CONSTRUCTION LAW REPORT

Fall 2004

ON SITE — IN THE OFFICE — AT THE COURTHOUSE
D'Ancona Lawyers Bolster Seyfarth Shaw's Construction Industry Practice

Within the last year, Seyfarth Shaw merged with the century-old Chicago firm, D'Ancona & Pflaum. A significant portion of D'Ancona's practice was dedicated to counseling clients regarding construction-related issues. With clients engaged in the development and construction of office, retail, industrial, residential, hotel and mixed-use properties throughout the United States, D'Ancona advised property owners, developers, construction managers, designers, general contractors and subcontractors regarding property development and redevelopment, contractual matters, mechanics liens, labor and employment, workplace health and safety, and more.

D'Ancona lawyers were actively involved in dispute resolution as well. Its trial lawyers have handled numerous complex, construction-related matters, successfully litigating, arbitrating and mediating contract claims, design deficiencies, delay damages, mechanics lien claims, breach of fiduciary duty claims, and insurance coverage claims in a variety of venues and cases arising out of public as well as private projects.

As a result of the merger, Seyfarth Shaw now has one of the largest, most experienced construction practices in Chicago. A number of our partners have been designated as Leading Lawyers in construction law and related areas by our peers, according to the publishers of the *Chicago Daily Law Bulletin*. With over three dozen attorneys around the country, Seyfarth Shaw's construction team brings breadth and depth to its treatment of construction issues. The full-service nature of our firm also enables us to handle all other business issues facing construction companies today.

Texas Joins Trend of Allowing Subcontractor "Pass-Through Claims"

When an owner changes a project, it often affects a subcontractor's scope of work. A lack of contractual privity between the subcontractor and the owner, however, prevents a direct claim by the sub against the owner. Instead, the sub initiates a lawsuit against the contractor for its "extras," which then typically leads to a lawsuit by the contractor against the owner. Many contractors have sought to insulate themselves from such a dispute by inserting a clause into their subcontract agreements that accepts an obligation to submit the subcontractor's claim to the owner, but limits the contractor's liability to the subcontractor to the amount actually recovered from the owner. Such a situation gives rise to what is referred to as a "pass-through claim."

For many years, federal courts permitted contractors to assert *pass-through claims* on behalf of their subcontractors. State courts, though, are not so uniform. Recently, the Texas Supreme Court, in *Corporation v. City of Dallas*,

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135 S.W.3d 605 (2004), endorsed the concept. In that case, the City of Dallas let a contract for the construction of levees and the excavation of two areas to create "lakes" for storm water detention. The material from the excavations was to be used as fill for the construction of the levees, but the material turned out to be unsuitable. Extra costs were incurred to obtain suitable fill, and the contractor sought to recover from the City of Dallas on behalf of its subcontractor.

By recognizing such a pass-through claim, Texas became the 19th state to explicitly recognize the concept (the other 18 are Alaska, California, Florida, Georgia, Kansas, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New Jersey, New York, North Carolina, Oregon, Rhode Island and Virginia). Connecticut, on the other hand, has specifically rejected the concept, unless the contractor is willing to admit its liability to the subcontractors. The remaining 30 states have not addressed pass-through claims.

The pass-through claim is an efficient tool for a subcontractor, in that it allows the contractor to prosecute the subcontractor's claims in a more cost-effective manner because the contractor can pursue the subcontractor's claims directly against the owner without initiating the first lawsuit. In addition, it protects the contractor against potential liability to a subcontractor for the owner's actions in a situation where the contractor cannot recover from the owner (especially important in a multiple-venue situation, where disparate decisions are possible). In order to obtain its advantages, however, the clause must provide for the contractor to maintain contingent liability to the subcontractor. In other words, the insulating clause cannot eliminate the contractor's responsibility to the subcontractor altogether. The contractor must remain liable to the subcontractor in the event the contractor refuses to present the pass-through claim to the owner, or if the contractor refuses to *pay* any funds collected.

— Scott J. Smith

Connecticut Adopts Majority View That Surety Who Settles Solely for Its Own Self Interests Is Not Entitled to Indemnity from Principal

A surety who pays out on a performance bond is typically entitled to seek indemnification from its principal, on whose behalf the payment was made. However, when presented with a contested claim, the surety is faced with what courts characterize as the "classic dilemma." Should the surety defend the principal and refuse to settle the claim on demand? Or should it settle the contested claim in order to avoid further liability? Either way the surety is subject to accusations of "bad faith" conduct from either the principal or the claimant, depending on what it does.

Recognizing this dilemma, courts typically hold that a surety is entitled to indemnification only for payments that were made in good faith. Connecticut recently joined the majority of jurisdictions in defining "bad faith" as requiring an "improper motive" or "dishonest purpose." The Connecticut Supreme Court reasoned that "this standard preserves a proper balance between affording the surety the wide discretion to settle that it requires, while ensuring that the principal is protected against serious and willful transgression." *PSE Consulting, Inc. v Frank Mercede and Sons, Inc*., 267 Conn. 279, 305, 838 A.2d 135, 153 (Jan. 13, 2004).

At issue in *PSE Consulting, Inc*. was a payment bond issued by National Fire Insurance Company of Hartford (National) on behalf of general contactor Mercede and Sons, Inc. (Mercede). PSE Consulting, Inc. (PSE) was a sub-subcontractor of one of Mercede's subcontractors. PSE sought payment from Mercede for $600,000, plus delay and other damages, when the subcontractor filed for bankruptcy. When Mercede refused to pay, PSE demanded payment from National under the surety bond. Mercede contested the entirety of the claim and, after discussing the claim with Mercede, National refused to pay. PSE filed a lawsuit against Mercede, alleging various claims, including bad faith. PSE also filed a complaint about National with the insurance commissioner. Without Mercede's knowledge, National changed its position and settled with PSE, paying it $700,000. National secured a release from PSE on its own behalf, but did not secure a release on Mercede's behalf.

Relying on the standard "right-to-settle" language in surety contracts, National then sought indemnification from Mercede for the $700,000 paid to PSE. Nevertheless, the Connecticut Supreme Court noted that the surety's right to settle disputes is not unfettered, reaffirming that settlement must be made in good faith. Here, National failed to investigate adequately the facts surrounding PSE's claim, even though it was on notice that its own principal, Mercede, believed the claim was baseless. National not only then settled the case without advising Mercede, but it did so solely on its own behalf, obtaining a release for itself, but not for Mercede. Taken together, these facts constituted bad faith, which forfeited National's right to indemnity.

— Meghan Hubbard

Recent Victories

Fraud Claim Against General Contractor

Roger L. Price and Mark L. Johnson obtained judgment on behalf of a general contractor against a fraud claim asserted by the owner of a nursing home, which arose out of the construction of a 200-bed addition to the facility. The owner asserted that the general contractor had defrauded it, in that the general contractor knew at the time of contracting that it could not properly construct the addition within the guaranteed maximum price. After judgment was entered against it on the fraud claim, the owner withdrew its claims for defective construction and delay.

OSHA

Brent I. Clark and James L. Curtis obtained significant results on behalf of a client arising out of two fatal falls on one of the largest road/bridge construction projects in the state of Illinois within the past several years. Our Seyfarth Shaw team persuaded OSHA not to issue any citations in one of the incidents and agreed to a minor citation in the other. OSHA also agreed to withdraw an alleged repeat violation in the case.

Accessibility Standards

Patrick E. Zeller and Jerome F. Buch successfully resolved a lawsuit on behalf of a national retail firm brought against it by the Illinois attorney general, who alleged that the lack of appropriate parking, pedestrian walkways, and entrances at its Illinois stores violated Illinois' Environmental Barriers Act and other accessibility standards. Our team negotiated a unique settlement that provides for a survey process tracked by an independent monitor, vested with discretion to accept existing conditions that may not *technically* comply with the accessibility standards when it would be economically unjustifiable to bring them into full compliance. The settlement was highly publicized by the attorney general's office as the most wide-ranging and significant of its kind relating to the correction of barriers to accessibility. Other states' attorneys general are filing similar suits against property owners with increasing frequency.

False Pay Applications

Jeffrey Jahns and John H. Anderson were successful in resolving a series of mechanic's liens, totaling $1.1 million against a mashed potato manufacturing plant in Ohio, where the general contractor had filed false payment applications and lien waivers to obtain payment from the owner, but never paid its subcontractors.

Overstated Lien

Although the right to record a lien is a powerful remedy for general contractors and subcontractors who have not been paid on a construction project, sometimes a lien is grossly overstated, which can be very damaging to an owner. Roger L. Price and Molly M. Joyce encountered just that situation recently, where a subcontractor filed a lien for over $1.4 million against a condominium developer, despite having previously submitted a lien waiver to the effect that no more than $85,000 was due. The subcontractor claimed that the developer knew of the sub's claims and obtained the waiver by fraud and duress. The Seyfarth Shaw team successfully attacked the lien with a motion for summary judgment, and secured a reduction of the lien back down to $85,000.

Affirmative Action Requirements Affect Federal Construction Contractors

Affirmative action requirements imposed by federal law affect all contractors working on federal and federally assisted construction projects. Compliance with those requirements is monitored by the Office of Federal Contract Compliance Programs (OFCCP), an agency within the Employment Standards Administration of the U.S. Department of Labor. The OFCCP administers and enforces three equal employment opportunity laws:

Executive Order 11246: Prohibits discrimination on the basis of race, color, sex, religion and/or national origin and requires affirmative action with regard to employment policies and practices. Executive Order 11246 applies to federal or federally assisted construction contracts in excess of $10,000.

Section 503 of the Rehabilitation Act of 1973, as amended (Section 503): Prohibits discrimination and requires affirmative action with regard to all employment policies and practices for qualified individuals with disabilities. Section 503 likewise applies to federal or federally assisted contracts in excess of $10,000.

Vietnam Era Veterans' Readjustment Assistance Act of 1974, as amended, 38 U.S.C. 4212 (VEVRAA): Prohibits discrimination and requires affirmative action in all employment policies and practices with respect to disabled veterans, veterans of the Vietnam era and veterans who served on active duty. VEVRAA currently applies to federal or federally assisted contracts in excess of $25,000, but that threshold will soon increase to $100,000.

The OFCCP frequently monitors compliance with the foregoing laws through random "compliance evaluations," during which detailed reviews of contractor/subcontractor affirmative action efforts and employment policies and practices are conducted. There are 16 specific affirmative action requirements with which construction contractors must comply on federal and federally assisted projects.

Affirmative Action Requirements

1. Maintain a harassment free work environment at all sites and locations.
2. Create and maintain a current list of female and minority recruiting sources.
3. Maintain extensive information regarding applicants.
4. Notify Deputy Assistant Secretary of union nonreferral of females or minorities.
5. Develop or participate in on-the-job training opportunities.
6. Follow steps outlined to disseminate EEO policies properly.
7. Annually review EEO policies and affirmative action obligations with everyone responsible for making employment decisions.
8. Follow steps outlined to disseminate properly EEO policies externally.
9. Follow steps to recruit females and minorities actively.
10. Encourage female/minority employees to recruit other females and minorities.
11. Conduct impact ratio analysis to determine any adverse affect upon hiring, promotion and termination practices.
12. Annually assess female/minority employees for promotional opportunities.
13. Ensure that no employment practices have any discriminatory effect.
14. Ensure that all company facilities and activities are non-segregated, with the exception of toilet and changing areas.
15. Document and maintain solicitation of offers from female and minority construction contractors and suppliers.
16. Annually review manager/supervisors' adherence to EEO policies and affirmative action obligations.

The Seyfarth Shaw Affirmative Action Consulting Team has extensive experience assisting employers in connection with such audits, as well as compliance reviews in which the OFCCP has alleged discrimination in hiring, compensation, promotion or termination. We also work with employers in conducting self-audits and counseling them regarding their HR information systems' effectiveness as a compliance tool. Certain contractors that enter into supply and service contracts with the federal government may also be required to develop affirmative-action guidelines that cover their permanent internal workforce. Your Seyfarth Shaw team has tremendous experience in developing these types of guidelines as well.

— Halcolm L. Holliman (Sr. Affirmative Action Advisor)
— Michele D. Merkel (Sr. Affirmative Action Analyst)

Calendar of Events

"New Threats and Creative Responses: Emerging Issues for Construction Industry Management"

Seyfarth Shaw and McDonough Bolyard Peck are sponsoring a full-day seminar on October 28, 2004, in Tyson's Corner, Virginia, Kenneth Simonson, chief economist for the Associated General Contractors of America, will be the guest speaker. For more information, visit our web site at www.seyfarth.com

"Liability Challenges On a Construction Site"

Mark A. Lies II will speak on this current and hot-topic subject, which also covers personal tort and criminal liability of supervisors and owners for workplace accidents. He will be making presentations to the following organizations on the indicated dates:

American Society of Safety Engineers
October 12, 2004, in Chicago, Illinois

National Association of Demolition Contractors
October 28, 2004, in Chicago, Illinois

Outdoor Advertising Association of America
November 15, 2004, in Nashville, Tennessee

Publications

Mark L. Johnson's and Scott J. Smith's article "Substantial Completion and the Impact of the Architect's Certificate" appeared in the Winter 2004 edition of *Construct!*, a magazine published by the Construction Litigation Committee of the American Bar Association's Section of Litigation.

Chip Ingraham's and Clay Haden's article "Digital Disputes: Are You Ready?" appeared in the most recent edition of the *Repro Report* (vol. 23, no. 4, 2004).

Ira Fierstein's article "It's Just a Phase (Issues and Answers for Landlords When Phasing a Shopping Center)" appeared in the August 2004 edition of *Commercial Leasing Law & Strategy*.

Presentations

"Getting Paid on California Private and Public Construction Projects"

On January 14 and 15, 2004, Michael T. McKeeman and Larry Watts gave this presentation in San Francisco and Los Angeles, respectively, to various construction industry professionals.

"Lien Laws: Tools That Get You Paid"

On January 15, 2004, Scott J. Smith spoke on this topic to the Association of Subcontractors & Affiliates in Chicago, Illinois.

"Legal Issues on Construction Projects: When Bad Things Happen on Good Projects"

On February 6, 2004, Roger L. Price addressed the National Concrete Masonry Association on these issues during its annual convention in Atlanta, Georgia.

Caught In the Steel Trap: Strategies for Dealing with the Fallout from Material Price Increases"

On April 21, 2004, C. Clay Haden and Kamyar (Kamy) Molavi spoke on this topic in Atlanta, Georgia, to contractors directly affected by steel-price increases.

"Liability Challenges on a Construction Site"

On July 9 and July 22, 2004, Mark A. Lies II made this presentation to the National Electrical Contractors Association in Lake Geneva, Wisconsin and to the Associated General Contractors National Safety Committee in Chicago, Illinois, respectively.

Awards

Leading Lawyers Network

Jerome F. Buch, Philip L. Comella, Jeffrey Jahns, and Roger L. Price have been selected to the prestigious Leading Lawyers Network. These lawyers were named by their peers as being among the top lawyers in the state of Illinois in the areas of Construction Law (Buch, Jahns, and Price) and Environmental Law (Comella).

ADA Accessibility Guidelines Changing

Major revisions to Title III of the Americans With Disabilities Act's (ADA) Accessibility Guidelines may be coming. The Accessibility Guidelines, which establish the architectural requirements for providing physical access to persons with disabilities, have seen few substantive changes since ADA's enactment in 1992. On July 26, 2004, however, revisions to the Accessibility Guidelines were published in the *Federal Register.*

If adopted, the changes to the Accessibility Guidelines will affect both public and private enterprises and institutions that design, build, lease or own commercial properties and places of public accommodation. And properties that are in compliance today may not be in compliance with the *new* Accessibility Guidelines.

Seyfarth Shaw is continuing to monitor reaction to the new guidelines.

Do You Have a Seyfarth Shaw LLP Construction Hat Stress Reliever?

If you would like one of our stress hats, contact Hannah Lopas at hlopas@seyfarth.com.

Nevada Is Latest State to Recognize Exceptions to "No Damages for Delay" Clauses

"No damages for delay" clauses generally waive one's right to be reimbursed for the other party's delay. These clauses often cause contractors a great deal of trouble at the end of a delayed project, when the final tally of their cost overruns is realized. Recently, in *J.A. Jones Construction v. Lehrer McGovern Bovis* (No. 39235), the Nevada Supreme Court joined a majority of other states by finding that, although valid and enforceable, exceptions to "no damages for delay" clauses do exist. These exceptions lessen the burdens imposed on contractors.

J.A. Jones Construction (Jones) was hired by construction manager Lehrer McGovern Bovis (LMB) to provide structural concrete for the Sands Exposition Center expansion in Las Vegas. Jones claimed that it significantly lowered its bid, by about half, because LMB promised to prepare and maintain the site in a manner that would allow Jones to perform its work efficiently in a continuous sequence. Jones claimed that it encountered problems which led to delays throughout the project. Initially, none of the excavation work had been completed. Once the excavation was done, Jones was prevented from pouring the concrete in the manner it initially intended. Eventually the entire site flooded. Underground sewer lines and rough ground conditions proved to be more difficult than anticipated. According to Jones, all of these problems prevented it from being able to use its efficient rolling formwork system as planned. Instead, Jones was forced to handset, move, and store the formwork piece by piece. Jones finished its work eight months behind schedule and with significant cost overruns.

At trial, Jones proposed a jury instruction that identified various exceptions to "no damages for delay" clauses. The district court rejected the instruction.

On appeal, the Nevada Supreme Court reversed the trial court's ruling, noting that a majority of jurisdictions have adopted the following exceptions to "no damage for delay" clauses:

1. willful concealment of foreseeable circumstances that affect timely performance;

2. delays so unreasonable in length as to amount to project abandonment;

3. delays caused by the other party's bad faith or fraud; and

4. delays caused by the other party's active interference.

With one modification, the Nevada high court adopted these exceptions, reasoning that they are a logical extension of the established laws of good faith and fair dealing. The court found that the instructions should combine exception one (willful concealment) with exception three (bad faith/fraud) to create a more general exception.

The Nevada Supreme Court did not, however, adopt Jones's proposed exception for "delays not contemplated by the parties at the time they entered into the contract." Although some courts, such as New York, have recognized this exception, the Nevada court refused, reasoning that parties, knowing that unforeseen delays can occur, could bargain accordingly.

— Molly M. Joyce

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