

“Construction Law Issues for Small and Growing Businesses”

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by

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Introduction

Today’s construction projects increasingly require a deft blend from many divergent parties whose individual interests sometimes supersede the common goal of completing a job on time and within budget. Even smaller jobs typically involve owners, a general contractor, design professionals (architects and engineers), lenders, sureties, insurance companies, subcontractors and suppliers.

Given this dynamic, there has been no shortage of appellate decisions in recent years involving construction disputes. This article examines by topic several of the more recent and significant opinions from United States Court of Appeals for the Eighth Circuit, federal district courts in Missouri, and, of course, Missouri’s appellate courts, from which the lion’s share of case law on this subject is generated.

I hope this will be of some interest and relevance to those engaged in a general practice of law who often represent small and growing businesses.

Contractor's Insurance May Cover Owner for Subcontractor Defective Work

Contractors typically have in place a commercial general liability insurance policy. In Aten v. Scottsdale Ins. Co., 2008 WL 65595 (8th Cir. 2008), a homeowner sued its contractor over a variety of alleged defects in the construction of the house. The contractor, Castle Rock Construction LLC, had not paid its material suppliers for certain items, requiring the homeowner to satisfy on its own a mechanic's lien of \$11,035.62.

This case highlights the complexity of insurance claims involving construction projects, even when they seemingly involve a simple matter as to who had responsibility for an improperly poured concrete floor.

The homeowner sued the general contractor for recovery of this amount and an additional \$90,000.00 to correct defects and deficiencies in construction. The trial court entered a default judgment in the homeowner's favor. In its findings of fact, the court listed the defects, including missing trim, exposed sheet rock screws, interior walls that were not plumb, floors that were uneven, gaps between the flooring, and a basement floor that was not graded properly towards the drain, thereby causing water damage. The homeowner at trial was not able to identify what specific work had been done by the general contractor and what specific work had been done by its subcontractors.

After the default judgment, the homeowner filed a separate lawsuit against Scottsdale Insurance Company. Scottsdale had issued a commercial general liability insurance policy for the general contractor. The homeowner

alleged that Scottsdale was obligated under the policy to pay the default judgment.

The policy required an “occurrence” before coverage was triggered. This is typical. The policy defined “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” The Eighth Circuit decided the evidence supported that an improperly poured concrete floor had caused water to flow away from a floor drain, thereby causing damage. Thus, the Eighth Circuit found this to be an occurrence within the meaning of the policy.

The policy had an exclusion, however, that excluded under “your work” property damage to the contractor’s own work. Agreeing that this applied, the homeowner argued an exception to the exclusion. This exception was that if the damage was caused by a subcontractor, then the exclusion did not apply and insurance coverage was in place.

Since the underlying action was a default judgment and thus there had been no discovery, the homeowner could not determine if subcontractor work caused the damage. Therefore, the Eighth Circuit remanded to allow the homeowner the opportunity to conduct limited discovery on this point.

Surety Not Subject to Arbitration on Performance Bond

Performance bonds are typical on construction contracts. A surety issues the performance bond to secure the contractor’s performance.

In Liberty Mutual Ins. Co. v. Mandaree Public Dist. No. 36, 503 F.3d 709 (8th Cir. 2007), Liberty Mutual had issued a performance bond on a contract to

remodel and expand a public school. The contract between the school and the general contractor provided that disputes between them would be resolved by binding arbitration in accordance with the rules of the American Arbitration Association.

The bond incorporated by reference the prime construction contract but also provided that “any proceeding, legal or equitable, under this bond may be instituted in any court of competent jurisdiction.” Thus, the bond called for litigation between the surety and the contractor, but the incorporated contract called for binding arbitration between the owner and the contractor.

A dispute arose between the school district and the contractor, prompting the contractor to initiate arbitration. The school district counterclaimed and attempted to add Liberty Mutual. The arbitrator denied the public school district’s request to join the surety. The surety initially consented to arbitration, but then withdrew its consent. The AAA decided that the arbitration would proceed without the surety.

The school district moved in court to compel the surety to arbitrate its claims. The district court denied this motion and the Eighth Circuit affirmed on appeal, relying on a nearly identical ruling it had previously made in Aggrow Oils, LLC v. Nat’l Union Fire Ins. Co. of Pittsburgh, 242 F.3d 77, 780 (8th Cir. 2001). The Eighth Circuit concluded that the incorporation provision in the bond did not reflect a mutual intent to agree to arbitration of all disputes.

The opinion also discussed whether certain negotiations between counsel constituted the surety’s agreement to arbitrate. The school district had

requested the arbitrator to join the surety. After the surety stated it would not agree, there was a telephone conference with the arbitrator, who issued an order denying the school district's request to amend its counterclaim because the surety did not consent to becoming an additional party.

The court determined that this action meant there was no contractual "offer" still pending to arbitrate. Therefore, when the surety subsequently consented to joining the arbitration, this was not acceptance of the school district's offer. Rather, it was a voluntary act in the arbitration proceeding that the surety could later revoke (which it did) without violating 9 U.S.C. § 2 of the Federal Arbitration Act. This provision states that agreements to arbitrate are "irrevocable."

Agreement to Arbitrate Not Enforceable

Construction contracts often contain binding arbitration provisions. Not infrequently, the parties even consent to binding arbitration after the dispute arises, when no previous agreement existed.

The Western District addressed this point in Arrowhead Contracting, Inc. v. M.H. Washington, LLC, 2008 WL 169714 (Mo. Ct. App. 2008). A subcontract agreement between Arrowhead, as contractor, and Weitz, as owner, provided that any claim would be determined by binding arbitration at owner's option. A dispute arose and Arrowhead filed a lawsuit to recover money allegedly owed for its work on the project. Counsel for the parties discussed the possibility of arbitrating the claim.

The contractor's attorney sent a letter to the owner's attorney memorializing their discussion wherein Weitz' counsel acknowledged he "is open to negotiating the latitude provided" the arbitrator regarding his decision, for example, will the decision be limited to affirming the position of one party or the other, or will he be allowed to award what he feels is just and equitable, or "somewhere in between." In response to this letter, one of Weitz's attorneys sent an e-mail stating in part: "I believe your letter of October 23 does correctly outline the type of arbitration we have agreed upon."

From this a dispute ensued about whether they had agreed to arbitrate. Weitz' counsel took the position that his client had not so agreed. The court emphasized that an obligation to arbitrate is based on assent and agreement. "If the parties reserve any of the essential terms of the purported contract for future determination, there is no valid, binding agreement."

The court concluded that the attorneys were merely engaged in negotiations. While Missouri will imply certain terms to solidify an agreement, it concluded that the parties through counsel did not want to leave the term regarding the latitude provided to the arbitrator to be implied by Missouri law. Instead, they wanted to reach an agreement on this term and absent having done so, they had not agreed to binding arbitration.

In many instances, once a dispute arises, that otherwise is subject to traditional litigation, counsel for the parties discuss the possibility of arbitration. This case highlights the importance of reaching definitive

understandings as to those terms that are fundamental to the consent required between both before the matter can be submitted to binding arbitration.

Subcontractor Cannot Recover in Quantum Meruit

It is well established law in Missouri that an owner who has paid the general contractor in full is not subject to an unjust enrichment or quantum meruit lawsuit by the subcontractor. See Breckenridge Material Co. v. Allied Home Corporation, 950 S.W.2d 340 (Mo. Ct. App. 1997) and Northeast Painting Co. v. AOC Intern. (U.S.A.), Ltd., 831 S.W.2d 711 (Mo. Ct. App. 1992).

In County Asphalt Paving Co., Inc. v. Mosley Construction, Inc., 239 S.W.3d 704 (Mo. Ct. App. 2007), the owner, Christian Assembly Church, had not paid the general contractor, Mosley Construction, in full for work performed. Accordingly, Mosley's subcontractor, CAPC, filed a lawsuit against the owner for quantum meruit.

The subcontractor did not file and thus could not pursue enforcement of a mechanic's lien. Had it done so, it might have been able to recover and it certainly would have had a significantly enhanced opportunity for a judgment against the owner.

The owner had obtained a construction loan and the funds went into an escrow account with a title company to act as the disbursing agent. The general contractor had recommended payment of the balance due to its subcontractor. The title company issued a check from the escrow account, but the check was returned for insufficient funds.

The title company's principles were indicted for federal mail and wire fraud for allegedly misappropriating escrow funds, including the church's account. Thus, neither Mosley nor CAPC received any of the remaining funds otherwise due to the subcontractor.

CAPC also had filed a breach of contract action against the general contractor. Its lawsuit against the owner, however, given no mechanic's lien, was limited to a claim for quantum meruit.

The subcontractor's legal position was simple. The subcontractor had provided \$18,838.70 in value for which it did not receive payment, and thus the church had been unjustly enriched by this amount. The church, however, had paid the money to the title company. This forced the Eastern District Court of Appeals to balance the interest between an innocent owner who had paid once and an innocent subcontractor who had not been paid.

The court decided that since the owner had paid someone—in this case, the escrow agent—it should not be required to pay again. By reaching this result, the court focused on what the owner had paid rather than on what the general contractor or subcontractor had received.

With this decision, the appellate court reaffirmed the need for each party in the construction link to consider what it must do to protect itself. The owner needs lien waivers and control over the payment process. The general contractor needs similar control over owner payments when they are made through an escrow agent. The subcontractor should always consider filing mechanic's liens whenever possible.

Pay-If-Paid Clause Found Ambiguous

Many construction contracts between the general contractor and the subcontractor contain a pay-if-paid clause. In essence, this clause provides that the contractor does not have to pay its subcontractor until it has received payment from the owner. Absent payment from the owner, the contractor under this contractual provision asserts that it does not owe the subcontractor for subcontractor work for which the owner did not pay. In recent years, while Missouri appellate courts have embraced the concept of enforcing pay-if-paid clauses, they have found the actual wording of the contracts in question to be ambiguous. See MECO Systems, Inc. v. Dancing Bear Entertainment, Inc., 42 S.W.3d 794 (Mo. Ct. App. 2001).

The trend continues in the most-recent case of Lobo Painting, Inc. v. Lamb Construction Co., 231 S.W.3d 256 (Mo. Ct. App. 2007).

The Eastern District decided that a pay-if-paid clause in a subcontract is only enforceable if it is very clear on its face. Otherwise, the parties to the contract may offer at trial their competing interpretations about whether payment is due and ultimately they will have to rely upon a judge or jury to decide who should prevail.

In this case, the subcontract provision in question read:

Final payment, constituting the entire unpaid balance of the Subcontract Sum, shall be made by the Contractor to the Subcontractor when the Subcontractor's Work is fully performed in accordance with the requirements of the Subcontract Documents, the Architect has issued a certificate for payment covering the Subcontractor's completed Work and the Contractor has received payment from the Owner. If,

for any cause which is not the fault of the Subcontractor, a certificate for payment is not issued or the Contractor does not receive timely payment or does not pay the Subcontractor within three working days after receipt of payment from the Owner, final payment to the Subcontractor shall be made upon demand.

Id. at 258-59.

The appellate court determined that the second sentence could be read different ways. On the one hand, it could mean that the clause “for any cause which is not the fault of the Subcontractor,” only applies to the next part of the sentence that a certificate for payment is not issued. With this interpretation, if the reason for non-payment was other than subcontractor fault, payment would be due three days after a demand from the subcontractor, regardless of whether the owner had paid.

On the other hand, the second sentence could condition the contractor’s payment on receiving the money from the owner. In this case, if subcontractor fault caused the owner not to pay, then the contractor would have a contractual reason to withhold payment from the subcontractor.

Given these circumstances, the appellate court sent the case back to the trial court for it to determine “the parties’ intent,” essentially moving the dispute to who has more credibility or is more believable. That can be especially difficult when neither party may have actually read the provision at the time they entered into the contract. While the lawyers often read the contracts before execution, the parties, by practice, more typically do not read them.

Missouri Supreme Court Favors Contractor—Overturning 14 Years of Contrary Court Precedent

The Missouri Supreme Court ruled in the fall 2007 in favor of a subcontractor and by doing so overturned established Missouri case law from 1993. The decision allowed George Weis Company, a subcontractor, to proceed with its separate lawsuit for breach of contract and tort, when a prior mechanic's lien lawsuit involving the same project had been filed. Weis was not a party to that mechanic's lien lawsuit.

Before this decision, no one practicing construction law in Missouri thought this was possible, given prior court opinions. The case is George Weis Co. v. Stratum Design-Build, Inc., 227 S.W.3d 486 (Mo. 2007).

Subcontractors who have small claims and those who choose not to file mechanic's liens can now pursue their claims in a separate lawsuit. This eliminates the dilemma of whether to abandon breach of contract claims that were too costly to pursue in a separate complicated, multi-party mechanic's lien lawsuit.

The trial court had dismissed Weis' lawsuit, relying on Mo. Rev. Stat. § 429.300 (2007), Missouri's Mechanic's Lien Act, by stating in part: "A contractor or supplier on a construction project cannot recover in a breach of contract suit if a mechanic's lien suit is filed by a different entity which did work on the same job, unless the breach of contract suit is joined with the mechanic's lien suit." Weis' lawsuit was for breach of contract and in tort, so the trial court's decision to dismiss Weis' lawsuit seemed to be based on firm statutory footing.

Previously, the Missouri legal community largely thought that if a contractor or subcontractor had any claim relating to a project, and a mechanic's lien lawsuit had been filed by anyone, that contractor had to bring its claim in the already existing mechanic's lien lawsuit. If the contractor failed to do so, it could not recover in its own, separate lawsuit.

The Missouri Supreme Court reasoned that if a subcontractor has no lien claim, public policy does not favor forcing that subcontractor to consolidate its case with lien claimants. By contrast, the court also decided that anyone who has a lien must join the mechanic's lien case to pursue its lien and all other claims it may have, such as breach of contract.

The high court did not specifically reconcile the language in § 429.300, which some can read to be at odds with this decision. Nor did the Supreme Court address exactly what was misplaced about the trial court's reliance on prior case law and on arguably clear statutory language.

Contract's Standard Insurance Waiver Does Not Preclude Subrogation Claim

Recently, the Western District Court of Appeals decided that a school district could maintain on behalf of its insurance company a subrogation lawsuit against a subcontractor for damages it caused to the school's roof despite a contract that waived all claims the insurance company may have against the subcontractor for work it performed. The Western District announced this result, in a case of first impression, after considering a standard contract provision (AIA Document A201-1997, General Conditions of

Contract for Construction, Section 11.4.7) that waives all claims by an insurance company against all parties to the contract.

The case is Knob Noster R-VIII School Dist. v. Dankenbring, 220 S.W.3d 809 (Mo. Ct. App. 2007). In reaching this decision, the appellate court tackled the thorny world of insurance and how different insurance provisions in the standard construction contract can be harmonized to determine if coverage exists.

The opinion is a must-read for anyone involved in insurance construction issues under Missouri law, particularly those who draft and negotiate contracts.

A school district had a contract with a construction company for replacement of windows and air conditioning work for approximately \$2.5 million. The contract incorporated the general conditions of contract for construction, AIA Document A201-1997.

The general contractor hired Don Dankenbring Masonry to brick up various window openings. Masonry applied an acid wash solution that destroyed several layers of protected galvanizing on the existing portion of the high school's roof, causing more than \$116,000 in damage. The parties agreed that either the school district recovers if insurance applies or Masonry owes nothing if the AIA clause precludes recovery.

At issue on appeal—for the first time in Missouri—were standard AIA provisions by which the parties agreed to waive any subrogation claim against each other for work performed on the project. Did this waiver apply when the

damage that Masonry caused was to an area, in this case the high school roof, which clearly was outside Masonry's scope of work? The Western District concluded that this provision only applied to a waiver of a subrogation claim relating to damage to the subcontractor's own construction work; that is, in this case work per Masonry's subcontract. The roof was not part of Masonry's scope of work and thus the waiver did not apply. Accordingly, the school district could collect from Masonry for the roof damage.

Original Owner/Builder of Apartment Can be Sued for Defect Ten Years Later

Owner/builders now face potential liability for extended periods of time after selling their construction project to a buyer, according to Missouri's Western District Court of Appeals. The case is Thompson, et al. v. Higginbotham and Sherlock, 187 S.W.3d 3 (Mo. Ct. App. 2006).

No Missouri appellate court had previously been asked to decide whether Missouri law allows a former owner to continue to face potential litigation for a balcony collapse causing personal injury that occurred more than ten years after the former owner had sold the property. The court decided that the claim could proceed given allegations that the former owners may have had superior knowledge of a defect in their construction.

In addition to owners and builders, the O'Rileys also were the subcontractors, designers, developers and marketers of the apartment. Ultimately, their combined roles as owners and builders proved to be decisive to the outcome.

The O'Rileys had argued that Missouri has an established statute of repose, Mo. Rev. Stat. § 516.097 (2007), that requires that all lawsuits for personal injury must be brought within ten years of completion of the improvement. The statute protects architects, engineers and builders whose "sole connection with the improvement is performing or finishing, in whole or part, the design, planning or construction, including architectural, engineering or construction services, of the improvement."

The Act does not apply, however, to those who conceal a defect or deficiency in the design, planning or construction, where the defect or deficiency directly results in the defective or unsafe condition.

In this case, the appellate court's decision turned on whether the O'Rileys were solely connected to the defective condition in the apartment as designers, planners or builders, or whether their additional status as former owners made them potentially liable.

The Western District decided that to the extent the plaintiffs based their argument to avoid the statute of repose on the O'Rileys additional status as former owners, this was not enough to overcome the "sole connection" aspect of the statute of repose. Plaintiffs' however, had also alleged that the O'Rileys were liable for the injuries because they were builders and planners who sold the property with superior knowledge of the defect.

The court noted that while former owners generally do not owe a duty to those later injured by a defective or unsafe condition, there is an exception contained in the section of the restatement of torts. It provides that someone

that sells property involving an unreasonable risk is subject to liability to the buyer and its guests for physical harm caused.

No previous Missouri appellate court had adopted this section even though many other state courts recognize it is a positive development reflecting an increased regard for human safety and the need to improve bargaining ethics.

The appellate court decided to adopt this section, and thereby “foster greater openness and candor in real estate transactions.” In doing this, the Western District recognized its decision could open the door to potentially unlimited extensions of liability. “Because we believe that each case must be decided on its facts, we do not believe that this potential negative consequence outweighs the potential benefits.” *Id.* at 9.

Attorney Fees Allowed for Failure to Make Scheduled Payments

Owners and contractors now risk paying for the other side’s attorney fees and up to 18% interest when they withhold scheduled payments in private construction contracts pursuant to Mo. Rev. Stat. 431.180 (2007), a/k/a Missouri’s Private Prompt Payment Act. They cannot rely on a good faith belief of reasonable cause, such as poor workmanship or untimely delivery, to justify withholding payments otherwise due pursuant to the contract.

The case is Vance Brothers, Inc. v. Obermiller Construction Services, Inc., 181 S.W.3d 562 (Mo. 2006).

The decision has sweeping ramifications for all construction projects in Missouri that involve private contracts and places an emphatic declaration

from Missouri's highest court that disputes during construction will not justify by themselves withholding scheduled payments.

The Act itself provides that all persons who enter into a contract for private design or construction work "shall make all scheduled payments pursuant to the terms of the contract." It also provides that the court, in its discretion, may in addition to other damages "award interest at the rate of up to one and one-half percent per month from the date payment was due pursuant to the terms of the contract, and reasonable attorney fees, to the prevailing party."

Strictly applying § 431.180, which does not provide to an owner in a private construction project statutory reasons for withholding payment, the appellate court's result will prompt prudent owners and contractors who might otherwise be inclined to withhold contractually scheduled payments to reconsider whether they can afford this risk.

The Supreme Court summarily reached its conclusion in this case. The Supreme Court also concluded that the Act vests with the trial judge discretion to award interest, or attorney fees, or both, or neither.

While the Act does not require that the cause of action has to be for breach of contract, there must be a contractual basis for the scheduled payment before the Act will apply.

Industry Standard Contract Forms

Changes in AIA Documents

The American Institute of Architects has for years published a set of form documents to be used by all segments of the construction industry from owner to surety to architect to engineer to contractor and subcontractor. After years of study, the AIA released updated, and in many instances, substantially changed sections to its various form documents. The most significant change can be found in the standard document now known as A201-2007, the General Conditions to Construction. This particular form document contains definitions and describes the terms and conditions for the primary contractual relationship between the two parties in question, for example, between the owner and the contractor.

Recent substantive changes in these form documents include a “check box system” by which parties are offered options as to their choice of dispute resolution. Previously, the forms required mediation as a precondition to arbitration and then binding arbitration with the American Arbitration Association. The new forms provide options and choices for the parties, and if for some reason they do not affirmatively select binding arbitration, by default the dispute will ultimately be resolved by litigation in a traditional court of law. If the parties do select arbitration, the forum for dispute resolution remains the American Arbitration Association. Naturally, the parties can override any of the provisions in any of these form contracts by making their own appropriate modifications. In addition, mediation remains a condition precedent to arbitration or litigation.

Another important change is that more participants to the construction dispute may be joined into one proceeding. Previous form documents essentially segregated the dispute into segments so that, for example, an architect or engineer would not be joined into a dispute between an owner and a contractor. This led to more costly and more numerous lawsuits.

Another change in the new documents is that the AIA has defined the standard of care for an architect to better set out the expectancy of what the architect is supposed to professionally fulfill to comply with his or her legal obligations. The standard is that an architect shall “perform its services consistent with that level of skill and care ordinarily provided by architects practicing under the same or similar circumstances.” This sounds very similar to a standard of care jury instruction that would be given for example in a negligence cause of action under Missouri law.

ConsensusDocs

In addition to the recent revisions in the AIA documents, a completely separate group of organizations represented by disciplines from owners, contractors, subcontractors and others created a set of documents known as the ConsensusDocs. This series of documents replaces previous documents sponsored by the Association of General Contractors (the “AGC”). The documents reflect an effort to balance more evenly the risk and interest between an owner and a contractor and other parties whose interests in a construction project can at times be inapposite and adverse. This series of documents includes the owner/architect-engineer agreement, an

owner/contractor standard agreement and general conditions, and a contractor/subcontractor agreement.

The construction industry anticipates there will be considerable competition between use of the AIA form documents and the ConsensusDocs in years to come. As with the AIA documents, parties who decide to use the ConsensusDocs, of course, may modify any of the form documents to fit their particular situations.

Missouri's Retainage Statute

Missouri created a new statute to cover money that is being withheld on a private construction project (known as "retainage"). It is §436.330 R.S.Mo. and went into effect in 2002. It covers private construction projects, in summary as follows:

- Applies to contracts between owners and contractors and between contractors and subcontractors.
- Retainage is limited to 10%.
- However, if the owner and contractor believe additional assurance that work will be completed satisfactorily is needed, additional monies may be retained if provided for in the contract.

- Contractors cannot withhold from retainage from a subcontractor any amount greater than that which the owner is withholding from the contractor for that particular subcontractor's work.
- There is an exception, however, where the subcontractor does not perform wherein additional money may be retained.
- Retainage embraces the concept that the money is being held "in trust."
- Substitute security in lieu of actually setting the money aside can occur through certificates of deposit, retainage bonds and unconditional letters of credit. Contractors and subcontractors are entitled to recover interest and income earned on securities posted as a substitute security but not on monies actually set aside in retainage.
- If a contractor or subcontractor finishes its work early, the statute permits them to request of the owner the release of the retainage for that particular portion of the work in advance of the next contractual payment cycle.
- Benchmark for release of retainage is "Substantial Completion"
- Substantial Completion is defined as the earlier of (a) a certificate of substantial completion issued by architect/engineer per contract

documents or (b) the owner's acceptance of performance of the contract in full. At one of those two points, owner must release all retainage.

- Owner can retain after substantial completion 150% of the cost to complete remaining items on the punch list.
- Portions of any private contract found to be in violation of the Act can be deemed unenforceable.
- The statute has never been considered at an appellate court level.
- There are many open issues given lack of appellate review.