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CONSTRUCTION LAW BRIEFING

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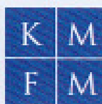

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Watch your step!

Payment formalities can trip up anyone

The process of correctly paying every party involved in a construction project entails a lot of detailed paperwork. Not surprisingly, this fact often leads to disagreements and disputes.

Failing to strictly adhere to the payment procedures and attendant legal requirements stipulated under a construction contract has tripped up many an owner, contractor and subcontractor. The recent Oklahoma federal court decision in *Murphy Oil USA v. Wood* illustrates this very problem.

Running on empty

Murphy Oil USA builds and operates filling stations at Wal-Mart stores in several regions across the United States. Murphy contracted with Trivental Inc. to build filling stations under both a master agreement and separate "specific contracts" that included scope, price and payment terms for each location.

The Oklahoma lawsuit involved four filling stations, three in Oklahoma and one in Louisiana. Murphy ran into financial difficulties while building the four stations and refused to pay Trivental for extra work that it had requested when constructing the first three stations.

Trivental had used some of the cash it received in payment on the fourth location to pay for subcontractor extras on the three earlier projects. Consequently, some of the subcontractors at the fourth location weren't paid in full for their work.

Appealing for justice

Trivental sued Murphy for $215,000 for the unpaid extras at the first three locations. In response to Trivental's lawsuit, Murphy claimed that, by taking money from Murphy and not paying it to the subcontractors on those jobs, Trivental had breached the three specific contracts for the Louisiana site and the first two Oklahoma sites.

The U.S. Court of Appeals, Tenth Circuit, agreed that Trivental's failure to pay subcontractors the amounts listed for them on the project draws was both a breach of contract and a violation of Oklahoma statutes regarding a general contractor's duty to receive payments in trust for subcontractors.

Fortunately for Trivental, however, the court also ruled that Murphy couldn't successfully defend on this basis. Why? Because Trivental's diversion of funds was caused by Murphy's earlier failure to pay for the extra work it had requested on the first three projects.

The court invoked the general rule that "a party who prevents or hinders performance cannot seek performance by the other party." (For another example of this concept, see "School's in session: Another payment claim decision" on page 3.)

Ultimately, the court reinstated the jury award of $215,000 due to Trivental from Murphy and overturned the trial court's ruling in favor of Murphy on the improper payment issue.

Learning the lesson

The lesson from this case is clear. General legal principles, as well as mechanic's lien laws and other construction-specific state statutes, require that a general contractor accepting owner payments designated for the work of specific subcontractors must use that money to pay *only* those subcontractors itemized on the payment application.

Yet as a job nears completion, and change order disputes rear their ugly heads, the temptation is often great to apply an owner's payment first to subcontractors that still have work to do — even if

School's in session: Another payment claim decision

There are many often-ignored legal rules in the construction industry. One example: General contractors cannot provoke or cause a subcontractor to violate the terms of an agreement — and then complain about the violation.

A recent case in the Supreme Court of Alabama, *Tolar Construction v. Kean Electric Company*, illustrates just how this rule works. Tolar Construction signed a contract with Fort Payne Board of Education to build Wills Valley Elementary School. Tolar subcontracted the electrical work to Kean Electric, which was to finish the electrical work by Jan. 18, 2001.

Tolar's roofing mistakes, however, delayed drying in the building for more than a month. Consequently, Kean was unable to finish the electrical work on schedule. When the job was finished, Tolar refused to pay Kean $88,652.27 due for the electrical work — despite the fact that Tolar had already been paid by the Board of Education.

When the case went before the Alabama Supreme Court, the judge not only upheld the award amount to Kean but also added interest and attorneys' fees to Tolar's bill as a penalty for unreasonably withholding the payment. School was definitely in session that day.

doing so means *not* paying a subcontractor for which funds were drawn but whose work is complete.

The belief is that paying subcontractors in this manner will speed completion and increase the likelihood that everyone will eventually get paid. Such manipulations, however, are more likely to land the project, and often the general contractor, in hot water with the owner — and even with the law.

This is particularly true when a subcontractor's change order work takes place *before* the general contractor and owner have agreed on pricing for the change. Absent such agreement, the general contractor cannot bill the owner for that work, though subcontractors performing the work to keep the project on schedule will expect to be paid when they're finished.

Sticking to the plan

During the course of any construction project, general contractors encounter numerous ways to cut corners to save money and time. But succumbing to many of them can, at the very least, hurt the quality of the job and, at worst, land the company's owners in court. It's generally best to stick to the plan outlined in the contract and consult an attorney before deviating from it.

EIFS claims highlight a common insurance foible

As you read this, massive litigation is underway nationwide over homes and other buildings suffering moisture damage because of defective varieties of exterior insulation and finish systems (EIFS).

To protect against the cost of both defending multiple lawsuits and repairing EIFS-caused moisture damage, general contractors have made claims against their liability insurance. Yet a recent insurance opinion from the Texas Court of Appeals (*Lennar Corporation v. Great American Insurance*) illustrates the complexities and potential shortcomings of these policies.

Do you smell something?

Lennar and its affiliates were in the business of building houses. The company had a number of layers of liability insurance covering damages it might be

legally liable to pay due to property damage "caused by an occurrence."

Between 1996 and 1999, Lennar built more than 400 homes in the Houston area, using synthetic stucco EIFS. In 1999, Lennar began receiving a number of complaints about wood rot, mold and termite infestation caused by water trapped by the EIFS systems that subcontractors had installed in its homes.

By the fall of 1999, Lennar began removing and replacing EIFS on all the homes it had built, replacing it with traditional stucco. While doing this work, Lennar also repaired any rot, mold, termite damage and other water damage caused by moisture the EIFS had trapped.

When Lennar filed claims with its liability insurance companies for the cost of removing and replacing the defective EIFS and repairing the resultant damage, the insurers denied the claims, asserting that liability policies don't cover a general contractor for defective work.

Is it damage or not?

In considering Lennar's lawsuit, the Texas Court of Appeals had to carefully analyze the insurance issues at stake.

> *The court had to rule on whether defective subcontractor work was an unexpected "occurrence" and an exception to the "business risk" exclusion of the general contractor's insurance policy.*

The insurers argued that the defective construction was not an occurrence under their policies because it wasn't accidental. Moreover, they considered it a business risk of the general contracting business. The court disagreed, ruling that defective work by subcontractors was an unexpected "occurrence" and an exception to the "business risk" exclusion that had been written into the policies for subcontractor work.

The insurers also contended that none of the amounts claimed by Lennar were within the policy definition of "property damage." The court split the analysis on this issue. It ruled that repair of rot, mold, termite damage and other water damage was property damage. But the expense of removing and replacing the EIFS, as well as the overhead, inspection costs and attorneys' fees involved in replacing it, was not property damage.

That's the rule?

At this point, it seemed that Lennar might actually get back some of the money it spent repairing the houses and replacing the EIFS. But the fatal blow to Lennar's claim against its insurers came when the court ruled that the construction of each home with defective EIFS was a separate occurrence under the insurance policies.

Lennar argued that the defective EIFS was a single occurrence, but the court rejected its position. Because, under most of the policies, Lennar had a deductible (or "self-insured retention") of $250,000, the court ruled it could recover nothing unless the cost of repairing the mold, termite damage, rot and other water damage on a single house exceeded $250,000. And under that rule, even Lennar had to admit it couldn't recover a dime.

Are you really protected?

The key point for general contractors in this complicated case is that each house is a separate project, and insurers will not pay even covered losses if the deductible is greater than the cost of fixing up a single house. Ultimately, no construction company can insure itself against its own shoddy work — or that of a subcontractor. *T*

Sometimes overachievers achieve nothing

"Value engineering" leads to delays ... and a lawsuit

When the parties involved in a construction project are also busy creating a new legal organization for their business venture, *and* designing and building the facilities to house *that* business, things can go awry.

As a recent case of overachievers gone wrong demonstrates, failure to carefully coordinate all legal documentation with the formation of a new legal entity to operate the business can lead to financial disaster.

Planting the seeds

The seeds of *Greentex Greenhouses v. Pony Express Greenhouse* were planted when Randy Cruise decided to start a hothouse tomato business in Nebraska. In February 2002, he led a meeting with potential investors and convinced several of them to invest $3 million to $5 million in the enterprise.

The investors instructed Cruise to begin building a turnkey tomato greenhouse operation on land owned by a corporation the investors controlled. In March 2002, Cruise and the investors formed a new corporation, Pony Express Greenhouse, to own and operate the business.

In May 2002, Pony Express and CT Farms, a corporation owned by Cruise, entered into a written contract for CT Farms to construct a turnkey greenhouse on the investors' property for $3.8 million. CT Farms then secured a bid from Greentex to build the hothouse operation.

As head of CT Farms, Cruise decided some "value engineering" was in order and contracted Greentex to build most of the project, excluding a boiler house, silo, burner and other items, which Cruise thought he could obtain from other sources for less money.

Going too far

During the construction project, Cruise asked Greentex for certain extras, increasing the value of its work to $4,128,818.40. Pony Express paid Greentex $3.75 million but refused to pay the $378,818.40 balance. Greentex sued.

Pony Express countersued, claiming that what Greentex had built was not a turnkey greenhouse and that Pony Express had been hurt financially by the cost of providing or repairing the items that Greentex didn't supply.

Hearing from the judge

The U.S. District Court for the District of Nebraska awarded Greentex the $378,818.40 it was claiming but denied any damages to Pony Express on its counterclaim. The judge pointed out that, if there was a turnkey contract by Pony Express, the contract was with CT Farms — not with Greentex.

Pointing to the detailed scope definition and exclusions in the Pony Express/Greentex contract — which were value engineered by Cruise — the judge determined that the Greentex contract wasn't for a turnkey hothouse operation. He found that Greentex had completed the specified work and hadn't been fully paid for it and, thereby, awarded Greentex the entire $378,818.40 claim.

Moreover, the judge denied any damages to Pony Express for failure to build a "turnkey" hothouse, because that promise had been made by CT Farms and not by Greentex.

Ultimately, the conflict in this case arose because of the changing legal entities and their fluctuating relationships while forming the new business. The investors' failure to integrate all the specific legal entities and their promises to each other left a gap created by Cruise's value engineering, which the court declined to fill in.

Keeping a promise

When working with new business ventures, contractors need competent legal advice. Someone needs to ensure that promises a builder receives from investors are coming from viable legal entities rather than from a person initially involved in the project who ends up distancing him- or herself from the final arrangements.

Tick tock tick tock:
If you want to sue, watch the clock

Contractors beware: Even though you're already in court over a payment dispute, time can run out on other, related claims if you're not careful. One Connecticut subcontractor learned this lesson the hard way in *Brian's Floor Covering Supplies, LLC v. Spring Meadow Elderly Apartments.*

No more floor

Floors & More entered into a subcontract to furnish and install flooring at a senior citizen housing project in Trumbull, Conn. Disputes over payment developed, and, on July 6, 2000, Floors & More's installer filed a lawsuit because it hadn't been paid.

The lawsuit involved the project developer, the general contractor, Floors & More and the installer that Floors & More had hired to install carpet and vinyl sheet goods. By September 2000, the flooring installer had walked off the job.

In January 2001, Floors & More filed a timely written claim with Seaboard Surety, the performance and payment bonding company on the project. And during that year, the various parties spent a lot of time in court vigorously contesting their assorted claims respecting nonpayment, extra work and the validity of the subcontracts for the flooring in question.

Big mistake

The various claims of Floors & More amounted to a little more than $160,000. Floors & More, however, failed to actually name Seaboard as a party to the lawsuit until Nov. 29, 2001.

> *The various parties spent a lot of time in court vigorously contesting their assorted claims.*

Big mistake: The applicable Connecticut statutes regarding performance and payment bonds required that suit on the bond be filed within one year after the date labor or material was last provided to the project. Floors & More's own written bond claim recited that the last work was done in September 2000.

Despite the fact that the original lawsuits over the project had begun in July 2000, and that, in the written notice of claim, Seaboard had been notified of the nature and amount of Floors & More's claim in January 2001, the judge ruled that filing suit against Seaboard on Nov. 29, 2001, was more than a year after Floors & More's last work and, therefore, the lawsuit against Seaboard couldn't proceed.

There seemed to be no particular reason for Floors & More to delay filing suit on the performance and payment bond other than the complacency brought on by the fact that court proceedings were already underway involving the project.

Floors & More's bond claim of $114,727 went unrecovered — all because it waited too long to add Seaboard as a defendant in the lawsuit.

Time gone by

The moral of this tale? Even if a general contractor, subcontractor or owner is already in court on a particular job dispute, the clock may still be ticking on other related claims. To avoid losing important rights, all parties should monitor and meet all court deadlines — just as with a construction schedule.

When can't an architect be a general contractor?

The increasing popularity of the design/build and "construction manager at risk" formats for new and rehab construction have architecture and engineering firms competing with general contractors for project management work. One complicated and largely overlooked aspect of this industry development is that architects and engineers have different kinds of professional and business licenses than general contractors do.

California dreamin'

In California, as in several other states, unlicensed general contractors are prohibited from bringing lawsuits to collect compensation for their work as general contractors. This point came into play in *Thoryk Architecture v. Trans West Housing*. In this case, residential developer Trans West Housing hired architect Thoryk Architecture to act as "project manager" for remodeling work to two La Jolla homes.

The contracts required Thoryk to review design and construction documents, send out plans and receive bids, hire subcontractors, review trade work, approve payment applications, collect lien releases, and provide final inspection services.

Scope changes, project delays, cost overruns and disputes over Thoryk marking up self-performed labor costs, however, led Trans West to terminate Thoryk. After the termination, Thoryk brought a lawsuit and recovered $99,586 in unpaid costs and project management fees.

Nothing at all

On appeal by the developer, however, the recovery was reversed. The California Court of Appeals ruled that the nature of the tasks performed by Thoryk under the "project management" contract amounted to acting as a general contractor — not an architect.

And because California's statutes specifically prohibited lawsuits for recovery of costs and fees by unlicensed general contractors, the appellate court determined Thoryk could recover nothing at all.

Careful analysis

Before an architecture, engineering or other professional services firm undertakes a contract to provide construction management services, a legal analysis should be procured to determine whether, in the jurisdiction where the project is located, a general contractor's license is required.

Meanwhile, general contractors need to be aware of these relatively new competitors and how they're altering the construction landscape.

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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.

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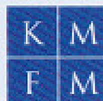

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