July/August 2006

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

File like the wind

Timeliness key for subcontractor nonpayment claims

For budgetary reasons, large government building projects are often divided into phases or other units for which separate contracts are put out to bid. If one general contractor is awarded more than one phase or unit of the work, subcontractors have a special dilemma in tracking the time limits for filing performance and payment bond claims.

If a subcontractor continues to work on the site for a long time after one phase or unit of work is finished, its claims for nonpayment in the early phases may expire before it leaves the project. And the subcontractor could be barred from pursuing the performance and payment bond surety if it doesn't get paid for the early phase.

In *Subterranean Construction v. W. D. Curran*, one subcontractor learned a harsh lesson about keeping track of claim expiration deadlines separately even though it was working for one general contractor.

Where's the starting line?

W. D. Curran was the general contractor for construction of the Smithsonian Environmental Research Center in Harwood, Md. The project was subdivided into a number of separate government contracts, including one for "approach road improvements" and another for "dormitory expansion."

Subterranean first came on the project site as a subcontractor to Curran for the approach road improvements, performing site clearing, earth work, paving and landscaping. The approach road was completed on Oct. 10, 2002.

But, before completion, Subterranean also became a subcontractor for the dormitory expansion phase. This work continued through Sept. 7, 2004, so Subterranean waited until completing it before filing a lawsuit on Dec. 8, 2004, against Selective Insurance Company (Curran's Miller Act surety on the approach road project). In the suit, the subcontractor sought to recover $204,251 in unpaid work.

> *It's imperative to track the filing deadlines for lien and bond claims on each separate part of the job.*

When does the clock start?

In its decision, the District Court in Maryland had to carefully consider the structure of the various contracts that Subterranean had been working under. A key factor: The time limit for filing suit on a Miller Act performance and payment bond is one year from the date the subcontractor last worked on the project.

Because the approach road improvement contract was separate from the dormitory expansion contract, the judge decided that the claim should have been filed within a year after completion of that phase. More specifically, the deadline was Oct. 10, 2003 — one year after the approach road was finished.

The court dismissed Subterranean's claim against the surety on the performance and payment bond for the approach road project. The subcontractor was left with only its claims against Curran, which it had to pursue in the state courts.

Is it a sprint or a marathon?

When a subcontractor is working on more than one phase or unit of a complex government project, it's imperative to track the filing deadlines for lien and bond claims on each separate part of the job. In other words, this is a marathon — not a sprint.

Failing to do so, the subcontractor may lose valuable rights against the only solvent parties available to respond to nonpayment claims for substantial work a court determines was performed on an early phase or unit of the project that was completed long before the subcontractor left the job.

Even if all of the work is performed for a single construction manager or general contractor on the same site, the subcontractor may need to bring separate lawsuits — even before project completion — to preserve the ability to collect for all of the work performed.

How can subcontractors win?

In addition to tracking the filing deadlines for each job phase or unit, subcontractors need to make sure all project documentation and billing includes a specific contract number. Only by conducting the most meticulous administrative oversight can they preserve all collection rights under available performance and payment bonds and emerge the real winner.

Tiptoeing into trouble

Stealth bidder suffers consequences of low profile

Some bidders on government contracts deliberately fail to take full advantage of prebid procedures for getting detailed information about the project on which they're bidding. They seek to keep a low profile in the mistaken belief that secrecy will give them a competitive advantage.

Yet, in a recent instance of such "stealth bidding," a dredging company found itself tiptoeing straight into serious financial trouble.

Pretty sneaky

The case of *Renda Marine v. United States* arose over a contract to dredge the Houston-Galveston Navigation Channel in Texas.

A dredging company, Renda, adopted a bidding strategy of keeping its participation in the bids a secret from competitors, subcontractors and suppliers who might tip off other bidders to the fact it intended to submit a bid on the Upper Bayou contract. It particularly avoided indicating an interest in the project to local subcontractors, which do almost all of the levee work for the Galveston District.

To maintain the desired level of secrecy, Renda stayed away from the prebid conference and conducted most of its site inspection activities under cover of darkness. Renda also declined the opportunity to submit to the government any written questions regarding the details of the areas of the channel to be dredged.

Said one Renda witness, "[The dredging company's owner] didn't feel like going to the prebid conference was necessary because any questions would be in writing and the response [would be in writing]. He felt that anonymity would be reasonable."

Initially, the stealth bid proved successful: Renda was the low bidder and won the contract. But, at the project's conclusion, it was forced to submit $10,842,811 in claims for "differing site conditions" that had made dredging significantly more costly than contemplated in the bid.

Salt in the wound: Another reason for the claim denial

Another, independent reason the court denied Renda's claims (see main article) was insufficient and untimely notice to the government of the nature and amount of the claims.

To recover for excess costs because of differing site conditions, the contractor must promptly notify the government when it encounters the problem. That way, the government can investigate the matter and determine the most economical method of managing the unexpected conditions.

In its lengthy decision in *Renda Marine v. United States*, the court provided a detailed review of the correspondence between Renda and the government addressing many different aspects of the cost overrun claims. Ultimately, the court found that Renda's position regarding many of the claimed unexpected site conditions changed significantly between the time of notice to the government and the time of trial.

Therefore, it was impossible for the government to have investigated the discovered conditions before the bottom of the channel was dredged up and irrevocably altered.

Ugly results

When the case went to court, the court began by citing a legal principle applying to all bidders on government contracts. That is, no matter how large or small a government contractor may be, and regardless of where it's located or how experienced it may be with a certain type of project, the construction company must know what it's getting into.

The court went on to refer to the specific contract language respecting prebid investigation of site conditions:

> The Contractor acknowledges that it has taken steps reasonably necessary to ascertain the nature and location of the work, and that it has investigated and satisfied itself as to the general and local conditions which can affect the work or its cost. … The Contractor is expected to examine the site of the work and make its own determination as to the character of the materials to be dredged.

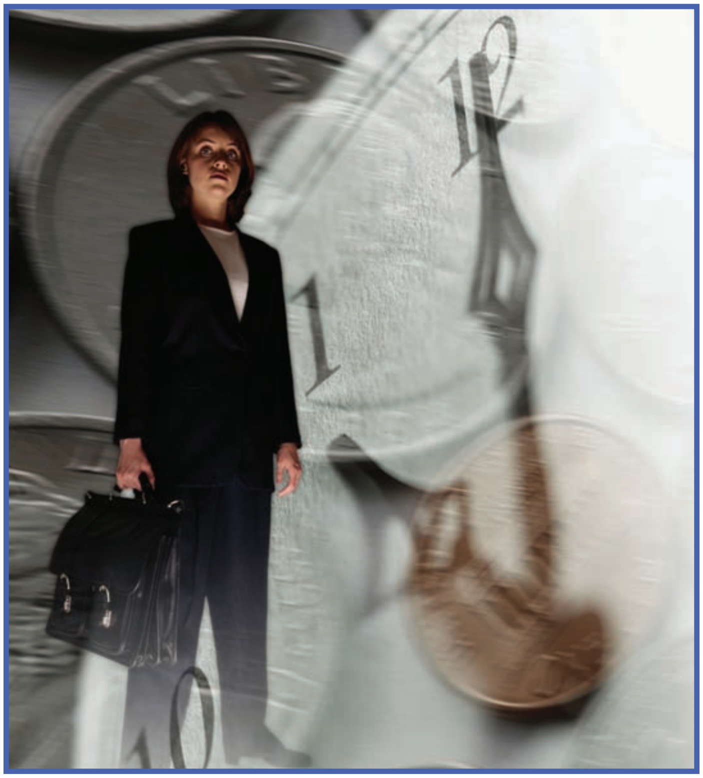
Doing some dredging of its own, the court then pointed to even more detailed contract specifications that said, "Prior to dredging, the Contractor shall carefully inspect the entire area to be dredged, from estimated top of cut to top of cut, by whatever means the Contractor deems suitable to locate any debris which may interfere with dredging."

Based on this language, the court determined that Renda's conscious decisions not to attend the prebid conference, not to submit any written questions, not to contact likely subcontractors and not to ask the government for any information about past dredging operations in the channel made the company something less than "a reasonably prudent contractor."

In the court's view, Renda had failed to establish that the subsurface conditions it complained about were reasonably unforeseeable. So, ultimately, Renda's stealth bid backfired and the company was denied all of the more than $10 million in extra costs claimed as a result of encountering unexpected materials and conditions during the channel dredging, levee construction and spoil placement operations.

A costly victory

As this case shows, stealth bidding can indeed win contracts. But, as Renda learned the hard way, it may prove a costly victory. The risk of running into unforeseen site conditions or other impeding circumstances simply outweighs the benefits of "sneaking in the back door."



"Cost" isn't always a "plus" in cost-plus contracts

William Randall made a verbal agreement with Keever & Associates to build a house and barn on the Randall farm in Kittitas County, Wash., for "cost plus 10%." Sounds simple enough, right?

During the project, Keever billed Randall $25 an hour for laborers, $30 an hour for carpenters and $35 an hour for foremen along with a 10% markup on the $130,266.43 that Randall paid suppliers and rental equipment providers. Finally, Keever demanded $39,325 for the time its president had spent administering the contract.

Randall balked at paying the markup on materials and equipment he had paid for directly and the administration fee, which totaled $52,351.65, and Keever sued. The trial judge ruled that Keever should recover the $39,325 but denied the $13,026.65 markup for materials and equipment. Both sides appealed.

"Actual cost" vs. "quoted rate"

On appeal, the Washington Appellate Court held that Keever had actually overbilled Randall a great deal more than the $52,351.65 that Keever was seeking.

It decided that Keever was entitled to bill only 110% of what it had actually paid workers on the project, including wages, benefits and taxes withheld. The higher quoted hourly rates for project labor weren't "costs," and, therefore, shouldn't be billed under the "cost-plus" contract.

Likewise, because the company president was paid nothing more than his regular salary for the time spent administering the contract, there was no "cost" to the contractor for his time. Therefore, the appellate court reversed the trial judge's award of $39,325 for contract administration. It reasoned that the 10% "plus" part of the cost-plus agreement represented the fees compensating Keever for contract administration.

Working capital is the key

Although neither of the courts involved in this case mentioned the concept of working capital, any analysis of a cost-plus contract nearly always depends on which party has working capital at stake during contract performance.

If the contractor's working capital is at risk until the owner pays the bill, the amount of working capital at risk represents the contractor's aggregate "cost" to which the "plus" applies — unless the parties have a written agreement expressly defining the term "cost" in detail as something else.

But, by the same reasoning, if the owner lays out working capital to fund the purchase, storage and delivery of long lead materials and rental equipment, the amount of the owner's working capital at risk for such items is *not* a "cost" to which any "plus" should be added.

Simpler isn't always better

The two parties in this case believed that a verbal agreement for cost-plus construction was a simple solution to the problem of accurately pricing a small project through formal bids and a written contract. Yet they still ended up in court.

The lesson? Whatever the estimated cost of a construction project, spending a very few dollars for competent and experienced legal advice, rather than relying on verbal understandings or preprinted form documents, is the best way to ensure all parties clearly understand their responsibilities and financial obligations.

When is arbitration … not?

Sometimes the legal language in construction contracts just doesn't mean what everyone thinks it should. And arbitration clauses often present prime examples of this phenomenon. Despite the fact that most companies in the construction and development businesses include arbitration clauses in their contracts, doing so doesn't always keep them out of court. This very issue arose in *Aberdeen Golf & Country Club v. Bliss Construction*.

Teeing off the claim

Aberdeen Golf and Country Club in Florida decided to spend $2 million to rebuild its clubhouse. The construction contract went to Bliss Construction Inc. and included an arbitration clause requiring all disputes to be initiated within 21 days of the disagreement by notice to the project architect.

The arbitration provisions specifically required that, during the pendency of the dispute, "the Contractor shall proceed diligently with performance of the contract and the Owner shall continue to make payments in accordance with the contract documents." The clause also required a decision by the architect on the dispute as a condition to "mediation, arbitration or litigation of all claims."

During the reconstruction, Bliss discovered mold infestation in the clubhouse and sought a time extension and a price increase to deal with the problem. When the architect sided with the contractor, the club refused further payment and terminated the contract. Not surprisingly, the contractor went straight to court with a lawsuit seeking substantial damages for early termination.

Slicing the language

Once the contractor filed its lawsuit, the owner moved to compel arbitration under the contract's arbitration clause. The trial judge refused to order arbitration, and the Florida Appellate Court affirmed.

In analyzing the arbitration provisions of this particular contract, the court distinguished between an arbitration clause designed to eliminate litigation at *all* events and an arbitration clause designed to merely preclude lawsuits and require the parties to proceed with construction during the conflict's resolution.

The court distinguished between an arbitration clause designed to eliminate litigation at all *events and an arbitration clause designed to merely preclude lawsuits and require the parties to proceed with construction during the conflict's resolution.*

Examining the exact terms of the arbitration clause in question, the court decided that the parties' intent was only to avoid lawsuits until after completion, not to keep everyone out of court at all times.

Missing the green

The court particularly emphasized the provision that referral of a dispute to the architect under the arbitration clause was a condition to "litigation," pointing out that such wording would be completely unnecessary if the parties had meant to stay out of court even after the project was done. Specifically, it observed:

> Obviously it is unreasonable to suppose that an arbitration provision meant to resolve disputes while work continues has any application to a termination of the entire contract before completion.

After the contractor was terminated, the court felt justified in refusing to order the contractor to go to arbitration at the behest of the terminating owner. It ruled that, in this particular agreement, the limited arbitration clause "failed of its essential purpose," which was to keep work going while disputes were resolved.

Knowing the course

As mentioned, many owners and contractors rely on arbitration clauses as a way of staying out of court. But, with the teachings of this case firmly in mind, both parties would be wise to read the entire clause carefully — and know what they're getting into.

Specific performance: On the rise in construction settings

When it comes to construction lawsuits, courts usually like to let the parties get the work done and then resolve disputes based on the dollars one litigant owes another.

Occasionally, however, when one litigant is less wealthy, it will ask the court to order the opposing litigant to perform work required under a contract or lease rather than require the less wealthy party to pay for the work and then sue for damages. This remedy is commonly referred to as "specific performance."

From reluctance to willingness

Courts have long been reluctant to order specific performance in a construction setting, ruling that supervision of a court-ordered construction project would be impractical because the judge would have to oversee "continuous acts involving mechanical skill and judgment, or technical knowledge, and discretion ..."

But there seems to be a new trend developing. Judges are apparently becoming more willing to assume greater authority to directly order the performance of construction work rather than the mere payment of money by one litigant to another.

Trouble at the mall

Case in point: *William L. Patton Jr. Family Limited Partnership v. Simon Property Group*. Here a family trust owned a large tract of vacant land along University Avenue in Little Rock, Ark. The trust leased the land to a real estate developer to construct a shopping mall.

For about 30 years, both the developer and the family trust made money from University Mall. But the advent of more modern malls close by hurt sales and sent a number of retail tenants packing. Consequently, the developer began to defer significant maintenance work, allowing University Mall to fall into disrepair.

The family trust sued the developer, seeking a court order directing the developer to undertake between $15 million and $18 million in repairs. The developer made the traditional arguments against an order directing specific performance of construction work.

But instead of dismissing the family trust's claim, the court ordered a trial to determine whether such repairs would be economically wasteful and whether judicial supervision of the work would be practical.

A more available solution

There is no record of a decision in this case; a settlement likely occurred after the ruling. The point is, however, that specific performance might increasingly become a viable solution to problems that money alone cannot solve.

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