

CONSTRUCTION LAW BRIEFING



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Considering some government work?

Additional rules may apply

When litigation involves a federal construction project, the usual rules don't always apply. Suing the U.S. government requires a plaintiff to jump through some additional hoops. In *Nelson Construction Co. v. United States*, one contractor learned this lesson the hard way.

My way or the highway

In this case, the prime contractor, Lemhi Environmental Diversified (Lemhi), entered into a contract with the Federal Highway Administration (FHA) to perform work on Idaho State Highway 21. Donald Nelson, owner of Nelson Construction, acted as a mentor to Lemhi's president, Rod Ariwite.

Nelson assisted Ariwite, a Native American, in obtaining Section 8(a) minority set-aside work under a federal program favoring disadvantaged minority-owned businesses and worked as a subcontractor on the job. In addition, both Nelson and his company served as indemnitors on performance and payment bonds furnished by Travelers Casualty & Surety Co.

Not long after the project began, Lemhi collected payments from the FHA but "created a false claim" against Nelson and refused to pay the company for the work it had done. Nelson sued Lemhi and its surety in state court and won a judgment of nearly \$1 million but was unable to collect. That is, Nelson

made a claim on the payment bond, but Travelers refused to pay, noting that Nelson, as indemnitor, would have to give the funds right back to Travelers.

Recognizing his dilemma, Nelson notified Lemhi, Travelers and the FHA that he would cease work on the project unless alternative payment arrangements were made.

Shortly thereafter, Lemhi executed an agreement in which it assigned future payments on the project to Travelers. The alleged purpose of the assignment was to ensure performance by having Travelers serve as escrow holder for the benefit of Nelson and Nelson Construction. But the agreement didn't say this; in fact, it didn't mention Nelson at all.

The FHA acknowledged receipt of the assignment and made six consecutive payments to Travelers. But, contrary to the terms of the assignment, the agency made the final payment of more than \$600,000 directly to Lemhi. Nelson Construction sued the federal government in the U.S. Court of Federal Claims, seeking to collect its share of the final payment.

Strike one, strike two ...

Nelson offered three theories of recovery against the government. The first two counts relied on the doctrine of equitable subrogation, which allows a party who has been compelled to satisfy a debtor's obligation to a creditor to "stand in the shoes" of the creditor and pursue any legal remedies it may have against the debtor.

In this case, Nelson argued that he and his company were obligated to indemnify Travelers for payments on the payment bond and, therefore, Nelson and Nelson Construction were subrogated to Travelers' rights to collect from the government under the indemnity agreement or the assignment agreement.

The court dismissed both counts, explaining that, under the doctrine of sovereign immunity, the federal government can't be sued unless it consents. And, while statutes permit suits against the government for monetary relief under certain circumstances, they're generally limited to plaintiffs who are in "privity of contract" with the government (that is, who contract directly with the government).



AN UNCERTAIN OUTCOME

Although the complaint in *Nelson Construction Co. v. United States* survived the motion to dismiss (see main article), it's far from clear, as of this writing, whether the plaintiffs will prevail at trial.

The facts may very well reflect the government's implied intent to benefit the plaintiffs directly, but that result is by no means certain. If the assignment had expressly stated that the purpose of the alternative payment arrangement was to protect Nelson and Nelson Construction (see "My way or the highway" on page 2), perhaps the outcome would be more certain.

Count three is a hit

Count three asserted that Nelson and Nelson Construction were third-party beneficiaries of the assignment agreement and the agreement between Lemhi and the government to modify the contract's payment terms. (Intended third-party beneficiaries are another exception to the privity rule.)

Here the court denied the government's motion to dismiss. The key issue in determining third-party beneficiary status is whether the agreements reflect the government's intent to benefit the plaintiffs directly. During oral argument, the government contended that it had no intent to benefit plaintiffs — in fact, it didn't

really care whether subcontractors were paid or not because it could easily replace a subcontractor that walked off the job.

The plaintiffs countered that only a few contractors were capable of performing the work in the required timeframe, so Nelson was essential to completion of the project. And for purposes of a motion to dismiss, the court assumes that the plaintiffs' allegations are true. In this case, the plaintiffs alleged that:

- ✓ They had notified the government and other parties that they would stop work on the project unless their interests were protected,
- ✓ Lemhi and Travelers had entered into an assignment agreement to protect the plaintiffs, and
- ✓ The government had acknowledged receipt of the assignment, modified the contract's payment terms, and made six consecutive payments to Travelers under the new arrangement.

Giving the plaintiffs the benefit of the doubt, these allegations were sufficient for the case to proceed to trial.

A different animal

This case illustrates how important it is for contractors working on federal projects to ensure that the government's obligations to them are clearly spelled out in the construction contract as well as in other documents — for the government has rights and legal recourse not typically available to an owner in the private sector. ↑

Actions speak louder than words

When contracts are ambiguous, courts look to conduct

In the event of a construction dispute, a written contract is usually the best evidence of the parties' intent. But, if a contract's terms are ambiguous or contradictory, courts place a great deal of weight on the parties' *interpretation* of that contract as reflected by their statements and conduct.

Such was the case in *Building Construction Enterprises, Inc. v. Gary Meadows Construction Co., Inc.*, which involved a dispute over the scope of work to be completed by the defendant. The contract itself was unclear, but the parties' dealings

with each other during the course of the project provided compelling evidence.

Plaintiff digs in

In July 2001, Building Construction Enterprises (BCE), as general contractor for work on the Arkansas State University student center, subcontracted with Meadows for certain demolition, earthwork, paving and other services.

A dispute between the parties, however, arose in March 2005. BCE claimed that Meadows was

responsible for excavation, fill and backfill work under the contract, while Meadows argued that the parties hadn't intended for the contract to cover those items. BCE sued Meadows in the U.S. District Court for the Eastern District of Arkansas.

Contract contradictions

Unfortunately, the contract's terms were contradictory. Paragraph 4, which listed the general categories of work to be performed by Meadows, included excavation, fill and backfill. But these services weren't listed in paragraph 5 of Attachment "A," which outlined the specific work items Meadows was required to perform. This list mirrored the items set forth in Meadows' original proposal, which didn't include excavation, fill and backfill.

Meadows asserted that, given a contradiction between the contract's general provisions and more detailed, specific provisions, the specific provisions should control. He also offered evidence that BCE's conduct was consistent with Meadows' construction of the contract.

For example, Meadows alleged that, several months after the contract was signed, BCE asked him to submit a proposal for excavation work, which BCE ultimately rejected. Nevertheless, from October 2001 until November 2004, BCE asked Meadows to perform extra work consisting of excavation, fill and backfill. Meadows submitted invoices for this extra work and BCE paid for the work as billed.

According to Meadows, it wasn't until March 2005, when a new job superintendent took over, that BCE took the position that excavation, fill and backfill were within the scope of the original contract. After that, BCE refused to pay Meadows for extra work that had already been completed.

Defendant eligible for "parol"

BCE filed a motion for an evidentiary ruling before trial, asking the court to exclude Meadows' evidence under the "parol" evidence rule. This rule generally prohibits the introduction of extrinsic evidence — such as proposals, bids, negotiations or other communications between the parties — to change the meaning of a written contract.

The district court denied BCE's motion. The rationale behind the parol evidence rule is that the written contract is the best evidence of the parties' intentions. But that rationale falls apart when the contract is ambiguous. Under those circumstances, parol evidence is admissible to aid the court in resolving the ambiguity.

The court also pointed to a well-established Arkansas law that says, when interpreting construction contracts, "the construction the parties themselves have placed on the contract is entitled to great weight" — especially, the law specifies, when the written contract is ambiguous.

In this case, because the subcontract between BCE and Meadows was ambiguous, Meadows was entitled to introduce parol evidence at trial, including the parties' conversations, negotiations and behavior related to the contract.

Let the contract do the talking

As this case demonstrates, a party's conduct and other extrinsic evidence can be a lifesaver from a poorly drafted contract. But, to avoid the time and expense of litigation, the best course is to ensure the contract spells out each party's rights and obligations clearly. *T*



Tanks but no tanks: Neglected permit fuels lawsuit

A contractor hired to remove and replace underground gasoline storage tanks neglected to obtain a building permit, igniting a lawsuit by the gas station's owner. That lawsuit, *Hamedi-Fard v. Padda*, provides a clear lesson on the risks of skirting permit requirements on a construction project.

Plaintiff runs out of gas

The plaintiff, Ravinder Padda, owned a gas station and convenience store. Over the years, she'd hired the defendant, Frank Hamedi-Fard, to remediate underground leakage from the storage tanks and provide advice on complying with California law.

In 1999, a change in state law required the replacement of older underground storage tanks. Padda couldn't afford to replace her tanks, so she stopped selling gas but continued to operate the convenience store.

In 2002, Padda contracted with Hamedi-Fard to remove the old tanks and replace them with a new tank. The contract price was \$130,000, with \$70,000 paid up front and the balance to be paid monthly. Hamedi-Fard agreed to obtain "all necessary permits" and estimated the job would take eight to 10 weeks.

After Padda paid the initial \$70,000, Hamedi-Fard began removing the old tanks. And when a city building inspector visited the site, Hamedi-Fard's foreman told him they were only removing the old tanks and repaving the lot, so a building permit wasn't necessary. On a later visit, however, the inspector saw that Hamedi-Fard's crew was installing a new tank and immediately issued a stop-work notice.

In response, Hamedi-Fard asked Padda to obtain the permit, explaining that it would take only five to 10 days. But Padda soon learned that, because the gas station had been dormant for more than 180 days, its use permit had expired. Padda would have to apply for a new use permit before she could obtain a building permit for the new tank.

After about a year of proceedings, the city's planning commission denied Padda's request for a use permit (or, alternatively, a variance), and the city council rejected Padda's appeal. The commission's action was likely at least partly motivated by Hamedi-Fard's attempt to do the work without a building permit.



The courts weigh in

At trial, Padda won more than \$70,000 in damages as well as more than \$70,000 in attorneys' fees and costs. These amounts were offset, however, by the cost of removing the old tank and the scrap value of the new tank.

On appeal, Hamedi-Fard raised several arguments, some of which attempted to shift responsibility to Padda for failing to maintain the use permit. The California Court of Appeal rejected these arguments, however, noting that Hamedi-Fard's failure to obtain a building permit was a factor in the denial of the use permit and that, had he attempted to obtain a permit, much of Padda's damages could have been avoided.

In addition, the court ruled that, because of Hamedi-Fard's experience with Padda's business, he should have known that the use permit had expired. Ultimately, the award was upheld, with the exception of \$2,500 for repaving the site, which was deemed part of the tank removal costs.

A costly mess

As this case demonstrates, when a contractor works without a permit, he or she doesn't risk only delays and fines. There's also a very real possibility that the project itself may turn from a pleasantly profitable endeavor into a costly mess. ↑

Court confronts statutory notice requirement in homebuilding dispute

When a homebuilder is accused of substandard workmanship, courts must often determine whether the owner provided adequate notice of the project's shortcomings and whether the builder had actual knowledge of the alleged defects. Such were the questions in *Frank v. Tran*.

Dissatisfied customer

The case arose when the homebuilder, Melton Frank, sued the homeowner, Bill Tran, for the final two payments under their contract. Frank claimed that only minor detail work remained but that Tran denied him access to the home to complete it.

Tran denied these allegations and filed a reconventional demand — the Louisiana equivalent of a counterclaim — seeking damages for various construction defects under the state's New Home Warranty Act (NHWA). Frank responded that Tran couldn't recover under the act because he'd failed to notify Frank of the defects by registered or certified mail within one year and to give him a reasonable opportunity to correct them, as expressly required by the NHWA.

The record showed a history of complaints during construction, including detailed fax transmissions (such as a punch list of 27 items) outlining specific construction defects.

Frank moved for summary judgment on his claim as well as on Tran's, and the Louisiana 31st Judicial District Court granted the motion. The court ruled that Frank had substantially completed the project and



was entitled to the remaining contract payments. It also ruled that Tran's counterclaim was barred by his failure to meet the NHWA's notice requirements.

An absurd consequence

In Louisiana, as in most states, summary judgment is appropriate when the pleadings, depositions, affidavits, interrogatory answers and other filings show that there is no genuine issue of material fact, and that the party filing the motion is entitled to judgment as a matter of law.

In this case, the court of appeal reversed the summary judgment. Regarding Frank's claim for payment, the court found there were genuine issues of material fact as to whether Frank had substantially completed the project. Among other things, the court pointed to an architect's affidavit stating that construction was of substandard quality and failed to comply with local building codes.

With regard to Tran's claim under the NHWA, the court of appeal cited Article 9 of the Louisiana Civil Code, which provides for a statute to be applied as written when it's "clear and unambiguous and its application does not lead to absurd consequences. ..."

The record, including Frank's deposition, showed a history of complaints by Tran during construction, including detailed fax transmissions (such as a punch list of 27 items) outlining specific construction defects. To deny Tran the opportunity to pursue his NHTA claims under these circumstances, the court reasoned, would be an absurd consequence.

A significant ruling

The court's ruling left several issues to be decided at trial, including whether Tran had provided Frank with an opportunity to correct the alleged defects. It's significant, however, that the court was unwilling to deny Tran an opportunity to pursue his claims based solely on failure to comply with formal notice requirements. *T*

CLB Quickcase

Argonaut Great Central Insurance Company v. Ditocco Konstruction, Inc. **Subrogation waiver extends to postconstruction losses**

The issue in this case was whether the waiver of a subrogation clause contained in the standard AIA construction contract extends to losses that occur *after* a project is completed.

The contract was for renovating and remodeling a T.G.I. Friday's restaurant. Nearly five years after the work was done, a fire destroyed the restaurant. The fire marshal determined that the fire had been caused by a broiler that had been installed directly against a combustible wood wall with unsealed cut-outs.

At the time of the fire, Argonaut insured the restaurant property. After paying the owners more than \$3 million under the policy, Argonaut sued the contractor and subcontractors for negligence and breach of warranty, claiming it was subrogated to the owner's rights against them. The defendants moved for summary judgment on the ground that the owners had waived any subrogation rights against the defendants, and the district court granted their motion.

The purpose of a waiver of subrogation clause is to allow one party (usually the owner) to provide property insurance for all parties to the construction contract. It helps prevent disruption and disputes over responsibility for property damages by shifting the risk of loss to the insurer.

In this case, Argonaut contended that the clause applied only to losses *during* construction, reasoning that, once the contract is completed, the policy justification for the clause (to prevent disruption of the project) disappears. The United States District Court for the District of New Jersey, however, found that the language of the AIA contract "is unambiguous and clearly extends the waiver of subrogation to post-construction losses suffered by the Owners."

Contractors should keep in mind that, for a waiver of subrogation to be effective, the insurance company must consent. Many policies allow the insured to waive subrogation before a loss, but some policies prohibit it — particularly with respect to design professionals. Others allow it, but only with the insurer's prior permission. It's critical, therefore, to examine the policy language carefully.

