January/February 2008

CONSTRUCTION LAW BRIEFING

IN THIS ISSUE

Seeing a claim through to fruition requires an eye for details

Subcontractor focus
Miller Act time limits may affect payment contingency

Contractors may face new public safety liability

Got insurance paperwork? Don't let it slide

Criminal actions: An extreme case of kiting funds

Seeing a claim through to fruition requires an eye for details

One might assume that a claim for "differing site conditions" would cover items such as additional pile depths and the removal and replacement of unsuitable subsurface material under slab-on-grade floors. As the case of *AAB Joint Venture v. United States* demonstrates, however, a court might not make the same assumption.

Multiple claims

AAB Joint Venture was awarded a contract by the Army Corps of Engineers to build a storage base near El'ad, Israel. The bid package included a geotechnical report on the site of the new base.

> *Many contractors try to save time and expense by putting together a claim without involving their attorneys. But this can be a penny wise and pound foolish approach.*

After the contract was awarded, AAB performed exploratory borings and discovered subsurface conditions different from those described in the report the Corps had included in the bid package. AAB presented the contracting officer with two certified claims for differing site conditions:

1. A $1,458,554 claim for increasing subsurface piling lengths, and
2. A $6,510,310 claim for excavating and removing unsuitable subsurface materials in the areas of foundation footings.

When the contracting officer failed to act on these claims within 60 days, AAB sued in the Court of Claims under the Contract Disputes Act, increasing the claim for excess material removal by $412,239 for removal of unsuitable material under slab-on-grade floors.

Claim increase or new claim?

The Corps made a motion to dismiss the additional claim for $412,239, arguing that removal of unsuitable material under foundation footings is different from removal of unsuitable material under slab-on-grade floors. Therefore, it further asserted, the court had no jurisdiction over the "new" claim for differing site conditions.

AAB argued that it was merely increasing the amount of its certified claim for removal of unsuitable subsurface material not disclosed in the geotechnical report, rather than making a new claim.

The Court of Claims sided with the Corps of Engineers and dismissed the claim for the additional $412,239 for removal and replacement of unsuitable subsurface material under the slab-on-grade floors. The court reasoned that the issue of suitability of material around deep foundation footings concerned technical requirements different from the issue of suitability of subsurface material to support slab-on-grade floors.

Therefore, reasoned the court, the $412,239 was a new claim rather than an increase in the claim certified to the contracting officer. Because the Court of Claims Act gives that court jurisdiction only after a

contracting officer has rejected or failed to timely act on a contractor's claim, the court determined it had no jurisdiction over the claim.

The claims process

Many contractors view the claim preparation and presentation process as a function of their estimating and engineering operations. Often, they try to save time and expense by putting together a claim without involving their attorneys. This case illustrates how such an approach can end up being penny wise but pound foolish.

By failing to detail the issue of the material under slab-on-grade floors in its initial claim to the contracting officer, AAB faced the added expense of starting over with the pursuit of that part of the claim — even though it was already pursuing nearly $8 million in the Court of Claims case.

The cost of pursuing $8.4 million could end up being double the cost of pursuing $8 million, making the collection of the additional $412,239 a most inefficient proposition.

A better chance

Because the legal technicalities of claim submission and Court of Claims jurisdiction may not seem entirely logical or sensible to estimators and engineers, the wisest course of action is to involve an experienced construction attorney at the earliest feasible point in time. Doing so will give any claim that might be denied by a contracting officer a better chance of being seen through to fruition. *T*

Subcontractor focus

Miller Act time limits may affect payment contingency

Governments can be slow to pay and prone to contest whether work added during a project is actually "extra work" requiring extra payment.

In the hope of shifting away some of the risk of government refusal to pay, general contractors on public projects often insert so-called "pay when paid" clauses in their subcontracts. Such clauses typically provide that receipt of payment from the government is an absolute condition precedent to the subcontractor's entitlement to payment from the general contractor.

Enforceability of these payment contingencies, however, may vary from state to state. Moreover, recent federal court decisions limit a payment bond surety's ability to use "pay when paid" clauses. One example: *U.S. ex rel Straightline Corp. v. American Casualty Company of Reading.*

Courthouse millwork

Dick Corp. was awarded the general contract for construction of an annex to the federal courthouse in Wheeling, W.Va. Dick hired Straightline Corporation as the subcontractor for architectural millwork under a subcontract agreement containing an absolute "pay when paid" contingency clause.

The original millwork subcontract was for $511,520 but, during the course of the project, Dick added further millwork costing $233,958.46 to Straightline's scope. At the job's end, however, the government refused to pay Dick for the additional millwork.

Inherent conflict

Straightline sued Dick and its Miller Act bond surety, American Casualty, for $232,079.76 in unpaid extra work. (A few of the extras did get paid for.) American Casualty made a motion for summary judgment. It contended that, based on the subcontract's "pay when paid" clause, neither Dick nor American Casualty had any obligation to pay Straightline because the government had never paid Dick for the extras.

The U.S. District Court for the Northern District of West Virginia denied the surety's summary judgment motion, pointing out the inherent conflict between the "pay when paid" clause and the time limits set forth by the Miller Act. Under the act, an unpaid subcontractor or supplier may sue on the payment bond 90

days after its last work is performed or its last materials are supplied. The limitation period for bringing such suits is one year after providing the last work or materials.

Thus, given the timing of the government's payment to the general contractor, the court reasoned that allowing the Miller Act surety to rely on the "pay when paid" provision could effectively erase all rights under the bond in cases when government payment does not occur until more than a year after the subcontractor has finished.

Because such a result would destroy the protection of bonds required under the Miller Act, the court ruled that allowing the surety to rely on the "pay when paid" defense would be contrary to the terms of the act itself. So the general contractor was protected by the provision.

A matter of absolutes

The Miller Act requires general contractors working on federal construction projects to provide a *performance* bond in favor of the government and a *payment* bond in favor of subcontractors and suppliers.

Yet despite the general legal doctrine that the payment bond surety may assert any defense against a subcontractor or supplier that the general contractor would have under the contract, recent federal court decisions have used these absolute time constraints in the Miller Act as a reason to deny use of the "pay when paid" contract defense to Miller Act and state law payment bond sureties.

The lesson for all

Ultimately, even though a subcontractor or supplier has a "pay when paid" clause in its contract with a general contractor, and even though payment from the government (or even a private owner) to the general contractor may be delayed or altogether doubtful, the unpaid subcontractor or supplier should consult an experienced construction attorney.

An attorney can help determine whether action against a payment bond surety to collect the unpaid balance can proceed despite the seemingly clear subcontract language prohibiting collection. Even in states where the law permits the use of "pay when paid" subcontract clauses, courts are often reluctant to permit this "risk shifting" of owner insolvency from general contractors to subcontractors. *T*

Similar results: State laws and private contracts

Even when no federal laws are involved in the construction project at issue, bonding companies have suffered unfavorable legal results similar to those reached in *U.S. ex rel Straightline Corp. v. American Casualty Company of Reading.* (See main article.)

For example, in *Moore Bros. Co. v. Brown & Root, Inc.*, the U.S. Court of Appeals for the Fourth Circuit upheld rulings favoring a subcontractor that built portions of a private toll road between Dulles Airport and Leesburg, Va. In doing so, the court relied on provisions in the private payment bond setting out the same time limits as a Miller Act bond for bringing suit to deny the "pay when paid" defense to the surety on the bond.

Because the insolvency of the toll road owner made it unlikely that the general contractor would be paid on time, if at all, the Court of Appeals reasoned that the terms of the bond had to take precedence over the "pay when paid" clause — despite the fact that, under Virginia law, "pay when paid" clauses are enforceable against subcontractors and suppliers.

Contractors may face new public safety liability

It's fairly safe to say that most general contractors know that they must secure their job sites to protect not only those who work there, but also the general public. A recent lawsuit against the Washington, D.C., public transit authority, *Briggs v. Washington Metropolitan Area Transit Authority*, however, could signal the development of a new kind of legal liability related to public safety.

A tragedy in D.C.

The case arose from Clark Construction and Sherman R. Smoot's decision to form a joint venture to bid on a project to build a new convention center in Washington, D.C. Part of the job called for renovation and revision of the Mount Vernon Square Metro commuter rail station.

The contractor ultimately won the bid and began work on the station. One job phase involved putting up a two-story plywood barrier enclosing a pedestrian passageway near some subway escalators. Very early one morning, the body of a murdered D.C.-area physician was discovered inside this plywood enclosure.

The mother of the murdered doctor sued the transit authority, the convention center and the contractor, claiming that the two-story temporary construction barrier provided an inadequately lighted and improperly secured hiding place for the criminal or criminals who murdered her son.

The district court granted summary judgment in favor of the defendants, and the D.C. Circuit Court of Appeals affirmed, ruling that the expert affidavit and depositions presented by the murdered man's mother failed to identify any recognized lighting or public safety standards that the plywood barriers violated.

The appeals court made clear, however, that, had such expert evidence been presented, the court would have permitted the wrongful death case against the contractor to go before a jury.

Means and methods

Although unsuccessful, this lawsuit emphasizes the need for contractors to be able to demonstrate that their site security provisions have taken into consideration the need for proper lighting and security where temporary barriers create secluded pockets in which criminals could commit illegal acts.

Indeed, the techniques used to secure a job site are part of the general contractor's responsibility for every project's "means and methods." Many construction projects — particularly those in an urban environment — involve some temporary interference with pedestrian traffic. And some of the protective barriers erected may obstruct the usual light and visibility into passageways and neighboring structures.

The best defense

The best defense against lawsuits that may arise from job site security breaches, wherein crime victims or their families seek to impose liability on a contractor, is the ability to clearly demonstrate that the impact of site security provisions on potential criminal activity was considered and dealt with in designing and setting up the job site. The cost of a few extra light fixtures and a security camera is probably far less than a single verdict in favor of the family of a murdered pedestrian.

Got insurance paperwork? Don't let it slide

Any principal on a construction project probably knows the importance of accurately completing any insurance paperwork involved. But neglecting to follow up with an insurance agent or provider after requesting coverage could create problems as well. Such was the case in *Adams v. Western States Insurance.*

The house burns down

Premier Building started constructing a house for the Galpin family. The owners of Premier went to their insurance agency, Western States, and asked their agent to place property coverage on the house during construction.

The agent, who had placed coverage for other houses Premier was building, said he would take care of it. But, apparently, no one did anything further about the property insurance until after the half-built house burned down on Nov. 27, 2004.

Following the fire, the lender financing the project inquired about insurance. Premier's owners referred the bank to Western States and, on Dec. 30, 2004 — a month after the fire — the agency printed out a binder on the Galpin house with an effective date of Nov. 20, 2004, and delivered it to the bank.

Although the binder didn't name Hudson Insurance Co. specifically, it did identify, by policy number, a property policy issued by Hudson that covered various homes Premier was building. This policy, however, didn't name the Galpin house.

When Hudson refused to pay the loss on the Galpin house, Premier and its owners sued Hudson and Western States.

> *Only persistent, repeated inquiry by the lender after the house burned down led the insurance agency to print out and deliver a binder to the bank.*

Word is not passed

Both defendants moved for summary judgment. The federal district court in Oregon granted the motion, dismissing all claims for fire damage to the half-built house.

The initial loan paperwork on the Galpin house indicated State Farm would be providing insurance coverage. Yet Premier didn't tell the lender it had changed insurance agencies to Western States after applying for the loan and before construction started.

Moreover, neither the Galpins nor anyone on behalf of the lender, Premier or Premier's new insurance agent followed up on insurance coverage after the initial meeting between the owners of Premier and its new insurance agent with Western States.

Only persistent, repeated inquiry by the lender after the house burned down led the insurance agency to print out and deliver a binder to the bank. No one could produce any paperwork dated before the fire indicating that Hudson had accepted the risk on the Galpin house.

The federal judge found that the absence of anything in writing specifically naming Hudson as the insurer covering the Galpin property meant that both Hudson and its managing agent were off the hook. This decision, however, did not dispose of the claims against Premier's insurance agency, Western States.

Everyone must be involved

In the construction business, it's not uncommon to move forward on the basis of verbal or telephone agreements and document things on paper later. The law allows for this process — as long as the parties understand what they're doing and actually document things in a timely manner.

As this case illustrates, however, neglecting to follow up in a prompt fashion with the required paper documentation can have catastrophic consequences.

Criminal actions: An extreme case of kiting funds

On both public and private construction projects, most states (and, indeed, the federal government) require the general contractor to apply owner payments toward obligations to suppliers of labor and material for that job *before* using any of the money to pay other bills.

Violating these restrictions is known as "kiting funds," and many, if not most, general contractors are well aware of the dangers of this practice to their financial solvency. What many may not be aware of, however, is the *criminal* danger. A recent federal conviction in Puerto Rico, *United States v. Munoz-Franco*, illustrates this danger.

From job site to prison cell

Over the years, two Caguas Central Federal Savings Bank officers steered construction contracts with developers financed by the bank to three companies owned by Ariel Gutierrez-Rodriguez. Then, without approval or knowledge of the bank's board of directors, the two officers knowingly permitted the Gutierrez companies to use loan proceeds released for certain projects to pay bills incurred on other projects — all while construction on the developments for which the money was approved by the board languished.

When the scheme finally collapsed, all three men were convicted of multiple federal crimes and sentenced to five years in prison.

Convenience has a price

Although it may seem convenient for a general contractor to use money released on one project to pay more pressing creditors from other jobs, such payments should never be made without consulting an experienced construction lawyer to determine whether the use of funds is a legal one.

Failure to seek such advice may lead to unforeseen consequences of dire proportions — not just for the construction business but for the individuals authorizing the payments.