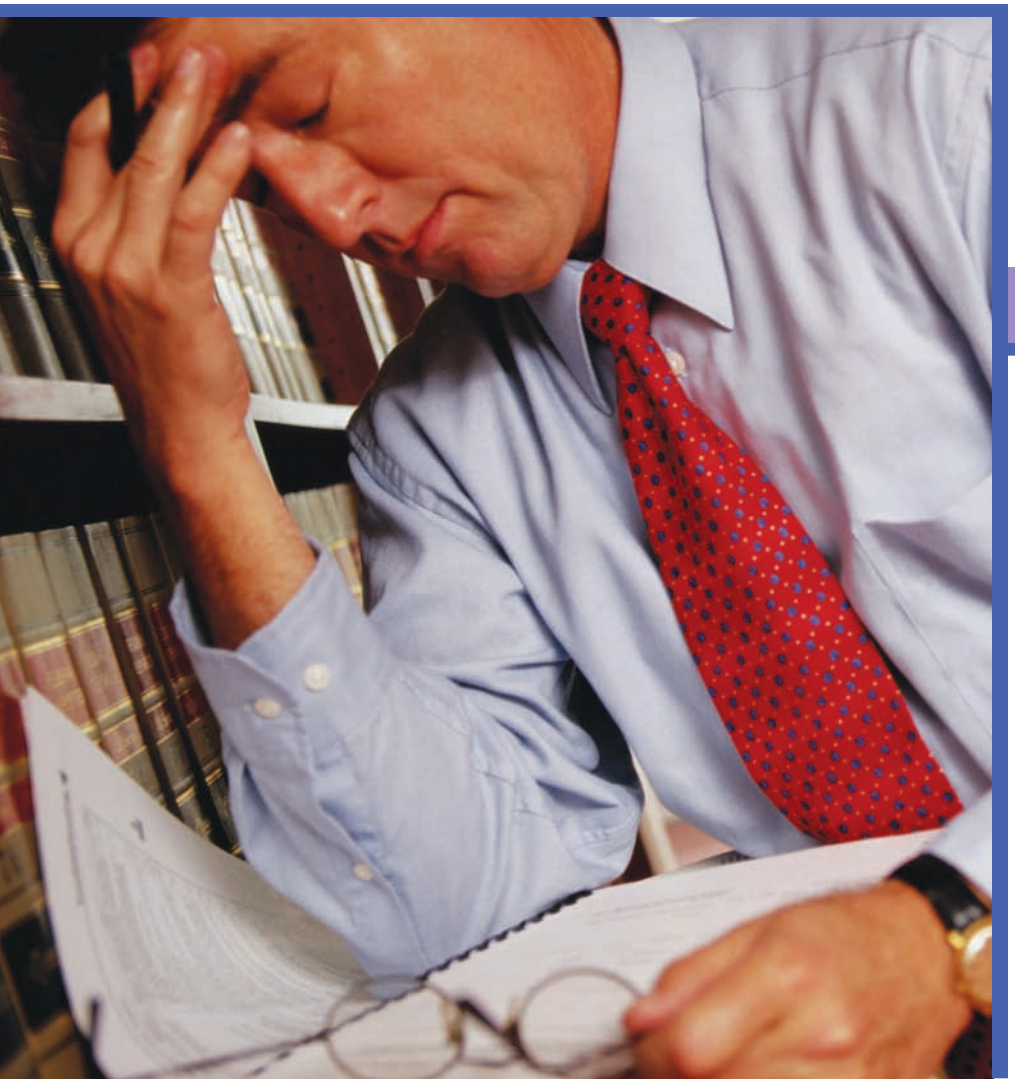
Premiere Issue

CONSTRUCTION LAW BRIEFING



IN THIS ISSUE

KOLETSKY, MANCINI, FELDMAN & MORROW

ATTORNEYS

K M
F M

CONSTRUCTION RISK MANAGEMENT & LITIGATION

Los Angeles
3460 Wilshire Boulevard
Los Angeles, CA 90010

www.kmfm.com

Oakland
1999 Harrison Street
Oakland, CA 94612

Permit process frustrates everyone (even judges)

The complexities of the permit process, combined with the chronic understaffing of most municipal building departments, lead to many frustrations for contractors, owners, developers and the municipal officials themselves. Permit paperwork needs to be efficiently managed on every project — no matter how large or small. Failing to do so could lead to a situation like the one that occurred in a recent New York case.

A long time to be busy

In *Washington v. Culotta*, two homebuyers on Staten Island sued the builder for failing to obtain permanent certificates of occupancy for their houses (typically the last step in the permit process). The sale contracts stipulated holding $2,500 in escrow pending delivery of the certificates, but they didn't specify any deadline. Nonetheless, the court ruled that:

> … the seven years it has taken the defendant [the homebuilder] to still fail to perform is manifestly *unreasonable* and *shocks the conscience* of the Court. … Seven years is a long time to be busy. It took Ferdinand Magellan's expedition less than half that time to circumnavigate the world in wooden ships almost five hundred years ago.

While the court concluded it couldn't award monetary damages to the homebuyers for the unreasonable delay (see "When it comes to permits, money isn't everything" at right), the judge found a different way to motivate the builder to finish the paperwork:

> [I]t would seem that a practical remedy would be for the Buildings Department to cease issuing any more building permits to this defendant or any corporation in which the defendant is a principal or an officer. This would afford him time from his "busy" work schedule to resolve his past obligations … [N]ot only does the Buildings Department have the authority to regulate the final issuance of a certificate of occupancy and to compel the builder to obtain it, but it has a legal obligation to do so. To assert that the Buildings Department is remediless against the holders of the permits it issues is ludicrous.

When it comes to permits, money isn't everything

Why did the judge in *Washington v. Culotta* (see main article) *not* award monetary damages to the homebuyers? Probably because doing so wouldn't have cured the real ill.

The builder wasn't the only one being lazy. The homebuyers could have contracted with a different builder to finish up the deficient items and obtain permanent occupancy certificates. They would have then known the exact amount of damages and a monetary award would have been legally correct.

Based on the court's opinion, however, it appears the cost of completing the deficient work and pulling the permanent certificates would have considerably exceeded the amount of money held in escrow. So, understandably, the homebuyers probably wouldn't have wanted to pay a second time for work they'd already paid for.

Yet their failure to get the work done and obtain final certificates left the cloud of building code violation fines — and a potential vacate order — hanging over their heads. Thus, the point the judge was likely trying to make was that everyone involved in a construction project — owners, builders and permit officials — has a responsibility to see the permit process through to fruition.

Ultimately, the court was none too pleased with any of the parties involved — be it the builder, buyers or municipality — for their respective roles in the permit debacle.

His Honor gets creative

Because he deemed a monetary award inappropriate and ineffective, the judge fashioned a remedy of his own. First, he directed the builder to complete all

deficient work and secure permanent occupancy certificates within 25 days or be in contempt of court.

Next, he ordered the Buildings Department officials to appear in court two weeks after the deadline for issuing the certificates, when he proposed to:

- ✓ Issue an injunction against any building violations issued to the homeowners for failure to have permanent certificates,
- ✓ Order the Buildings Department to revoke all outstanding building permits issued to the defendant or his corporations, and
- ✓ Invoke civil penalties against the builder on every project that Buildings Department records showed still had "open" final occupancy certificates.

In other words, the judge was going to shut down the construction business until its owner completed all of the paperwork on his "open" Staten Island projects and did his part to see permanent occupancy certificates issued to the homebuyers involved.

Paper is a building material

Although this judge's response (threatening to close down a construction business and levy hefty civil fines if it doesn't clean up its neglected permit filings) may be unlikely to occur in most situations, it illustrates just how frustrating — and costly — the permit process can become if not properly managed.

On every job, project managers should work with their company's lawyer to make sure they understand all legal requirements. Moreover, they need to diligently oversee the completion of all inspections and issuance of permanent occupancy certificates.

Last, to avoid any buildup of "open" certificates, top management should work with their legal teams to periodically audit their occupancy certificate status.

Everybody wins, eventually

By establishing an effective permit management process, contractors can do their part to promote good relations with owners, local building officials and, most important, the courts. Granted, doing so entails substantial time and effort but, in the end, everybody wins.

Going nowhere fast?

Request an extension before claiming delay damages

It's a rare construction project that goes exactly as it was planned when the contractor bid the job. A common cause of extra costs for construction companies — and of bitter disputes among contractors, owners and design professionals — is a significant delay arising from causes beyond the builder's control.

When such things occur, the contractor must pay particular attention to the procedures set forth in the contract documents for making a timely request for additional days. Failing to do so risks losing the right to claim additional costs resulting from the delay.

Read the fine print

Many large construction contracts — especially in the public sector — contain clauses that attempt to limit the contractor's ability to extend the job schedule and claim additional payment when delays are caused by the owner or design professionals.

The enforcement of such provisions, however, is typically limited by the so-called "*Spearin* doctrine," which came about as a result of the 1918 U.S. Supreme Court decision *United States v. Spearin*. In this case, the Court found that an owner, when issuing plans and specifications for bid, gives an implied

warranty that the plans and specifications are free from defects that would materially increase the contemplated completion cost.

So, when changes in plans and specifications required to correct such deficiencies cause significant delays, the construction company may be entitled to extra payment from the owner to cover the cost of having its supervisors, crews and subcontractors on the project substantially longer than originally planned — regardless of a "no damages for delay" clause in the contract.

But that doesn't mean the contractor can ignore all contract provisions related to owner- or designer-caused delays. In fact, failing to promptly request an extension may leave a court no choice but to deny delay damages that, otherwise, would have been payable.

Ask first, file later

A recent example of just such a failure is *Dugan & Meyers Construction v. State of Ohio*. Here the Ohio State University school of business began construction of three new buildings — a project involving more than $24 million in state funding and nearly $10 million from private donors.

During the job's second year, design changes triggered 176 requests for information, 48 field work orders and 15 architect supplemental instructions. These interruptions caused the project to last six months longer than expected.

At completion, the contractor sued for delay damages and won about $3.5 million for the six months of extra general conditions and overhead. The university appealed, and that court reversed the delay damages award.

Despite the contractor's argument that requesting extensions would have been futile, the appellate court ruled that the construction company's failure to request extensions within 10 days of each delaying event precluded recovery of damages for delays, including those caused by errors or omissions in the plans and specifications.

Forecast the pain

To ensure the best chance of getting paid for extended general conditions and overhead borne from the mistakes of the owner or design professionals, a construction company's project managers and scheduling staff need to carefully identify and comply with the contract requirements regarding extensions.

Failing to promptly request an extension may leave a court no choice but to deny delay damages that, otherwise, would have been payable.

Whenever an event such as a request for information or change order looks like it may materially delay the planned critical path of construction, the contractor should forecast the extent of the expected delay, assess its effect on the job schedule and, if appropriate, promptly submit a request for extension to the owner in accordance with the contract.

Collect what's due

Assuming there's no sense asking for an extension because an owner won't pay for additional work is risky business. Doing so could cost a contractor thousands, if not millions, of dollars that it otherwise might legitimately collect. And, let's face it, there are few things worse than having to pay for someone else's mistake. *T*

Don't give subcontract documents the brush-off

In their rush to mobilize following award of a significant project, general contractors often assign clerical staff to assemble the subcontract documents. These workers typically pull together boilerplate forms with excerpts from owner-provided "issued for construction" plans and specifications.

Yet haphazard attention to detail in this process can produce material gaps in trade scope definitions, causing expensive problems should errors or omissions in the plans turn up later on during construction. This very issue arose in one case recently, leaving the general contractor in question on decidedly shaky ground.

Who foots the bill?

Gillingham Construction v. Newby-Wiggins Construction arose following a decision by the Idaho Department of Parks and Recreation to build a new regional headquarters in Boise. Unfortunately, the project drawings inaccurately reflected existing soil elevations on the site. They also failed to show the location of the site benchmark from which final elevations were to be shot.

By the time these mistakes were discovered, site work was 85% complete. The excavation subcontractor had to remobilize — at considerable extra cost — to correct the problem by excavating a significant additional quantity of soil and repeating the site grading.

When it sued the general contractor, the excavator was awarded more than $50,000 in additional payment for the corrective work. The general contractor sought to pass this loss on to the Parks Department, but it refused the claim. The Idaho Supreme Court determined that the general contractor had an obligation to verify field conditions — including existing elevations and the benchmark location — before work began.

The court also ruled that the general contractor couldn't impose the same obligation on the excavator, because the subcontract expressly excluded survey work from the scope of the excavator's work. The court's decision cost the general contractor $50,000.

Could it have been avoided?

Perhaps the harshest result of this verdict wasn't the monetary loss, which was certainly substantial, but the fact that the entire situation could have been avoided. The project in question involved significant

planning to create the work schedule and to identify the need for a benchmark to measure elevations as part of the general conditions.

Thus, the project manager, rather than an office clerk, was clearly much better suited to notice the dangerous gap created by the boilerplate excavation subcontract. He or she should have carefully reviewed the subcontract documents *before* they were forwarded to the excavator for signing.

This relatively simple step would have prevented not only the massive revenue loss, but also the lengthy project delay, costly legal proceedings and strained relations with the project owner.

Is there a lesson here?

The lesson is fairly obvious: No boilerplate document is suited to every project. In addition to identifying which trade subcontractor is to perform what scope of work, the subcontract documents must explicitly assign responsibility for plan review and work layout. This way, it'll be clear which company is in charge of identifying areas where more information may be needed to complete work correctly.

Design errors call for creative lawyering

In all fairness to design professionals everywhere, shouldn't *they* bear the costs of any design errors or omissions that significantly delay a construction project? Not according to the courts. In most areas of the country, "economic loss doctrines" prevent anyone but the owner who contracted for the design services from suing the design professionals when extra costs are the only damage arising from an error or omission.

That means a contractor subjected to extra work correcting design flaws can't directly bring a suit or claim against the project architect or engineer responsible for the mistake. Fortunately, attorneys for contractors and owners can work around an economic loss doctrine by ushering the parties into a "liquidating agreement." Under it, the owner agrees to admit liability for any design mistakes and then sue the design professional via its errors and omissions insurance to recover the loss.

North Moore Street Developers v. Meltzer/Mandl Architects presents a good example of how this works. In this case, the architect was paid a little more than $600,000 in fees to design the rehab of an older eight-story Manhattan building.

Because of serious design mistakes, however, the general contractor had to perform $2.5 million in change orders, and the owner incurred $4.1 million in carrying costs during the extended completion time. Attorneys for the owner and contractor combined the total $6.6 million in errors and omission claims in one liquidating agreement.

Not surprisingly, the architect's lawyers argued that merging the owner's and contractor's claims was improper. But the court ruled that the combined claim was appropriate for determination in one proceeding.

Of course, the rules for pursuing claims against architects and engineers vary from locale to locale, just as the design mistakes themselves vary from project to project. Nonetheless, before presenting a claim, the legal teams of the owner and any contractors involved must work together. The goal: Preserve all of the respective claims, so the burden of the design mistakes can rest where it should — on the shoulders of the design professionals responsible.

"Renovation" doesn't always mean "construction"

Reviewing insurance coverage before starting a project is critical

Perhaps the only thing more complicated than insuring a new construction project is insuring the renovation of an existing building. A recent case in California drove home this point with painful clarity to the parties involved.

Too little, too late

In *TRB Investments v. Fireman's Fund*, an owner/developer bought a bank building, intending to renovate it. The company added the building to its existing property insurance policy with Fireman's Fund, which covered a number of its other commercial properties. The policy excluded coverage for water damage to buildings vacant for more than 60 days but exempted those "under construction."

After the existing tenant moved out, renovation work progressed for about a month. One weekend, a water heater failed, and the architect discovered a large amount of standing water in the building the following Monday morning. The owner/developer presented the water damage claim to Fireman's Fund, which denied it because the building had been vacant for more than 60 days when the flooding occurred.

The language of loss

When the owner/developer sued Fireman's Fund, it lost. The court determined there were two policy provisions that differentiated "renovation" from "construction." It compared the exception to the vacancy exclusion for buildings "under construction" with the cancellation endorsement excluding buildings "under construction, renovation or addition."

Based on the dissimilar wording of these two clauses, the court concluded that "construction" and "renovation" were different and presented varying degrees of increased risk for the insurer. The court justified its decision on two grounds. First, it wrote:

> Buildings under construction will usually have workers on the property on a daily basis, which deters potential vandals and encourages early discovery of fire or water damage. Renovation, however, does not require daily involvement with the property.

The court went on to state that it wasn't leaving the owner/developer without insurance protection:

> Of course, our decision does not prevent property owners from purchasing insurance policies that would cover periods of renovation during which the property is not occupied. They need only negotiate and pay for the coverage.

It's worth noting that many consider California an "insurance friendly" jurisdiction, and the result may have been different elsewhere. That said, the court's second observation is perfectly correct: The time for owners and developers to carefully consider their insurance requirements is *before* work begins — not after a loss occurs.

A small price to pay

When undertaking a project that will require all or a substantial portion of a building to be vacant for more than a few days, owners and developers need to first consult with their legal and insurance professionals to ensure they're covered for any claim-inducing eventuality. The premium increase required to buy such coverage is a small price to pay in light of the losses possible should a casualty occur during renovations.

KMFM CONSULTING GROUP
RISK MANAGEMENT SERVICES

You probably know that Koletsky, Mancini, Feldman & Morrow is an "AV" rated construction litigation firm with 40 attorneys serving California from offices in Los Angeles and Oakland. But what you may not know is that in addition to providing unparalleled legal services, the Firm has formed **KMFM Consulting Group** which has joined forces with Gallagher Construction Services to assist our clients in the construction industry with their risk management needs. The goal of the program is to aid builders of all sizes in developing or enhancing in-house protocols for the reduction or elimination of risk associated with medium to large construction projects.

KMFM Consulting Group's Specialized Risk Management Services:

Increased construction defect litigation has resulted in higher costs and increased risks to developers and general contractors. The increased expense of litigation is seen not only in a company's bottom line, but also when renewing necessary commercial liability insurance. The resulting higher premiums, deductibles, and self insured retention limits in connection with these policies can have a devastating impact on companies of all sizes. Increased deductibles and self insured retention limits means increased legal costs bourne by your company when defending claims within the parameters of these limits. The core objective of **KMFM Consulting Group** is to eliminate or significantly reduce these costs and risks by:

- ✓ Working with clients at the outset of the building process to ensure subcontractor agreements are in place with proper indemnification and mandatory insurance clauses in effect. The drafting of proper subcontract agreements is essential for the shifting of risk of future construction defect claims to the subcontractors who performed the work, and their insurers;
- ✓ Providing employee training and instructive seminars in prevention and management of defect-related risk including the right of builders to avail themselves of California's Right to Fix Statutes (Title 7 of the Civil Code formerly SB800).
- ✓ Training relating to claims handling and early resolution procedures to avoid potential litigation;
- ✓ Effective identification, investigation, documentation and file retention of potential losses in order to maximize effective claim evaluation and resolution;
- ✓ Working with claimants in order to facilitate early resolution of claims prior to the institution of formal legal proceedings. Early, effective resolution of homeowner claims is an essential part of customer satisfaction and brand relations. It also helps maximize recovery from subcontractors whose work is implicated by the claim should future litigation become necessary.

These are just a few examples of the risk management services provided by **KMFM Consulting Group**. We invite you to contact our offices to arrange for a meeting where we can further demonstrate how this new aspect of the Firm's construction practice can benefit your business.

Contact:

Marc Feldman, Esq.; MSF@KMFM.com

Peter K. Pritchard, Esq.; PKP@KMFM.com

Bryan Reiner, Esq.; Breiner@KMFM.com

(213) 427-2350

K M
F M

KOLETSKY, MANCINI, FELDMAN & MORROW

Los Angeles
3460 Wilshire Boulevard
Los Angeles, CA 90010

www.kmfm.com

Oakland
1999 Harrison Street
Oakland, CA 94612