



# NYCLA CONSTRUCTION LAW JOURNAL

A publication of the NYCLA Construction Law Committee

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## Letter From the Chair

Dear colleagues, thank you all for your participation and contributions over the past year. The effort that everyone has put forward has really allowed the Committee to grow and make a difference. The support and contributions to the Journal have been remarkable. Again, congratulations to our Editor, Gary Strong, who really deserves all the credit for making the Journal happen. Special thank you to all of those who made the time to be a speaker at a CLE or a committee meeting.

As we move into the summer months planning for the fall and next spring will gather momentum. I encourage all of you reading this to get more involved. We are always looking for people to speak at and lead CLEs. If you have an idea for a CLE or a topic for discussion at a meeting, please contact Ariel Weinstock or myself. We would love to hear from you. If you have an idea for an article for the Journal, please contact Gary Strong or myself.

I hope to see you all again this fall and encourage those of you thinking about it to join us.

Regards,

Joel

## Statement of the Editor In Chief

Summer will soon be upon us with heat and humidity and hopefully many public and private construction projects will be in full bloom in New York and the tri-state area. This issue of the Journal contains a wide range of articles including but not limited to Labor Law §240, termination for convenience clauses, and the usual case summaries.

As I am always seeking to improve the journal we will soon be soliciting articles for the Fall Journal so if you are working on an interesting case and have a topic feel free to contact me or the co-chairs about submitting such an article.

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# Recent Trends And Financing 101 For Construction Projects

By Sarah B. Biser, Esq., Robert A. Rubin, Esq., and Stephanie Spangler

It is no secret that the downward economy effected a change of pace in the construction industry, resulting in notable shifts in bargaining leverage of the parties involved in construction projects, and subsequently altering some financing practices. This article briefly outlines the recent trends in the construction industry, and a basic description of how projects are financed.

## Recent Trends in the Construction Industry

The past year has been characterized by three main trends: resurgence of stalled construction projects, increased litigation, and increased bargaining leverage for owners. Though there has been a decrease in new starts for both residential and commercial construction in the past year,<sup>1</sup> there has been a slow but perceptible resurgence of projects that had been suspended or terminated, particularly in New York City. New projects principally seem to be started by self-funded owners.

During 2009, there was a significant reduction in litigation because of, among other factors, an unwillingness to spend scarce funds on litigation and uncertainty in the collectability of judgments once obtained. However, 2010 was characterized by a slight uptick in litigation because money and credit appeared to be more available, and because some members of the business community were more willing to accept the risks and expense of litigation.

The third trend marks increased leverage for owners. Owners have increased negotiating power with regard to existing, large projects. On the other hand, only a limited number of contractors have the financial resources to do large projects, a fact that offsets the shift in negotiating power to owners. Any owner who is able to proceed with a construction project, despite the economic downturn, has greater negotiating power in the global economic slowdown. Owners are reported to be renegotiating contracts with contractors for small and medium-sized projects, and contractors often have no choice but to renegotiate terms. Owners are keenly aware that they have increased leverage to negotiate, and given that owners' ability to finance projects is restricted, owners are terminating for default more easily and threaten to invoke termination for convenience clauses to force renegotiation of certain terms.

## Financing 101

The identity of the owner (i.e. a public or private entity; municipality; large cap, mid-market or new venture) and type of construction project greatly influences how a project is financed. Corporations can fund construction projects by: (1) funds borrowed from construction lenders, which is the most common financing arrangement; (2) capital reserves; (3) equity investments; and (4) bond or letters of credit issuance. Municipal projects are frequently financed through government grants and the issuance of tax exempt bonds.

Typical construction lenders include national banks, state-chartered banks, federal savings associations, real estate investment trusts, pension funds, and insurance companies. Before making a loan, construction lenders require proof of both equity investment and reachable assets beyond the construction site or work in progress.

Commercial bonding companies offer third party guarantees of performance. In exchange for the bond premium, a bonding company completes the contract work for the lender on payment of reserved loan funds, if all is otherwise in balance (that is, if there are sufficient funds remaining in the construction budget to finish the project).

Letters of credit in lieu of bonds have become an increasingly popular method of financing. Though letters of credit are proffered for the same reason as bonds--security to the owner--the differences are noteworthy. The issuer of a letter of credit must pay the beneficiary upon receipt of proper documentation as specified by the letter. The issuer cannot complete the project nor loan its principal funds to complete the project. Importantly, if there is a dispute between the contractor and owner, but the conditions for payment pursuant to the letter have been met, the contractor must resort to recovery from the owner and in the form of a lawsuit if necessary.

Lenders also require borrowers to conditionally assign the construction and design contracts (even if they are not secured by surety bonds), and the contractors' and suppliers' warranties, which are taken over in the event of borrower default. Loan funds are typically advanced (after a hold-back of usually 10%) to the borrower/owner (or, as may be required by the lender, directly to the contractor) on satisfaction of various conditions provided for in the loan agreement. Such conditions typically include, without limitation, the provision of: (1) a bring down report from the title company indicating that there are no intervening liens since the last disbursement; (2) an architect's certification that the work has been performed in accordance with the contract; and (3) partial or final lien

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<sup>1</sup> *February Construction Slips 4%*, ENGINEERING NEWS-RECORD, Mar. 28, 2011, at 9.

waivers from the contractor, subcontractors and suppliers.

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## RPAPL §881 And Preventing Collapse Of An Adjacent Building

By Kenneth G. Roberts, Esq.

What happens if the Building Code requires a developer to perform safety or protective work on an adjacent property in order to proceed with construction on the developer's property, but the neighbor will not grant access? Normally, New York State Real Property Actions and Proceedings Law ("RPAPL") §881 would provide important relief to the developer by authorizing a judicial grant of a license to enter the adjacent property and perform the required work. But what if the court denies the license? Public safety could be threatened, or important development could be stymied.

The issue becomes significant when the Building Code requires stabilization of an adjacent building that may be subject to collapse. When a developer excavates its property near an existing adjacent building, the New York City Building Code ("Building Code") requires underpinning – a process of strengthening and stabilizing the foundation of a building – to avoid destabilization and collapse of the building.<sup>1</sup> Obviously, building collapses cause substantial property damage and personal injury not only to the adjacent property owner but also to other properties and innocent passersby.

The case law on whether RPAPL §881 applies to underpinnings of adjacent buildings is sparse, likely because the majority of these situations are resolved amicably. Recent decisions, discussed below, appear to indicate that a Section 881 license cannot be granted for an underpinning. However, when amicable resolution is impossible, a court should be able to balance the competing interests under §881 and grant a license to underpin adjacent property "in an appropriate case upon such terms as justice requires."<sup>2</sup>

### The Underpinning Problem

In dense urban areas such as Manhattan – where many buildings are built right up to the adjacent property line – developers often need access to the adjacent property in order to comply with safety requirements imposed by the Building Code. Common examples include a requirement to install protection on the roof of an adjacent building to protect it from falling debris, or a requirement to erect sidewalk bridging in front of adjoining property in order to protect pedestrians walking near the construction site.

According to experts, inadequate underpinning results in more frequent failures and costly lawsuits than any other construction failure event. In recognition of the problem, the New York City Department of Buildings ("DOB") created a special excavation unit to inspect sites and ensure protection of adjacent properties. According to the DOB, "[e]very excavation site has the possibility of impacting at least three existing buildings on neighboring lots, as well as nearby public walkways and streets."<sup>3</sup> For example, in 2008, DOB issued 4,300 permits for excavation work in conjunction with new buildings, "meaning that approximately 13,000 neighboring buildings could have been affected."<sup>4</sup>

In order to prevent destabilization and collapse of adjacent foundations, the Building Code requires developers to "at his or her own expense, underpin the adjacent building" provided the developer is afforded "a license ... to enter and inspect the adjoining buildings and property, and to perform such work thereon as may be necessary for such purpose."<sup>5</sup> This brings us to the question: what can a developer do if the adjacent property owner refuses or imposes unreasonable conditions to a license to underpin?

### RPAPL §881

In general, when an adjacent property owner refuses to grant a developer necessary access, Section 881 allows the developer to commence a special proceeding to obtain a license to enter the adjacent property. The developer must demonstrate: (1) it "seeks to make improvements or repairs to real property"; (2) the improvements are "so situated that such improvements or repairs cannot be made by the owner... without entering the premises of an adjoining owner"; (3) "permission so to enter has been refused"; and (4) the dates on which entry is needed. RPAPL §881.

Significantly, §881 evenhandedly protects the neighboring property owner by making the developer "liable to the adjoining owner or his lessee for actual damages occurring as a result of the entry." *Id.* It also allows the court to impose "such terms as justice requires." *Id.* Thus, once a developer demonstrates that entry onto an adjacent property is necessary for improvement to real property, it would appear that the only issue for the court to decide is what conditions, if any, "justice requires" to be imposed on the developer. The statute thus calls for the court to balance the

<sup>1</sup> Building Code §3309.5 (the Building Code is contained in N.Y.C. Admin. Code §28-701.2).

<sup>2</sup> RPAPL §881.

<sup>3</sup> *The New York Times*, "City to Overhaul 'High-Risk Construction' Rules," Feb. 3, 2009, <http://cityroom.blogs.nytimes.com/2009/02/03/city-announces-overhaul-of-high-risk-construction>.

<sup>4</sup> *Id.*

<sup>5</sup> Building Code §3309.5.

competing interests of both the developer and the adjacent owner – allowing construction to proceed while protecting the adjacent owner’s property rights with safeguards such as insurance, indemnity, and temporal and spatial restrictions on the incursion.<sup>6</sup>

In *Chase Manhattan Bank v. Broadway, Whitney Co.*,<sup>7</sup> the New York Court of Appeals upheld the constitutionality of §881 under, inter alia, the due process, taking, and equal protection clauses of the United States and New York Constitutions. The Court affirmed the lower court’s opinion which recognized that “the statute is in accord with the modern concept of permissible police power, particularly in large cities, where failure or inability to repair existing structures encourages urban blight.”<sup>8</sup>

In addition to being based in the principle of permissible police power, Section 881 can also be seen as rooted in the common law exception to trespass known as the doctrine of “private necessity”. As recognized by the New York State Law Revision Commission when it recommended the enactment of RPAPL §881, the doctrine of private necessity “is an important qualification to the statement that entry of a person on the land of another is an actionable wrong.”<sup>9</sup> Under the doctrine of private necessity, “[o]ne is privileged to enter or remain on land in the possession of another if it is or reasonably appears to be necessary to prevent serious harm to (a) the actor, or his land or chattels, or (b) the other or a third person, or the land and chattels of either, unless the actor knows or has reason to know that the one for whose benefit he enters is unwilling that he shall take such action.”<sup>10</sup> Significantly, even the fact that the adjoining property owner is unwilling “does not destroy the privilege to act for the protection of the interest of a third person.”<sup>11</sup>

§881 is also grounded in the equitable principle that any one landowner’s property rights are not immutable but, rather, are subject to balancing with other private and public interests. As explained by the New York Court of Appeals, a court of equity will not blindly protect an adjacent owner’s property rights where there are “other considerations which forbid, as inequitable, the remedy of the prohibitive or mandatory injunction.”<sup>12</sup> Thus, in balancing the competing

interests, New York courts will not enjoin a trespass that causes relatively little harm to the landowner when the purpose is to prevent great private or public danger: “If the protection of a legal right even would do a plaintiff but comparatively little good and would produce great public or private hardship, equity will withhold its discreet and beneficent hand and remit the plaintiff to his legal rights and remedies.”<sup>13</sup>

Thus, it is seen that §881’s balancing of interests is well-grounded in the concept of permissible police power, the common law qualification on trespass known as “private necessity,” and equitable principles of balancing the relative benefits and hardships of the parties.

### **Between a Rock and a Hard Place**

The Building Code requires a developer who is excavating its property to, “at his or her own expense, preserve and protect from damage any adjoining structures,”<sup>14</sup> and to, “at his or her own expense, underpin the adjacent building.”<sup>15</sup> Each of the preceding requirements expressly condition the developer’s obligations on the neighbor affording the developer a license “to enter and inspect the adjoining buildings and property, and to perform such work thereon as may be necessary for such purpose.”<sup>16</sup> If the neighbor refuses, the Building Code shifts the “duty to preserve and protect the adjacent property” to the neighbor.<sup>17</sup>

Yet shifting the “duty to preserve and protect” the property to the neighbor may leave the developer between a rock and a hard place. The Building Code does not, for example, specify that the neighbor must underpin his own property or state when he is required to perform the work. Thus, the neighbor is in a position to stymie the development. Even if the neighbor proceeds immediately, the Building Code by no means releases the developer from liability if the neighbor’s underpinning is defective and collapse of the neighbor’s building causes personal injuries and property damage to third parties.

### **Judicial Application of RPAPL §881 to Underpinnings**

The difficulty faced by a developer who needs to underpin a recalcitrant neighbor’s property appears custom-made for a court to alleviate under RPAPL §881. Allowing a developer to underpin the neighbor’s property in order to protect the public from a dangerous collapse would seem to be precisely a circumstance

<sup>6</sup> *E.g., Rosma Development, LLC v. South*, 798 N.Y.S.2d 713 (Sup. Ct. Kings Co. Oct. 19, 2004).

<sup>7</sup> 294 N.Y.S.2d 416 (Sup. Ct. Queens Co. 1968), *aff’d mem.*, 24 N.Y.2d 927, 249 N.E.2d 767, 301 N.Y.S.2d 989 (1969).

<sup>8</sup> 57 Misc. 2d at 1094.

<sup>9</sup> N.Y.S. Law Revision Commission, Leg. Doc. (1966) No. 65(B), at 11.

<sup>10</sup> Restatement (Second) of Torts § 197 (1965).

<sup>11</sup> *Id.* at Comment e.

<sup>12</sup> *McCann v. Chasm Power Co.*, 211 N.Y. 301, 305 (1914).

<sup>13</sup> *Id.*

<sup>14</sup> Building Code §3309.4.

<sup>15</sup> *Id.* §3309.5.

<sup>16</sup> *Id.* §§ 3309.4, 3309.5.

<sup>17</sup> *Id.*

RPAPL §881 was designed to address. Yet, in *Broadway Enterprises, Inc. v. Lum*,<sup>18</sup> the courts refused to grant the builder a Section 881 license for an underpinning. The builder had obtained a permit from DOB to construct a three-family home on its property but was refused access to underpin the neighbor's foundation. The motion court denied the builder's Section 881 petition for a license to perform the underpinning, and the Appellate Division affirmed on the grounds that "the underpinning could constitute a permanent encroachment and there are alternative methods of construction that the petitioner may utilize in constructing its property."<sup>19</sup>

By combining two reasons for its decision – (1) the underpinning could be permanent; and (2) alternative construction methods may exist – the Appellate Division may have left open the possibility that a Section 881 license could be granted for a permanent underpinning if no reasonable alternative exists. However, if the two bases for the decision are seen as disjunctive, the holding in *Broadway Enterprises* may preclude operation of Section 881 whenever there is a possibility of a permanent encroachment – as at least one court has recently stated.<sup>20</sup>

Yet precluding a Section 881 license for a permanent underpinning may not be justified under the statute or the principles on which it is based. First, §881 does not expressly limit its application to temporary encroachments or expressly preclude a license for a permanent encroachment. Rather, its only limitation is that the case must be "appropriate" and the terms of the license must be "just": "Such license shall be granted by the court in an appropriate case upon such terms as justice requires." Second, the only case cited by the Appellate Division in *Broadway Enterprises* for the proposition that §881 does not apply to permanent encroachments was a 1969 lower court decision, which itself did not cite any precedent for the proposition.<sup>21</sup>

Third, the permissible police power recognized by the Court of Appeals as justifying the constitutionality of §881 may justify allowing a permanent underpinning in order to protect the public from possible destabilization and collapse.<sup>22</sup> Fourth, applying §881 to a permanent underpinning in an appropriate case would be consistent with the common law doctrine of private necessity recognized by the New York State Law

Revision Commission when it recommended the enactment of RPAPL § 81.<sup>23</sup>

Finally, application of §881 to a permanent underpinning when the private and public benefits outweigh any inconvenience to the adjoining property owner would be consistent with equitable principles requiring the balancing of private and public interests. A court of equity will not protect an adjacent owner's property rights when it would do him relatively little good as compared to "great public or private hardship" that would be caused by denial of access.<sup>24</sup>

Thus, either judicial or legislative clarification of this issue is needed. Because underpinning of adjacent properties is required by the Building Code when excavation approaches the property line and is essential to protection of the public from dangerous building collapses, a court should be allowed to balance the respective property rights and grant a Section 881 license for underpinning "in an appropriate case upon such terms as justice requires."<sup>25</sup>

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<sup>18</sup> 16 A.D.3d 413 (2d Dep't 2005).

<sup>19</sup> *Id.*, 16 A.D.3d at 414 (citations omitted).

<sup>20</sup> *Buck Dev. LLC v. Noury*, 2008 N.Y. Misc. LEXIS 10732 (Sup. Ct. N.Y. Co. Dec. 15, 2008).

<sup>21</sup> *Foceri v Fazio*, 306 N.Y.S.2d 1016 (Sup. Ct. Queens Co. 1969).

<sup>22</sup> *Chase Manhattan Bank*, 57 Misc. 2d at 1094, *aff'd mem.*, 24 N.Y.2d at 927.

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<sup>23</sup> N.Y.S. Law Revision Commission, Leg. Doc. (1966) No. 65(B), at 11.

<sup>24</sup> *McCann*, 211 N.Y. at 305.

<sup>25</sup> RPAPL §881.

## Performance Bonds: Default, Defenses & Discharge

By Brian G. Lustbader, Esq.

In the present economy, performance bonds are often important for construction projects, for several reasons:

1. Although construction manager/contractor defaults have always been of concern (public agencies routinely require bonds), such defaults have increased recently with the worsening economy;
2. Owners, developers, sureties, construction managers and contractors need to protect their interests; and
3. Such bonds enhance the viability of construction projects generally. It is always important to make sureties as secure as possible, or else they won't issue bonds, thereby drying up what little construction is in – or about to enter – the pipeline.

There are several basic concepts in the performance bond context. First, the relationship here is tripartite, not the normal one-on-one contractual relationship. The three parties are the construction manager or contractor (in many forms referred to as the “Principal”), the surety, and the project owner (in many forms referred to as the “Obligee”). Each side's rights are interdependent, but the surety is a powerless bystander for most of a project. The latter is injected into the process only when the project owner has formally declared a default.

### Declaration of Default – the Surety's Options

Prior to the owner's formal declaration of default, there is no legal basis for the surety to take any action vis-à-vis the owner or the construction manager/contractor.<sup>1</sup> Once the owner has formally issued its declaration holding the construction manager/contractor in default, the surety has five options:

1. fund the principal to completion;
2. perform the work itself by retaining a completion contractor and overseeing that contractor's work;
3. tender a completion contractor and then walking away;

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<sup>1</sup> There is one narrow window through which the surety might be able to inject itself into the process prior to an owner's formal declaration of default. The AIA form performance bond, AIA document A312-1984 requires that a conference be held within 15 days after the owner has formally announced that that it is considering declaring a default. Following up on that possibility, where a surety becomes suspicious about its principal's ability to complete its work, the surety can preempt matters by requesting that the owner conduct such a meeting.

4. tender payment to the owner up to the Penal Sum of the bond, less amounts previously paid, or

5. do nothing and interpose all defenses against the owner's default.

### Surety's Defenses to Owners' Claims on the Bond

Once an owner has declared the construction manager/contractor to be in default, several defenses are available to the surety, including those that the construction manager/contractor may have had, unless waived, vis-à-vis the owner, e.g., non-payment, obstruction of construction activities, or other such claims.

In essence, the surety will argue that the owner had no right to default the construction manager/contractor. In addition, the surety may have its own defenses, separate and apart from those of the construction manager/contractor, bases on which it can claim that it was discharged from its obligations under the bond by virtue of improper conduct on the part of the owner vis-à-vis the construction manager.

Whether to pursue the construction manager/contractor's defenses can be an unenviable choice for the surety. If the surety sides with its principal (i.e., the construction manager/contractor), it risks a claim from the owner of bad faith disclaimer of liability or breach of its obligations under the bond. On the other hand, if the surety sides with the owner and admits that the owner's default determination was justified, then the construction manager/contractor may claim that that determination was unjustified. The CM or contractor can then use that claim to avoid its indemnification obligations under the general agreement of indemnity it would have executed to obtain the bond in the first place, arguing that the surety was acting as a “volunteer”.<sup>2</sup> One possible solution to this difficult choice is for the surety to apply to a court for a declaratory judgment adjudicating the rights and obligations of the respective parties.

The surety has a duty to investigate the owner's demand on the bond, both in order to decide how best to pursue its defenses and to meet its good faith obligations under the bond. It should employ consultants or otherwise learn of problems; not just problems related to the actual construction but also other issues such as unpaid taxes, payroll taxes, etc. – in short, all of the possible claims that might be made against the bond.

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<sup>2</sup> Typically, before issuing a performance or payment bond to a construction manager/contractor, a surety will require that construction manager/contractor to execute a general agreement of indemnity (GAI), which often involves personal liability of the principal of the construction manager/contractor.

In addition, the surety should also investigate the construction manager/contractor's claims against parties other than the owner, e.g., subcontractors or other prime contractors, claims that the surety could pursue by way of subrogation. After investigation, the surety must then decide which side to support, owner or construction manager/contractor, or whether to complete its principal's work under a reservation of rights.

### **Distinct Defenses Available to the Surety**

There are also several defenses unique to the surety. The surety could argue that certain owner acts have relieved or discharged the surety from its obligations under the bond. Among the bases for such a discharge are any of the following:

1. Relinquishing security, including overpayment to the construction manager/contractor;
2. Material alteration of bonded contract;
3. Misrepresentation, concealment or fraud; and
4. Owner's release of the construction manager/contractor.

The overpayment defense is perhaps the most common. The concept is that the surety has relied on the owner compliance with contract terms, including the requirement that the owner make timely payments to the construction manager/contractor, but not overpay. That is, the contract balance/retainage acts as security for the surety, not just the owner. For example, if the owner were to pay its construction manager/contractor 80% of the GMP or lump sum for only 40% completed work, the surety will have lost collateral valued at 40% of the GMP/lump sum. This is not a theoretical concern, as owners often advance funds to their construction managers/contractors, which is why it is important for the owner and construction manager/contractor to obtain consent of surety for each such advance. Whether an advance is in fact a violation of the bond sufficient to discharge the surety is a fact-specific determination, where the legal standard is whether the owner has used reasonable prudence and has a good faith reasonable basis for making the payment and whether the payment created actual harm to the surety.

The barriers to a complete discharge are many. The burden is on the surety to demonstrate both the fact of overpayment and the harm created thereby. But even where the surety is able to meet both of these criteria regarding an overpayment, it will only gain a so-called *pro tanto* discharge, that is, a discharge limited to the extent of the overpayment.

Another defense is that there were material alterations to the bonded agreement, both in terms of contract terms, e.g., extensions of time, failure to give notice, and in terms of drastically changing the scope of the work to be performed. According to the case law, examples of material alterations include changing the

project from building a warehouse to building a hospital, imposing an inordinate number of change orders (although there is no absolute standard as to the number or even the dollar amount of change orders necessary to qualify), a material change in allocation of revenues, and failure to obtain lien waivers.

Among the examples of non-material alterations are changing a building's height, changing the location of the building, adding an additional floor, adding a basement, and failure of the owner to obtain builder's risk insurance from the contractor.<sup>3</sup> In analyzing each situation, the court will not permit *ex post facto* perspective – that is, the situation must be viewed from perspective of the time when the bond was issued.

### **Owner's Claims Against the Surety**

Just as the surety may maintain its principal's claims against the owner, the owner may likewise maintain against the surety its (the owner's) claims against the principal, the construction manager/contractor. Among the claims that owner may assert are those for incomplete or defective work (but the owner has a duty to mitigate these claims), unexcused delays, including liquidated damages (which the surety may in turn pursue against its principal's lower tier trade contractors/subcontractors). If the agreement does not provide for liquidated damages, the owner may pursue a claim against the surety for its actual delay damages, assuming the terms of the bond permit direct plus consequential damages.<sup>4</sup> The owner may also pursue other claims it might have against its construction manager/contractor, such as breach of warranty or latent defects, even if the bond form does not explicitly so permit.

### **Conclusion**

While in many instances, certain technical defenses might appear to let a surety disclaim coverage or be discharged, such a result will not always obtain. Key to any such determination will be whether the surety can sustain its burden of proof both as to the defense itself and also that the event giving rise to that defense caused actual prejudice to the surety, something that usually cannot be shown.

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<sup>3</sup> This last item is troubling in that a failure to procure insurance appears to be a very material alteration of agreement as it jeopardizes the surety's (and the owner's) interest in the project.

<sup>4</sup> Examples of such delay damages that the owner might legitimately assert are (1) Interest, but not at an increased interest rate; (2) Loss of use; (3) Overhead, including field office overhead, increased equipment costs, overtime pay, increased labor costs, winterizing, etc. The AIA document A312-1984 § 6.3 permits liquidated damages if specified in the underlying agreement, or if not specified in the agreement, then "actual damages."

Where the surety's defenses are not permitted and liability is assessed against it, however, the ultimate liability will rest not with the surety but with the principals of the construction manager/contractor for which it has issued the bond, as they will have issued the general agreement of indemnity for the bond, which usually includes a personal guarantee. In that sense liability will come full circle and ultimately fall on the defaulted construction manager/contractor, or at least its principals. As a result, corporate insolvency/bankruptcy will not help the construction manager/contractor.

The key factor in seeing that the process is handled properly, as is often the case for construction projects, is close project monitoring, of claims, change orders, time requests and extensions, and like matters, together with providing proper notice thereof, and especially obtaining consent of surety for these various items. Such monitoring and notice will help all parties see that the inevitable project difficulties and obstructions are handled as effectively and painlessly as possible.

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# Traditional Design-Bid-Build Contracts May Contain Unanticipated Design Risks For Contractors

By William J. Tinsley, Jr., Esq.

A contractor's potential responsibility for design pursuant to a traditional design-bid-build ("DBB") contract may pose significant risk. A properly drafted design-build contract utilizing performance specifications clearly shifts design responsibility to the contractor and its retained design professionals. Responsibility for design under a DBB contract, however, is often neither obvious nor recognized by the contractor or its subcontractors until problems arise from the resulting construction work. When problems arise, allocation of design responsibility for the work at issue is critical because the party that bears the design responsibility may be financially responsible for remediation costs and other potential damages. The purpose of this article is to briefly discuss the more subtle design risks for contractors that may be contained in a DBB contract and New York law addressing allocation of such risks.

## All Contract Delivery Methods May Impose Design Risks upon the Contractor

Pursuant to the nearly century-old, *Spearin* doctrine, the project owner and its design professionals warrant to the contractor that, so long as the contractor and its subcontractors follow the supplied design, the contractor has no responsibility for design defects.<sup>1</sup> In contrast, the utilization of unambiguous performance specifications for all or some portion of the work in a design-build contract shifts some design responsibility and resulting risk to the contractor and its own design professionals.

A traditional DBB contract supplies the contractor with "design" specifications. True design specifications do not permit the contractor any discretion to deviate from the owner's design.<sup>2</sup> "Performance" specifications, on the other hand, allow the contractor and its independently retained design professionals significant discretion in designing the work and require only that the finished product meet the performance criteria. In concept, the distinction between design and performance specifications is straight-forward; in practice, however, it may not be because many construction contracts exhibit both design and performance characteristics.<sup>3</sup>

Typically, where a DBB contract delivery method is utilized, especially by a sophisticated owner, the owner's design professionals will supply detailed design specifications for the majority of the work. In a true design-build or a "hybrid" DBB contract that intentionally blends performance and design specifications, the design elements left to the contractor should be clearly identified. If so, the contractor is on notice to budget and plan for reallocation of the design risks to design professionals and/or specialty subcontractors. The design risks associated with DBB contracts, however, are much more subtle and often arise from the owner's failure to provide certain details and/or by leaving design details for completion through shop drawing procedures. As such, contractors sometimes fail to even recognize, much less properly plan for these less obvious design risks.

There is significant variation with respect to the level of design detail provided for DBB projects. Unsophisticated owners, design professionals unfamiliar with certain components of the work and design budget constraints, are just three of the many reasons why owners may leave, intentionally or otherwise, some level of design-related detail to the contractors' discretion. With respect to project quality and costs, this growing practice is not necessarily detrimental. Often the contractor, its specialty subcontractors and/or design professionals have superior knowledge and experience to provide a better and more economical design for certain components.<sup>4</sup> The issue is recognition of ultimate responsibility for design so that the resulting risks are properly allocated by the contractor through budget contingencies and risk reallocation to specialty subcontractors, suppliers and to its own design professionals.

## Identification of Design Responsibilities

Identification of potential design risk begins with a careful analysis of the contract and design documents. Unspecified or missing design details<sup>5</sup> and the breadth

<sup>1</sup> *United States v. Spearin*, 248 U.S. 132, 136 (1918).

<sup>2</sup> *See Blake Constr. Co., Inc. v. United States*, 987 F.2d 743, 745 (Fed. Cir. 1993).

<sup>3</sup> *Fru-Con Construction Corporation. v. United States*, 42 Fed. Cl. 94, 96 (Ct. Fed. Cl. 1998).

<sup>4</sup> In New York, construction companies are not permitted to provide professional design services. *See, e.g.*, New York Education Law §7202 ("Only a person licensed or otherwise authorized under this article shall practice engineering or use the title 'professional engineer.'"); *See also, Charlebois v. J.M. Weller Associates, Inc.*, 72 N.Y.2d 587, 592 (1986) (Only a professional corporation exclusively comprised of persons licensed to provide designated professional services may contract to engage in the practice of engineering. Contractors are typically business corporations and not qualified to practice engineering or subject to the regulatory or disciplinary oversight of the State Education Department.) As such, where design responsibility is delegated to the contractor, it is required to retain independent design professionals to perform such work.

<sup>5</sup> *See, e.g., Conner Brothers Construction Company, Inc. v. United States*, 65 Fed. Cl. 657, 685-686 (Ct. Fed. Cl. 2005) (holding that the

(footnote continued)

and complexity of the required shop drawing submittals should alert the reviewer to areas of concern. Performance specifications are not always clearly identified. Other than true “means and methods” and temporary “false work,” which are almost always the contractor’s sole responsibility, (and not typically considered to be part of the project’s “design”), any portion of the work that allows the contractor significant discretion in how to construct or finish the work may shift design risk to the contractor. It is the level of discretion left to the contractor in completing the work that determines whether the specification is “design” or “performance,” and not necessarily what it is labeled by the contract.<sup>6</sup>

**Design Risk May Remain With the Contractor Despite the Owner’s “Acceptance” of Required Submittals**

An additional topic of confusion and dispute is the significance of “approval” or “acceptance” of submittals by the owner’s design professional. To what degree and whether the owner accepts responsibility for possible design elements contained in contractor submittals vary based upon the contract and submittal process. Rarely, if ever, however, does acceptance of a submittal alone relieve the contractor and/or its design professional from potential liability for a design-related error in the “approved” submittal.

Most construction contracts attempt to limit the meaning of the owner’s design professional’s “approval” of shop drawings. By example, the AIA A201 form requires the Architect to review and approve the contractor’s submittals,

but only for the limited purpose of checking for conformance with information given and the design concept expressed in the Contract Documents. ... Review of such submittals is not conducted for the purpose of determining the

lack of detail in the plans concerning placement of diffusers and grilles for the HVAC system indicated that they were performance specifications, not design specifications, and denied the contractor’s design defect claim).

<sup>6</sup> See *Fruin-Colnon Corp. v. Niagara Frontier Transp. Auth.*, 180 A.D.2d 222, 229 (4<sup>th</sup> Dept. 1992) (Although one section of the contract, read alone, appeared to be a performance specification, “the language and structure of the contract as a whole, as well as the parties usage and course of performance under the contract, support the conclusions that a design specification was created.”) In this landmark decision, the Appellate Division held that an alleged performance specification that required the contractor to deliver a tunnel that was “watertight” was invalid because the design left no discretion to the contractor as to how to construct the tunnel. In effect, the “watertight” performance specification was an attempt to make the contractor an unwilling guarantor that the specified design would result in a leak-free tunnel.

accuracy and completeness of other details such as dimensions and quantities, or for substantiating instructions for installation or performance or equipment or systems, all of which remain the responsibility of the Contractor...<sup>7</sup>

At best, the language quoted above leaves significant ambiguity concerning which party will be responsible for a subsequent design problem for that portion of the design that was enhanced or completed through the submittal process. Often, additional disclaimers attempting to deflect liability for approval or acceptance of the contractor’s submittals are contained in the transmittal cover sheet returning the approved submittal and/or are included in the stamp utilized to signify acceptance of the submittal. Before entering into a contract, the contractor should ask for and carefully review such documentation and, in conjunction with its review of the scope of required submittals, determine what, if any, design responsibility may result.

**New York Expressly Permits Delegation of “Ancillary” Design to Contractors**

Until recent years, New York generally prohibited the primary project designer from delegating design responsibility, especially to secondary design professionals retained through a contractor. That has changed. New York now permits the delegation of the design of “project components ancillary to main components of the project” through an “intermediate entity not authorized to provide professional design services,” (i.e., a contractor), “involving the performance of a design function requiring a professional license.”<sup>8</sup> Although the delegating design professional is required to “review and approve” such designs, its review is limited to ensuring conformance “with the established specifications and parameters” for the project.<sup>9</sup>

The Rule reinforces the need for contractors to be on “high alert” for potential design responsibility and the resulting risks. The Rule does not define the “ancillary” project components that it allows to be delegated. Depending upon the size and complexity of the project, design liability for an “ancillary” component could be significant, especially for a lower tier, specialty subcontractor who may have assumed design

<sup>7</sup> AIA form A201 at §3.12.4. The AIA form, however, at least expressly excludes the contractor from providing professional design services unless they are “specifically required by the contract.” See §3.12.10. Of course, this may leave the unanswered question of whether the contract “required” such services.

<sup>8</sup> 8 NYCRR §29.3(b) (the “Rule”).

<sup>9</sup> 8 NYCRR §29.3(b)(2).

responsibility through its subcontract. Moreover, there is little question, that due to the Rule's limited scope of review and approval, if a design-related issue arises related to the "ancillary" component, both the contractor and its design professional or specialty subcontractor will face potential liability for remediation costs and damages.

### **Conclusion**

Among other factors, increased government regulation, environmental awareness and project complexities have resulted in the need for multiple design professionals from a wide range of disciplines to work together to enhance and complete a project's design. Delegation of design responsibilities to the contractor and its design professionals, for at least some part of the design process, is permitted and the practice will likely expand.

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# Construction Law Developments In Interpreting The Scaffold Act, Labor Law §240

By Barry Temkin, Esq., and Mark J. Weber, Esq.

## Introduction

Workers who have suffered an elevation-related injury commonly assert claims against contractors and owners under Labor Law §240, also known as the “Scaffold Act.” Often referred to as an “absolute liability” or “strict liability” statute, owners and contractors generally cannot avoid liability under Labor Law §240 if a plaintiff can prove that the statute was violated and that the violation proximately caused the plaintiff’s injury.<sup>1</sup> The injuries involved in height-related accidents are often catastrophic and claims can result in large jury verdicts. For example, a recent jury verdict awarded \$50.5 million to a brain-injured plaintiff who was paralyzed after he fell 15 feet from an equipment storage rack on which he was working.<sup>2</sup>

Until 2007, many New York contractors and owners could rely upon a judicially-created “routine cleaning” exception to the Scaffold Act, which allowed a defendant to avoid liability if the plaintiff was not engaged in cleaning incidental to construction work.<sup>3</sup> In 2007, however, the Court of Appeals settled a split in the appellate departments, effectively eliminating the routine cleaning and maintenance defense in *Broggy v. Rockefeller Group, Inc.*<sup>4</sup> This decision makes it significantly more difficult for a defendant to defend against cleaning-related Labor Law §240 claims.

## Labor Law 240

Labor Law §240(1) requires contractors, owners, and their agents to provide “exceptional protection” to workers engaged in certain elevation-related activities involving a building or structure.<sup>5</sup> The statute provides that:

All contractors and owners and their agents, except owners of one and two-family dwellings who contract for but do not direct or control the work, in the erection, demolition, repairing, altering, painting, cleaning or pointing of a building or structure, shall furnish or erect, or cause to be

furnished or erected for the performance of such labor, scaffolding, hoists, stays, ladders, slings, hangers, blocks, pulleys, braces, irons, ropes, and other devices which shall be so constructed, placed, and operated as to give proper protection to a person so employed.<sup>6</sup>

The statute also requires a safety rail on outdoor scaffolding over twenty feet in height, and mandates that all scaffolding be capable of bearing “four times the maximum weight required to be dependent therefrom or placed thereon when in use.”<sup>7</sup>

The Court of Appeals has recognized that the statute’s purpose is to protect “workers by placing ultimate responsibility for safety practices at building construction jobs where such responsibility actually belongs, on the owner and general contractor (1969 NY Legis Ann, at 407), instead of on workers, who are scarcely in a position to protect themselves from [an] accident.”<sup>8</sup> Therefore, “the duty imposed by Labor Law §240 (1) is nondelegable and ... an owner or contractor who breaches that duty may be held liable in damages regardless of whether it has actually exercised supervision or control over the work.”<sup>9</sup> The Court of Appeals has further held that “this statute is one for the protection of work[ers] from injury and undoubtedly is to be construed as liberally as may be for the accomplishment of the purpose for which it was thus framed.”<sup>10</sup>

The Scaffold Act imposes strict liability, and the injured worker’s comparative negligence is no defense to a prima facie showing of contractor liability. A defendant cannot attempt to contract out of liability under the statute. However, “an owner or general contractor who is held strictly liable under Labor Law §240 (1) is entitled to full indemnification from the party actually responsible for the incident.”<sup>11</sup>

## Development of The Routine Cleaning and Maintenance Exception

Over the years, courts have found limited exceptions to the Scaffold Act’s strict liability mandate, even though not expressly provided for in the statute. However, these exceptions have not been applied consistently, creating a confusing and contradictory body of case law.

<sup>1</sup> *Blake v. Neighborhood Hous. Svcs. of N.Y. City*, 1 N.Y.3d 280, 286 (2003).

<sup>2</sup> *Savillo v Greenpoint*, No. 114418/07, Slip Op. (Sup. Ct. - N.Y. County Dec. 23, 2010).

<sup>3</sup> See Barry R. Temkin, *New York’s Labor Law section 240: Has it Been Narrowed or Expanded by the Courts Beyond the Legislative Intent?*, 44 N.Y.L. Sch. L. Rev. 45 (2000).

<sup>4</sup> 8 N.Y.3d 675 (2007).

<sup>5</sup> See *Ross v. Curtis-Palmer Hydro-Elec. Co.*, 81 N.Y.2d 494, 500-01 (1993).

<sup>6</sup> Labor Law §240.

<sup>7</sup> Labor Law §§ 240(2) and (3).

<sup>8</sup> *Rocovich v. Consol. Edison Co.*, 78 N.Y.2d 509, 513 (1991)(internal punctuation omitted).

<sup>9</sup> *Ross*, 81 N.Y.2d at 500.

<sup>10</sup> *Blake*, 1 N.Y.3d at 286, 292, (internal punctuation omitted).

<sup>11</sup> *Frank v. Meadowlakes Dev. Corp.*, 6 N.Y.3d 687 (2006) quoting *Gillmore v Duke/Fluor Daniel*, 221 A.D.2d 938, 939 (4th Dept. 1995).

For example, although “cleaning” is one of the activities specifically listed as protected under the statute, the Court of Appeals had previously held that §240 was inapplicable to activities such as cleaning a storm window outside of a private residence. In the 1958 decision of *Connors v. Boorstein*, the court reasoned “as a matter of logic and common sense, that the word ‘cleaning’ as used in this context, has reference to the ‘cleaning’ incidental to building construction, demolition and repair work and not to the cleaning of the windows of a private dwelling by a domestic.”<sup>12</sup> So limiting the applicability of §240 appeared in accord with legislative intent, which is reinforced by the fact that the statute appears in Article 10 of the Labor Law which applies to “Building Construction, Demolition and Repair Work.”<sup>13</sup>

The court subsequently reaffirmed that routine cleaning activities such as washing the exterior windows of a single cooperative apartment did not fall within the protections of the statute.<sup>14</sup> The court similarly concluded that changing a light bulb was not protected by the statute because the broken light bulb “needs maintenance of a sort different from ‘painting, cleaning or pointing,’ the only types of maintenance provided for in the statute.”<sup>15</sup>

Despite the seemingly clear language of *Connors* that “cleaning” in the context of Labor Law §240 was intended to apply to cleaning “incidental to building construction, demolition and repair work,” decisions by New York’s lower courts held otherwise, often reaching contradictory results regarding whether § 240 applied to “cleaning” in a non-construction context. For example, in *Bermel v. Board of Education of City of New York*,<sup>16</sup> the Second Department held that “the ‘cleaning’ encompassed under the statute does not include ‘routine’ cleaning in a non-construction, nonrenovation context” such as cleaning light fixtures in a school. The First Department, on the other hand, held in *Bustamante v. Chase Manhattan Bank*,<sup>17</sup> that §240(1) covered the claim of a worker who fell from a ladder while cleaning the tops of partitions in a bank’s offices, stating that the judicially recognized “routine cleaning” exception only applied to cleaning of private residences.

The Court of Appeals itself suggested that Labor Law §240 applied to protect workers performing cleaning activities outside of the construction context. In 1998, the Court rejected an argument that “a guiding

principle for courts should be to examine the context of the work leading to the injury, and only when it is performed as part of a building construction job should Labor Law §240 (1) liability attach.”<sup>18</sup> The court did not cite to *Connors* or explain why it suddenly seemed to reverse its prior holdings, but simply noted that if it adopted such a rule, it would ignore prior holdings upholding the applicability of the statute outside of the construction context.

### **The Court Holds that Cleaning is Covered by the Act**

Finally, the Court of Appeals in the 2007 decision of *Broggy v. Rockefeller Group, Inc.* conclusively ruled that “‘cleaning’ is expressly afforded protection under section 240 (1) whether or not incidental to any other enumerated activity.”<sup>19</sup> Since the statute expressly references the word “cleaning,” the court held that the legislature meant exactly what it wrote. As the *Broggy* court explained:

the crucial consideration under section 240 (1) is not whether the cleaning is taking place as part of a construction, demolition or repair project, or is incidental to another activity protected under section 240 (1); or whether a window’s exterior or interior is being cleaned. Rather, liability turns on whether a particular window washing task creates an elevation-related risk of the kind that the safety devices listed in section 240 (1) protect against.<sup>20</sup>

Thus, the court effectively eliminated the “routine cleaning” exception, focusing instead on whether the task creates an elevation-related risk.<sup>21</sup>

Although it appears clear that the “routine cleaning” exception is no longer a valid defense to a Labor Law §240 claim, defendants have had more success when they can characterize a plaintiff’s activities as “routine maintenance.” For example, courts have held that activities such as routinely removing debris from a section of a dam<sup>22</sup> and clearing dust particles from a hopper, an activity that had to be performed one to five times per shift and was essential to the functioning of the machine,<sup>23</sup> are the type of “routine maintenance” not covered by the statute.

In light of the Court of Appeals’ shift, building owners, contractors, and their agents should take all

<sup>12</sup> *Connors v. Boorstein*, 4 N.Y.2d 172, 175 (1958).

<sup>13</sup> See *Temkin*, *supra* note 4 at 61.

<sup>14</sup> *Brown v. Christopher St. Owners, Corp.*, 87 N.Y.2d 938 (1996).

<sup>15</sup> *Smith v. Shell Oil Co.*, 85 N.Y.2d 1000, 1002 (1995).

<sup>16</sup> 231 A.D.2d 663 (1996).

<sup>17</sup> 241 A.D.2d 327 (1st Dept. 1997).

<sup>18</sup> *Joblon v. Solow*, 91 N.Y.2d 457, 463-64 (1998).

<sup>19</sup> *Broggy*, 8 N.Y.3d at 680.

<sup>20</sup> *Id.*, 8 N.Y.3d at 681.

<sup>21</sup> See *Id.*

<sup>22</sup> *Len v. State of New York*, 74 A.D.3d 1597 (3d Dept. 2010).

<sup>23</sup> *Wicks v. Trigen-Syracuse Energy Corp.*, 64 A.D.3d 75 (4th Dept. 2009).

necessary steps to protect workers who engage in such activities and ensure that comprehensive defense and indemnity arrangements are made with all involved contractors.

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# The Rights Of Project Owner Against A Contractor Terminated For Convenience

By Frederick Cohen, Esq. and John S. Wojak Jr., Esq.

Consider this hypothetical scenario. An owner-developer commences construction of a 30-story hi-rise residential building toward the end of the real estate boom. As the core and shell of the building is close to completion, the owner realizes that the boom is over and it will be unable to sell the apartments at a profit for at least two to three years. When the building is fully enclosed, protected from the elements and approximately 60 percent complete, the owner terminates the contract "for convenience." The contractor is paid for all work performed to date, demobilization costs, subcontractor close-out costs, and 60 percent of its profit. Three years later, the owner-developer is ready to re-commence construction and discovers that a substantial number of structural steel reinforcing members required to be imbedded in the building's columns have been omitted.

This article will examine the very limited question of whether an owner can recover from the contractor the cost of remedying the defective work discovered after a "termination for convenience."

## The Common Law Doctrine

Under the common law doctrine of freedom to contract, parties have been free to confer a contractual right upon one or both parties to terminate the contract "without cause," popularly known as a "termination for convenience." Such contractual provisions first arose at the end of the Civil War to allow the federal government to wind down military procurement and settle with the contractor for the portion of the work already performed.

In a 1982 decision, the Court of Claims wrote: "It originated in the reasonable recognition that continuing with wartime contracts after the war was over clearly was against the public interest. Where the circumstances of the contract had changed so dramatically, the government had to have the power to halt the contractor's performance and settle." *Torncello v. United States*, 681 F.2d 756, 764 (Ct. Cl. 1982).

During World Wars I and II, termination for convenience clauses were used extensively in governmental procurement contracts and have thereafter been standard in peace time in both military and non-military contracts for the government.

Since World War II, termination for convenience clauses have been universally used in private construction contracts and since 1997 appear in most form contracts published by the American Institute of Architects (AIA) and other industry groups.

For example, the current version of the AIA termination for convenience provisions provide, in part:

§14.4 Termination By The Owner For Convenience.

§14.4.1 The owner may, at any time, terminate the Contract for the owner's convenience and without cause.

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§14.4.3 In case of such termination for the owner's convenience, the Contractor shall be entitled to receive payment for Work executed, and costs incurred by reason of such termination, along with reasonable overhead and profit on the Work not executed.

Termination for convenience provisions usually provide for compensation to the contractor for all work performed and fee earned to the date of termination, demobilization costs and costs of closing out subcontracts. Although the current AIA provision provides for recovery for anticipated (unearned) profit on the unperformed portion of the work, typically this provision is deleted or modified in negotiation so that no recovery is allowed for anticipated profit on unperformed work or for any type of consequential damages. However, occasionally the parties will agree to a provision for an additional "break-up" fee depending upon what percentage of completion of the work has been achieved.

## When Is It Appropriate?

Whether a termination for convenience is appropriate in a particular circumstance is not always obvious. The owner must make a rational business judgment with many questions to consider:

1. What stage of completion is the project?
2. Is there reason to terminate for cause?
3. If it is a close question as to whether proper grounds exist to terminate for cause, will a termination for cause result in expensive and time-consuming litigation exposing the owner to damages for a wrongful termination?
4. How will a termination affect subsequent completion of the project?

However, another less-obvious question which should factor into the owner's decision of whether to terminate for cause or for convenience is the extent to which already-completed work contains defects requiring remedial work for which the owner may want to recover from the contractor. While the owner's costs of remedying the contractor's defective work are recoverable as damages in a termination for cause, the law is unsettled as to whether such costs are recoverable in a termination for convenience absent clear contractual provisions granting such recovery. Reported decisions addressing the owner's right to recover for defective

work following a termination for convenience in the absence of specific contractual language have been few and inconsistent.

### **Board of Contract Appeals**

Since termination for convenience clauses first originated in federal government contracts, it logically follows that most of the reported decisions on this question come from the federal Board of Contract Appeals (BCA). BCA and other decisions have repeatedly held that where the parties' contract expressly allows recovery for defective work after a termination for convenience or provides that the contractor's corrective obligations survive such a termination, that agreement will be enforced. *United States for the Benefit and Use of EPC Corporation v. Travelers Casualty & Surety Company of America*, 423 F.Supp. 1016, 1027 fn. 9 (D. Ariz. 2006) (the "express agreement of the parties takes precedence"); *Aydin Corporation*, 89-3 BCA P 22044, Energy Board of Contract Appeals, No. 355-5-86, 1989 WL 74785 (EBCA 1989); *New York Shipbuilding Co.*, Armed Services Board of Contract Appeals No. 15443 (1972), 1972 ASBCA Lexis 111 at 17-18.

For example, one court recently held that where the parties' contract provided that the contractor's warranties and obligations survive termination (not specifically limited to terminations for cause), the contractor remained liable for corrective costs following a termination for convenience. *Layton Construction Co. Inc. v. Barclays Capital Real Estate Inc.*, No. 2009 CV 606, slip op. (District Court, Eagle County, Colo., Sept. 15, 2010). Although the contract was terminated prior to substantial completion and the contractor's primary warranty did not contractually arise until substantial completion, the court found other warranties and corrective work obligations existing from the commencement of the work which survived termination.

The court additionally held that the termination for convenience was not a waiver of any claims for corrective work which already may have existed prior to the date of termination. See, *Armour and Company v. Nard*, 463 F.2d 8, 10 (8th Cir. 1972), *Chicago Titles Ins. Co. v. Title Consultants Inc.*, 472 So.2d 1380 (Fla. App. 1985).

In the absence of express contractual language, two lines of federal BCA decisions have evolved. One line of cases holds that while the owner may not affirmatively recover from the contractor the costs of correcting defective work, the owner may set off such costs against the contractor's recovery for work completed through the date of the termination to the extent that the defective work resulted from the contractor's "gross disregard" of its contractual obligations. The other line of cases calls into question

this rule prohibiting direct recovery, declining to follow it while not expressly overruling it.

The BCA cases barring direct recovery by the owner and limiting an offset to the contractor's gross disregard of its contract obligations are epitomized by *New York Shipbuilding Co.*, ASBCA No. 15443 (1972), 1972 ASBCA LEXIS 111. The board relied upon earlier BCA decisions denying direct recovery for costs to correct defective work after a termination for convenience, rationalizing that a contractor who has been terminated for convenience did not have prior notice of defective work and therefore did not have the opportunity to perform its own corrective work. Thus, reasoned the board, it would be unfair to charge the contractor with the owner's (presumably higher) costs to correct any defects in the contractor's work.

The board further stated, however, the contractor should not benefit from its own "lack of care, fault or folly," and that the contractor's recovery from the owner for work performed through the date of the termination would be reduced by the cost of any such work which was defective to the extent that the deficiencies stemmed from the contractor's "gross disregard...of its contractual obligations." This exception was based upon the earlier BCA opinion in *Caskel Forge Inc.*, ASBCA No. 7638, 1962 BCA P3318, and has been restated in later opinions which adopted the overall approach of *New York Shipbuilding*. See, e.g., *Best Foam Fabricators v. United States*, 38 Fed.3d 627, 640-641 (Fed. Cl. 1997); *Morton-Thiokol Inc.*, 90-3 BCA P 23207, ASBCA No. 32629 (1990).

Therefore, under the rule established by this line of cases, an owner who terminates a contractor for convenience may only recover the cost of correcting defective work if the owner can show that the defects resulted from the contractor's gross disregard of its contractual obligations, and even then only as an offset against the amounts otherwise due the contractor for unpaid work performed up to the date of termination.

In a further enigmatic remark, however, the board in *New York Shipbuilding* also stated that "our decision... does not affect the inclusion [as a setoff against the amount due contractor] of [contractor's] estimated costs... for correcting alleged deficiencies... had it not been terminated," indicating that even if the defects were not the result of gross disregard of the contractor's obligations, the owner could still offset the contractor's (not the owner's) estimated cost to correct that work under the theory that the contractor would have had to correct its work as part of the completion of its contract had it not been terminated. No further BCA opinions appear to have commented on this particular language, although it would seem to present the most equitable solution to the dilemma.

Indeed, while some later BCA opinions have followed the general rule stated in *New York Shipbuilding*, other boards and courts have expressly declined to follow its prohibition against direct recovery for defective work. On an appeal from a BCA case, the U.S. Court of Appeals for the Federal Circuit expressly declined to follow this rule in *Lisbon Contractors Inc.*, 828 F.2d 759 (Fed. Cir. 1987), instead denying the owner recovery for defective work costs after a termination for convenience on unrelated grounds of failure to prove the amounts at issue.

In *Air Cool Inc.*, 88-1 BCA P 20399, ASBCA No. 32838, 1987 WL 46144 (1987), the BCA itself "questioned whether [the *New York Shipbuilding*] rule will continue to be followed," and further stated in *Aydin Corporation*, *supra*, that "the continued applicability of *New York Shipbuilding* and its forerunners is seriously in doubt" while "declin[ing] to mechanically follow *New York Shipbuilding*." These two seemingly contradictory lines of federal decisions have not been reconciled, and the current viability of the principles set forth in *New York Shipbuilding* is uncertain.

### New York Law

Although New York state law is also sparse on this issue, it is clearer than federal law and favors the terminated contractor. In *Tishman Construction Corporation Inc. v. City of New York*, 228 A.D.2d 292 (1st Dept. 1996), the city terminated *Tishman* for convenience and then attempted to recover the costs of correcting defective work as counterclaims against *Tishman*'s claim for termination costs, citing (i) the contract's generalized boilerplate "all defenses reserved" and "no waiver" clauses and (ii) the overwhelming complexity and implications of a termination for cause as reasons why its claims should be allowed in spite of the city's failure to cite cause in terminating the contracts.

Relying on the earlier Appellate Division opinion in *Fruin-Colnon Corp. v. Niagara Frontier Transportation Authority*, 180 A.D.2d 222 (4th Dept. 1992) (which in turn cited no precedent for its denial of an owner's claim for remedial work costs against a contractor deemed to have been terminated for convenience), the court rejected the city's arguments and held that the city could not counterclaim for the cost of curing any defective work. The Court did leave open the possibility of recovery by the city "to the extent that the city can show that overpayments were made [to the contractor] on a theory of fraud or mistake, rather than under the terms of the contract;" however, this is an extremely difficult burden of proof to establish and is more contractor-favorable than the federal BCA "gross disregard of contractual obligation" exception.

The difficulty in meeting the *Tishman* exception is underscored by *Paragon Restoration Group Inc. v. Cambridge Square Condominiums*, 42 A.D.3d 905 (4th Dept. 2007), where the Appellate Division dismissed an owner's defective work counterclaims following a termination for convenience, relying upon the *Tishman* opinion. The court further dismissed any fraud or tort-based defective work claims (apparently interposed by the owner in an attempt to make use of the *Tishman* exception), stating that New York law is clear that separate fraud or tort claims are generally not actionable when they arise solely from contractual obligations and not from independent legal duties arising outside of the contract.

The *Tishman* court further muddied things, however, by concluding its opinion with the enigmatic statement that "nothing in [the lower Court's] decision affects the city's defenses based on breach of contract principles." This unexplained comment has not been addressed in any further decision and might leave open the possibility of a broader defensive offset against a contractor's claims for unpaid work through the date of termination.

### The Court of Appeals

New York's highest Court, the Court of Appeals, has only addressed the issue peripherally and that was long before the Appellate Division's decision in *Tishman v. City*. In *Arc Electrical Construction Co. Inc. v. George A. Fuller Company Inc.*, 24 N.Y.2d 99 (1969), the Court of Appeals held that a contractor which had been terminated for convenience and was therefore denied notice of defective work and the opportunity to cure the defects was entitled to be paid for all work actually performed; however, the Court further stated that "if there were any deficiencies in performance, they would merely diminish the amount to which [the contractor] would be entitled..."

This holding would appear to allow the owner to offset the cost of curing defective work against the contractor's post-termination recovery but would not allow a direct affirmative recovery; moreover, it is not clear whether the Court intended such an offset to be based upon the cost to the owner to correct the defects or the (presumably lower) estimated cost to the contractor to correct those defects. In view of the Court's recognition of the unfairness of denying the contractor the opportunity to perform its own corrective work, it is logical to assume the Court intended a reduction based upon the estimated cost to the contractor to correct its own work had it not been terminated. The obvious inconsistencies between this case and the later Appellate Division opinion in *Tishman v. City* have not been addressed by the New York Courts.

In view of the uncertain nature of existing law, the increasing use of termination for convenience clauses in private contracts and the recent lessons regarding the vagaries of the real estate market, it would seem that this issue is ripe for more definitive treatment by the courts on both a federal and New York state level. This need is further exemplified by the recent decision from the Supreme Court, Kings County, in *400 15th Street, LLC v. Promo-Pro, Ltd.*, No. 20651/2006 (Sept. 10, 2010), wherein the court allowed the after-the-fact conversion of a termination for convenience into a termination for cause, thus suggesting a way around the *Tishman* rule in order for an owner to recover for defective work after first exercising its contractual right to terminate for convenience.

A logical compromise rule which is suggested by some of the cases would be to allow an owner that terminates a contract for convenience (thereby denying the contractor the opportunity to self-correct any defective work and, perhaps more importantly, probably denying the contractor the opportunity to compel its subcontractors to perform that work) to affirmatively recover directly from the contractor only the estimated costs which the contractor (or its subcontractors) would have incurred in correcting the work had the contract not been terminated (as opposed to the owner's presumably higher cost to perform the same work).

Such a result would prevent the contractor from reaping a windfall for not properly performing its work and would lessen the burden placed on the owner to correct the work, but would not reward the owner for circumventing the often difficult (and costly) process of establishing through litigation a basis for a termination for cause and avoiding the risk of a wrongful termination finding (as the city attempted to do in the *Tishman* case). Since the contractor would have had to incur some cost to correct its defective work had it not been terminated, it would seem a fair and reasonable trade-off to charge the contractor with those costs, but to deny the owner its own presumably much greater corrective costs, in exchange for the owner's avoidance of the costs and risks of a termination for cause.

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# New Jersey's Construction Lien Law Undergoes Reform

By Gary Strong, Esq.

## Background

Governor Christie has signed into law an important amendment (“the Amendment”) to New Jersey’s Construction Lien Law (“the Law”), the first such change since the Law’s adoption 16 years ago. The Amendment, effective January 5, 2011, sets forth a new timeline for perfecting liens arising from residential construction contracts, clarifies key concepts relative to the Law’s application, and provides new definitions to aid in the Law’s interpretation.

The Amendment incorporates the entirety of the New Jersey Law Revision Commission’s final report on the Law. After learning that the Law was notoriously complicated, confusing, and inherently contradictory, the Commission set about modifying the Law to make it clearer, simpler, and more inclusive of language used in the construction industry.

The CLL became effective in 1994, and replaced the old Mechanic’s Lien Law. The statute’s two main purposes are: (1) to enable private project contractors, subcontractors and suppliers to secure payment for labor and materials by a lien filing process; and (2) to protect property owners from exposure to double payment for work or materials for which they have already paid. The law sets forth procedures for filing and perfecting the lien claim, establishing the amount of the lien claim, and enforcement of the lien.<sup>1</sup> Since 1994, the CLL has been the subject of much litigation over the meaning and application of concepts such as the lien fund and lien claim. Although judicial opinions provided some clarification, the legal community was troubled by what was viewed as contradictory interpretations of the CLL by the courts prompting the revisions embodied in the bill signed into law by the governor. The new CLL provisions became effective immediately upon adoption, January 5, 2011.

## Clarification of Residential Construction Lien Claims

### Changes to Timing Requirements for Filing

Under the CLL, a lien claimant involved in a residential construction contract must complete various additional procedural steps before filing a lien, most of which are not required of a non-residential claimant. Specifically, as a condition precedent to filing a residential construction lien, a claimant must file a

<sup>1</sup> Final Report of New Jersey Revision Commission Relating to Construction Lien Law (2009), pp. 3-4.

Notice of Unpaid Balance and Right to File Lien (NUB), serve a demand for arbitration, satisfy the procedures for instituting an expedited proceeding under the American Arbitration Association (AAA), and, finally, arbitrate the claim. Under the prior CLL, all of these prerequisites had to be accomplished within a 90-day period, which, for some claimants, resulted in the unsuccessful filing of their residential construction lien.

Residential construction claimants must file a Notice of Unpaid Balance (NUB) and Right to File Lien within 60 days from when the claimant last performed work or supplied materials on the project. Within 10 days after filing the NUB, the claimant is required to serve a demand for arbitration for the purpose of determining the amount of the lien claim. This time may only be extended upon consent of the parties and arbitrator. Within 10 days after the arbitrator’s determination, but within 120 days from when the claimant last performed work or supplied materials, the claimant must record the lien claim.<sup>2</sup>

## Inclusion of Large-Scale Residential Developments

The prior CLL did not clarify whether the construction of a large residential development was considered a “residential construction contract” and was, therefore, subject to the additional procedural steps of residential lien filing. The New Jersey Bankruptcy Court attempted to answer this question in *Kara Homes v. Central Kitchens*.<sup>3</sup> There, the court held that a large-scale residential development fell within the definition of “residential construction contract” and, therefore, the lien claimant had to file a NUB and make an arbitration demand before filing a construction lien.

The amended CLL adopts the court’s holding in *Kara Homes*. The definition of “residential construction contract” now includes the construction or improvement of units, dwellings, or any other portion of a residential real property development.<sup>4</sup> The amended CLL provides additional clarity by defining the terms “real property development” and “residential construction” and “residential unit” for the first time.<sup>5</sup>

## Streamlining the Arbitration Process

Under the CLL, as discussed above, a lien claimant must make an arbitration demand as a prerequisite to filing a residential construction lien. The purpose of the arbitration is to determine the proper amount owed to the claimant. The prior law failed to address, however, the potential for multiple arbitrations arising from the

<sup>2</sup> *N.J.S.A. 2A:44A-6*

<sup>3</sup> 374 B.R. 542 (D.N.J. 2007), upheld by *Kara Homes v. Century Kitchens*, 396 B.R. 131 (D.N.J. 2008)

<sup>4</sup> *N.J.S.A. 2A:44A-2*

<sup>5</sup> *Id.*

same residential construction project. This gap allowed different arbitrators to conduct separate arbitration hearings based on the same construction project, often resulting in inconsistent awards for lien claimants.

The CLL amendments attempt to streamline the arbitration process to eliminate inconsistent arbitration awards. They provide that, whenever possible, all arbitrations of NUBs pertaining to the same residential construction project should be determined by the same arbitrator.<sup>6</sup> Additionally, the amended CLL states that any party to the arbitration can request (at the discretion of the arbitrator) a consolidation of NUBs that have not yet been arbitrated.

### **Clarification of Leasehold vs. Fee Interests**

In the situation in which a leasehold tenant contracts for improvements to leasehold property, it is permissible to attach a construction lien to the tenant's leasehold interest in the property. The CLL, however, did not clarify when it was permissible to attach a lien to a landlord's fee interest in the property if improvements were ordered by the leasehold tenant and not approved by the landlord. In *Cherry Hill Self Storage v. Racanelli Construction Co.*,<sup>7</sup> the Appellate Division held that, in the context of improvements to leasehold property, a construction lien attaches to both the fee interest of the landlord and the leasehold interest of a tenant only if the landlord expressly authorized the improvements in writing.

The amended CLL clarifies that "the lien shall attach to the leasehold estate of the tenant." The landlord's fee interest will only be impacted where the landlord expressly authorizes the improvements in writing or pays or agrees to pay for the improvements. Also, where the landlord is a party to the document that created the leasehold interest and provides that the landlord's interest is subject to a lien for the particular improvement, the lien will attach to the fee, not leasehold, interest.

### **Clarification of the Lien Claim and Lien Fund Mechanism**

Once a construction lien is established, the total liability of the owner must be calculated and deposited into a lien fund. This important mechanism, however, was not properly explained in the prior CLL. The amended CLL for the first time defines "lien claim" and "lien fund," and clarifies exactly what should be included in, or excluded from, the fund.

### **Definition of 'Lien Claim' and 'Lien Fund'**

Prior to the revisions, "lien claim" and "lien fund" were left undefined. The New Jersey Supreme Court addressed this issue in *Craft v. Stevenson Lumber Yard, Inc.*,<sup>8</sup> holding that a property owner subject to a construction lien only has to pay to the claimant amounts due consistent with the work already performed by the claimant.

The amended CLL defines the lien fund as the "pool of money from which one or more lien claims may be paid." The statute provides: "[t]he amount of the lien fund shall not exceed the maximum amount for which an owner can be liable. The amount of the lien that attaches to the owner's interest in the real property cannot exceed the lien fund." The statute shows how to calculate the lien fund to ensure that an owner will not pay more than once for the same work. The statute provides that the fund will not be reduced by payments that do not discharge the obligations for work performed or materials provided (for instance, payment for liquidated damages or payments not in accordance with written contract provisions, among other things).

### **Amounts Includable in the Lien Fund**

The prior CLL did not address whether the entire chain of construction contractors (i.e., contractors, sub-contractors, sub-subcontractors, suppliers, etc.) must be considered in calculating the amount of the lien fund. While lien claimants have argued that only the prime contract and relevant subcontracts should be considered in calculating the fund, New Jersey courts have consistently held that the entire chain of construction must be considered.<sup>9</sup> The amended CLL resolves this ambiguity by clearly setting forth that lien rights shall only exist for first-, second-, or third-tier lien claimants.<sup>10</sup>

Another notable absence from the prior CLL was the issue of impermissible deductions to the lien fund. The amended CLL clarifies that liquidated damages, advance payments, payments yet to be earned, and collusive payments will not reduce the amount of the lien fund.<sup>11</sup>

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<sup>8</sup> 179 N.J. 56 (2004).

<sup>9</sup> *Sil-Kemp Concrete, Inc. v. Conte & Ricci Const. Co.*, 2005 WL 3742271 (App. Div. 2005) (holding that up to three tiers of claimants must be considered to calculate lien fund and owner liability); *Riggs Distler v. Valerio Refining Company, et al.*, 2005 WL 2897483 (D.N.J. 2005) (concluding entire construction chain must be considered for lien fund, giving credit to all payments earned and due even if not subsequently forwarded down).

<sup>10</sup> *N.J.S.A. 2A:44A-9* (g).

<sup>11</sup> *N.J.S.A. 2A:44A-9*(c).

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<sup>6</sup> *N.J.S.A. 2A:44A-21*(b)(3)

<sup>7</sup> WL 1756914 (App. Div. 2007).

Finally, the amended CLL clarifies timing issues with regard to multiple claimants that will draw from the same lien fund. If more than one lien claimant participates in a given fund, the fund is considered established on the date that the first lien claim is “lodged for record.”<sup>12</sup> If, however, the first lien claimant settles before the second lien claimant has lodged for record his claim, then the lien fund for the second lien claimant is established when the second lien claim is lodged for record.

### **Clarifications in the Enforcement and Discharge of a Lien**

#### **Enforcement of Lien**

The CLL as amended provides greater detail with regard to enforcement actions of lien claims. Lien enforcement actions must be filed in the Superior Court within one year of the last date of nonpayment for services or materials.<sup>13</sup> To ensure the proper calculation of the lien fund, a lien claimant must join all necessary parties to the claim, including the owner, community association, prime contractor or subcontractor and any other interested party that has failed to make payments and would be adversely affected by a judgment in favor of the claimant.<sup>14</sup> The CLL now further requires a lien claimant to file a Notice of Lis Pendens with the county clerk’s office in the county where the dispute arose. If the suit is resolved in any way other than by final judgment, however, the claimant must also remove the Notice of Lis Pendens as appropriate.

#### **Summary Discharge of Lien**

The prior CLL did not expressly provide for a summary proceeding to discharge a construction lien, although a New Jersey appellate court did find that such a summary proceeding was appropriate. The amended CLL adopts the view of the court: In the event that a claimant fails to discharge a lien, any party may now proceed in a summary manner by filing an order to show cause.<sup>15</sup> This same mechanism may be used by any party to discharge a lien that was filed without a factual basis.<sup>16</sup> Additionally, if 13 months have passed after a lien claim has been paid in full, an owner may submit a

statutory form to the Superior Court acknowledging such payment.<sup>17</sup>

### **Conclusion**

The foregoing amendments represent significant reform of New Jersey’s Construction Lien Law. The new CLL is expected to resolve the ambiguities that plagued the prior statute and will hopefully reduce litigation and streamline the construction lien process.

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<sup>12</sup> *N.J.S.A. 2A:44A-9(f)*. The amended CLL created a distinction between “lodged for record” and “filing”. A document is “lodged for record” if it is delivered to the county clerk and marked by the clerk with a date and time stamp or other mark indicating the date and time received. This distinction is important because the claimant has no control over when the document is actually “filed.”

<sup>13</sup> *N.J.S.A. 2A:44A-24(a)*.

<sup>14</sup> *N.J.S.A. 2A:44A-30(b)*.

<sup>15</sup> *N.J.S.A. 2A:44A-30(c)*.

<sup>16</sup> *N.J.S.A. 2A:44A-30(d)*.

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<sup>17</sup> *N.J.S.A. 2A:44A-30(d)*.

## Why Claims For Contribution And Indemnification Are Not As Simple As They Seem

By David J. Pfeffer, Esq. and Abraham Gdanski, Esq.

In the world of construction defect litigation, it is all too common for defendants to quickly point their finger at various non-party contractors and design professionals in an effort to seek contribution and indemnification. This litigation tactic often results in several third-party claims for indemnification and contribution against contractors, design professionals and suppliers involved in an underlying construction project. While construction litigators have grown accustomed to alleging contribution and indemnification almost out of habit, a recent decision from Judge Louis B. York in the Supreme Court, New York County in an action titled *Andrew Beck, III v. Studio Kenji, LTD., et al.*, 2001 N.Y. Misc. LEXIS 691 (“Action”), proves that only in certain limited instances will claims for contribution and indemnification be maintained. As evidenced by Judge York’s decision, claims of contribution and indemnification involve complex issues of law which, if improperly alleged, are subject to dismissal.

In the Action, a homeowner (“Plaintiff”) undertook renovations in his penthouse apartment located in downtown Manhattan which he purchased for over \$5.5 million dollars. As part of his renovations, Plaintiff assembled a design team to help with the architectural portions of the work. In July of 2005, a design professional (“Defendant”) was retained as the architect of record for the project. Ultimately, Plaintiff terminated Defendant from the project due to, among other things, Defendant’s mismanagement of the project and failure to comply with New York City building codes and regulations.

On June 24, 2009, Plaintiff commenced an action against, among other design professionals, Defendant for (i) breach of contract; (ii) breach of third-party beneficiary contract; (iii) breach of an implied covenant of good faith and fair dealing; (iv) unjust enrichment; (v) negligence; (vi) gross negligence; and (vii) professional malpractice. On May 1, 2007, Defendant filed a third-party complaint against numerous contractors, vendors and design professionals for indemnification and contribution. The basis for Defendant’s third-party complaint was that to the extent Plaintiff sustained any damages to his apartment, said damages were not caused by Defendant but rather by other third-party entities.

One of the third-party defendants, the contractor on the project (“Contractor”), by counsel David Pfeffer and Abraham Gdanski from Tarter Krinsky & Drogin LLP, filed a pre-answer motion to dismiss alleging that

Defendant has failed to state a cause of action for indemnification and contribution. On January 7, 2011, Judge York issued a decision dismissing the third-party complaint not only against Contractor, but in its entirety. Judge York explained in his decision that “CPLR 1401 does not permit contribution between two parties whose potential liability to a third party is for economic loss resulting only from a breach of contract.” 2001 N.Y. Misc. LEXIS 691 at 3. Accordingly, because Plaintiff’s underlying complaint sought recovery for breach of contract, there can be no claim by Defendant for contribution from third-parties. Furthermore, while the underlying complaint alleges causes of action sounding in negligence, said causes of action do not support claims for contribution. As Judge York held, “[t]he determining factor as to the availability of contribution is not the theory behind the underlying claim, but rather, the measure of damages sought.” *Id.* at 3. Therefore, notwithstanding the language sounding in tort, Judge York held that all of Plaintiff’s claims against Defendant sought identical damages for economic loss.

Judge York also dismissed Defendant’s cause of action for common law indemnification. Judge York held that since the predicate for common law indemnification is vicarious liability without actual fault on the part of the proposed indemnitee, absent such vicarious liability, Defendant’s indemnification claim is without merit. Defendant’s third-party complaint did not allege that the third-party defendants were vicariously liable for the damages alleged in the underlying complaint, but rather only that their separate defective work caused Plaintiff’s damages. Accordingly, Defendant’s cause of action for common law indemnification was dismissed.

As we can see, while it has become standard practice to plead contribution and indemnification as “form” causes of action in a responsive pleading, claims for contribution and indemnification involve very complex issues of law. A proper analysis of legal issues such as (i) vicarious liability and (ii) the economic loss doctrine is crucial prior to asserting claims for contribution and indemnification in a responsive pleading. It is therefore legally insufficient to seek contribution and indemnification solely because a third-party may have caused some of the underlying plaintiff’s damages. Not only must a third-party’s conduct cause the underlying plaintiff’s damages, but the third-party’s conduct must also fit within the parameters of vicarious liability and the economic loss doctrine.

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## **Pay-If-Paid Provisions In Construction Contracts Are Enforceable In New York Where The Project Is Located Outside The State.** DGI-Menard, Inc. v. Yonkers Contracting Co., Inc., Index No. 27435/2008, Westchester County Supreme Court.

By Michael S. Zicherman, Esq.

In 1995, the New York Court of Appeals issued its landmark decision in *West-Fair Elect. Contractors v. Aetna Casualty & Surety Co.*, 87 N.Y.2d 148 (1995), which ruled that pay-if-paid provisions (contractual clauses that shift the risk of an owner's nonpayment from the general contractor to the subcontractor or supplier) violated the anti-lien waiver provisions of New York's mechanic's lien law and were thereby unenforceable, changing more than 100 years of precedent that routinely enforced such provisions. While *West-Fair* seemingly slammed the door shut on the ability of a contractor to enforce a pay-if-paid provision in New York against its lower tier contractors, the Court of Appeals revisited the issue in *Welsbach Elect. Corp. v. MasTec North America, Inc.*, 7 N.Y.3d 624 (2006) and held that pay-if-paid clauses are not "truly obnoxious" to New York public policy and may be enforced against a party on a New York construction project, where the parties agreed to be bound by the law of a state that enforces pay-if-paid provisions; in that case Florida law.<sup>1</sup> Now, in a recent unpublished decision by the Westchester County Supreme Court, the *West-Fair* door has been nudged open even further, to allow the enforcement of a contractual pay-if-paid provision where the construction project was not located in New York.

The holding and pertinent facts found by the court were as follows:

The plaintiff was a subcontractor to the defendant general contractor on a failed construction project in New Jersey, where the project owner had constructively suspended the project and then filed for bankruptcy. The plaintiff thereafter sued the defendant in the Westchester County Supreme Court seeking to recover allegedly unpaid contract balance and retention, extra work it allegedly performed, as well as alleged delay costs. The parties' subcontract contained a pay-if-paid clause that stated "payment by the Owner shall be a condition precedent to Contractor's obligation to make payment to Subcontractor." Based on this provision, the defendant contended that it is only obligated to pay

plaintiff if it is paid by the owner and that since it was never paid by the owner for the retainage, the alleged extra work, or the claimed delay costs, it is entitled to summary judgment dismissing those claims.

The court found that the applicable provision of the parties' contract constitutes a "pay-if-paid" clause that transfers the risk of nonpayment to the subcontractor. It also found that the plaintiff failed to raise a triable issue of fact that the defendant had been paid by the owner for the retention, extra work, and delay costs claimed in the lawsuit. As such, the court then turned to whether the "pay-if-paid" provision was enforceable.

In this regard, the court held that such clauses have been held to be void as a matter of public policy, pursuant to Lien Law Section 34, where it results in a waiver of the right to file or enforce a lien created under Article Two of the Lien Law. However, the New York Lien Law only applies to improvements to real property within New York, and as a matter of law, has no extraterritorial force outside the state (*Allied Thermal Cop. v. James Talcott, Inc.*, 3 N.Y.2d 302; See Also, *Carrier Corp. v. J.E. Schecter Corp.*, 347 F.2d 153; *Zysk v. Smith*, 2010 WL 5027493 [E.D.N.Y. 2010]). The court thus ruled that the New York Lien Law is inapplicable in the case at bar, as the construction project involved was located in New Jersey. The court also noted that pay-if-paid clauses are not contrary to New Jersey's public policy. Therefore, the "pay-if-paid" clause was held not to violate the Lien Law or public policy and is enforceable. Accordingly, the court granted the defendant's motion for partial summary judgment.

Though unpublished, this case stands as a significant decision for New York contractors and subcontractors that do not exclusively perform work in the state. General contractors (and even subcontractors with respect to their sub-subcontracts) do not need to exclude pay-if-paid clauses from their standard contracts when they are performing work in another state that permits the enforcement of such clauses. Likewise, subcontractors that regularly perform work in New York cannot be complacent in simply believing that any pay-if-paid clause in their contract is void and will not be enforceable against them.

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<sup>1</sup> The contract at issue in *Welsbach* preceded the 2003 amendment of the General Business Law that proscribed provisions that make construction contracts for New York projects subject to the laws of another state.

**Architect’s Decision Making Authority To Resolve Disputes Under A Construction Contract Is Defined By The Terms Of The Contract. Procedural Errors In Architect’s Decision Making Are Beyond The Scope Of Judicial Review.** *Ostberg v. Dragan Litric*, 2011 NY Slip Op 00283 (1st Dept 2011)

By Peggy Gizzarelli, Esq.

In *Ostberg v. Dragan Litric*<sup>1</sup>, the Appellate Division, First Department, held an action for confirmation of Architect’s Decision was not barred, as a matter of law, where there was not strict compliance with the time limitations set forth for ADR and the contractor failed to challenge the procedural defects in ADR or through Arbitration.

The homeowner, Ostberg, entered into a construction contract with Litric, a contractor, to perform renovation work at Ostberg’s home. The contract included AIA form contract AIA 201-1997 which sets forth ADR procedures to resolve disputes between the owner and contractor. The contract required all claims “shall be referred initially to the Architect for decision. An initial decision by the Architect shall be required as a condition precedent to mediation, arbitration or litigation of all Claims between the Contractor and Owner arising prior to the date final payment is due, unless 30 days have passed after the Claim has been referred to the Architect with no decision having been rendered by the Architect.” The agreement also set forth certain time constraints on the parties, including that claims must be submitted to the Architect within twenty-one days of the occurrence and that a demand for arbitration must be made within thirty days of the Architect’s decision. The agreement provided that failure to demand arbitration within thirty days of the Architect’s decision “shall result in the Architect’s decision becoming final and binding upon the Owner and Contractor.”

Throughout the renovation, Ostberg was dissatisfied with the quality of Litric’s work. Following a site inspection, the project architect advised Litric of work which required remediation and completion. Eventually, Litric refused to return to complete the work. Ostberg submitted a claim to the Architect on December 21, 2007, some nine months after Litric ceased work on Ostberg’s home. On October 30, 2008, Ostberg submitted an amended claim to the Architect, seeking additional damages incurred after the initial claim. The Architect issued a written decision on December 12, 2008, awarding Ostberg \$248,323.97 in

damages. Litric did not participate in the Architect’s determination; nor did Litric demand arbitration after receiving the Architect’s decision.

Ostberg brought a declaratory judgment action seeking a declaration that the Architect’s Decision was binding and entry of judgment in the amount awarded by the Architect. Litric moved to dismiss, arguing the Architect did not have authority to render a decision on the claim due to Ostberg’s failure to submit the dispute within the time constraints set forth in AIA 201-1997 and the Architect’s failure to render a decision pursuant to the time constraints. The Supreme Court found the action was not barred due to procedural deficiencies in the ADR. The Appellate Division, First Department, affirmed.

The Appellate Division, First Department, rejected Litric’s argument that an architect’s authority to render a decision on a construction claim ends, as a matter of law, with the completion of construction or termination of the contract due to either party’s default. On the contrary, the court held the scope of an architect’s authority is governed by the language of the particular dispute resolution procedures contained in the contract at issue. The court found the agreement between Ostberg and Litric to be broadly worded, requiring all “disputes and matters in question between the Owner and the Contractor arising out of or relating to the Contract” be initially submitted to the architect. The court determined the agreement between Ostberg and Litric did not place any time limits on the architect’s authority to render a decision.

The court did not consider Litric’s arguments that the architect should not have rendered a decision on the claim due to Ostberg’s failure to submit the dispute within the time set forth in the contract. Disputes as to whether there has been compliance with the procedural requirements of an ADR agreement should be resolved by the ADR forum or through arbitration<sup>2</sup>. The Ostberg court found the time constraints in AIA201-1997 were procedural. Therefore the court did not have authority to address any procedural errors.

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<sup>1</sup> *Ostberg v. Dragan Litric*, 2011 NY Slip Op 000283, (1<sup>st</sup> Dept 2011)

<sup>2</sup> *Rockland County v. Primiano Const. Co.*, 51 NY.2d 1 (1980).

**As A Result Of A Stay, The Surety Does Not Get the Benefit Of Its Bargain And May be Irreparably Harmed.** Safeco Ins. Co. of America v. M.E.S., Inc.

By Melaine C. Alphonso, Esq.

In *Safeco Ins. Co. of America v. M.E.S., Inc.*, 2010 U.S. Dist LEXIS 133857 (E.D.N.Y. Dec. 17, 2010), the Eastern District of New York granted the Defendants' motion for a stay pending appeal to the Second Circuit with respect to the Court's order enforcing the surety's right to collateral security pursuant to written indemnity agreements among the parties therein.

Defendants, MES and Hirani, allegedly defaulted under three bonded contracts with the U.S. Army Corps of Engineers ("Corps") for the completion of three separate construction projects at the Picatinny Arsenal in Dover, New Jersey. Plaintiff-Surety, Safeco, issued performance and payment bonds for all three construction contracts. Safeco also entered into identical written indemnity agreements with both of the Defendants.

The Corps declared default on each bonded contract and terminated the Defendants from all three projects. As a result of the Defendants' defaults, Safeco contends that it will incur substantial losses on all three projects and asserts that it is entitled to indemnity for those losses from Defendants in accordance with the indemnity agreements between Safeco and Defendants. Safeco, then, made a motion seeking collateral security under the indemnity agreements for its losses until the ultimate issue of indemnification is resolved.

The Court granted Safeco's motion for partial summary judgment with respect to its right to collateral security pursuant to certain provisions of the indemnity agreement and awarded specific performance of that right (the "5/18 Order"). Pursuant to the Court's 5/18 order, Safeco served its specific demand for collateral security upon the Defendants, which requested "actual and anticipated losses" on all three bonded projects, as well as, Safeco's legal and consulting fees for the projects ("Safeco's Collateral Demand"). Defendants, then, moved for a reconsideration of the 5/18 order.

On the authority of certain provisions of the indemnity agreement, the Court directed Safeco to eliminate all amounts for losses on each project that was already paid as of the date of Safeco's collateral demand. The Court reasoned that specific performance to enforce a collateral security provision is only available for anticipated losses as Safeco has an adequate remedy at law for paid claims by enforcing the indemnification clause. Therefore, the Court ordered Safeco to remove paid claims from its collateral demand. After reviewing Safeco's revised specific

demand for collateral security, the Court ordered the MES Defendants and Hirani Defendants to pay approximately \$6.6M and \$4.9M, respectively (the "11/22 Order").

Once again, the Defendants requested that the Court reconsider its 11/22 order pending appeal, or alternatively, grant a stay of that order pending the Defendants appeal to the Second Circuit pursuant to Rule 62(c). The Defendants made this request primarily because the 11/22 order requires the Defendants to post collateral security that "far exceeds" their assets, and thus, would cause them to become insolvent and unable to defend this case. The Court denied the Defendants' motion for reconsideration, but granted their motion for a stay based upon the analysis below.<sup>1</sup>

In order to determine whether to grant the Defendants' motion for a stay pursuant to Rule 62(c)<sup>2</sup>, the Court must balance the following four factors as articulated by the Supreme Court in *Nken*<sup>3</sup>: (i) movant's likelihood of success on the merits; (ii) irreparable harm to movant absent a stay; (iii) substantial injury to the non-movant if the stay is granted; and (iv) where the public interest lies. The Supreme Court has instructed that the first two factors are the "most critical" in conducting this analysis. Further, a stay should only be granted to preserve the status quo pending appeal.

The Court's analysis of each of the *Nken* factors with regard to the Defendants' motion for a stay is as follows:

**Defendants' Likelihood of Success on the Merits**

The Court noted that "the probability of success that must be demonstrated is inversely proportional to the amount of irreparable injury the moving party will suffer absent the stay." Interestingly, even though the Court believed that the Defendants would not succeed on their appeal, the Court found that the Defendants made the

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<sup>1</sup> At this time, the Court also considered Safeco's motion for enforcement of its right to an assignment of Defendants' claims on the three bonded projects and its right to a power-of-attorney to effectuate that assignment under the Indemnity Agreements, which the Court granted as the Defendants did not contest same and the Court determined that the Defendants were not entitled to a stay of the enforcement of such rights.

<sup>2</sup> Rule 62(c) provides that "While an appeal is pending from an interlocutory order or final judgment that grants, dissolves, or denies an injunction, the court may suspend, modify, restore, or grant an injunction on terms for bond or other terms that secure the opposing party's rights." The Court noted that although its 11/22 order does not provide injunctive relief, its enforcement of Safeco's right to collateral security through specific performance is injunctive in character.

<sup>3</sup> *Nken v. Holder*, 129 S.Ct. 1749, 1760 (2009).

requisite showing for a stay under this prong. In reaching its conclusion, the Court reasoned that a denial would result in significant harm to the Defendants because an award of collateral security threatens to render Defendants insolvent.

### **Irreparable Harm to Defendants Absent a Stay**

A monetary loss that threatens the continued existence of a business, i.e. insolvency, can constitute irreparable injury. Based upon the evidence submitted regarding the Defendants' financial status, the Court found that the amount of collateral security it directed Defendants to pay would render the Defendants insolvent and such harm constitutes irreparable injury. However, the Court noted in a footnote that under the indemnity agreements, Safeco is entitled to collateral security regardless of the financial impact upon Defendants.

### **Substantial Injury to Safeco if Stay is Granted**

If a stay is granted, Safeco will be harmed because it won't get the benefit of its bargained-for right to collateral security for anticipated losses under the indemnity agreements until the appeal is resolved. This right is intended to secure Safeco against anticipated losses until the ultimate issue of indemnity can be resolved. Further, it is significant to note that Safeco would be substantially harmed if the Defendants file for bankruptcy before the appeal is resolved because Safeco would be relegated to an unsecured claim and would be forced to share its debtor's property with other creditors. In fact, this is the exact situation that Safeco sought to avoid in bargaining for the collateral security clause.

### **The Public Interest**

Sureties provide assurance that defaults by any of the myriad parties to a construction contract will not result in a loss to other parties. As a practical matter, suppliers and small contractors on large construction projects need reasonably prompt payment for their work and materials in order for them to remain solvent and stay in business. Therefore, the public interest lies in favor of promptly enforcing Safeco's right to collateral security under the indemnity agreements, and thus, denying Defendants' motion for a stay.

In balancing the *Nken* factors with respect to the principle of a stay pending appeal – to maintain the status quo – the Court found that the first two factors, the “most critical” factors, weigh in favor of granting a stay. Here, in order to maintain the status quo, a stay must be granted to the Defendants. If a stay is not granted, Defendants face an imminent threat of insolvency and would no longer be able to prosecute this matter. Furthermore, the Court determined that any harm caused to Safeco by granting the stay can be mitigated by requiring the Defendants to post a bond

before the stay is issued. Thus, the Court granted the Defendants' motion for a stay and ordered the MES Defendants and Hirani Defendants to post a bond in the amount of \$200,000<sup>4</sup> and \$1M, respectively.

\* \* \* \* \*

The bond amounts are a far cry from the amount of collateral security the Court ordered the MES Defendants and Hirani Defendants to pay in the approximate amounts of \$6.6M and \$4.9M, respectively, pursuant to the Court's 11/22 order. Realistically, these bond amounts offer little protection to Safeco. And, of course, the real fear for Safeco, as noted by the Court above, is the possibility of the Defendants filing bankruptcy before the appeal is even resolved. If this happens, Safeco would simply be an unsecured creditor of the Defendants-Debtors. Since the secured creditors and priority creditors get paid first from the debtor's assets, there may little or no assets left with which to satisfy Safeco's claim.

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<sup>4</sup> The amount of the bond imposed upon the MES Defendants was increased to \$445,000 in light of certain financial documents which were later submitted to the Court. See *Safeco Ins. Co. of America v. M.E.S., Inc.*, 2010 U.S. Dist LEXIS 137189 (E.D.N.Y. Dec. 29, 2010).

## Gifford v. U.S. Green Building Council: In Development

By Stephanie Spangler

Leadership in Energy and Environmental Design (“LEED”) is a green building certification system developed by the U.S. Green Building Council (“USGBC”), a 501(c)(3) non-profit organization and a leader in the green building industry. The term LEED generally refers to two areas in the green building industry: building certification or professional credentialing. The USGBC provides points-based building certification systems through which owners may achieve various certifications. The different certification systems depend on the type of building or construction, and can include, but are not limited to, LEED for New Construction, LEED for Core & Shell, LEED for Existing Buildings, and LEED for Commercial Interiors.<sup>1</sup> In addition, there are four levels of LEED certification for buildings: LEED Certified, LEED Silver, LEED Gold, and LEED Platinum. The levels of LEED certification correspond to the number of points achieved, and the greater the number of points, the higher the certification level.

Professionals may also be certified as having LEED specialization through a professional credentialing program. These professionals must take a LEED Professional Exam to achieve the title of LEED Green Associate, LEED AP, and/or LEED Fellow.<sup>2</sup> The benefit of being a certified LEED Professional is that it advertises to others of one’s knowledge and understanding of green building practices.

Undoubtedly, the USGBC is one of the most influential leaders in the green building industry because it sets one of the most used standards of establishing what a “green” building is. Though some have predicted inevitable “LEEDigation”<sup>3</sup> (or green building litigation) to arise from green building certification, such an influx of litigation has not yet happened with any frequency.<sup>4</sup> However, in October 2010, *Gifford v. U.S.*

Green Building Council<sup>5</sup> was filed in the Southern District of New York, and is notably the first lawsuit brought against the USGBC challenging the green building certification system. This case symbolizes the growing pains in the green building industry of defining what is “green,” and determining who gets to make that conclusion. *Gifford* is a reminder that this certification process is not without its critics. The following article highlights the arguments brought by both parties to this case thus far.

### Plaintiffs’ Amended Complaint

On February 7, 2011, Henry Gifford, joined by three other plaintiffs, filed an amended complaint alleging false advertising and deceptive trade practices violating the Lanham Act, New York law, and common law. *Gifford*, originally initiated the suit as a class action on October 8, 2010, but has since dropped all class claims. The plaintiffs now include Gifford, an energy efficiency consultant; Matthew Arnold, an architect; Andrew Ask, a professional engineer; and Elisa Larkin, a barrier design and mold remediation specialist.

Plaintiffs’ causes of action involve allegations of false advertising under the Lanham Act and §350 of the New York General Business Law (“N.Y.G.B.L.”), deceptive trade practices under §349 of the N.Y.G.B.L., and an array of common law claims of false advertising, unfair competition, and unfair business practices. Plaintiffs base their allegations on a variety of published materials, including those available through the USGBC’s website, printed brochures, press releases, and a study by the New Buildings Institute.<sup>6</sup> The amended complaint states the USGBC willfully and falsely advertises that LEED-certified buildings provide greater energy efficiency and savings.<sup>7</sup> In addition, plaintiffs claim that the USGBC intentionally and falsely advertises that LEED certification is verified by a third party, which plaintiffs contend is incorrect.<sup>8</sup> According to the amended complaint, the USGBC’s false and deceptive advertisements “ha[s] and will continue to deceive consumers and voters, taxpayers, developers, municipalities, and legislators at the local, state and federal levels,” whom plaintiffs contend have spent billions of dollars on LEED-certified buildings and who would not otherwise have done so without the USGBC’s alleged false advertisements.<sup>9</sup>

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<sup>1</sup> See Building Certification, <http://www.gbci.org/main-nav/building-certification/leed-certification.aspx> (last visited Apr. 19, 2011).

<sup>2</sup> See LEED Professional Credentials, <http://www.gbci.org/main-nav/professional-credentials/credentials.aspx> (last visited Apr. 19, 2011).

<sup>3</sup> “LEEDigation” is a term coined by Chris Cheatham, author of the Green Building Law Update Blog. See LEEDigation, <http://www.greenbuildinglawupdate.com/2009/04/articles/legal-developments/leedigation/> (last visited Apr. 19, 2011).

<sup>4</sup> Though, in addition to *Gifford v. U.S. Green Building Council*, more litigation surrounding green building may well be on the horizon. See Rick Moriarty, *Internal Revenue Service Audits Destiny’s “Green” Bonds*, THE POST-STANDARD, Apr. 18, 2011, available at (footnote continued)

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[http://www.syracuse.com/news/index.ssf/2011/04/internal\\_revenue\\_service\\_audit.html](http://www.syracuse.com/news/index.ssf/2011/04/internal_revenue_service_audit.html) (last visited Apr. 19, 2011).

<sup>5</sup> Docket Number 1:10-cv-07747-LBS.

<sup>6</sup> Am. Compl. ¶¶ 26-31.

<sup>7</sup> *Id.* at ¶ 36.

<sup>8</sup> *Id.* at ¶¶ 44, 54.

<sup>9</sup> *Id.* at ¶¶ 57, 59.

Plaintiffs request the following relief:

1. permanent injunction ordering the USGBC to stop dissemination of material
  - a. advertising that LEED buildings perform 25-30% more efficiently than non-LEED certified buildings;
  - b. advertising that LEED buildings are more energy efficient than non-LEED buildings;
  - c. promoting LEED-certification as proof that a buildings has been built according to plans; or
  - d. misrepresenting the benefits of the LEED accreditation system.
2. issue corrective advertising materials; and
3. compel the USGBC to disclose the actual energy use of LEED properties.

Plaintiffs also request extensive damages of the following:

1. all of USGBC's profit derived from the alleged false advertising and deceptive practices;
2. treble damages;
3. all expenditures used to correct the false advertising;
4. costs, including expenses and fees, of bringing the action;
5. attorneys' fees;
6. exemplary damages to punish the USGBC for past willful conduct and to discourage future willful conduct; and
7. pre-and post-judgment interest.

Plaintiffs' request for relief and damages are broad-sweeping and punitive in nature. Notably, the disclosure of actual energy use poses inherent issues of privacy, and it is questionable whether a court, without legislative mandate, may compel the owners and users of LEED-certified properties to reveal their energy-use information. A court mandating that all LEED-certified buildings disclose energy information should be a requirement imposed by the legislature and not the courts.<sup>10</sup>

#### **USGBC's Pre-Answer Motion to Dismiss**

On April 6, 2011 the USGBC filed their motion to dismiss based on plaintiffs' lack of standing. The motion to dismiss begins with characterizing Gifford as a "longtime gadfly, preoccupied with critiquing the USGBC and LEED through the media, internet forums and the like. Gifford has every right to voice his criticisms of USGBC and LEED in the public forums of

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<sup>10</sup> Cf. Local Law 84, 28 N.Y. CITY ADMIN. CODE §309.8 (2009) (requiring disclosure of energy use for certain covered buildings in New York City as part of the Greener, Greater Buildings Plan of New York City).

his choosing. But unlike the internet and the public square, access to the federal courts is limited to those with standing to sue."<sup>11</sup>

In regards to the Lanham Act claims, the USGBC contends that plaintiffs have failed to meet the pleading requirements under *Bell Atl. Corp. v. Twombly*<sup>12</sup> and *Ashcroft v. Iqbal*.<sup>13</sup> The USGBC claims that plaintiffs' amended complaint fails to allege facts "above the speculative level,"<sup>14</sup> and that the facts pleaded do not "state a claim that is plausible on its face."<sup>15</sup> In addition, the USGBC claims that plaintiffs lack standing because they fail to establish the required allegations of injury-in-fact under *Lujan v. Defenders of Wildlife*.<sup>16</sup>

The USGBC further contends that plaintiffs' claims under the New York Consumer Protection Act, as codified in N.Y.G.B.L. §§ 349 and 350, must also be dismissed for lack of standing. The USGBC argues that the Consumer Protection Act is aimed at addressing consumer-to-business claims, not business-to-business claims; and the argument further states that plaintiffs' claims are of a business-to-business nature.<sup>17</sup> Like the federal claims, the USGBC argues that plaintiffs have stated no actual and direct injury. More specifically, plaintiffs have failed to plead (1) a causation requirement, which is necessary under the N.Y.G.B.L. §§ 349 and 350; or (2) an actual reliance requirement necessary under §350.

Finally, the USGBC contends that plaintiffs' common law claims also fail to meet the pleading requirements, which include the same elements required under the Lanham Act plus an allegation of bad faith that the USGBC argues is absent from the amended complaint.<sup>18</sup>

#### **Impact of Gifford on the USGBC's Role in the Green Building Industry**

Whether *Gifford* is leading the way for increased litigation related to LEED certification remains to be seen. If the Court grants the USGBC's motion to dismiss, then the USGBC will have successfully swatted away their "gadfly." However, *Gifford* is a costly reminder of the resonating critiques regarding the role of LEED certification in the green building industry. The USGBC itself stated that while still under belief that the case was a class action and before plaintiffs' amended

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<sup>11</sup> Mot. to Dismiss 1.

<sup>12</sup> 550 U.S. 544 (2007).

<sup>13</sup> 129 S. Ct. 1937 (2009).

<sup>14</sup> *Twombly*, 550 U.S. at 554.

<sup>15</sup> *Iqbal*, 129 S. Ct. at 1949.

<sup>16</sup> 504 U.S. 555 (1992).

<sup>17</sup> Mot. to Dismiss at 18-20.

<sup>18</sup> *Id.* at 23 (citations omitted).

complaint was filed, the “USGBC invested considerable time and resources preparing a motion to dismiss the Class Action Complaint.”<sup>19</sup> If the motion to dismiss is granted, at the very least this case has shined a judicial light on LEED certification and perhaps could spur a refining change in the USGBC’s certification process.

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<sup>19</sup> *Id.* at 6.

**Second Circuit Upholds Packet of Invoices as Sufficient Written Notice Under New York’s Little Miller Act.** MJJ Trucking, LLC v. Fidelity & Deposit Co. of MD, 2011 WL 13899 (2d Cir., Jan 5, 2011) (Summary Order)

By Geoffrey S. Pope, Esq.

The Second Circuit, construing N.Y. State Finance Law §137(3), has eroded<sup>1</sup> a rule that the written notice, required to be given by a payment bond claimant not in privity with the general contractor, must indicate that the claimant is looking to the general contractor for payment.

Perfetto Contracting (Perfetto), owned by Cesare Perfetto (Cesare) was general contractor on a public improvement project in Staten Island. Perfetto subcontracted to BD Haulers (BD) the removal of asphalt debris from the site. BD sub-subcontracted with MJJ Truckers (MJJ), owned by José and Myra Alvarado, for additional trucks for the job.

BD allegedly being in arrears in paying MJJ, the Alvarados made an unscheduled visit to Perfetto’s offices. Advised that Cesare was not there, they left with the receptionist a business card, and a packet containing invoices showing more than \$200,000 owing from BD to MJJ on the Staten Island project, plus about \$18,000 in unrelated invoices included by mistake. They encountered no principal of the company, or employee having authority to pay subcontractors. No express “bond claim,” or cover letter, payment demand, or indication that MJJ was looking to Perfetto for payment accompanied the invoices.

Later that day, there ensued a 40-minute cell phone conversation between José and Cesare. Although the trial judge seemed to have inferred, from the length of the conversation, that José necessarily told Cesare that MJJ expected payment from Perfetto if BD continued in its failure to pay, at trial José (although asked) did not assert or deny having made such a statement. To the contrary, José testified that he was unaware at the time that there was a payment bond, seemingly ruling out that José had made such a demand.

Cesare’s take on the conversation was that José claimed to be owed the improbably high amount of \$400,000, and was asking that Cesare intercede with BD’s owner, Gillette, and urge him to pay MJJ. José testified that Cesare told him that, although he “was gonna talk to [Gillette] to see if he can pay us,” that if “we didn’t resolve this thing... [José] would have to do it with Mr. Frank Gillette.”

Cesare spoke with Gillette, who stated that BD was paying MJJ, although there were “adjustments on the invoices on the way he was billing and the union benefits.” Because the amount MJJ claimed to be owing was nearly 90% of what Perfetto had paid to BD, Cesare credited Gillette’s assertion that MJJ’s claim was overstated. Cesare reported this discussion with Gillette in a second, brief phone conversation with José. There ensued a second impromptu visit by José to Perfetto’s offices (again finding Cesare absent) but no bond claim, or express indication that MJJ expected Perfetto to pay, if BD failed to do so.

Assuming that matters between BD and MJJ had been resolved, Perfetto paid BD its full unpaid subcontract amount. Months later, and BD having bounced a check to MJJ paid by way of settlement and closed its doors, MJJ sued Perfetto’s surety, Fidelity, under its payment bond. Fidelity asserted the notice defense at trial. MJJ stressed the policy favoring payment to persons furnishing labor or materials on public works contracts; maintained that the invoices constituted sufficient written notice; and argued, in the alternative, that actual notice on the general contractor’s part should permit written notice to be dispensed with entirely.

Following a bench trial, a Magistrate Judge awarded judgment for MJJ in the amount of \$255,591. The Court’s key finding was that:

Although the written invoices here did not expressly state that MJJ was seeking payment from Perfetto for BD’s debts, the Alvarados’ two visits to Perfetto’s office and the telephone conversations between José and Cesare leave no doubt that José communicated to Cesare that he was seeking payment from Perfetto.

“Little Miller Act” cases borrow freely from decisions under the federal analogue. On appeal, Fidelity cited inter alia two cases from the Second Circuit, *United States v. Charles R. Joyce & Son v. F. A. Baehner, Inc.*, 326 F.2d 556 (2d Cir. 1964) and *United States v. J. A. Edwards & Co., Inc. v. Thompson Construction Corp.*, 273 F.2d 873 (2d Cir. 1959) imposing a requirement in addition to those stated in the statute: namely, that the written notice must itself contain notice, express or implied, that the second-tier subcontractor or supplier is looking to the general contractor for payment.<sup>2</sup> *Fidelity distinguished United*

<sup>1</sup> Howbeit slightly, as “Summary Orders” are ostensibly “non-precedential.”

<sup>2</sup> Fidelity did *not* argue that the written notice must, *in haec verba*, advert to a “bond claim.” The argument that courts may not add requirements to those set forth in the statute is rebutted by the doctrine that, both the Miller Act and State Finance Law §137 having (footnote continued)

*States w/b/o Consol. Elec. Distribs., Inc. v. Altech, Inc.*, 929 F.2d 1089 (1991) as, in that case, the general contractor had confirmed to the claimant, in writing, that it understood that the claimant was looking to it for payment. Fidelity argued further that *Maccaferri Gabions, Inc. v. Dynateria Inc.*, 91 F.3d 1431 (11th Cir. 1996) was poor support for the outcome below, among other things as that case had characterized as “crucial” that the written notice state a claim directly against the general contractor, found insufficient a notice more ample than that provided by MJJ, and dismissed the claimant’s action.

The Second Circuit, affirming the District Court’s judgment, relied on *Am. Bldg. Contractors Assocs., LLC v. Mica & Wood Creations, LLC*, 804 N.Y.S.2d 109 (2d Dept. 2005) which held that §137(3) “does not specifically require that a notice refer to a bond claim.”<sup>3</sup> As MJJ’s packet of invoices was deemed to state with substantial accuracy the amount owed, and the name of the party for whom the labor was performed, “any reasonable notice requirements were met here.” Thus, Perfetto was forced to pay twice for MJJ’s work, to the tune of more than a quarter million dollars.

Whereas the District Court outcome was predicated on their supposedly being “no doubt that that José communicated to Cesare that he was seeking payment from Perfetto,” the Second Circuit nowhere indicated that it is essential to a successful bond claim that it be communicated to the general contractor, whether in the written notice or otherwise, not only that the claimant is owed money from the first-tier subcontractor, but expects payment from the general contractor. That is not, I think, consistent with the view expressed in several cases, among them *J. A. Edwards*, supra, 273 F.2d 873:

A brief letter from the supplier to the prime contractor will make certain and unambiguous the rights and liabilities of all concerned ... We do not believe that Congress intended to have it held that such little expenditure of effort is too much diligence to require of a supplier in order that he may secure his right of action on the payment bond.

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been amended, and Congress (or the Legislature) being presumed to have known of the construction given by the courts, they approved the added requirement, by failing to abrogate it when amending the respective statutes.

<sup>3</sup> By this citation, the Second Circuit deftly sidestepped addressing the considerable body of case law holding that the written notice must state a claim against the general contractor (although not necessarily mentioning the payment bond) or give notice, express or implied, that the claimant is looking to the general contractor for payment.

As I read it, the Second Circuit found itself unable to adopt the District Court’s finding that there was “no doubt” but that Cesare understood José to be looking to Perfetto for payment, but was reticent about making law for New York where the courts of the State have not plainly adopted, or rejected, the rule adding, to the two requisites in the statute, a requirement that the writing communicate that the claimant expects payment from the general contractor, should the first-tier subcontractor fail to pay. Thus, it fashioned an outcome it thought fair, and by designating its decision as a “Summary Order” sought to negate its precedential value as to whether the rule of *J.A. Edwards* still applies in the Second Circuit, in cases under the Miller Act proper.

“Summary Orders” and other supposedly non-precedential decisions are readily available online. Both the bench and bar are increasingly skeptical concerning the pretence that reasoned appellate decisions, addressing legal or mixed questions, if not binding precedent are predictive of how courts will act in future cases. Thus, over and above the outcome unfavorable to my client, I expect that *MJJ Trucking* will be cited as impliedly overruling *J.A. Edwards*, and suggest it would be preferable, where federal and state courts freely cite from cases, wherever decided, construing analogous state and federal statutes, that issues such as the rule requiring that the writing announce the expectation of payment from the general contractor be addressed squarely when presented.

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