

## Greetings from the Editor

This issue of *BR&H News In Brief* addresses some of the more important changes in construction law that became effective in 2002, as well as recent cases that will affect many of our clients.

Please remember to join us on March 8, 2002 for our next BR&H Breakfast Forum where Christine Mosen, Executive Director of the Alameda County Transportation Authority, will discuss the highway projects currently underway, and those planned for the future.

—CMF ❖

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## WINDS OF CHANGE ARE BLOWING IN PUBLIC CONTRACTING

**F**or the past decades, public entities have mostly been constrained to follow the design-bid-build model of contracting. Under this traditional model, projects are fully designed with approved plans and specifications before contracts are awarded to the lowest responsible and responsive bidder, after open competitive bidding. See *Graydon v. Pasadena Redevelopment Agency* (1980) 104 Cal.App.3d 631, 635. The main purpose of these constraints is to provide the public with the best quality project at the best price through a fair, efficient, and clear bidding process. See Public Contract Code section 100. Recently, however, construction industry studies, numerous commentaries, and the experience of various public agencies have resulted in the perception that alternative project delivery methods, such as design-build contracting or the use of a construction manager, at-risk or not, may under the right circumstances, deliver projects faster and cheaper than the traditional design-bid-build system, and may have other attributes beneficial to the public interest, such as reduction of claims.

Movement away from the traditional design-bid-build model of project delivery in the public contracting arena is gaining momentum. For example, contractors have recently expressed frustration that some charter cities have failed to follow the Public Contract Code, which generally mandates the traditional design-bid-build model of contracting. See Senate Rules Committee Analysis of SB 974 (enacted 10/21/01). Of 475 cities in California, 105 cities are "charter cities." Under the California Constitution, a city may, as an alternative to being entirely subject to the general law of the state, elect to operate pursuant to a charter that authorizes the enactment of ordinances and regulations superseding the general law of the state with respect to municipal affairs. Cal. Const., Article XI, Section 5. Such "charter cities" are authorized by the constitution to "make and enforce all ordinances and regulations in respect to municipal affairs . . . and with respect to municipal affairs (such as ordinances and regulations) shall supersede all laws inconsistent therewith." *Id.* In *Bishop v. City of San Jose* (1969) 1 Cal.3d 56, 61-62, the Supreme Court held that a charter city may make and enforce all ordinances and regulations with respect to its municipal affairs, subject only to restrictions and limitations contained in its charter, but with respect to other matters, such as those of statewide concern, it is bound by general laws if it is the intent and purpose of such general laws to occupy the field to the exclusion of municipal regulation. The Court recognized no exact definition of the term "municipal affair" but noted that what constitutes a municipal affair or matter of statewide concern may change over time in response to changing conditions

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## WINDS OF CHANGE ARE BLOWING IN PUBLIC CONTRACTING

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in society. *Bishop, supra*, at 62–63; see also *Committee of Seven Thousand v. Superior Court* (1988) 45 Cal.3d 491, 505. The current trend and climate in public contracting lends support to public entities that wish to deviate from the traditional model of competitive bidding and make their own rules in awarding public contracts.

In 1998, a court of appeals held that charter city status does not necessarily exempt a charter city from application of the Public Contract Code. Frustrated that some charter cities fail to follow the Public Contract Code when administering public works contracts, the Engineering and Utility Contractors Association sought legislation to reaffirm that the Public Contract Code applies to charter cities. As a result, on October 21, 2001, Governor Gray Davis signed into law SB 794, codified as Public Contract Code, section 1100.7. This new statute states that “With regard to charter cities, [the Public Contract Code] applies in the absence of an express exemption or a city charter provision or ordinance that conflicts with the relevant provision of [the] code.” Although the bill was opposed by the League of California Cities on the grounds that it would cause unnecessary confusion and on the grounds that, in order to protect themselves, cities would have to provide express exemptions from the Public Contract Code, this new legislation promises to add to the gravitational pull for charter cities to experiment with alternative project delivery methods, and other deviations from the Public Contract Code as a “municipal affair.”

In a parallel development, effective January 1, 2002, the legislature authorized school districts to deviate from the traditional competitive bidding model of project delivery and to enter into design-build contracts based on factors other than price and cost for the design and construction of school facilities that exceed \$10 million in cost. Education Code section 17250.10 *et seq.* The design developed by the design-builder must be approved by the Department of General Services, and if a school district elects to use the design-build process it must submit a report on the process to the Legislative Analyst.

This movement away from the traditional model of project delivery promises to present risks that may not be fully understood. While the terms used to describe some of these new delivery systems like design-build are generally understood, there are endless variations of these

systems in common use throughout the industry. Each variation alters in some material way the risks associated with a particular project. It will take time and experience with these new systems in order for each of the players to fully understand the risks. The challenge for public entities will be to develop appropriate guidelines that are efficient and fair and that maintain the best aspects of the traditional competitive bidding model—open access. Public entities will have to find ways to mitigate new risks presented. For example, in choosing a design-build project delivery method, a public entity loses the design professional as its advocate, and loses control over many of the details of the design, while assuming the risk of deficiencies in the description of the program. The challenge for contractors will be to adapt to this new diversity in public project delivery methods, and to best exploit the opportunity provided to provide a quality project at a fair price, with minimum claims. –RN ❖

**For further information** about Bell, Rosenberg & Hughes LLP or to pursue a particular question, please call Roger Hughes or Jim Nelson at (510) 832-8585.

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## CONTRACTOR BEWARE

### Recovery of Monies Paid to an Unlicensed Contractor is Now Permitted by Recent Change in the Law

Unlicensed contractors lead a risky existence with few, if any, legal protections for their work. In particular, unlicensed contractors have long been barred from using the courts to obtain payment for their work. As of January 1, 2002, the unlicensed contractor's situation became even riskier.

In order to protect the public from unqualified contractors, the Legislature has determined that the importance of deterring unlicensed persons from engaging in the building or contracting business outweighs any harshness caused to those persons performing construction services in violation of the state's licensing requirements by denying them the right to sue for compensation for their unlicensed work.

Assembly Bill 678 (Papan), enacted into law this past September, makes the penalties to an unlicensed contractor even harsher: Business and Professions Code section 7031 now authorizes any person who pays an unlicensed contractor for work for which a contractor's license is required to sue that contractor to recover all compensation

paid for the work. Introduced following one court's recent refusal to require an unlicensed contractor to refund monies paid by an owner, the Senate deleted language from the original bill that would have precluded such refund actions by persons who knowingly pay unlicensed contractors, in the apparent belief that this will further encourage contractors to be properly licensed.

Enactment of this legislation also calls into question the decisions by some courts (see, e.g., *Culbertson v. Cizek* (1964) 225 Cal.App.2d 451; *S&Q Constr. Co. v. Palma Ceia Dev. Org.* (1960) 179 Cal.App.2d 364; *Marshall v. Von Zumwalt* (1953) 120 Cal.App.2d 807) that the Business and Professions Code did not bar an unlicensed contractor who was a defendant from claiming as an offset sums due under his or her illegal contract.

In conclusion, the risks are greater than ever before for the contractor who is not "duly licensed" by the Contractors State License Board—including those contractors that may face board suspension or encounter problems with their license renewal. —HGC ❖

### BR&H BREAKFAST FORUM

welcomes

#### Christine Monsen

*Executive Director of the  
Alameda County Transportation Authority*

Date: March 8, 2002

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

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

BELL, ROSENBERG & HUGHES LLP is pleased to announce guest speaker **Christine Monsen** of the Alameda County Transportation Authority. Ms. Monsen was appointed Interim Executive Director of ACTA in January 1998. She holds a bachelor of science degree, a masters in city planning and a second masters in engineering, all from UC Berkeley. She has worked in both the public and private sectors and has served in a number of community service roles. Ms. Monsen is a past president of the Bay Area Chapter of the Scholarship Board of the Women's Transportation Seminar. She will discuss current highway projects and future projects planned.

*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.*

## CALIFORNIA ENACTS NEW REQUIREMENTS FOR PAYMENT SECURITY ON PRIVATE WORKS

**ANOTHER OF THE LEGISLATURE'S** 2001 enactments is Assembly Bill 1534 (Longville), which adds a new provision to the California Civil Code that requires many private owners and tenants who contract for construction work in excess of specified amounts to provide payment security for that work. The new provision, Civil Code section 3110.5, was introduced as a legislative response to the California Supreme Court's decision in *Wm. R. Clarke Corp. v. Safeco Ins. Co.* (1997) 15 Cal.4th 882 declaring "pay-if-paid" clauses in construction contracts to be unenforceable as a matter of public policy. Section 3110.5 permits the required payment security to be provided by means of corporate surety bonds, irrevocable letters of credit, or "construction security escrow accounts" with acceptable escrow agents. When an owner required to provide payment security fails to do so, the original contractor may, after giving the owner a written demand, suspend work until that security is provided.

Effective January 2002, the key features of Section 3110.5 include the following:

**COVERAGE** Section 3110.5 applies to "owners," including tenants, who contract for construction, alteration, addition to, or repair upon private property, as follows:

- (1) If the contracting owner owns a "fee simple absolute interest" in the property, then the statute applies only to work valued in excess of \$5,000,000.
- (2) A tenant whose initial lease term is for 35 years or more is considered an owner of a fee simple absolute interest.
- (3) If the contracting owner has less than a "fee simple absolute interest"—including most tenants—the statute applies to work valued in excess of \$1,000,000.
- (4) Regardless of the value of the work, the statute does NOT apply to:
  - Construction of single-family residences, including single-family residences within a subdivision;
  - "Fixed works" associated with the construction of a subdivision by a general engineering contractor (e.g., site work);

- Public works projects; or
  - Housing developments eligible for density bonuses under state planning and zoning law (viz., Government Code section 65915).
- (5) The statute also does NOT apply to a contracting owner that is either a "qualified" publicly traded company or a "qualified" private company, or their wholly-owned subsidiaries:
- A "qualified" publicly traded company is one where the equity shares are traded on a national exchange (NYSE, ASE or NASDAQ) or the non-subordinated debt securities are rated as "investment grade" by Standard & Poor's or other statistical rating organization.
  - A "qualified" private company is one that is not publicly traded but that has a net worth exceeding \$50 million.

**SPECIFIC REQUIREMENTS** Generally, if there is a construction loan for a covered private work of improvement, Section 3110.5 requires that the contracting "owner" (including a tenant contracting for work) do the following: (1) furnish the original contractor with a copy of the recorded construction mortgage or deed of trust, certified by the County Recorder, and that discloses the amount of the construction loan; and (2) with a few exceptions, provide security for the owner's payment obligations under the contract, as follows:

• **Amount of payment security required:**

- (1) Not less than 25% of the value of the work if substantial completion is scheduled within six months of the start of work.
- (2) Not less than 15% of the value of the work for all other covered contracts.

• **Methods of providing payment security:**

- (1) Payment bond issued by a surety admitted in California;
- (2) An irrevocable letter of credit from a "financial institution" as defined in the California Financial Code; or
- (3) A "construction security escrow account" maintained with a licensed escrow agent located in California.

The foregoing requirements for payment security may not apply, however, where the contracting owner also is a majority owner of the original contractor.

**REMEDY FOR NON-COMPLIANCE** Civil Code section 3110.5 was enacted for the relief of original contractors, and the remedy provided for by the statute is one that only an original contractor may employ. If a contracting owner or tenant fails to furnish the payment security required by this section, the original contractor may make written demand on that owner or tenant to do so. If the owner or tenant fails to provide the required security within 10 days after the contractor's written demand, the original contractor is free to **suspend work** until the required security is provided in accordance with the statute.

Significantly, in enacting Assembly Bill 1534 the Legislature expressly declared that no part of Section 3110.5—

“shall be interpreted to affect . . . mechanics' liens, stop notices, bond remedies, or prompt payment rights of a subcontractor, including the original contractor's payment responsibilities as set forth in Section 7108.5 of the Business and Professions Code and Section 10262 of the Public Contract Code.”

Thus, a contracting owner's or tenant's failure to provide payment security required by Section 3110.5 does not afford the original contractor any defense to payment claims by subcontractors, suppliers and other claimants.

**CONCLUSION** Civil Code section 3110.5 is both lengthy and complicated, addressing many matters not touched upon here. Examples include (1) the method by which the “net worth” of a “qualified” private “owner” (including tenant) is to be determined, (2) the timing of deposits required to be made into a “construction security escrow account,” and (3) the deposit of “retainage” or “retention” into escrow if allowed by the contract. Private owners and tenants contemplating new work are encouraged to review the statute in its entirety and to consult with legal counsel regarding specific coverage issues. **-HGC ❖**

**EDITOR'S NOTE:**

“More New Legislation,” on page 8, also pertains to bidding.

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## CONSTRUCTION INDUSTRY TARGETED BY PRIVATE PROP. 65 “BOUNTY-HUNTERS”

**TARGETING THE CONSTRUCTION INDUSTRY**, among others, thousands of notices were mailed out in December by plaintiffs' attorneys threatening private lawsuits for alleged violations of California's Safe Drinking Water & Toxic Enforcement Act of 1986, more commonly referred to as “Proposition 65.” Virtually all of these notices were mailed by attorneys known to regularly prosecute Proposition 65 enforcement actions, including Reuben Yeroushalmi and Kamran Ghalchi. Some of the “plaintiffs” identified in the notices include Consumer Advocacy Group, Inc., Michael DiPirro, and Citizens for Responsible Business.

In addition to contractors, the notices allege violations by various manufacturing and servicing facilities, automobile dealerships, and manufacturers and retailers of consumer products running the gamut from vehicle parts to building materials, and household cleaning products.

The notice—entitled “60-Day Notice of Intent to Sue Under Health & Safety Code Section 25249.6”—is required before a private citizen may file a lawsuit alleging a violation of Proposition 65. The purpose of the notice is to give the California Attorney General, local District Attorneys and other local prosecuting authorities the opportunity to file suit to enforce Proposition 65 on behalf of the state or local public entity. The most current rash of notices appeared to be timed, however, to beat a recent change in the law that became effective on January 1, 2002. That change requires that a “certificate of merit,” based upon consultation with an appropriate expert, be included with each notice that alleges a violation of Proposition 65's warning requirements.

Briefly, many of these notices complaining of Proposition 65 violations by contractors allege that they exposed their employees, consumers and others to products containing asphalt and coal tar during roofing and paving operations, to asphalt during demolition and renovation of older buildings, or to silica and diesel exhaust.

Several industry groups, including the Construction Employers Association, Associated General Contractors of California, the Southern California Rock Products Association, Northern and Southern California Asphalt Paving Association, and the Construction Materials Association of California, are working to address this situation on an industry-wide basis.

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## PROPOSITION 65

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The California Attorney General's office recently wrote Mr. Yeroushalmi to express concern about the large number of notices and the very general nature of the allegations contained in them. The Attorney General also demanded to know the extent to which Mr. Yeroushalmi or Consumer Advocacy Group have investigated and what evidence they have that the alleged violators in fact exposed employees, consumers and other persons to the substances in question.

In view of this situation, we encourage our clients to review their overall Proposition 65 compliance posture. The following summarizes many of the key features of this law:

### **What is Proposition 65?**

California's Proposition 65 was a voter initiative passed to address citizen concerns about exposure to substances which cause cancer or reproductive toxicity. Generally, the law prohibits businesses from discharging such chemicals into sources of drinking water and requires that warnings be given to individuals exposed to them.

The state's scientific advisory board determines which chemicals are "known to the state" to cause cancer or reproductive toxicity, and periodically publishes updated lists in the California Regulatory Notice Register.

### **Who is Subject to Proposition 65?**

Companies with 10 or more employees that discharge listed chemicals into sources of drinking water or expose individuals to listed chemicals are subject to Proposition 65. Employees and other individuals may be "exposed" to listed chemicals through (1) the manufacture, distribution, or sale of consumer or commercial products, (2) industrial or commercial operations that discharge listed chemicals into the environment, or (3) occupational exposures to listed chemicals.

### **Who is Exempt from Proposition 65?**

Exempt from Proposition 65's warning requirements are companies with fewer than 10 employees, companies that can prove that the exposure falls below the level for which a warning is required, companies that cause exposures where federal law preempts state warning requirements, and state and local governments.

In order for an exposure to a listed chemical to be considered as falling below the level for which a warning is

required, the company (not the government or private enforcer) must prove that—for carcinogens—the exposure will not cause more than 1 excess lifetime case of cancer per 100,000 individuals exposed ("NSREL"). For reproductive toxins, the company must prove that the exposure is less than 1/1000 of the level at which there is no observable effect ("NOEL").

### **How Does a Company Comply with Proposition 65?**

- **Determine if company's employees or others will be exposed**

Chemicals on the state's list of carcinogens and reproductive toxins are updated frequently. The current Proposition 65 list can be found on the Internet or in Title 22 of the California Code of Regulations, at section 12000. If it is determined that the company uses or may expose employees and others to listed chemicals, then the company may need to perform a risk assessment to determine if the exposure is in an amount that exceeds the "NSREL" or 1/1000 of the "NOEL."

Methods for performing risk assessments are discussed in the California Code of Regulations and, for a number of chemicals, the California Environmental Protection Agency has set exposure levels which can be utilized in performing risk assessments. Companies are permitted to use other exposure levels, if scientifically valid, but they bear the burden of proof on the use of other levels in an enforcement action.

- **Eliminate discharges into sources of drinking water**

The definition of a "source of drinking water" was recently defined by the California Supreme Court to include tap water faucets.

- **Obtain a "Safe Use Determination"**

The California Code of Regulations provides for a limited "safe use determination" where the lead agency "will consider the applicability of the Act or the exemptions specified in the Act to business activities or prospective business activities." (22 Cal. Code Regs. section 12104(a).) Several important exceptions apply. Also, these determinations are not binding on public or private prosecutors or the courts. Additionally, the agency will not provide a safe use determination where the subject matter of the request is at issue in a pending civil or criminal case, or where the request does not involve a current or planned activity of the requester.

- **Provide Appropriate Warnings**

The regulations implementing Proposition 65 provide limited guidance on appropriate warning methods and messages. These vary depending upon the types of exposures (e.g., consumer products, environmental, occupational). This guidance is published in Title 22 of the California Code of Regulations, section 12601. The regulations provide “safe harbors,” which, if followed, are “deemed” to be in compliance with the statute. Actual experience in enforcement actions has revealed, however, that it may be difficult for companies to rely upon many of the safe harbor provisions to avoid expensive litigation.

### Proposition 65 Enforcement

Proposition 65 may be enforced by the California Attorney General, county District Attorneys, and other law enforcement officials. If no public prosecutor, after 60 days written notice of a claimed violation, has commenced and is diligently prosecuting an enforcement action against the alleged violator, any person may bring a private enforcement action in the public interest.

Regarding the required 60-day notice, effective January 1, 2002, Health & Safety Code section 25249.7 requires that any notice alleging a violation of Proposition 65’s warning requirements include a certificate of merit. The private enforcer, or his or her attorney, must certify that they believe there is good cause for the notice based upon consultation with an expert who has reviewed the appropriate information. The intent of this change is to address abusive action brought by private persons containing little or no supporting evidence by barring such actions from proceeding or shifting the burden of proof provided by the statute.

Past violations of the warning requirements—up to four years—may result in civil penalties of up to \$2500 per exposure. Court injunctions may be obtained to prevent threatened or occurring violations of Proposition 65. Often, public prosecutors and private enforcers file suit under California’s Unfair Competition Statute in addition to Proposition 65. That law allows public prosecutors to obtain an additional penalty of \$2500 per violation, and allows any enforcer, including private plaintiffs, to obtain restitution against the alleged violator. **-HGC ❖**

*Further information concerning Proposition 65 may be obtained by contacting Howard G. Curtis at (510) 832-8585.*

## NON-COMPETE AGREEMENTS: WORTH THE RISK?

In *Walia v. Aetna Inc.* (A091221, 11/21/01), a California Court of Appeal upheld a \$1.26 million decision in favor of an account manager who was terminated for refusing to sign a non-compete agreement. The court of appeal held that terminating an employee for refusing to sign an illegal agreement was improper, entitling the manager to punitive damages.

In *Walia*, an employee was asked to sign a non-compete agreement that contained several “covenants,” including: non-competition, non-solicitation, confidentiality, and cooperation. The employer, Aetna U.S. Healthcare, had demanded that the manager sign an agreement barring her from working for any competitor engaged in the health care business in California (or elsewhere where Aetna was in the business) for six months after leaving the company. The employee refused to sign.

Non-compete agreements are generally illegal in California under Business and Professions Code section 16600 (with certain limited exceptions), which voids any contract that restrains a person from engaging in a lawful profession. Business and Professions Code section 16600 provides: “Every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.” The court of appeal found the Aetna agreement restricted employee mobility and therefore violated section 16600.

Moreover, the court saw Aetna’s termination of the manager for refusing to sign as willful and oppressive, thus warranting punitive damages. The trial court awarded the terminated manager \$1,080,000 in punitive damages, an amount that heavily outweighed the compensatory damages awarded in the case.

Courts have previously permitted agreements that only “narrowly” restrain competition. Two California cases that discuss these “narrow” restraints primarily concern themselves with property (in one case, denying one type of business in the use of a piece of real estate; in the other, use of intellectual property). A 1997 federal case interpreting California law (*General Commercial Packaging v. TPS Package Engineering* (1997) 126 F.3d 1131) interprets a subcontractor’s non-compete agreement, wherein a packaging subcontractor was barred for one year from working directly for or soliciting work from a client of a packaging contractor. The subcontractor was hired specifically to do

overflow work for the client. The court affirmed the agreement, which limited access to only a narrow segment of the market. The court's holding suggests that as long as a non-compete agreement restricts employment with single companies and not with an entire industry (as the agreement in *Walia* did), it will probably be enforceable.

The federal court in *General Commercial* recognized, however, that since, "... most businesses cannot succeed with only a handful of customers, a contract can effectively destroy a signatory's ability to conduct a trade or business by placing a substantial segment of the market off limits" (p. 1134). Therefore, even limited non-compete clauses can, in some circumstances, run afoul of section 16600. Furthermore, while the court in *Walia* discussed *General Commercial* and distinguished the restraints from the facts in *Walia*, California courts may yet weigh in and disapprove the federal court interpretation of California law.

#### WHAT SHOULD EMPLOYERS DO?

Most employers probably never use non-compete agreements and have no need for them. However, what about the employer who brings in a subcontractor to perform a time-limited, specialized job for a particular client or customer?

Business and Professions Code section 16601 and 16602 permit broad covenants not to compete in two narrow situations: where a person sells the goodwill of a business, and where a partner agrees not to compete in anticipation of dissolution of a partnership. Narrower contractual restraints, such as prohibiting a departing employee from using confidential information taken from a former employer, have been upheld by the courts. (But obtaining relief under such restraints requires proof that the information is truly confidential and not available elsewhere; that the former employee intended to harm the former employer; that the business is such that the customer will only patronize one concern; and that the established business relationship would normally continue unless interfered with. *Peerless Oakland Laundry Co. v. Hickman* (1962) 205 Cal.App.2d 556.) Courts may not be as tolerant of contracts that prohibit employees from soliciting all of their former employer's customers. (See *Hollingsworth Solderless Terminal Co. v. Turley*, 622 F.2d 1324, 1338 (9th Cir. 1980) and *Moss, Adams, & Co. v. Shilling* (1986) 179 Cal.App.3d 124, 127.)

An employer builds personal bonds with several constituencies important to running its business; perhaps the most important of these constituencies are the employer's customers. In *General Commercial*, the subcontractor entered into a contract, bargaining for the work and agreeing to a

contract clause designed to prevent one party from losing business to the other. Thus, a non-compete agreement that is a contracted part of the original employment bargain, that is time limited and limited to the very customer the subcontractor provides services to through the employer, should pass muster with the California courts.

If you sue your subcontractor to enforce a non-compete contract clause, he/she might defend under *Walia*. A very narrowly drawn non-compete contract is distinguishable from that in *Walia*. The employee in *Walia* was prohibited from working anywhere in the same industry after the end of employment. If you restrict your subcontractor from working for one employer, he or she may still pursue work with other employers in the same industry. Also, the *Walia* court indicated that since the employee was required to sign sometime after commencing employment, there was no "bargained for" exchange. We recommend that you make your contractors sign as a condition of first accepting the employment assignment with a customer.

Nevertheless, even with all these safeguards, there is a risk that a court would refuse to enforce your contract. For example, in *General Commercial*, the contract was between companies, whereas in *Walia* an individual was involved. If you never intend to enforce a non-compete agreement, you might think twice about having subcontractors sign one.

Employers should also review all employment agreements, handbooks, and policies and remove any broad non-compete provisions. Do not include broad non-compete language in offers of employment. Instead, adopt and enforce policies related to disclosure of trade secrets.

—BDN ❖

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#### MORE NEW LEGISLATION

Before January 2002, a state or local authority could not draft a bid specifying a specific type of product unless specific guidelines were met. Assembly Bill No. 1442 amends Sections 3400 and 10129 of the Public Contract Code, allowing these awarding authorities to specify "brand name or equal" products if the awarding authority specifies a product in order to either: (1) make a field test, or (2) match a material or service already in use on that particular work of improvement. This bill also extends to legislation enacted in 2000 that allows bidders on state contracts to submit requests to substitute products "equal" to those specified in the bid for up to 35 days after the award of the contract.

## COURT WATCH

## ARBITRATION

**Parties to arbitration agreement cannot validly agree that arbitration award is subject to judicial review to determine whether award is supported by law and evidence.**

Answering a question of first impression under the State Arbitration Act, a split panel of the court of appeal in Los Angeles ruled that parties to an arbitration agreement cannot agree to have a court review the arbitration award to determine if it is “supported by law and substantial evidence.”

The case arose out of an agreement between a physician and a hospital for emergency services. Although calling for binding arbitration of disputes under the California act, the parties also agreed that the arbitrator’s decision would be subject to a court’s authority to vacate the award if it “is not supported by substantial evidence or is based on an error in law.” When an actual dispute did arise, the physician demanded arbitration and the hospital replied that the arbitration agreement was void and unenforceable because of the judicial review provision.

In the 2–1 decision, the majority agreed with the hospital, rejecting the physician’s argument that since binding arbitration is a matter of contract, the arbitration act’s specification of the grounds on which a court may vacate an award are “merely default provisions” that apply only when the parties cannot otherwise agree. Citing to *Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1, the court of appeal concluded that parties to an arbitration agreement cannot validly expand the jurisdiction of a trial court to review arbitration awards beyond the jurisdiction provided by statute. In *Moncharsh v. Heily & Blase*, the California Supreme Court held that the statutory bases for vacating and correcting arbitration awards are exclusive, and that permitting parties to expand that review by agreement would undermine arbitration. In the case of the physician-hospital agreement, because the provision for court review was so central to the arbitration that it could not be severed, the court ruled that the entire arbitration agreement was invalid.

One of the three justices hearing the case sharply dissented, arguing that parties may consent to have the courts review their arbitration awards for errors of law and sufficiency of evidence. In the dissenting justice’s view, the majority’s ruling “will discourage people from agreeing to arbitrate, which is the exact opposite of California’s public policy.”

*Crowell v. Downey Community Hospital Foundation* (Jan. 28, 2002) 02 C.D.O.S. 840.

*EDITOR’S NOTE:* This is a significant decision, the long-term impact of which, if not overturned by the Supreme Court, can only be speculated about at this time. Nevertheless, based on BR&H’s collective experience, we agree with the dissenting justice that many parties who otherwise would be willing to agree to binding arbitration will be hesitant to do so from now on without the “safety net” that judicial review can provide against an entirely arbitrary result by the arbitrator.

## INSURANCE

**Property insurance coverage for “hidden decay” was not limited merely to organic decay in building materials.**

The court of appeal reversed a judgment for the insurer, holding that coverage for “hidden decay” was not limited to organic decay, as argued by the insurer, but also covered the concealed process by which building materials gradually lost their strength.

The insured, Stamm Theaters, owned a 49-year-old theater that was insured by Hartford against catastrophic collapse due to “hidden decay.” When ceiling plaster cracked and fell, inspection by an engineer determined that the building was in imminent danger of collapse due to the structural failure of the wooden roof trusses. Hartford denied Stamm’s insurance claim, however, arguing that the policy’s coverage for “hidden decay” meant due to rot or the decomposition of organic matter, such as from bacteria, fungus, insects, vermin and the like, and did not cover the gradual deterioration of building materials due to age alone.

Finding the insurance policy’s use of “decay” was ambiguous, since the dictionary defines decay as covering both gradual deterioration and rot, the court of appeal held in favor of Stamm. Well-established principles of law covering the construction of insurance contracts required that any ambiguity be construed against Hartford and in favor of its insured. Thus, the court held that Hartford’s policy covered Stamm’s loss due to the gradual deterioration of the roof trusses.

*Stamm Theaters, Inc. v. Hartford Casualty Insurance Co.* (2001) 93 Cal. App.4th 531.

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## COURT WATCH

(CONTINUED FROM PAGE 9)

## MECHANIC'S LIENS

**Trucker hired by subcontractor to transport construction materials to building site entitled to assert mechanic's lien remedies.**

In *Ivy Trucking, Inc. v. Creston Brandon Corporation* (2000) 84 Cal.App.4th 85 the court of appeals held that Ivy—hired by subcontractor Creston to haul fill dirt to a Caltrans freeway project—was entitled to enforce a stop notice served on Caltrans because Ivy had contracted with an agent of the owner (Caltrans). The court noted that Civil Code section 3110 has expanded the definition of agent to include every sub-agent:

“For the purposes of [the chapter on mechanic’s lien remedies] . . . every contractor, subcontractor, sub-subcontractor, architect, builder, or other person having charge of a work of improvement or portion thereof shall be held to be the agent of the owner.”

In particular, the court found that this result (recognizing that Ivy had lien rights under these facts) was consistent with the policy of interpreting the lien laws liberally to accomplish their intended purpose of preventing unjust enrichment at the expense of unpaid workers. *Ivy Trucking, Inc. v. Creston Brandon Corporation*, *supra*, 84 Cal.App.4th at 89 (citing *Primo Team, Inc. v. Blake Construction Co.* (1992) 3 Cal.App.4th 801, 812; *Industrial Asphalt, Inc. v. Garrett Corp* (1986) 180 Cal.App.3d 1001, 1006). The court of appeal refused to enforce a rental equipment company’s \$159,000 mechanic’s lien claim because of defective 20-day preliminary notices. Specifically, the court found the sub-tier supplier’s preliminary notices were fatally flawed because they did not give the owner a reasoned “estimate” of the total price of the rented equipment furnished for the work. Instead, the court found that the \$10,000 stated in the preliminary notices was based on nothing more than conjecture. According to the court, Civil Code section 3097 requires “a derived figure, arrived at by rational analysis.”

*Ivy Trucking, Inc. v. Creston Brandon Corporation* (2000) 84 Cal. App.4th 85.

## PUBLIC CONTRACTING

**U.S. Supreme Court dismisses challenge to the constitutionality of the U.S. Department of Transportation’s Disadvantaged Business Enterprise (“DBE”) Program.**

Six years ago, Adarand Constructors, Inc. prevailed in a case before the U.S. Supreme Court in which the use of race-based classifications by the U.S. Department of Transportation (“DOT”) was challenged as a denial of equal protection. In *Adarand v. Peña* (1995) 515 U.S. 200, the Supreme Court held that the use of race-based classifications in affirmative action programs is unconstitutional unless the government can show that their use is narrowly tailored to serve a compelling governmental interest.

On remand, the federal district court determined that the DOT DBE program, as it was still administered in 1997, could not survive the “strict” standard of review mandated by the Supreme Court. The Court of Appeals for the Tenth Circuit concluded that the DOT DBE Program, as changed in 1999, did pass constitutional muster. Following the court of appeals’ decision, the Supreme Court agreed to review whether the 10th Circuit had misapplied the strict scrutiny standard in determining that Congress had a compelling interest to enact legislation to remedy the effects of racial discrimination and that DOT’s current DBE program is narrowly tailored to serve a compelling governmental interest.

During the most recent proceedings before the Supreme Court, however, Adarand took the position that it was challenging only those statutes and regulations under which DOT directly contracts for highway construction on federal lands. Since the current DOT DBE program pertains almost exclusively to state and local highway procurement, and not direct federal contracts, the Supreme Court concluded that Adarand did not have standing to challenge the DOT DBE program and dismissed Adarand’s case on that narrow procedural basis.

*Adarand Constructors, Inc. v. Minetta* (Nov. 27, 2001) 01 C.D.O.S. 9903.

**EDITOR’S NOTE:** *The Adarand case caught national attention back in 1995, when the Supreme Court held that the U.S. Department of Transportation’s “subcontracting compensation clause (SCC)” was subject to strict scrutiny by the courts. While the Supreme Court’s most recent dismissal on procedural grounds is a setback for Adarand, several other cases are currently proceeding through the federal courts that may offer the Supreme Court a better vehicle to review the constitutionality of DOT’s current Disadvantaged Business Enterprise program.*

**Supreme Court holds that a City's public works contract cannot be abandoned by the owner and that the contractor did not introduce sufficient evidence to justify an award of damages based upon its "total cost claim."**

In a lengthy opinion, the California Supreme Court recently decided that the abandonment theory of liability does not apply against a public owner, since that theory is "fundamentally inconsistent with the purpose of competitive bidding statutes," and the jury's award of damages to the contractor based on its "total cost claim."

Briefly, the City of Thousand Oaks awarded a contract for electrical work in connection with a new arts center. Over the two-year construction period, the City submitted over 1000 drawings clarifying and changing the original contract drawings. The City's frequent changes not only caused the contractor to expend more resources than originally planned, they caused the work to be delayed and disrupted. After completion, the contractor submitted a "total cost" claim to the City under the theory that the City abandoned the original contract.

The court of appeal affirmed the jury's \$2.1 million verdict for the contractor, rejecting the City's defense that, as a matter of law, a public owner cannot be found to have abandoned a public work contract. The court of appeal also disagreed with the City's argument that a total cost claim is never permitted against a public entity.

In reversing the court of appeal, the Supreme Court observed that:

"Under the abandonment doctrine, once the parties cease to follow the contract's change order process, and the final project has become materially different from the project contracted for, the entire contract—including its notice, documentation, changes, and cost provisions—is deemed inapplicable or abandoned, and the plaintiff may recover the reasonable value for all of its work. Were we to conclude such a theory applied in the public works context, the notion of competitive bidding would become meaningless."

Relying on the long-held principle that the competitive bidding statutes are for the benefit of the taxpayers and not bidders, the majority of the justices concluded that it was difficult to see how the general public benefits by allowing a contractor's abandonment claim against a public owner. Rather, "[p]ermitting such recovery would appear to unduly punish the tax-paying public."

In reversing the jury's award of damages to the contractor, the Supreme Court stopped short of holding that a "total

cost claim" is never appropriate in a breach of public contract case but did acknowledge that the total cost method of determining damages is generally disfavored by the courts. In this case, the court agreed with the City that the contractor (Amelco) failed to show that it was not responsible for any of the additional costs included in its claim. The court concluded that the jury was improperly instructed that, if it found any basis for breach of the contract by the City, regardless of when the breach occurred, the contractor was entitled to damages measured by the reasonable value of the work over the life of the contract.

*Amelco Electric v. City of Thousand Oaks* (Feb. 4, 2002) 02 C.D.O.S. 1056.

**State False Claims Act was not violated by contractor's payment application after a state agency abandoned competitive bidding in favor of awarding an allegedly improper sole source contract.**

This case involves a private *qui tam* lawsuit between contractors after one of them was awarded a sole source contract by the state's Department of General Services ("DGS").

DGS solicited competitive bids from American Contract Services ("ACS") and others to furnish infant training cups for a state program. ACS's bid stated that it intended to obtain the cups from Allied Mold & Die. When DGS concluded that Allied was the only source of acceptable infant cups, the bid solicitation was canceled and DGS issued a sole source contract directly to Allied. Following delivery of the cups, Allied applied to and was paid by the state.

ACS's *qui tam* lawsuit against Allied alleged that Allied submitted a false claim when it applied to the state for payment because Allied knew that the amount of its sole source contract with DGS exceeded that agency's authority and thus was void. The Attorney General then intervened in the ACS lawsuit on behalf of the state and successfully moved to dismiss the *qui tam* complaint.

In affirming, the court of appeal found that there was good cause for dismissal of ACS's *qui tam* complaint against Allied for the reason that a violation of the False Claims Act requires a "knowing" presentation of a false claim. The court held that where, as in this case, the state approves a claim while fully aware of all surrounding facts, including any alleged improprieties, there cannot be a "knowing" presentation of a false claim. Thus, when DGS aborted the competitive bidding process in favor of awarding a sole source contract to Allied, Allied's subsequent application for payment following performance of that contract was not a false claim.

*American Contract Services v. Allied Mold & Die, Inc.* (Dec. 21, 2001) 01 C.D.O.S. 10639.

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Join us for the next  
**BR&H Breakfast Forum**  
March 8 (see page 3)

## COURT WATCH

(CONTINUED FROM PAGE 11)

### TORTS

#### **Hirer of contractor is liable for injuries suffered by contractor's employee only if hirer affirmatively contributed to injuries.**

The California Supreme Court reversed a court of appeal by holding that a hirer of an independent contractor, such as Caltrans, is not liable for injuries suffered by that contractor's employee unless the hirer affirmatively contributed to those injuries.

The contractor's employee was killed when the crane he was working on had to retract its outriggers to permit traffic to pass because Caltrans had not blocked off traffic around the jobsite. The court of appeal agreed with the employee's widow that, because Caltrans had retained control over the worksite, its negligent exercise of that control defeated its claim of immunity and made the agency liable in tort.

The Supreme Court disagreed and reversed the court of appeal on the basis that Hooker's widow failed to show that Caltrans' conduct affirmatively contributed to his death. In short, Caltrans' passive conduct in permitting traffic to pass the jobsite and permitting the crane outriggers to be retracted did not constitute the type of affirmative conduct that gives rise to liability on the part of the hirer.

*Hooker v. California Department of Transportation* (Jan. 31, 2002) 02 C.D.O.S. 942

#### **Uphill neighbor who channeled surface water into pipe was liable for consequential damage to noncontiguous downhill property.**

The court of appeal affirmed a judgment holding that properties need not be contiguous in order for an uphill property owner to be liable for damage caused by surface waters channeled by it onto a downhill neighbor's property.

In this case, the Town of San Anselmo channeled water from a public street and gutter into a pipe which traversed one property to discharge onto a second property. When excess water collected on the second property, it caused a landslide which damaged the downhill property of plaintiff, who sued his uphill neighbor and the Town.

In affirming the judgment against the Town, the appellate court relied on the Supreme Court's decision in *Keys v. Romley* (1966) 64 Cal.2d 396, holding that an uphill landowner who alters the natural drainage of surface waters may be liable for the damages caused by the discharge of those waters onto "adjacent" property based upon a reasonableness of conduct test. The court of appeals rejected the Town's argument that *Keys v. Romley* does not apply unless the two properties are contiguous to each other. The court concluded that the Supreme Court did not intend to limit its rule to abutting properties and that "adjacent" may be interpreted to mean properties that are simply near each other.

The court also rejected the Town's denial of liability based on its lack of ownership or control over the pipe into which water from the street and gutter was channeled. The court found such an argument to be at odds with recent cases expanding the test of *Keys v. Romley* to situations in which surface waters channeled into a waterway caused downstream property damage.

*Lombard Acceptance Corp. v. Town of San Anselmo* (Dec. 21, 2001) 01 C.D.O.S. 10608. **-HGC** ❖