

# COMMON SENSE CONTRACTING

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federal tax law can be expected. However, one tax law, which is already enacted, will bite contractors performing public projects beginning on January 1, 2011.

As part of the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222), Congress included a special withholding section (Section 511) for the apparent purpose of combating alleged tax evasion by contractors. Under the new law, the United States Government, every state, every political subdivision of a state and instrumentality of the foregoing (including multi-state agencies) making total payments for property or services of \$100 million or more per year (all contracts) will be required to withhold 3% from all payments made to contractors for goods and services. This law applies to construction contractors, service contractors, as well as other entities furnishing goods and services.

This withholding is based on the total contract price rather than the projected net earnings. It is separate from the progress retention, which is typically reduced as the work progresses. As many general contractors and

## The Taxman Cometh

**547** With the results of the recent mid-term elections changing control of both Houses of Congress, questions or proposals regarding possible changes to the

## 2007 Construction Industry Update

Mark your calendars and plan on attending **Smith, Currie & Hancock’s 2007 Update for the Construction Industry** to be held on March 1-2, 2007 at the Hyatt Regency Hotel in Atlanta. Avoiding costly claims and disputes is a priority for everyone (contractors, subcontractors, owners, designers, etc.) working in the construction industry. One of the best ways to avoid problems and cost overruns is to obtain current information regarding project delivery systems, construction defect claims and defenses, recovery of extended overhead and lost productivity costs, as well as recent construction and employment law rulings that affect your rights, obligations, and bottom line. In addition, if you need continuing education (“CE”) credits as a Florida licensed contractor, this program will permit you to obtain 7 hours CE credits. See the last page of this newsletter for more details.

Hold these dates for our **Atlanta** program. Shortly after the first of the year, you will receive more detailed information on the program. In the meantime, if there are topics you would like to see us address in the program, please feel free to contact **Eric Nelson**, (404)582-8061 or [elnelson@smithcurrie.com](mailto:elnelson@smithcurrie.com) or any of the firm’s attorneys.

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construction managers perform projects with margins of 3% or less, this withholding will adversely impact cash flow and funds necessary to pay subcontractors and suppliers to complete the work. Consider the following example:

A contractor is awarded a \$5 million contract to be performed within a one-year period. Under this law, the public agency is required to withhold for federal income tax purposes, \$150,000 of the contract revenue. If the contractor actually nets 3% on this contract, its maximum tax is 35% of the net or \$52,500.00 (35% of \$150,000). The amount being withheld for tax purposes is nearly three times the maximum tax liability. Viewed differently, for the contractor to have a tax obligation of \$150,000 on the \$5 million contract, it would have to net slightly more than \$428,571 on that contract. ( $\$428,571 \times 35\% = \$149,999.85$ ) or approximately 8.57%. The implications for cash flow projections and project financing (payments to subcontractors or suppliers) are obvious.

In the waning moments of the 2006 Republican led Congress, a bill was narrowly rejected, which would have accelerated the effective date of this withholding to as early as January 1, 2007! Unless repealed, this effort may be renewed as the new Congress seeks means to enhance revenue.

Trade associations such as the AGC of America are actively seeking to repeal this excessive withholding tax prior to its current January 1, 2011 effective date. The success of that effort in the new Congress will depend, in part, on the strength of the grass roots support from the contracting community and the education of the members of the new Congress. For more information, please feel free to contact this firm or the AGC of America.

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## Georgia: CGL Coverage for Defective Work

**548** Nearly every contractor obtains Commercial General Liability (“CGL”) insurance. Yet the scope of coverage, or lack thereof, can be confusing especially when the interpretation of similar policy language can vary from state to state. In a very recent decision, the Georgia Court of Appeals broadened the scope of the exclusions for defective work from coverage under a CGL policy. The

exclusions generally applicable to contractors in a CGL policy embody the well-established Business Risk Doctrine. In Georgia, these business risk exclusions have been interpreted to exclude coverage for defective workmanship by the insured causing damage to the work itself. The principle behind the business risk exclusions is based upon the distinction made between the two kinds of risk incurred by a contractor. The first kind of business risk borne by the contractor is the risk of having to replace or repair defective work to make the building or project conform to the agreed contractual requirements. In the presence of the business risk exclusions, this type of risk is generally not covered by the CGL policy. The second risk incurred by a contractor is the risk that defective or faulty workmanship may cause injury to people or damage to other property. As the liability associated with this risk is potentially limitless, it is the type of risk for which the CGL coverage is contemplated.

Perhaps the most hotly contested business risk exclusion is the exclusion for damage to “your work.” This exclusion performs the lion’s share of the labor in reducing coverage for losses arising from a contractor’s poor workmanship in a completed operations context. The exclusion for damage to “your work” in a typical CGL policy excludes coverage for:

“Property damage” to “your work” arising out of it or any part of it and included in the “products-completed operations hazard.”

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

The policy defines “your work,” in part, as:

- a. work or operations performed by you or on your behalf; and
- b. materials, parts or equipment furnished in connection with such work or operations.

Given that the definition of “your work” includes not only work performed by you but “on your behalf,” the first sentence of the exclusion excludes any damage to a general contractor’s work, which includes the work of its subcontractors as defined by the policy. However, the second sentence of the exclusion operates as an exception to the exclusion and is commonly known as the “Subcontractor Exclusion.”

Currently, jurisdictions are split as to the ultimate effect of the subcontractor exception. Some courts that have interpreted the provision have determined that the

“subcontractor exception” requires coverage for property damage to the insured’s own work when performed on the insured’s behalf by a subcontractor. *Travelers Indem. Co. of America v. Miller Bldg. Corp.*, 2005 WL 1690552 Va. 4<sup>th</sup> Cir. 2005). At the same time, other courts have refused to recognize the subcontractor exception to the “your work” exclusion, relying instead on the rationale behind the business risk doctrine, i.e., the risk of having to replace or repair defective work to make the building or project conform to the agreed contractual requirements is not a risk contemplated under a CGL policy. See, e.g., *Lassiter Constr. Co. v. American States Ins. Co.*, 699 So. 2d 768 (Fl. Ct. App. 1997). Until this year, Georgia courts had not rendered a definitive decision as to which approach would be adopted in Georgia. However, the Georgia Courts finally chimed in and delivered a blow to a contractor’s ability to seek coverage for work performed by its subcontractors.

In *McDonald Const. Co., Inc. v. Bituminous Cas. Corp.*, 632 S.E. 2d 420 (Ga. App. 2006), the Georgia Court of Appeals addressed the question of whether a claim for defective construction constituted an “occurrence” under a CGL policy. In this case, the contractor, McDonald, entered in a contract to renovate and remodel a housing project for the Augusta Housing Authority. As part of the work, McDonald purchased, and its employees installed, plywood underlayment on the second floor of the apartment buildings. In turn, McDonald subcontracted the application of vinyl composition tile flooring for the buildings. After McDonald completed its work, the second floor tiles delaminated from their plywood underlayment. There was no evidence of any damage to the building or other property caused by the delaminated tiles or that the Housing Authority ever asked McDonald to pay for any property damage. After replacing the tiles, McDonald sought reimbursement from its CGL insurer, in part, for the cost of replacing the delaminated tiles.

The *McDonald* Court concluded that when the property damage at issue was to the insured’s own work product alone, and when no damage is alleged to any other property, there was no “occurrence” under the subject policy. Without delving too deeply, the court found that for there to be coverage under a CGL policy for faulty workmanship, there would have to be damage to property other than the work itself **and** the insured’s liability for such damage would have to arise from negligence, not breach of contract. *McDonald*, 632 S.E. 2d at 423. (emphasis added). In coming to this conclusion the court used the rationale behind the business risk doctrine, i.e., coverage under a

CGL policy is for tort liability to other property and not for contractual liability.

Turning to the subcontractor exception, the court refused to recognize the subcontractor exception to the “your work” exclusion. Specifically, the court reaffirmed the principle that the business risk exclusions, including the “your work” exclusion, are designed to preclude coverage for defective workmanship, even if performed by a subcontractor, because defective workmanship is a pre-existing contractual obligation borne by the contractor. The only saving grace to contractors under the *McDonald* opinion is that the court specifically noted that coverage may be contemplated if a subcontractor’s work causes damage to the contractor’s own work. *Stratton & Co. v. Argonaut Ins. Co.*, 469 S.E. 2d 545 (Ga. App. 1996).

In the *Stratton* case, the Georgia Court of Appeals considered a similar issue raised by a broad form endorsement which stated that “the insurance does not apply . . . to property damage to work performed by or on behalf of the *named insured* arising out of the work or any portion thereof, or out of materials, parts, or equipment furnished in connection therewith. . . .” *Stratton*, 469 S.E. 2d at 548. The court ruled that the language adopted in the broad form endorsement specifically deleted the phrase “or on behalf of” which was found in the basic policy. As a result, the court held that the endorsement narrows the exclusions found in the basic policy so as not to preclude coverage regarding faulty work or materials performed or supplied by subcontractors and that the plain language of the exception provides that damage to “your work” is covered if the damage results from the work performed by a subcontractor. Since most contractors obtain standard CGL policies, the “limiting” language found in the broad form endorsement contained in the CGL policy at issue in *Stratton* will most likely not assist in extending coverage.

In summary, the *McDonald* decision has delivered a mighty blow to contractors by refusing to recognize the subcontractor exception to the “your work” exclusion, relying instead on a rationale behind the business risk doctrine. What does this mean to you, the contractor? In this author’s view, it appears that in Georgia, contractors will not be allowed to seek coverage for faulty workmanship performed by subcontractors, unless the work by the subcontractor causes damage to property other than the work itself.

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## South Carolina: DOT Design/Build Contracting

**549** The use of the design/build delivery system on public projects continues to generate questions regarding the authority of public agencies to utilize that method of procurement absent specific legislation authorizing its use. The 2005 decision of the South Carolina Supreme Court in *Sloan v. Department of Transportation*, 618 S.E. 2d 876 (S.C. 2005) and the subsequent action by the South Carolina legislature illustrates these questions and their resolution.

In the *Sloan* case, the South Carolina Department of Transportation (“SCDOT”) elected to use the design-build delivery method in conjunction with a request for proposals to award contracts for the construction of three state highway/bridge projects rather than use the traditional design-bid-build delivery method with competitive sealed bids. As issued for price proposals under the design-build delivery method, price was not the sole or primary criterion for award.

A taxpayer (*Sloan*) challenged the SCDOT’s use of this procurement method as inconsistent with S.C. Code Ann. § 57-5-1620. That statute provides in part that

*Awards of contracts, if made, shall be made in each case to the lowest qualified bidder whose bid shall have been formally submitted in accordance with the requirements of the department. However, in cases of emergencies, as may be determined by the Director of the Department of Transportation, the department, without formalities of advertising, may employ contractors and others to perform construction or repair work or furnish materials and supplies for such construction and repair work, but all such cases of this kind shall be reported in detail and made public at the next succeeding meeting of the commission.*  
(emphasis added)

*Sloan* contended that SCDOT violated § 57-5-1620 in using the design/build process because it would permit the award of contracts to someone other than the lowest qualified bidder. In the *Sloan* case, the DOT contended that other statutory authority allowed the use of the design/build procurement methods. In addition, the SCDOT asserted that it was in compliance with state law as it ultimately awarded the contracts to the lowest bidder on each procurement. Finding no specific statutory authority for the use of the design/build delivery method by the SCDOT, the Supreme Court held that the use of that project

delivery method violated state law.

The story did not end with this ruling. As a direct result of this legal action, the South Carolina Department of Transportation lobbied the South Carolina Legislature and S.C. Code Ann. § 57-5-1625 was passed into law in 2006. This new law specifically authorizes the SCDOT to award highway construction contracts using design-build procedure and provides as follows:

- (A) The department may award highway construction contracts using a design-build procedure. A design-build contract means an agreement that provides for the design, right-of-way acquisition, and construction of a project by a single entity. The design-build contract may also provide for the maintenance, operation, or financing of the project. The agreement may be in the form of a design-build contract, a franchise agreement, or any other form of contract approved by the department.
- (B) Selection criteria shall include the cost of the project and may include contractor qualifications, time of completion, innovation, design and construction quality, design innovation, or other technical or quality related criteria.

### Comment

The *Sloan* decision and the subsequent legislation illustrates that many courts will continue to interpret public bid laws in a fairly strict manner and not imply that public officials have substantial discretion to use innovative project delivery methods. At the same time, those factors which make design-build an attractive alternative to the traditional design-bid-build method are causing state legislatures, as well as the federal government, to authorize its use by procurement agencies even if new legislation must be enacted.

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## Relying on Subcontractor Quotes

### **550** Overview

Bidding or quoting a fixed price to perform work on a construction project always presents risks, such as questions of scope, ambiguities in the specifications, or unanticipated site conditions. Rapid price escalation for

materials, labor, and equipment only compound these risks. Historically, it is not unusual to find that each period of rapid price escalation spawns litigation between contractors and subcontractors or suppliers regarding whether the subcontractor or supplier is bound to honor its quoted price.

Typically, the party seeking to enforce the quotation attempts to rely on the doctrine of promissory estoppel. The doctrine of promissory estoppel is set forth in Section 90 of the Restatement (Second) of Contracts as follows:

A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee (or a third person) and which does induce such action or forbearance is binding if injustice can be avoided only by the enforcement of the promise. The remedy granted for breach may be limited as justice requires.

The leading case regarding the application of the doctrine of promissory estoppel to subcontractors' bids is *Drennan v. Star Paving*, 333 P.2d 757 (Cal., 1958). Many other state courts apply this doctrine in the context of subcontractor or supplier bids. One notable exception is North Carolina where in *Home Electric Co. v. Underdown Heating & Air Conditioning Co.*, 358 S.E. 2d 539 (N.C. App. 1987) the court simply rejected the application of the doctrine of promissory estoppel as being essentially one-sided.

In those states which enforce the doctrine, the party seeking to enforce the bid or quotation must show the following:

- 1) A clear and definite offer by the subcontractor (supplier) to perform the work at a certain price;
- 2) A reasonable expectation by the subcontractor (supplier) that the prime contractor will rely on the price in preparing the prime contractor's bid;
- 3) Actual reliance by the prime contractor on the subcontractor's (supplier's) bid; and
- 4) Detriment to the general contractor as a result of reliance on the subcontractor's (supplier's) bid and the subsequent refusal to perform at that price.

## 2006 Application of These Principles

### No Definite Quotation

Two recent decisions by federal district courts indicate that contractors cannot always presume that a price quote given by a subcontractor for a contractor's use in preparation of a bid for a project is enforceable or that it can readily apply the doctrine of promissory estoppel to recover its increased cost.

In *Fletcher-Harlee Corp. v. Pote Concrete Contractors, Inc.*, 421 F. Supp. 2d 831 (D.N.J. 2006) a federal court determined that a subcontractor was not required to perform at the price it had previously quoted because the subcontractor's quote did not convey an intention to be bound to its price by making a clear and definite offer to perform the work for that amount. Fletcher-Harlee ("F-H"), a prime contractor, solicited bids from concrete subcontractors for a portion of the project in preparation of its bid for the construction of wing additions and alterations at a college. F-H utilized a quotation from Pote Concrete in its bid and, upon receiving the award, sought to enforce Pote Concrete's quotation.

The Pote Concrete bid, actually used by the F-H, listed the scope of work to be performed and based its quote on that list, specifically excluding work not covered by the scope of the bid. Pote Concrete's quotation stated that it was "provided for informational purposes" and that "no reliance should be placed thereon." It also stated that the subcontractor would "not be responsible or liable in any manner pending execution of a written agreement covering the work in question" and that "submission of this information should not be regarded as a firm offer." During review of the project plans, Pote Concrete advised F-H that it could not perform the work for the price originally quoted because the cost of material had increased significantly. After seeking estimates for the concrete portion of the project for a second time, F-H sued the subcontractor for damages incurred due to the subcontractor's failure to deliver at the originally-quoted price. The prime contractor claimed breach of contract and promissory estoppel.

F-H's breach of contract claim failed because the subcontractor manifested no intention to be bound by its quote. The language of the subcontractor's bid stated that it was not an offer, as it expressly stated "pending execution of a written agreement covering the work in question." The promissory estoppel claim likewise failed. The court held that there was no clear and definite offer. The court also held that the language of the bid letter precluded the prime contractor from reasonably relying on the quote. The letter stated: "This is provided for informational purposes and no reliance should be placed thereon." The court dismissed both claims against the subcontractor.

### Prompt Action Consistent with Reliance on Quote

A decision from Kentucky, *Rotondo Weirich Enterprises, Inc. v. Rock City Mechanical, Inc.*, 2006 WL 950188 (E.D. Ky) illustrates the need to promptly act to

enter into a formal contract consistent with the quotation in order to benefit from the doctrine of promissory estoppel. In this case, Rock City Mechanical, Inc. (“Rock City”) responded to a request for pricing for certain HVAC and plumbing work from Rotondo Weirich Enterprises, Inc. (“RWE”), on a project to construct a medium-security prison facility. Rock City had contracted with the general contractor for HVAC and plumbing **outside** the cell chases. RWE had contracted with the same general contractor for construction and installation of pre-cast concrete prison cells, including the HVAC and plumbing work **inside** the cell chases.

RWE requested that Rock City submit pricing for the HVAC and plumbing work inside the cell chases. Rock City responded with an offer to design and to install the inside HVAC and plumbing work for either \$156,000 or \$165,000. RWE used Rock City’s bid, but never formally communicated any acceptance of that offer to Rock City. Rather, RWE went about preparing its own detailed design drawings of the HVAC and plumbing work inside the cell chases. RWE submitted these design drawings to the general contractor and to Rock City, which needed them to coordinate the cell chase HVAC and plumbing with the same systems outside the cell chases. The drawings differed significantly from the designs upon which Rock City had based its original bid. Using these new design drawings, Rock City sent RWE a second price proposal of \$395,000 for the inside work. Thereafter, RWE sued Rock City for damages, claiming breach of contract and promissory estoppel.

RWE’s breach of contract claim was dismissed because RWE never accepted Rock City’s original offer. The court noted that RWE’s use of the price quoted by Rock City in its own bid for a subcontract from the general contractor is not an acceptance that creates a contractual relationship. RWE had entered into a written contract with the general contractor, but did not enter into a written agreement with Rock City.

RWE’s promissory estoppel claim was similarly rejected. While the court noted that, in Kentucky (as in many other, but not all, states) incorporation of a subcontractor’s bid to the owner constitutes reliance that binds the subcontractor, it also noted that there must also be “an unequivocal communication of acceptance to the subcontractor, soon after the awarding of the contract” and “a timely request to enter into a formal contract.” RWE did neither. The doctrine of promissory estoppel is intended to prevent the subcontractor from revoking its offer before the prime contractor has the opportunity to

accept. It does not allow a subcontractor’s bid to remain open indefinitely for the prime contractor’s acceptance. Here, RWE offered Rock City a proposed subcontract at the initial price quoted by Rock City approximately nine months after RWE had been awarded its contract and after RWE itself had changed the design upon which Rock City based its initial bid.

### Comment: Alternative to Relying Upon Promissory Estoppel

Prime contractors can avoid the problem of changing prices from subcontractors by entering a conditional contract with the subcontractor upon deciding to incorporate the subcontractor’s price into its bid, conditioned upon the prime contractor’s bid being accepted by the owner. By so doing, a prime contractor can be assured that the prices it relied upon to develop its own bid will remain in place during performance of the prime contract, as the subcontractor will be bound to its agreement. A prime contractor can thus avoid having to make up the shortfall between an original price quote and a later, higher price.

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## “Retaliatory” Bid Rejection

### 551 Overview

What are the options for a contractor whose low bid has been rejected by a governmental entity because the contractor previously prevailed in litigation against *another* governmental entity? Can the government refuse to award a contract to a contractor, which it sees as “lawsuit happy”? Is it legal for one local government to refuse to do business with a contractor because the contractor won a lawsuit against a different local government?

Not surprisingly, the answer to each of those questions is “it depends.” The government is not supposed to retaliate against its *existing* employees or contractors for exercising their First Amendment rights. And while we usually think of the First Amendment as protecting the “freedom of speech,” the First Amendment also protects the right to petition the government, which includes the right to bring a lawsuit against the government – so long as the lawsuit is a “matter of public concern.” So existing government contractors are legally protected from direct retaliation – *i.e.* being terminated or put in default - for

suing the government about some matter of public concern.

The options of a low bid contractor who had not yet been awarded the contract in question because it had previously exercised its First Amendment rights – by bringing a lawsuit against a governmental entity – were less clear until recently. The question of a disappointed bidder's rights to assert a lawsuit against a public body for rejecting its low bid traditionally depended on (1) whether that contractor had a prior or existing commercial relationship with the governmental entity rejecting its low bid and (2) whether the contractor's lawsuit against the governmental entity that was considered to be a "matter of public concern" involved the same governmental entity, which sought to reject the contractor's bid.

The United States Court of Appeals for the Fifth Circuit recently held that a contractor did have the right to bring suit against the City of Lubbock, Texas, a city for which it had never done work, for rejecting its low bid, allegedly because the contractor won a breach-of-contract lawsuit and damages against the El Paso, Texas Water District. *Oscar Renda Contracting, Inc. v. City of Lubbock, Tex.*, 463 F.3d 378 (5th Cir. 2006).

### What Happened to Oscar Renda Contracting, Inc. in the City of Lubbock

In *Oscar Renda Contracting*, The City of Lubbock ("City") requested bids for a storm drainage system project and Oscar Renda Contracting, Inc. ("Renda") submitted the lowest bid by \$2.2 million. Under Texas law, the City was required to award the contract to the "lowest responsible bidder." When Renda found out that the City officials were recommending that the City Council award the contract to the 2<sup>nd</sup> lowest bidder, Renda requested a meeting with the City officials. At the meeting, the City officials stated that they knew Renda had previously filed a lawsuit and been awarded damages against the El Paso Water District and expressed concern that Renda was "lawsuit happy." Renda explained its previous lawsuit and the City officials decided to recommend Renda after all. The City Council, however, disregarded the recommendation and voted to award the contract to the 2<sup>nd</sup> lowest bidder, not Renda.

### Pre-Existing Commercial Relationship Not Required

The City argued that Renda could not bring a retaliation claim against it. Renda was not a City contractor and only existing contractors could bring First Amendment Retaliation claims against the government. In *Board of County Commissioners v. Umbehr*, 518 U.S. 668 (1996), the

Supreme Court held that contractors had the same First Amendment protection – freedom from retaliation for exercising First Amendment rights – as employees. In the case, a trash hauler lost his contract with the County after he publicly criticized the County Commissioners. In the case, the Supreme Court rejected the County's argument that only employees and not contractors could bring retaliation suits against the government. However, the Court did not address how to handle the retaliation claim of a contractor who was not awarded a contract in the first place. The Supreme Court had previously held in *Rutan v. Republican Party of Illinois*, 497 U.S. 62 (1990), however, that prospective employees have the right to bring a First Amendment retaliation lawsuit against the government. Applying the reasoning in these two cases, the Court of Appeals concluded that Renda's lack of contract or pre-existing commercial relationship with the City did not bar its retaliation claims.

### Previous Lawsuit: "Matter of Public Concern"

The federal district court held that Renda's claim was barred for the additional reason that Renda's suit against the El Paso Water District had nothing to do with a public issue in the City of Lubbock, which it called "the relevant community," and thus could not form the basis of Renda's First Amendment retaliation claim. Likewise, the City argued that while the allegations of wrongdoing Renda asserted in the El Paso Water District suit might be a "matter of public concern" in El Paso, they would be of little interest to the residents of the Lubbock community some 450 miles from El Paso. The Court of Appeals rejected that argument and held that a matter of public concern is something of "legitimate news interest" – without regard for location.

On appeal, the City also argued that Renda's lawsuit against the El Paso Water District was analogous to an employee's suit against an employer, which is not a matter of public concern per se. The appellate court, however, held that by alleging that its lawsuit against the El Paso Water District involved First Amendment retaliation and breach of contract claims, Renda put the City on notice that its lawsuit against the Water District implicated "matters of public concern."

Thus, Renda's suit against the El Paso Water District was a "matter of public concern" and could form the basis for its retaliation claims against Lubbock.

### Comment

The *Renda* opinion affects existing government contractors at least as much as those potential contractors

bidding on government contracts. When a contractor is deciding whether to bring suit against a public entity – even where it has strong claims for delay, differing site conditions, breach of payment terms, or the like – the contractor has to weigh the risk that it will be black-balled on future public projects. Before this opinion, governments could refuse to do business with contractors who had previously brought valid lawsuits against other public entities, which created a real imbalance of power between governments and their contractors.

The *Renda* opinion offers contractors a tool – the right to bring a First Amendment retaliation lawsuit – and a better bargaining position in their relationships with governmental entities. So far the Court of Appeals for the Fifth Circuit, which includes Alabama, Mississippi, Louisiana, and Texas, is the only United States Court of Appeals to address whether a contractor without a pre-existing relationship has the right to bring a First Amendment retaliation claim against a public entity. The *Renda* decision is based on two fairly recent Supreme Court cases so there is a strong likelihood that it will be adopted by other Circuits, which would be a positive development for contractors throughout the country.

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## Florida: Contractual Indemnification

### 552 Introduction

Indemnification provisions are often included in construction contracts as a way to transfer risk among the parties. This risk shifting technique is often a contentious issue among the entities (owner, general contractor, subcontractors) on a project. While some indemnification provisions are custom drafted, the language found in AIA Document A401-1997 Contractors-Subcontract Agreement is an example of an “industry standard” clause. It provides as follows:

#### §4.6INDEMNIFICATION

§ 4.6.1 To the fullest extent permitted by law, the Subcontractor shall indemnify and hold harmless the Owner, Contractor, Architect, Architect’s consultants, and agents and employees or any of them from and against claims, damages, losses and expenses, including but not limited to attorney’s fees, arising out of or resulting from performance of the Subcontractor’s Work under this Subcontract, provided that any such claim, damage, loss or expense is attributable to bodily injury,

sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions of the Subcontractor, the Subcontractor’s Sub-subcontractors, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or otherwise reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Section 4.6.

§ 4.6.2 In claims against any person or entity indemnified under this Section 4.6 by an employee of the Subcontractor, the Subcontractor’s Sub-subcontractors, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, the indemnification obligation under Section 4.6.1 shall not be limited by a limitation on the amount or type of damages, compensation or benefits payable by or for the Subcontractor or the Subcontractor’s Sub-subcontractors under workers’ compensation acts, disability benefit acts or other employee benefit acts.

Indemnification provisions are often addressed by state law, which may limit their scope and establish conditions on their enforcement. In addition, due to their significant effect on the allocation of risk, some trade associations lobby for and obtain new legislation affecting the enforcement of such clauses. The result is that a provision, which was valid under state law at one time, may be rendered unenforceable, in part or in full, under a later state law. The evolution of Florida’s laws addressing indemnification clauses illustrate this point. In that context, a party’s failure to appreciate the changes and adopt its contract may result in a ruling that the indemnification provision was void and leave the contractor without a remedy of contractual indemnification.

#### Florida’s Changing Law

Section 725.06 of Florida’s statutes addresses indemnification provisions. That statute has seen three versions in the 21<sup>st</sup> century.

Prior to July 1, 2000, agreements where one party sought to be indemnified for its own acts, omission or negligence were invalid and unenforceable unless: (1) the contract contained a monetary limitation on the extent of indemnification and was part of the project specifications or bid documents, or (2) the person indemnified by the contract gave specific consideration for this indemnification.

From July 1, 2000 through June 30, 2001, all

indemnification provisions in construction contracts were void and unenforceable as against public policy if they sought to indemnify one party for damages caused by that party's own acts, omissions or negligence. In fact, the provisions were only enforceable if the party providing the indemnification, its employees, or subcontractors caused the damage.

On July 1, 2001 the current version of Section 725.06 was adopted. The current law provides, in part, as follows:

- (1) Any portion of any agreement or contract for or in connection with, any construction of a building, including moving and excavating associated therewith, between an owner of real property and an architect, engineer, general contractor, subcontractor, sub-subcontractor, or materialman or any combination thereof wherein any party referred to herein promises to indemnify or hold harmless the other party to the agreement, contract, or guarantee for liability for damages to persons or property caused in whole or in part by any act, omission, or default of the indemnitee arising from the contract or its performance, shall be void and unenforceable, **unless the contract contains a monetary limitation on the extent of the indemnification that bears a reasonable commercial relationship to the contract and is part of the project specifications or bid documents, if any.** Notwithstanding the foregoing, the monetary limitation on the extent of the indemnification provided to the owner of real property by any party in privity of contract with such owner shall not be less than \$1 million per occurrence, unless otherwise agreed by the parties. Indemnification provisions in any such agreements, contracts, or guarantees may not require that the indemnitor indemnify the indemnitee for damages to persons or property caused in whole or in part by any act, omission, or default of a party other than:
  - (a) The indemnitor;
  - (b) Any of the indemnitor's contractors, subcontractors, sub-subcontractors, materialmen, or agents of any tier or their respective employees; or
  - (c) The indemnitee or its officers, directors, agents, or employees. However, such indemnification shall not include claims of, or damages resulting from, gross negligence, or willful, wanton or intentional misconduct of the indemnitee or its officers, directors, agents or employees, or for statutory violation or punitive damages except and to the extent the statutory violation or punitive

damages are caused by or result from the acts or omissions of the indemnitor or any of the indemnitor's contractors, subcontractors, sub-subcontractors, materialmen, or agents of any tier or their respective employees.

- (2) A construction contract for a public agency or in connection with a public agency's project may require a party to that contract to indemnify and hold harmless the other party to the contract, their officers and employees, from liabilities, damages, losses and costs, including, but not limited to, reasonable attorney's fees, to the extent caused by the negligence, recklessness, or intentional wrongful misconduct of the indemnifying party and persons employed or utilized by the indemnifying party in the performance of the construction contract.
- (3) Except as specifically provided in subsection (2), a construction contract for a public agency or in connection with a public agency's project may not require one party to indemnify, defend, or hold harmless the other party, its employees, officers, directors, or agents from any liability, damage, loss, claim, action, or proceeding, and any such contract provision is void as against public policy of this state.
- (4) This section does not affect any contracts, agreements, or guarantees entered into before the effective date of this section or any renewals thereof.  
(emphasis added)

Interpreting a prior version of Section 725.06 that contained similar language voiding contractual indemnification of the indemnitee for its own negligence, Florida courts have held that this statute and its requirements do not apply to clauses where the indemnitee does not seek indemnification for its own acts or negligence. See *Federal Insurance Co. v. Western Waterproofing Co. of America*, 500 So. 2d 162 (Fla. 1<sup>st</sup> DCA 1986).

In contrast, in *Barton Malow Co. v. Grurau Co.*, 833 So. 2d 1164 (Fla. 2d DCA 2002), the challenged indemnification provision provided as follows:

protect, defend, indemnify and save harmless. . . Barton-Malow Company. . . from and against all losses, claims, demands, payments, damages, suits, actions, attorney's fees, recoveries and judgments of every nature and description brought or recovered against. . . Barton-Malow Company.

While conceding that the scope of the indemnity clause in the subcontract was void under Florida law, Barton Malow argued that the duty to defend was severable from the duty to indemnify. The court rejected what is

characterized as an effort to enforce “one portion of an otherwise unenforceable provision” as it saw nothing in the contract’s structure indicating that the duties were intended to be distinct and severable.

### Practical Comments

Indemnification provisions are important risk allocation tools. The Florida statutes illustrate that such provisions must be drafted in compliance with the applicable version of Section 725.06. As noted in the most current version of that statute, it did not affect contracts entered into **before** the effective date of the statute. Thus the question of the validity of a particular clause must be determined by the version of the statute in effect at the time when that contract or agreement was entered into.

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## Corps of Engineers’ “Wetlands” Regulation Update

### 553 Overview

Pursuant to its authority under the Clean Water Act, (the “CWA”), the Army Corps of Engineers (the “Corps”) regulates the dredging and filling, as well as the discharge of pollutants, into navigable waters. The term “navigable waters” is defined under the CWA as “the waters of the United States, including the territorial seas.” § 1362(7). In 33 Code of Federal Regulations (“CFR”) § 328.3, the Corps has issued regulations defining the term “waters of the United States” to include “waters such as intrastate lakes, rivers, streams (including intermittent streams), mudflats, sandflats, wetlands, sloughs, prairie potholes, wet meadows, playa lakes, or natural ponds, the use, degradation or destruction of which could affect interstate or foreign commerce,” and “tributaries” of such waters. The Corps’s regulation under the CWA also extends to “wetlands adjacent to waters” of the United States. The Corps has defined the term “adjacent” as “bordering, contiguous, or neighboring,” and including “[w]etlands separated from other waters of the United States by man-made dikes or barriers, natural river berms, beach dunes and the like”. As a matter of practical application, the Corps’ has interpreted these definitions expansively to include almost all waters that are hydrologically connected in some way to a navigable water body.

In article 537 (Vol. 20, No. 2) of this newsletter, we reported on a 2005 decision of the United States Court of Appeals in *United States v. Gerke Excavating, Inc.*, 412 F.3d 804, (7th Cir. 2005), in which a contractor was fined

\$55,000.00 for dumping dredged stumps and roots, plus sand-based fill, onto a 5.8 acre tract containing wetlands which were drained by a ditch that ran into a non-navigable creek, which in turn ran into a non-navigable river, which in turn ran into a navigable river. The *Gerke* decision was important because it appeared to cement the principal long applied by the Corps that if any water, including flowing or standing water on a construction site, found its way to a navigable water body, then that connection would be sufficient to confer the Army Corps of Engineers with jurisdiction over the site for purposes of the CWA.

### 2006 United States Supreme Court Ruling

Since the *Gerke* decision, the Supreme Court of the United States has weighed in on the issue in *Rapanos v. United States*, 126 S.Ct. 2208 (2006). In *Rapanos*, Mr. Rapanos had backfilled wetlands on a parcel of land that he owned and sought to develop. The parcel included 54 acres of wetland that were periodically saturated. The nearest body of navigable water was 11 to 20 miles away. The Corps’ took the position that Mr. Rapanos’s wetlands were “waters of the United States” under the CWA that could not be filled without a permit. Twelve years of criminal and civil litigation ensued.

The decision rendered by the Supreme Court appears to have rejected an expansive interpretation of the Corps’ jurisdiction under the CWA significantly. While Supreme Court decisions typically mean closure on an issue, the *Rapanos* decision is a rare 4-1-4 split. A plurality of four justices “plurality opinion” was joined by a fifth justice, Justice Kennedy, who wrote a lengthy separate opinion vacating (voiding) the lower court’s decision in the *Rapanos* case. The plurality opinion first examined several lower courts’ decisions, including the lower court’s decision in the *Rapanos* case, which all had upheld the Corps’ sweeping interpretation of the CWA and assertion of jurisdiction over wetlands on the grounds that hydrological connections existed between the wetlands and corresponding adjacent tributaries of navigable waters, without regard to how remote, ephemeral, or intermittent the connection. The plurality then rejected those grounds as a valid standard for asserting jurisdiction under the CWA, and remanded the case. The plurality opinion directed the lower court to apply the following test on remand: First, a wetland that is covered by the CWA must be connected to traditional interstate navigable waters through channels that are relatively permanent, standing or flowing bodies of water, as opposed to ordinarily dry channels through which water occasionally or intermittently flows, or channels that periodically provide drainage for rainfall; second, the wetland must have a continuous surface connection with the water that makes

it difficult to determine where the water ends and the wetlands begins. According to Scalia's plurality, wetlands with only an intermittent, physically remote hydrologic connection to traditional interstate navigable waters would not fall within the Corps' jurisdiction pursuant to the CWA, despite the language of 33 CFR §328.3(a)(3), (5), 1999. This would be good news for developers and contractors, as the Corps' authority to regulate certain waters on project sites would be significantly limited.

#### Possible Future Issues

However, there is a potential for confusion over whether the plurality opinion issued by Justice Scalia is actually the decision of the Court that should be controlling, or whether the concurring opinion written by Justice Kennedy alone is the controlling decision. Although Justice Kennedy concurred that the judgment to vacate should be remanded, Justice Kennedy's underlying reasoning vastly differed. In his concurring opinion, Justice Kennedy stated that the appropriate test for determining the Corps' jurisdiction over wetlands should be whether there is a "significant

nexus" between the wetlands and the aquatic system as a whole, regardless of whether a hydrologic connection between the wetlands and a navigable water body even exists. Under Justice Kennedy's test for determining the Corps' jurisdiction, the effect of the *Rapanos* decision would depend squarely on whether lower courts interpret "significant nexus" broadly or narrowly.

Currently, the few lower court decisions that have emerged post-*Rapanos* are split on whether the criteria in the plurality opinion or the analysis in Kennedy's concurrence should be applied. More information on this potentially significant decision will follow in this newsletter as the information becomes available. In the meantime, if you have any questions or concerns, please don't hesitate to contact me at (850) 878-3700.

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*Member of the State Bar of Florida*

## SCH NEWS

#### NEW ATTORNEYS

Our national construction law and government contracts practice continues to grow, and we are pleased to have added ten new permanent attorneys to the firm's construction law and government contracts practice group in the last several months. Their names, office location, and the date(s) of initial admission to the applicable state bar(s) are as follows:

##### *Atlanta:*

Clifford F. Altekruze: Georgia 1982; Texas 1985

Joseph J. Dinardo: Georgia 1999

David C. King: Georgia 1996

Kirk D. Johnston: Georgia 2003; California 2000

John M. Mastin, Jr.: Georgia 2006

Garrett E. Miller: Georgia 2001

Douglas L. Tabeling: Georgia 2006

##### *Charlotte:*

Ryan Lee Beaver: North Carolina 2006

##### *Ft. Lauderdale:*

Xavier A. Franco: Florida 2006

##### *Tallahassee:*

William J. Simonitsch: Florida 2000

#### INDUSTRY AND BAR ASSOCIATION ACTIVITIES

Smith, Currie attorneys continue to be active in construction industry trade associations as well as professional bar association activities, as reflected by the following recent appointments:

#### *Industry Associations*

Philip E. Beck from our Atlanta office has been selected to serve on the Contract Documents Committee of the AGC of America and the Consulting Constructors' Council of America.

Robert J. Greene of our Charlotte office has been selected to serve on the NC Bar Association and CAGC Joint Committee for the Carolinas AGC. Bob Greene is the first Smith Currie attorney selected to serve on a standing committee for the CAGC.

Thomas J. Kelleher, Jr. of our Atlanta office has been selected to serve on the Risk Management Committee of the AGC of America.

Brian A. Wolf has been appointed as a member of the Board of Directors of the Associated Builders and Contractors Institute.

#### *National/State Bar Associations*

Hubert J. Bell, Jr., has been appointed by the American Bar Association (ABA) Board of Governors to represent it on the American Arbitration Association's National Construction Dispute Resolution Committee.

Hubert J. Bell, Jr. and Eugene J. Heady were elected to become Fellows of the American Bar Foundation.

Brian A. Wolf has been appointed to be Vice Chair of the Construction Law Committee of the Real Property, Probate and Trust Law Section of the Florida Bar.

## Notice to Florida Licensed Contractors

For many contractors, 2007 is the deadline for obtaining your mandatory fourteen (14) hours of continuing education "CE" credits to maintain your Florida contractors license. These requirements include one hour of workplace safety, one hour of workers' compensation, one hour of business practice, one hour of advanced code and ten hours of general topics. Smith, Currie & Hancock LLP is an approved course sponsor (Provider No. 0000998) by the Florida Construction Industry Licensing Board (FCILB). The absolute deadline for completion of these hours for many licensed contractors is August 31, 2007.

To avoid conflicts between the busy summer construction season and the August deadline for CE credits, we have scheduled three opportunities to attend FCILB courses in the first quarter of 2007. These courses are scheduled as follows:

**February 2, 2007** – Atlanta, Georgia in conjunction with the Georgia AGC (7 hours credit).

**March 1-2, 2007** – Atlanta, Georgia as part of our 2007 Construction Industry Update Program.

**March 23-23, 2007** – San Antonio, Texas in conjunction with the 88<sup>th</sup> Annual Convention of the AGC of America.

## UPCOMING SEMINARS

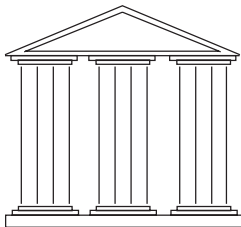
**Construction Dispute and Claim Avoidance**, February 2, 2007, Georgia Branch, AGC, Atlanta, Georgia.

**2007 SCH Annual Update Seminar**, March 1-2, 2007, Hyatt Regency Atlanta, Atlanta, Georgia.

*Address Change?* To ensure you continue receiving our newsletter, please call or e-mail your address changes to 404/582-8092 or [sivey@smithcurrie.com](mailto:sivey@smithcurrie.com).

**Supervisory Editors:** Thomas J. Kelleher, Jr., and Charles W. Surasky.

*This newsletter is intended to be a source of general information on new or current topics on construction law, government contracts and commercial law. It is not intended to render legal advice on specific problems. In assessing specific problems, advice and counsel should be sought from experienced professionals.*



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