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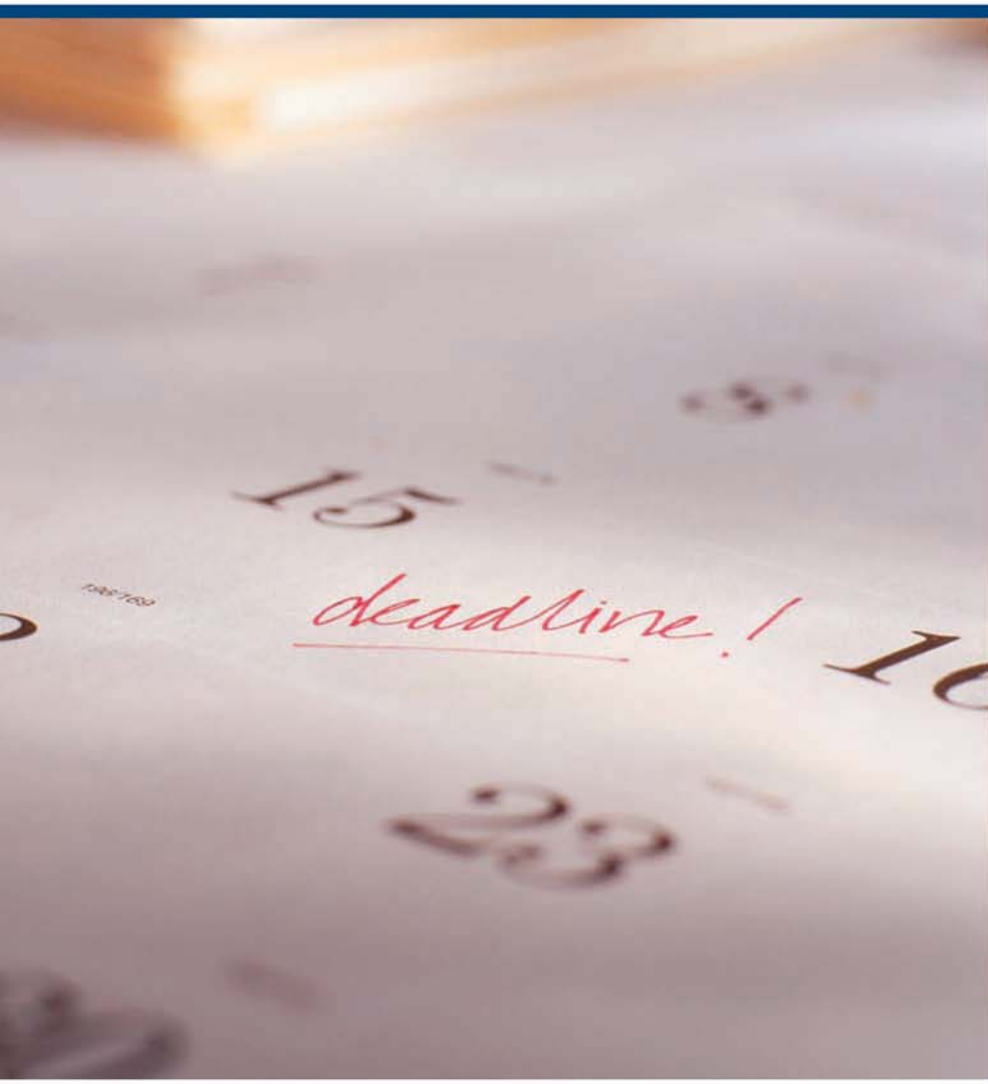
CONSTRUCTION LAW BRIEFING



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CIC

CASE, IBRAHIM & CLAUSS, LLP

ATTORNEYS AT LAW

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

A schedule's a schedule

Abiding by a recovery schedule is key to preserving legal rights

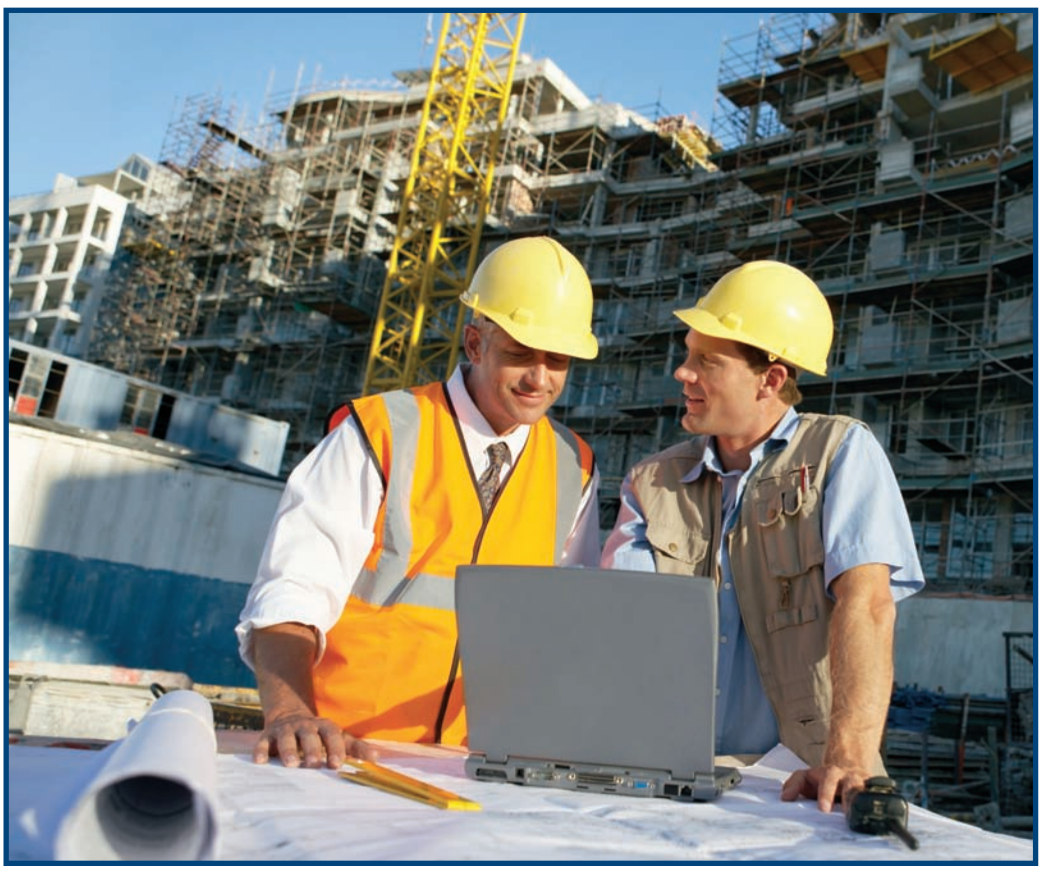
No matter what you're building, a schedule's a schedule. A recent case involving household names such as McDonnell Douglas, General Dynamics and, last but not least, the U.S. Navy provides ample evidence of this.

More specifically, *McDonnell Douglas v. United States* illustrates the ways in which a court can use a recovery schedule to justify early default termination of even the biggest of contracts.

Creating a stealth fighter

In 1988, the Navy contracted with McDonnell Douglas and General Dynamics for the design, development and production of a new aircraft-carrier-based stealth fighter.

The initial contract called for delivery and first flight of the first prototype airframe in June 1990, and delivery of seven progressively more fully developed and armed prototypes each month through January 1991. Thereafter, production aircraft would be manufactured and delivered in lots as the Navy deemed necessary.



The target price for development and delivery of the eight prototypes was $4.38 billion. The Navy would pay 40% of any overtarget costs, up to a ceiling of $4.77 billion. The contractors would pay the other 60% up to the ceiling and then all costs above that ceiling. Final payment was to occur by Nov. 1, 1992.

The contractors refused to sign off on a recovery schedule unless the Navy sought presidential relief from the contract's price terms.

Recognizing delays in the design process of the new aircraft, the Navy tried to negotiate a new schedule for prototype delivery with the contractors. The contractors, however, refused to sign off on a recovery schedule unless the Navy sought presidential relief from the contract's price terms, on which, by then, the contractors expected a $2 billion loss.

In August 1990, the Navy unilaterally issued a recovery schedule, calling for first flight on Dec. 1, 1991, and the delivery of the seven remaining prototypes every other month through February 1993. Design of the aircraft was approved by the parties in November 1990.

Granting an award …

Unfortunately, manufacturing the composite fuselage parts turned out to be more complex and difficult than

Same court, same result: A more construction-specific example

The same Federal Court of Claims that ruled against the Navy's stealth fighter contractors in *McDonnell Douglas v. United States* (see main article) used the same reasoning to deny recovery to the contractor in a similar, but more construction-specific, case.

In *Aptus Co. v. United States,* the contractor was terminated for defaulting on a federal contract to rebuild five units of the Sault Ste. Marie hydroelectric power generating station in Michigan. Noting the contractor's failure to achieve the deadlines set out in successive recovery schedules, which in this case the construction company itself submitted, the court ruled:

> Such extensive inability to conform to [its] own schedule is a clear indication that [the contractor's] work under the contract was simply failing to progress at the rate [the contractor itself] believed it should.

The moral? A contractor should never submit a recovery schedule merely telling an owner what it wants to hear. Failure to live up to a recovery schedule can, in and of itself, be grounds for a default termination.

expected. In response, the contractors began to cut costs by eliminating overtime and taking 110 employees off the project. On Dec. 17, 1990, the Navy issued a notice to cure.

Following an intense review of the project's status by the Department of Defense, the Navy terminated the contract for default on Jan. 7, 1991, asserting that the contractors lacked the ability to complete the contract within the schedule.

McDonnell Douglas and General Dynamics sued, seeking to convert the default termination to a termination for convenience. Initially, the Court of Claims agreed with the contractors and awarded them over $1.2 billion in termination costs.

… and then taking it away

After a series of appeals and new trials, however, the Court of Claims determined that the Navy's contracting officer's default termination had, in fact, been correct.

In its May 2007 opinion, the Court of Claims reviewed the requirements an owner needs to meet for early default termination of a contract for lack of progress. The court acknowledged the high standard of demonstrating that "there was no reasonable likelihood that the contractors could perform the entire contract effort within the time remaining for contract performance."

Yet the court faulted the contractors for refusing to discuss a mutually agreeable recovery schedule without presidential extraordinary relief from the contract's fixed price. Moreover, it determined that the Navy's unilateral recovery schedule was reasonable and enforceable.

The Court of Claims then reviewed a series of internal company memoranda in which contractor managers asserted that the first flight prototype wouldn't be delivered on schedule and, further, that production of airframe parts for the remaining seven prototypes also wouldn't be finished according to the schedule. The court observed:

> The law does not require the Government to help "fix the contract." The Government can point to reasons in retrospect why [the contractors] were not making the progress that some officials hoped and perhaps expected. So long as those reasons form a rational basis for a reviewing court to uphold [the] decision to terminate, the court must do so.

In the end, the court took away the entire $1.2 billion award from the contractors.

Facing the facts

When lack of scheduled progress becomes a source of friction between owner and contractor, courts tend to be reluctant to permit default termination of a contract that could perhaps be completed under the agreement.

Thus, a contractor facing a recovery schedule should review it carefully with its legal counsel and, assuming the schedule is reasonable, be prepared to abide by it. As this case shows, the new schedule can be used in court to justify early default termination of the contract.

Who pays for transportation to and from the job site?

In order to meet their parking obligations to workers in congested or remote areas, contractors may provide parking at a spot distant from the project location and give the workers free transportation from the parking lot to the job. Seems simple enough — until litigation arises over when the clock goes on and off for workers riding the company-provided transportation. Such was the circumstance in *Burnside v. Kiewit Pacific.*

From here to there

Kiewit Pacific Corp. required its fiber optic workers to assemble at the material yard each day, receive their assignments for the shift and pick up the required materials for installation. After the materials and the crews were loaded into company vans, they were driven to the job site, where the workers punched in.

Workers claimed a total of more than $16 million in overtime travel pay during the four-year duration of the two jobs in question.

At the end of the shift, workers punched out at the construction site and were driven back to the material yard where their cars were parked. The justification for these requirements was the absence of sufficient worker parking within 350 yards of the job site, as required by the union contract.

And from one court to another

A class action was filed in California on behalf of 271 Kiewit workers who claimed a total of more than $16 million in overtime travel pay during the four-year duration of the two jobs in question.

Kiewit removed the lawsuit to federal court, contending that the parking and travel time issues were covered by the union collective bargaining contract and, therefore, California law was preempted by the federal Labor Management Relations Act. The federal trial judge agreed, rejecting the workers' overtime travel

pay claims, and entered a summary judgment in favor of Kiewit.

On appeal, however, the U.S. Court of Appeals for the Ninth Circuit reversed, directing the federal judge to send the case back to the state court in California, which had ruled against employers in similar cases. The Court of Appeals ruled that no interpretation of the union contract was involved, because the workers' claim should be determined entirely based on California wage and hour laws.

Kiewit initially thought it had made a successful end run around the California statute that would have required $16 million in overtime travel pay for the installers on the two particular projects. Yet, following the appeal, it would be a worker-friendly California state court, rather than the employer-friendly federal court, that ultimately decided the dispute.

The high cost of travel

State-specific laws often require construction companies to pay wages for the time it takes workers to ride from employer-provided parking locations to job sites and back again. Thus, when bidding jobs in any congested or remote area, contractors must not only check out the parking situation — and include in their estimates the cost of parking or that of any employer-provided transportation that may be required under a collective bargaining agreement — but also consider the labor costs for the transportation time between parking lot and job site.

Arbitration case turns on two magic words: "Change order"

Arbitration provisions are typically part of the boilerplate "front end" documents of a construction agreement. Unfortunately, many contractors and subcontractors fail to carefully review these provisions before preparing project estimates.

Yet it's critical for contracting parties to be aware of whether such provisions are included in the documents and to conduct themselves accordingly throughout bidding or price negotiations as well as during performance of the work. A recent case involving the famed West Point military academy, *U.S. ex. rel. Mathusek Inc. v. J. Kokolakis Contracting,* shows just how important arbitration provisions can be.

A gym for the cadets

J. Kokolakis Contracting was awarded a contract to build a new gym for West Point cadets. Kokolakis hired Mathusek Inc. to install the gym floor for $285,000. The Kokolakis/Mathusek subcontract had a broad arbitration clause, permitting Kokolakis, in its sole discretion, to require arbitration of "any dispute between Contractor and Subcontractor."

During the project, the concrete subfloor poured by Kokolakis wasn't level, so Kokolakis agreed to pay Mathusek time and materials for remedial work required before the wood floor subcontract could be performed. Mathusek leveled out the subfloor slab and completed installation of the wooden gym flooring.

Nonetheless, when Mathusek finished, Kokolakis refused to pay $36,956.36 billed for the subfloor leveling work. It also withheld $75,152.44 of the $285,000 for the wood floor installation.

When Mathusek sued Kokolakis and its Miller Act surety for the more than $100,000 of unpaid invoices on the remedial work and the floor installation, Kokolakis demanded arbitration of the entire claim. Mathusek argued against arbitration, asserting that the remedial work was under a separate agreement, which had no arbitration provisions.

A decision for the court

In considering the Kokolakis arbitration demand, the U.S. District Court for the Southern District of New York reviewed the public policy favoring arbitration reflected in the Federal Arbitration Act, which expressly requires all federal courts to enforce contractual arbitration provisions.

While the court was willing to consider Mathusek's argument that the remedial work was performed under a separate agreement not requiring arbitration, the judge noted that all the Mathusek invoices for remedial work were labeled "change orders."

This designation, the judge reasoned, embodied the understanding of both parties that the remedial work was not separate from — but, rather, an addition of scope to — the original subcontract. The judge ordered the parties to arbitrate their entire controversy.

A matter of policy

Courts tend to favor the use of arbitration as a matter of policy and generally will order arbitration if they can find any reasonable interpretation of the situation requiring it. Arbitration, after all, lightens the workload of the judge. And, often, this can be a good thing for contractors.

If the particular nature of a prospective project, or of the other party, would make arbitration inadvisable from a contractor's point of view, however, an experienced construction attorney can help review the contract documents before they're signed to determine whether any provisions could be used to compel arbitration against the contractor's best interests.

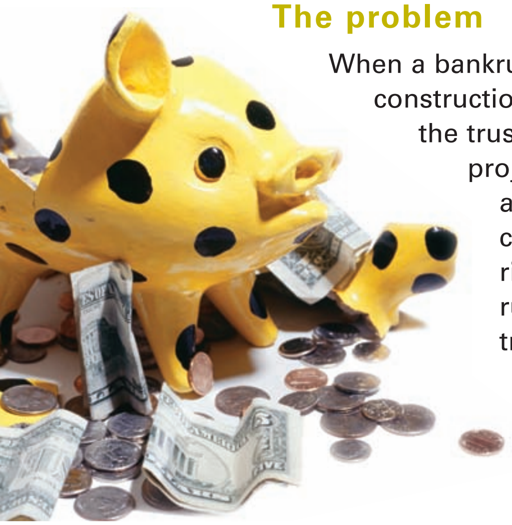
Separate identities

"Trust fund" conflicts often complicate the bankruptcy process

Several states have laws on the books stipulating that a general contractor who receives an owner payment must hold the money in trust for the subcontractors and suppliers who provided labor and materials on the project. This way, if the general contractor goes bankrupt, the subcontractors and suppliers have a claim on the money before the bankrupt contractor's general creditors can get at it.

Under the right (read: wrong) circumstances, however, these superior rights of the "trust fund" beneficiaries can be lost. Such was the dilemma addressed in the case of *In re R. W. Leet Electric.*

The problem



When a bankruptcy involving a construction company occurs, the trust fund rights of a project's subcontractors and suppliers often conflict with the rights of the bankruptcy trustee, who's trying to recover all payments made during the last 90 days before bankruptcy.

The problem originates when a general contractor deposits an owner's payment into a bank account containing payments received from other projects and then uses the money in that account to cover both its own bills, such as for labor and overhead costs, and the payments it owes to subcontractors and suppliers.

Because most general contractors don't maintain segregated bank accounts for each construction job, owner payments from multiple projects are all too often mixed up within a single account in this manner. The problem then crystallizes when the balance of the single account falls below the total trust fund payments received — sometimes before a check to a particular supplier or subcontractor is cut.

Even when money from borrowings or other sources is deposited to cover the check issued to the subcontractor or supplier, if the contractor files bankruptcy within 90 days after issuing the check, a bankruptcy trustee may be able to force that subcontractor or supplier to return the payment to the bankrupt estate.

Case in point

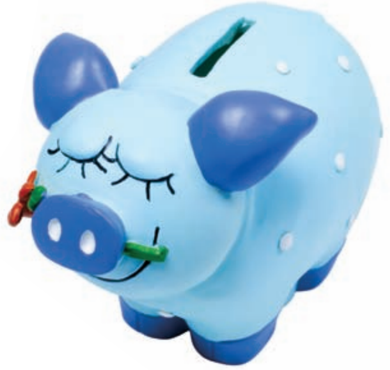
R. W. Leet Electric, a Michigan electrical contractor, filed bankruptcy on Sept. 6, 2002. During June, July and August 2002, Leet had made 14 payments totaling $321,878.49 to Kendall Electric for materials Kendall supplied to Leet for various Leet projects.

The payments arrived in the form of checks drawn on Leet's general bank account, into which payments from many different sources were deposited. During the time between the last payment to Leet on a project using Kendall materials and the payments to Kendall, the balance in the Leet general account dropped as low as $36,255.85.

Leet borrowed from its bank and made other deposits from non-Kendall projects to cover the $321,878.49 in checks written to Kendall. The bankruptcy court held, however, that only the "lowest intermediate balance" of $36,255.85 represented traceable "trust funds" paid to Leet on projects using Kendall-supplied materials.

Therefore, it ruled that Kendall would have to repay to the trustee all the remaining $285,622.64, unless Kendall could demonstrate that all or part of that money was paid to Leet by owners of projects using Kendall-supplied materials.

The solution



In circumstances where a general contractor is in financial difficulty, the only way subcontractors and suppliers can protect against this type of result is to insist that payments by owner check be payable jointly to the contractor and each separate subcontractor or supplier.

The general contractor endorses the joint check and delivers it directly to the subcontractor or supplier in question, maintaining the separate identity of the trust funds. The only check being deposited directly into the general contractor's bank account would be an owner's payment covering the general conditions, overhead and profit on the job.

One certain way

No one likes the additional administrative burden imposed by an arrangement of this sort. Yet it's one certain way to avoid the potential problem of a subcontractor or supplier having to give back substantial payments received during the three months before the failure and bankruptcy of a troubled general contractor.

An experienced construction attorney can help any party to a construction contract fully understand its rights and obligations should a bankruptcy occur.

Liability insurance doesn't cover everything — but it did cover this

The case of *Travelers Indemnity v. Miller Building* arose from PVC Inc.'s hiring of Miller Building Corp. to build a hotel in Wrightsville Beach, N.C. During the course of the project, Miller failed to properly apply tension to the building's post-tension concrete structural components, resulting in numerous defects in the concrete shell and core as well as water leaks in the exterior windows, walls and doors.

Once the defects became apparent, PVC refused to pay Miller the balance due on the construction contract, so Miller sued. PVC counterclaimed against Miller, seeking to recover the cost of repairing Miller's defective construction work and replacing owner-furnished carpeting installed by Miller that had been damaged by the water leaks.

Miller sought insurance coverage for the counterclaim from Travelers, its general liability carrier. But, instead of providing the coverage, Travelers sued Miller in federal court, seeking a declaration that the Travelers general liability policy didn't cover losses caused by Miller's own substandard work.

One small exception

The U.S. Court of Appeals for the Fourth Circuit agreed with Travelers that the general liability policy didn't cover the losses caused by Miller's slipshod work — with one small exception.

The court ruled that, since the owner-furnished carpeting was undamaged when PVC delivered it to Miller for installation, under the policy it would be considered "other property" and the water damage to it after installation would constitute "property damage." Thus, Travelers was required to defend Miller in the underlying arbitration with PVC and to pay any loss attributable to the water-damaged carpet. Everything else PVC recovered was deemed uninsured loss, and Miller would have to pay for it.

Because the owner-furnished carpet was part of Miller's hotel project, rather than the owner's separate property, courts in states outside the Fourth Circuit might find no coverage at all under the same circumstances. Yet because of the unusual interpretation of "other property" adopted by the court in this case, Travelers was required to pay for the defense of a big arbitration proceeding — even though it was responsible for only a very small proportion of the loss claimed.

The point remains

Despite this case's unusual result, the point remains that, generally, a contractor's liability insurance protects neither contractor nor owner from losses arising from shoddy work. Although an exception may occasionally come to light, contractors shouldn't expect their policies to perform miracles.