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CONSTRUCTION LAW BRIEFING

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This changes everything ...

Bankruptcy poses dire threat to any mechanics' lien

The idea behind a mechanics' lien is to put the contractor near the top of the creditors' priority list, right behind the purchase money mortgage lender. Delays in initiating and prosecuting mechanics' lien rights, however, can squander the priority the lien law is designed to provide. A recent California case, *In Re Turner,* provides a prime example.

An ill-fated project

K H Construction contracted with the Turners to renovate an existing building into a medical center. Unfortunately, design flaws, cost overruns and construction delays led to disputes and payment delays, and K H filed a mechanics' lien against the property.

In September 2004, K H sued to foreclose its lien, and, in October of that year, agreed with the Turners to arbitrate the lien claims along with claims to $55,272.70 in construction loan proceeds escrowed as undistributed retention. So far, so good.

The arbitration, however, was still not concluded in July 2005 when the Turners filed for reorganization under the bankruptcy laws. The reorganization filing automatically stopped K H from going forward in state court with the mechanics' lien foreclosure lawsuit, as well as in the agreed arbitration proceedings.

Settlement negotiations

The parties attempted to negotiate a settlement that would result in a reorganization based on revenue produced by the completed medical center. But, by May 2006, talks had broken down and the Turners converted their reorganization proceeding into outright bankruptcy liquidation. The bankruptcy court appointed a trustee to oversee liquidation of the Turners' assets, including the medical center building.

K H sought to lift the bankruptcy stay, asserting its right as a secured creditor to proceed with foreclosure of its lien on the medical center property. And both the trustee and the bankruptcy court agreed that K H had the right to a judicial sale of the medical center with the proceeds going toward the lien it had perfected before the bankruptcy filing.

The trustee, however, opposed a general lifting of the stay respecting K H because, under state law, proceeding with the agreed arbitration would require that K H's right to the escrowed retention funds be decided in the same arbitration.

A Gordian knot

When the case went to court, the trustee argued, and the bankruptcy judge found, that ownership claims in the title escrow by the trustee, the lender and K H, as well as claims by K H for a deficiency judgment in excess of the judicial sale proceeds, should remain under the bankruptcy court's jurisdiction rather than proceeding in state court.

On one hand, foreclosure of K H's lien and sale of the medical center would relieve the bankruptcy estate of the secured portion of K H's claim. It would also relieve the bankruptcy estate's expense of maintaining and insuring the building.

On the other hand, state law regarding the foreclosure arbitration and litigation would require the trustee to incur substantial attorneys' fees and arbitration expenses in litigating the deficiency amount, as well as the disputed ownership of the escrow, or be barred from ever defending the deficiency amount or asserting ownership of the retention funds.

Mechanics' liens sometimes necessitate buyouts

The difficult choice facing K H Construction in the case of *In Re Turner* (see main article) was complicated by the fact that K H was second in line of priority behind the purchase money mortgage lender. To promptly and successfully sell the building and collect anything on its lien, K H essentially had to *buy out* the purchase money mortgage.

Otherwise, proceeds of the sale would be applied first to costs of the foreclosure and second to payment of the purchase money mortgage. Only if there were anything left would K H realize any positive result from its efforts and investment in foreclosing the mechanics' lien.

Describing the situation as a "Gordian knot," the bankruptcy court ruled that it would be premature to compel the trustee to expend estate resources in litigation and arbitration of the deficiency and the escrow ownership. After all, events in the due course of the bankruptcy proceeding might make such litigation unnecessary because of the nature and extent of the bankruptcy estate's other assets.

4 conditions for relief

The bankruptcy judge offered K H relief from the stay respecting only the building's foreclosure sale and only if K H agreed to four conditions:

1. That foreclosure and sale of the medical center would proceed immediately, without unnecessary legal expenses,
2. To bifurcate the trustee's claims to the escrowed retention and defenses to a deficiency judgment for later determination in the bankruptcy court,
3. To waive all legal arguments that the trustee's failure to defend the deficiency and claim the escrow in the mechanics' lien foreclosure precluded the trustee from asserting those claims and defenses later, and
4. That the bankruptcy court retained jurisdiction of the deficiency claim and the escrow ownership issues.

In other words, if K H wanted to pursue the sale of the medical center quickly, and apply the proceeds of that sale toward satisfaction of its lien, it would have to consent to wait until the bankruptcy court was prepared to proceed with determination of its other claims.

Otherwise, K H would have to let the whole matter languish in the bankruptcy court until that proceeding was ultimately concluded.

> *The bankruptcy court described the situation in* In Re Turner *as a "Gordian knot."*

The moral of the story

For contractors, the moral of this story is clear: If there's any chance that an owner is headed for bankruptcy, the only way to ensure the priority and efficiency of a lien claim is to pursue it with all possible speed. Don't stop to rest or negotiate until *after* the property has been sold to satisfy the lien claim. Otherwise, the owner's bankruptcy filing could negate any advantages gained by recording a mechanics' lien in the first place. *T*

You have to feed both horses

Design/build project mired in cost and contract disputes

The siren song of the design/build method of construction has long been, "On time and under budget." And it can trip up owners who misunderstand the process. An Indiana car dealership encountered just such a problem, among others, and ultimately learned a harsh legal lesson: If you choose to change horses midstream, you have to feed them both.

New dealership building wanted

The case of *Dorsetts Auto Sales v. C. H. Garmong & Son* arose from Dorsett Mitsubishi's desire to construct a new auto dealership building in Vigo County, near Terre Haute, Ind. The dealership, which had never been involved in construction before, met with at least three contractors to discuss the proposed store. Specifically, Dorsett told one of those construction companies, Garmong, that the dealership:

- ✓ Had no building plans,
- ✓ Wanted union labor,
- ✓ Could afford to spend about $500,000, and
- ✓ Needed to be in the building by December 2000.

In the spring of 2000, Garmong presented a proposed design/build contract document for cost plus 10% fee, with the fee including office overhead and accounting services.

> *Is verbal approval of a revised draft document, coupled with a show of reliance by beginning work, enough to make an unsigned document an enforceable contract?*

Dorsett marked up the document and sent it back to Garmong, which made the requested revisions. In June 2000, Dorsett orally approved the revised contract, but neither party ever signed it. Nonetheless, Garmong began work in July 2000.

Another builder hired

Halfway through July, Garmong presented a new design with an estimated cost of $1.2 million. Dorsett rejected it, so Garmong presented yet another set of copyrighted design drawings in September with a guaranteed cost of $750,000.

Dorsett took this set of design drawings to one of the other builders it had talked to in the spring and, in October 2000, signed a contract with the second builder for $525,000 for the shell and core of the dealership building, with Dorsett retaining responsibility to complete HVAC, plumbing and electrical work.

The second builder completed the new car store in August 2001, using the Garmong plans with some minor revisions, at a final cost of $927,000.

A suit is filed

As one might expect, Garmong sued Dorsett for design costs and estimating services, along with $92,700 (or 10% of the final cost of the project as built) in lost profit. The trial judge awarded Garmong $26,766.86 in design costs and $2,273.62 in estimating expenses, plus a fee of $50,000 (or 10% of the original construction budget of about $500,000). Total damages awarded at trial were $79,040.48.

Both sides appealed, and the Indiana Court of Appeals affirmed the damage award to Garmong — with one minor modification: The $50,000 fee was recalculated to $45,454.55 based on the ruling that the original $500,000 budget was supposed to include the 10% fee. Thus, the "costs" of the cost-plus agreement

would include only $454,545.45 for construction costs with a 10% fee of $45,454.55. Thereby, the judgment was reduced to $74,495.03.

When all was said and done, the Court of Appeals ruled that oral approval of the revised draft document, coupled with Garmong's show of reliance by beginning work, was enough to make the unsigned document an enforceable contract.

Oral approval counts

Although this particular court noted the misappropriation of the plans prepared by Garmong for Dorsett, that fact alone did not bring about the result reached. Most courts would likely have found the orally approved document to be a binding contract under the circumstances and would have awarded lost profits to Garmong — even if the second contractor had used a completely different set of plans. *T*

Sales and use taxes: The perils of guesstimation

On most private construction jobs, sales and use taxes aren't an issue. The builder pays the taxes on materials and equipment going into the project and prices these amounts into its bid. Government construction projects, however, are a much more complex situation.

Opportunities and problems

For obvious reasons, federal, state and local governments are often exempt from paying sales and use taxes on items purchased for government use. This fact presents both opportunities and problems for bidders on public construction projects.

Opportunities arise from the fact that, if the sales and use taxes on materials and equipment are included in the bid price, the contractor need not pay the taxes later because of government exemptions. Thus, project profitability increases.

Yet problems can also arise when competing bidders *don't* price sales and use taxes into their bids. These companies often wind up winning bids because their bid prices don't include the tax amounts.

Savvy contractors bidding on public projects try to get a competitive advantage by predicting as accurately as possible which materials and equipment specified on the job will be subject to tax and which will not. A wrong guesstimate, however, can turn a profitable job into financial disaster.

Back taxes in the bayou

Case in point: *Cajun Constructors v. Strain*. Cajun Constructors was awarded the contract to upgrade and expand sewage pumping stations and tanks in Slidell, La. Cajun didn't pay sales and use taxes on the pumps, aerators, valves, controllers and related fittings installed in the upgraded pumping stations. But after an audit, the company was assessed $78,300.61 in unpaid taxes, interest, deficiencies, penalties and audit fees. Cajun paid the assessment but sued for a refund.

The company argued that the City of Slidell was the ultimate consumer of the equipment and fittings because each could be removed from the construction without substantial damage. The court, however, ruled that Cajun was the ultimate consumer because the articles were permanently attached plumbing components, and the contractor should have paid the taxes.

Unanticipated consequences

Before bidding a public job, every contractor should work with its attorney to carefully check the tax code. Failure to fully understand sales and use tax rules could result in losing the bid, or worse, getting the award and receiving an unanticipated tax and penalty assessment at job's end.

Who knew what ... and when?

A claim lives and dies according to its "birthday"

Unless pursued in court, every claim for money expires at some point. In most instances, a statute of limitations defines the length of time a claim will survive before either a suit must be filed or the claim is lost forever.

The difficulty in deciding when a claim dies is not in reading the statute and determining the lifetime of the claim. Rather, it often is in pinpointing the claim's "birthday" — the date on which the limitations period begins to run.

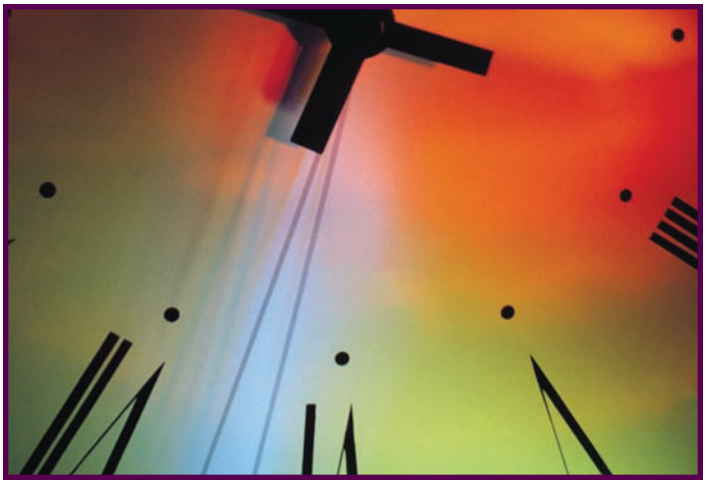
Waiting for spring

The case of *Johnson v. Kraus-Anderson Construction* arose in May of 1997, when the Woodcrest Apartment Building in Warroad, Minn., was damaged by fire. The roof was destroyed and the building stood open to the weather until January 1998, when Kraus-Anderson Construction began temporary repairs and the owner's agent, Ontra Inc., ordered weather protection work.

> *Johnson, an experienced builder himself, inspected the fire-damaged building several times before closing the purchase.*

A new roof was required to keep out rain and snow, but, when the time came to install the trusses, Kraus-Anderson discovered that frost heave had raised the center wall footings above the frost line. This made installation of the new roof trusses impossible because the top of the center wall was higher than the tops of the end walls.

Ontra and Kraus-Anderson agreed that the best solution was to temporarily remove the top plates of the center wall, install the roof trusses on the end walls, and come back in the spring, after the soil thawed, to reinstall the center wall top plates. Ontra took its time in deciding what to do with the fire-damaged property, eventually selling the building "as is, with



all faults" to a Mr. Scott Johnson in August 2001, rather than completing repairs.

Johnson, an experienced builder himself, inspected the fire-damaged building several times before closing the purchase. Nevertheless, he didn't notice the missing center wall top plates until April 2002. And it wasn't until October 2003 that Johnson sued Kraus-Anderson for the cost of replacing the missing center wall top plates.

Picking a date

The trial judge dismissed Johnson's lawsuit, and the Minnesota Court of Appeals upheld the dismissal. The appeals court reasoned that the limitations period on Johnson's claim was two years "after discovery of the injury."

Johnson argued that he didn't discover the missing center wall top plates until April 2002, and, therefore, he had until April 2004 to file suit. The appeals court disagreed, ruling that Kraus-Anderson's discovery and the subsequent discussion of the top plates in 1998 with Ontra was the birthday of the claim. Johnson's failure to notice the plates were missing when he inspected the fire-damaged property in 2001 could not delay the claim's expiration.

Starting the clock

In construction claims, as in many other areas of law, the birthday of a claim depends on who knew there might be a claim — and when they knew it. As Mr. Johnson from the case in question can surely explain, the person bringing the claim is not the only one whose knowledge can start the clock ticking. T

Government projects

Collecting delay damages depends on the fine print

Unavoidable delays can strike any construction project, but government jobs are particularly prone to this problem. To protect themselves against increasing construction costs because of project delays, government units often include contract clauses excluding certain or even all damages for delay.

This issue came to a head in the case of *Trucco Construction v. City of Columbus*. Here, the City of Columbus, Ohio, tried to restrict recovery of damages for delays in project mobilization by including a contract provision permitting the city to delay the start of, or suspend, construction operations for the length of time it deemed necessary.

If the city ordered delays through no fault of the contractor, it would pay for "any increase in the cost of performance" caused by its unreasonable delay.

Argument over a definition

When the case went to court, the city argued that "increased costs of performance" meant only material price increases and labor rate hikes, and it agreed to pay Trucco Construction, the successful bidder on two sewer improvement jobs with starts delayed by nine months, for the material price and wage rate increases.

Trucco argued that "increased costs of performance" also included additional overtime hours worked to maintain completion schedules in the face of the delayed project start dates. The trial judge granted summary judgment in favor of the city, dismissing all of Trucco's claims for overtime increases, and Trucco appealed.

Required proof

Acknowledging that Trucco had already received nearly $70,000 from the city for material cost and wage rate increases due to the nine-month delay, the Ohio Court of Appeals nevertheless reversed the summary judgment and sent the case back for trial on the issue of delay damages suffered by Trucco.

The appeals court ruled that Trucco was entitled to prove that overtime costs incurred on the projects went up because of schedule compression caused by the nine-month mobilization delay imposed unilaterally by the city. The appeals court reasoned that "increased costs of performance" meant all such costs, not just the straight time rate increases and material unit price hikes that took place during the delay.

Eyes wide open

Bidders on public construction projects need to keep their eyes wide open regarding contract provisions limiting damages for delay. They also must know the history of the government unit in question when it comes to lengthy delays between contract award and notice to proceed. And once the contract is awarded, the contractor needs to diligently and thoroughly document any and all cost escalation caused by delayed mobilization, including labor inefficiencies and additional overtime worked because of schedule compression required to meet completion requirements imposed in the contract.