September/October 2006

CONSTRUCTION LAW BRIEFING

IN THIS ISSUE

CIC

CASE, IBRAHIM & CLAUSS, LLP

ATTORNEYS AT LAW

www.ciclaw.com 714-540-3636 firm@ciclaw.com

Finish work promptly or face a financial loss

Many states have laws requiring general contractors to pay subcontractors promptly after receiving payment from the owner for the subcontractor's work. Failing to do so could trigger penalties in the form of interest and attorneys' fees on the delayed payments. Although this "prompt payment act" concept is simple in theory, it's often complicated and contentious in practice.

School's out

In *Jerry Bennett Masonry v. Crossland Construction*, the general contractor for a school in Jasper County, Mo., was facing significant completion delays. A number of factors caused the slowdowns, including weather, soil conditions, general contractor errors, subcontractors interfering with each other and the masonry subcontractor understaffing the project.

Eventually, the masonry subcontractor completed the masonry work and applied for release of its retention. The general contractor received the $67,057.50 retention from the owner but refused to release it to the subcontractor until resolution of the owner's liquidated damages claim arising from late completion of the school building.

The general contractor eventually settled the owner's claim by building, at no extra cost, a road and sidewalk on the school site. Meanwhile, the masonry subcontractor sued the general contractor under the Missouri version of the prompt payment act, seeking the retention amount of $67,057.50, plus 18% interest and attorneys' fees.

In response, the general contractor asked the court to deduct from the masonry subcontractor's prompt payment act claim the $33,496 cost of building the road and sidewalk for the owner.

No interest

The trial judge ruled that the general contractor was entitled to withhold the masonry subcontract retention only until the owner paid the amount to the general contractor.

The judge, however, denied the masonry company's claim for 18% interest and attorneys' fees under the prompt payment act. It stated that the mason's understaffing had contributed significantly to the completion delays, and, therefore, justified the general contractor withholding the mason's retention until the delay claims were resolved with the owner.

The trial judge also ruled that, because the mason had contributed substantially to the project delays, the general contractor was entitled to recover from the mason the $33,496 in road and sidewalk construction costs. The trial judge awarded to the mason a total of $33,561.50, the difference between the $67,057.50 masonry retention and the $33,496 cost of building the road and sidewalk.

Partial reversal of fortune

The mason appealed to the Missouri Court of Appeals, claiming that it was entitled to 18% interest and attorneys' fees under the prompt payment act, and that the general contractor wasn't entitled to set off its delay claim against the masonry retention amount.

What about the surety?

In *Jerry Bennett Masonry v. Crossland Construction* (see main article), the mason sued not only the general contractor for unpaid retention, but also the performance and payment bond surety for the same amount. Under general rules of construction contract bond law, the surety's liability would be identical to that of the general contractor, and the mason could collect from either the surety or the general.

But the terms of the Firemen's Fund bond on this project further complicated the lawsuit. In part, they stated: "With respect to Claimants, this obligation shall be null and void if the contractor promptly makes payment directly or indirectly, for all sums due."

The trial judge ruled that, under this provision, the surety would be liable only in the event the mason couldn't collect from the general contractor, and the appellate court agreed. So, under the terms of various laws and bond provisions, "prompt payment" may mean many different things.

The appeals court ruled that there was sufficient evidence to support the finding that the mason's understaffing of its work had, in fact, delayed the project. It affirmed the decision of the trial judge to allow the general contractor to offset the cost of the delay damage compromise with the owner — that is, the road and sidewalk construction — from the mason's retention amount.

The appellate court also agreed with the trial judge that there was "reasonable cause" under the prompt payment act for the general contractor to withhold the mason's retention until the delay damages were resolved and deny the claimed 18% interest and attorneys' fees.

The court, however, reversed the decision of the trial judge to deny interest on the mason's claim altogether. It ruled that the mason was owed 9% interest under the general Missouri statute providing for prejudgment interest on liquidated amounts due under contracts and sent the case back to the trial judge to add 9% interest to the net judgment of $33,561.50.

Mixed results

This case had mixed results — and important lessons — for both of the parties involved. The general contractor avoided the severe consequences of not making prompt payment to the subcontractor but received a costly reminder of its responsibility to pay the regular prejudgment interest due to a subcontractor. And the subcontractor learned that it must complete work promptly to preserve its payment rights. *T*

Warning: May require heavy lifting

Getting insurers to pay up is rarely easy

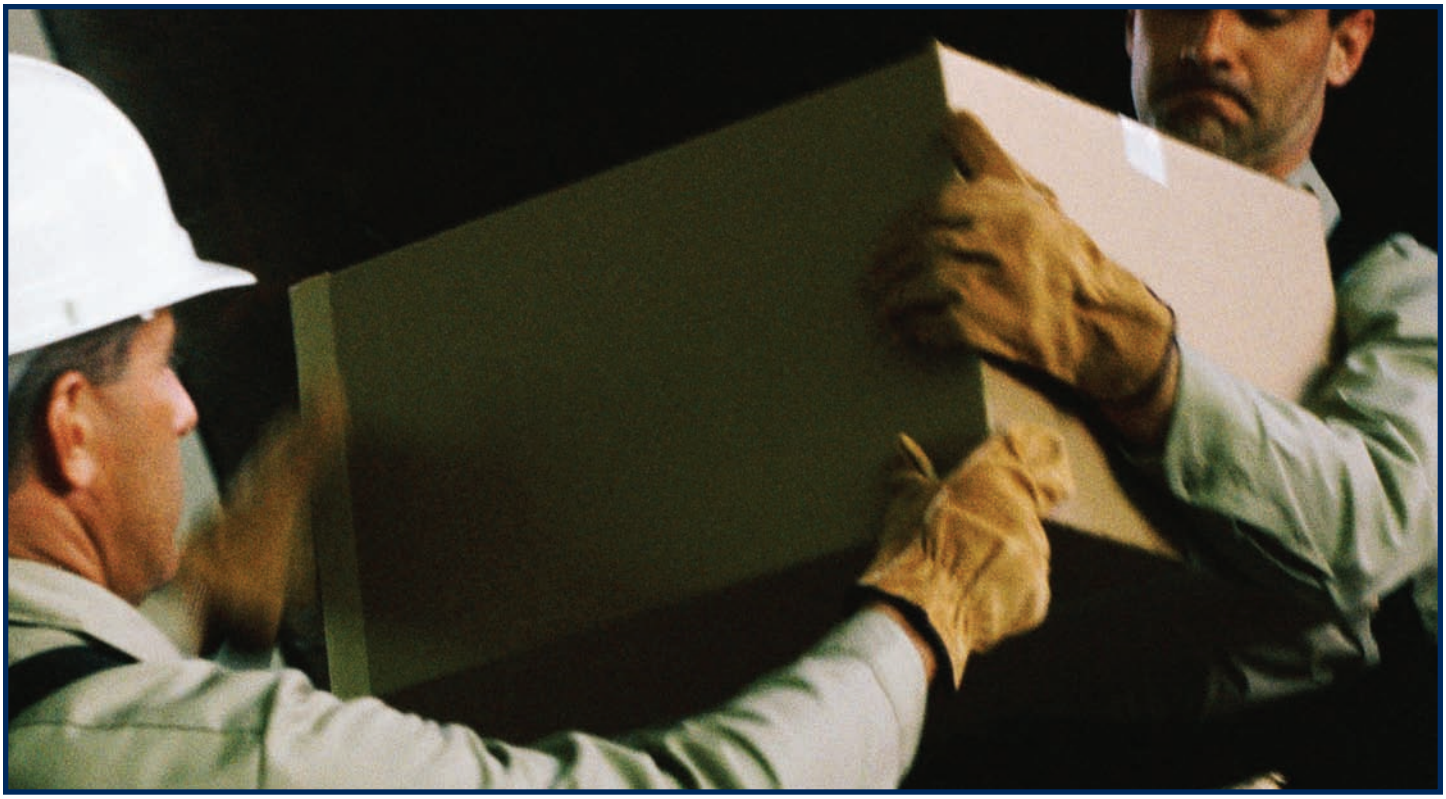
One of the most complex sets of legal relationships on a construction job is the one among the contracting parties and their respective insurance companies. Many innovations, such as owner-controlled or contractor-controlled "wrap up" insurance programs, have been devised in an effort to simplify and clarify coverage. But the litigation over insurance for construction projects never seems to end.

When there is a fire or other casualty on a job site, someone's insurance company will usually step up and pay the loss. Yet that's rarely the end of the story: Looking for ways to avoid paying for all of the damage, and assisted by battalions of lawyers on its payroll, the insurer will almost always look around for other parties (contractors, subcontractors, other insurance companies) to share in the misery.

Going from bad to worse

Case in point: *Allianz v. Structure Tone*, involving the explosion of a chiller turbine in the subbasement of a Manhattan office building. After the turbine blew up, the building owner hired a contractor to clean up the mess and replace the equipment. During the operation to dismantle the damaged equipment, a fire erupted in the area, damaging the subbasement further.

Allianz, the owner's property insurance company, paid the fire loss but then sued the repair contractor and its dismantling subcontractor to recover the $1.45 million it had paid to the building owner. The



contractors sought summary judgment dismissing the case on the grounds of a waiver of subrogation provision in the repair contractor's contract with the building owner.

Allianz opposed the motion for summary judgment, asserting that it wasn't a party to the subrogation waiver and, therefore, couldn't be bound by the waiver clause. The federal court in the Southern District of New York thoughtfully examined the long and involved history of construction contract waiver of subrogation provisions and ultimately refused the arguments advanced by Allianz and dismissed the case against the contractors.

Ensuring the insurance

In developing and revising its form construction contract agreements, the American Institute of Architects (AIA) has assiduously tracked and responded to court decisions like this one. Its intent has always been:

- ✓ To make sure, insofar as possible, that a construction site casualty loss ends up on the books of the insurer that has received a premium for covering the loss, and
- ✓ To minimize the attorneys' fees and litigation expenses arising from efforts to shift the loss from one insurance company to another — or to an uninsured contractor, subcontractor or owner.

For instance, the version of the AIA form contract involved in this dispute included the following language: "A waiver of subrogation shall be effective as to a person or entity even though that person or entity would otherwise have a duty of indemnification, contractual or otherwise ... ."

The federal judge determined that these words were clearly intended to quash the efforts of any insurance company that is paid premiums for underwriting construction site risks to offset the losses they're paid to cover.

The American Institute of Architects (AIA) has assiduously tracked and responded to court decisions like this one.

Footing the bill

Typical construction contract documents have been revised over the years to try to ensure that the insurer receiving a premium for underwriting a particular risk ultimately bears that risk and pays the loss. An astute construction attorney can review the pertinent language and help ensure that the contractor involved won't end up footing the bill should an insurer attempt to sidestep its responsibility.

You are going to sue *me*? I don't think so ...

A Wisconsin couple contracted with Groveland Craftsman to build them a new house. Groveland in turn hired subcontractors to apply stucco to the exterior and to put on the roof.

Unfortunately, stucco and roof defects allowed water penetration that caused deterioration of interior finishes, mold growth and bad indoor air quality in the finished home. As you might imagine, the case went to court soon after.

Soggy business

In *Linden v. Cascade Stone*, the couple sued the general contractor, the stucco subcontractor and the roofer for the damages suffered as a result of the water penetrations. While allowing the couple to proceed against the general contractor, the trial judge granted summary judgment dismissing the stucco and roofing subcontractors from the case.

The judge reasoned that "at its core, the [couple's] complaint is that the house they received is not the house for which they contracted," and that under the "economic loss doctrine," which states that recovery for purely economic loss must come under a contract and not under a negligence claim, the couple had no claim against either the roofer or the stucco subcontractor.

Tough break

The couple appealed all the way to the Wisconsin Supreme Court, which agreed with the ruling against them. It decided that "allowing [the couple] to maintain a tort action against the subcontractors harms [the couple's] and [the general contractor's] freedom of contract, because permitting [the couple] to maintain a tort claim would get around the warranties and remedies they had already bargained for with [the general contractor]."

The ruling in this case is no particular surprise, as it follows the development of the "economic loss doctrine" in many other jurisdictions. What is remarkable is the dissent, which points out that the result goes against common sense and will preclude Wisconsin homebuyers from ever suing the subcontractors who are directly responsible for defects in their new houses.

> *Common sense would dictate that a property owner should be able to directly go after the party immediately responsible for damage to a construction project that the owner has paid for.*

In her dissent, Wisconsin Supreme Court Justice Ann Bradley points directly to this hardship:

> In theory, if homeowners want to protect themselves against the possibility that the general contractor may be financially unable to remedy shoddy work done by subcontractors, they can seek to obtain contract warranties directly from each subcontractor. In practice, however, this approach is problematic because homeowners often do not know beforehand with whom the general contractor will be subcontracting. They may not be able to find out this information because the general contractors themselves may not yet know.

Common sense would dictate that a property owner, whether an unsophisticated homebuyer or an experienced commercial property developer, should be able to directly go after the party immediately responsible for damage to a construction project that the owner has paid for. Yet the law in most states provides otherwise.

Expert advice

The decision of the Wisconsin Supreme Court clearly favors contractors, but no party should enter into even the smallest home construction or remodeling project without the consideration and expert advice of an experienced construction lawyer. He or she can help generate a contract that is equitable and clear for all involved.

The ugly truth: Aesthetics and arbitration may not mix

A South Dakota public school district contracted to have an addition built onto an elementary school. Ready for anything, the district's construction contract contained an alternative dispute resolution clause, calling for mediation and then arbitration of "any claim arising out of or related to the Contract, except Claims relating to aesthetic effect ... ." With those last four words in mind, you might guess what happened next.

We are not pleased

After the addition was completed, the school district was unhappy with the appearance of the cement masonry block walls — especially in the gymnasium and in the hallways where the new addition met the older building. The president of the school board complained that the new walls included uneven texture variations, chipped blocks, surface holes, patches and other apparent attempts to cover up defects.

He also noted the use of two different qualities of block in the gym walls, creating an inconsistent and ugly appearance significantly inferior to the original building. The school board hired an expert to recommend repairs, who called for tuck-pointing, painting and installing alternative wall surfaces.

The court is not moved

In *Flandreau Public School District v. G. A. Johnson Construction*, the school district sought to recover the cost of the recommended repairs, and the contractor asked the court to compel arbitration under the alternative dispute resolution clause of the contract. The trial judge denied the motion to compel arbitration, and the contractor appealed to the South Dakota Supreme Court.

The contractor argued that the case should be sent to arbitration, where the arbitrator could decide whether the "aesthetic effect" exception to the arbitration clause was applicable. That court ruled that, unless the contracting parties have expressly provided for an arbitrator to determine whether a conflict is subject to arbitration, a judge should decide whether a particular controversy is covered by a contractual arbitration clause.

Streamlining isn't always simple

The South Dakota Supreme Court's decision provides a detailed analysis of when arbitration should be compelled and who should decide whether the parties have agreed to arbitrate a particular dispute.

It also points out that parties to a construction contract may believe they have simplified and streamlined their dealings during the project by inserting an arbitration clause into their contract. But the very streamlining desired through use of arbitration can be defeated by a lengthy trip through the courts in an effort to get a decision on whether the dispute in question is subject to arbitration in the first place.

Looks can be deceiving

Any party to a construction contract — be it owner, general contractor or subcontractor — may think the agreement completely spells out the course of action to be taken under any circumstances. But looks can be deceiving, and the last thing one expects to happen can occur with alarming frequency. This is why competent legal advice should play a role in each and every project.

"Illegal" is a relative term when it comes to military contracts

Congressional appropriations for military construction require specific approval from Congress, while expenditures for operations and maintenance of existing military facilities don't need line item consent.

What happens when operations and maintenance budget funds are improperly used to pay for construction of military facilities without the line item approval of Congress? You might think the federal government would be prohibited from enforcing the illegal construction contract — but you'd be wrong!

An improper payment

In *United Pacific Insurance v. United States*, the government entered into a $3.1 million contract with Castle Abatement to renovate three buildings at McGuire Air Force Base in New Jersey. Although it had collected most of the contract price, Castle had failed to complete the work. So the government called on its Miller Act surety, United Pacific Insurance, to finish the project. United Pacific hired another contractor to finish the job at a cost of more than $2.9 million of its own money.

In the course of arranging to complete the project, United Pacific discovered that the job had been improperly paid for out of the military operations and maintenance budget when it should have been funded with a specific Congressional appropriation.

United Pacific sued the government in the Federal Court of Claims, asserting that it would not have issued a bond on the Castle contract if it had known the contract was illegal. It claimed that the government should pay for all the $2.9 million worth of work performed at United Pacific's expense for finishing the illegal contract.

The Federal Court of Claims decided that, though the contract and United Pacific's Miller Act bond were made by the government in violation of the laws controlling appropriations for military construction, the government could still enforce the contract and bond against United Pacific. More important, United Pacific couldn't get out of the completed deal even though it was illegal from the beginning.

The public trust

The court reasoned that the appropriations laws were intended to protect the public treasury and not the contractors and bonding companies that might enter into illegal military construction projects. Allowing United Pacific to collect an additional $2.9 million from the government would harm, rather than protect, the interests that the appropriations laws were intended to favor.