



## NYCLA CONSTRUCTION LAW JOURNAL

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### Letter From the Chair What Goes Down Must Go Up

Last month the American Institute of Architects released its Consensus Construction Forecast for 2013 and 2014 (the “Forecast”). The Forecast, which is based on forecasts from seven other forecasts including McGraw-Hill, Moody’s, FMI, and others, predicts healthy improvement in construction activity over the next two years. According to the Forecast, nonresidential construction spending will increase 5% in 2013 and 7.2% in 2014. Hotel construction is predicted to lead the pack with double digit gains in both years, while commercial construction (including hotels) is predicted to improve by 9% in 2013 and 11% in 2014. According to the National Association of Realtors’ quarterly commercial real estate forecast released Feb. 25, 2013, vacancy rates are trending downward in each of the major commercial real estate sectors. Residential construction in the New York metro area is booming as stalled projects stir back to life and foreign buyers continue to line up with cash. National home construction, however, remains slow, falling 8.5% in January after soaring 15.7% in December. The construction lawyers I have spoken with recently have all reported an increase in transactional front end work. With a little luck the “sequestration” and other political and international economic risk factors will allow a stable and healthy rebound to continue. Better to be lucky than good. Although, as the up cycle matures, it would be nice to see some “good” bankers with the willpower to just say no to questionable lending and bad procedure.

### Statement of the Editor In Chief

This Construction Law Journal contains a potpourri of cutting edge articles having to do with the Construction Industry. While the aftereffects of the Great Recession are still being felt within the Construction Industry there does appear to be light at the end of the tunnel with an increased focus on public work including but not limited to repairs being performed after Hurricane Sandy. As always we are looking for anyone who is involved in an interesting construction law issue to write for the journal.

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# A Roadmap For Determining Coverage for Construction Defect Claims in New York<sup>1</sup>

By Richard B. Friedman, Esq., Stephen Berry, Esq., and Michael Freed, Esq.

The typical construction defect coverage case involves a familiar storyline: a property owner contracts with a general contractor to perform a specific construction project; the general contractor—either on its own or through sub-contractors—performs the work; and the owner later sues the general contractor alleging defects in the construction that have caused economic loss—usually the cost of repair and/or diminution in value of the property. The general contractor turns to its commercial general liability (“CGL”) insurer, but the insurer disclaims coverage and a coverage suit ensues.

Fortunately, case law provides a roadmap for when these type of claims are covered under New York law. This article looks at the two broad categories of claims – those involving faulty workmanship, and those involving faulty materials – and identifies the legal precedents that provide guidelines that make coverage determinations easier.

## **FAULTY WORKMANSHIP**

The threshold issue in these cases is whether there is an “occurrence” that triggers coverage. CGL policies typically cover claims for bodily injury or property damage caused by an “occurrence.” An “occurrence” is typically defined as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”

### **A. Incomplete Work**

The leading New York case is *George A. Fuller Co. v. United States Fidelity & Guaranty* 200 A.D.2d 255 (1st Dep’t 1994). *Fuller* addressed a liability insurer’s duty to defend a general contractor in a suit filed by a property owner who

had contracted with the insured for the construction of a commercial building. The property owner asserted claims based on its dissatisfaction with the insured’s performance under the contract, as well as tort claims, including negligence and breach of fiduciary duty. Specifically, the property owner alleged faulty installation of wood flooring, curtain walls and windows, and a water metering system. The allegedly defective work was performed by a sub-contractor hired by the insured. The property owner alleged that “the flooring buckled and cracked, rendering it unusable, the defective curtain wall and window installation caused widespread water infiltration into the building ....” *Fuller*, 200 A.D.2d 256. The property owner sought damages for unnecessary construction costs and diminished value of the property.

The court held that the property owner’s complaint did not allege an “occurrence” under the general contractor’s CGL policy. The court reasoned that that claim arose from a contract dispute between the insured and the property owner, and the property owner’s allegations were simply that the insured failed to meet its contractual obligations. The court then articulated the following rule regarding the scope of coverage for construction defects under CGL policies:

“[The insured’s policy] does not insure against faulty workmanship in the work product itself but rather faulty workmanship in the work product which creates a legal liability by causing bodily injury or property damage to something other than the work product. The policy was never intended to provide contractual indemnification for economic loss to a contracting party because the work product contracted for is defectively produced.”

*Id.* at 256. Significantly, the court found that the loss resulted from “intentional cost-saving or negligent acts only affecting [the property owner’s] economic interest in the building.” *Id.* This did not constitute an “occurrence” because it was neither an “accident” nor a “continuous or repeated exposure to substantially the same general harmful conditions.” *Id.*

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In short, under *Fuller*, property damage is not caused by an “occurrence” if:

- the damage does not extend beyond the insured’s project; or
- the damage resulted from cost-saving measures.

### **B. Completed Operations**

Since *Fuller*, courts applying New York law have consistently held that construction defect claims arising from contractual obligations or for the mere recovery of economic loss to the owner do not involve an “occurrence” that triggers coverage under a CGL policy. A court applied *Fuller* to completed operations in *Transportation Insurance Co. v. AARK Construction Group*, 526 F. Supp. 2d 350 (E.D.N.Y. 2007). The insured was hired to construct a parking garage. The insured subcontracted all of the work. After construction was completed, a delivery truck fell through the first floor of the garage.

The property owner sued the insured, asserting claims for failure to supervise, failure to comply with applicable building codes, and failure to construct a building that would adequately support vehicles entering the garage. The contractor’s CGL insurer disclaimed any obligation to defend or indemnify.

The court in the coverage action quoted and relied upon *Fuller* extensively in holding that there was no “occurrence” alleged in the underlying case. *Fuller* established that “an ‘occurrence’ of property damage under a CGL policy cannot exist where a general contractor’s ‘negligent acts only affect the property owner’s economic interest in the building.’” *Id.* at 257 (quoting *Fuller*, 200 A.D.2d 256). Based on this rule, the court stated, as follows:

“[The] policy does not cover the costs of repair of the garage and loss of use of the building incident to the closure of the garage, because the alleged negligence only affected [the owner’s] economic interest in [the insured’s] completed work product. To hold otherwise would convert [the insurer] into a surety for [the insured’s] performance, which is a result that the parties to the contract never intended.”

*Id.* at 257 In a footnote, the court stated further that “CGL policies do not provide coverage for complaints sounding in contract.” *Id.* n.3.

Another significant finding of law in *AARK* was that a claimant cannot “plead around” New York’s rule that claims that are essentially contractual do not involve an “occurrence” required for coverage under CGL policies. “A contract default under a construction contract is not transformed into an accident ... by the simple expedient of alleging negligent performance or negligent construction.” *AARK* at 357 (internal quotation omitted) (quoting *Fuller*, 200 A.D.2d at 256); *See also Parkset Plumbing & Heating Corp. v. Reliance Ins. Co.*, 87 A.D.2d 646 (2d Dep’t 1982) (“The complaint ... is clearly one sounding in contract and not in negligence ... and the mere use of the word ‘negligent’ alone cannot turn the complaint into a cause of action for negligence.”).

In short, under *AARK*, property damage to an insured general contractor’s completed operations is not caused by an “occurrence” even if:

- the complaint against the insured includes a tort count; or
- the damage results from defective work of the insured’s subcontractor.

Notably, a New York court recognized that New York’s law on this point differs from other states in *QBE Insurance Corp. v. Adjo Contracting Corp.*, 934 N.Y.S.2d 36 (N.Y. Sup. Ct. 2011) (citing *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 4–5, 16 (Tex. 2007)) (finding coverage for insured general contractor where its project was damaged by defective work of subcontractor).

Finally, in *Continental Insurance Co. v. Huff Enterprises, Inc.*, No. 07-CV-3821, 2010 U.S. Dist. LEXIS 71272 (E.D.N.Y. June 21, 2010), a property owner sued its roofing contractor for breach of contract for failure to construct and install roofs in a workman-like manner and failure to supply materials specified in their contract. The property owner sought to recover the cost of repair and replacement of the insured’s work. The court held that the roofer’s CGL insurer had no duty to defend or indemnify for the owner’s claims. Relying on *Fuller* and its progeny, the court held that the owner’s claims did not involve an “occurrence.” Rather, the crux of the claims was that the insured

failed to comply with contractual obligations. The court reiterated the established rule that there is no “occurrence” where the insured’s alleged acts only affect the owner’s economic interest in the property.

### **FAULTY MATERIALS**

While New York law is relatively restrictive with regard to coverage for faulty workman-ship, it allows for relatively broader coverage when the defect at issue arises out of faulty materials. However, coverage for general contractors remains constrained by the boundaries laid out in *Fuller*.

#### **A. Incorporation of Faulty Materials into Otherwise Good Work**

New York courts have held that where an insured unintentionally sells a defective product that is then incorporated into a third-party’s finished product, any resulting damage to the third-party’s finished product is an “occurrence” triggering coverage under a CGL policy. *See, e.g., Chubb Ins. Co. of N.J. v. Hartford Fire Ins. Co.*, No. 97 Civ. 6935, 1999 U.S. Dist. LEXIS 15362 (S.D.N.Y. Sept. 27, 1999). In *Chubb*, the insured sold apple juice concentrate to Coca-Cola. After incorporating the concentrate into its product, Coca-Cola claimed that it did not meet specifications. As a result, Coca-Cola was forced to discard the products containing the concentrate. Coca-Cola sued the insured for breach of contract and breach of warranty. The CGL carrier argued that Coca-Cola’s claims did not constitute an “occurrence” because the claims arose out of a breach of contract or breach of warranty. Relying on a long line of New York cases, the court held that claims were an “occurrence” triggering coverage. *Chubb*, 1999 U.S. Dist. LEXIS 15362, at \*13-28; *See also Marine Midland Servs. Corp. v. Samuel Kosoff & Sons, Inc.* 60 A.D.2d 767 (2d Dep’t 1977).

While the *Chubb* case contains the most thorough discussion of this issue under New York law, it and most of the cases cited therein involved products rather than buildings. However, significantly, the *Chubb* decision also relied on a case involving building mate-rial. *Md. Cas. Co. v. W.R. Grace & Co.*, 23 F.3d 617, 624 (2d Cir. 1993) (reh’g granted Jan. 11, 1994) (op. amended May 16, 1994) (finding “property damage” caused by an

“occurrence” in claim involving installation of asbestos in building).

In short, under *Chubb* and *W.R.Grace*, CGL policies provide coverage where the insured’s faulty materials have been incorporated into and damaged other property.

#### **B. Removal of Faulty Materials**

New York law does not afford coverage where an insured’s faulty materials need to be removed or replaced and there is no resulting damage to other property. The court in *Bonded Concrete, Inc. v. Transcontinental Insurance Co.*, 12 A.D.3d 761 (3d Dep’t 2004), followed the *Fuller* court’s reasoning. That case involved a suit by a general contractor against a concrete supplier asserting claims for breach of contract, breach of various warranties, and deceptive business practices. The contractor alleged that the supplier poured defective concrete in a sidewalk. The contractor sought damages for the costs of correcting the defect. The supplier’s CGL insurer denied coverage, asserting, among other things, that the claim did not allege an “occurrence” under the policy.

Relying heavily on *Fuller*, the court agreed with the insurer. Critical to its ruling was that “[t]he damages sought were the costs of correcting the defect, not damage to property other than the completed work itself.” *Id.* at 764. The court noted the “well-settled rule” that a CGL insurer is not a surety for faulty workmanship. *Fuller* dictated that CGL policies “were never intended to provide indemnification to contractors from claims that their work product was defective.” *Id.* at 763. Rather, the purpose is to provide cover-age for tort liability for physical damage to third parties, not for contractual liability for economic loss based on defective workmanship.

In short:

- Under *Bonded Concrete*, CGL policies do not cover the cost of removing or replacing the insured’s faulty materials.
- The installation cases cited above do not apply where the faulty materials have not damaged other property.

#### **C. Installation/Incorporation Claims Against General Contractors**

Under the dictates of *Fuller* and *Bonded Concrete*, New York law provides that CGL

policies do not cover general contractors for the costs of remedying the installation of faulty materials into an otherwise good project. This was the outcome in *Amin Realty, L.L.C. v. Travelers Property Casualty Co.*, No. 05-CV-195, 2006 U.S. Dist. LEXIS 40867 (E.D.N.Y. June 20, 2006), where the court considered coverage for an underlying suit brought by a property owner against a general contractor hired to construct a four-story building. A concrete subcontractor allegedly mixed concrete improperly. As a result, the concrete, along with adjacent steel decking, beams, and metal joints had to be re-placed. The property owner sued the general contractor for breach of contract and negligence, seeking money for property damage and business interruption.

In the subsequent coverage action, the court held that the general contractor's CGL insurer had no duty to indemnify the insured for the judgment in the underlying case because the underlying complaint did not allege an "occurrence." The court noted that the CGL coverage is for tort liability for physical damage to others, *not* for contractual liability for economic loss based on defective final work product. Relying on *Fuller*, the court reasoned that the property owner's claim was essentially just a contract dispute based on allegations of faulty workmanship resulting in only property damage to the building itself and/or economic damages from the loss of use of the building.

Importantly, the court held that the property owner's claim for negligent supervision does not alter this conclusion.

"For purposes of determining whether there is a duty to indemnify, the important distinction is not whether the complaint states a contract or tort theory, but whether the damage to be remedied is the faulty work or product itself, or injury to person or other property. A contract default under a construction contract is not transformed into an 'accident, including continuous or repeated exposure to substantially the same general harmful conditions' by the simple expedient of alleging negligent performance or negligent construction."

*Id.* at \*11-12 (citations and internal quotations omitted).

In short, under *Amin*, property damage is not caused by an "occurrence" if:

- the damage does not extend beyond the insured's project;
  - this also applies to impairment or replacement of good work or materials;
  - regarding general contractors, this applies to the entire project.
- the damages are essentially contractual in nature, regardless of how they are labeled in the complaint against the insured.

#### D. Mixed-Coverage Claims

In some cases, the rules discussed in two or more sections above have been combined. For example, in *Adler & Nelson Co. v. Insurance Co. of North America*, 434 NY2d 1335, 1336 (N.Y. 1982), an ironworks subcontractor was sued by its general contractor after defective ironwork damaged masonry in the building for which the general contractor hired the subcontractor's work. The general contractor sought \$54,000 as the cost to remedy the situation. The insurer paid \$29,000 (for damage to the masonry) but denied coverage for the remainder, which applied to remediation of the ironwork. The trial court agreed with the insurer's decision, and the appellate court affirmed.

The same rule applies to insured general contractors. For example, the court in *Amin, supra*, concluded that **only a portion** of a claim could be deemed to be caused by an "occurrence" when there is damage to third-party property:

In such a situation, the courts concluded, **that portion** of the damage that extended beyond the insured's work product could be found to have resulted from an "accident or "occurrence." See *Marine Midland*, 60 A.D.2d at 768.

*Amin* at \*18 (emphasis added). Indeed, in footnote 9, the *Amin* court hypothesized that if the claimant had sued the subcontractor instead of the general contractor, and the subcontractor sought coverage "for **that portion** of the damage that extended to parts of the building other than the concrete foundation" (emphasis added), there would be coverage for damage caused by an "occurrence" for that portion. Because the claim in *Amin* was brought by a general contractor, there was no damage to property beyond its work (the entire project), so, pursuant to *Fuller*, no portion was caused by an "occurrence."

In short, under *Amin* and *Adler & Nelson*, it is possible for some, but not all, property damage involved in a claim to have been caused by an “occurrence”:

- that portion of the property damage that occurs to the insured’s work product is not caused by an “occurrence”, but
- that portion of the property damage that extends beyond the insured’s work product is caused by an “occurrence.”

### **CONCLUSION**

New York law is very strict with regard to CGL coverage for defective workmanship and defective materials. Insureds will seldom if ever find coverage when sued for defects in their own work. The law is especially strict with regard to general contractors; according to *Fuller* and its progeny, their “own work” includes the entire project. Accordingly, while the bullet-point lessons above may not apply to the facts and circumstances of every claim, they should be helpful guidelines applicable to many frequently occurring fact patterns.

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# Disputing Construction Contracts with the City

By Jennifer Clark, Esq.

Pursuant to the Procurement Policy Board (“PPB”) Rules, contracts with the City of New York contain a clause that requires contractors to submit most claims to alternative dispute resolution (“ADR”). Some contractors may be unaware of how to pursue these claims properly. Many such claims have been dismissed on procedural grounds. For example, in 2011, half of the claims that went through the dispute resolution process were dismissed by the Contract Dispute Resolution Board (“CDRB”) as time-barred. This article highlights some of the common pitfalls in complying with the requirements of the ADR process.

## The ADR Process

The ADR procedure is a three-step process. It is commenced by the contractor’s submission of a Notice of Dispute to the head of the agency which is party to the contract.<sup>1</sup> If the Agency Head issues a decision with which the contractor disagrees, or fails to issue a determination in the required timeframe, the contractor may appeal its claim to the Comptroller by submitting a Notice of Claim.<sup>2</sup> In the event that the Comptroller fails to settle or adjust the claim, the contractor may submit an appeal to the CDRB.<sup>3</sup> The CDRB is a three member panel composed of an administrative law judge of the Office of Administrative Trials and Hearings who chairs the panel, a pre-qualified panelist selected by the chair, and a representative from the Mayor’s Office of Contract Services.<sup>4</sup> The submission requirements for each stage of the ADR process are contained in section 4-09 of title 9 of the Rules of the City of New York (the “PPB Rules”).

## Claims Precluded by the PPB Rules

Several types of claims can be dismissed as outside the jurisdictional grant of authority in the PPB Rules. The PPB Rules specify that for construction contracts, the ADR procedure applies

“only to disputes about the scope of work delineated by the contract, the interpretation of contract documents, the amount to be paid for extra work or disputed work performed in connection with the contract, the conformity of the vendor’s work to the contract, and the acceptability and quality of the vendor’s work.”<sup>5</sup> Both the courts and the CDRB have found that disputes concerning damages to the contractor due to delays by the contracting agency (“delay damages”) do not fall within this grant of jurisdiction.<sup>6</sup> The PPB Rules also specify that the CDRB has no jurisdiction over disputes involving supplier pre-qualification, determinations of responsibility, terminations other than for cause, or patents, copyrights, trademarks or trade secrets.<sup>7</sup>

## Proper Parties to the Dispute

Claims may also be dismissed due to lack of standing. The party to initiate the ADR procedure must be a party who has a contract with the City.<sup>8</sup> Sub-contractors on City construction projects are often subject to the PPB Rules as well by virtue of their contract. However, sub-contractors lack privity with the City and therefore may not submit a claim on their own behalf; they must have the prime contractor make submissions on their behalf at each level of the ADR process.<sup>9</sup>

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<sup>5</sup> 9 RCNY § 4-09(a)(2).

<sup>6</sup> See *Trocom Constr. Corp. v. City of New York*, 51 A.D.3d 533 (1st Dep’t 2008); *CAB Assoc. v. City of New York*, 32 A.D.3d 229, 232 (1st Dep’t 2006); *Schlesinger-Siemens Elec., LLC v. Dep’t of Envtl. Prot.*, OATH Index No. 1817/10, mem. dec. (Apr. 28, 2010); *J.H. Electric of New York, Inc. v. Dep’t of Sanitation*, OATH Index No. 2637/09, mem. dec. (Aug. 27, 2009).

<sup>7</sup> 9 RCNY § 4-09(a)(1).

<sup>8</sup> 9 RCNY § 4-09(a).

<sup>9</sup> See *URS Corp. v. Dep’t of Design & Constr.*, OATH Index No. 1448/07, mem. dec. at 4 (May 18, 2007) (“as a subcontractor, E. Friedman, lacks the privity of contract necessary to invoke the provision of the [PPB] rules directly against the City.”); *URS Corp. v. Dep’t of Design & Constr.*, OATH Index No. 1868/01, mem. dec. (Sept. 10, 2001) (contractor required to submit claims on behalf of the subcontractor, which lacked privity with the City); see also *A.J. Pegno Constr. Corp. v. Dep’t of Envtl. Prot.*, OATH Index No. 1436/08, mem. dec. (May 21, 2008) (contractor submitted petition on behalf of subcontractor); *Kreiser Borg Florman Gen. Constr. Co. v. Dep’t of Design & Constr.*, OATH Index Nos. 1079/06 & 1100/06, mem. dec. (June 1, 2006) (same).

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<sup>1</sup> 9 RCNY § 4-09(d) (Lexis 2012).

<sup>2</sup> 9 RCNY § 4-09(e).

<sup>3</sup> 9 RCNY § 4-09(g).

<sup>4</sup> 9 RCNY § 4-09(f).

## Statute of Limitations

Parties need to pay close attention to deadlines. The PPB Rules contain a specific deadline for submission at each phase of the three-step ADR process. The initial notice of dispute must be submitted to the Agency Head within 30 days of notice of the determination or action which is the subject of the dispute.<sup>10</sup> The appeal of the Agency Head's determination must be submitted to the Comptroller within 30 days of the agency head's decision.<sup>11</sup> The Comptroller has 45 days from receipt of all materials to issue a decision (unless the parties agreed to a further extension of up to 90 days). After that time period passes or the issuance of a determination by the Comptroller, the petitioner has 30 days to submit a petition to the CDRB.<sup>12</sup> At the CDRB level, respondent may argue that any of these timeframes has been missed. Such arguments are not waived by respondent's failure to raise them at the Agency Head or Comptroller level.<sup>13</sup>

It is important to be aware that these time periods are not extended by virtue of on-going negotiations. For example, if a contractor submits a request for a change order which the project manager or engineer denies, the contractor must submit its Notice of Dispute within 30 days of the denial, even if the contractor has continued discussions with the engineer or requests that the change order be reevaluated.<sup>14</sup>

If the Agency Head or Comptroller fails to issue its determination within the timeframes specified in the PPB Rules, that failure is deemed a non-determination, permitting the contractor to proceed to the next level of the ADR process.<sup>15</sup> Any such

non-determinations will start the clock running for purposes of the statute of limitations.<sup>16</sup>

## Arguments Precluded by the Contract

The PPB Rules specify that the CDRB's determination must be consistent with the terms of the Contract.<sup>17</sup> Accordingly, the CDRB may not make findings on equitable grounds that conflict with the language of the contract.<sup>18</sup> For example, most construction contracts have a "No Damages for Delay" clause. While a court may find that clause unenforceable on equitable grounds (e.g., the delay was beyond the parties' contemplation when they entered into the contract),<sup>19</sup> the CDRB does not have the authority to do so.

Another common clause in construction contracts is the ambiguity clause. While generally in contract law, ambiguities in contracts are interpreted against the drafter, most City contracts include a provision (usually in the instructions for bidders) which requires contractors to request clarification on any ambiguities in the contract prior to bidding. If a contractor fails to do so, it cannot later argue that its interpretation should prevail.<sup>20</sup> This issue frequently comes up in cases where there are conflicting contract provisions. In such cases, most ambiguities clauses state that if the contractor

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<sup>10</sup> 9 RCNY § 4-09(d)(1); *see, e.g., Manuel Elken Co., P.C. v. Dep't of Design & Constr.*, OATH Index No. 1010/07, mem. dec. (Feb. 22, 2007).

<sup>11</sup> 9 RCNY § 4-09(e)(1); *see, e.g., Hernandez v. Human Res. Admin.*, OATH Index No. 943/08, mem. dec. (Feb. 20, 2008).

<sup>12</sup> 9 RCNY § 4-09(g); *see, e.g., Delcor Assoc. v. Dep't of Hous. Pres. & Dev.*, OATH Index No. 1872/10, mem. dec. (Apr. 13, 2010).

<sup>13</sup> *Maracap Constr. Indus., Inc. v. Dep't of Transp.*, OATH Index No. 711/08, mem. dec. at 7 (May 9, 2008).

<sup>14</sup> *See Dell Tech Enters., Inc. v. Dep't of Envtl. Prot.*, OATH Index No. 427/07, mem. dec. (Nov. 22, 2006).

<sup>15</sup> 9 RCNY § 4-09(b).

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<sup>16</sup> *See JCH Delta Contracting, Inc. v. City of New York*, 44 A.D.3d 403, 404 (1st Dep't 2007); *Start Elevator v. City of New York*, Sup. Ct. N.Y. Co., Jan. 9, 2012, Bransten, J., index No. 104620/11 at 9; *Barele v. Human Res. Admin.*, OATH Index No. 1470/11 mem. dec. at 4 (May 16, 2011); *Prime Constr. Force v. Dep't of Parks & Recreation*, OATH Index No. 942/06, mem. dec. at 5 (Apr. 4, 2006); *Demo-Tech Corp. v. Dep't of Hous. Pres. & Dev.*, OATH Index No. 659/03, mem. dec. at 5-6 (Nov. 25, 2002). It should be noted that petitioner in *Barele* has filed an Article 78 proceeding with the New York County Supreme Court with regard to this issue. The matter is pending. *Barele v. Contract Dispute Resolution Bd.*, Sup Ct. N.Y. Co., filed Sept. 19, 2011, Billings, J., index No. 110138/2009.

<sup>17</sup> 9 RCNY § 4-09(g)(4).

<sup>18</sup> *See Schlesinger-Siemens Elec.*, OATH 1817/10.

<sup>19</sup> *See Corinno Civetta Constr. Corp. v. New York*, 67 N.Y.2d 297 (1986).

<sup>20</sup> *See Angelakis Constr. Corp. v. Dep't of Envtl. Prot.*, OATH Index No. 3525/09, mem. dec. (Jan. 19, 2010); *Tully Constr. Co., Inc. v. Dep't of Sanitation*, OATH Index No. 3524/09, mem. dec. at 6 (Dec. 10, 2009); *see also L&L Painting Co., Inc. v. Contract Dispute Resolution Bd.*, 14 N.Y.3d 827 (2010).



has not requested clarification, he or she is bound by the City's interpretation of the contract.<sup>21</sup>

Most City contracts also include "no estoppel" provisions, preventing estoppel based on any determination, decision, approval, order, letter, payment or certificate made or given under or in connection with the Contract.<sup>22</sup> This is consistent with the common law rule barring the assertion of estoppel or waiver against the government.<sup>23</sup> Thus, arguments that a contractor should get additional payment for certain work because it has received additional payment for such work in the past, will not necessarily be persuasive. Likewise, arguments that an agency employee assured a contractor that a change order would be granted may be unconvincing depending on the context; very few individuals have the authority to change a City contract and the City is not bound by statements of those without the authority to do so.

In summary, construction law practitioners, whether representing the City or a private party, should be aware of the PPB Rules, how they operate, and the nuances of the ADR process. The rules are quite detailed and close attention to them can save time and effort and preserve valid arguments that could otherwise be dismissed on procedural grounds. Further insight into the ADR process may be gained by reviewing past decisions of the CDRB, which are available in the CityAdmin Online Library at [www.citylaw.org](http://www.citylaw.org), where they are categorized as OATH decisions. Prior decisions are also available on LexisNexis.

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<sup>21</sup> See *Cipico Constr., Inc. v. City of New York*, 279 A.D.2d 416 (1st Dep't 2001); *Thalle Constr. Co. v. City of New York*, 256 A.D.2d 157 (1st Dep't 1998).

<sup>22</sup> See, e.g., *Angelakis Constr. Corp. v. Dep't of Envtl. Prot.*, OATH Index No. 3525/09, mem. dec. at 17 (Jan. 19, 2010); *Alta Indelman, Architect/Builders Group, LLC v. Dep't of Sanitation*, OATH Index No. 1092/05, mem. dec. at 7 (June 16, 2005).

<sup>23</sup> See *Safway Steel Prods. v. Craft Architectural Metals Corp.*, 183 A.D.2d 452 (1st Dep't 1992); *Eden v. Bd. of Trustees*, 49 A.D.2d 277, 284 (2nd Dep't 1975).

## Challenging the Building Department's Permit Determinations in Court

By Vincent T. Pallaci, Esq.

One of the most frustrating, and potentially expensive, experiences for developers in New York City can be the suspension, revocation or cancellation of a building permit. Although the City issues thousands of permits every year, it also rejects, suspends and revokes plenty as well. Luckily, that stalled job does not need to sit idle for eternity because Article 78 of the Civil Practice Law and Rules provides building owners with a way to seek review of an adverse building department determination. That's the good news. The bad news is that the process is not quick. Prior to making an Article 78 Application, the developer must exhaust all of its administrative remedies within the department.<sup>1</sup>

In order to exhaust all of its administrative remedies, the developer that challenges the permit determination should first seek a review of the determination within the Department of Buildings. This process can involve the design professional meeting with the plan examiner, and even the Borough Commissioner, to try and resolve the problems that led to the rejection or revocation of the building permit in the first instance. If the meeting with the Department of Buildings is not successful, the developer must then proceed to file an appeal with the New York City Board of Standards and Appeals ("BSA").<sup>2</sup> If the BSA rejects the appeal and sustains the adverse determination, then the matter has become ripe for judicial review under Article 78 of the CPLR.

It should be noted that in certain, limited, instances, the developer may be able to circumvent the BSA and proceed directly to the Article 78 Proceeding. However, to avoid the BSA the party challenging the permit determination must establish that challenging the revocation through the BSA would be "futile."<sup>3</sup> Futility is the exception rather than the rule. In the majority of challenges, where futility cannot be established, the developer must

first proceed to the BSA before it seeks judicial intervention.

Once the matter is ripe for Article 78 review, the standard of review depends upon the type of challenge to the permit that is being made. When the permit revocation or denial is based upon a zoning board's interpretation of a zoning ordinance, Courts will give great deference to the zoning board and only disturb the board's determination where it can be shown that the board acted irrationally or unreasonably.<sup>4</sup> However, where the question faced by the zoning board is one of "pure legal interpretation," then the Court need not give deference to the board and the standard of review is whether the zoning board's determination was contrary to the clear wording of the code.<sup>5</sup> For other challenges, such as whether a building permit can be revoked based upon misrepresentations in the application, the standard of review is whether the BSA was arbitrary or capricious,<sup>6</sup> lacked reasonable basis for its decision or whether its conduct was an abuse of discretion.<sup>7</sup>

The Article 78 proceeding must be commenced against the body or officer whose performance is sought.<sup>8</sup> Great care should be taken in selecting the entity named as the respondent in the Article 78 petition. For example, naming the board of appeals as the respondent, when only the board's director has the power to revoke a building permit, has been found to be error.<sup>9</sup> This means that prior to filing the Article 78 Proceeding some research and investigation will be required. Developers would therefore be wise not to wait until the last minute to proceed with the Article 78 challenge. Instead, making the decision to challenge the BSA determination as early as possible will allow the developer's legal team ample time to determine the

<sup>1</sup> CPLR §7801(1).

<sup>2</sup> Brunjes v. Nocella, 40 A.D.3d 1088 (2<sup>nd</sup> Dept. 2007)

<sup>3</sup> Lehigh Portland Cement Co. v. New York State Dept. of Envir. Cons., 87 N.Y.2d 136 (1995)

<sup>4</sup> Avramis v. Sarachan, 97A.D.3d 874 (3<sup>rd</sup> Dept. 2012)

<sup>5</sup> McGrath v. Town of Amherst Zoning Board of Appeals, 94 A.D.3d 1522 704 (4<sup>th</sup> Dept. 2012)

<sup>6</sup> Mainstreet Makover 2, Inc. v. Srinivasan, 95 A.D.3d 1331 (2<sup>nd</sup> Dept. 2012)

<sup>7</sup> Lucas v. Board of Appeals of Village of Mamaroneck, 93 A.D.3d 844 (2<sup>nd</sup> Dept. 2012)

<sup>8</sup> Id.

<sup>9</sup> Id.

proper standard of review for the challenge at issue and to determine the appropriate body or officer against whom the petition must be filed.

Of course it is not just the developer seeking a building permit that can seek review of the Building Departments' building permit determination. When someone not involved with the construction (for example a neighbor) seeks to challenge the issuance of a building permit through an Article 78 proceeding, the right to challenge the permit accrues when the permit is issued and does not constitute a continuing wrong.<sup>10</sup> This means that those seeking to challenge the issuance of the permit must act quickly and not wait until the project is completed. Anyone seeking to challenge a determination of the BSA must do so within four months after the determination to be reviewed has become final.<sup>11</sup> Note however that for proceedings outside of New York City, specifically, proceedings where the Town Law applies, the period of limitations may be as short as thirty days from the issuance of a final determination that is filed with the Town Clerk.<sup>12</sup>

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<sup>10</sup> Duchmann v. Town of Hamburg, 90 A.D.3d 1642 (4<sup>th</sup> Dept. 2011).

<sup>11</sup> CPLR §217(1).

<sup>12</sup> Town Law §267-c

## Be Careful How You Dig: Court Held Excavators Responsible for Damage to Neighboring Property

By Raymond T. Mellon, Esq., and Calvin Lee, Esq.

In the past, when a neighboring property in New York City was damaged during excavation of a new construction project, the search for the responsible party or parties was often the subject of lengthy litigation. A recent decision by New York's Court of Appeals accelerates this process by imposing strict liability on certain parties, at least for damages caused by construction that preceded the enactment of the New York City 2008 Building Code. In the recent decision of *Yenem Corp. v. 281 Broadway Holdings, et al.* (and other related actions)<sup>1</sup>, the Court of Appeals held that a former provision of the New York City Building Code, found under former Administrative Code of the City of New York § 27-1031(b)(1), imposed absolute liability on defendants whose excavation work caused damage to adjoining property.

Technically, this ruling only impacts lawsuits involving excavation damage that occurred to adjoining properties prior to the enactment of the 2008 Building Code. In such instances, developers, owners, and contractors performing excavation, which exceeded ten feet below the curb level, are now deemed absolutely liable for damage to adjoining property. This ruling empowers courts to grant summary judgment relief on liability against the developer/owner and the excavator/contractors upon the proffer of evidence of excavation and resulting property damage. The remaining issue for the trier of fact will be the determination of the amount of damages attributable to the excavation activities.

To determine whether the violation of former Administrative Code § 27-1031(b)(1) constituted negligence per se (i.e., strict liability) or merely some evidence of negligence, the Court of Appeals traced the history of the subject code provision and found that it was a municipal ordinance rooted in state law. The Court then held that although "not every municipal ordinance with state law roots is entitled to statutory treatment," this particular code

is unique because "[i]ts language and purpose are virtually identical, in all relevant aspects, to those of its state law predecessors" and "neither the wording nor the import of that statute was materially or substantively altered." Accordingly, the Court of Appeals held that the violation of former Administrative Code § 27-1031(b)(1) imposes absolute liability on those who undertake excavation work.

Since the *Yenem* ruling was based on a Code provision that was subsequently superseded in 2008, it ostensibly has limited application due to the three-year statute of limitations for negligence actions in New York. Nonetheless, the decision may be a harbinger for a similar judicial determination on the equivalent provision now found in the 2008 Building Code, under Administrative Code, Title 28, Chapter 33, Section 3309.4 (effective on July 1, 2008). It is important to note that the 2008 Code provision eliminates the ten-foot requirement of both the former Code section and the 1855 special law<sup>2</sup>. The Court of Appeals, however, specifically declined to make any determination on the new Code provision since it was not an issue in the *Yenem* lawsuit. Whether the elimination of the ten-foot requirement materially alters the law and, thus, renders the new Code provision a municipal ordinance, violation of which merely constitutes evidence of negligence, remains an open issue for future judicial determination.

In its analysis, the *Yenem* Court noted that the specific wording of the law is only one of the factors that led to the holding that the former Code provision was rooted in a state statute. Indeed, the Court of Appeals emphasized the substance and intent of the original state law as compared with the

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<sup>2</sup> The statute enacted by the state legislature in 1855 created a duty, when none had previously existed, to protect neighboring landowners in "the city and county of New York" from harm due to excavation work. The statute effectively shifted the burden of protecting against harm from the landowner to the excavator.

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<sup>1</sup> *Yenem Corp. v. 281 Broadway Holdings*, 18 N.Y.3d 481 (2012)

former Code provision. Specifically, the Court stated “[e]ven more important, its original purpose of shifting the risk of injury from the injured landowner to the excavator of adjoining land has remained constant over the years” and “[t]o hold that a violation of the provision is only ‘evidence of negligence’ would thus defeat the legislation’s basic goal.” Additionally, the Court found that the former Code provision “continues to embody the specific legislative policy that in New York City those who undertake excavation work, rather than those whose interest in neighboring land is harmed by it, should bear its costs.”

Imposing the same factors identified in *Yenem* on the equivalent revision of the 2008 Code also reveals a valid basis for the imposition of strict liability. No one can credibly argue that the purpose embodied in the 2008 Code provision is different from that of its predecessor Code provisions. The 2008 Code is clearly seeking to shift “the risk of injury from the injured landowner to the excavator of adjoining land.” Nothing has changed in the dynamics of construction or public policy to deviate from the identified legislative intent that if you undertake excavation work in New York City, you bear the burden and risk of any damage incurred.

It can additionally be argued that the 2008 Code’s elimination of the ten-foot requirement is more than just semantics and that it actually reinforces the policy of protecting adjoining property. Compare the 2008 Code to the former Administrative Code § 27-1031(b)(2) which required the owner of the adjoining property to protect his own structure if the excavation depth is ten feet or less. Under the 2008 Code, as long as the excavator is granted a license to enter and inspect the adjoining buildings and property, and to perform the necessary work, the excavator has the responsibility to “preserve and protect from damage any adjoining structures.”

The 2008 Code imposes the additional requirement that the excavating party document the existing conditions of all adjacent buildings in a preconstruction survey prior to commencement of the work. As such, the 2008 Code imposes increased burdens on the excavator to protect the adjoining property. At the same time, the original legislative intent of the special law of 1855 protecting adjoining properties remains intact.

Thus, it would appear that the stage is set for a subsequent judicial determination holding that the 2008 Code imposes strict liability for damage to adjoining property caused by excavation.

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*Calvin Lee, Esq.*

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## “Am I Covered?” Insurance Considerations For The Design Professional “Going Green”

By Gary Strong, Esq.

The emergence of green building and sustainable design has introduced the world of building construction to new territory in the realm of energy savings and design implementation requiring new innovations in project delivery. On the flip-side, green building has also introduced new avenues of liability and exposure to design professionals beyond the traditional risks inherent in performing professional design services. Most business savvy design professionals make the wise decision to invest in professional liability insurance to cover the risks of an unfortunate error or omission. However, in the environment of green building and sustainable design, traditional liability insurance may not be adequate to cover the risks and potential exposure of a failed green project. For the design professional considering “going green” the question which must be asked is: “Am I covered?”

The standard professional liability insurance policy covers architects, engineers and other design professionals for wrongful acts arising from the performance of their professional services. Such policies will typically define the term “professional services” to mean services that the insured is legally qualified to perform for others in the insured’s practice as an architect, engineer, land surveyor, landscape architect, construction manager, scientist, or technical consultant – or similar language to that effect. These same policies will exclude coverage for any express warranties or guaranties other than guarantees that the insured’s professional services will conform to the generally accepted standard of care. Some policies may even exclude consequential damages arising from contractual obligations in certain circumstances.

The concern then becomes whether a design professional is covered by his or her existing professional liability policy for services involving green building. This concern is predicated on three principal aspects of green building. The first is the fact that green building, while certainly becoming more mainstream as time goes on, often involves services beyond traditional architectural/engineering and construction

administration raising the question of whether such services are “professional services” within the policy coverage. Second, green building projects, and especially those adhering to a specific green building rating system, often include project objectives which may be beyond those considered to be within generally accepted standards of care implicating concerns of guarantees and warranties which would otherwise be excluded from coverage. Finally, in the event that a green project is not delivered per the owner expectations, the damages which flow from such failure may be in the form of lost financing, tax incentives, energy savings and marketability which could be considered consequential in nature arising from the contracts for design and construction.

For example, assume that an owner wishes to develop a green building project which, when completed should achieve a LEED Silver rating per the USGBC LEED-NC guidelines.<sup>1</sup>

Part of the owner’s motivation for a development achieving this certification is the allowance of additional square footage than otherwise permitted by local zoning laws, state and local grant money and low interest financing made available for such projects, tax credits and incentives, reduction of energy costs and acquisition of energy credits, and the overall marketability of the property. In order for the owner to realize these goals, LEED Silver rating must be achieved and the owner makes this a requirement in all contracts for design and construction.

In order to achieve the LEED Silver rating, the project must adhere to specific design and construction guidelines for certification not

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<sup>1</sup> LEED is an acronym for Leadership in Energy and Environmental Design. The LEED Green Building Rating System was established by the United States Green Building Council (USGBC) for the purposes of defining and measuring green buildings. While several rating guidelines and pilot programs have been created since its inception, LEED-NC (LEED Green Building Rating System for New Construction & Major Renovations) provides a set of performance standards for the design and construction of commercial, institutional and high rise residential developments.

otherwise required by state construction and energy codes. In addition, there are procedures which must be followed for project registration, design and construction submissions, and ultimate certification not otherwise required in the typical construction project. Further, in order to achieve the desired certification, the LEED guidelines require commissioning and in some cases enhanced commissioning by a Commissioning Authority. These requirements may raise an issue of whether the insured architect or engineer is performing professional services within the scope of his or her practice.

Moreover, it is certainly within the owner's benefit to require that the project delivered will achieve the desired LEED rating, otherwise the efforts and expense of achieving the same would be meaningless. This raises a concern of whether agreeing to deliver a specifically rated project, which arguably requires performance beyond the general standard of care, will constitute a guarantee or warranty triggering an exclusion in coverage.

Finally, while the owner may certainly end up with a functioning development, should the project fail to achieve the desired LEED Silver rating the sought after "green" incentives may be in jeopardy or unobtainable. In such instance, will these consequential damages be covered by the traditional professional liability policy?

Certainly, there are arguments which can be made on both sides of the coverage issue. Arguably, green building, green consulting or green commissioning services may fall within the broad definition of professional services. As to the concerns of whether agreeing to furnish a specific green result will constitute a guarantee or warranty, a carefully worded contract can certainly help to alleviate this risk. Finally, as to the damages resulting from a green project, one can certainly argue that such are not consequential, i.e., arising from contract, but rather a proximate result of a deviation from the standard of care, i.e., negligence and thus covered. Again, a carefully worded contract would assist in this regard.

Even so, it is untold how the insurance industry will respond to green building claims against design professionals. Coverage may certainly be excluded, limited, or subject to a reservation of rights for the reasons discussed above. Also, a variety of insurance coverage is presently being made

available to owners, contractors, and most recently design professional as an endorsement to their existing policies for green building projects. The fact that such green coverage is available may suggest that not having it means that one is not covered for claims arising from projects. Again, this is an uncharted territory and the design professional must proceed with caution.

While time will certainly tell how green building will affect professional liability coverage, for now, the prudent design professional should inquire and ensure that coverage is available for those green services which he or she proposes. It is too late at the end of the project to question whether a claim, which given the nature of green building project may be substantial, will be covered by insurance or the unfortunate design professional alone.

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# Ethical Issues And Alternative Fee Arrangements: What To Do And What Not To Do<sup>1</sup>

By Richard B. Friedman and P. Michael Freed

Few topics in the practice of law have generated as much discussion over the last few years as alternative fee arrangements (AFAs). This is equally true in construction law.<sup>2</sup> Most of those discussions focus on clients – their desire to gain some level of control over costs. And, when properly implemented, AFAs not only can benefit clients, but can also improve the overall quality of legal services rendered and, as a result, lawyers enhance relationships with their clients.

AFAs' most obvious benefit is predictability – clients can more accurately budget and plan for legal costs. This, in turn, encourages practitioners to provide legal services more efficiently. AFAs also encourage lawyers to increasingly focus on value-driven client services. Finally, AFAs reinforce the sense of shared commitment towards a client's goals and shared financial risk in obtaining those goals.<sup>3</sup>

While the potential benefits of AFAs are readily apparent, the potential risks are often less obvious. Financial risks aside, practitioners face a plethora of potential ethical pitfalls when implementing AFAs. Fortunately, effective practices, from a business standpoint, can serve to resolve the ethics issues. Outside construction counsel who adopt certain of the practices discussed below will be better able to incorporate AFAs in their practice and be better positioned to grow their practice in the future. In-

house construction counsel who understand the ethical issues that arise with respect to AFAs will be better equipped to implement arrangements that are successful from their employer's perspective.

## Defining the Playing Field

AFAs have become more prevalent as attorneys and their clients have collaborated to construct creative solutions for managing legal costs. There are numerous types of AFAs, so first we will define the relevant terms and the types of AFAs being considered.

Generally speaking, an AFA is a fee arrangement based on factors other than solely on hourly rates.<sup>4</sup> The most effective AFAs are customized to the needs of the particular client and matter. As a result, AFAs can come in countless shapes and sizes. Among the most popular ones are the following:<sup>5</sup>

*Flat or fixed fee* – a set fee for an entire matter or specified portion of a matter (e.g., \$5,000 for the negotiation and drafting of a contract).

*Blended rate* – a fee where the same hourly rate is charged for all timekeepers or the same hourly rate is charged for all partners and a different rate is charged for all associates.

*Success fee* – a result-oriented arrangement where a fee in addition to the agreed-upon hourly rates is assessed upon occurrence of a specified result.

*Collar fee* – the coupling of a targeted budget number for a particular matter with an hourly rate; the client and attorney periodically review fees against a budgeted amount and make necessary adjustments if fees are outside a predetermined range (e.g., attorneys bill hourly fees, but if the

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<sup>1</sup> This article was adopted from the article entitled, "Ethical Issues and Alternative Fee Arrangements," written by Richard B. Friedman and P. Michael Freed, from the New York State Bar Association *Journal*, May 2012, Vol. 85, No. 4, published by the New York State Bar Association, One Elk Street, Albany, New York.

<sup>2</sup> See Christopher G. Hill, *Alternative Billing for Construction Claims: "An offer you can't refuse,"* Construction Law Musings, Sept. 9, 2011, <http://constructionlawva.com/alternative-billing-for-construction-claims-offer-cant-refuse/>

<sup>3</sup> See Andrew Nicely & Elisa Kantor, *Malpractice Risks in Alternative Fee Arrangements*, 20 No. 10 Westlaw J. Prof. Liability, March 2011; *Strategies for Alternative Fee Arrangements*, ZG Alert, 1 (Mar. 2010), <http://www.consultzg.com/assets/Uploads/ZGAlert-AFAs-March2010.pdf> ("The reasons for this renewed interest in AFAs are clear: clients want to drive costs down, they want greater predictability, and they want their lawyers to have 'skin in the game.'").

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<sup>4</sup> See J. Randolph Evans & Shari L. Klevens, *Alternative Fees May Lend Solutions*, Daily Report, Oct. 10, 2011 ("Alternative fee arrangements are fee agreements or billing agreements customized to fit the goals and needs of a client and matter based on discussion between a client and its counsel as opposed to the standard hourly fee arrangement.").

<sup>5</sup> See *id.*



actual fees are more or less than the budgeted total by a certain amount (e.g., 10%) (i.e., the “collar”), the firm and the client share savings below or additional costs above the collar).

*Retainer* – a fixed fee per month (or some other agreed-upon period of time) for predetermined services regardless of how much time attorneys devote to the matter.

*Capped fee* – a fee arrangement based on standard hourly rates with a cap on the total amount that can be billed during a particular period of time or on a particular matter.

*Portfolio fixed fee* – a fixed fee for a number of matters (e.g., all contract negotiations or bid protests).

*Performance-based hold back* – a fee arrangement based on standard hourly rates where a client pays only an agreed-upon percentage of those rates (e.g., 80%) and then pays additional amounts at certain intervals based either on its own assessment of the attorneys’ performance or certain agreed-upon criteria.

*Hybrid hourly rate/success arrangement* – blending an agreed-upon hourly rate with an additional success fee upon the achievement of certain defined goals.

### **Ethical Considerations**

As with any fee arrangement, AFAs present certain ethical issues. One general ethical concern is whether the financial and business considerations inherent in operating a law firm, whether engaged exclusively in the practice of construction law or otherwise, will interfere with attorneys’ ethical obligations to their clients. Other concerns include preserving the client’s absolute right to terminate the relationship at any time without penalty and the attorney’s rights and obligations regarding flat fees or other fees paid in advance.

Fee agreements that fix or cap the client’s fees at a specified amount can tempt an unethical attorney to curtail work after the cap has been reached. For example: a law firm and its commercial construction company client implement a portfolio fee arrangement pursuant to which the client pays the firm \$400,000 per year for the firm’s legal services related to a defined scope of matters. The average standard hourly rate for the attorneys doing the work is \$400, meaning that it would take

1,000 total hours at the attorneys’ average standard rate to reach the \$100,000 annual fee. A potential issue arises when the firm reaches or exceeds those 1,000 hours prior to the end of the year and additional work on the defined matters is required.

Because of hypothetical situations such as the foregoing, some clients have become leery of “low-ball” flat fee proposals knowing that the actual cost for the quality of work they expect exceeds the amount proposed.<sup>6</sup> Clients considering a flat fee arrangement may fear that the firm will “under work” the matters.<sup>7</sup> On the flip side, some attorneys refuse flat fee work imposed by clients because they assume that they will not get paid if additional work is required.<sup>8</sup>

Another ethical issue related to fixed fees in the context of construction law matters and otherwise is whether a fixed fee payment immediately becomes the property of the attorney or remains the property of the client until earned by the attorney’s performance of legal services.<sup>9</sup> This issue has generated much discussion since the District of Columbia Court of Appeals wisely held that a flat fee is not earned upon receipt but upon the performance of legal services.<sup>10</sup> The answer to this question affects attorneys’ obligations in handling flat fees.

### **Model Rules**

The ABA’s Model Rules of Professional Conduct provide guidance on many issues of AFAs. Perhaps most important is Rule 1.5 of the ABA Model Code which establishes the following reasonableness standard for assessing legal fees: “A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.”<sup>11</sup> This general rule applies to all types of fee agreements.

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<sup>6</sup> Rebecca M. Lamberth et al., *Alternative Fee Arrangements: Who’s Responsible for Making Them Work?*, 22 No. 2 Cal. Litig. (2009).

<sup>7</sup> *Id.*

<sup>8</sup> See Meredith Hobbs, *Lawyers: Flat Fees Pose Ethics Issues*, Daily Report, Jan. 10, 2011

<sup>9</sup> For an extended discussion on this issue, see Tyler Moore, *Flat Fee Fundamentals: An Introduction to Ethical Issues Surrounding the Flat Fee After In re Mance*, 23 Geo. J. Legal Ethics 701 (Summer 2010).

<sup>10</sup> *In re Mance*, 980 A.2d 1196 (D.C. 2009).

<sup>11</sup> Model Rules of Prof’l Conduct R. 1.5.

Comment 5 to Rule 1.5 is especially relevant to any type of fee agreement that caps the client's payment at a specified amount (including fixed or flat fees, capped fees, retainers, and portfolio fees):

An agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest. For example, a lawyer should not enter into an agreement whereby services are to be provided only up to a stated amount when it is foreseeable that more extensive services probably will be required, unless the situation is adequately explained to the client.<sup>12</sup>

Comment 5 imposes a high standard on attorneys using any type of capped fee arrangement because it prohibits any fee agreement that "*might* induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest."<sup>13</sup> On its face, this is a high standard because, arguably, any type of fixed or capped fee arrangement *might* induce any attorney to curtail his or her services after the specified cap has been reached. The Comment goes further, prohibiting such an agreement if it is merely *foreseeable* that additional services will be needed – unless the attorney adequately explains the situation to the client.

The Model Rules contain additional relevant guidance. Model Rule 1.3 requires a lawyer to "act with reasonable diligence and promptness in representing a client."<sup>14</sup> Comment 1 states in relevant part as follows:

A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client with zeal in advocacy upon the client's behalf.<sup>15</sup>

In addition, Comment 10 to Model Rule 1.7 states that "[t]he lawyer's own interests should not be permitted to have an adverse effect on representation of a client."<sup>16</sup> These Rules prohibit lawyers from allowing their financial interests to interfere with or supersede their obligations to their clients. This has implications for AFAs. For example, these Rules govern a lawyer's conduct where a flat or fixed fee, retainer, or capped fee has been earned in full, but necessary work remains on the client's matter(s).

Then there is Model Rule 1.1, which requires a lawyer to "provide competent representation to a client."<sup>17</sup> Comment 1 provides the following non-exclusive list of factors for determining whether a lawyer is "competent" to handle a particular matter:

- "the relative complexity and specialized nature of the matter";
- "the lawyer's general experience";
- "the lawyer's training and experience in the field in question"; and
- "the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question."<sup>18</sup>

Model Rule 1.1 has implications for a lawyer tempted to "push work down" to less experienced attorneys when a blended rate is used. The supervising attorney must ensure that all work is assigned to attorneys with sufficient skill and experience to handle the particular project.

Of course, outside counsel implementing AFAs must adhere to these Rules (and any other governing rules or precedent). The challenge for these attorneys is to provide legal services as efficiently as possible without in any way sacrificing effectiveness or compromising their obligations to the client. The Model Rules provide a good starting point for learning to strike this balance.

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<sup>12</sup> *Id.* cmt. (5).

<sup>13</sup> *Id.* (emphasis added).

<sup>14</sup> Model Rules of Prof'l Conduct R. 1.3.

<sup>15</sup> *Id.* cmt. (1).

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<sup>16</sup> Model Rules of Prof'l Conduct R. 1.7 cmt. (10).

<sup>17</sup> Model Rules of Prof'l Conduct R. 1.1.

<sup>18</sup> *Id.* cmt. (1).

## **Implement Best Practices for Addressing the Potential Ethical Issues Associated With AFAs**

The use of AFAs is still relatively new in most practice areas, construction law included. As a result, some practitioners are undoubtedly attempting to implement AFAs without much, if any, experience doing so. This can make navigating the potential ethical and legal issues difficult. It is critical, therefore, that law firm lawyers contemplating the use of AFAs consider the applicable ethical issues and develop systems and best practices to avoid the potential risks. Outside counsel who embrace and effectively address these challenges will almost certainly reap the benefits, given the nature of today's legal marketplace.

### **Best Practices - General Considerations**

At the risk of stating the obvious, AFAs must work for both the client and the attorney or law firm to be successful. AFAs must succeed from a business standpoint and must avoid the associated ethical issues. Effective AFA practices that further the purposes and benefits of AFAs while minimizing the ethical, professional, and legal risks should be predicated upon the following: knowledge, experience, trust, collaboration, and communication. Implementing these concepts will assist outside counsel in avoiding the ethical and legal pitfalls associated with AFAs and help attorneys foster a closer relationship with their clients.

#### **Knowledge**

In-house and outside counsel considering implementing AFAs should first take time to educate themselves about the various types of AFAs, how each works, their respective benefits and risks, and the types of matters for which each AFA is best matched.

Of course, it is also critical that attorneys considering AFAs understand the unique ethical and legal issues they present. This should include, at the very least, consideration of the governing rules of professional conduct and other bar- or jurisdiction-specific rules. This will help practitioners implement AFAs that meet their clients' needs while avoiding the ethical and legal issues that these arrangements can present.

But being fluent in the various AFAs is not enough. Even if an attorney has an advanced

knowledge of AFAs, he or she will not be able to implement an effective AFA without also obtaining an adequate understanding of the client's business, its legal needs, and how the two fit together. The practitioner should then work with the client's in-house counsel or other personnel to select and craft a fee agreement that best addresses the client's needs.<sup>19</sup>

The client, too, must be knowledgeable about its fee options. It is incumbent upon in-house counsel to learn various AFA options. Outside counsel should be able to advise the client on the pros and cons of each option for the particular matter at hand. All of this should go hand-in-hand with the attorney's knowledge of the client's business and legal objectives.

#### **Experience**

AFAs that effectively meet the client's business and legal needs while balancing the practitioner's need to run a profitable practice should be based, in part, upon the attorney's or law firm's experience in handling similar matters. It is difficult to implement an effective AFA for matters with which the attorney or law firm has little experience.<sup>20</sup>

Of course, an attorney who has experience handling similar matters or projects will be better equipped to predict the fees and costs associated with a matter, and to suggest appropriate terms and parameters for the fee agreement. The experienced attorney should look at data collected over time, which includes the number of hours necessary for completing specific tasks, the associated tasks, and the necessary staffing. Experience and data will put the attorney in a better position to implement a fee arrangement that meets the needs and expectations of both the client and the attorney while simultaneously decreasing ethical risks.

#### **Trust**

Trust between the attorney and client is essential for an AFA to work. For this reason,

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<sup>19</sup> David T. Brown, *Approaching Alternative Fees*, Chicago Daily Law Bulletin, Nov. 18, 2010 (“[A] firm must maintain the flexibility to work with each client to define the best approach based on its unique business and legal needs, as well as the specific challenges of each case or transaction.”).

<sup>20</sup> *Id.* (noting that “one-time deals (which are more typical at midsize firms) are much harder to predict and control, making it that much more difficult to employ alternative fee arrangements.”).

AFA work best for matters where there is a pre-existing attorney-client or other relationship which has allowed the parties to develop a trust in one another. However, a pre-existing relationship is not a prerequisite ethically or otherwise for a successful AFA. Trust is often intertwined with experience. A client is more likely to trust an attorney who has handled similar matters and has experience and expertise in the relevant area.

### **Collaboration (Pre-Engagement)**

Practitioners should decide upon and implement an AFA in close collaboration with the client. The first step is to work with the client to determine whether an AFA would be effective for the particular matter(s), and which AFAs might work best. This type of collaboration provides an opportunity to develop the client's trust regardless of whether an AFA is eventually implemented; the attorney has the opportunity to listen to the client and learn about his or her business and legal needs and to educate and advise the client on various fee agreement options.

The second step is for the outside counsel to carefully draft a fee agreement in collaboration with the client. The agreement should address the client's needs and goals. It should also clearly define the scope of the representation, the details of the fee and how it is to be determined, and how the matter will be staffed.

### **Communication (Post-Engagement)**

After the representation has begun, the attorney should keep the client informed on the status and the budget.<sup>21</sup> Attorneys should consider a provision in the fee agreement that allows the parties to reassess the agreement at specified points during the representation and to allow for alterations in certain specified instances. This provides both the practitioner and the client with a "safety net" should the matter and the billing not play out as anticipated.

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<sup>21</sup> James A. Comodeca & Scott R. Everett, *Alternative Fee Arrangements: Risk Sharing Requires a Strong Partnership*, *The National Law Review* (May 3, 2010), <http://www.natlawreview.com/article/alternative-fee-arrangements-risk-sharing-requires-strong-partnership> ("[R]elationships created on alternative fee arrangements will only be successful if there is an open and honest dialogue between the parties.").

### **Specific Tips**

In addition to the general principles discussed above, the following specific issues should be considered when implementing AFAs:

- For blended rate agreements, consider a tiered system in which there is one rate for partners and one for associates. Some blended rate agreements contain even more narrow tiers, applying a separate rate for senior partners, junior partners, senior associates, and junior associates.
- For blended rate agreements, the attorney and client should agree upon and understand how the matter will be staffed and how work will be delegated to junior attorneys.
- For flat or fixed fees, consider a "collar fee" or "true-up" provision that would provide partial compensation in the event the actual fees are significantly above or below the agreed-upon fee.
- The fee agreement must allow the client to terminate the representation at any point without any penalty.

### **Conclusion**

Alternative fee arrangements are important tools in the current legal services marketplace, and are being used with increased frequency in the area of construction law. Although AFAs can present unique ethical issues, outside counsel who embrace the solutions to those issues are more likely to succeed in this environment. And in-house counsel who familiarize themselves with various kinds of AFAs and understand the ethical issues confronting outside counsel will be better equipped to structure such arrangements that benefit their employers in the long term.

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# **IMP Plumbing And Heating Corp. v. 317 East 34th Street, LLC et. al.**

By Gary Strong, Esq.

Contractors, subcontractors and material suppliers are granted by New York statute the right to file a mechanic's lien against the realty being improved to the extent of the work and labor performed and materials furnished. A mechanic's lien operates much like attachment and garnishment, to make sure that a subcontractor, for example, who supplies labor or materials for a construction project and does not have a contractual relationship with the owner of the property will receive the amount due to himself or herself. The mechanic's lien secures the amount due to the subcontractor by a lien on the real property improved. However, the rights of a subcontractor are derivative of the rights of the general contractor, and a subcontractor's lien must be satisfied out of any monies due and owing from the owner to the general contractor at the time the lien is filed. The subcontractor cannot enforce his lien if full payment has been made by the owner to the general contractor. One way in which an owner can pay a general contractor in full is to take credits against the amount owed to the contractor based on incomplete or defective work, commonly known as back charges.

In the recent case of *IMP Plumbing and Heating Corp. v 317 East 34th Street, LLC et. al.*, 89 A.D.3d 593 (1<sup>st</sup> Dep't 2011) a subcontractor sought to enforce a mechanic's lien where the owner claims that there are no monies due to the general contractor because of back charges against the general contract.

## **Background**

In 2008, IMP entered into a plumbing subcontract with a general contractor to perform work for the project owner, New York University, for the fixed sum of \$77,520. Shortly after IMP completed its work, NYU terminated the general contractor's contract, claiming that the contractor defaulted by failing to complete the work in accordance with the project's schedule. It was undisputed that at the time NYU defaulted the general contractor, it had only paid the contractor \$358,110 of the \$495,108 amount of the prime contract.

In the trial court, IMP moved for summary judgment foreclosing its subcontractor's lien. In doing so, IMP contended that it had established that it had completed its work, and that there was money remaining due to the general contractor on the prime contract. In opposition, NYU contended that as the result of back charges against the general contractor,

there was no money left owing to the general contractor.

## **Decision**

The trial court accepted IMP's arguments and granted its motion for summary judgment against the owner. On appeal, the trial court's determination was reversed. In doing so, the appellate court found that the trial court improperly failed to consider the merits of NYU's claim that the general contractor had breached the contract. This breach, if established at trial, could form a defense to NYU's payment of the amount outstanding on the prime contract. A subcontractor cannot enforce its lien against an owner where there are no monies due from the owner to the general contractor at the time the subcontractor's lien is filed.

## **Comment**

One way in which an owner may "pay" a general contractor is to deduct credits based upon back charges against the prime contract. Where an owner pays the general contractor in full (either by payment, by back charge credit, or through a combination of the two), an owner is generally not liable to a subcontractor. The theory is that the services performed by the subcontractor are for the benefit of the general contractor who is responsible for the completion of the improvement, not for the benefit of the owner. A mechanic's lien filed without delay increases the likelihood that the lien will attach to monies due and owing from the owner to the general contractor. Accordingly, the prudent subcontractor or material supplier should promptly file a mechanic's lien once it becomes clear that there is a problem with payment on the project.

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# Matter of K.S. Contracting Corp. v New York City Department of Design and Construction

By Gary Strong, Esq.

New York's competitive bidding statutes serve a dual purpose. The primary purpose is to benefit the taxpaying public by enabling government agencies to obtain the best price for public construction projects through open, competitive bidding. The secondary purpose is to assure that contractors are on an equal footing when bidding public works.

These statutes are designed to reject a contractor who is unqualified or whose bid is not responsive to the invitation to bid. The award must be made to the lowest responsible and responsive bidder. The factor most likely to cause problems in the bid selection process is responsiveness, as shown in the case of *Matter of K.S. Contracting Corp. v New York City Department of Design and Construction*, 2011 NY Slip Op. 32838U (N.Y. County, 2011).

## Background

In September of 2010, the DDC solicited bids for a general construction project to renovate the Bronx River Arts Center. The title of the solicitation referred to the work as general construction, and the contractor requirements specified that the contractor must have completed three similar projects in scope to the required work within the past five years. These requirements permitted the bidder to use the experience of its employees gained at different entities if the employee had a significant management role in the prior entity and had a significant management role in the bidding entity for at least six months prior to bid.

K.S. submitted a bid which ultimately turned out to be the low bid. In setting forth its experience, K.S. listed projects which involved primarily exterior renovation. K.S. also listed projects by other entities which involved its current employees. The DDC rejected K.S.'s bid, finding that it was not responsive to the solicitation. K.S. brought a lawsuit challenging the DDC's finding.

## Decision

The Court upheld the DDC's finding that K.S.'s bid was not responsive to the solicitation because of its failure to meet the project's experience

requirements. Specifically, the Court upheld the city's determination that because the project involved significant interior renovation work, K.S.'s exterior renovation projects were ineligible to be counted as experience sufficient to meet the bid's requirements. In doing so, the Court held that the city's listing of the project as a "general construction work" project, as opposed to a "major gut renovation work" did not require it accept exterior renovation experience as the equivalent of interior renovation experience. The Court also upheld the city's discounting of the experience of one of its employees because his previous position as a "Construction Project Manager" was not a significant managerial role.

## Comment

The determination of who is and who is not a responsive bidder depends on the exercise of discretion. If the municipality has a rational basis for determining that a bidder has not met the bid qualifications requirement, a court will uphold the discretionary determination of non-responsiveness.

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