

Construction Law Newsletter

ENFORCING YOUR RIGHT TO PAYMENT — PAYMENT BOND CLAIMS UNDER THE MILLER ACT



Fall 2004

This article is the third and final article in our series addressing the remedies available to contractors for payment of labor, services, equipment or material furnished on a public work. On state and local projects, the remedies are a stop notice claim and a payment bond claim. These remedies are discussed in the Spring and Summer 2004 issues of our Newsletter and are available at www.rjop.com. On federal projects, the remedy is a payment bond claim under the Miller Act, 40 U.S.C. § 131, which is the subject of this article.

The Miller Act provides the *exclusive* payment remedy available to a subcontractor or a supplier on a federal contract for the construction or improvement of a public work. Under the Miller Act, a payment bond in an amount equal to the total amount payable by the terms of the prime contract must be posted. Note that, on occasion, the contracting officer for the federal project may reduce the amount of the Miller Act payment bond, but the amount of the payment bond cannot be less than the amount of the performance bond; the performance bond is also set by the contracting officer at the amount he or she determines is adequate to protect the Government's interest.

A Miller Act payment bond provides for payment of all persons supplying labor or material used in the work covered by the prime contract. All first and second tier subcontractors and suppliers are entitled to

make a claim against a Miller Act payment bond. Third-tier subcontractors and suppliers, however, are not protected by and have no remedy under the Miller Act payment bond.

To prevail on a Miller Act payment bond claim, the claimant must establish that it furnished labor or material that was used in the prosecution of the work, or that it furnished labor or material in good faith and with the reasonable belief that it was intended for use in the prosecution of work. If the claimant's labor or material was actually used on another job, the claimant still has rights under the Miller Act payment bond unless the claimant knew or should have known that its labor or materials were being diverted to another project.

The first step in presenting a claim under a Miller Act payment bond is to file a written notice with the prime contractor. The notice must be filed within 90 days of the date the claimant last performed labor or furnished materials for which the claim is made. The notice must state the amount claimed and the name of the party to whom labor or materials were furnished. The notice must be delivered by a means that provides a written, third-party verification of delivery. Thus, for example, personal delivery by a third-party who signs an affidavit verifying delivery would be acceptable. Certified mail with a return receipt would also be acceptable. In addition, sending a copy of the no-

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tice to the surety is recommended, but it is not required.

If the claimant is not paid after the notice is sent, a lawsuit on the Miller Act bond must be brought by the claimant within one year after the claimant last performed labor or supplied material to the job site. This is true regardless of when the contract is completed. The claimant brings the lawsuit against the payment bond surety but files the lawsuit in the name of the *United States* on behalf of the claimant. The prime contractor for the project may be, but is not required to be, named as a defendant in the action. The action must be filed in the federal district court where the job is located. The one-year time limit for commencing a lawsuit under the Miller Act is *not* satisfied by filing an action in state court or a demand for arbitration. Further, the presence of an arbitration clause in a subcontract agreement does not prevent the unpaid subcontractor from pursuing a claim against the Miller Act payment bond in federal court.

A claimant's recovery under the Miller Act payment bond is measured by either the contract price including extra work, or the reasonable value of the labor or material furnished to the job. The claimant is entitled to seek interest on the amount owed, which is recoverable to the extent provided under state law. In California, 10 percent is the statutory rate of prejudgment interest. The courts are split, however, as to whether and under what circumstances a Miller Act payment bond claimant is entitled to recover attorney's fees and costs. ♦

— *Patricia A. Meagher*



Aaron Silberman has been appointed vice-chair of the Legal Advisory Committee of the Associated General Contractors of California.



PROPOSITION 209 UPDATE: COURT HOLDS SMUD AFFIRMATIVE ACTION PROGRAM NOT NECESSARY TO MAINTAIN FEDERAL FUNDING

A California appeals court recently held that the Sacramento Municipal Utility District's (SMUD) race-based affirmative action program does not meet the standards of the federal funding exception of the California constitution provision enacted by Proposition 209. *C&C Construction v. Sacramento Municipal Utility District*, 2004 DJDAR 11480, is the second time a California appellate court has applied the constitutional provision to public contracts. The first was the 2000 California Supreme Court decision, *Hi-Voltage Wire Works, Inc v. City of San Jose*, 24 Cal. 4th 537 (2000), in which the court held that a municipal contracting scheme requiring preferential treatment on the basis of race or gender violates the provision.

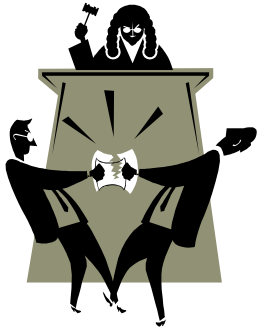
In the *C&C Construction* case, a contractor challenged SMUD's affirmative action program that included minority-owned business enterprise (MBE) price and evaluation advantages, good-faith MBE subcontracting requirements for primes, and incentives to SMUD employees to meet MBE participation goals. SMUD's program was the result of disparity studies it conducted in 1993 and 1998 to determine if factual conditions existed to justify remedial discrimination in the form of race-based affirmative action. SMUD conceded that the program was discriminatory, but argued that it fell within a Prop. 209 exception permitting agency programs that are required to maintain federal funding.

The court held that SMUD did not present substantial evidence that it will lose federal funding without the race-based program. In particular, the court found that SMUD failed to cite any federal law or regulation establishing that the race-based measures contained in the program are necessary to maintain federal funding, and that SMUD did not establish that race-neutral measures were unavailable when efforts to remedy past discrimination are necessary to maintain federal funding.

This case comes just two months after a San Francisco trial court held that the City's MBE/WBE program violates Prop. 209 and highlights yet another challenge for agencies seeking to maintain affirmative action contracting programs. ♦

— *David J. Tomlinson*

COURT OF APPEAL LIMITS EQUITABLE INDEMNITY IN CONSTRUCTION DISPUTES



In the typical construction project, the design professionals, project manager and prime contractors are in direct contract with the owner, and not with each other. When disputes arise and the owner sues all for breach, all the players are brought to the table to respond for the damages they caused.

Where an owner does not sue

all the involved parties, the practice has been for the parties sued to join the others by equitable indemnity cross-complaints. The Fourth District Court of Appeal has held in *BFGC Architects Planners Inc. v. Forcum/Mackey Construction Inc.*, 119 Cal. App. 4th 848 (2004), that there is no legal basis for such equitable indemnity claims.

In *BFGC*, the Porterville Unified School District paid \$6.1 million to settle claims and requests for change orders made by its prime contractor, S.C. Anderson. It then sued BFGC, an architectural firm which had prepared drawings and supervised construction, alleging breach of contract and professional negligence. BFGC cross-complained against Anderson, the prime contractor which had handled construction, and Forcum/Mackey Construction Inc., which had done site work under a direct contract with the school district. BFGC alleged that each contractor had breached its duties in performing its contract with the district, which BFGC characterized as negligence, and it sought damages, implied equitable indemnity, apportionment of fault/contribution, and declaratory relief for indemnity.

The contractors attacked BFGC's negligence theory arguing that in seeking only economic damages the claim was defective. See *Aas v. Superior Court*, 24 Cal. 4th 627 (2000). BFGC conceded the point but nonetheless contended it could pursue its equitable indemnity claims. The Court of Appeal disagreed. It observed that the body of law regarding equitable indemnity "has not fully gelled but is still evolving" and acknowledged that a threshold requirement for equitable indemnity, that there be co-tortfeasors, has been treated "expansively" to encompass concurrent or successive acts. Nevertheless, the court found no basis for an equitable indemnity claim. An indemnity claim must be predicated on a party's potential tort liability, such as negligence. The Court of Appeal concluded that neither of the two contractors targeted by BFGC could have been found liable in tort to the school district, and neither owed a contractual duty to BFGC. The contractors' potential liability to the

school district was solely contractual. The *Aas* decision forbids re-casting a breach of contract action as a tort claim. Since the contractors owed no duties to BFGC, in contract or in tort, and owed only contractual liability to the district, the indemnity claim failed as a matter of law.

The First District Court of Appeal considered similar issues in *Ratcliff Architects v. Vanir Construction Management Inc.*, 88 Cal. App. 4th 595 (2001), a decision the Fourth District did not mention. In *Ratcliff* an architect attempted to bring an indemnity claim against a construction manager in contract with the owner, and the court held that a manager owes no duty to a project architect. In *Ratcliff*, however, the effect of this holding was diluted by the construction manager's good faith settlement with the owner, which served to bar any indemnity claims.

BFGC holds that parties in contract with the owner but not each other, may not seek indemnity from each other. This holding suggests several things:

1. When an owner has sued one but not all of the entities in contract with it, as occurred in *BFGC*, the exposure of the defendant will theoretically not be increased by denying it the right to sue others. The owner must still prove causation. If an owner sues a contractor but not a design professional, then the contractor would be liable only for damages it caused, not for those caused by the design professional. What the *BFGC* decision costs the contractor is the opportunity to extract participation in settlement.

2. General contractors could presumably use the holding in *BFGC* to demur to owners' complaints, where the owner has sued for breach of contract and negligence, arguing that a breach of contract claim against them should not be "re-cast" as a negligence claim. However, a decision to do so would be dangerous, since most liability insurance policies exclude contractual liability from coverage. In fact, insurers themselves may elect to use the *BFGC* decision to attempt to deny coverage for claims.

3. In deciding *BFGC*, the Fourth District Court of Appeal did not have to consider the right of owners to sue contractors for strict liability in certain contexts. It is an open question what the Court of Appeal might have done had the contractors in *BFGC* faced a strict liability claim. In addition, after the *Aas* decision, the Legislature enacted Civil Code Sections 895 *et. seq.*, which define the duties builders, contractors, materialmen, design professionals and others owe for "original construction" of "dwelling units." It is unlikely the holding of *BFGC* would be extended to such claims.

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Construction Disputes (cont.) ...

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4. The *BFGC* decision gives a strategic advantage to owners. An owner can deal with the design professionals and contractors separately, knowing that none of them has the power to compel the others to join in settlement negotiations or a subsequent suit. In much the way a prosecutor might try to turn criminal codefendants against each other, the owner can try to get a pre-litigation settlement from one party and obtain at least implicit support for the owner's action against others who do not settle. More often than not, an owner will benefit in construction litigation by obtaining the design professional's support. Ironically, contrary to the result in *BFGC*, design professionals may be the principal beneficiaries of the decision.

For years, in construction litigation, the equitable indemnity cross-complaints have flown among defendants and cross-defendants. Indeed, some "standing orders" prepared by special masters have deemed indemnity cross-complaints to have been filed and served by all parties. The *BFGC* decision reminds us of the strategic underpinning of the indemnity law, and how tenuous "conventional wisdom" can be. At a minimum, the decision certainly invites new approaches to handling a construction dispute.

— *J. Michael Matthews*

Mr. Matthews' article was originally published on September 22, 2004 in The Recorder, San Francisco's legal newspaper. It is reprinted here with permission.



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