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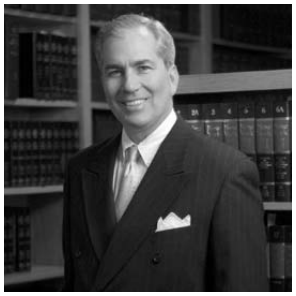
THE CONSTRUCTION AND SURETY LAW UPDATE

CONSTRUCTION • GOVERNMENT CONTRACT CLAIMS • SURETY • LABOR • LITIGATION

FALL 2005



Henry L. Goldberg
Managing Partner

ACCELERATING TO ACHIEVE AN INCENTIVE MILESTONE

- **Can You Be Compensated For Both The Incentive and The Acceleration?**
- **Is Notice of a Delaying Event Without Asserting Damages Sufficient Contract Notice?**

New York State Department of Transportation (NYS-DOT) projects are frequently based upon incentive/disincentive or "A+B" type bidding. In an interesting recent decision, the New York Court of Claims took up two important questions which frequently arise on heavy highway projects. There, the segment of the work identified by the NYS-DOT's contract as "B" portion work was time-sensitive. It contained both an incentive for the contractor to finish the "B" portion work ahead of schedule and a disincentive if the work was not completed on time.

The contractor alleged that during the course of the project the State caused delays which prevented it from completing the "B" portion on time. The contractor asserted that, in order to earn the incentive payment

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Major Construction Claims Settlement Against NYC-DOT (page 5)

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Accelerating to Achieve... (*Continued from page 1)*

(and avoid disincentive penalties), it was required to accelerate the "B" portion work, requiring an increase in labor and equipment costs. The contractor completed the "B" portion work ahead of schedule and was given the full 30 day incentive award. However, the contractor also alleged that the DOT created the need for acceleration and the resulting increased expenditures, and made claim for same. This claim was in addition to the contractual incentive it had received. In other words, but for the interference by the DOT, the contractor would have achieved the B portion incentive without a costly acceleration, as originally planned.

Contractor Notice

The contractor maintained that it gave written notice of DOT's delay-causing events as they occurred. It provided the court with copies of correspondence sent to the DOT, which demonstrated that the contractor was concerned about the progress of its "B" portion work. However, the court observed that "notice of delay" is not the same as "notice of a claim for damages" relating to those delays. The State's contract required that "within ten workdays after the contractor had knowledge, or should have had knowledge, of any event, matter or occasion which will result in time-related damages, the contractor must provide the Engineer with written notice of a dispute for time-related damages."

The correspondence sent by the contractor, from the Courts perspective, did "not give the State reason to believe that these notices were anything more than requests for extensions of time to complete the B portion of work (extensions which were, in fact, given by the State). DOT argued that while the notices submitted by the contractor were concerned about delays and requests for extensions of time to complete the B portion work, the claimant did not give notice that it intended to assert a claim for money damages. The court agreed.

Claim for "Constructive" Acceleration

With regard to the claim for acceleration undertaken to overcome the admitted State-caused delays, the court found that the contract's language with regard to "acceleration" was specific. The contractor contended that the DOT, typical of public agencies, responded to its notices concerning interferences by informing the contractor that the extra "B" portion days would be resolved "when the "B" portion work was complete." The Contractor argued, quite correctly, that the DOT's response was a "non-answer" and "unsatisfactory." Caught between "a rock and a hard place" the contractor concluded that since it could not get a commitment from the DOT regarding an extension of time for the "B" portion of the work, it was "forced" to accelerate to assure timely achievement of the incentive milestone.

However, the contract specifically addressed such disputes. It provided that "if claimant is dissatisfied with the resolution as proposed by the Engineer In Charge (EIC), then claimant is to provide written notice to the Commissioner within ten days." Instead, the Court observed, after being dissatisfied with the EIC's response to its request for additional "B" portion days, the contractor unilaterally accelerated performance. In doing so, the Court held that the claimant chose to forego the contractually provided avenue for settling disputes, which required written notice to the Commissioner.

In addition, the Court held that, even if it were to find that the State's failure to properly respond to the Contractor's notices "compelled" the Contractor to accelerate, the contract specifically prohibited it from unilaterally accellerating.

The DOT's contract addressed such issues as follows:

> "ACCELERATION DISPUTES". The Contractor may not maintain disputes for costs associated with acceleration of the work unless the Department has given prior express written direction by the Engineer to the Contractor to accelerate its effort…for purposes of this subsection, lack of express written direction on the part of the Department shall never be construed as assent.

Thus, the Court held, without using such term, that under the NYS-DOT contract, there could be no "constructive" acceleration and that written authorization would always be necessary.

G&C Commentary: While this finding is certainly subject to criticism, contractors must, again, be reminded of the importance of following the specific language of their contract, the "Bible" on their project. Here, there is no question that the contractor had a very difficult decision whether or not to devote additional resources to assure it reached its "B" portion incentive milestone. If it didn't accelerate, it stood the chance of losing both the "B" portion incentive and incurring disincentive costs.

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Accelerating to Achieve... (*Continued from page 2*)

We would counsel a contractor in such a position to take every effort to preserve its incentive and, at the same time, to meticulously follow contract provisions regarding State-caused delay and the administrative appeal of disputes. In this regard, the Court showed no sympathy to the real-world, relational problems between a contractor and an EIC that would result from a contractor's too freely invoking the "appeal" process when an EIC does not timely respond to inquiries.

If the contract was properly administered, it is possible that the contractor could have obtained its incentive and still have been compensated for the State's admitted delay which necessitated its acceleration. The contractor's scrambling to justify its actions after the fact, when it did not give the State proper notice along the way, simply did not suffice in the view of the Court of Claims.

NYC-DOT'S UNFAIR CONTRACT CLAUSES

• No Extension of Time For Concurrent Delays

Among the major public agencies that let major heavy highway projects Federal, New York State and New York City the NYC-DOT may stand out as perhaps the least "contractor friendly." The basic difficulties with the NYC-DOT, of course, begin at the beginning, its uniquely unfair construction contract clauses.

This is the first in the series of articles which will appear in the "Heavy Highway" section of G&C's Blueprint which will address, and hopefully call attention to, such problematic contract clauses. Action must be taken to see that these provisions are eliminated and/or reformed. We recognize that this will not happen without concerted effort, but the first step in galvanizing the industry to address this problem is to identify and focus upon the specific, offensive clauses. This first article will address the NYC-DOT's uniquely unfair treatment of so-called "concurrent" delays.

The general rule regarding concurrent delays throughout the United States, applicable, for example, to all federal projects, is that when an owner is the sole cause of delay, the contractor is entitled to both an extension of time and delay damages. The delay is both excusable and compensable. Conversely, if a contractor is the sole cause of a delay, it receives neither an extension of time nor damages and, in fact, may be exposed to liquidated damages for late completion. However, if a contractor and the owner both have caused delay during the same "concurrent" period, the generally accepted rule is that the contractor is entitled to an extension of time, but is not entitled to damages. The delay is excusable, but not compensable.

New York State treats concurrent delays in much the same manner as the Federal government. It might be noted, however, that under the State DOT's contract, notwithstanding the granting of an extension of time to compensate the contractor for DOT-caused delay, the State may impose upon the contractor additional engineering charges. Section 109-16(B) of the standard DOT contract provides that in the event of a concurrent delay "the contractor shall be compensated solely by an extension of time, with or without engineering charges as appropriate, to complete the performance of the work…" Thus, the contractor will receive an extension of time thereby relieving it of liquidated damages.

However, the NewYork City-DOT, does not see it that way. Incredibly, Article 13 of its standard contract states:

> "If one of the several causes of delay operating concurrently results from any act, fault or omission of the Contractor or of its Subcontractors or Material men, and would of itself (irrespective of the concurrent causes)

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G&C CELEBRATES 50 YEARS (1955 - 2005)

Goldberg & Connolly, founded in 1955, is celebrating its first half-century milestone. We are proud of our long history and are truly thankful for our extremely loyal and supportive clients, many of whom have been with the firm for decades. We believe this provides the best insight into who we are and how we practice our profession.

Through the years we have developed a creative team of professionals with the necessary experience to comprehensively serve all sectors of the construction and government contracting industries. As our firm completes its golden anniversary, we look forward to successfully representing our clients for years to come.

NYC-DOT Unfair... (*Continued from page 3)*

> have delayed the Work, no extension of time will be allowed for the period of delay resulting from such act, fault or omission."

Thus, in the event of "concurrent" delay, a contractor working for the NYC-DOT will recover neither damages nor an extension of time. Under this unfair NYC-DOT provision, even when the Department itself causes the delay, the contractor receives no consideration. The concurrent delay would be neither excusable nor compensable, and the contractor would be exposed to liquidated damages for late completion.

G&C Commentary: It is hard to imagine the justification for such a provision. The granting of an extension of time should always be available to a contractor where the owner itself was responsible for delay. To maintain a contract provision to the contrary, thereby exposing the contractor to liquidated damages when the owner itself is at least, in part, at fault is unconscionable. However, the outrageous nature of this provision - so out of the mainstream of public contracting in this country - is only matched by the dismal failure of the industry in tolerating such treatment by a major NYC contracting agency.

ARE CLAIMS "LIENABLE" UNDER NEW YORK LIEN LAW?

In the performance of work on construction projects, contractors are often required to assert claims for interruption/disruption and delays occasioned by an owner. It is not surprising, therefore, that in our practice we are often asked whether such claims can be secured by means of a mechanic's lien. The answer lies in the original purpose of the New York Lien Law's mechanic's lien provisions.

"Labor and Material" *Incorporated into* the Improvement

The mechanic's lien was intended to provide security for the payment to those that improve real property by furnishing materials and/or labor incorporated into the improvement. With regard to construction claims, if the various components of a claim fall within either of these two categories, "labor" or "material," then, in all likelihood, the claim is lienable. On the other hand, a claim solely for lost "profits" will not constitute the basis for a valid mechanic's lien. Lost profits are neither "labor" nor "material" furnished for an improvement to real property.

Courts have treated contract claims, including delay damage claims, in a similar fashion. One New York court found as "lienable" a subcontractor's delay damage claim against a general contractor on a public contract. The subcontractor had been forced to keep full crews on the job for long periods during which there was insufficient work for them to be fully productive. Consequently, the subcontractor's labor costs were grossly in excess of what they would have been had the general contractor not significantly delayed the project. The court construed New York's Lien Law liberally and reasoned that:

"If an improvement includes 'reasonable rental value for the period of actual use of machinery, tools and equipment' and 'the value of the materials actually manufactured for but not delivered to the real property', as also "any work done upon … property or materials furnished for its improvement" (Lien Law §2, Subd. 4), the reasonable value of laborers "kept on hand," together with materials and equipment, would also be an improvement."

Entitlement to Extra Compensation

In the case of private improvements, during the course of construction an owner will often require a contractor to perform additional work. If the contractor performs the extra work and is not paid for such work, he can secure his claim for the extra work by means of a mechanic's lien. Problems arise when the owner fails to recognize the work as extra work.

Many private contracts have a provision that the contractor may not perform extra work unless it first obtains a signed written authorization of the owner, construction manager, architect or engineer in charge. If this requirement is in a contract, no valid claim for extra work may be made without the contractor first obtaining the required written authorization or proving that the requirement was waived.

Similarly, contracts for public works also commonly contain a provision regulating extra work. Such provisions usually require advance approval by some authorized official before claims for extras are allowed. If the provision is properly followed, then there is a valid claim under the contract. A mechanic's lien will attach to the amount of the extra work. Even if the value of the work is in dispute, its validity is not.

Thus, the driving issues as to the "lienability" of a construction claim are: (1) whether the items is

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cognizable under the lien law as "labor" and "material" incorporated into the improvement, and (2) the validity of the claim from the context of entitlement to the "extra" compensation.

G&C Commentary: Many times the over-riding issue is good faith. The Lien Law only prohibits "willfully" exaggerated mechanic's liens. If the liened dollars represent labor and material put into the improvement of real estate and the lienor has a good faith belief in its claim (i.e., there is a colorable right to the extra compensation which will eventually be vindicated in subsequent court proceedings), it may be advisable to secure the funds via a mechanic's lien to avoid a subsequent favorable court ruling from being a Pyrrhic victory after all trust funds have been dissipated. After all, timely security, and not an adjudication of the rights of the parties, was the original intended purpose of the mechanics' lien. Conversely, speculative, unfounded or exaggerated construction claims will expose the lienor to accountability for "exaggeration of lien" which is typically dollar for dollar the extent of the amount of the exaggeration. We believe that if the foregoing "labor and material" test is utilized and good faith is employed as to the bonafides of the claim, that it is both appropriate and prudent to secure the claimed funds by means of a mechanics' lien.

"NO DAMAGES FOR DELAY"

• Exceptions Addressed By NYS Appellate Court

We have long crusaded for fairness in the handling of construction delays by public owners. Our Managing Partner, Henry L. Goldberg, has co-chaired the industry-wide coalition that drafted legislation outlawing "no damage for delay" clauses in public works contracts in New York State. This legislation passed the New York State Senate unanimously and the New York State Assembly by all but four votes. It was only the veto of the so-called friend of the construction industry, Governor George Pataki, which frustrated this coordinated legislative effort on the industry's behalf. While initiatives to reintroduce similar legislation in the current session continue, for now contractors are left to their own devices, and the skill of their construction counsel, to navigate the exceptions to the enforceability of "no damage for delay" clauses.

A recent New York intermediate appellate court decision sheds light on possible strategies to avoid the successful invoking of the notorious "no damages for delay" clause by an owner. The appeal involved a delay claim filed by an electrical subcontractor concerning services provided in the renovation of the Grand Central Terminal. Both the prime contract and electrical subcontract contained "no damages for delay"

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G&C SETTLES $20+ MILLION CONSTRUCTION CLAIM AGAINST NYC-DOT

A major renovation of the eight-lane Williamsburg Bridge offers a striking case study of how owner/contractor cooperation can avert a project's meltdown and resolve an extraordinarily complex construction dispute. The end result - the project finishing only eight months behind schedule, and a final $20+ million claim settlement for the Perini/O&G II, Joint Venture with the New York City Department of Transportation - is proof that a creative, collaborative approach can work.

The original $155 million contract called for reconstruction of the bridge's south roadway.

Perini, one of the joint venture members, initially opted for litigation to settle the claim on the advice of its attorneys at the time. But after several years, eight lawsuits, and only minor progress by the NYCDOT in auditing massive T&M change orders, Perini approached Goldberg & Connolly in search of a faster solution.

G&C developed a strategy to obtain a more efficient result. The plan involved suspending all prior litigation and establishing a working group of the contractor and the city agencies, including the Office of the Comptroller and the Office of the Corporation Counsel that first met on September 10, 2001. The terrorist attacks on NYC that occurred the next day, and the resulting demands of the rebuilding effort on many of the negotiators, could have derailed the efforts. But the group persevered and stayed on track.

This dispute resolution-partnering effort ultimately resulted in one of the largest settlements in the City's history, with a $20+ million final payment to Perini/O&G II, J.V. The twenty-seven meetings, none in a court setting, were an exercise in resolve, and showed how creative problem solving can avoid years of litigation, even in the context of a complex, multi-million dollar construction claim.

clauses. Citing prior decisions of NY's highest court, the intermediate appellate court reiterated the judicial limitations previously placed on "no damage for delay" clauses. These clauses may not be utilized to bar contractor damages for: (1) delays caused by the bad faith or willful, malicious or grossly negligent conduct of the party asserting the clause, (2) uncontemplated delays, (3) delays so unreasonable that they constitute an intentional abandonment of the contract, and (4) delays resulting from the breach of a fundamental obligation of the contract.

What is determinative, of course, is the successful application of these exceptions to particular circumstances. This recent appellate decision sheds further light on this issue. The delays in question totaled two and a half years, the value of the work eventually performed was more than twice the contract price, and the owner allowed design changes to continue unabated. These extreme circumstances led the court to conclude that the contractors' delay claims could not be dismissed without a trial to determine if the facts had established one of the aforementioned exceptions to the enforcement of a "no damages for delay" provision. In the opinion of the appellate court in this particular case, the facts were sufficient to raise genuine factual issues concerning whether the delays (two and a half years) were unreasonable, whether the changes in the work caused by the delays (doubling the value of the work) were either beyond the contemplation of the parties or were so unreasonable as to constitute an "intentional abandonment" of the contract or both, and whether the owner's actions (allowing unabated design changes) amounted to "bad faith and/or willful, malicious or grossly negligent conduct."

G&C Commentary: The facts in this case were extreme. We believe that the threshold for finding an exception to the enforceability of the offensive "no damage for delay clause" is far less. An owner's attempt to categorically apply the clause in all circumstances is unreasonable and will not be enforced by New York courts. Such an effort by an owner would constitute an improper attempt to shift all of the risk of delay to one side - the contractor.

NYC agencies have become unique in this extreme, one-sided approach. Federal agencies have never toyed with such counterproductive, costly provisions and the major NYS building agencies - the NYS-DOT (heavy highway) and the NYS-Office of General Services (building construction) - have moved away from this policy and now specifically allow for exceptions in their contracts.

In our daily practice, we live and breathe the exceptions to the enforcement of "no damage for delay" provisions. We believe such exceptions can successfully be brought to bear on behalf of contractors. This appellate court demonstrated the type of circumstances that will allow a delay claim to succeed despite a "no damages for delay" clause and which will, at the very least, enable a claim to proceed to a trial on the merits. Depending upon the facts in your case, skillful advocacy may still get you your "day in court."

SURETY NOT RESPONSIBLE FOR VALUE OF UNRETURNED EQUIPMENT

In what signals a departure from a prior judicial holding elsewhere in New York State, the intermediate New York appellate court for most of the downstate metropolitan area has recently held that absent express language to the contrary [in the bond itself], a surety on a public improvement labor and material bond (State Finance Law § 137) is not obligated to pay for unreturned rental equipment.

The facts of the case were not unusual. The contractor entered into a contract with the Dormitory Authority to perform excavation and foundation work at the Queens Hospital Center. In furtherance of its contract, it leased concrete forms and shoring equipment from a supplier. The rental agreement provided, in part, that the contractor pay the supplier the current sales price for any equipment or component part which was not returned. The contractor was terminated for non-performance by DASNY and its surety undertook to complete the project. The supplier demanded the return of its equipment and sent a driver to the site to pick up the equipment. It became apparent that the equipment was lost or missing when the supplier sought to retrieve it. The supplier asserted a claim for the unreturned equipment under the contractor's payment bond.

Prior to this case, relying upon the federal Miller Act for guidance, an upstate intermediate New York appellate court had held that the value of unreturned

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Surety Not Responsible ... *(Continued from page 6)*

equipment was recoverable under a labor and material bond. The basis for this upstate decision was the belief that the surety benefited from lower rental costs attributable to its principal's (the contractor) assuming, in the contract, the risk of the loss of the equipment. Since the surety enjoyed the benefit of the lower monthly rent paid by the contractor, the upstate appellate court concluded that if the equipment were lost and not returned, it (the surety) should pay for that equipment. Now, a downstate New York appellate court has held to the contrary:

> We decline to adopt the rule that a surety is liable under a State Finance Law § 137 bond for the value of unreturned rental equipment merely because it benefited from lower rental costs attributable to its principal's assumption of the risk of such loss in a contract. A payment bond issued under State Finance Law § 137 is not intended to insure the supplier of material against every risk accepted by the surety's principal in a contract… Rather, we conclude that, absent express language to the contrary, the surety on a State Finance Law § 137 bond is obligated to pay only for the unreturned rental equipment which the parties reasonably anticipated would be consumed in the work.

Thus, this appellate decision finding the surety not liable is limited to equipment and material which the bond claimant expected would be returned and would be capable of being re-used. Conversely, if the equipment or materials were expected to remain in place (e.g., stay in place forms), the court held that the cost of this equipment or material would be recoverable under the bond

G&C Commentary: The unspoken rationale in this decision might be the Court's desire to distinguish between a contract surety's assuring that all material that goes into a project is paid for, and a casualty insurer protecting against damage or loss to the equipment under a CGL or builder's risk policy. While the distinction, on a construction project, between the scope of a performance or payment bond and the coverage of a liability-based insurance instrument may blur, in this case, at least with regard to rental equipment, the New York appellate court made the point of drawing a clear bright line between the two.

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Spotlight On . . .

DARRELL W. HARP

As former General Counsel and Assistant Commissioner for Legal Affairs of the **New York State Department of Transportation (NYS-DOT)**, Darrell W. Harp enjoys a national reputation for leadership and innovation in heavy construction and public highway contracting. As most of our readers know, he has joined Goldberg & Connolly as Counsel to the firm. We welcome Darrell's exceptional insight into the workings of the New York State DOT and its capital program. Darrell literally "wrote the book," having developed and drafted most of the NYS-DOT contract and regulatory innovations of the last quarter century. In this regard, he established innovative contracting practices such as A+B bidding, lane rental and incentive/disincentive contract procedures. During his long tenure with the State, he participated actively in the resolution of virtually every major contract claim made against the NYS-DOT.

He is regularly called upon by heavy-highway construction trade associations, such as the **Construction Industry Council of Westchester and the Hudson Valley (CIC)** and the **Long Island Contractors Association** on legal and regulatory issues.

CONSTRUCTION LENDERS BEWARE

• Recorded Mortgage No Substitute For Notice Of Lending

In a decision of import to all construction lenders, New York's highest court, the Court of Appeals, has recently emphasized the importance of a duly filed "Notice of Lending" under the New York Lien Law. The court specifically held that a recorded construction loan mortgage, which when filed with the appropriate county clerk is "notice to the world" of the bank's lien priority, will not suffice to protect a lender from a trust fund diversion claim under New York's Lien Law.

Lender Liability For Trust Fund Diversion

What type of trust fund diversion could a construction lender possibly be guilty of? The use of trust fund (loan) proceeds for any purpose other than

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Construction Lenders... *(Continued from page 7)*

an improvement to the property (i.e., labor and materials) is a potential "diversion." Thus, repaying the construction lender from its own loan proceeds would be a "diversion."

The irony of the lending institution not being able to be repaid from its own loan proceeds is certainly compelling. In fact, if the loan is so repaid without a Notice of Lending having been filed, the bank would have to disgorge the funds and return the payments to the trust fund to be used for trust (direct construction cost) purposes. The fact that the bank created the trust fund with its own loan is to no avail.

In this decision, the construction lender unfortunately did not file a Notice of Lending. The defendant bank indicated, however, that there was a clear reference to a collateral re-assignment in its recorded loan mortgage which was the equivalent of the required Notice of Lending to potential trust fund claimants. The bank argued, quite reasonably, that potential trust beneficiaries would certainly be able to ascertain its priority as a secured mortgage lender. However, the Court of Appeals noted that nothing in the mortgage documents identified the bank as a trustee of Lien Law (Article 3-A) trust fund assets. The court emphasized that, "Even if the plaintiffs had surmised the bank's role as the trustee by examining the mortgage documents, those filings would not have informed beneficiaries that the bank planned to use trust assets to repay itself."

The court concluded that only the filing of a Notice of Lending would have satisfied the lender's fiduciary duty to provide notice to the trust beneficiaries of its use of trust assets to discharge the developer's debt to the bank. Notably, had the bank filed a Notice of Lending, the beneficiaries could have ascertained that (1) the trust assets were being depleted, and (2) the bank was a trustee acting as both transferor and transferee of those funds.

G&C Commentary: It should be kept in mind, that when all funds have ostensibly "dried up" on a development project "gone bad," one source of recovery for the well-advised contractor, subcontractor or supplier, as a trust fund beneficiary, could be an action against the (creditworthy) construction lender for the disgorgement of all loan repayments previously made. When all else fails, this may be the difference between getting paid or incurring a significant loss on a project. Conversely, from the point of view of the lending institution, nothing could be more frustrating than having to disgorge loan repayments previously received from the bank's debtor.

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We would love to hear your comments and suggestions.

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