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CONSTRUCTION LAW E-UPDATE

ONE-SIDED CONSTRUCTION CONTRACTS
... Two Recent New York Cases, Importantly, Buck the Trend

By Henry L. Goldberg, Managing Partner, Goldberg & Connolly, STA Legal Counsel

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We have repeatedly observed, and decried, the fact that construction contracts, both owner-prime, and contractor-sub, in both the public and private sector, are increasingly one-sided. Gone is any sense of partnering; in its place is a relentless effort to shift all risk downstream. Parties with the "upper hand" have pressed their advantage to the extreme. Unnecessary, but strictly enforced, notice and damage reporting provisions, for example, have increasingly led to the unintended, wholesale waiver of millions of dollars of valid contractor and subcontractor claims.

We have derisively referred to these excessive contract provisions as nothing more than contractor forfeiture enhancement devices or "COFEDs." Originally, the beneficiaries of COFEDs had overwhelmingly been public owners. This is no longer the case. One indefensible COFED that originated in the public sector, is the "self-appointment" of a party's chief engineer (or other representative) as the sole arbiter of any disputes on a project. (*See, Westinghouse Electric vs. NYCT*). This technique has now spread like a cancer to the private sector. The two cases discussed below recently addressed this "self-arbitration" provision, and other COFEDs, in a manner dramatically at variance with the routine "rubber stamping" of such provisions by New York courts.

I'm pleased to report that these two decisions in New York City — one at the appellate level in Brooklyn, and one at the trial court level (but reportedly on appeal) in the Bronx, have recently provided a breath of fresh air. They may not fully eradicate the stench of these outrageous contractual provisions, but they buck the judicial trend and provide hope that New York courts may, at long last, be: (1) finally employing a sense of fairness, and (2) demonstrating a more accurate understanding of the "pro-payment" mechanisms and safeguards in New York, established, as a matter of public policy, by the New York legislature.

In the appellate case, the court held that the COFED contained in the "dispute resolution provision" of a subcontract was void for illegality for violating said mechanisms and safeguards, and the public policy upon which they are based. In *American Architectural, Inc.*, just decided by the Appellate Division on September 11, 2013, the particular subcontract at issue required that the subcontractor provide a "seven-day notice of claim" and further stated that the failure of the sub to comply with this "condition precedent" would result in the complete waiver of its claim for payment against the contractor (i.e., a classic COFED).

The subcontract also, incredibly, named the contractor, itself, the sole arbiter of all claims and disputes under the subcontract. These two provisions taken together could have effectively gutted any effective right of the project's subcontractors or suppliers to be paid in the event of a dispute.

Because the subcontractor in the case did not receive payment of more than a $1 million owed to it, it filed a mechanic's lien and subsequently commenced an action against the contractor for breach of contract and to foreclose upon on its mechanic's lien. In response, the contractor moved to dismiss the lawsuit due to the failure to follow the aforementioned dispute resolution procedures in the subcontract.

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In the original trial court decision in *American Architectural*, the court, consistent with recent judicial holdings, had dismissed the subcontractor's breach of contract claim against the contractor because it had failed to strictly follow the notice requirements. However, the trial court did not dismiss the lien foreclosure cause of action because it found the terms of the subcontract's dispute resolution provision were unenforceable as against public policy in violation of Section 34 of the Lien Law.

Section 34 of the New York Lien Law states, in pertinent part: "Notwithstanding the provisions of any other law, any contract, agreement or understanding whereby the right to file or enforce any lien created under Article 2 [of the Lien Law] is waived, shall be void as against public policy and wholly unenforceable."

On appeal, the appellate court affirmed the trial court's refusal to dismiss the lien foreclosure action. However, it went still further, finding that the trial court should have also refused to dismiss the breach of contract claim for the same reasons, thereby fully preserving the subcontractor's right to payment. This is a significant break with past precedent.

Citing to the landmark decision of the Court of Appeals (New York's highest court) in *West-Fair*, the appellate court held that the designation of the contractor by the contractor itself, as the sole arbiter of all disputes under the contract, "violates the principles of trusteeship as reflected in the Lien Law by creating an inherent conflict between [the contractor's] duty to the trust beneficiaries and its own self-interest, and is unenforceable as an impediment to plaintiff's right to bring an action under Article 3-A of the Lien Law." The appellate court further also cited to Section 34 of the Lien Law, which, as stated above, forbids, as void and against public policy, any provision of any contract that creates a waiver of the right to file or enforce a mechanic's lien.

Finally, the appellate court, citing to the recent *Navillus Tile v. Bovis Lend Lease* decision, also held that the seven-day notice of claim "condition precedent" to the subcontractor's right to pursue its contractual dispute was also void as against public policy because such condition precedent was a more stringent requirement than those imposed under State Finance Law Section 137 with regard to the preservation of public improvement payment bond rights.

It gets better. In the second decision referred to above, *Anron Heating & Air Conditioning Inc.,* decided by a trial court in the Bronx, the very same contractor, AMCC Corp., lost again in its efforts to enforce its COFEDs. The *Anron* trial court similarly found a direct conflict of interest in the contractor serving as the sole arbiter of all disputes <u>and</u> being the Lien Law Art. 3-A trust fund trustee.

In addition, the trial court in *Anron* observed that the subcontract had a dispute resolution procedure that indicated "that any disputes, claims or questions which arise during the Work shall be resolved in accordance with Contractor's dispute resolution procedure ...that provides as an express condition to bringing an action for payment, that the subcontractor file a written verified Notice of Claim..." and that "(f)ailure to strictly comply with the Dispute Resolution Procedure here set forth, and strictly within the time periods here set forth, shall constitute an <u>absolute and unconditional waiver</u> of Subcontractor's right to recover extra or additional compensation, contractual payments, ... and shall <u>preclude any action</u> or proceeding by Subcontractor against the Contractor..." (Emphasis added.)

The *Anron* trial court judge held that the "Dispute Resolution Procedure and the Notice of Claim both violated the principles of the trusteeship as reflected in the Lien Law, and is unenforceable as it impedes the Subcontractor's right to bring an action under the Lien Law" and "violates public policy as it impedes plaintiff's right to enforce its lien."

Significantly, the *Anron* trial court cited the *American Architectural, Inc.* trial court decision (i.e., at the time of the *Anron* decision by the trial court judge in the Bronx, *American Architectural* had not yet been affirmed on appeal). Therefore, New York courts, in a mutually reinforcing manner, appear to be finally moving in the right direction, reflecting a more realistic understanding on their part of the fundamental deprivation of rights and forfeiture COFEDs have for far too long caused contractors and subcontractors, as well as the public policy of New York State that aims to assure full and fair payment for work and material on construction projects statewide.

G&C Commentary

These are good... <u>very</u> good legal developments for all who believe in fair, bilateral contracts in the construction industry and who oppose the forfeiture and waiver of valuable contract rights caused by COFEDs. It has always been my hope that as the brazenness of COFEDs becomes more outrageous and, therefore, their <u>un</u>enforceability more evident, that reason and fairness would eventually prevail, even among New York's judiciary, which has consistently shown a fundamental lack of understanding of the construction industry. We certainly want to believe that this is what is now occurring.

As I write this article, the Bronx trial court decision in <u>Anron</u> is on appeal. I believe the legal reasoning upon which it is based,

discussed above, is sound and should withstand appellate scrutiny. That decision should be affirmed, as was the trial court decision in *American Architectural, Inc.*

Meanwhile, all players in the construction industry should treat (private sector) "self-arbitration" provisions as legally vulnerable. In addition, if they fall victim to an attempted enforcement of a COFED, they should consider challenging its enforceability as inconsistent with established New York Lien Law and State Finance Law payment protections. While it is preferable to provide required notices and to timely participate in dispute resolution provisions, the public policy now affirmed by these decisions could provide an important safety net.

There is a good chance that these decisions, and others which will follow, will mark an important turning point in what was the wrongful, if not shameful, strict enforcement of COFEDs by New York courts which have been complicit, for far too long, in their use. While the legal ramifications of these decisions will be tested over time, I am much more sanguine than I have been for some time, regarding judicial curtailment of the run-away use and abuse of COFEDs which have undermined the financial well-being, and even the financial viability, of many, many construction companies for far too long.

Mr. Goldberg may be reached by email at hlgoldberg@goldbergconnolly.com or by telephone at (516) 764-2800.

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