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Law

WINTER 2008

Legal Tools for Surviving the Financial Crisis of 2008

By Brian P. Waagner, Esq

The ongoing crisis in the financial systems and declining economic indicators are having an enormous impact on the construction industry. Private developers and public owners are rethinking their spending priorities.

With the failure of Lehman Brothers and the emergency bailouts of AIG, Citigroup, and other well-known financial institutions, a significant number of ongoing projects are suffering from financial distress. In the worst cases, developers that are unable to arrange alternative financing may be forced to put projects on hold or to default on their payment obligations. Lack of credit or default on a significant receivable could put contractors or key subcontractors at risk of insolvency.

Although most contractors and subcontractors cannot reasonably expect a bailout from the federal government, there are a number of legal tools that will assist them in minimizing the financial consequences of a distressed project.

The first source of legal protections is the construction contract itself. Many construction contracts (including standard documents published by AIA, the Consensus Docs and EJDC) include provisions allowing the contractor to request information about financing arrangements for the project. If the owner fails to provide the information, the contractor may stop work. Significantly, the accessibility of financing information is

available at any time the contractor has a legitimate concern about the availability of funding.

Another contract provision of interest to contractors on distressed projects is the clause that addresses the contractor's right to suspend work and terminate the contract. As a general rule, contractors may stop work if the owner fails to make payment as required. They may formally terminate the contract if the nonpayment continues. Complying with requirements to give notice of the work stoppage and notice of the termination, however, can take a long time. One way that contractors can accelerate their right to stop work and end the contractual relationship is to demand that the owner provide assurances of its intention to pay for the completed work and its ability to pay for the work. An owner's failure to adequately respond to such a request may constitute a breach of contract, which would itself justify a contractor to stopping work and terminating the contact.

A second source of contractor legal protections are the state laws governing the project. The most obvious of these are the mechanic's lien statutes, which typically grant any person that provides labor or materials for a construction project an enforceable interest in the project itself. Although many contractors are accustomed to using mechanic's liens as a source of leverage in negotiating the close-out of a difficult project, the ongoing financial crisis gives such liens new importance. With an insolvent bank or developer, the project itself may be the only real guarantee of payment.

Contractors and subcontractors can take a number of steps to simplify the process of recording and enforcing a lien. First, identify the full name and address of the person or entity that owns the property, which may or may not be the party executing the construction contract as "the owner." This information should be gathered at the beginning of a project or as soon as the contractor becomes concerned about the availability of funds, and should be stored in a readily-accessible file along with copies of the contract and related documents. On a distressed project, there is no sense in making an emergency out of such a simple task.

Second, record the lien as early as possible. The timeliness of a lien may be a significant factor in determining its value. The date upon which a lien is recorded may bear on the lienholder's priority—the order in which the lienholder is eligible to receive payment when the property is sold. A lien

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filed outside of the statutory deadline may have no value at all.

In addition to the contract documents and state laws, the federal bankruptcy code is an important consideration on a distressed project. While the insolvency of the owner or key subcontractor will be disruptive, there are a number of provisions in the bankruptcy code that allow contractors to mitigate the impact of a bankruptcy. For example, it may be possible to be identified as one of the debtor's "critical vendors," without which the debtor's business would not be successful. Critical vendor status could improve a contractor's ability to get paid for work done before the bankruptcy petition was filed.

Bankrupt debtors are also required to "assume or reject" contracts that have not yet been fully performed. Rejection is a breach of contract, but assumption requires the debtor to cure its defaults and prove that it will be able to meet its obligations. On any project that is underway, rejection or assumption of a key contract would limit some of the uncertainty associated with a significant owner or subcontractor bankruptcy.

Aside from the contractual and statutory protections, the most important tools available to contractors in the midst of the financial crisis are their own common sense, due diligence, and swift action. It is no longer sufficient to accept a promise of payment and a statement that financing is provided by a well-known financial institution. Now more than ever, contractors must make sure money is available before proceeding with the work. They must continue to demand assurances as to the availability of funds as the project proceeds, and take action to stop work and record a lien as soon as possible if a funding issue arises.

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AB 2738: Will The Intended Reforms Result in Increased Litigation Costs and Possibly Create New Inequities?

By Bridget M. Moss, Esq.

California Assembly Bill 2738 ("AB 2738"), signed into law by Governor Arnold Schwarzenegger on September 29, 2008, is being lauded by many as much needed construction industry reform, legislatively leading the industry away from a "top down" risk allocation model toward a "shared risk" model for residential construction defect claims. While few industry professionals would disagree that something should be done to decrease the cost and burden of construction defect litigation in California, AB 2738's inherent ambiguities may create new problems and actually serve to increase, rather than decrease, the overall cost and scope of construction defect litigation.

HOW AB 2738 CHANGES EXISTING LAW

Defense and Indemnity Obligations

Section 1 of AB 2738 amends Civil Code § 2782 to restrict the defense obligations of a subcontractor to a builder or non-affiliated general contractor ("builder/GC") under a contractual indemnity provision in a residential construction agreement subject to SB 800 which is entered into after January 1, 2009. The new law clarifies that a subcontractor's defense obligations are subject to the comparative fault principles embodied in existing Civil Code § 2782(c).

Most significantly, AB 2738 adds a new subsection (d) to Civil Code § 2782 which allows a subcontractor under an applicable contract the following election upon tender

by the builder/GC of a claim arising from the subcontractor's scope of work: (1) the subcontractor may defend with counsel of its own choosing and maintain control over that portion of the claim against the builder/GC to which the indemnity applies; or (2) the subcontractor may pay a portion of the builder/GC's costs which directly relate to defending the allegations made against the subcontractor's scope of work. Failure to tender or late tender will negatively impact the builder/GC's right to a defense by the subcontractor under the indemnity provision.

The Subcontractor's Insurance Obligation

AB 2738 amends Civil Code § 2782(c) to make clear that clauses in applicable contracts which require a subcontractor to "insure" a builder/GC for claims or damages arising from the subcontractor's scope of work are also subject to the comparative fault strictures of existing Section 2782(c). At the same time, the new bill expressly affirms the holding in *Presley Homes, Inc. v. American States Insurance Company*, 90 Cal. App.4th 571, 108 Cal.Rptr.2d 686 (2001).

Wrap Programs and Self-Insured Retentions

Sections 2, 3 and 4 of AB 2738 add new Civil Code §§ 2782.9, 2782.95 and 2782.96 which address the obligations of builders, contractors and subcontractors on projects that utilize wrap-up or consolidated comprehensive general liability insurance programs.

New Civil Code § 2782.9 applies to all residential construction agreements (not just those subject to SB 800) entered into after January 1, 2009 where a wrap up or consoli-

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dated comprehensive general liability insurance program is used. This section provides that all provisions in applicable agreements that require a subcontractor participating in a wrap program to indemnify, hold harmless or defend another party against any claim covered by the policy are unenforceable, and eliminates claims for equitable indemnity on those matters as well.

Civil Code § 2782.9(b) provides a formula for determining the maximum amount of deductible or SIR under a wrap program for which a subcontractor can be held responsible based upon a determination by the builder/GC of the reasonable and proportionate relationship of any potential liability arising from the participant's scope of work to the project's total anticipated potential losses due to third party claims.

Disclosure Obligations In Connection With Wrap Up Programs

New Civil Code § 2782.95 provides that for any residential construction project utilizing a wrap up or consolidated insurance program that *first commences construction* after January 1, 2009, the builder/GC purchasing the insurance program must disclose the total amount or method of calculation of any credit or compensation for premium required from a subcontractor for that wrap up program in the contract documents. Also, the builder/GC shall disclose the following in the contract documents, if and to the extent known: (1) the policy limits; (2) the scope of coverage; (3) the policy term; (4) the basis upon which the SIR/deductible is triggered; (5) the number of units covered by the wrap if it covers more than one work of improvement; and (6) a good faith estimate of the remaining limits of the policy as of the date of the disclosure. Failure to provide this information to a subcontractor at the bid stage may result in the subcontractor being allowed to recalculate that portion of its bid which reflects its anticipated insurance costs.

New Civil Code § 2782.96 provides that for a public works project or any other project that is *not* residential construction

that utilizes a wrap up or consolidated insurance program and is put *out to bid* after January 1, 2009, the total amount or method of calculation of any credit or compensation for premium must be disclosed in the bid documents. The named insured must also disclose in the contract documents: (1) the policy limits; (2) the known exclusions; and (3) the length of time the policy is intended to be in effect.

Sample Questions Raised by the New Changes

Will the New Defense Election Actually Increase The Overall Costs of Defense?

The subcontractor's right under AB 2738 to elect to defend a portion of a third party claim against the builder/GC with counsel of its own choosing and to control the defense of the portion of any tendered claim against the builder/GC which arises from its scope of work may result in several trades, each with potential conflicts with the builder/GC and cross-actions against each other, defending a portion of a third party claim against the builder/GC. Not only would such a result increase the overall cost of the litigation, it is hard to imagine how the builder/GC's interests could be adequately defended under such a scenario.

The alternative election, payment of a proportionate share of the builder/GC's defense costs during the pendency of litigation, is not without its problems as well. First, it forces the builder/GC to assign a proportionate share of liability to each of the parties, including itself, before the true nature of the claim is known. Second, the periodic payments are subject to reallocation both during the pendency of litigation and thereafter.

Does AB 2738 Limit an Insurer's Defense Obligation?

The inclusion of clauses that seek to "insure" the builder/GC against third party construction claims in the comparative fault portion of Section 2782(c) seems to suggest that the defense and indemnity obligations of a subcontractor's insurer are

Federal Preference Program for Small Disadvantaged Business Held Unconstitutional by Federal Appellate Court.

By James Coleman, Esq.

In a case that may be more important for what it portends than for its immediate effect,

on November 4, 2008, a three-judge panel of the United States Court of Appeals for the Federal Circuit in *Rothe Dev. Corp. v. Dep't of Defense and Dep't of the Air Force*, No. 2008-1017 (Fed. Cir. Nov. 4, 2008) issued an opinion that struck down a Department of Defense minority set aside program (10 USC § 2323) as unconstitutional. Reportedly, DOD is reviewing the opinion with respect to whether to seek review by the United States Supreme Court, so this decision is not likely to affect the way DOD conducts business in the short term. A similar challenge to the statute (and the Small Business Administration Section 8(a) Program) by Dynalantic Corporation is currently pending in the United States District Court for the District of Columbia, the outcome of which should provide an early indicator of how persuasive other federal courts will find the Federal Circuit's opinion. But if the decision stands, and especially if other courts adopt its reasoning, the Federal Circuit has laid down a serious requirement that lawmakers better justify minority set aside programs. The government contracting community will watch with great interest as other contractors attempt to follow in Rothe's and Dynalantic's footsteps.

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The statute in question, 10 U.S.C. § 2323, (also known as Section 1207), compels the DOD, Coast Guard and NASA to favor socially and economically disadvantaged small businesses (SDBs) in the award of contracts and subcontracts. The contracts in question include those for operation, maintenance, and military construction, among other tasks. The Federal Circuit held that the law is unconstitutional. Chief Judge Michel, writing for the three appellate judges, concluded that Congress did not have a "strong basis in evidence" to justify compelling the governmental agencies to discriminate based on race. Furthermore, the court found that the studies allegedly referenced by Congress to justify discriminating in favor of SDBs were too flawed and too limited to warrant Congress's conclusion that favoring SDBs was required on a nationwide basis. In other words, the court said that a study showing that there was discrimination against minority contractors in Virginia does not justify a preference program in favor of a minority contractor in Mississippi (where Rothe was to perform the contract).

Rothe Development Corporation, whose owner is white, first brought its federal district court suit challenging Section 1207 on equal protection grounds in 1998 when it lost an Air Force construction contract to an Asian-American-owned business despite Rothe's lower bid. The district court ruled against Rothe, and Rothe appealed. Subsequently, Rothe lost two more times in district court, and each time successfully appealed. In the ten years that this case ping-ponged between the district and appellate courts, Congress reenacted the statute several times. It was only on this last appeal that the Federal Circuit directly addressed Rothe's constitutional challenge.

Section 1207 was part of the Small Business Act passed by Congress in 1986. Other statutes created under the Act are not addressed by this ruling, specifically the 8(a) Program (15 U.S.C. § 637(a)). Congress originally enacted Section 1207 for a three-year period, but it has reenacted

it for varying terms several times, and it is up for reenactment again in 2009. The law establishes a "goal" of giving 5 percent of DOD contracts to SDBs. To achieve this goal, SDBs can be given a 10 percent price advantage over non-small business competitors. It was this price evaluation adjustment (PEA) that led the Air Force to select Rothe's competitor even though Rothe had the low bid.

In 1998, the year Rothe filed its lawsuit, the lawmakers added a provision that suspends the PEA for a year if DOD determines, based on "the most recent data," that it has met the 5 percent SDB goal. Because DOD has met the 5 percent goal every year from 1998 to 2007, the PEA has been serially suspended from 1999 to 2008.

The court held that, when Congress last enacted the statute in 2006, it did not have adequate evidence of the existence of national discrimination by DOD to justify the broad sweep of the law. Applying the "strict scrutiny" test, the court accepted that remedying past discrimination is a compelling government interest. However, while statistical under-representation may indicate discrimination, it is not proof of discrimination. The court noted that, to justify laws that remediate discrimination, the Supreme Court requires that Congress have before it "strong evidence" that the discrimination it is seeking to remedy exists. The court elaborated that, even where there is strong evidence of discrimination, the discrimination to be remedied must be identified with specificity to ensure that the statute is "narrowly tailored" to reverse the effects of that discrimination. Because Section 1207 explicitly discriminated in the awarding of DOD contracts based on race, the court reviewed if Congress had reasonably determined that there was strong evidence of past DOD discrimination that this statute remedied.

The court was not impressed with Congress's evidence. The court critiqued each of the studies that Congress had relied upon and concluded that two of the six did not determine if unsuccessful minority contractors were qualified to perform the work. The court also found that five of six

studies made no allowance for the size and relative capacity of the firms. With no accounting of how qualifications and capacity affected award rates to SDBs, the court found questionable those studies' conclusions that discrimination was the cause of low SDB participation. The court did not completely discount the studies' findings, however. It conceded that the studies might be strong evidence of discrimination in some localities. However, according to the court, the bar is higher when the legislation applies nationally.

Since Section 1207 was set to expire at the end of 2009, and because the 10 percent price evaluation adjustment it authorized in was not in effect in 2008 (and potentially would not be in effect in 2009), the direct effects of this decision could be short-lived. In the short term, no action is required, because the district court has not issued a mandated order, so the law remains in effect. Assuming the order is forthcoming, it seems that the DOD, Coast Guard and NASA will be relieved of their obligation under this statute to establish a 5 percent minority participation goal. In addition, they will be relieved of the obligation to "provide procedures or guidelines" along with other affirmative steps to channel a portion of their awards to SDB contractors. But the court's ruling is confined to this statute. Other programs favoring SDBs under other statutes are unaffected by this ruling. Since DOD is reportedly studying the ruling, and the incoming Democratic administration and Congress are not likely to be actively hostile to set-aside programs, dramatic DOD action seems unlikely.

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CALTRANS CAN PLAY OUTSIDE

By Robert M. Shaw, Esq.

The California Supreme Court's ruling in *Consulting Eng'rs and Land Surveyors of California v. California Dep't of Transp.*, No. 07AS00049, (Cal. Super. Ct. October 30, 2008), held that the legislature may not require the California Department of Transportation ("Caltrans") to use in-house architects and engineers to perform certain types of work.

The California Supreme Court's ruling is one more step toward ending the longstanding battle between the Professional Engineers in California Government ("PECG"), a union that represents California transportation engineers, and Consulting Engineers and Land Surveyors of California ("CELSOC"), a trade association of private sector engineers.

The animosity between the two engineering associations has a long and significant history. In 1998, on the heels of an earlier California Supreme Court decision that Caltrans could contract only for those services not readily available from civil service employees, the California electorate defeated Proposition 224 at the urging of CELSOC's \$8 million campaign against it. Proposition 224, proposed by PECG, would have required that even contracts for services not available from civil service employees be awarded only after determining the work could not be done by civil service employees at a lower cost. Proposition 224, however, mandated a cost comparison calculation that would have artificially reduced civil service costs, thereby undermining the competitive bid process.

In 2000, promising timely-delivered and cost-efficient projects, CELSOC garnered the support of the electorate in passing

Proposition 35 to add Article XXII to the California Constitution. Proposition 35 (also known as the Fair Competition and Taxpayer Savings Initiative) enabled the State of California, in all phases of project development, to "contract with qualified private entities for architectural and engineering services for all public works of improvement."

Since the passage of Proposition 35, PECG has unsuccessfully attempted to limit the reach of Article XXII through regulatory action and by negotiating for restrictive language in its Memoranda of Understanding ("MOU") – the union's collective bargaining agreements with the State.

Design-build projects are ordinarily a cooperative arrangement where the architect and general contractor package the design and construction services, in contrast to the design-bid-build delivery system that has a separate bid process for the design and construction. California's legislative approach to design-build projects is to approve such projects on an agency-by-agency or project-by-project basis as an exception to the competitive bid statutes. In 2006, Senate Bill 1026 amended the California *Public Contract Code* to permit the Los Angeles Metropolitan Transportation Authority, in connection with Caltrans, to use the design-build process for the construction of a northbound carpool lane on the 405 Freeway. Additionally, SB 1026 required that only civil service employees prepare performance specifications, plans, preliminary engineering, environmental documents, pre-bid services, project reports, construction inspections and quality control inspections.

The amendments of Senate Bill 1026 gave the California Supreme Court an opportunity to address the question of

Article XXII's breadth when CELSOC filed suit seeking (1) a judicial determination that the provisions of SB 1026 — requiring that certain architectural and engineering work be performed by civil service employees — violate Article XXII, and (2) an order permanently enjoining Caltrans from implementing those statutory provisions.

PECG intervened in the action and argued that California *Government Code* § 4529.13 (also added by Proposition 35) exempts design-build projects from Proposition 35's grant of freedom to contract with private architects and engineers in all phases of the project. California *Government Code* § 4529.13 states, "[n]or shall any provision of [Proposition 35] be construed to prohibit or restrict the authority of the Legislature to statutorily provide different procurement methods for design-build projects or design-build-and-operate projects." PECG argued that "procurement method" as used in *Government Code* § 4529.13 refers to the method of procuring the *project* as opposed to the method of procuring the *contract* for the project.

In its analysis, the California Supreme Court rejected PECG's reading of *Government Code* § 4529.13 and distinguished a "procurement method" — such as lowest-bid, best qualified or single source — from a "project delivery method" — such as design-build, design-bid-build or multi-parameter bidding. The court's decision reaffirms government entities' "unfettered discretion to contract with qualified private architects and engineers for all phases of public works projects." Specifically, the court's holding accepts that Caltrans may *choose* to have certain architectural and engineering services performed by civil service employees but cannot be *mandated* to do so by the Legislature in light of Article XXII of the California Constitution.

A February 2008 study, *A National Assessment of Transportation Strategies and Practices: Lessons for California*,

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foreshadowed the court's decision and assures California citizens that private sector contracting for transportation infrastructure — now accessible to Caltrans — can help meet the demand for infrastructure improvements. The study examined the best-practices of ten state transportation programs and found that only California was not already using the private sector design-build process to deliver projects faster and more efficiently. The other state programs evaluated were: Arizona, Florida, Georgia, Missouri, New York, Oregon, Texas, Utah and Washington. The study also found that the option between in-house and private sector should be based on timely project delivery and that increasingly complex transportation projects require the specialty skills of private sector engineers.

Although factually specific to Caltrans, the California Supreme Court's decision in *CELSOC v. Caltrans* is impliedly applicable to all California agencies contracting for architectural and engineering services. However, the Legislature's case-by-case approach to permitting design-build projects may invite additional challenges against individual agencies' efforts to contract for architectural and engineering services. Moreover, given the court's post-Proposition 35 support for the State's option of private-sector contracting, it is unclear whether PECG will further attempt to constrain Proposition 35 through regulation, MOU or its own ballot initiative.

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Changes in Maryland's Retainage Law in Favor of Contractors

By Farah Khan, Esq.

The Maryland Legislature recently amended its Real Property statute, Md. Code Ann. Real Property § 9-304 limiting the percentage an owner may retain on a private construction contract to 5 percent.

The statute, which took effect on October 1, 2008, applies to construction contracts in excess of \$250,000, where a performance bond and a payment bond for the full amount of the contract is furnished by the contractor. This law follows the lead of several other states that have capped retainage on construction contracts.

Indeed, like Maryland and other states, Virginia also places a 5 percent cap on retainage for public construction contracts that provide for progress payments based upon an estimated percentage of completion. Both Maryland's and Virginia's laws also prohibit a contractor from retaining a higher percentage from a subcontractor than the owner retains against the prime contractor. Despite the similarities between the Maryland and Virginia laws, however, Maryland's law reaches further than Virginia's, as it applies to both private and public construction contracts. The Maryland law does provide an exception through which owners, contractors and subcontractors may withhold an amount over 5 percent where there are reasonable grounds for withholding the additional amount. The Virginia statute does not provide such an exception.

Historically, standard retainage for construction contracts was 10 percent. Many supporters of retainage reform argue that 10 percent is well above a contractor's profit margin and that it places an undue burden on contractors and subcontractors to finance construction projects. In 2004, the Foundation for American Subcontractors Association found that retainage reduces competition and increases the cost of projects, as contractors and subcontractors factor the extra cost into their bids. These negative effects are part of the reason states are passing legislation to limit retainage in public and private contracts.

Opponents of retainage caps and retainage reform argue that withholding a percentage of a contractor's progress payments until completion is the only effective method to ensure full performance. Owners, they argue, face great risk of financial loss in construction projects, they argue, and many go as far as to argue that withholding even 10 percent of the contract price only provides minimal protection against that risk. In response to arguments that retainage negatively affects construction projects, retainage reform supporters argue that if retainage produced such negative consequences, private parties would have recognized such effects and voluntarily done away with retainage.

Supporters of retainage reform suggest several alternatives. One of the more popular alternatives employed by states, like Maryland and Virginia, is to limit retainage to 5 percent. This approach accommodates

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both owners and contractors. Owners may still retain some of the contract price to deter a contractor or subcontractor from abandoning a difficult project, while contractors and subcontractors are protected by a statutory limit on the amount that may be withheld. Other alternatives include not requiring retainage where payment and performance bonds are secured for the full contract price, paying interest on retainage, and a line item release of withheld payments as certain phases of the contract are completed.

Retainage reform supporters view Maryland's legislation as a victory because both public and private contracts are subject to the 5 percent limit. In Virginia, however, only public contracts are regulated, and private parties are still free to enter into agreements pursuant to their own terms. This freedom from interference in private contracts is favored by owners who prefer to negotiate agreements without government regulation. This added flexibility will likely make Virginia a favored place to build for owners and Maryland a favored place to work among contractors and subcontractors.

Ultimately, the construction industry is hesitant to abandon the tradition and security of retainage altogether. However, states are actively seeking ways to alleviate some of the burden caused by retainage to contractors and subcontractors. The middle-of-the-road approach employed by Maryland and Virginia comes closest to offering the best of both worlds.

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likewise limited to matters arising from the subcontractor's scope of work. However, the new statute expressly affirms the holding in *Presley Homes, Inc. v. American States Insurance Company*, 90 Cal.App.4th 571, 108 Cal.Rptr.2d 686 (2001), which provides that, once an insurer for a subcontractor has a duty to defend any portion of a claim, it has the obligation to defend the entire claim. This seems to be an inherent ambiguity which may lead to additional litigation.

Are Indemnity Agreements Enforceable for Matters that are Excess to the Wrap Policy?

The question here is whether a builder/GC can seek indemnification (or equitable indemnity) for claims that would otherwise be covered under the wrap if the limits are exhausted or otherwise unavailable. If the answer to that question is "no," this change in existing law is extremely problematic as there can be any number of reasons why insurance is not available under the wrap policy that has nothing to do with high deductibles, inadequate coverage or inadequate limits. What if the carrier goes out of business? What if the carrier denies coverage because the subcontractor commits fraud or engages in willful misconduct? In the latter scenario, a liability cap to the limits of insurance would leave the builder/GC without a viable remedy against the subcontractor.

What Steps to Take Now

AB 2738 operates to limit the potential exposure of subcontractors on residential construction projects, but the statutory language contains many ambiguities. Builders and general contractors should carefully review their bid documents and construction contracts to make sure they will be enforceable after the new law takes effect. They should also work with coverage counsel, their insurance brokers and all parties affected by any wrap up insurance for the project to ensure that coverages and limits are acceptable to all and sufficient to cover anticipated risks. Finally, many problems may be potentially avoided if all parties discuss and attempt to resolve at the contract negotiation stage, and in a manner consistent with AB 2738, how the defense of third party construction claims will be managed.

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Construction Law Update
Winter 2008