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CONSTRUCTION LAW BRIEFING

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The long slow road to court

Innovative "warranty" leads to IRS dispute

For contractors, tax accounting for project revenue presents many challenges. This is especially true where extended warranty periods may require a contractor to spend money on a project years after payment for that job was received.

In a recent New Mexico case, *Koch Industries v. Internal Revenue*, government efforts to initiate a new era of controlling the long-term costs of public infrastructure construction could have imposed unwarranted tax burdens on the contractor involved. Fortunately, the contractor's attorneys had other ideas.

A deal is struck

The State of New Mexico was looking for a way to more accurately control the long-term costs of highway construction and maintenance. Answering the call, asphalt contractor Koch Industries formed a subsidiary named Koch Performance Roads Inc. (KPR) to market Koch's new concept for long-term public highway cost control.

Rather than taking the traditional approach of quoting a price for initial roadway construction to be carried out under state-provided specifications and then periodically rebidding for repairs and maintenance, KPR proposed to offer a fixed price for the initial construction *as well as* all required maintenance and repairs to a particular highway over a 20-year period.

Calling this its "life-cycle approach," KPR believed it could deliver greater budget predictability to its government customer while hoping to realize increased profits from:

- ✓ Investment in higher initial costs for superior and longer lasting paving materials,
- ✓ Superior design knowledge and more conscientious preventive maintenance, and
- ✓ Continuous rehabilitation of the pavement.

Without this single price covering a long period, government "lowest responsible bidder" requirements would prohibit use of high-tech, high-cost materials in the initial construction. Koch and the State of New Mexico agreed to try this new approach on a major project to expand U.S. Highway 550, which would be funded with bonds backed by a pledge of future Federal Highway Administration funds. Total project cost: $420 million.

The IRS steps in

Out of that $420 million, $124 million was for interest payments on the bonds, and a little over $187 million was for subcontractor expenses during initial installation of the new pavement. KPR was to receive the balance of $108,753,000 divided between $46,753,000 in professional services for highway design and construction management and $62 million for its 20-year maintenance "warranty."

Koch and the IRS agreed that Koch was required to recognize the payment of $46,753,000 for professional services in the tax years during which it was received. Although the $62 million warranty payment was received in full at the end of the construction period, Koch sought to amortize that amount over the road's 20-year life in proportion to its budgeted expenses for preventive maintenance, repairs and replacement of failed roadway areas.

The IRS, however, insisted that the entire $62 million was revenue in the year in which Koch deposited the check in the bank. Obviously, this treatment would have had a very unfavorable income tax impact on the project's financial viability.

Nonetheless, Koch filed tax returns for 1998 through 2001 based on the percentage-of-completion method of reporting the $62 million payment under Internal Revenue Code Section 460 regarding income from long-term contracts. The IRS disagreed and sent Koch a notice of deficiency.

> *Calling it a "life-cycle approach," KPR proposed to offer a fixed price for the initial construction as well as all required maintenance and repairs over a 20-year period.*

To avoid penalties and interest on the disputed amount, Koch paid the additional tax assessed by the IRS but filed claims for refunds for each of the tax years involved. The IRS denied the refund claims, and Koch sued in the United States District Court for the District of Kansas (Koch is incorporated in Kansas), seeking refunds of the disputed tax payment.

The district court decides

The IRS argued that the document requiring the $62 million payment was designated by New Mexico and Koch as a "warranty," though both the state and Koch agreed that they used that term for political purposes to fit into the state highway contracting scheme, and that the warranty was merely incidental to the construction design and management services contract. Therefore, the IRS argued, the payment of $62 million represented income in the tax year received and shouldn't be amortized over the warranty's life.

In opposition, Koch filed a motion for summary judgment, asserting in detail how much money it — and the State of New Mexico — expected Koch to spend annually in maintenance and repairs over the two decades. The company further argued that the warranty part of the deal was, in fact, a long-term construction contract that would permit amortization of the $62 million over the 20-year contract life in proportion to those expected expenditures.

Ultimately, the district court granted the motion for summary judgment and awarded Koch a refund of the tax deficiencies assessed by the IRS.

Objective support is critical

It would be tempting to try to use this case as a basis for assigning an arbitrary price to any "warranty" provision of a construction contract, thereby deferring recognition of the specific amount of revenue into future tax years. Such arbitrary pricing of warranty provisions is exactly what the IRS was attacking in this case — and will likely attack again in the future.

In truth, the success of Koch in this case was based on the fact that, rather than merely claiming to have assigned an arbitrary portion of the contract revenues to future tax years, the contractor could objectively support that it had a legitimate basis for the $62 million price attached to the 20-year repair and maintenance requirement. Moreover, Koch could demonstrate how that requirement was integrated into the deal to likely enhance its own profit while giving budget certainty to the State of New Mexico. *T*

Faking a college degree can prove costly

More and more government bodies and private developers are requiring contractors submitting bids to provide resumés for the key managers who will be assigned to the job. A recent New Jersey case involving international construction contracts, *Wartsila NSD North America v. Hill International*, illustrates why these submittals must be reviewed for accuracy every bit as carefully as the final pricing information accompanying the bid itself.

The job goes slowly

In 1994, Wartsila signed a contract with Coastal Salvadoran Ltd. for construction of a diesel engine electric power plant in Nejapa, El Salvador. Wartsila then subcontracted the construction to Black & Veatch International.

When the project fell behind schedule, Wartsila hired Hill International as a consultant for management of the project. Hill's proposal for the consulting work included the resumé of Hill's senior consultant Richard LeFebvre, which stated that he:

- ✓ Held degrees in electrical engineering from Penn State and in business from Duquesne,
- ✓ Had taken business law courses at the University of North Florida, and
- ✓ Was a licensed professional engineer in Pennsylvania, New York and Massachusetts.

From January through May 1995, LeFebvre worked for Hill as project manager on the Nejapa construction site, and on June 1, 1995, with Hill's approval, Wartsila hired LeFebvre directly to manage work and claims on the job.

The job, however, wasn't completed on schedule. In May 1996, Wartsila and Black & Veatch commenced arbitration proceedings over Black & Veatch's delay claims as well as the cause of Wartsila's loss of an early completion bonus provided for in the contract with Coastal Salvadoran.

A shocking discovery

During arbitration hearings on the disputed claims in September 1997, Wartsila presented LeFebvre as an expert witness on the construction schedule and the impact of certain delaying events on the project.

> *Hill's proposal for consulting work included the resumé of a senior consultant who claimed, among other things, to have two college degrees.*

Cross-examination by attorneys for Black & Veatch disclosed that, contrary to representations on his resumé, LeFebvre had never attended Penn State, Duquesne or the University of North Florida. What's more, he had never been licensed as an engineer in Pennsylvania, New York or Massachusetts. After Wartsila's attorneys withdrew LeFebvre's perjured testimony, and tried to restructure their case, the arbitrators awarded $4.65 million to Black & Veatch.

In turn, Wartsila sued Hill for supplying LeFebvre's fraudulent resumé and, after a jury trial, Wartsila was awarded a verdict for $2,047,952 of the loss it had suffered against Black & Veatch. Hill appealed the verdict to the U.S. Court of Appeals for the Third Circuit, and that court sent the case back to the trial court for a determination of which part of the award represented direct damages to Wartsila and which part represented consequential damages (because Wartsila's contract with Hill had an enforceable provision excluding consequential damages).

Expensive exaggerations

Despite the fact that the verdict against Hill International could be reduced on retrial of the damages amount, this case presents a stark lesson for any contractor submitting professional resumés of its personnel with bid documents.

In short, exaggeration of professional qualifications and misrepresentation of background information on the education and experience of key managers — even if unintentional on the part of the contractor — can lead to expensive losses should a project fall behind schedule or not be completed according to the plans and specifications. *T*

4 CRITICAL TIMES TO UPDATE KEY EMPLOYEES' RESUMÉS

Every occasion for updating the resumé of a key employee or consultant also represents an occasion for checking the *accuracy* of that document. Four critical times to do so are:

1. Anytime employee resumés are submitted along with bid documents,
2. Whenever a new key employee is assigned to an ongoing project,
3. Anytime a departing employee in a key role is replaced by someone who has not previously worked on the project, and
4. Upon completion of a project, to correct any mistakes that may have been previously overlooked.

How do you spell "complete"?

One of the perpetual problems in writing clear construction contracts is defining the point at which contracted work is complete and final payment is due. Even when the contract is for moving completed homes from one location to another, sloppy draftsmanship can complicate what, theoretically at least, should be a relatively obvious legal outcome. Such was the case in *Laraway and Sons v. B&B Enterprises*.

Houses on the move

The City of Portage, Mich., condemned three homes for a public project. B&B Enterprises contracted with the City to remove the three houses from the land so the project could proceed and hired Laraway and Sons to transport the buildings to land B&B owned in Pavilion Township.

In a contract signed July 20, 2001, Laraway agreed to transport the homes for $70,000, with:

- ✓ $7,000 to be paid upon signing of the contract,
- ✓ $28,000 to be paid before the house moving began on July 23, 2001, and
- ✓ $35,000 (the balance) to be paid "when the houses are moved to their new location."

B&B didn't pay the $28,000 installment until Oct. 3, 2001, and closed on the purchase of the Pavilion Township property where the houses were going on Oct. 12, 2001. Laraway accepted the Oct. 3, 2001, late payment without protest.

On Nov. 6, 2001, Laraway moved the buildings to the Pavilion Township location, despite B&B's failure to disconnect the utilities and trim trees as called for in the contract. Because B&B hadn't yet excavated and built foundations for the three homes, Laraway set them close together on the Pavilion Township parcel.

In February 2002, B&B had completed one foundation, so Laraway moved one house and set it down on that foundation. When final payment for moving the homes was still not forthcoming, Laraway filed a lien claim against the Pavilion Township property on July 24, 2002, and filed a lawsuit to foreclose its lien.

Not a valid excuse

At trial in January 2006, B&B asserted in defense that Laraway had breached the contract because the remaining two homes had not yet been set down on their foundations. Nonetheless, the trial judge awarded the entire final installment of $35,000 to Laraway.

B&B appealed to the Court of Appeals of Michigan, but it affirmed, ruling that, though the terms of the contract required Laraway to "lower the homes onto the new foundation and supports," B&B couldn't use its own delays in completing the foundations as an excuse for delaying payment to Laraway. The court cited the plain language of the contract, which stated that final payment was due "when the houses are moved to their new location."

Because the contract included specific provisions for lowering the homes onto new foundations — but didn't include that language in the provision setting the time for final payment — the court held that final payment was due once the houses arrived at the property in Pavilion Township.

A lesson in details

As this case shows, though a job may appear complete, it really isn't until *all* of the applicable contract's terms have been met. This lesson in legal details set B&B back quite a tidy sum.

Keep your license current — or pay the price

When the state or city sends you a letter about renewing or updating your contractor's license, don't just let it sit on your desk. Failure to keep your licenses current can lead to harsh legal consequences for your construction business. So learned a California contractor not too long ago in *Goldstein v. Barak Construction*.

A job, a lawsuit, an appeal

Anita Goldstein and Eric Mizrahi owned a house in Los Angeles. On June 18, 2004, they signed a $363,000 contract with Barak Construction for remodeling and building an addition onto their house. Barak started work on the project but didn't obtain its California contractor's license until Sept. 17, 2004.

As work progressed, Goldstein and Mizrahi paid Barak a total of $362,660.50. But when Barak left the job site without completing the construction, the owners sued Barak and its founder, Ami Weisz, seeking return of the amount they'd already paid as well as additional sums for construction defects and attorneys' fees.

Goldstein and Mizrahi also sought, and were awarded, a writ of attachment against a house owned by Weisz until any judgment was paid in full. Barak and Weisz appealed the writ of attachment to the California Court of Appeal, which affirmed.

> *The law provides that a contractor may not collect money for construction unless the contractor was duly licensed "at all times during the performance of that act or contract."*

The lack of a license

The California Contractor's State License Law was designed to protect the public from incompetence and dishonesty at the hands of those who provide building and construction services. The court recognized that the statute represents "a legislative determination that the importance of deterring unlicensed persons from engaging in the contracting business outweighs any harshness between the parties."

Acknowledging that the law provides that a contractor may not collect money for construction unless the contractor was duly licensed "at all times during the performance of that act or contract," the Court of Appeal ruled that, while a construction company may sign a contract before the state issues the license, the contractor may not begin work until it actually receives the license.

Thus, because Barak had begun working on the Goldstein/Mizrahi project before receiving its license, the Court of Appeal ruled that the legislature's intention to impose an all-or-nothing penalty on unlicensed builders should prevail over the fact that the homeowners would end up receiving over $300,000 worth of work without paying a dime.

Despite the fact that Barak claimed it was owed an additional $80,000 for certain "extras" to the original contract price that were installed after the license was

obtained, the Court of Appeal ruled that Barak's act of starting work on the site without first having received its contractor's license ruled out the possibility of Barak retaining any payment at all.

No mere formality

As this case demonstrates, the act of obtaining and maintaining a valid contractor's license is not the "mere formality" that many construction business owners assume it to be. Whatever the cost in money, time and effort Barak may have needed to expend to either get its license sooner, or delay commencement of work until it had the license, that cost most certainly would have been less than the nearly $400,000 worth of work that the homeowners got to keep for free.

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Loewe v. Seagate Homes

Building code trumps exculpatory clause in homeowner injury

In June 2003, Floridians Sue and Warren Loewe signed a contract to buy a new house from Seagate Homes. After construction was complete, the purchase was closed on Oct. 26, 2004, and the Loewes moved into their new home on Nov. 1, 2004. About a week later, a bathroom closet door fell off its track, hitting Mrs. Loewe in the eye and causing permanent injuries.

The couple sued Seagate for the eye injuries Mrs. Loewe had suffered, and Seagate defended on the basis of an exculpatory clause in the home purchase contract. The exculpatory clause purported to release Seagate from all injuries and damages resulting:

> … in whole or in part from the construction process, the constructed dwelling or the lot on which it is constructed, the materials and supplies used in or incorporated into the dwelling or the lot in which it is constructed and the components therein.

The trial judge ruled that this provision was unambiguous and enforceable, and dismissed the Loewes' lawsuit.

The Loewes appealed the dismissal to the Florida Court of Appeal. That court reversed, sending the case back for trial to determine whether the faulty closet door was a building code violation, and whether the problem with the door was due to negligence by Seagate. The Court of Appeal based its ruling on the reasoning that "a party may not contract away its responsibility to comply with a building code when the person with whom the contract is made is one of those whom the code is designed to protect."

The Court of Appeal further held that Florida's regulation and licensing of contractors and adoption of building codes to impose specific construction standards reflect a clear public policy to protect homebuyers from personal injuries caused by improper construction practices. Accordingly, the court ruled, if the defective closet door was a result of Seagate's negligence, Seagate would be liable to the Loewes — even if the problem with the bathroom closet door wasn't caused by a specific building code violation.

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