CONSTRUCTION RISK MANAGEMENT REPORTER

ERNSTROM & DRESTE LLP

ContrACT

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Delay + Deficiency = Diversion

KEVIN F. PEARTREE

The New York Appellate Division, Third Department has a message for those not vigilant about their bookkeeping requirements for statutory trust funds. Delayed and deficient verified statements of trust funds can lead to a finding of diversion. Article 3-A of the New York Lien Law requires owners, contractors and subcontractors to maintain funds in trust, using those funds to first pay all those providing labor and materials for the improvement of real property. The funds received by a contractor are held in trust for subcontractors and suppliers; so too the funds received by a subcontractor. As a trust fund trustee, the contractor and subcontractor are required to maintain books and records detailing trust funds received, trust payments made with trust assets and transfers in repayment of or to secure advances made pursuant to a notice of lending. Failure to maintain the required books "shall be presumptive evidence that the trustee has applied or consented to the application of trust funds....for purposes other than a purpose of a trust.[1] A diversion of trust funds can result in liability for the amount diverted plus interest, attorney's fees, and in the most egregious situations punitive damages and even criminal liability, not only for the corporate entity but also

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Construction Managers Enjoy the Spearin Doctrine But Beware Limitations

KEVIN F. PEARTREE

At risk construction managers across the country took notice this past June when a Massachusetts court ruled they cannot rely upon the long-recognized common law doctrine that an owner who furnishes plans and specifications for a contractor to follow impliedly warrants their sufficiency for the purpose intended. Would other courts follow suit and deny this established protection and expand the liability of at risk construction managers in ways not expected? Those fears were mostly put to rest in September when the Supreme Judicial Court of Massachusetts corrected the lower court.

Gilbane was the construction manager at risk under a guaranteed maximum price contract for the construction of a state psychiatric facility. Coghlin Electrical Contractors, Inc., Gilbane's subcontractor, sought an equitable adjustment for increased costs it blamed, in large part, on Gilbane. Coghlin blamed Gilbane for scheduling and coordination mismanagement, accusations construction managers typically face. Gilbane believed Coghlin's complaints had their root cause in design changes on the project, and submitted a corresponding change order request to the owner, the Massachusetts Division of Capital Asset Management (DCAM). DCAM rejected it as an inefficiency claim not allowed by the contract.

After Coghlin filed suit, Gilbane brought a third-party action against DCAM arguing that to the extent Coghlin were to prove its claim against Gilbane, DCAM breached its contract by refusing to pay Gilbane the amounts claimed by Coghlin. The crux of Gilbane's action was that DCAM was responsible for design changes and design errors and omissions, and impliedly warranted the design consistent with Massachusetts' version of the *Spearin Doctrine*. Gilbane also argued that its broad indemnification obligation to the owner did not override the owner's implied warranty of design. Moving to dismiss Gilbane's claims, DCAM asserted that as an at risk construction manager participating in the project design, Gilbane did not enjoy the benefit of the implied warranty of design, and remained obligated to indemnify DCAM.

The lower court agreed with DCAM. Characterizing construction management at risk as an "alternative delivery method" to traditional design-bid-build, the court compared and contrasted the construction manager's relationship to the owner with that of a general contractor. The court noted the construction manager's early retention and involvement, before design is completed, to assist in project planning and provide construction expertise as the design is developed. The court reasoned that the pre-construction services typically provided by a construction manager – cost estimation, consultation on design, preparation of bid packages, scheduling and cost control – make for a fundamentally different relationship with the owner, than that of a general contractor. The court also stressed both the manner of the construction manager's selection – qualification and fee based – and its guaranteed maximum price compensation, typically established after the completion of design, as creating a different relationship with respect to the risk of project cost overruns.

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Turning to the services Gilbane contracted to provide, the court cited the ongoing duty to "review the design documents for clarity, consistency, constructability, maintainability, operability and coordination among the trades, coordination between the specifications and drawings…" More significantly perhaps, Gilbane was required to review on a continuous basis "development of the Drawings, Specifications and other design documents produced by the Designer", performed by architects and engineers either employed or retained by Gilbane, "to discover inconsistencies, errors and omissions between and within design disciplines."

Gilbane perhaps believed it was still adequately insulated from design liability by language stating:

> The CM shall consult with DCAM and the Designer regarding the selection of materials, building systems and equipment, and shall recommend alternative solutions whenever design details affect construction feasibility, schedules, cost or quality ***(without, however, assuming the Designer's responsibility for design)*** and shall provide other value engineering services to DCAM.

This parenthetical clause, however, did not alter the lower court's interpretation of the owner/construction manager at risk relationship. Neither did Gilbane's argument that it had no duty to indemnify the owner for claims attributable to design changes and errors, despite the contract language stating the duty to indemnify "shall not extend to the liability of the Designer, its agents or employees arising out of (i) the preparation of approval of maps, Drawings, opinions, reports, surveys, Change Orders, designs and Specifications, or (ii) the giving of or the failure to give directions or instructions by the Designer, its agents or employees provided such giving or failure to give is the primary cause of the injury or damage." To the lower court this provision merely limited Gilbane's obligation to defend and indemnify the Designer. Since no claim was asserted against the Designer, it was inapplicable.

The lower court offered a curious reading of Gilbane's indemnification obligation. In suing DCAM, the lower court reasoned, Gilbane was essentially suing itself – to the extent it might win on its claim against DCAM, Gilbane was obligated to indemnify DCAM for this loss. This created "an impermissible circuity of obligation" because "Gilbane may not seek damages from DCAM when DCAM would have a right to be indemnified by Gilbane for those same damages."

Taking all these factors together, the lower court concluded that the construction manager at risk's role and relationship to the owner is so materially different from that of a general contractor, that Gilbane cannot enjoy the benefit of the implied warranty of design; rather, that is reserved for general contractors on a traditional design-bid-build project.

The lower court's interpretation of the owner-construction manager at risk relationship is perhaps understandable given that a construction manager is often involved in informing design decisions of the designer. Certainly, the provisions in Gilbane's contract obligating it to "discover inconsistencies, errors and omissions between and within design disciplines" influenced the court's interpretation. But the lower court went too far in denying Gilbane altogether, and all construction managers at risk, the benefit of the long-recognized implied warranty of design. On appeal, a number of industry groups filed friends of the court briefs challenging the ruling.

Fortunately, the Massachusetts' Supreme Judicial Court rejected the lower court's blanket denial of the application of the implied warranty of design to construction managers at risk.[1] Yes, the roles of general contractor and construction manager at risk are different in important ways, but those differences do not warrant abolishing the implied warranty as to at risk construction managers. While the construction manager at risk may consult on project design, the designer remains ultimately responsible for it, and neither the designer or owner are under any obligation to accept the recommendations of the construction manager. Nor did the Massachusetts statute enabling construction management at risk for public projects abolish the owner's implied warranty of design for those construction managers.

But since a construction manager can have a greater consultative role in project design, the Supreme Judicial Court ruled that the construction manager at risk "may benefit from the implied warranty only where it has acted in good faith reliance on the design and acted reasonably in lights of [its] own design responsibilities." The more the construction manager at risk is involved in the design process, the greater its burden will be to show that its reliance on the defective design was both reasonable and in good faith, if it is to enjoy the benefit of the implied warranty.

Having upheld and refined the application of the implied warranty of design, the court also found that the parties did not expressly disclaim the warranty in their contract, nor was there any statement that Gilbane assumed full liability for design defects. Finally, the court rejected the lower court's reading of Gilbane's indemnification obligation. With the implied warranty reaffirmed and refined, the indemnification properly interpreted, and its claims saved for now, it remains for Gilbane to carry its burden to demonstrate that it acted in good faith reliance upon the project design, and acted reasonably in light of its own project design responsibilities.

TAKEAWAYS: Care must be taken negotiating contract terms for services connected to project design. Avoid language that might be read to require the construction manager to vet the project design, or to assume liability for design and design defects. The requirement in Gilbane's contract to employ or retain licensed professionals to review the project design "to discover inconsistencies, errors and omissions between and within design disciplines" was atypical of most construction management agreements, and certainly involved the construction manager more deeply in project design. The contract should make clear the limited nature of the construction manager's role in project design and reiterate the designer's (and owner's) ultimate responsibility for project design. Be on the watch for express disclaimers of the implied warranty. Had the court in Coghlin found one, the construction manager would have lost any opportunity to argue for the implied warranty. Finally, an at risk construction manager should consult its insurance consultant on appropriate professional liability coverage. E&D

1 *Coghlin Electrical Contractors, Inc. v. Gilbane Building Company*, 2015 WL 5123135, 36 N.E.3d 505 (2015).

CONTINUED "DELAY + DEFICIENCY = DIVERSION"

those individual officers, directors and agents who knowingly participate in the diversion.

In *Anthony DeMarco & Sons Nursery, LLC v. Maxim Construction Service Corporation*,[2] a sub-subcontractor, contending it was owed additional monies by a subcontractor, filed a mechanic's lien and thereafter commenced an action. During the pendency of that action, the sub-subcontractor, DeMarco, served on subcontractor Maxim a demand for a verified statement of trust funds pursuant to Lien Law §76. When no response was forthcoming, DeMarco secured a court order compelling Maxim to provide a verified statement. Though one was ultimately served, DeMarco deemed it deficient, and again sought a court order to compel Maxim to provide a non-deficient verified statement. The court took matters a step further, finding Maxim's verified statement so deficient that it awarded DeMarco summary judgment on liability against Maxim.

On appeal, the Appellate Division upheld the award of summary judgment. The verified statement Maxim provided failed to set forth the dates and amounts of the trust assets receivable, trust accounts payable or trust funds received, all as required by Lien Law §75, nor did the statement provide a sufficiently detailed breakdown of the total amount of payments made with trust funds. Noting that sizeable sums (totaling perhaps millions of dollars) remained unaccounted for, and that despite ample time to provide a proper accounting, Maxim declined to do so or offer any explanation for the deficiencies, the court found that Maxim failed to overcome the statutory presumption of an improper diversion of trust funds.

Contractors and subcontractors alike should pay attention to this cautionary tale. Trust fund accounting requirements cannot be taken lightly. A demand for verified statement of trust funds requires a timely and complete response. Legal counsel should be involved to ensure a verified statement is both of those things. Otherwise, delay and deficiency can add up to liability. E&D

1 New York Lien Law §75.

2 130 A.D.3d 1409, 14 N.Y.S.3d 235 (3dDept. 2015).

Contractor Vigilance Saves Claims

KEVIN F. PEARTREE

Many of the cases reported in this newsletter are cautionary tales for contractors – "don't do what this contractor did." Lessons can be learned from those who get it right too. In the case of *Peter Scalamandre & Sons, Inc. v. FC 80 Dekalb Associates, LLC*,[1] the contractor got it mostly right and saved its extra work, delay and mechanic's lien claims from a swift defeat. The contractor started by reading and understanding its contract with the owner, which contained a specific contractor claims provision, Article 8, and a separate provision for changes ordered to the scope of the work by the owner, Article 4. Article 8 included condition precedent language requiring written notice of claim that, absent strict compliance, constituted a waiver of contractor's claim. Article 4 also had a written notice requirement, but without any condition precedent or waiver language.

The owner argued that the notice of claim and waiver language in Article 8 should be read broadly to cover the contractor's claims for extra work allegedly ordered by the owner. Because it had not issued *written* instructions for the work in dispute, but allegedly verbal instructions, the owner argued that Article 4 did not apply, sending the contractor back to Article 8 with its condition precedent written notice requirement that the contractor admitted it did not satisfy.

The appeals court disagreed. Admittedly, some of the language of the contractor claims provision, read by itself, might seem to cover the contractor's extra work claims, but Article 8 clearly directed that claims for work ordered pursuant to Article 4 be made under Article 4. That contract provision did not include a condition precedent notice requirement. Had it, the contractor's failure to comply would absolutely bar its claim. Without that higher standard, substantial compliance with the notice requirement is sufficient. Also, oral directives or a general course of conduct between the parties may modify or eliminate contract notice requirements.

The contractor was also vigilant in protecting its claims during the ordinary payment process. The owner argued that the mechanic's lien was waived by the language of a typical, contractually required progress payment lien waiver – contractor "waives, releases and relinquishes any and all claims, rights or causes of actions in equity or law whatsoever arising out of, through or under mentioned Contract and the performance of work pursuant thereto and including the date hereof." The waiver was submitted, however, along with the payment application listing pending change orders including the work in dispute. Viewed together, the waiver was not intended to encompass the claims subsequently presented for additional work, and was a mere receipt of the amount stated.

Hindsight can reveal opportunities for greater vigilance. The contractor might have given notice satisfying Article 8, if possible, just to be safe. The outstanding claims could have been referenced directly in the progress payment lien waiver, to remove all doubt. But overall, the contractor understood its contract, took steps to protect its interests and saved its claims from dismissal. E&D

1 129 A.D.3d 807, 12 N.Y.S.3d 133 (2nd Dept. 2015).

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Ernstrom & Dreste also publishes the Fidelity and Surety Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste's website (ernstromdreste.com).

FIRM NEWS

In October, Kevin F. Peartree gave a presentation to the DBIA Tri-State Chapter, Liberty Northeast Region, on "Which Design-Build Contract is Right for You and Your Project?"

Also in October, John W. Dreste was a featured presenter for an AGC of NYS webinar titled "MWBE and DBE Laws, Regulations and Best Practices for Utilization and Compliance".

In November and December, Thomas K. O'Gara gave presentations to the Junior Builders Exchange of Rochester on the "ABCs of M/WBEs" and "Getting Paid: Trust Funds, Liens & Bond Claims".

E&D recently readied for publication the 2016 Annual Supplement to the ConsensusDocs Contract Documents Handbook, by Aspen Publishers. The supplement will look at ConsensusDocs 907, the Equipment Lease.