May/June 2007

CONSTRUCTION LAW BRIEFING

IN THIS ISSUE

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Trouble overhead

Leaky roof raises important point about contract specs

Who pays for the cost of fixing a roof that leaks, even though it's built exactly as specified? That was the question posed in *Metric Construction v. United States*.

A tactical mistake

Metric was awarded a contract to build a medical supply warehouse on a Utah Air Force base. Unbeknownst to Metric, structural engineers with the Army Corps of Engineers had miscalculated the actual dead loads on the roof structure, resulting in a truss design with twice the appropriate camber.

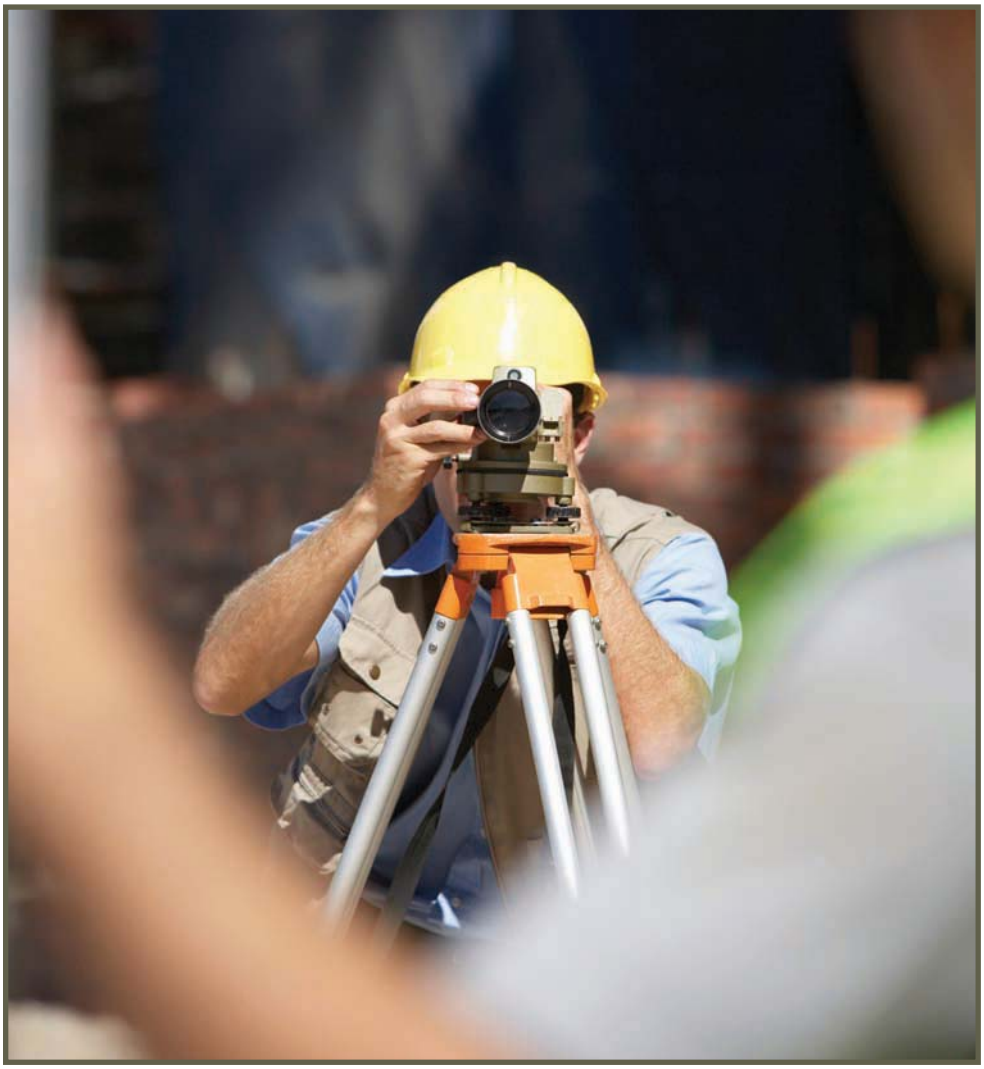
The contract documents called for Metric to select an appropriate product for sealing the roof. When it came time to install the roof membrane, Metric's roofer noted that the steel plane of the roof deck wasn't as specified by the roofing manufacturer.

Metric issued a request for information to the Corps of Engineers. The Corps replied that the roof should be at the roofing manufacturer's specified tolerances if the trusses were manufactured to specification. After Metric proceeded to install the roof membrane it had selected, the roof leaked.

The damage done

The government required Metric to replace the roof, repair the water damage to the warehouse interior and replace the ruined medical supplies. Metric complied, at a cost exceeding $2 million.

Metric then sued the government for the $2 million in extra costs, claiming that the defective structural steel specifications for roof truss camber caused the leaks. The government asked the Federal Court of Claims for summary judgment, which was denied.



Not enough information

In its statement, the court began with the widely accepted proposition that an owner supplying a contractor with drawings and specifications for construction makes a warranty to the contractor that the specifications are error-free. The contractor is responsible for questioning specifications only where there is an obvious problem.

In this case, the problem became obvious only when the roof was about to be installed and the roofer observed that, despite application of all the dead loads to the roof structure, the plane of the steel deck wasn't as flat as required by the membrane manufacturer.

Because Metric had produced some evidence of defects in the Army Corps of Engineers' specifications, the judge decided a full trial would be required to determine who should bear the $2 million roof replacement and water damage repair cost.

> *There is a widely accepted proposition that an owner supplying a contractor with drawings and specifications for construction makes a warranty to the contractor that the specifications are error-free.*

The government argued that Metric should have checked the structural calculations of the roof truss camber once the roofer identified the out-of-tolerance roof deck flatness. The court disagreed, ruling that once the request for information was issued and the Corps responded that the design was proper, Metric was justified in installing the roof in reliance on the engineers' representations.

The owner's responsibility

This case demonstrated that an *owner* is generally responsible for defects in contract specifications. Owners submitting building plans to contractors, and contractors carrying them out, should bear this in mind. T

Forming a new business entity?

Ignored paperwork can lead to significant losses

In the rush to get a new project "in the ground" as quickly as possible, owners, developers and contractors sometimes sign project documents before they've completed the paperwork creating the specific legal entities that will be involved in the construction.

Now, so long as the legal entities in question form promptly and act punctually to adopt the contracts signed in their names, this typically doesn't pose a problem. When this approach is taken without involving experienced construction lawyers for everyone concerned, however, it can lead to significant losses.

You scratch my back ...

Case in point: *Bordieri v. Nelson*. What started out in Avon, Conn., as a friendly "help thy neighbor" situation ended up in a nasty and fruitless court battle because of a failure to follow through.

Joseph and Marci Bordieri wanted a new house built on the vacant lot next to the one they already owned. They found some plans they liked for sale on the Internet, bought the plans, and took them to a local contractor, who provided them with specifications and a price estimate of $224,000 for the construction.

Across the street, the Bordieris' neighbor, Nelson (an electrician by trade, who worked as a construction manager), looked over the plans and the contractor's specifications, "priced things out," and told the Bordieris that he could build them more house for less money. In return, they would help him get some experience as a general contractor.

Across their kitchen table, with neither side using a lawyer, these neighbors drew up a construction contract naming the Bordieris and "Nelson Builders LLC," a limited liability company Nelson planned to form in the next few days, but which everyone knew didn't yet exist.

Legal inexperience leads to a dream home lost

As *Bordieri v. Nelson* (see main article) illustrates, having a lawyer review the provisions of a construction contract is important. But it's even more important that the attorney doing the review have experience in construction law. A retired law firm credit manager from King County, Wash., learned this the hard way in *Smith v. Preston Gates Ellis LLC*.

After retiring, Terry Smith asked one of the lawyers from his former employer to review the contract for construction of his multimillion-dollar dream home. The contract was for cost plus 20%, with no audit provision and only a $6,000 performance bond — even though Smith had experienced a 30% cost overrun earlier, when the same contractor built a log cabin on his property.

The house cost Smith so much to build that he couldn't afford to live in it when construction was finally complete. He ended up selling the house for $4.1 million. Smith then sued his former employer for legal malpractice — and lost.

The judge determined that, because Smith had already suffered through a big cost overrun with the same builder, his lawyer's failure to point out the defects in the home construction contract didn't cause his financial losses.

Nonetheless, an experienced construction attorney would have provided a detailed explanation of the risks of having such a small bond and no audit provision — and that very well could have saved Smith a great deal of heartbreak.

The best laid plans ...

Construction of the Bordieris' new house began and, though things proceeded haphazardly, Nelson eventually produced a certificate of occupancy dwelling.

But as the interior finishes were being put in place, the neighbors' agreement began falling apart. The project ground to a halt when Nelson refused to replace brass hinges on doors he had already hung.

Nelson insisted the Bordieris sign a paper acknowledging they owed him $10,902.27 for extra work, which they did. But Nelson refused to proceed without payment of the entire balance, and the Bordieris refused to pay until the hinges were changed out.

Let a judge decide ...

Nelson recorded mechanics' lien notices against the Bordieris' new and existing houses in the names of "Nelson Builders LLC" and "Samuel Nelson d/b/a Nelson Builders."

The Bordieris went directly to a lawsuit seeking damages for his failure to complete the contract. They also accused Nelson of consumer fraud because, in violation of the Connecticut Unfair Trade Practices Act, "Nelson Builders LLC" was never formed.

After a trial that must have cost each side a lot more than the $11,000 they were fighting over, the judge reached the following three conclusions:

1. Neither side could enforce the construction contract because, in breach of their contractual duties, both sides were guilty of "stubborn refusal to proceed."
2. The lien notices recorded in the names of the entities that were never actually formed couldn't be enforced.
3. The use in the contract documents of names of legal entities that were never created was, in fact, an unfair trade practice. But the Bordieris suffered no damages as a result, because they were aware that "Nelson Builders LLC" didn't exist when they signed the contract.

Both sides ended up losing in the end, and the failure to follow through on the legalities of creating Nelson Builders LLC ended up costing everyone a lot of legal fees at project's end.

Critical protection

If parties to a construction contract focus only on the "bricks and mortar" while neglecting the transaction's "pen and paper," trouble may soon follow. Careful, timely and expert handling of the legal details is critical to protecting one's interests.

Insurance matters

"Your work" exclusion catches many contractors off-guard

Naturally, contractors try to do the best possible work on every job. But no one can control the actions of every worker or the conditions on every job site. And though having the proper insurance coverage goes a long way toward guarding against many risks, there are some perils that contractors simply cannot insure against.

Roof trusses collapse

The case of *Journeyman Professionals, Inc. v. American Family Insurance* arose from Merit Plumbing's need for a new building for its business operations. Merit contracted with Journeyman to construct the new facility.

As the project began, Journeyman's workers set up roof trusses atop the concrete block walls and then left the site at the end of the workday. Later that day, the roof trusses collapsed, substantially damaging the concrete block walls.

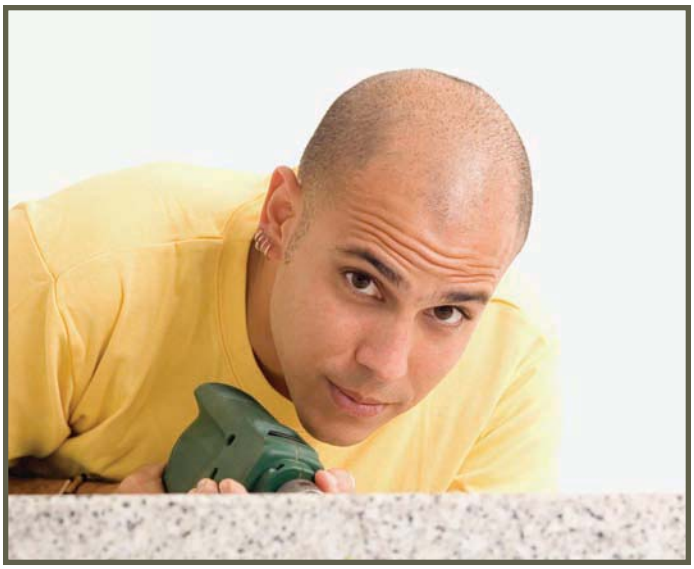
No one was ever able to determine whether the failure was caused by shoddy work or by unusually high winds. Merit's insurance company paid for the repairs, and Merit paid another contractor to finish the project. Then Merit and its insurance company sued Journeyman for their losses.

> *Was the failure caused by shoddy work or unusually high winds? And does it matter?*

Contractor sues insurer

Journeyman had liability insurance with American Family, but the insurer denied coverage for the roof truss collapse. So Journeyman sued American Family, seeking a court declaration that its liability policy covered the loss as well as the cost of defending the Merit lawsuit.

American Family sought and was granted summary judgment finding no insurance coverage under its policy and dismissing the Journeyman complaint for declaratory judgment. American Family's defense was



based on the so-called "your work" exclusion in the insurance contract:

> This insurance does not apply to ... property damage to ... that particular part of real property on which you ... are performing operations ... if the property damage arises out of those operations ... or ... that particular part of any property that must be restored, repaired or replaced because your work was incorrectly performed on it.

Journeyman argued that there was no evidence its work installing the roof trusses had been negligent or "incorrect," because no one ever determined the reason for the roof truss collapse. The judge disagreed, and the Ohio Court of Appeals sustained the ruling.

Courts cite exclusion

Both courts ruled that, whether or not Journeyman's work was negligent or otherwise improper, the "your work" exclusion to liability coverage still applied. So long as the collapsed roof trusses had been installed by Journeyman or a subcontractor or supplier to Journeyman, the loss "arises out of Journeyman's operations," and is, therefore, excluded from coverage by the "your work" policy provision.

The reason behind this ruling, as well as similar ones, is that insurance is to protect against the *unexpected* risk of accidental losses — not to protect against the business risk undertaken by every contractor: that the work completed won't perform as intended.

In the court's eyes, making sure partially erected construction will stand up during the completion process, even during overnight breaks in the work, was the business responsibility of Journeyman and its subcontractors. It wasn't a risk to be assumed by their liability insurers.

In this respect, fault was never an issue. No matter how careful and blameless, Journeyman was financially responsible for the success of its own work as well as that of its subcontractors and suppliers.

The promise implied

The promise to "get it right" is implied in every construction contract and subcontract. It's what owners pay for from their general contractors, and what general contractors pay for from their subcontractors and suppliers.

The financial risk of not getting it right is the cost of doing it over — and this is a cost that every contractor (not its insurance company) must bear. *T*

Bill now … or you may regret it later

When a project is going smoothly, the billing cycle can sometimes creep a little longer than it's supposed to. The dangers of letting this happen were illustrated all too well in *Newman Marchive Partnership v. City of Shreveport*.

A long-term project

In September 1994, the City of Shreveport, La., signed a contract for architectural services with Newman Marchive Partnership for additions and renovations to its city hall. This included several new buildings proposed as part of an expanded municipal government campus.

The architectural and construction project continued for nearly six years — under three different city administrations — until July 2000. Although a number of construction projects for the expanded campus were completed, some were designed but never built. On July 17, 2000, the city terminated the architectural contract for convenience.

Forgotten items

During the six years the project was under contract, the architect submitted, and the city paid, regular monthly invoices. But apparently there were some architectural services for designing later portions of the campus that never made it onto the invoices.

Once it received the notice of termination, the architectural firm claimed payment for several aspects of the work that it had never included on its monthly bills, including:

- ✓ $39,745 for a master plan cost comparison,
- ✓ $18,751 for a campus energy study,
- ✓ $134,103 for design of a police building that was never built, and
- ✓ $105,474 for construction management services during the police building design phase.

When the case went to trial, the Court of Appeal of Louisiana refused recovery of any part of these claimed amounts. It ruled that, because the architect's contract called for monthly billing, and because the services claimed for these items had never been included on an invoice during the six years the project was underway, the services in question must have been part of the hourly amounts that were billed over that time period. Thus, they couldn't be recovered separately.

Realistic expectations

The lesson here for not only architects, but contractors and subcontractors as well, is pretty clear. If you don't bill for it when you do it, you can't realistically expect to be paid for it should the project collapse.

Terminating a contractor too soon may prove costly

Before making final payment, an owner can require a contractor to fix substandard work. Should the contractor refuse, the owner may then sue to recover the cost of having another construction company correct the problem. Taking this step too soon, however, may prove costly.

Building in the spring

Consider *BCP/Fox Hollow LLC v. Alpha III Inc.*, a case in which BCP/Fox Hollow, a real estate investor, and Alpha III, a developer, created a partnership for developing low-income housing in San Diego. BCP provided the initial capital in return for 9% low-income housing income tax credits to be realized by the project. But to qualify for the tax credits, the partnership had to complete construction by Dec. 31, 2000.

The partnership hired Baronet, a contractor controlled by Alpha III, to build the units. The project start date was April 25, 2000, but construction was delayed until September 2000 because of BCP's failure to obtain a building permit. When construction remained incomplete on Dec. 31, 2000, the partnership lost the contemplated 9% tax credits and had to refinance using more widely available 4% tax credits. As a result, BCP terminated Baronet and another contractor finished the job.

Repairing the damage

In response, Baronet sued for $103,685 in damages, with BCP claiming it had spent $242,000 to correct Baronet's defective work. The California Court of Appeal ruled that terminating Baronet was improper, since most of the project delay was attributable to BCP's inability to obtain a building permit for five months beyond the contractual start date. Therefore, the court affirmed Baronet's claim.

The court also refused to let BCP recover the $242,000 it had spent to correct Baronet's defective work. The court reasoned that BCP's improper termination denied Baronet the opportunity to complete the project and require its subcontractors to bear some or all of the cost of correcting the portions of the work they had performed.

In other words, because BCP's wrongful termination interfered with Baronet's ability to have the bad work fixed without any cost to Baronet, BCP shouldn't be allowed to make Baronet pay for the corrections. The total cost to BCP of its bad termination decision was $345,685.

Guessing wrong

An owner considering terminating its contractor, or a contractor facing a potential firing, needs to know its rights under the law. The owner may, in fact, be able to bring in another builder to finish the project and correct improper work.

But if a court later determines it shouldn't have fired the original contractor, the costs of completion and correction will come out of the owner's pocket — with no recovery from the fired contractor.

Thus, the penalty for a wrong guess is substantial enough to make it worthwhile to continue working with a contractor on a problem project in all but the most impossible situations.