THARPE & HOWELL, LLP

CONSTRUCTION AND REAL ESTATE LITIGATION NEWSLETTER

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This informational Newsletter is brought to you by Robert Freedman, Chair of Tharpe & Howell's Commercial Litigation and Transactional Practice Group. A special report on licensing is also attached. Please feel free to contact "Bob" at rfreedman@tharpe-howell.com; or telephone number (818) 205-9955 to discuss any questions or comments you might have.

ENSURING INSURANCE AGREEMENTS WITH SECOND TIER SUBCONTRACTORS

In *Westfield Insurance Co. v. FCL Builders, Inc*., an Illinois Court recently ruled against a General Contractor ("GC") on its claim that the sub-subcontractor's insurance carrier unjustly failed to defend and indemnify. In this case, each subcontractor was required to procure certain specified insurance and list the GC as an additional insured pursuant to the GC-subcontractor contract. The subcontractor then subcontracted with a sub-subcontractor, with a contractual requirement that the sub-subcontractor be bound by the terms of the GC-subcontractor contract. Thereafter, a workplace injury prompted a lawsuit and the GC tendered the case to the sub-subcontractor's carrier. Coverage was denied.

The GC brought suit against the sub-subcontractor's carrier. The Court analyzed the contracts and policy in question and subsequently found against the GC. In reaching its decision, the Court noted the sub-subcontractor's insurance policy required a direct written contract between the second-tier subcontractor and the entity seeking insurance coverage and that, in this case, there was a lack of a direct communication, written agreement, or privity between the GC and sub-subcontractor.

Although this case dealt with an Illinois court and a manuscript policy of insurance, it is a good reminder that all contractors need to constantly monitor and manage their contractual insurance requirements and compliance. Failure to do so can compromise policy benefits to the detriment of the GC.

CALIFORNIA LAWMAKERS EXPAND PROHIBITION OF TYPE I INDEMNITY AGREEMENTS

In 2007, California lawmakers prohibited Type I indemnity agreements for residential projects. On June 1, 2011, the California Senate passed Senate Bill 474 ("SB 474") to further amend Civil Code § 2782 to prohibit Type I indemnity agreements for private **commercial projects** starting after January 1, 2013. The revisions in SB 474 state that agreements attempting to have another person indemnify, hold harmless, and defend another for their negligence or other fault is against public policy and void, and cannot be waived. Further, a provision in a contract requiring additional insured coverage is also void and unenforceable to the extent it requires such indemnification. These revisions do not apply to WRAP insurance policies or breach of contract causes of action which are separate from the indemnity requirements.

This new legislation appears to be in direct response to *Crawford v. Weathershield* and its progeny of case law now developing. Lawmakers appear intent on leveling the playing field between developers, general contractors, subcontractors, and artisan trades.

Is This The Beginning Of The End For The 10-Year Statute of Repose?

Developers and contractors in California currently enjoy certainty in relation to liability exposure for defect suits: after 10 years - all liability is likely cutoff (with a few exceptions). However, current Assembly Bill 1207 ("AB 1207") is challenging this comfort zone for cases concerning hazardous or toxic waste. As for these cases, AB 1207 would increase the defendant pool which would ordinarily be limited to the prior property owner. Important concerns regarding the AB 1207 include: Will this erosion lead to further degradation of the protections afforded developers and contractors? How will this affect the recovery of the current construction economy and the insurers who underwrite the industry?

The trigger for this revision lies in *Acosta v. Shell Oil Company* which involved a group of Southern California homeowners who attempted to sue Shell Oil Company and those involved in the construction of their homes for contamination. The homeowners' case was dismissed against the builders since the suit was brought nearly 50 years after the construction was completed. In response, AB 1207 was prepared to provide further exception to the 10 year statute of repose for damages from exposure to hazardous or toxic materials.

The Statute of Repose, CCP § 337.15, and the cases which flow from it, create and maintain the balance between the consumer homeowner buying a very complex product, and the developers and contractors who would otherwise face open-ended liability (which would eventually shrink the industry and further drive-up housing costs). This balance is important; and an increase in the protections afforded to consumers would likely lead to further pressure on an already stressed industry. Further concerns are that this amendment will lead to further exceptions being carved out in the coming years.

California Courts Strike Down Use Of Arbitration Agreements In CC&Rs

In *Villa Vicenza HOA v. Nobel Court Development*, an Appellate Court recently held that an arbitration provision inserted into the CC&R's by the developer who controlled the Board of Directors after the first sale was unenforceable against the HOA as CC&R's "are not an effective means of obtaining an agreement to arbitrate a homeowners association's construction defect claims against a developer." The CC&R's in this context are not a contract between the developer and the HOA and the right to a jury trial can only be waived upon actual notice. The CC&R's are meant to provide for the efficient resolution of suits between the HOA and its members, and not those involved in the construction and sale of the properties within the HOA. The court held that the CC&R's were not contracts and that the right to a jury trial can only be waived upon actual notice. Arbitration agreements contained in sales agreements continue to be enforceable as long as they are explicit and conspicuous.

Developers should continue to include explicit and conspicuous jury trial waivers in their purchase and sales agreements if they want to enforce arbitration or judicial reference with homeowners. Also, consideration from the recent *AT&T Mobility LLC v. Concepcio* can be used to further restrict class plaintiffs or multi party actions.

As for obtaining an enforceable jury trial waiver against a HOA, such a waiver appears unlikely, pending the outcome of the *Pinnacle Museum Tower Associate* case currently in front of the California Supreme Court, unless it is negotiated after the developer relinquishes control of the HOA.

California Courts Uphold *Krusi* – Homeowner Standing To Bring Suit

In an unpublished opinion, the California Courts in *Kizor v. BRU Architects* (2011) upheld *Kruzi*, which states, absent an assignment, the owner of a house at the time a defect is observable is the real party in interest with standing to bring suit, not a subsequent owner. In *Kizor*, the current homeowner brought suit against the architect, contractor, and others involved in the design and construction of the home he purchased from the original owners. The trial court ruled, and the appellate court affirmed, that since the defects accrued during the original owners' ownership of the house, they were the only parties with standing absent an assignment.

Primary Liability Insurer's Indemnity Obligation For Continuing Injuries Not Subject To Annual Stacking

Primary insurer filed an action against its insured for declaratory relief seeking a finding that the insurer's policies were exhausted and that the insurer had no further duty to defend or indemnify. The insured cross-complained against the excess carrier for coverage. The trial court found that the excess coverage would "drop down" upon exhaustion of the per-occurrence limit of a single primary policy. The appellate court reversed.

The appellate court found that the insured purchased primary policies from four carriers over the span of 40 years. In each year, the insured also purchased an excess policy. The insured was sued for asbestos claims covering multiple policy periods and the insured selected one particular primary policy from Truck for coverage - which had a $500,000 per occurrence limit (the policies with the other three primary carriers were exhausted). The primary insurer eventually paid the $500,000 per claim limit. The insured then tendered to the excess carrier. The excess carrier claimed all of Truck's primary policies must be stacked such that all primary policies at risk due to the continuing loss during the 40 years (i.e. Truck's other policies) are exhausted before the excess policy is activated. The appellate court disagreed and found that since the primary insurer's liability was limited per occurrence, the primary insurer is liable for no more than $500,000 per claim, and the multiple primary policies cannot be stacked, before the excess insurance is triggered. Truck's policy specifically read the insured may collect up to the policy limits of only one policy for each occurrence.

Attorney's Fees And Costs Cannot Be Awarded To Or Against State In Housing Discrimination Case

In *Department of Fair Employment and Housing v. Josefine Mayr*, Ruben and Sandra Mendoza and their three children filed a Complaint with the Department of Fair Employment and Housing ("the DFEH") alleging discrimination based on national origin in the terms and conditions of their apartment rental. The Mendozas charged the property's owner and manager with "coercion, intimidation, and harassment" and alleged that they (the Mendozas) had different rental terms and conditions than those accorded to non-Hispanic tenants. After investigation, the DFEH filed a Superior Court Complaint against the owner and manager alleging housing discrimination, intimidation, and harassment.

The matter went to Trial and, at the conclusion of testimony, the Court found **no discrimination had occurred**. At the Court's request, the parties then filed briefs on the question of whether attorney's fees and costs could be awarded against the State.

The DFEH argued that Government Code section 12989.2 prohibits an award of attorney's fees and costs **to or against the State** in housing discrimination cases; while the property owner and manager argued that such an award can be entered under California Code of Civil Procedure Section 1028.5 - which relates to cases between small businesses and State regulatory agencies. After consideration, the Trial Court found that where a case is brought by the DFEH "without substantial justification" (as it found to be the case herein) - an award of attorney's fees and costs can be entered against the State. The DFEH appealed.

The Court of Appeal held that although both Statutes allow for attorney's fees and costs to the prevailing party, Government Code section 12989.2 carves out a specific exception in housing discrimination cases under which the State may neither recover nor be subjected to such an award. The Appellate Court determined that this exception cannot be overcome and that attorney's fees and costs are therefore prohibited as to the State in housing discrimination cases - **even when it has abused its power therein**.

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RECENT WINS:

Green Construction – Solar Energy Litigation

Firm Associate Peter Bauman and Partner Robert Freedman recently obtained a victory in a binding arbitration on behalf of a commercial property owner in a case of first impression involving defective installation and performance of a voltaic solar panel alternative energy system. Cutting edge "green" energy issues that were litigated include contract terms, permitting and approvals, contractor licensing requirements, energy cost savings estimates, and mandated warranties by the California Solar Initiative. In addition to receiving damages, the arbitrator awarded the Firm's client attorneys' fees and interest which survived an appeal!

Favorable Jury Award Following 5-Day Trial

Firm Partner Paul Wayne obtained a favorable verdict for a property owner client following a 5-day Jury Trial! In this case, the adversary plaintiff (tenant) was descending a staircase leading to a carport in the complex - when she tripped and fell after failing to see two additional steps past the staircase landing. As a result of the fall, the plaintiff (tenant) suffered injuries to her right leg including a fractured tibia and dislocated knee. She subsequently underwent open reduction internal fixation surgery - with a subsequent surgery for hardware removal. Following the surgeries, plaintiff underwent six months of physical therapy and claimed that full right knee replacement surgery was still required. She also claimed to suffer from continuing peroneal nerve palsy as a result of the fall - requiring her to wear a brace and causing a limp.

The plaintiff (tenant) sued the Firm's (property owner) client - and asked for $2.5 Million in damages. On behalf of the Firm's property owner client, Attorney Paul Wayne did not contest the tibial fracture or dislocated knee, but argued that future knee replacement surgery was unnecessary and that plaintiff's peroneal nerve palsy was a pre-existing condition. Attorney Wayne further argued the property owner client was not responsible for plaintiff's fall in any event. After Trial, the Jury awarded the plaintiff (tenant) $988,250 in damages, but found her to be 80% at fault! This effectively reduced the Jury's award to only $197,650 - significantly less than the $2.5 Million plaintiff had sought! Because plaintiff had failed to accept a pre-trial Offer she will be required to pay various costs of defense. This will effectively reduce plaintiff's award to a somewhat negligable amount!

This Construction and Real Estate Litigation Newsletter has been brought to you by Robert Freedman, a Partner of Tharpe & Howell and Chair of its Commercial Litigation and Transactional Practice Group. Tharpe & Howell has been part of the California, Arizona, Nevada and Utah business communities for more than 35 years, providing clients with experience, judgment, and technical skills. We are committed to delivering and maintaining excellent client service and case personalized attention, and to be an integral member of each client's team.

For our clients and colleagues in the real estate construction industry, attached to this newsletter is a special report on licensing. I hope you find this informative, and invite any questions and/or comments you might have. Bob

For further inquiry about any of the articles discussed, please contact Mr. Freedman direct:

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LICENSING UPDATE

STARTING IN 2012 – LLCS CAN HOLD CONTRACTOR'S LICENSE!

LLCs have always been precluded from holding a California contractor's license. The legislature finally changed this anomaly and, starting in 2012, an LLC will be able to **hold** a license with the qualifier being a Responsible Managing Officer, Responsible Managing Manager, Responsible Managing Member, or Responsible Managing Employee. [California *Bus. & Prof. Code* §7068(a)(4).] But the requirements of LLCs holding a license will be more rigorous than what is required of other traditional business entities such as corporations. For example, as a condition precedent to the issuance of a contractor's license to an LLC, the licensee must file a $100,000 surety bond for damages arising out of employee wage and benefit claims. [*Bus. & Prof.* Code § 7071.6.5.] Corporations are not required to hold such a bond.

The LLC must also maintain liability errors and omissions insurance; with the policy being not less than $1,000,000 nor more than $5,000,000. [*Bus. & Prof. Code* §7017.19(b)(1).] And for LLCs with five or more members, an additional $100,000 per member is required up to a maximum of $5,000,000. [*Bus. & Prof.* Code § 7017.19(b)(2).] Also, upon LLC dissolution, a three-year policy extension must be maintained. [*Bus. & Prof. Code* § 7017.19(e).] No such insuring limits are required of corporations.

With these new requirements, it will be interesting to see how many licensees take advantage of the LLC option. Corporations will be able to transfer the license to an LLC; and an individual will be able to change to an LLC or corporation and have the license number reassigned. [*Bus. & Prof.* Code §7051.1(c)(5).] The corporate license can also be transferred to an LLC following the cancellation of the corporate license - provided personnel are the same. [*Bus. & Prof. Code* §7071.1(c)(7).] Also, a transfer can be made under an asset sale provided a qualifier is allowed as when an LLC creates a subsidiary to continue the business.

But the question of whether an LLC will be a cost effective option remains. Further, it may increase the possibility of license suspension if the requirements are not met - risking exposure to §7031 liability. In the end, contractors considering an LLC conversion must weigh the potential risks, costs, and benefits.

LICENSE NOT REQUIRED FOR INDEMNITY ACTION

In *UDC-Universal Development, L.P. v. CH2M Hill*, (2010) 181 Cal. App. 4th 10, the developer on a condominium complex entered into a contract with a project engineer, which obligated the engineer to indemnify and defend the developer against any suit, action or demand brought against the developer on any claim or demand covered by the contract. The homeowners' association eventually sued the developer for soil instability, erosion, unsettling and drainage problems. Although the developer filed a cross-complaint against the engineer for equitable, comparative, and express contractual indemnity, the engineer sought summary judgment - asserting that the developer's unlicensed status barred its claims.

Ultimately, the appellate court denied the engineer's motion and held that a cause of action which does not seek compensation for construction work is beyond the scope of *Bus. & Prof. Code* section 7031. When an unlicensed contractor files an action for indemnity and does not for compensation for its services, it is **not** barred by section 7031. However, for obvious reasons, contractors should still maintain proper licensure at all times.

DISGORGEMENT AWARDS DISCHARGEABLE IN BANKRUPTCY

The dim light at the end of the tunnel for an unlicensed contractor suffering from a disgorgement award under section 7031(b) is that such an award is dischargeable in bankruptcy. [See *In Re Sabban*, (9th Cir. 2010) 600 F.3d 1219.] However, such a contractor should be aware that any monetary **penalties** issued for obtaining money by fraud, false pretenses or false representations may **not** be dischargeable in the bankruptcy filing.

In Sabban, a homeowner entered into a remodeling contract with Sabban, a general contractor, who falsely represented that he was a licensed contractor. The homeowner paid $123,000 to Sabban for the work performed; and Sabban in turn paid $129,000, for the homeowner's benefit, to licensed subcontractors and other material and labor providers. The homeowner then sued Sabban alleging violations of California *Bus. & Prof. Code* 7061 and 7031(b).

The trial court found the homeowner had been induced to sign the contract in reliance upon false and fraudulent representations made by Sabban and awarded the homeowner the $500 penalty provided under section 7061. The trial court also awarded the homeowner $123,000 as disgorgement of compensation paid, pursuant to section 7031(b). Sabban subsequently filed for bankruptcy and the homeowner filed an action to determine whether the awards were dischargeable. The United States Bankruptcy Court ruled that the $500 **penalty** was **not dischargeable**, but that the **$123,000 debt was dischargeable**. The Court of Appeals confirmed.

Section 523(a)(2)(A) of the Bankruptcy Code prohibits the discharge of any enforceable obligation for money to the extent that that money was obtained by fraud, false pretenses or false representations. Liability under section 7031(b) requires only that compensation was paid to an unlicensed contractor. Fraud and actual harm are irrelevant to an award under section 7031(b). Because of this, the Appellate Court held that the award of $123,000 is not a debt for money obtained by fraud within the meaning of the Bankruptcy Code. Therefore, the court found that the award under section 7031(b) was dischargeable in bankruptcy.

HIRING UNLICENSED SUBCONTRACTOR MAY NOT AUTOMATICALLY SUSPEND LICENSE

Where a contractor presents sufficient evidence showing he obtained workers' compensation insurance, his contractor's license will not be **automatically** suspended for hiring unlicensed subcontractors. [See *Loranger v. Jones* (2010) 184 Cal. App. 4th 847.]

In this case, the contractor admitted he employed subcontractors without proper licenses and that they would be considered his employees. The contractor also testified he was a licensed contractor and had obtained a worker's compensation policy for his construction employees. Since the contractor provided sufficient evidence to show that his subcontractors and employees were covered by his worker's compensation insurance, the contractor's license was not automatically suspended and he could recover for his construction services.

In *Loranger*, homeowners hired a licensed contractor to build a single family residence. When the homeowners failed to pay the contractor's final bill, the contractor filed suit. The homeowners cross-complained alleging: (1) the contractor hired unlicensed subcontractors; (2) said subcontractors are treated as de facto employees under *Labor Code* section 2750.3; (3) the contractor failed to provide workers' compensation coverage to these subcontractor employees; (4) such failure resulted in the suspension of the contractor's license under *Bus. and Prof.* Code section 7125.2; and (5) without a license, the contractor could not recover for his construction services and had to disgorge all money paid to him under section 7031.

While the contractor admitted he employed subcontractors without proper licenses and that they would be considered his employees, he also testified he was a licensed contractor and had obtained a workers' compensation policy for his construction employees. Since the contractor provided sufficient evidence to show that his subcontractors and employees were covered under his workers' compensation insurance, the contractor's license was not automatically suspended and he could recover for his construction services.

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