S165113

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

LOS ANGELES UNIFIED SCHOOL DISTRICT,
Plaintiff and Respondent,

v.

GREAT AMERICAN INSURANCE COMPANY, et al.,
Defendants and Appellants.

After A Decision By The Court Of Appeal
Second Appellate District, Division Two
Case No. B1389133

REPLY BRIEF ON THE MERITS

Elwood Lui (State Bar No. 45538)
eglui@jonesday.com
Daniel D. McMillan
(State Bar No. 135119)
ddmcmillan@jonesday.com
Katie A. Richardson
(State Bar No. 238260)
katierichardson@jonesday.com
JONES DAY
555 South Flower Street, 50th Floor
Los Angeles, CA 90071-2300
Telephone: (213) 489-3939
Facsimile: (213) 243-2539

Roberta M. Fesler,
General Counsel
roberta.fesler@lausd.net
Mark Fall (State Bar No. 162497)
mark.fall@lausd.net
LOS ANGELES UNIFIED
SCHOOL DISTRICT
333 South Beaudry Avenue
23rd Floor, Suite 194
Los Angeles, CA 90017
Telephone: (213) 241-4969
Facsimile: (213) 241-8386

Counsel for Plaintiff and Respondent
LOS ANGELES UNIFIED SCHOOL DISTRICT

(Additional Counsel – See Next Page)

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SCHOOL DISTRICT
333 South Beaudry Avenue
23rd Floor, Suite 194
Los Angeles, CA 90017
Telephone: (213) 241-4969
Facsimile: (213) 241-8386

Counsel for Plaintiff and Respondent
LOS ANGELES UNIFIED SCHOOL DISTRICT

(Additional Counsel – See Next Page)

Gregory M. Bergman (State Bar No. 065196)
John P. Dacey (State Bar No. 136596)
Jorge J. Luna (State Bar No. 185512)
BERGMAN & DACEY, INC.
10880 Wilshire Boulevard, Suite 900
Los Angeles, CA 90024-4101
Telephone: (310) 470-6110
Facsimile: (310) 474-0931

Additional Counsel for Plaintiff and Respondent
LOS ANGELES UNIFIED SCHOOL DISTRICT

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INTRODUCTION

This appeal seeks to answer the following question: What does a contractor have to prove to hold a public agency liable for nondisclosure under an implied warranty theory for cost overruns allegedly arising from the failure to disclose some piece of information to the contractor at the time of bidding? Los Angeles Unified School District ("School District") argued in its Opening Brief that the weight of precedent and public policy requires the contractor to prove nondisclosure *and* that the public agency intended to conceal the undisclosed matter. Without such an intent element, as the School District explained, public agencies will effectively become insurers of any and all contractor cost overruns—a result that will inevitably and unnecessarily drive up construction costs and directly harm the public's interest in developing schools, libraries, hospitals, and other important public works.

Proffering a very different reading of the law and public policy, Hayward[1] takes the position that a contractor need not prove active concealment or intent so long as it can establish the simple fact of nondisclosure. As discussed below, Hayward's sweeping rule, which would hold public agencies strictly liable for any and all nondisclosures leading to cost overruns, and which admits of no exceptions, is unreasonable on its face as demonstrated by its application to this case. Hayward's proposed rule would force a public agency, here the School District, to incur the exorbitant expense of a trial even though the contractor agreed to repair all defects, patent *and* latent, for an agreed-upon maximum

[1] "Hayward" refers to both Hayward Construction Company, Inc. and Great American Insurance Company ("Insurance Company"), unless otherwise noted. Because the Insurance Company incorporates all of Hayward's arguments into its answering brief (Great American Answering Brief [hereinafter, "GAB"] at p. 1), the School District responds to all arguments in this single reply brief.

price, but nevertheless now seeks to recover cost overruns for a handful of latent defects which the contractor admits the public agency was unaware of and did not intentionally conceal. (*Los Angeles School Dist. v. Great American Ins. Co.* (2008) 163 Cal.App.4th 944, 964 [trial court found that School District "neither possesse[d] nor [was] aware of any evidence of affirmative misrepresentation or intentional concealment.") In other words, Hayward would have public agencies incur the substantial costs of litigating through trial and appeal when there is no evidence of an intent to defraud and where there is no evidence that the public entity intentionally concealed or misrepresented material information about the project. Hayward advances three main arguments in support of this view. However, neither the legal authority nor the public policy Hayward cites justify the dramatic and unwarranted expansion of public agency liability.

First, Hayward contends that the Legislature has already answered the question presented in this appeal by enacting Public Contract Code Sections 1104, 7104, 10120 and 10720, which Hayward erroneously reads as imposing liability on public agencies for nondisclosures without any intent requirement. (Hayward's Answering Brief ("HAB") at pp. 21-30.) None of these statutes say anything about whether intent is required for recovery. For example, Section 1104 merely preserves the right of contractors to sue public agencies for incomplete "architectural or engineering plans or specifications," but is silent as to what a contractor must prove to establish liability for breach of implied warranty based on a theory of nondisclosure. Indeed, Hayward admits this flaw in its argument when it concedes that "[i]mplied warranty liability for nondisclosure"—the very issue before this Court—"is *not* addressed by statute, but . . . remains the subject of judicial development." (HAB at p. 22, fn.10, emphasis added.) At bottom, Hayward is attempting to extrapolate a general rule disclaiming any intent requirement from a handful of narrow statutes

arising in discrete areas of public contracting law, and this attempt finds no support in those statutes or in logic.

Second, Hayward asserts that it is inappropriate to reference tort concepts (such as intent to conceal) or public policy concerns when answering questions about the scope of contractual liability, which Hayward claims is illustrated by cases declaring that contractors may recover on implied warranty theories without any showing of an intent to conceal. (HAB at pp. 2, 13-21, 38-41, 45-47.) Once again, the premise of Hayward's argument is invalid. Implied warranties—whether of good faith and fair dealing, of merchantability, or of complete disclosure—are by definition implied to advance particular public policy ends. Accordingly, it is both appropriate and necessary to consult public policy in defining the contours of these warranties. Nor do the cases Hayward cites hold public agencies strictly liable for nondisclosures. To the contrary, the public agencies in many of the cases Hayward cites were alleged (or proven) to have concealed undisclosed facts, and Hayward's attempt to read these cases broadly by uncoupling the language from their facts must be rejected. Along the same lines, the three scenarios of implied warranty liability referred to in *Warner* each entails either misstatements or half-truths—scenarios entirely consistent with an intent requirement. In short, the courts have not adopted Hayward's strict liability rule.

Third, Hayward tries to defend its rule on public policy grounds, contending that strict liability for nondisclosure is preferable because it will result in no greater cost to the public than the intent-based rule advanced by the School District and because it will also "take[] the gamble out of bidding." (HAB at p. 48; *id.* at pp. 47-53.) Hayward's analysis has it backwards. By holding the public agency liable for cost overruns due to any and all material nondisclosures, whether or not concealed by (or even known to) the public agency, Hayward's rule will indeed "take[] the

gamble out of bidding" because it will shift all risk onto public agencies by transforming those public agencies into insurers of cost overruns—even in cases such as this, where the contractor expressly assumed the risk of overruns due to latent (and thus undisclosed) defects, and the contractor lacks any evidence of affirmative misrepresentation or intentional concealment. The materiality limit provides public entities little protection from unwarranted litigation costs because, as Hayward notes, materiality is a question of fact to be decided post-hoc and is, moreover, likely to be defined as anything that (by the time of litigation) caused the cost of the project to increase.

Hayward's rule is adverse to the public interest because it eliminates the incentive for contractors to thoroughly investigate a project before bidding and, by providing blanket protection for cost overruns, encourages underbidding with the expectation that any shortfalls will be covered after expensive, post-contractual litigation. As between a rule that resolves cost issues up front and on a competitive basis, and a rule that leaves them to be resolved on the back-end through costly litigation, the public interest is surely served by the first rule. That rule, which is the rule the School District advocates, reserves implied warranty claims for those cases where the public entity is at fault for making affirmative misrepresentations or actively concealing information from the contractor, and in all other cases ensures that taxpayer money for public works is actually spent on much-needed public works projects—not litigation.

In short, both law and public policy justify requiring a contractor to prove more than a mere omission in a breach of implied warranty case based on a theory of nondisclosure. As held by the California courts that have considered the question, a contractor should not be able to impose liability on a public agency unless nondisclosure is accompanied by an intent to conceal. (See, e.g., *Thompson Pacific Construction, Inc. v. City of*

Sunnyville (2007) 155 Cal.App.4th 525, 551; *Jasper Construction, Inc. v. Foothill Junior College Dist. of Santa Clara County* (1979) 91 Cal.App.3d 1, 10. The Court of Appeal's decision adopting Hayward's strict liability rule should therefore be reversed.

COUNTERSTATEMENT OF FACTS

In its factual summary, Hayward ignores certain facts and distorts others in an attempt to portray the School District as failing to disclose information about the project and keeping Hayward in the dark. But it is important to understand what Hayward agreed to do and the circumstances under which Hayward agreed to do it. Hayward was not the initial contractor the School District hired to build the Queen Anne Place Elementary School (the "Project"). (3 HA 0761-0778.) The School District originally hired Lewis Jorge Construction Management, Inc. ("LJCM") for the Project. (1 HA 0067.) LJCM bid for the project using the original plans and specifications. The School District eventually terminated LJCM because LJCM's work was defective. (1 HA 0060, 0067; 2 DA 0263-0264.) The School District then hired Hayward to fix the work and finish the Project in accordance with the original plans and specifications. While the point gets lost in Hayward's rendition of the facts, Hayward is *not* attacking the accuracy or completeness of the Project's original plans and specifications. There was one set of designs and Hayward is not asserting that the School District omitted information from them. Rather, Hayward seemingly complains that information about LJCM's defective construction was somehow left out of the Completion Contract.

Hayward agreed in its Completion Contract "to correct deficiencies in the work performed by the former contractor [LJCM], without limitation" for a maximum guaranteed price of $4.5 million. (1 HA 0074, ¶ 15.) Hayward agreed to fix all defective work LJCM performed "without

limitation," whether latent or patent, and thus took the risk of cost overruns, including those incurred because of latent defects.[2] (1 HA 0074, ¶ 15.) Before making its bid and signing the Completion Contract, Hayward had full access to the construction site and LJCM's work. (3 DA 0580:7-10; 2 HA 0370:6-14.) Hayward had every incentive to do a thorough inspection because it knew it was dealing with defective and incomplete work. The School District relied on Hayward because a contractor, not a school district, is better able to assess what is wrong with a contractor's work. As a courtesy, the School District gave Hayward a non-exhaustive list of defective items. (1 HA 0229-0265.) The pre-punch list clearly stated that it "should not be taken as a final inspection punch list." (1 HA 0229.)

As expected, Hayward did encounter latent defects not specified on the preliminary punch list and, consistent with its Completion Contract, tried to fix them, but without submitting change orders as required whenever it encountered conditions materially different from those anticipated. (1 DA 0063:14-0064:24, 0066:12-19, 0090, 0115 [Hayward's admission no. 87].) This course of conduct is consistent with a duty to correct all defects, including latent defects. (See, e.g., *Crestview Cemetery Assn. v. Dieden* (1960) 54 Cal.2d 744, 754 ["When the parties to a contract perform under it and demonstrate by their conduct that they knew what they were talking about the courts should enforce that intent."]; *Internat. Billing Services, Inc. v. Emigh* (2000) 84 Cal.App.4th 1175,1185 [same].)

Not until Hayward reached the guaranteed maximum price, and its profits were at risk, did Hayward claim latent defects were outside the

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[2] Although the Court of Appeal remanded the case for consideration of extrinsic evidence to interpret the Completion Contract, the trial court (the only court to reach a decision on this issue) ruled that Hayward was obligated to fix all defects, including latent defects, not just defects listed on the courtesy pre-punch list. (*Los Angeles School Dist. v. Great American Ins. Co.* (2008) 163 Cal.App.4th 944, 956-959.)

scope of its contract. (2 HA 0440-0460.) Hayward then asked for more money even though it was unaware of any affirmative misrepresentation or intentional concealment by the School District. (4 HA 1077:6-17.) Though Hayward tries to downplay the significance of it now, Hayward's owner, Toby Hayward, repeatedly and unequivocally testified at deposition there was no evidence that the School District (i) intentionally concealed or misrepresented information (see, e.g., 3 DA 0569:18-0571:19, 0574:12-0575:5, 0577:22-0578:1, 0581:11-21, 0584:18-0585:6, 0590-0592), or (ii) knew of latent defects before Hayward discovered them during the course of its work. (*Id.* at 0569:2-14, 0574:1-11, 0578:3-8, 0580:25-0581:10.) As the Court of Appeal stated, the trial court relied on this deposition testimony and found that Hayward admitted it "neither possesse[d] nor [was] aware of any evidence of affirmative misrepresentation or intentional concealment." (*Great American*, *supra*, 163 Cal.App.4th at p. 964.)

Nevertheless, Hayward now argues that the School District withheld information about LJCM's defective work. Hayward claims, for example, that the School District failed to disclose a report prepared by a consultant named Pruter, and thus Hayward did not know how best to "fog coat" stucco discoloration. (HAB at p. 7.) But, as Hayward concedes, the stucco discoloration was "stated on the pre-punchlists and visible by site inspection." (*Ibid.*) That the prior contractor did not perform this fog coating properly is unremarkable; the prior contractor did little right, and Hayward, as the expert on construction methods, agreed to fix it. The fact that Hayward now raises issues about patent defects demonstrates, as the School District argued in its opening brief, that the strict liability rule Hayward proposes will encourage contractors to scour public records for any fact that was previously "undisclosed" to serve as an after-the-fact justification for a nondisclosure claim. The law should not provide contractors with such perverse incentives that risk making public entities

insurers for contractors' cost overruns, absent some evidence of intentional wrongdoing.[3]

ARGUMENT

I. THE PUBLIC CONTRACT CODE SECTIONS HAYWARD RELIES ON DO NOT ANSWER THE LEGAL QUESTION HERE

A. The Purpose Of Section 1104 Is To Prevent Public Entities From Shifting Design Responsibility To Contractors

Hayward contends for the *first time* in this case that the California Legislature, through Public Contract Code Section 1104, "has . . . decided . . . that knowing and intentional misrepresentation is not an element of implied warranty liability." (HAB at p. 26.) Section 1104 provides, in pertinent part: "No local public entity, charter city, or charter county shall require a bidder to assume responsibility for the completeness and accuracy of architectural or engineering plans and specifications on public works projects, except on clearly designated design build projects." (Pub. Contract Code, § 1104.) The plain language of Section 1104 says nothing about what a contractor must prove to prevail on a breach of implied

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[3] Hayward also complains that the School District overstated the Project's percentage completion on LJCM's final pay application. (HAB at p. 5.) But LJCM, not the School District, made this estimate, which the School District approved in the hope that LJCM would complete the project. (4 HA 1066:10-1068:25, 1073:11-1073:25.) In any event, Hayward's asserted reliance on the estimate is suspect given Hayward agreed to a maximum completion cost of $4.5 million when the estimate was approximately $1 million left on the original contract. Apart from being factually inaccurate, the fact that Hayward now tries to rely on a payment application it characterizes as "intentionally overstated" is telling given that Hayward's proposed strict liability rule requires no intent at all. By focusing on intent in its own brief, Hayward tacitly acknowledges the unfairness of a rule that holds public entities liable for alleged nondisclosures absent active concealment.

warranty claim, much less that knowing and intentional misrepresentation "is not an element of implied warranty liability." (HAB at p. 26.)

The statute's legislative history confirms Section 1104 means precisely what it says. Section 1104 derives from Assembly Bill 1314 ("AB 1314"). (See Request for Judicial Notice [RJN] at Ex. 1.) AB 1314 sought to prevent public entities from inserting contract provisions requiring "contractors, as a condition of the contract, to review and certify the sufficiency and completeness of the documents" and to "certify that there are no omissions or inconsistencies within the architectural designs." (RJN at Ex. 7.) Thus, contrary to Hayward's suggestion, Section 1104 is not intended to make public entities strictly liable for alleged nondisclosure without proof of intent to conceal. Section 1104 simply does not apply here because there was no express provision in the Completion Contract requiring Hayward to certify the sufficiency and completeness of the plans and specifications or to accept responsibility for the Project's design.

Hayward also distorts the legislative history by claiming that Section 1104 was enacted "in reaction to *Jasper*." (HAB at p. 24.) Nothing in the statute's legislative history, from either the author or supporters of AB 1314, reflects an intention to overturn *Jasper*, a case decided nearly 20 years before AB 1314 was even introduced. (See *Jasper Construction, Inc. v. Foothill Junior College Dist. of Santa Clara County* (1979) 91 Cal.App.3d 1.) Rather, the arguments in *opposition* to the bill set forth a statement by a single opponent that, if enacted, AB 1314 "could have the effect of overturning the decision in *Jasper*." (RJN at Ex. 8, p. 3.) But the possibility that someone "could" raise the argument—an argument not advanced by anyone in support of AB 1314 and not supported in any way by the intent of the statute—does not make the argument right, or convey the Legislature's intent to overrule *Jasper*. Simply put, the comment referenced by Hayward is nothing more than a cautionary note that

someone might make the argument (as Hayward does) that Section 1104 somehow overruled *Jasper* when that was never intended. And the only court to confront the argument that Section 1104 overturned *Jasper* expressly rejected that argument. (See *Thompson Pacific Construction, Inc. v. City of Sunnyville* (2007) 155 Cal.App.4th 525, 553.)

Hayward predictably contends that *Thompson* was wrongly decided because it viewed Section 1104 as dealing with the "burden of proof" and was "result oriented." (HAB at pp. 35-36.) But the *Thompson* court made no finding that Section 1104 dealt with the burden of proof—rather, the court acknowledged that Section 1104 "says nothing about the contractor's burden to prove that the public entity breached the warranty." (*Thompson, supra*, 155 Cal.App.4th at p. 553.) This finding makes sense because, as the language and legislative history of Section 1104 make clear, Section 1104 speaks only to the non-waivability of a breach of implied warranty claim for omissions in "architectural or engineering plans or specifications," and does not speak to *what* a contractor must prove to prevail on a breach of implied warranty claim. It is the latter issue that is at the heart of this case, and because Section 1104 does not answer it, neither *Jasper* nor *Thompson* is in conflict with Section 1104. The *Thompson* court correctly interpreted Section 1104 and properly considered the likelihood that contractors will fail to diligently examine plans and specifications—and consequently underbid to secure public works contracts—if proof of affirmative misrepresentation or active concealment is not required to establish liability for breach of the implied warranty. There is thus no basis for Hayward's generic attack that *Thompson* was somehow "result oriented."

If any doubt about the meaning of Section 1104 remains, contractors like Hayward have removed all doubt by their unsuccessful attempts to amend Section 1104. Hayward's contention that Section 1104

"unambiguously" establishes that intentional misrepresentation is not required (HAB at p. 22) is belied by the fact that in September 2008 Governor Schwarzenegger vetoed Assembly Bill 983 ("AB 983"), which would have amended Section 1104 to include language requiring "full, complete, and accurate plans and specifications." (Governor's veto message to Assem. on Assem. Bill No. 983 (Sept. 30, 2008) Recess J. No. 17 (2007-2008 Reg. Sess.) p. 7405; see RJN at Ex. 11 [Enrolled Assem. Bill No. 983 (2007-2008 Reg. Sess.) Aug. 8, 2008].) More importantly, AB 983 also would have added language—not present in any of the statutes cited by Hayward—that "[n]othing in this section shall be construed to require a contractor to prove an affirmative or intentional misrepresentation or active concealment on the part of the local public entity, charter city, or charter county that provides the plans and specifications."[4] (RJN at Ex.11.) Of course, this latter language demonstrates that the proponents of AB 983 did not believe, as Hayward argues here with respect to similar language in Sections 10120 and 10720 of the Public Contract Code, that the phrase "full, complete, and accurate plans and specifications" means a contractor need not prove intent for a nondisclosure claim. The fact that contractors like Hayward have tried not once, but twice, to add this language to Section 1104 shows that Section 1104 does not say what Hayward claims.

B. Section 7104 Warrants Against Differing Site Conditions For Excavation Work And Does Not Apply Here

Hayward also contends for the *first time* that Public Contract Code Section 7104 demonstrates that a public entity should be liable for omissions in plans and specifications regardless of intent. Section 7104 codifies the warranty of differing site conditions for work "which involves

[4] Following the governor's veto, contractor lobbyists sought to resurrect AB 983 through AB 815, which includes identical language. (See RJN at Ex. 12 [Enrolled Assem. Bill No. 815 (2009-2010 Reg. Sess.) as introduced Feb. 26, 2009].)

digging trenches or other excavations that extend deeper than four feet below the surface." (See Pub. Contract Code, § 7104, subd. (a).) Both committee reports and floor statements confirm this limited scope by repeatedly referring to Senate Bill 1470 ("SB 1470"), the precursor to Section 7104, as pertaining to the notice requirements for "underground excavation" and "differing soil conditions." (RJN at Exs. 9-10.) Nothing in Hayward's implied warranty claim concerns underground excavation, thus Section 7104 does not apply to Hayward's claim. Even if, as Hayward contends, Section 7104 creates liability without any proof of intent in the narrow circumstance of underground excavation (which does not apply here), the Legislature limited the statute's reach to unknown subsurface conditions, and there is no reason to judicially extend it to other elements of construction.[5]

C. Sections 10120 And 10720 Are Likewise Inapplicable

Hayward asserts that other sections of the Public Contract Code requiring State agencies to prepare "full, complete, and accurate plans and specifications," bolsters its argument that Section 1104, which applies to local public entities, attaches liability for any omission regardless of intent. (HAB at p. 27.) Yet neither Section 10120 nor 10720 supports this conclusion. First of all, there is nothing to bolster, because as demonstrated above, Section 1104 does not address whether a public entity is *strictly liable* for any omission. Moreover, unlike Section 1104, which governs the relationship between a public agency and contractor, Sections 10120 and 10720 (which by their terms do not even apply to the School District)

[5] The fact that Hayward cites to federal differing site conditions clauses, which are broader in scope than Section 7104, demonstrates that Section 7104 does not apply here. Federal differing site conditions clauses apply to "any part of the work" under the contract (48 C.F.R. § 52.236-2(b)), whereas the application of Section 7104 is limited to (among other things) work "which involves digging trenches or other excavations."

govern the submission of plans and specifications for approval and review by advisory boards before the public agency accepts bids. (See Pub. Contract Code, §§ 10121 [specifying "a certified copy of the plans, specification and estimates of cost shall be filed permanently in the office of the department before further action is taken"]; 10721 [same].) These record-keeping statutes require the complete package of plans and specifications, whatever they are, to be filed with the applicable regulatory agency for further review and ultimate approval of the project, and do not create liability for any omission, let alone one that occurred without any wrongdoing on the part of the public entity.

II. INTENT IS AN APPROPRIATE CONSIDERATION IN DETERMINING LIABILITY FOR BREACH OF IMPLIED WARRANTY BASED ON NONDISCLOSURE

A. Implied Warranties Originated In Tort Law And Are Designed To Promote Important Policy Considerations

Hayward devotes most of its brief to dissociating tort and contract principles in an effort to dissuade this Court from adopting a rule of law that would effectuate the very purpose of contract law—ensuring the parties receive the benefit of their bargain—in a manner consistent with the public's interest. But Hayward's attempt to hermetically seal contract from tort law fails to recognize that "[h]istorically, liability in implied warranty sounds in tort, and it can be reasoned that the true basis of such recovery now lies in tort, rather than contract." (*Gottsdanker v. Cutter Labratories* (1960) 182 Cal.App.2d 602, 606.) As such, implied warranties serve important policy goals that courts consider in defining their scope. (See, e.g., *Siders v. Schloo* (1987) 188 Cal.App.3d 1217, 1221 ["public policy considerations which justified extension of implied warranty concepts to sales of new construction by commercial developers did not warrant application of implied warranty concepts in this case"]; *Cazares v. Ortiz*

(1980) 109 Cal.App.3d Supp. 23, 30 [identifying public policy supporting adoption of the doctrine of implied warranty of habitability].)

As an outgrowth of tort law, warranty law has borrowed from tort theories in formulating contract principles that effectuate the public's interest. (See *Gottsdanker, supra*, 182 Cal.App.2d at p. 606.) Thus, implied warranty law often considers fault or a party's mental state in assessing liability. (See, e.g., *Peterson v. Superior Court* (1995) 10 Cal.4th 1185, 1206 [holding breach of implied warranty of habitability requires showing of negligence on the part of landlord]; *Carma Developers (Cal.), Inc. v. Marathon Development California, Inc.* (1992) 2 Cal.4th 342, 372-73 [a "party violates the covenant [of good faith and fair dealing] if it subjectively lacks belief in the validity of its act"]; *Wolf v. Walt Disney Pictures and Television* (2008) 162 Cal.App.4th 1107, 1123 ["[t]o establish a claim for breach of the implied covenant of good faith and fair dealing," a party must show "either [the defendant] lacked subjective good faith in the validity of its act . . . or the act was intended to and did frustrate the purpose" of the parties' agreement," citing *Carma Developers, supra*, 2 Cal.4th at p. 372]; *Careau & Co. v. Security Pacific Business Credit, Inc.* (1990) 222 Cal.App.3d 1371, 1395 [holding that for a claim for breach of the implied covenant of good faith and fair dealing there must be "conduct [that] . . . demonstrates a failure or refusal to discharge contractual responsibilities, prompted not by an honest mistake, bad judgment or negligence but rather by a conscious and deliberate act . . ."].)

This case is a perfect example of why courts should require contractors to prove something more than innocent omission in determining liability for breach of implied warranty. The School District, which did not misrepresent any information, contracted with Hayward to complete construction both parties knew involved defective work by a prior contractor. Certainly Hayward, as the construction expert, was in a better

position than the School District to identify defects in construction for purposes of its bid. Indeed, this is the focus—i.e., which party is in the best position to evaluate inherent risks—on which the United States Supreme Court's decision in *United States v. Spearin* (1918) 248 U.S. 132 rests. Requiring a contractor to prove some form of intentional misconduct by a public entity in a nondisclosure case will ensure that the taxpaying public is not unjustly saddled with costs attributed to a contractor's failure to satisfy itself of conditions about which it possesses expert knowledge and skill.

B. California Precedent Properly Focuses On Intent In Assessing Liability For Breach Of Implied Warranty

As noted in the School District's opening brief, the Courts of Appeal have imposed an intent requirement for nondisclosure liability with respect to breach of the implied warranty. (See *Jasper, supra*, 91 Cal.App.3d at p. 10; *Thompson, supra*, 155 Cal.App.4th at p. 552.) Hayward cites a number of federal cases in support of its argument, but those cases merely state that the implied warranty exists and there is good reasons for the warranty. (See, e.g., HAB at p. 25.) The School District does not dispute that an implied warranty exists, but disagrees with Hayward as to the standard a contractor must meet to establish a breach in the case of alleged nondisclosure. The School District believes that requiring intent for a breach of implied warranty on a theory of nondisclosure is consistent with this Court's prior decisions, as well as the sound decisions of *Jasper* and *Thompson*. Hayward's arguments for a strict liability standard do not withstand scrutiny.

When this Court first recognized the implied warranty as a basis for contract liability in *Souza*, it did so in a case involving allegations of intentional omission, which the Court described as a "misrepresentation." (*Souza & McGue Construction Co. v. Superior Court* (1962) 57 Cal.2d 508, 508.) To be sure, this Court allowed the entire complaint to stand,

including a claim Hayward characterizes as "unintentional failure to inform" (HAB at p. 14), because both claims hinged on the City's alleged intentional nondisclosure. (*Souza, supra*, 57 Cal.2d at p. 509 ["[t]he fourth cause of action incorporates the allegations of the third" cause of action].) The Court thus found the contractor "state[d] *causes of action* in contract on the basis of the alleged *fraudulent* breach." (*Id.* at p. 511, emphasis added.) Contrary to Hayward's suggestion, the Court did *not* decide—let alone hold—that an innocent omission standing alone, without an allegation of intentional fraud, is sufficient to establish a breach of implied warranty claim, which is the issue before this Court. And the School District is aware of no case in this context that gives *Souza* the broad strict liability read that Hayward urges.

As discussed in the School District's opening brief, other California cases likewise address intent in determining liability for breach of warranty. These cases are not, as Hayward claims, limited to materiality or reliance. (HAB at pp. 41-44.) In *Morrill*, for example, this Court considered whether the State made "positive and material representation[s]" about the site conditions in the plans and specifications. (*E. H. Morrill Co. v. State of California* (1967) 65 Cal.2d 787, 792, internal quotations and citation omitted.) The Court found that the State had "flatly assert[ed] that the bidders could expect to confront only specified site conditions," which was false. (*Ibid.*) Given this "express [false] statement of fact" (*id.* at p. 793), this Court held the complaint stated a cause of action for breach of the implied warranty, and distinguished its holding from other cases like *Wunderlich* "[where] there was no positive assertion of fact as to condition" (*id.* at p. 791) or "positive assertion of fact upon which liability could be based" (*id.* at p. 793). Thus, *Morrill* does focus on whether the public entity made false representations.

Weichmann is another good example. There, the contractor alleged the State was liable for cost overruns for concealing subsoil conditions. (*Weichmann Engineers v. State of California* (1973) 31 Cal.App.3d 741, 741.) Citing *Morrill* and *Souza*, the court made clear that a public entity can be liable for breach because of a "misrepresentation" or by "misleading" the contractor through its plans and specifications. (*Id.* at p. 749.) The court found that the State was not liable because "[t]here was no partial disclosure, no half-truths *which purported to be the whole truth or which were likely to mislead.*" (*Id.* at p. 750, emphasis added.) Contrary to Hayward's assertion that *Weichmann* did "not [concern] the State's intentions," the court held that "there [was] no evidence of *deliberate or calculated attempt* by the state to create false or misleading information as to subsurface conditions." (*Id.* at p. 751, emphasis added.) Thus, *Weichmann*, like *Jasper* and *Thompson*, found that there was no intent that would support liability. (See also *Wunderlich v. State of California* (1967) 65 Cal.2d 777, 783 [holding that "statements honestly made," for which there were "reasonable grounds," could not create liability for the State]; *Jasper, supra*, 91 Cal.App.3d at p. 10 [holding that a breach of implied warranty claim for nondisclosure "cannot be maintained upon a showing of a 'defect' unless that defect consists of intentional concealment or positive assertions of material facts which prove to be false or misleading"]).[6]

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[6] Hayward cites *Tonkin Construction Company v. County of Humboldt* (1987) 188 Cal.App.3d 828, as evidence that *Jasper* has been "rethought." (HAB at p. 34, fn.16.) This is untrue, and, if anything, *Tonkin* is consistent with *Jasper* and cases like it. The *Tonkin* Court based its holding on contractual provisions that impliedly represented that a dredge would be available at a certain time so the contractor could complete its work, and the representation proved false. (*Id.* at p. 832.) Thus, like in *Jasper*, the court found that liability exists "for positive and material misrepresentations contained in the plans upon which a contractor had a right to rely." (*Id.* at p. 834.)

Requiring intentional wrongdoing for a nondisclosure claim is consistent with the warranty's purpose of ensuring that contractors are not unfairly "misled" (*Souza, supra*, 57 Cal.2d at p. 510) by information received before bidding and, more importantly, that the interests of taxpayers who fund these projects are protected. (See *Kajima/Ray Wilson v. Los Angeles County Metropolitan Transportation Authority* (2000) 23 Cal.4th 305, 316.) Interpreting implied warranty law as Hayward advocates would give contractors an easy excuse for failing to conduct diligent inspections consistent with the terms of a contract, and thereby gain from careless bidding practices. This Court has made clear such a result must be avoided. (See *Wunderlich, supra*, 65 Cal.2d at p. 786 ["It is obvious that a governmental agency should not be put in the position of encouraging careless bidding by contractors who might anticipate that should conditions differ from optimistic expectations reflected in the bidding, the government will bear the costs of the bidder's error."].)

Even the Insurance Company agrees that Hayward's strict liability standard goes too far. The Insurance Company contends in its brief that, even without a strict liability standard, "[a] contractor must still prove negligence—i.e. that the public owner knew or should have known that the plans and specifications were either misleading or omitted material information." (GAB at p. 2.) The fact that the Insurance Company advocates a standard that would require that the public agency "knew or should have known" indicates that some element of intent should be required and underscores the unreasonableness of the strict liability standard advocated by Hayward. But just like Hayward's standard, the Insurance Company's negligence standard (for which the Insurance Company cites no authority) would for the same reasons encourage contractors to search public records for a single fact that was undisclosed during the bidding process to support a nondisclosure claim by arguing the

public agency "should have known" of the allegedly omitted item. The Insurance Company's concession that some intent standard is appropriate reinforces the extreme nature of the strict liability standard urged by Hayward.

C. *Warner* Does Not Support Hayward's Broad Standard

Hayward relies heavily on *Warner Construction Corp. v. City of Los Angeles*, but that case does not hold that intent is irrelevant in a breach of implied warranty case for nondisclosure. To the contrary, *Warner* sets forth three scenarios where liability for nondisclosure may arise, and each of them is consistent with intentional misconduct. (See *Warner Construction Corp. v. City of Los Angeles* (1970) 2 Cal.3d 285, 294.) Indeed, all of the authority on which the *Warner* Court relied in setting forth these scenarios speak of fraud. (*Id.* at p. 294 fns. 5-7.) A public entity that "actively conceals" information should be liable for breach of the implied covenant, just as it would be in tort. (*Ibid.*; see *Younan v. Equifax, Inc.* (1980) 111 Cal.App.3d 498, 512 ["active concealment or suppression of facts by a nonfiduciary is the equivalent of a false representation, i.e., actual fraud."].) So too should a public entity that withholds material facts when it "knows they are not known to or reasonably discoverable by the plaintiff." (*Warner, supra*, 2 Cal.3d at p. 294.) This is just another form of fraud that inherently includes some intent to mislead. Similarly, a public entity that "makes representations but does not disclose facts which materially qualify the facts disclosed" (*ibid.*) is making a false statement, which is far different than a public entity that makes an innocent omission with no intent to defraud. (See *Cicone v. URS Corp.* (1986) 183 Cal.App.3d 194, 201 [noting that one who "volunteers information must be truthful, and the telling of a half-truth *calculated* to deceive is fraud"], emphasis added.) In fact, in identifying this scenario as a basis for breach of implied warranty liability, the *Warner* Court cited to California Civil

Code Section 1710 (*Warner, supra,* 2 Cal.3d at p. 294, fn. 5), which defines "deceit"—a term even Hayward admits "includes the element of 'intentional concealment or suppression.'" (HAB at p. 45.)

Hayward thus reads *Warner* far too broadly in concluding that it creates liability for a public entity that had no intent to mislead but made an innocent omission. The School District has found no case that extends *Warner* so far in this context. Not even *Welch*, one of the main cases on which Hayward relies, holds that a public entity is liable for an omission under any and all circumstances. (See *Welch v. State of California* (1983) 139 Cal.App.3d 546, 555.) *Welch* dealt with a situation where the State withheld information that "would have eliminated or materially qualified the misleading effect of the misrepresentation in the general note." (*Id.* at p. 556.) Because "[t]he failure to disclose such information compounded the effect of misleading half-truths," the court predictably held that the State could be liable for breach of implied warranty. (*Id.* at p. 558.) This is far different than the situation here where Hayward admits there is no evidence of fraud or concealment, yet seeks to hold the School District strictly liable for its cost overruns even though Hayward agreed to a guaranteed maximum price for fixing the prior contractor's work.

III. A STRICT LIABILITY STANDARD WILL HAVE PROFOUNDLY ADVERSE POLICY IMPLICATIONS

An implied warranty rule that would impose liability for nondisclosure absent a showing of intent by the public agency to mislead or conceal material bidding information creates bad public policy. The policy implications of Hayward's strict liability rule, as with other implied warranties, must be considered and cannot be understated. (Cf. *Kajima, supra,* 23 Cal.4th at pp. 317-318 ["In determining what remedy 'justice requires,' it is incumbent on this court to consider the broad-ranging social consequences of the chosen remedy."].) Billions of dollars in public funds

have been allocated to the completion of important public works projects throughout California. Substantially increasing the scope of liability that public entities face in the case of innocent nondisclosure when entering into these projects will divert that money from its intended purpose and will undermine the ability to fund vital construction projects in California. Absent active concealment, no good reason exists for expanding the scope of liability and diffusing the effectiveness of crucial public infrastructure dollars. This Court has made clear that the Public Contract Code was "enacted for the benefit of property holders and taxpayers, and not for the benefit or enrichment of bidders" and should thus be construed "with sole reference to the public interest." (*Id* at pp. 316-317; see HAB at p. 48.) The rule Hayward advocates will have the opposite effect.

Contrary to Hayward's argument, public entities like school districts will be burdened with increasing and more costly litigation unless some showing of active concealment or affirmative misrepresentation is required. (Cf. HAB at pp. 51-53.) Allowing contractors to proceed with nondisclosure claims where there is no evidence the public entity intended to conceal material information at the time of bidding will land public entities in the same position in which the School District finds itself here—expending substantial resources litigating a claim through trial and appeal. This case illustrates the expense to which a public agency will be exposed absent an intent requirement: The School District is entrenched in protracted litigation even though, as the Court of Appeal acknowledged, the trial court found that Hayward admitted it "neither possesse[d] nor [was] aware of any evidence of affirmative misrepresentation or intentional concealment." (*Great American, supra*, 163 Cal.App.4th at p. 964.) The costs of litigating these claims, which are borne by the public, certainly do not benefit the public interest. The money spent on such litigation would

be better spent on critical public works projects for California like building schools, hospitals, and new roads.

Moreover, Hayward contends that requiring a showing of intent will result in higher bids, but just the opposite is true. A rule allowing liability without proof of intentional wrongdoing will *increase* contractor bids. (Cf. HAB at pp. 4, 26, 49-50.) Under the rule Hayward advances, a public entity would have a significant incentive to dump on contractors every scrap of paper that may relate, even remotely, to a given project as a form of protection or "insurance" against a potential nondisclosure claim. This sort of incentive and overbroad disclosure is counterproductive in the context of public contracting. Overbroad disclosures will be more costly for contractors, who will have to sift through mounds of information to discern what is and is not important in preparing a bid. Many contractors may decide to forego bidding because of the burden of sifting through an unnecessarily large volume of information—an outcome harmful to the goal of encouraging competitive bidding. Those contractors who do participate in these circumstances will increase their bids because of the increased cost of sorting through large volumes of defensively disclosed information, i.e., higher bids with no obvious benefit to the public.

An intent standard, however, avoids this conundrum. A contractor who believes the risk is too great can decide not to bid or include contingencies in its bid, thereby protecting itself, and the public entity can decide whether to award the contract to the lowest responsible bidder or reject all bids. (See, e.g., Pub. Contract Code, § 20166.) Even if such contingencies marginally increase a project's cost, at least the public entity will be aware of the cost at the outset to complete the project and will be able to budget accordingly, rather than leaving the cost to strategic conduct by the contractor and the risks associated with any litigation. And the marginal cost increase to the public entity, if any, in the context of a

competitive bidding process will pale in comparison to the litigation costs that public entities will expend defending breach of implied warranty claims that would arise were there no intent standard.

It is important to note that the rule Hayward proposes would apply even to competitively bid contracts that must be awarded to the lowest responsible bidder. Most contracts for public works projects in California must be awarded to the lowest responsible bidder following competitive bidding. (See, e.g., Pub. Contract Code, § 20162.) So unless there is an exception to the competitive bidding statutes, the public entity has no choice but to accept the lowest bid. A strict liability standard for breach of implied warranty will turn the competitive bidding rules on their head and make the "lowest" bid illusory. A contractor who experiences cost overruns can simply make a public records request and scour the records for a single undisclosed fact that could serve as a hook for a nondisclosure claim. The public entity will then be faced with costly litigation without the prospect of disposing of the case early because, as Hayward concedes, the real issue will be "materiality," which is a question of fact. (HAB at pp. 41-44.) The contractor, through strategic conduct, will then have all the leverage over the public entity for additional money with little downside, all at the expense of the taxpaying public. This Court has previously made clear that rules like this that benefit only contractors at the expense of the public should be rejected. (*Amelco Electric v. City of Thousand Oaks* (2002) 27 Cal.4th 228, 239 [holding that the laws governing public construction contracts have been enacted and implemented "for the benefit of property holders and taxpayers, and not for the benefit or enrichment of bidders, and should be so construed and administered as to accomplish such purpose fairly and reasonably with sole reference to the public interest.], citation omitted.) An intent requirement in the context of alleged breach of

the implied warranty due to nondisclosure achieves the proper balance and is most consistent with sound public policy.

CONCLUSION

For these reasons, the School District respectfully requests that this Court reverse the Court of Appeal's decision.

Dated: April 1, 2009

Respectfully submitted,

Jones Day

By: _____
Elwood Lui

Attorneys for Plaintiff and Respondent
LOS ANGELES UNIFIED SCHOOL DISTRICT

CERTIFICATE OF COMPLIANCE

Counsel of Record hereby certifies, pursuant to Rule 8.520(c)(1) of the California Rules of Court, that the enclosed brief was produced using 13-point type, including footnotes, and contains approximately 7,363 words, which is less than the 8,400 words permitted by this Rule. Counsel relies on the word count of the computer program used to prepare this brief.

Dated: April 1, 2009

Respectfully submitted,

JONES DAY

By: _____
Elwood Lui

Counsel for Plaintiff and Respondent
LOS ANGELES UNIFIED SCHOOL DISTRICT

PROOF OF SERVICE BY MAIL

I am a citizen of the United States and employed in Los Angeles County, California. I am over the age of eighteen years and not a party to the within-entitled action. My business address is 555 South Flower Street, Fiftieth Floor, Los Angeles, California 90071-2300. I am readily familiar with this firm's practice for collection and processing of correspondence for mailing with the United States Postal Service. On April 1, 2009, I placed with this firm at the above address for deposit with the United States Postal Service a true and correct copy of the within document(s):

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I declare under penalty of perjury under the laws of the State of California that the above is true and correct.

Executed on April 1, 2009, at Los Angeles, California.

Susan Ballard

Susan C. Ballard

Service List

California Court of Appeal Second Appellate District Division 2 300 S. Spring Street, 2nd Floor, North Tower Los Angeles, CA 90013-1213	
Hon. Wendell Mortimer Los Angeles Superior Court Central Civil West Courthouse Division 307, Room 1402 600 S. Commonwealth Avenue Los Angeles, CA 90005	
John J. Immordino, Esq. Wilson, Elser, Moskowitz, Edelman & Dicker 555 S. Flower Street, Suite 2900 Los Angeles, CA 90071 213-624-3044 213-624-8060 (fax)	Attorney for Great American Ins. Co.
Joseph Miller, Esq. Monteleone & McCrory 725 S. Figueroa Street, Suite 3200 Los Angeles, CA 90017-5446 213-612-9900 213-612-9930 (fax)	Attorney for Hayward Construction Co., Inc.
Gregory M. Bergman, Esq. John P. Dacey, Esq. Jorge J. Luna, Esq. Bergman and Dacey, Inc. 10880 Wilshire Boulevard, Suite 900 Los Angeles, CA 90024-4101 310-470-6110	Attorney for Los Angeles Unified School District
Roberta M. Fesler, General Counsel Mark Fall, Esq. Los Angeles Unified School District 333 S. Beaudry Avenue 23rd Floor, Suite 194 Los Angeles, CA 90017 Tel: 213-241-4969 Fax: 213-241-8386	