they can provide the requisite notice and make the necessary inquiries. -TJM ❖

EMPLOYMENT

Employee's lengthy and satisfactory work history did not establish implied-in-fact contract that employee was no longer terminable at will.

After being terminated when his work group was disbanded, a forty-nine-year-old plaintiff sued his former employer alleging age discrimination and breach of an implied contract allegedly providing that he would be terminated only for good cause. The employee argued that when his work unit was discontinued, the employer rejected him in favor of younger employees when filling alternate openings.

The California Supreme Court disagreed with the Court of Appeal and affirmed the trial court's judgment in favor of the employer. The Supreme Court held in part that an employee's implied-in-fact contractual rights did not bar an employer's elimination of an entire work unit, regardless of whether issues of poor performance or workload reduction prompted the employer's action. Thus, the Court found that elimination of the work unit was distinct from a personnel decision directed at an individual employee. *Guz v. Bechtel National, Inc.* (California Supreme Court, Oct. 5, 2000)

Mandatory arbitration clause in employment agreement was unconscionable for requiring that employee pay all costs associated with claim for administrative relief outside arbitration.

When an employee sued her former employer for discrimination and harassment based on sex and pregnancy, the employer moved to compel arbitration based on a contractual arbitration clause. The clause required, in part, that any party bringing any other form of legal action to pay the responding party's costs, expenses and attorney fees. The employee opposed the motion to compel arbitration, in part, on the ground that the arbitration clause was unconscionable.

While upholding the employer's demand for arbitration, the Court of Appeal agreed that the agreement to arbitrate was unconscionable in one respect. The court ruled that the agreement placed an unconscionable burden on the employee by requiring the employee to pay any fees

Continued on page 8

associated with administrative relief sought outside of arbitration. The appellate court concluded, nevertheless, that this unconscionable provision could be severed from the remainder of the arbitration clause. *Shubin v. William Lyon Homes, Inc.* (First Appellate District, Nov. 14, 2000).

INSURANCE

“Accident” in occurrence/accident provision of insurance policy included unintended harm flowing from intentional acts, and insurer therefore had duty to defend.

An employee sued her former employer alleging negligence, fraud, sexual harassment, battery, breach of contract and intentional infliction of emotional distress. In a complicated dispute among five insurance carriers, the errors and omissions insurance carrier, Gulf, agreed to defend the claims, while the four liability insurers declined to do so, arguing that the alleged injuries were the result of intentional conduct and not a covered “accident.” Gulf then sued the other carriers contending that they were obligated to defend the supervisor because there was a potential for coverage under the various policies’ “bodily injury” and “personal injury” provisions.

In a 2-1 decision, the Second District Court of Appeal agreed with Gulf that the term “accident” as used in occurrence-type liability policies included unintended harm flowing from intentional acts. The court ruled that the harm the employee alleged could have been the consequence of an “accident” and thus a covered “occurrence” under the various liability policies. In reaching this result, the majority rejected as “overly simplistic” the bright line test used by another appellate court in *Merced Mutual Insurance Co. v. Mendez* (1989) 213 Cal.App.3d 41, which held that the term “accident” excludes any conduct intended by the insured, as well as the unexpected or unintended consequences flowing from that intentional conduct. *Commercial Underwriters Insurance Co. v. Superior Court* (Second Appellate District, Oct. 16, 2000).

Insured could not maintain bad faith tort claim against insurer based on unsatisfactory performance of contractor whose work the insurer guaranteed.

USAA insured plaintiffs, who were homeowners that suffered a loss due to fire. At USAA’s suggestion, the homeowners retained one of USAA’s “preferred contractors” to make structural repairs. A “preferred contractor” was one whose work was guaranteed by USAA.

After learning that the contractor’s work had numerous defects, the homeowners brought a bad faith tort suit against the insurer. The trial court directed a verdict for USAA and the Court of Appeal affirmed. The court found that in guaranteeing the work of its “preferred contractor,” USAA at most undertook only to cure defects in the contractor’s workmanship. The court further pointed out that no tort remedy for breach of the covenant of good faith and fair dealing was available because the homeowners received the financial benefit of their contract with USAA when the insurer paid for the repairs necessitated by the contractor’s defective work. *Rattan v. United Services Automobile Association* (Fourth Appellate District, Nov. 1, 2000).

Insurer was estopped from raising policy’s one-year statute of limitations as defense to insured’s suit where insurer had not complied with disclosure regulations regarding all applicable time limits.

After a ski lodge’s roof collapsed, Balboa Insurance denied the insured’s property damage claim arguing that the snow’s weight on the roof caused the collapse and was not a named peril that the policy covered. The insured contended that vandalism, a covered risk, caused the collapse, and requested that Balboa reconsider its denial.

Nearly two years later, the insured sued and the trial court granted Balboa’s motion for summary judgment based on the policy’s contractual one-year statute of limitations.

The Court of Appeal reversed, ruling that Balboa had failed to comply with California’s Department of Insurance regulations requiring insurers to disclose to first-party claimants all time limits. Because there was no evidence that Balboa had disclosed the one-year limitation period to this insured, the appellate court concluded that Balboa was estopped from raising the one-year provision as a defense. *Neufeld v. Balboa Insurance Company* (Fourth Appellate District, Nov. 2, 2000).

Insurer did not breach duty to defend by accepting defense in mixed action with reservation of rights to seek reimbursement of defense costs.

This is an insurance bad faith action brought by the insured against his insurance carrier, Liberty Mutual, after settling the underlying tort litigation alleging both covered and non-covered claims (viz., a “mixed” action). In agreeing to defend the underlying litigation, Liberty Mutual had unilaterally reserved its rights to seek reimbursement of its defense costs. The insured argued that Liberty Mutual’s reservation of rights breached its duty to defend and the trial court agreed.

Relying on the California Supreme Court's decision in *Buss v. Superior Court* (1997) 16 Cal.4th 35, the Court of Appeal reversed in part, holding that the reservation of rights did not breach Liberty Mutual's duty to defend. In *Buss*, the Supreme Court held that an insurer may condition its defense of its insured in a mixed action on a reservation of its rights to seek reimbursement of defense fees. Thus, Liberty did not breach its duty to defend. *Prichard v. Liberty Mutual Insurance Company* (Fourth Appellate District, Nov. 8, 2000).

MECHANIC'S LIENS

Settlement agreement exonerates surety's stop notice release bond.

A California appellate court held a surety's stop notice release bond is exonerated when a subcontractor enters into a settlement agreement with a prime contractor releasing all claims. In this case, a prime contractor posted a bond to release a subcontractor's stop notice. The contractor and its subcontractor then entered into a written settlement agreement mutually releasing all claims arising out of the work. Significantly, the surety neither joined as a party to the settlement nor consented to it. When the prime contractor later defaulted on payments due under the settlement agreement, the subcontractor sued the surety to recover under the release bond.

The Court of Appeal held that the subcontractor's release of all claims exonerated the surety's obligation under the release bond. The court reasoned that the subcontractor fully released the prime contractor from its claim for payment under the bonded obligation and accepted in its stead an un-bonded obligation under the settlement agreement. Under California Civil Code section 2819, a surety is exonerated if the promisee (in this case the subcontractor) materially alters the principal obligation in any respect or impairs or suspends its rights or remedies against the principal. By releasing the prime contractor, the subcontractor extinguished its obligations under the bond and thus met the test for exoneration. *R.P. Richards Inc. v. Chartered Construction Corp.* (Second Appellate District, Aug. 18, 2000).

PUBLIC CONTRACTING

City's "outreach" program to encourage minority-owned and women-owned business participation in public contracts violates Proposition 209.

The California Supreme Court unanimously agreed that the City of San Jose discriminated in favor of subcontractors on the grounds of race or sex in violation of the state constitution, as amended by Proposition 209, by requiring bidders to demonstrate that they attempted to obtain subcontract bids from minority and women owned business enterprises or to prove the adequate use of such subcontractors in city projects. *Hi-Voltage Wire Works, Inc. v. City of San Jose* (California Supreme Court, Nov. 30, 2000).

EDITOR'S NOTE: A more complete discussion of this important case is contained in a featured article on page 4.

City breached mandatory statutory duty by accepting contractor's payment bond without verifying surety's status as admitted surety.

May a California public owner be found liable in damages to unpaid subcontractors and suppliers if the public owner negligently approves a payment bond that is required by law? The answer now appears to be yes. In the first reported decision of its kind, the Court of Appeal reversed a Riverside County trial court and held that California's Bond and Undertaking Law, when read in conjunction with the Civil Code sections requiring payment bonds on certain public works projects, imposes a mandatory duty on a public owner to investigate the sufficiency of the surety—whether corporate or individual—before approving the bond. Here, the public owner failed to check whether the offshore corporate surety was licensed in California or to confirm its solvency before accepting the payment bond. Finding that the public agency failed to discharge a mandatory duty, the court also rejected the public owner's claim that it was nevertheless immune from any liability in damage for its failure. *Walt Rankin & Associates, Inc. v. City of Murrieta* (Fourth Appellate District, Oct. 31, 2000).

EDITOR'S NOTE: This decision should sound alarms for California public agencies and their representatives. Although the court's ruling does not appear to require an exhaustive investigation, California public agencies should have in place procedures for determining whether proposed sureties are admitted in California and are sufficiently solvent to honor their obligations. Failure to do so could result in significant liability.

Continued on page 10

REAL PROPERTY

County's agreement with developer was proper although actual building plan approval was still pending.

This is a challenge to an agreement between San Luis Obispo County and a private developer. After lengthy negotiations and a public hearing, the county entered into an agreement with the developer to freeze zoning and other land-use regulations for up to five years in exchange for the developer's commitment to submit a specific plan for construction in compliance with then existing land-use requirements and a dedication of certain lands for public use. A group of local residents and taxpayers asked the court to set aside the agreement, arguing that it failed to conform to state statutes and unconstitutionally contracted away the county's police powers.

The appellate court disagreed, holding that, under California's Development Agreement Statute, the county's agreement could properly precede the approval of actual building plans and could legitimately obligate the county to freeze zoning temporarily without compromising the county's police powers. In particular, the court concluded that the Development Agreement Statute was not limited to development agreements that created "vested rights" to complete construction of a project according to completed plans because such a narrow construction of the statute would unduly restrict the county from working with private landowners to plan and develop facilities that support public needs. *Santa Margarita Area Residents Together v. San Luis Obispo County Board of Supervisors* (Second Appellate District, Oct. 18, 2000).

Lender did not violate anti-deficiency laws by non-judicially foreclosing on succession of parcels held as security for loan without crediting debtors with fair market value of each property.

Union Bank issued a loan secured by deeds of trust on three separate parcels of real property. When the loan fell into default, the bank non-judicially foreclosed on each property in turn with its final credit bid amount for all three equaling the amount due on the debtors' loan. The debtors then sued the bank for failing to credit them for the fair market value of each property.

On appeal the debtors contended that a creditor is not entitled to obtain a windfall by underbidding successive properties in non-judicial foreclosure. The California Supreme Court disagreed, holding that the anti-deficiency statutes (Code of Civil Procedure section 580a and 580d) did not bar a lender from non-judicially foreclosing on successive items of collateral without crediting the

debtors with the fair market value of each property foreclosed on. *Dreyfuss v. Union Bank of California* (California Supreme Court, Nov. 6, 2000).

Binding arbitration clause in housing developer's CC&R's was unconscionable and unenforceable.

In the first reported decision of its kind in California, the Court of Appeal for the Fourth District refused to enforce an arbitration clause contained in a condominium project's recorded Covenants, Conditions and Restrictions ("CC&R's").

A developer recorded, as part of a condominium project's CC&R's, a provision requiring the homeowners to arbitrate any defect claim against the developer. When the homeowners' association filed suit against the developer for alleged construction and design defects, the developer asked the court to order that the claims be arbitrated. The trial court denied the request and the Court of Appeal affirmed.

The court found that the CC&R's were an adhesion contract because the homeowners had no opportunity to negotiate or amend them, and that the arbitration clause was unconscionable because it was found at the end of a 70-page document that was drafted and recorded years before any units were sold. Thus, the court refused to enforce the clause. Further, in rejecting the developer's argument that the arbitration clause should have been enforced as an "equitable servitude" under real property law, the court determined that the clause violated public policy and that found it to be a "blatant attempt" by the developer to curtail the buyers' statutory rights to adequate notice before waiving their constitutional right to a jury trial. *Villa Milano Homeowners Association v. Il Davorge* (Fourth Appellate District, Nov. 6, 2000).

TORTS

Injured employee of independent contractor may not bring negligent hiring claim against company that hired contractor.

In this case, the Court of Appeal considered whether, under the California Supreme Court's decisions in *Privette v. Superior Court* (1993) 5 Cal.4th 689 and *Toland v. Sunland Housing Group, Inc.* (1998) 18 Cal.4th 253, an employee of an independent contractor may pursue a claim for negligent hiring against a third-party hirer. The plaintiff, an employee of an independent contractor hired by Contadina Foods to do insulation work at a cannery run by Contadina, sued for damages due to exposure to asbestos while working at the cannery.

The appellate court held that, after the Supreme Court's decisions in *Privette* and *Toland*, a claim for negligent hiring brought by an employee of the independent contractor against a hirer of that independent contractor is no longer viable because the hirer's duty to exercise reasonable care in employing a competent and careful independent contractor, with the skills necessary to perform the work without creating an unreasonable risk of injury to others, does not extend to the contractor's employees. *Minster v. Contadina Foods, Inc.* (First Appellate District, Oct. 27, 2000).

EDITOR'S NOTE: This decision directly contradicts the holding in *Carmago v. Tjaarda Dairy* reported in our September 2000 issue of News in Brief. Until the California Supreme Court addresses the issue squarely, this area of law is likely to remain uncertain.

Homeowners cannot recover tort damages for building code violations that have not yet resulted in personal injury or property damage.

In a five-to-two split decision, the California Supreme Court ruled that homeowners cannot sue for economic losses in construction defect cases where the alleged defects have not caused property damage or personal injury.

The case arose out of two lawsuits filed by more than 160 homeowners in two San Diego County residential subdivisions built by the same developer, which contained numerous building and electrical code violations. Although most of the code violations had not yet caused physical damage or injury, the homeowners sued to recover the cost of repair and for the homes' diminished market value. Both the trial and appellate courts denied the homeowners' requests to introduce evidence of the building code violations in support of their negligence claims.

In affirming the lower courts' decisions, the five justice majority relied on *Seely v. White Motor Co.* 63 Cal.2d 9, a 1965 Supreme Court decision, which recognized that in actions for negligence, a manufacturer's liability is limited to damages for physical injuries and barring recovery for economic loss alone. This general principle, which distinguishes between tort recovery for physical injuries and contract or warranty recovery for economic loss, is known as the "economic loss rule."

In the context of construction defect cases, the court also cited its own decision in *Erlich v. Menezes* (1999) 21 Cal.4th 543, in which the court reversed an award of damages for emotional distress caused by negligent home construction, thus rejecting the homeowner's argument that the negligent performance of a construction contract, without more, justifies the award of tort damages.

Two justices criticized the majority's broad decision, one of them noting that "cutting corners is a prevailing problem in the development industry." In the dissent's view, the court could have drawn a narrowly tailored opinion to exclude the recovery of tort damages for minor construction defects that do not pose a risk of personal injury or property damage:

In determining that a negligently constructed home must first collapse or be gutted by fire before a homeowner may sue in tort to collect costs necessary to repair negligently constructed shear walls or fire walls, the majority today embraces a ruling that offends both established common law and basic common sense.

The majority opinion recognized the competing policy implications raised by construction defect litigation but suggested that the California Legislature, rather than the courts, is better suited to decide among the various policy options and choices. *Aas v. Superior Court* (California Supreme Court, Dec. 4, 2000). **-HGC ❖**

OUR NEW LOOK

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BR&H

Bell, Rosenberg & Hughes LLP
1300 Clay Street, Suite 1000
P.O. Box 70220
Oakland, California
94612-0220
(510) 832-8585

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Our next issue will feature...
things we did not get to in this issue!

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Construction:	Roger Hughes or Roland Nikles
Commercial litigation:	Jim Nelson or John Banister
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