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CONSTRUCTION LAW BRIEFING

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A question of cake

Can an owner recover costs of completion not actually incurred?

Owners dissatisfied with the pace or quality of work on their projects sometimes, in frustration, terminate the contractor and sue for estimated "costs of completion" while occupying or selling off the property. In other words, the owner seeks to have its cake and eat it, too. The courts, however, have had their say on these gustatory intentions.

Grist for the mill

Case in point: *Braun v. Agri Systems*, in which Coast Grain Company contracted with Agri Systems on March 1, 2000, to build a dairy feed mill in Madera County, Calif., for $8,543,000. The contract called for completion within 365 days after notice to proceed.

During the work, Coast Grain fell behind in payments, and Agri Systems suspended work when the unpaid balance passed the million dollar mark. The parties canceled the March contract on Oct. 14, 2001, and Coast Grain paid a down payment of $500,000 toward completion of the work and acknowledged the balance due with 12% interest under the earlier contract.

Then, on Nov. 28, 2001, Coast Grain filed for bankruptcy. Agri Systems notified Coast Grain that the feed mill was finished on May 6, 2002. Coast Grain's bankruptcy trustee started up the feed mill in August 2002 and demonstrated its operation to potential buyers from the Coast Grain bankruptcy estate. Between May 2002 and June 2003, the bankruptcy trustee spent $500,000 to complete punch list work and make the feed mill operational for potential buyers, and on June 20, 2003, the mill was sold by the trustee to Pacific Ethanol for $5.1 million.

Back and forth

Not content with the recovery of the sale price, the bankruptcy trustee sued Agri Systems for breach of the feed mill construction contracts, seeking to recover more than $2.6 million in damages because of the claimed failure of the feed mill to "meet all plans, specifications, reasonable industry standards, building codes and OSHA requirements."

Agri Systems filed a motion seeking to prevent the trustee from introducing evidence of any completion costs that the trustee hadn't actually paid out, arguing that the trustee should be permitted to recover only "expenses it actually incurred in the repair of construction defects or the completion of work that was Agri Systems' responsibility but not completed by them."

Work slows, suit filed: Another "costs of completion" case

Does the "have your cake and eat it, too" concept (see main article) play out similarly in trailer parks in Connecticut as it does in grain mills in California? The case of *Pasqualin v. Northeast Home Improvement* holds the answer.

Judy Pasqualin owned a house trailer in New London, Conn. She hired Northeast Home Improvement to build her a deck with sliding glass doors for $15,890. When the project was 75% complete, she decided that the contractor had taken longer than she thought it should have and the deck wasn't as nice as she'd expected. Her lawyer sent a letter terminating the contract.

Pasqualin then sued her contractor for the estimated costs of completing the deck and sliding doors. She even produced a witness to testify to the estimated costs of completing the project, though, at the time of trial, she had done nothing about having the work finished. Northeast Home Improvement filed a counterclaim, contending the termination was in breach of the contract and seeking to recover the full price. Both parties wanted their cake!

The Connecticut Superior Court found that, because the project was 75% complete, Northeast Home Improvement was entitled to recover 75% of the contract price less the amount already paid. And as Pasqualin hadn't actually spent anything at all toward completion of the work, she was allowed no recovery at all.

In the end of what must have been costly litigation under the circumstances, Pasqualin had no deck, and Northeast Home Improvement recovered a judgment for the paltry sum of $1,324.18. No cake for anyone!

The bankruptcy trustee objected to the limitation on damage evidence sought by Agri Systems, arguing that the bankruptcy estate should be able to recover "the amount it would have to have expended, but did not expend, in order to realize the benefit of its bargain to a Project free of construction defects."

The court's decision

The U.S. District Court for the Eastern District of Columbia observed that damages in construction claims are usually measured by the difference between the value of the project as specified and its value as actually built.

Costs of repairing construction defects in the project are the proper measure of damages only if the repair cost is less than the difference between the as-built value and the as-specified value of the finished project. The judge observed that the trustee sold the project to Pacific Ethanol "as is, without recourse," having rejected higher priced purchase offers with less appealing conditions.

The court found no evidence that the sale price of less than the cost of construction was the result of anything other than changed dairy feed market conditions in the vicinity of the property. The judge ruled that the sale of the property by the trustee "establishes conclusively that [the trustee] will not spend an award for cost of repairs on repairs."

A limited recovery

In this case, mindful of the "have your cake and eat it, too" nature of the damage evidence the trustee sought to introduce, the judge sided with Agri Systems and prohibited the introduction into evidence of any repair costs not actually incurred by the trustee.

Indeed, a number of recent court decisions have discouraged the practice of an owner suing for costs of completion. Generally, they've limited the owner's recovery to costs actually spent in completing the work rather than the estimated cost of bringing the project as it exists up to the contract specifications.

Construction conglomerates renovate legal playing field

Recent consolidation trends in the construction industry are leading to ownership of local operating companies by conglomerate holding companies located out of state and incorporated in Delaware or New York. How much legal significance does this have should a dispute arise between a contractor and a locally situated owner or developer? Plenty.

A shell game

Consider a recent situation in Florida, in which Development Corporation of Palm Beach contracted with Willard Brothers Construction to construct a large number of shell homes in Palm Beach County.

During the project, through a series of complex corporate transactions, Willard Brothers was transformed into a subsidiary of a subsidiary of Building Materials Holding Corporation, which was located in California and incorporated in Delaware. This left only a thinly capitalized operating company called WBC Construction in Florida and all cash and other assets in California.

Consequently, when WBC failed to complete the shell homes contracted for, Development Corporation of Palm Beach sued not only Willard Brothers and WBC, but also Building Materials Holding Corporation, because it was the only defendant with substantial assets that might satisfy any judgment.

The Florida Appellate Court, however, ruled that Florida courts had no jurisdiction over Building Materials Holding Corporation, because it wasn't doing business in Florida.

More holding companies

Even today's larger family-owned construction businesses are evolving corporate structures using holding companies to own major assets, while local, state-by-state limited liability company subsidiaries employ construction labor and enter into contracts with owners and developers.

These companies have seized on this sort of ruling to protect themselves from liability should a local operating company fail to live up to its promises. And many owners and developers have responded by asking bidders to include a "consolidated" financial statement of the parent company as evidence of financial capability to handle the project.

The owners and developers are insisting on seeing the CPA's consolidation worksheets behind the statements to determine whether the assets reflected on the financials are owned by the construction business that will sign the contract or by some out-of-state and hard-to-reach parent holding company that may not be very responsive should problems develop.

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2 options for owners

If most of the assets are held in the name of the parent, there are two choices available to the owner or developer for protecting itself in the event the local contracting entity should fail to perform as promised:

1. A performance and payment bond. While bonding may add 2% or 3% to the overall cost of a project, it does provide demonstrable financial resources that will be more readily available in the event big problems are encountered on the job.

2. A parent guaranty. This is a legal document in which the parent holding company financially guarantees completion of the job should its local operating subsidiary fail to complete performance.

For owners and developers, the time to negotiate a parent guaranty is when the local operating bidder submits its parent's consolidated financial statements as evidence of economic strength. After all, if the bidder expects the developer to rely on the parent's financial capacity, it's only fair for the parent to put itself in a position to respond directly should the local operating company go belly up.

Fewer surprises

As holds true for any business relationship, the more the parties to a construction contract know about the other, the fewer surprises will arise if a dispute develops. Construction companies, large or small, should seek competent legal advice to ensure their interests are protected.

Similarly, owners and developers signing a construction contract with a company whose name is different from the name on the financials submitted by the bidder need to do some research into whom they're dealing with, and consult an attorney for advice on whether they should obtain a surety bond or parent guaranty.

Go fly a kite — and you might go to jail

When is your money not your money? When you're in the construction business and behind bars. At least that seems to be the lesson of one recent case.

Playing chicken

In *State of Louisiana v. Spears*, contractor Jack Spears entered into a contract with Karen and Richard Kirkham to build two turnkey chicken houses on the Kirkhams' poultry farm in Choudrant, La., for $196,000. Spears walked off the job after drawing $176,000 of the contract price.

Spears' abrupt departure from the job was followed closely by the recording of six mechanics' liens amounting to $47,000 against the project and the Kirkhams' poultry farm. The Kirkhams had to borrow an additional $50,000 to complete the construction with other contractors.

Louisiana, like many states, has a law against general contractors failing to apply contract proceeds to settle claims for material and labor on their projects. The Kirkhams, understandably upset by the economic setbacks caused when Spears walked off their job leaving subcontractors and suppliers unpaid, pressed criminal charges against him, resulting in his arrest.

Referring to the ridiculous

When the case went to court, a jury convicted Spears of misapplication of payments under the Louisiana statute. His initial appeal reversed the conviction, but the prosecutors appealed to the Louisiana Supreme Court.

It determined that there was sufficient evidence to prove that Spears had knowingly failed to apply the money he'd received from the Kirkhams to the completion of their chicken houses, based on Spears' response to their letter stating that "… if he would simply finish the job, there would be no legal repercussions."

The court reasoned that Spears' statement that the letter was "ridiculous," accompanied by clear evidence that Spears had misapplied as much as two thirds of the cash the Kirkhams had paid him, was sufficient proof he'd acted knowingly. It reinstated the conviction.

Paying Paul (the wrong way)

The practice of using payments from one owner to fund the labor and materials used on a project for a different owner, known as "kiting funds," is a dangerous one for more reasons than the economic jeopardy to the contractor's business.

> *A general contractor that's on the ropes financially must not succumb to the temptation to rob Peter to pay Paul.*

Although it's generally true that a business receiving payment from a customer is entitled to use the money it gets as its own, in any way it sees fit, this general principle has exceptions in the construction industry.

As this case emphatically demonstrates, a general contractor that's on the ropes financially must not succumb to the temptation to rob Peter to pay Paul. Theft is a crime and carries criminal penalties — even if the payment from the customer was due the contractor and no force or other improper conduct was used to collect it.

Avoiding the hoosegow

What a construction company does with the money it receives in payment is just as important as how it got the money in the first place. For contractors, the only honest and safe practice is to follow the detailed application of funds shown on the contract.

That is, they should pay for the labor and materials on a particular customer's project *before* applying any fee or profit to any use on other projects or for other business purposes. Doing anything else can literally land one in jail.

When it comes to mechanics' liens, the devil is in the details

When contractors have disputes with owners, recording a notice of mechanics' lien may be the only effective remedy they can pursue to get paid for their work. Yet many construction company owners fail to realize the danger they invite by improperly recording a mechanics' lien.

Before recording a lien, contractors need to make sure they've meticulously laid the foundation for a proper lien claim. Otherwise, any hopes of successfully recording the notice could come crashing to the ground and end up costing them dearly.

Additional problems

This very issue came to the fore in *Fahey v. Senterline Construction*. Soon after Senterline Construction agreed to build an addition onto Patricia Fahey's house for $39,561, the relationship between builder and owner became contentious. Eventually, Senterline demanded final payment before the work was finished.

When Fahey refused to pay the last $9,535.93 Senterline claimed, the contractor walked off the job, leaving some work that had to be corrected before the local building inspectors would approve the addition for occupancy. Fahey notified Senterline that her contract with Senterline was terminated, and Senterline countered with a mechanics' lien notice for the claimed balance.

Fahey, in turn, sued Senterline for the $10,954.48 cost of completing the project and correcting defective work, and Senterline counterclaimed for the contract balance of $9,535.93.

Missing items

The Connecticut Superior Court found that Senterline's contract was unenforceable because it didn't have a start date or end date, and the company had delivered no signed copy to Fahey. It therefore denied Senterline's claim for the contract balance.

The court went on to rule that, because Senterline's lien notice wasn't enforceable, Fahey was entitled to recover her attorneys' fees, amounting to an additional $11,540. So an angrily recorded lien notice for less than $10,000 ended up costing Senterline more than $20,000.

Compliance considerations

Most states follow the rule that mechanics' liens are "in derogation of the common law." Therefore, successfully filing such a claim requires strict compliance with all terms of the pertinent statute. This alone is reason to consult an experienced attorney before putting such a notice on the public record.

The lesson in our little morality play from Connecticut, however, is broader than that. A construction company's lawyer also needs to periodically review its business practices to ensure they're up to date and in compliance with all applicable laws and rules.

Without such review, a contracting firm with outdated business practices might innocently seek to protect its claims against an intransigent owner, only to find itself exposed to liability for more than twice the amount it was seeking to collect.

A basic need

Murphy's Law of "if anything can go wrong, it will" is, unfortunately, a governing principle of many construction projects. It naturally follows, then, that expert legal advice is a basic need of every contractor.

Does insurance cover plain old bad work?

If a building falls down after it's occupied because of a defective foundation, the contractor's completed operations insurance will cover the loss. But what happens if the building has to be torn down and rebuilt before occupancy because of that defective foundation?

This was the question that eventually arose in *Fortney & Weygandt v. American Manufacturers Mutual Insurance*, after Fortney & Weygandt contracted with Frisch's Restaurants to build a Golden Corral eatery in Canton, Ohio.

From foundation to litigation

When the building was nearly complete, yet still unoccupied, the foundation shifted and underground utilities became disconnected. Upon inspection, the owner determined that the foundation design was defective, and the brand new restaurant was demolished and rebuilt. Not surprisingly, lawsuits involving the owner, contractor and architect soon followed, each blaming the others for the loss.

To make matters worse, Fortney's insurers refused to defend or indemnify Fortney in any of the litigation and arbitration cases. So Fortney sued the insurance companies, seeking a declaration from the court that it was entitled to coverage under the insurance policies because the completed operations coverage was in effect once the building had been finished.

No insurance available

The court disagreed, ruling that, because the restaurant was never put into service before demolition and rebuilding, there was no "completed operation" to be covered.

Furthermore, it stated that policy exclusions for damage to "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it" meant there was no insurance available to defend the claims or pay the loss.

Only quality ensures protection

No insurance company will sell a policy insuring a contractor against its own work that doesn't meet plans and specifications. A performance and payment bond protects the owner against incomplete or incorrect work, but, if the bonding company pays a claim to the owner, the bonding company will sue the contractor to recover the claim amount.

Thus, the only true protection against getting sued for not living up to the plans and specifications is to follow them.