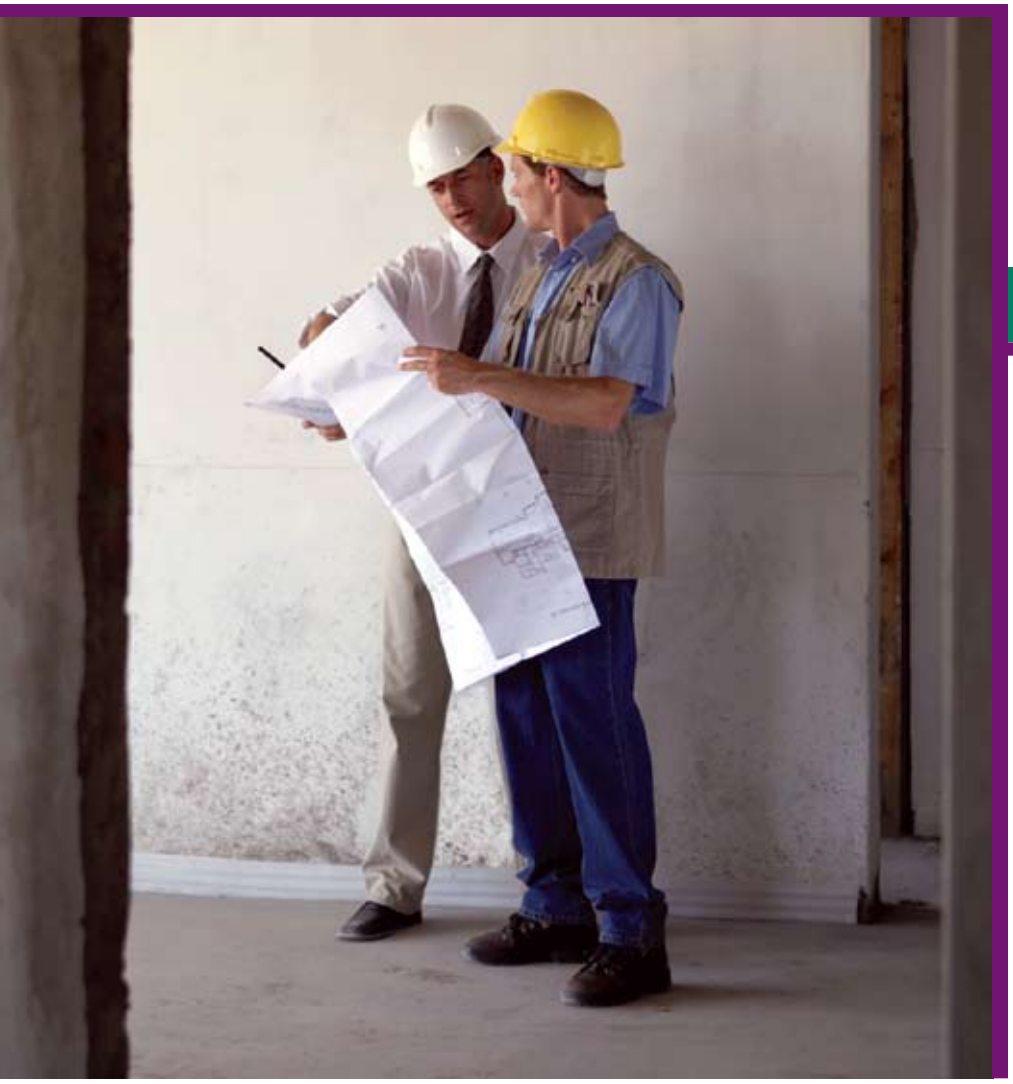
January/February 2009

CONSTRUCTION LAW BRIEFING



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Say what?

Subcontractor's lawsuit turns on verbal change orders

Most construction contracts contain a provision requiring that all changes to it be made by way of written change orders. In *practice*, however, changes are frequently agreed to verbally.

Courts commonly recognize this fact and will enforce verbal changes where the parties to a contract have made a practice of accepting and paying for verbal changes — even in the face of a "written changes only" clause in the contract.

But when one party tries to abuse the law's tolerance for verbal approval of changes, a court may strictly enforce the "written changes only" provision. Such was the circumstance that arose in *PB Group v. Proform Thermal Systems*.

The contract signing

Gilbane/Clark Joint Venture was the construction manager for construction of the Biomedical Science Research Building at the University of Michigan in Ann Arbor, Mich. Proform Thermal Systems was the Gilbane HVAC contractor, and Proform subcontracted PB Group Inc. to engineer and build certain specialized environmental rooms within the project under a $937,000 purchase order subcontract signed in August 2003.

The purchase order subcontract between Proform and PB Group was signed before the Gilbane/Clark prime contract with Proform was ever signed, though the purchase order purported to incorporate the terms of Proform's contract with Gilbane. Once it was eventually signed, however, the Proform prime contract with Gilbane/Clark included a standard form of the "written changes only" provision.

A copy of the unsigned prime contract was provided to PB Group by Proform during the bidding process.

Work and meetings

During the course of the work, PB Group consistently insisted that Proform sign written change orders whenever Proform requested work by PB Group that PB Group considered outside its original scope of work under the purchase order.

When the project experienced delays, Proform used its own forces to complete certain work originally included within PB Group's scope. Proform then claimed a back charge against PB Group amounting to $125,000 for this work. PB Group disputed the back charge and asserted $166,561 in claims for:

- ✓ Lost parts and equipment,
- ✓ Material cost increases because of Proform delays, and
- ✓ Extra drafting time and overnight charges for equipment placement locations.

At a meeting on Sept. 7, 2005, to discuss these offsetting claims, Proform and PB Group settled on a change order reducing the amount of the purchase order subcontract by $95,000. The change order was put in writing and signed by the parties on Sept. 19, 2005.

The Sept. 19 change order recited only that the deduction was "for work within the original scope of PB Group's subcontract that was instead performed by Proform," without any reference to PB Group's offsetting $166,561 in claims.

Federal court proceedings

Over a year later, on Oct. 28, 2006, PB Group presented a breach of contract claim against Proform and Proform's payment bond surety for the $166,561 in extras and lost parts. When the claim was denied, PB Group brought a lawsuit in federal court against Proform and its surety.

E-mail reveals deceptive intent

Although the federal judge who ruled in *PB Group v. Proform Thermal Systems* (see main article) wrote a decision based solely on strict interpretation of Michigan's law of contracts, he did recite within his opinion an interesting sidelight.

The opinion details the contents of an e-mail from PB Group to Gilbane, which had been turned up during discovery in the litigation. That e-mail describes what took place at a Sept. 7, 2005, settlement meeting and closes with these words:

> You may be best off deleting this e-mail once you have read it, and not choosing to forward it to anyone as it may not be in Gilbane's best interest in the event of any litigation causing "discovery" of documents, etc. I will delete it on my end as well.

Although the court opinion doesn't comment on this paragraph of the e-mail, it's reasonable to expect that no federal judge would be favorably influenced by such a blatant description of efforts to conceal evidence.

Recent changes to the rules of discovery dealing with electronic documents in federal and many state courts — coupled with the fact that most e-mails reside not only on the computers of the sender and receiver, but also on third party servers involved in their transmission — make it essential for all parties involved in construction projects to step carefully. No matter how informal an e-mail may seem to be at the time, every word of it (or an instant message) can be retrieved by an opponent and used against you.

Proform and the surety moved for summary judgment, contending there was no written change order authorizing any part of the claimed "extras" included within the $166,561 amount and, therefore, PB Group should recover nothing on its claims. Relying on the Gilbane/Clark contract language requiring changes to be in writing, the federal judge agreed and entered summary judgment in favor of Proform and its surety, dismissing all of PB Group's claims.

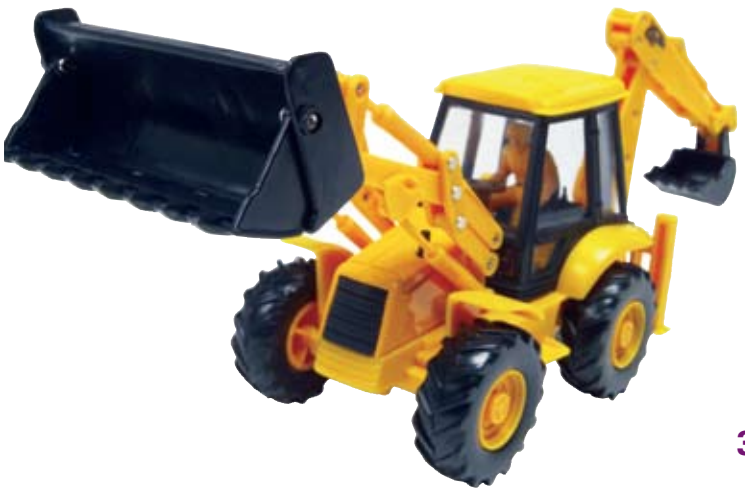
In making its ruling, the court relied in particular on PB Group's consistent practice during the project of refusing to begin extra work until a written change order was signed and presented to PB Group.

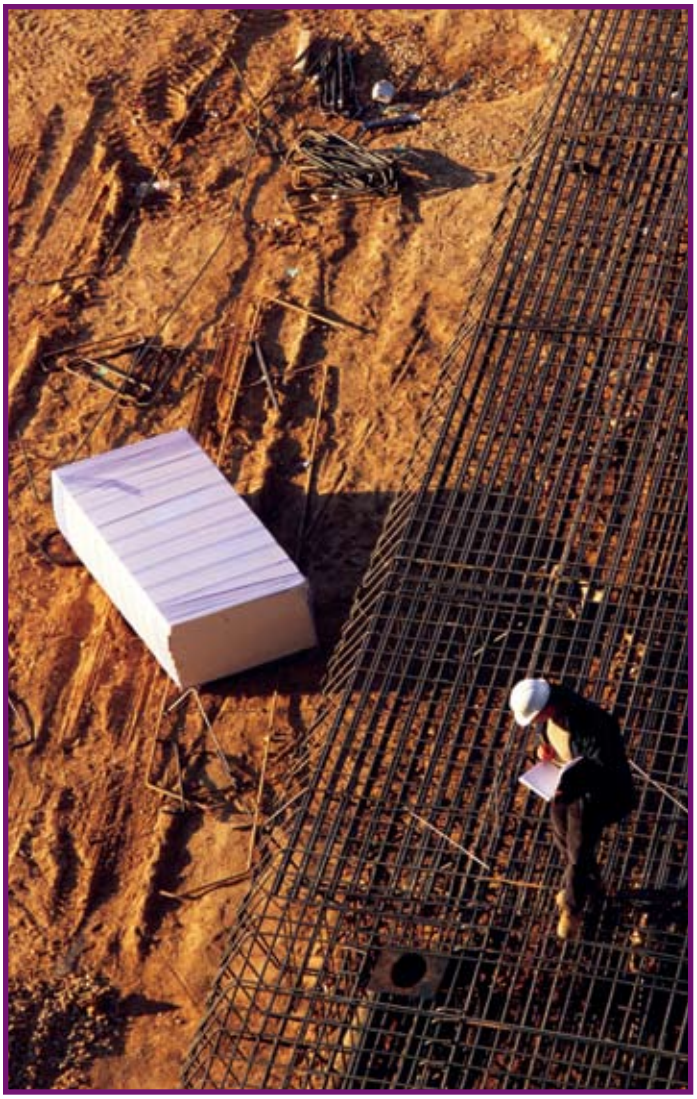
Consistency (or lack thereof)

As this case shows, when it comes to change orders, consistency can be either a help or hindrance, depending on a party's position. Although verbal change orders are fairly common in the course of many construction projects, they may not hold up in court if they're inconsistent with the established procedures of the parties involved. *T*

Policy limits: Even owners can't insure against faulty work

It's been well documented in many rulings from jurisdictions nationwide that a contractor can't buy insurance covering losses caused by its own faulty work. The same principle applies to building owners — if damage to a building results from faulty construction work, the owner's property insurance likely won't cover the loss. The case of *KAAPA Ethanol v. Affiliated FM Insurance* provides an example.





Taking a shortcut

In September 2002, KAAPA Ethanol hired a contractor to build an ethanol fuel production plant in Minden, Neb. Geotechnical reports on the plant site showed the native soil wasn't strong enough to bear the weight of the facility's huge tanks, some of which would hold nearly a million gallons of liquid.

Based on the soil reports, the design engineers called for construction of "compacted soil rafts" to support the tank foundations. These soil rafts were to be composed of two-foot layers of compacted aggregate, separated by layers of Tensar® Geogrid fabric. But instead of filling the soil rafts with the compacted aggregate layers called for by the geogrid manufacturer, the contractor backfilled the soil raft layers with clay excavation spoil from the site.

After a year of construction, the plant was put into operation in November 2003. And, in August 2004, KAAPA bought a property insurance policy from Affiliated FM covering the plant as well as business interruptions resulting from damage to the facility. The policy included a typical exclusion denying coverage for losses caused by "latent defect ... faulty workmanship, faulty construction or faulty design. ..."

Filing the claims

Within a month of buying the policy, KAAPA officials began to notice failures at the locations where some of the tank walls were fastened to their foundations.

KAAPA notified Affiliated of the situation and, over the next 14 months, KAAPA made a series of claims against the Affiliated policy, including claims for the cost of injecting grout into the soil to shore up the foundation walls and tank floors and for the business interruption resulting from having to shut down the tanks while repairing them.

Affiliated denied all KAAPA's claims, asserting that the losses were caused by faulty construction and, therefore, specifically excluded from coverage. KAAPA sued Affiliated, and both sides filed motions for summary judgment on the issue of coverage under the property policy.

> *Against the manufacturer's recommendation, the contractor backfilled the soil raft layers with clay excavation spoil from the site.*

The summary judgment motions were referred to a magistrate judge for recommendation. The magistrate recommended granting Affiliated a judgment of no coverage under the policy, reasoning that the "faulty construction" exclusion accurately described the causes of both physical damage to the tanks and the resulting business interruptions.

Knowing one's policies

The outcome recommended by the magistrate judge in this case emphasizes the general rule that, while parties to a construction contract can purchase insurance against acts of God and Mother Nature, neither the owner nor the contractor can purchase insurance to protect against shoddy construction work. And what holds true for contractor and owner alike is the importance of knowing one's insurance policies inside and out. *T*

Yesterday's promises

Doctrine of merger can create pitfalls for the unwary

In the course of developing real estate, transactions often consist of a combination of real estate contract documents and construction contract documents. Not surprisingly, such a plethora of paperwork can lead to confusion, assumptions and misperceptions — particularly when a legal dispute develops. Such was the case in *Bickerstaff Real Estate Management v. Hanners*.

No dumping

Earl Hanners, Jr. bought 1.59 acres of vacant property in Clayton County, Ga., from Southern Eagle Partners. Hanners intended to develop and sell the property for commercial use and arranged to have it graded and leveled for development using fill excavated from a nearby construction site. Once the grading and leveling was completed, Hanners agreed to sell the parcel for $375,000 to Bickerstaff Real Estate Management, which planned to build commercial buildings on the property.

In the sale contract, Hanners represented that the parcel hadn't been used "as a landfill or as a dump for garbage or refuse." During the time between execution of the sale contract and the closing, however, Bickerstaff's geotechnical engineer discovered that parts of the property contained buried construction debris. In response, Bickerstaff attempted to negotiate a reduction in the sale price equal to the cost of removing the debris and replacing it with clean fill.

But Hanners wouldn't agree to a price reduction, and the sale was closed at the full $375,000 price, with Hanners delivering to Bickerstaff a deed making no mention of the promise that there was no "garbage or refuse" on the land.

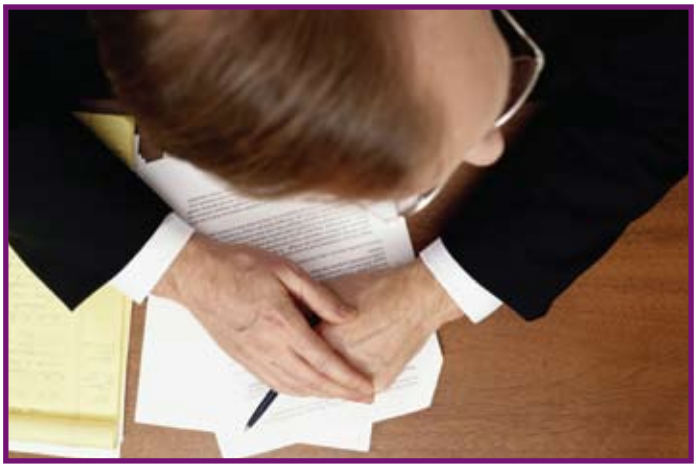
Not unexpectedly, while developing the property, Bickerstaff discovered the refuse and eventually spent $65,000 for removal of the construction debris and soil remediation. In turn, Bickerstaff sued Hanners, claiming Hanners had violated the promise in the sale agreement that there was no "garbage or refuse" on the site.

Applying the doctrine

After hearing the case, the trial court granted summary judgment in favor of Hanners and against Bickerstaff, ruling that the "doctrine of merger" applied. This is a legal rule providing that, unless the property transfer deed recites promises made in earlier agreements (such as a real estate sales contract or construction contract), those promises don't survive delivery of the deed that closes the real property sale.

The idea is that all previous documents are merged into the deed, and that only the provisions of the deed govern the rights and obligations of the parties once the deed has been delivered. As a result, the promise regarding refuse on the site didn't survive delivery of the deed, because it wasn't recited in the deed itself and the sale contract didn't specifically recite that that particular promise would survive the closing.

The Court of Appeals of Georgia affirmed the ruling in favor of Hanners and against Bickerstaff. Bickerstaff had to absorb the $65,000 cost of cleaning up the property before it could proceed with the planned commercial development.



Knowing what's important

Laymen may consider a deed of sale to be incidental to a transaction involving many pages of both real estate and construction documents. However, this case illustrates that in many circumstances the deed, though often only a page or two long, may be the most important document in the entire package.

In entering into a development transaction involving both construction and real estate documents, it's important for all parties to have experienced counsel review those documents. After all, there are special rules applying to real estate sales contracts and the deeds by which real property sales are closed. And anyone involved in such a mixed transaction needs to be aware of unexpected effects the "doctrine of merger" may have on the transaction.

Neighbor helping neighbor leads to AIA contract dispute

Many great communities have been built on the concept of neighbors helping neighbors. But when a construction project enters the picture, it doesn't take much for things to go awry. Case in point: *D'Angelo Development v. Cordovano*.

A contract is drawn up

D'Angelo and Cordovano were neighbors in Norwalk, Conn. D'Angelo Development had a contract to buy the vacant lot next door to Cordovano, and Cordovano wanted a new, custom-built house.

Being good neighbors, D'Angelo arranged for D'Angelo Development to sell the lot to Cordovano, and Cordovano hired D'Angelo Development to build a custom home on the lot, originally estimated to cost $578,700. Both parties were represented by lawyers.

At the closing on the vacant lot, the lawyers had their respective clients sign an AIA form of a cost-plus contract for construction of the Cordovano home, which was to be built according to a Cordovano design. D'Angelo Development was to be paid the actual costs of construction plus a fee of 20%, and Cordovano put down a $50,000 deposit toward construction.

Each party claimed the other owed it money because of a breach of the AIA contract their lawyers had prepared for them to sign.

The project proceeds ... poorly

Once the ink dried on the AIA contract, however, construction proceeded in complete disregard of its terms. Cordovano hired a "designer," who was neither an architect nor an engineer, to plan the home. D'Angelo Development hired trade contractors, without the competitive bids required by the AIA contract, to begin construction of the Cordovano house.

Partial permits were pulled, and changes were marked up on the designer's plans without any of the written

change orders called for by the AIA contract. Framers on the site modified structural elements based on conversations they had with D'Angelo and Cordovano.

Cordovano cut checks to D'Angelo Development totaling $1,217,523.31 without asking for or receiving any of the financial documentation the AIA contract called for to support D'Angelo's invoicing. By the time Cordovano moved into the new home, D'Angelo had billed for, but hadn't been paid, an additional $159,305.85.

What's more, Cordovano had paid an additional $42,489.69 to trade contractors and presented D'Angelo with a 27-item punch list. Lawsuits soon followed.

A judge rules

The case went to trial in the Waterbury District of the Connecticut Superior Court. Each party claimed the other owed it money because of a breach of the AIA contract their lawyers had prepared for them to sign.

The judge concluded otherwise, ruling that "it is clear to the court that the Cordovanos, D'Angelo Development and D'Angelo proceeded as if there were no contract in place." As a result, the judge sent both parties away empty handed, concluding that justice would leave them exactly where she had found them.

A simple concept expressed

The lesson from this case for contractors and developers springs from a fairly simple concept: A contract is only a contract if you act as if a contract exists. Ignoring the terms of a signed legal agreement could very well leave you bereft of recourse in court.

CLB *Quickcase*

Bannaoun Engineers v. Mackone Development

Stop notice costs contractor in the long run

Subcontractors with claims for extras on public works jobs sometimes seek to increase their leverage in settlement negotiations by asserting liens on project funds for inflated amounts. Their hope is that the general contractor will have to negotiate their claims quickly in order to get the government to continue making progress payments on the project. But such tactics often backfire, as illustrated by a recent case from Lynwood, Calif.

Mackone Development Inc. was awarded a contract to construct a new elementary school by the Lynwood Unified School District. Mackone subcontracted the curb, gutter and paving work to Bannaoun Engineers Constructors Corp.

During the course of the work disputes arose over extra work assigned to Bannaoun. Seeking to leverage its claims, Bannaoun served the School District with a stop notice for $144,300, including unreleased retention in the amount of $23,700 plus $117,000 in extras claims. Bannaoun's stop notice required the school district to withhold $180,000 in payments otherwise due to Mackone.

After a bench trial on the extra work claims, the trial court awarded Bannaoun a net recovery of $10,744.91 in damages plus a statutory late payment penalty of $2,138.07. Mackone appealed, challenging the late payment penalty award and asserting that the absence of written notice of Bannaoun's extras claims precluded recovery.

The California Court of Appeal determined that written notice of the extras claims wasn't required by the contract, and Bannaoun's *verbal* advices to Mackone that it was claiming extra compensation were adequate. The Court of Appeal, however, reversed the award of any late payment penalty. It ruled that the delay in payment arose from Bannaoun's own filing of the inflated stop notice, which held up payment to Mackone of far more than the amount ultimately determined to be due to Bannaoun.

Bannaoun's action in filing the stop notice holding up payment of more than fifteen times the amount it ultimately recovered ended up costing Bannaoun a little over 16.5% of the amount it was awarded in the trial court. In other words, the subcontractor's overreaching resulted in significant costs at the end of the day.