BELL, ROSENBERG & HUGHES LLP
ATTORNEYS AT LAW

NEWS IN BRIEF
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Greetings from the Editor

Welcome to the winter issue of BR&H's *News in Brief*. The new year finds Bell, Rosenberg & Hughes busier than ever with new cases, new clients, and plenty of ongoing projects.

Thanks to all of you who wrote to us recently complimenting the newsletter's new look and valuable content. We hope to continue making *News in Brief* a useful tool for our clients and colleagues alike, and we welcome your feedback on how we can best serve your interests.

In this issue, look for the latest information on changes in labor law, a handy introduction to selling a business to an Employee Stock Ownership Plan, an overview of contemporaneous time extension issues, and a survey of relevant news from the bench.

"Spotlight on California Construction" is a new feature in this edition. Each *News in Brief* will profile friends of BR&H who are breaking new ground in the construction world. This time we're spotlighting Mendoza & Associates and the new SR 125 San Diego Toll Road project. See page 11.

Breakfast is on us Thursday, March 11, 2004, when Derek Cunz, project manager for Mortenson Construction, addresses the BR&H Breakfast Forum about innovative construction techniques used on the visionary Disney Concert Theater in Los Angeles. See page 4.

—**Paul Kotapish** ❖

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The Holy Grail of Troubled Projects:
Negotiating Time Extensions Contemporaneously

OWNERS, DESIGNERS, AND CONTRACTORS ALIKE know that completing a project in the planned duration of time is a hallmark of success. Delays in project completion are predictably expensive, and, because volunteers for bearing unanticipated expenses are hard to come by, delays lead to disputes. At the "Owner's Construction Superconference" held in San Francisco recently, experts stressed the virtue of negotiating time extensions for delays as they are incurred. Negotiating time extensions and attendant costs in a timely manner can minimize or avoid disputes. On failing projects, however, the quest to negotiate contemporaneous time extensions is frequently elusive.

In years of litigating failed and troubled projects (to date we have not been sent forth to take depositions to discover why a project has succeeded!) we have found that projects that are significantly behind schedule, over budget, and in litigation invariably have one thing in common: the parties did not negotiate or grant realistic time extensions during the project. This is not a coincidence. Failing to address project delays as they are incurred is a mistake for the owner as well as the contractor because a project that is allowed to hobble to completion two years late and burdened with millions of dollars in outstanding claims will result in a wasteland of litigation. Let's examine some reasons why project delays on failing projects are not timely addressed, and then take a look at some recommended ways owners and contractors can avoid this pitfall.

The Illusion of Contractual Certainty

Most owners on major projects require the contractor to create a critical-path-method network baseline schedule showing the sequence of all activities to be performed during construction before commencing the work. Contractors are required to update the baseline schedule periodically during construction, usually monthly, in order to reflect the actual progress of the work and to show the impact of any changes, unforeseen conditions, and delays. The contractor is required to provide prompt written notice of potential delays and to demonstrate the effect of individual delays on the schedule through a time-impact analysis tied to the most recently updated schedule. Provisions typically force the contractor to forfeit its right to a time extension or to additional compensation if a time-impact analysis is not provided timely.

One item missing from most owner contracts, however, is a requirement that the owner issue a prompt decision on the contractor's time-impact analysis, or that the owner issue a prompt change order granting additional time if this is

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The Holy Grail of Troubled Projects

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warranted. Most contracts are silent on how soon the owner must act on the contractor's request for additional time. Some owners expressly reserve the right to resolve all time issues after the work is complete.

Subject to some limitations, owners and contractors are free to allocate risk of project delays in any manner they knowingly and willingly agree to. Owners typically draft the construction contract, and they often incorporate terms that attempt to shift the risk of time-related costs to the contractor. Owner representatives will argue that all such clauses are enforceable; contractors will argue they are not. Statutes may bear on the question of enforceability. All parties should firmly keep in mind, however, that contract certainty is an illusion. Owners, therefore, should never refuse to act sensibly in granting time extensions based on a perceived contractual advantage; conversely, contractors should never assume that a strict notice or scheduling requirement will not ultimately be enforced.

The Temptation to Defer the Negotiation for Extra Time

Several reasons conspire to ensure that time extensions are often not resolved during the course of a troubled project. First, it is extremely difficult and expensive for the contractor to accurately update the baseline schedule of a failing project. The effect of numerous small and overlapping changes, multiple requests for information that remain outstanding for indefinite durations, and unforeseen project changes driven by inadequacies in the design are hard to accurately quantify on a monthly schedule update. Second, in light of this uncertainty, contractors are reluctant to negotiate a specific time request that may prove to be grossly inadequate as the project unfolds. Third, hope springs eternal, and both parties may cling to the fantasy that time will be recaptured through good project management. If so, the owner will be reluctant to grant a time extension—and resign himself to accepting the project late—because the time extension may ultimately not be needed. Fourth, owners may mistakenly perceive that it is not in their best interest to grant a time extension on a troubled project. By maintaining the original completion date, the owner can pressure the contractor to work more expeditiously, threaten liquidated damages, and use liquidated damages to offset anticipated contractor claims. Finally, the owner's contract manager may be reluctant to grant time extensions when the contractor has not strictly complied with the contract notice requirements. Granting time extensions when there has been less than strict compliance with the contract may later be criticized as giving up a bargained-for advantage.

What Should Owners Do?

Owners should employ construction managers who have scheduling expertise equal to the task at hand. Just as the contractor needs to increase its resources devoted to the scheduling effort when a project encounters multiple changes, design issues, and delays, the owner's construction manager needs to increase its resources to evaluate schedule impacts. Owners should include provisions in their contracts that permit the owner to charge this additional cost to the contractor if the problem is contractor caused, and should not balk at bearing this cost if the problems are properly the owner's risk or responsibility.

In light of the fact that the owner should always hire sufficient resources to evaluate the impact of problems on the schedule, the owner should never refuse to negotiate time solely on the grounds that the contractor did not meet the technical requirements of the contract.

If the owner and contractor disagree regarding the amount of time, the owner should grant unilateral changes rather than defer any decision. A failure to grant contemporaneous time extensions may be construed later as a constructive direction to accelerate the work. Although pressure placed on the contractor by maintaining the original completion date and leverage gained by withholding liquidated damages are both beneficial to an owner, this perceived advantage is illusory if millions of dollars in attorneys fees and experts fees are required to resolve a major dispute at the end of the project.

What Should Contractors Do?

First of all, contractors must commit the necessary manpower and financial resources to handle the added paperwork and clerical hassle of staying on top of schedule and time issues. Contractors must discipline themselves from the beginning to promptly address every excusable delay,

even if the delay occurs at the very outset of the project. At the start of a new construction job when all parties are appropriately focused on the partnering spirit, no problem appears insurmountable. As a result, contractors are often reluctant to formally request time early in a project. This is a mistake. The contractor should devote sufficient resources to establish a proper schedule and sufficient resources to revise the schedule in accordance with actual progress and the contract requirements. On problem projects that encounter multiple delays, it is especially important to establish a pattern of dealing with time-extension requests early. If the work is delayed due to deficiencies in the contract documents at the outset, it is prudent to assume that these problems will persist. In practice, owners and contractors often avoid the hard process of negotiating contemporaneous time extensions on problem projects by resequencing work or adjusting milestones in the ill-founded hope that this will recapture lost time and that problems will not continue. This is not recommended.

In order to recognize when additional resources must be devoted to address delay issues, contractors should aggressively monitor projects to identify project delays as early as possible. Without proper monitoring, the problem project may not be recognized in time to keep the upper hand in documenting and justifying time extensions. Properly documented, the additional costs required to document project delays may be recaptured.

An unresponsive owner should be placed on notice that the failure to timely grant a properly documented request for additional time is a breach of contract. An extraordinary effort should then be made to track accurately the additional costs resulting from the owner's breach. The contractor should make a conscious decision whether to treat an owner's refusal to grant time extensions as a constructive order to accelerate. The owner should be placed on notice of this decision, and any resulting additional costs should be accurately documented.

OWNERS AND CONTRACTORS OFTEN AVOID THE HARD PROCESS OF NEGOTIATING CONTEMPORANEOUS TIME EXTENSIONS ON PROBLEM PROJECTS BY RESEQUENCING WORK IN THE ILL-FOUNDED HOPE THAT THIS WILL RECAPTURE LOST TIME. THIS IS NOT RECOMMENDED.

If entitlement can be clearly demonstrated, a reluctant owner may be compelled to process time extension requests by threatening to abandon a project unless time extensions are promptly processed and granted. If a project is correctly identified as a problem project, one that will finish years late and many millions of dollars over budget, forcing the issue early may be beneficial to all concerned. The contractor should recognize that its leverage is greater early in the project, when the owner's retention account is smaller. If the contractor gives up its right to time extensions in early change orders, and the owner then refuses to grant time or additional compensation, the owner will be playing with the contractor's money by the time the project nears completion.

Conclusion

The failure to negotiate time extensions contemporaneously during the project assures a major dispute if the project is significantly delayed and over budget. It is of paramount importance for owners and contractors alike to address and resolve issues of time as early as possible. Although the cost to fully document and analyze time impacts during the project is large, the cost of completing this effort with lawyers and their consultants after the project is complete and in litigation is much greater.

—Roland Nikles ❖

BR&H BREAKFAST FORUM

PHOTO: TOM BONNER

BR&H Breakfast Forum welcomes

Derek Cunz

M.A. Mortenson Company

THE NEW WALT DISNEY CONCERT THEATER in Los Angeles, designed by visionary architect Frank Gehry, is among the most significant structures built in recent decades, and it has already achieved landmark status. Its complex form and demanding program required many design, management, and construction innovations to realize.

Mr. Cunz will provide an illustrated, behind-the-scenes look at the innovative construction techniques required for this and future 21st-Century buildings.

Catch this chance to learn about the future of construction with someone working on the cutting edge of technique and technology, and enjoy a complimentary breakfast with members of the BR&H team.

DATE: Thursday, March 11, 2004

TIME: 7:30 A.M. Complimentary Continental Breakfast
8:00 A.M. Presentation and Q&A Session

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

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 email at sgarvey@brhlaw.com.

NEW LAWS FOR THE NEW YEAR

There are a number of new laws that take effect in 2004 that affect contractors and other employers. A summary of some of the most interesting and important follows.

Growing Concerns About the Underground Economy Prompted Legislative Action

In the past several years both California Senate and Assembly committees considered the growing "underground economy" in California and recognized that the state's Department of Industrial Relations is ineffective to control the underground activity. The committees identified lack of enforcement of wage and hour laws as one problem area. They also realized that under current law the state is unable to control businesses that contract for labor knowing that the amounts they are paying the contractor are insufficient to cover legally mandated wages and payments.

Two new laws seek to remedy these situations. The first allows employees to bring an action against employers for violations of wage and hour laws instead of relying on the DIR; the second adds penalties for knowingly signing a contract for labor that provides insufficient funds to pay wages, and the required federal and state payments.

Senate Bill 796: The "Bounty Hunter Law"

Senate Bill 796 creates a private right of action for employees claiming violations of wage and hour laws. The bill adds a new part to the Labor Code. Among other provisions, the new Labor Code sections provide as follows:

- For violations previously punishable only as misdemeanors, the bill adds civil penalties of $100 for each aggrieved employee per pay period for an initial violation, and $200 for each aggrieved employee per pay period for continuing violations.
- Any aggrieved employee may sue to recover civil penalties in an action brought on behalf of himself or herself or other current or former employees.
- An aggrieved employee who prevails in such an action can recover attorney's fees and costs.
- Any penalties recovered will be distributed 50 percent to the General Fund, 25 percent to the Labor and Workforce Development Agency (parent agency to the DIR) for employer education, and 25 percent to the aggrieved employees.

Several employer groups opposed the bill arguing that it will encourage employees and attorneys to act like "vigilantes" and pursue minor Labor Code violations, spurred on by the right to recover both attorney's fees and a portion of the penalties. These groups also argue that, as the bill provides for an award of attorney's fees to prevailing employees, but not to employers, it contains no disincentive for meritless actions. Finally, employer groups fear that undiscovered innocent errors could lead to huge penalties as "continuing violations."

The bill's proponents argue that people are unlikely to abuse the new law. First, the bill limits private rights of action to aggrieved employees or former employees, so that public interest groups cannot bring actions. Second, the bill's statutory penalties are relatively low. Finally, because the bill provides for the bulk of the penalties to be distributed to the LWDA and the General Fund, with only 25% divided between the employees, it discourages individuals from bringing actions over minor violations simply to win the penalties.

Senate Bill 179: Sufficient Funds for Wages in Certain Contracts

Senate Bill 179 adds Labor Code section 2810, which requires that any contract for construction, farm labor, garment, janitorial or security guard services must provide funds sufficient to allow the labor contractor to comply with all applicable laws and regulations governing the labor or services to be provided.

The purpose of SB 179 is to ensure that employers who use labor contractors pay sufficient fees to allow the contractor to make contributions on behalf of its workers to mandatory social-insurance benefit programs such as social security, workers compensation, and unemployment insurance. The remedy for violation of the law is the

greater of an employee's actual damages or $250 per employee per violation for an initial violation, and $1,000 per employee for each subsequent violation. The employee also may recover attorney's fees and injunctive relief.

Penalties apply only to persons or entities that "know or should know" that the contract in question does not provide enough money for the contractor to make the required payments.

Homeowners and employers covered by collective bargaining agreements are exempt from the provisions of the new code sections.

The new code section also establishes a rebuttable presumption that a person contracting for labor does not violate the code provisions if there is a voluntary written agreement with the contractor that includes certain information such as:

- A description of the labor and services to be performed, including commencement and completion dates;
- Proof of workers-compensation coverage; and
- The estimated number of workers needed, the total wages the employer will pay, and the pay dates.

The bill is aimed at businesses that leverage their economic advantage to pressure labor contractors to enter into contracts that don't pay enough for the contractor to comply with applicable laws and regulations. Janitorial industry supporters of SB 179 argue that these unethical contractors have an unfair advantage in competing for cleaning contracts, putting ethical and law-abiding contractors out of business. Similar practices in the field of agriculture result in labor contractors either not paying mandated taxes, or paying farm workers below the minimum wage. In construction, labor law violators typically use bad checks and cash pay, and lack workers-compensation insurance coverage.

Opponents argue that the bill requires contracts to include information that normal labor contracts don't require, that small companies can't afford to hire an attorney to draft a contract every time they use a specialty contractor, and that that the new law will prevent the use of introductory discounts for first-time customers.

Proponents argue that the new law protects by a "know" or "should have known" standard, which is a common one referring to an ordinary, reasonable person in like or similar circumstances. While this standard may protect some persons, it will not excuse a total lack of knowledge of wage and hour laws. Persons or companies contracting for labor cannot bury their heads in the sand when the amount they are paying under the contract is clearly insufficient to insure compliance with the law.

Like Senate Bill 796, Senate Bill 179 provides for a private right of action by employees.

Other New Laws of Interest to Contractors

In addition to the statutes affecting wage and hour laws and labor contracts discussed above, there are several other new statutes that may affect contractors.

Assembly Bill 453: Quantum Meruit Recovery Under Void Public Works Projects

Current law does not allow contractors on public works projects to recover for the labor and materials furnished if, after the contractor starts work, a court finds that a public works contract is void due to a bidding error. New Public Contract Code section 5110 provides a remedy for contractors that find themselves in that situation.

Section 5110 provides that, when a public entity awards a contract for public work and another contractor challenges the award, the public entity and the contractor may enter into the contract pending resolution of the challenge. If a court later finds the contract to be void due to a defect in the bidding process caused solely by the public entity, the contractor can recover the cost of the labor, equipment, materials, and services furnished before the contract was invalidated. The new code section specifically excludes recovery of profits by the contractor.

In order to recover, the contractor must have acted in a good faith belief that the contract was valid and the work performed must be satisfactory. The code also restricts the amount that a contractor can recover.

Even with the new restrictions, this law adds protection for contractors and allows public works projects to go forward pending the outcome of bid protests.

Assembly Bill 1386: A New Requirement for Substantial Compliance with Licensing Law

This bill amends Business & Professions Code section 7031. The current statute provides that a person or company who hires an unlicensed contractor can bring a civil action to recover an amount due under the contract. The court, however, has the power to find that the contractor substantially complied with the licensing requirements if certain conditions are met.

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Sale of a Business to an ESOP

You started your business years ago and struggled through its growth and eventual success. As you approach retirement age you are concerned about who will continue the business after you are no longer involved. There may be no outsider interested in purchasing your business. You may have key employees who have the experience, aptitude, and ability to run the business, but they cannot raise the money to buy out your interest. A purchase financed by future company earnings may be unattractive to you and to them. What are your alternatives?

One possibility is to implement a leveraged ESOP. "ESOP" stands for Employee Stock Ownership Plan. Simply put, it is a retirement plan benefiting employees that invests in the stock of the company. The plan borrows money from a third party source, such as a bank, to purchase the stock from the departing shareholder. The company guarantees repayment of the loan. The retirement plan repays the loan from annual company contributions to the plan. Each employee's account in the retirement plan is credited with a portion of the shares in the company.

Ownership of a company by an ESOP is beneficial in many ways. First and foremost, management and employees become owners of the company. Ownership typically has a positive effect on work habits, increasing the employees' feeling of having a stake in the outcome of the business. Customer concerns about change in ownership are generally less than with a sale to an outsider. Sale to an ESOP creates a smooth transition to new management.

The financial benefits of sale to an ESOP are considerable. Company contributions to the ESOP (used to repay the loan) are tax deductible with certain limitations. Thus, purchase by an ESOP is significantly preferable over a company-financed buyout. With an "S" corporation the income allocated to the ESOP is not currently taxable. With a "C" corporation, selling shareholders can receive tax-free rollover treatment of proceeds of the sale if the ESOP owns at least 30% of the company. In addition, a "C" corporation can achieve the same tax benefits as an "S" corporation if it elects "S" corporation status after the sale to the ESOP.

Planning is an important part of implementing this strategy. If you already have a qualified profit-sharing plan in place (beyond a 401[k]), the plan assets may be used to make a stock purchase or down payment taking the stress off the leveraging needed. It is critical to have key employees in a position to manage and continue the company before the sale takes place. Finally, a sale over time can be structured where the current key shareholders buy out one or more departing shareholders while remaining on as key managers to run the company until the buyout of all the shares can be accomplished.

As an incentive to the new management team, a

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New Laws for the New Year *Continued from page 6*

The new amendment adds a requirement that the court find that the contractor has acted promptly and in good faith to reinstate his or her license upon learning that it was invalid. This finding would be a prerequisite to the court's finding substantial compliance.

Assembly Bill 17: Domestic Partner Benefits

Assembly Bill 17, which goes into effect in 2007, adds section 10295.3 to the Public Contract Code. The new code section provides that a state agency may not enter into a contract for goods or services with a value of $100,000 or more with a contractor that discriminates between spouses and domestic partners in providing benefits. The law has several exceptions, including certain utilities contracts and emergencies.

The new statute defines "domestic partners" as persons who have filed a Statement of Domestic Partnership with the Secretary of State.

AB 17 includes safeguards for employers. For example, if there is a difference in cost to the contractor for providing benefits to a domestic partner as opposed to a spouse, the employer can ask the employee to pay the additional cost. In addition, if the contractor takes reasonable measures to provide a benefit on a nondiscriminatory basis, but cannot, the law does not consider it discrimination.

—Teresa J. Main ❖

Court Watch

ARBITRATION DENIED

Unconscionability in Contract Precludes Arbitration Clause

The Harpers and Frank Ultimo and the Ultimo Organization signed two contracts for work on the Harpers' property. The contracts contained arbitration provisions providing that all controversies related to the contract were subject to the Uniform Rules for Better Business Bureau Arbitration. Under those rules, customers cannot obtain compensation for "personal injuries" unless all parties agree in writing, and customer remedies are limited to full or partial refund, completion of work, costs of repair, or any out-of-pocket loss, but in an amount not in excess of $2,500. The rules were not attached to the contract. The Harpers eventually filed suit alleging that Ultimo damaged their property and lied to them about the amount of work performed. Ultimo brought a motion to compel arbitration, but the trial court denied the motion on grounds that the clause was unconscionable.

The appellate court found both procedural and substantive unconscionability present in the contract. Procedural unconscionability focuses on surprise and oppression. The contract was procedurally unconscionable because the Harpers were surprised to discover that no relief was available for fraud or even for damage to property, and oppressed by the fact that the rules limiting their ability to receive full relief were not attached.

Substantive unconscionability focuses on the one-sidedness or overly harsh effect of a contract term or clause. The Ultimo contract was substantively unconscionable because, absent agreement from the defendant, there was not even the possibility of full relief. The court found that the fact that Ultimo was limited in what he could recover from the Harpers was not enough mutuality to render the clause enforceable.

Significantly, the court stated that adhesion is not a prerequisite to unconscionability. Parties can prove procedural unconscionability by showing that a contract is adhesive, but that is not the only standard. The court held that the contract in this case involved procedural unconscionability regardless of whether it was a contract of adhesion.

Finally, the court concluded that it was within the scope of the trial court's discretion to refuse to sever arbitrable from nonarbitrable claims. Severing the claims could lead to inconsistent results. The court also pointed out that the trial court acted reasonably in not sending the entire case to arbitration because doing so would rewrite the arbitration clause of the contract. *Harper v. Ultimo* (2003) 113 Cal.App.4th 1402.

—Tamra Miller ❖

Sale of a Business to an ESOP

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portion of the shares can be purchased by the new management team outside of the ESOP—depending on the resources of the buyers—while the ESOP acquires the balance of the stock.

What are the negatives? Company assets typically serve as collateral for the loan, potentially impacting future borrowing. Some lenders require personal guaranties of the loan by the selling shareholder or a pledge of the shares purchased by the loan. Also, maintaining an ESOP can be expensive if company shares are not traded on an established market because an annual appraisal is required. You must have a significant payroll base on which to make Company contributions to the ESOP, as you are limited annually to 25% of eligible payroll. Retirees during the first few years of the plan may not enjoy the benefit as the plan is allowed to pay off debt before making distributions to retired employees. When distributions commence, the retirees' account balances can be paid over five years.

ESOPs are an extremely technical area of tax law and implementation of an ESOP should only be considered with appropriate planning and informed consultants.

If you would like more information about ESOPs, please contact Cathy Fisher at BR&H.

—Catherine M. Fisher and Ed Traille of S.J. Gallina ❖

ECONOMIC LOSS RULE

Determination of Whether Defective Part Is "Other Property" Is Question of Fact

KB Home installed over 2,000 gas-fired horizontal forced air furnaces manufactured by Consolidated in California homes. Because California limits nitrous-oxide emissions in some areas, Consolidated installed stainless-steel NOx rods above the burners in furnaces to be installed in those areas. After the furnaces were installed, KB Home discovered that several of the furnaces had bent or melted NOx rods, cracked fire boxes, cracked heat exchangers, melted burners, separations at the control joints, and rusted components.

KB Home sued Consolidated and other defendants alleging causes of action arising from KB Home's replacement of the defective furnaces, including tort claims for strict liability and negligence. At trial, the court requested briefs on the "economic loss" rule, which generally precludes recovery in negligence where there is no property damage. The question was whether the furnaces were "other property" damaged by their components. The trial court held that the furnaces were not "other property" for the purposes of the economic-loss rule, and KB Home's costs for replacing the furnaces were not recoverable on theories of strict liability or negligence.

On appeal, the court of appeal held that distinguishing between "other property" and the defective product itself in a case involving component-to-component damage requires determining whether the defective part is a sufficiently separate element of the larger product that it is not reasonable to expect its failure invariably to damage other portions of the finished product. Resolution of that issue was for the trier of-fact. Because the trial court's rulings deprived KB Home of its right to have the issues of fact submitted to a jury, the court of appeal ordered the trial court to allow KB Home to proceed with its strict liability and negligence claims. *KB Home v. Superior Court* (2003) 112 Cal.App.4th 1076.

—Tamra Miller ❖

INSURANCE COVERAGE

Damage to Property Excluded from Coverage During Ongoing Construction

Baroco West, Inc., a construction company, sued its insurance carrier, Scottsdale, for failing to defend it in a homeowner's action for negligent construction of a private residence. Scottsdale moved for summary judgment arguing that policy exclusions precluded coverage for property damage that occurred during construction. Because Baroco did not complete construction and put the home to its intended use before the policy expired, there was no potential for coverage under the policy and no duty to defend. In the absence of a duty to defend, there is no cause of action for breach of contract or breach of the implied covenant of good faith and fair dealing.

Baroco appealed, claiming that the trial court erred because Scottsdale failed to establish that there was no potential for coverage. The appellate court agreed that there was no potential for coverage under the policy and no duty to defend in the third-party action. The court phrased its determination broadly, stating that, "the policy excludes damage to the property caused during ongoing construction operations performed by the contractor or subcontractor." The court of appeal, therefore, affirmed the trial court's judgment. *Baroco West, Inc. v. Scottsdale Ins. Co.* (2003) 110 Cal.App.4th 96.

—Tamra Miller ❖

FRAUD

Pro Forma Invoices in Government Contract Not Fraudulent Unless Evidence Shows Intent

The United States Army hired Precision Machining, Inc. (PMI) to build aluminum ribbon bridges. PMI submitted three requests for progress payments based in part on pro-forma invoices from its independent supplier, Taber Extrusions, LP. A supplier commonly uses pro-forma invoices to advise a customer who is not creditworthy what price the customer must pay before the supplier will assemble and ship a specific order. Officers of PMI pleaded guilty to criminal fraud, admitting that the submitted progress payment requests improperly included the amounts invoiced by Taber as "incurred costs," current obligations PMI had either paid or recorded on its ledgers as accounts payable, when, in fact, PMI had no current obligation to Taber.

The government brought this action, alleging that Taber violated the Federal False Claims Act by conspiring with PMI to submit false progress payment requests, and by causing the submission of false claims by issuing false invoices used by PMI to support false progress payment requests. The district court granted summary judgment for the government, concluding that Taber's invoices were "false or fraudulent" because proper invoices may only be based upon current obligations and the lack of the words "pro forma" on the invoices allowed PMI to present them as such.

On appeal, the court reversed, concluding that the district court ignored evidence from Taber that could have lead a reasonable jury to find that the invoices were not false or fraudulent. For example: PMI did not submit the Taber

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COURT WATCH *Continued from page 9*

invoices with its payment requests; both Taber and the government knew PMI was in financial difficulty when the Army awarded the contract; PMI had used pro-forma invoices from Taber to obtain progress payments on prior military contracts; and the invoices in question were obviously pro forma because they did not contain a shipping date or other shipping information. The evidence also raised genuine issues of fact as to materiality and the government's knowledge, and whether Taber's conduct caused the government to make the progress payments in question.

The appellate court also concluded that Taber did not "knowingly assist" PMI's fraud. To hold Taber liable, the government must prove that Taber knew that PMI would use Taber's pro-forma invoices in a manner that would cause the facts represented or omitted in the invoices to defraud the government. Although the government had evidence creating that inference, Taber presented contrary evidence. A jury could thus find that Taber's demanding payment in advance was reasonable, and that the government might allow progress payments to fund PMI's advance payments to a critical vendor. *United States of America v. Taber Extrusions, LP* (8th Cir. 2003) 341 F.3d 843. **—Alice Chuang** ❖

CONTRACTUAL ADR

Contractually Mandated ADR Biased Against Subcontractor under Certain Conditions

Sehulster Tunnels, a subcontractor that supplied precast concrete ring segments to line a tunnel, filed a complaint for breach of contract and related causes of action against Traylor Brothers, Inc./Obayashi Corporation (TBO), the contractor on the tunnel project. TBO cross-complained against the owner, City of San Diego, for indemnity. The dispute involved cost overruns incurred by Sehulster as a result of design changes. Sehulster sought damages against TBO, which sought indemnity from the City.

The contract between TBO and Sehulster incorporated a mandatory dispute review board (DRB) process in the contract between the City and TBO. Under the contract terms, the City and TBO appointed the DRB members; Sehulster was not allowed to participate in choosing a neutral third member to make the DRB more balanced and impartial. And, although the DRB's recommendation was nonbinding, it was admissible as evidence in any later dispute resolution or legal proceeding. TBO argued that Sehulster's action was barred because it did not comply with the DRB process. The trial court disagreed, finding that, where the interests of the general contractor and the owner were adverse to those of the subcontractor, the contractually mandated DRB process was presumptively biased against Sehulster and thus unenforceable as a condition precedent to pursuing litigation. The court awarded damages to Sehulster against TBO and required that the City indemnify TBO. The appellate court affirmed the judgment except the indemnity decision against the City.

The appellate court agreed that the DRB process was unenforceable. Further, it held that TBO could be held liable on an abandonment theory even though the City was immune from such damages. TBO had breached and abandoned the purchase order it had with Sehulster by imposing new designs on Sehulster without formal changes to the purchase order. TBO, however, did not allege that the City breached its contract. The court of appeal found that without such breach, the City could not be held liable through implied contractual indemnity for cost overruns incurred by Sehulster. To permit a general contractor to recover under an indemnity theory would be inconsistent with California public policy that a public contract awarded under competitive bidding statutes may be amended or modified only if it is so provided in the contract or by law. *Sehulster Tunnels/Pre-Con v. Traylor Brothers, Inc./Obayashi Corp.* (2003) 111 Cal.App.4th 1328. **—Alice Chuang** ❖

MECHANIC'S LIENS

Federal Law under ERISA Does Not Preempt State Action to Enforce Mechanic's Lien to Collect Unpaid Union Trust-fund Contributions

Several union laborers working for a subcontractor on a residential construction project filed a mechanic's lien when the subcontractor failed to make union trust-fund contributions required under a collective-bargaining agreement. The laborers and the union subsequently filed suit to foreclose on the mechanic's lien. The project owners sought dismissal arguing that the federal Employee Retirement Income Security Act of 1974 (ERISA) preempted the state law because the amounts due were fringe-benefit contributions owed under the union's employee benefit plan. The trial court held that ERISA preempts "any and all State laws…(that) relate to any employee benefit plan described (under ERISA)," but that an action under the general mechanic's-lien statute is not "related to" ERISA plans.

The California Supreme Court upheld the trial court's decision. While acknowledging that the United States Supreme Court found that actions under a California statute relating to liens for trust fund payments under labor agreements is preempted, that statutory provision singled out ERISA plans for

special treatment and thus "related to" to ERISA plans under ERISA's preemption clause. In contrast, the Civil Code section providing for mechanic's liens does not make reference to or have a connection with ERISA plans, but rather, is a law of general application. The Court also found it significant that the laborers were neither suing nor being sued to enforce the terms of an ERISA plan. **—Eric J. Phillips** ❖

NONSOLICITATION COVENANT

Right to Compete Fairly Outweighs Employer's Right to Protect against Competition

Daniel Thompson worked for Pac-West Labels. After Impaxx Inc. bought Pac-West, Thompson refused to sign a covenant not to compete that would have barred him from soliciting Pac-West customers for one year after his termination. Impaxx fired Thompson as a result. Thompson sued Impaxx for wrongful termination, contending that firing him for refusing to sign an unenforceable covenant violated Business and Professions Code Section 16600, which voids every contract that restrains one from engaging in a lawful profession, trade or business. Thompson alleged Impaxx did not keep the identity of its existing and potential customers secret and, therefore, the information was not confidential information or a trade secret.

The trial court concluded that Impaxx's covenant not to compete did not violate Business and Professions Code Section 16600 because it was a narrowly drawn clause intended to protect Impaxx's proprietary interest in its customer information. The covenant was, therefore, legal and enforceable, and Thompson's termination for refusing to sign the clause did not violate public policy.

The court of appeal reversed, holding that Impaxx could not prove its customer information was confidential. The appellate court acknowledged that the covenant did not bar Thompson from any particular trade, but rather sought only to restrict his soliciting of existing customer contacts for a defined period. Similar clauses have withstood challenge in previous cases, but those cases involved confidential, proprietary or trade information. While Impaxx might have been able to prove that its customer information was confidential and subject to protection, it had not done so. Merely labeling information as a trade secret or as confidential information does not conclusively establish that it fits such a description. The appellate court also rejected Impaxx's assertion that nonsolicitation clauses are not allowable only when they protect trade secrets or confidential proprietary information. The cases upholding that assertion were inapplicable and did not contradict the established rule that "in the absence of a protectable trade secret, the right to compete fairly outweighs the employer's right to protect clients against competition from former employees." *Thompson v. Impaxx Inc.* (December 8, 2003) 2003 Cal.App. LEXIS 1813. **—Alice Chuang** ❖

SPOTLIGHT ON CALIFORNIA CONSTRUCTION

SR 125 TOLL ROAD PROJECT

The demand for new highway carrying capacity throughout California is expanding at the same time that the state is scraping the bottom of the traditional funding sources barrel. Innovative planners are finding new life for the ancient notion of the toll road to make ends—and highways—meet. SR125, a new toll-road project near San Diego will comprise nine miles of new freeway alignment with eight interchanges and a 1400-foot-long segmental bridge over the Otay River. The new alignment will connect State Route 54 to State Highway 905. Construction began in April 2003 with completion anticipated in August 2006.

BR&H friend Mendoza & Associates, a consulting engineering firm, has teamed with Parsons Transportation Group to provide construction management services for the project. Phase One is a $300 million design/build project being developed by the San Diego Expressway Limited Partnership. Mendoza & Associates will be providing resident engineering, office engineering, construction inspection, management of construction staking, and materials sampling and testing for the project. The Design/Builder is Otay River Constructors, a joint venture partnership between Washington Group International and Fluor Daniels. Bell, Rosenberg & Hughes is pleased to announce that we have been selected as construction counsel for this exciting project.

To read more about the project, go to: www.mendoza-associates.com.

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

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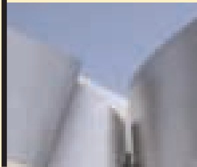

Join us for breakfast and learn how a cutting-edge construction firm uses satellites to place structural steel. Derek Cunz of the M.A. Mortenson Company will fill us in on the latest trends in building technology and give us a behind-the-scenes tour of Mortenson's work on the futuristic Disney Theater in Los Angeles.

Thursday, March 11, 7:30 A.M. **Lake Merritt Hotel, Oakland**

For more information and RSVP options, please see page 4.

Firm Overview

Bell, Rosenberg & Hughes LLP provides a full range of expert counsel to the construction industry, from contract negotiations to dispute resolution to aggressive litigation. Our clients are building some of the biggest and most important projects in the country, and we are helping them every step of the way. For 35 years we have enjoyed an international reputation for excellent service, effective representation, and integrity. We have unparalleled expertise in all aspects of construction law and business practice including dispute resolution, real estate development, insurance coverage, environmental law, trusts and estates, and business succession planning.

With a seasoned team of attorneys, Bell, Rosenberg & Hughes LLP is ready to handle the most complex and challenging cases. And our in-house forensic support team provides state-of-the art graphics and multimedia exhibits that rival the best in the industry for a fraction of the cost.

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Teresa Main
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Of Counsel

Howard Bell
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Chris Carrillo
Alice Chuang
Kimble Cook
Raymond Kong
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Nancy Sandifer
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