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CONSTRUCTION LAW BRIEFING



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There must be a gang

Civil RICO convictions are no slam dunk

When cheated on a construction project, many victims are tempted to bring claims under the Racketeer Influenced and Corrupt Organizations Act (RICO). This is understandable because this federal law against organized crime permits the granting of triple damages and attorneys' fees to successful plaintiffs.

Seeking to discourage the wholesale filing of civil RICO claims, however, federal courts are issuing constant reminders that the successful pursuit of such a claim requires the presence of certain criteria. The recent decision in *Wickes Furniture v. Carpman*, a construction cheating case in a Chicago federal court, illustrates one decisive factor in particular.

Kickbacks and flooring

Wickes Furniture Company, headquartered in suburban Chicago, hired Ira Carpman in 1998 as construction manager for the Wickes expansion program in Illinois and California. Early in the new century, Carpman decided he would line his own pockets at the expense of his employer by hatching schemes with contractors on Wickes store construction projects in Illinois and California to overpay for

flooring work in the new stores and arranging kickbacks from the contractors involved.

Wickes claimed that four California stores were built with Carpman allowing substitution of cheaper materials than those specified but not getting any price reduction in connection with these substitutions. In addition, Wickes claimed, Carpman paid the flooring

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subcontractor directly for flooring materials, while also permitting the general contractor to include the price of the same materials in its invoices to Wickes, which Carpman approved for payment by Wickes.



Finally, Wickes claimed that Carpman allowed tenant build-outs in the California stores exceeding the value of the work letters from Wickes, with Carpman approving Wickes' payment of the additional build-out costs over the lives of the stores' leases. And, in connection with the construction of four stores in Illinois, Wickes claimed that Carpman paid the flooring subcontractor for supplying and warehousing basement or attic flooring stock and then authorized payment by Wickes a second time when the same flooring material was delivered to a new store and used to finish the floors there.

The judge's analysis

In his analysis of the motion by the defendants to dismiss Wickes' RICO claims, the district court judge acknowledged that the claims set out in the complaint by Wickes adequately alleged that Wickes had been defrauded in a scheme or schemes by Carpman, the general contractor and the flooring subcontractor.

Furthermore, the district judge determined that Wickes' complaint was sufficient to allege the predicate acts of mail and wire fraud, federal crimes required to bring the claims of Wickes within the coverage of civil RICO violations. This is because the bids, invoices, change orders and payment requests from the general contractor and subcontractor were delivered to Wickes by interstate courier service.

Yet, after weighing the detailed Wickes complaint against the requirements for pleading a civil RICO case, the district judge ultimately dismissed the RICO claims and sent Wickes' lawsuit down to state court for determination of the fraud and breach of fiduciary duty allegations against the defendants.

A missing ingredient

Repeating a refrain used over and over in court opinions rejecting civil RICO lawsuits for fraudulently obtaining payment on construction projects, the federal judge ruled that the Wickes complaint was missing one of the key ingredients of a civil RICO case: the existence of an organized gang that presents a long-term criminal threat to society. In other words, in a case where, for instance, a supplier gangs up with one or more of your employees to cheat your construction company, you probably wouldn't have a defensible RICO case unless the same gang of thieves was also cheating someone else.

We have all seen the movies and TV shows depicting the "mob wall" in the station house, complete with photos of gang leaders pinned up in an arrangement of an organizational chart with a leader, lieutenants and

soldiers carrying out the criminal activities of the enterprise. Unless your lawsuit can depict a similar ongoing gang, according to the *Wickes* opinion, including "reference to a system of governance, an administrative hierarchy, a joint planning committee, a board, a manager, a staff, headquarters, personnel having differentiated functions, a budget, records, or any other indicator of a legal or illegal enterprise," there will not likely be a federal case for triple damages and attorneys' fees under civil RICO.

BRINGING AN UNSUCCESSFUL CIVIL RICO CASE HAS ITS RISKS

In a lawsuit seeking damages for fraud, the temptation is great to include a civil claim under the Racketeer Influenced and Corrupt Organizations Act (RICO). After all, triple damages and attorneys' fees are in the offing. But there are risks to doing so.

The greater the accumulation of judicial opinions dismissing such claims, like the one in *Wickes Furniture v. Carpman* (see main article), the greater the risk that a judge dismissing your RICO claim will conclude that it was presented in bad faith.

If that happens, Rule 11 of the Federal Rules of Civil Procedure permits the judge to compel you to pay the other side's attorneys' fees incurred in preparing and presenting its motion to dismiss or motion for summary judgment against your RICO allegations. So you don't merely lose the gamble of collecting three times your losses — you end up *paying* the other side's lawyer. Most of the time, this risk isn't worth the long shot of pursuing the pot of gold at the end of the RICO rainbow.

More than cheating

History is full of examples of mob involvement in the activities of the construction industry. But, unless you can point to clear evidence that you were cheated by an organized gang of criminals who have also cheated other victims on other construction projects, you're unlikely to make a successful federal case out of your unfortunate situation. *T*

Prove it or lose it

Surety required to substantiate bond losses

Contractors that bid on public construction projects are required to post performance and payment bonds insuring that the work will be completed and suppliers and subcontractors will be fully paid for their participation. Of course, in order to get an insurer to underwrite such a bond, the construction business and its owners have to sign an indemnification agreement promising to repay any losses and expenses incurred should the surety have to complete work or pay for labor or materials under the bond's terms.

Reported cases litigated over the terms of these indemnification agreements are as rare as diamonds the size of your fist because, when the surety is called upon by an owner to pay claims or finish work on a project, it's almost always because the bonded construction business has failed and is either out of business or in bankruptcy.

In such circumstances, it's hardly worthwhile for the insurance company writing the bond to pursue its claims under the indemnification. When the owners of the contracting business have financial means other than the assets of the contractor, however, bonding companies may pursue collection



Centennial presented a number of conflicting spreadsheets summarizing its damage claims, so the judge ruled Centennial would have to have a trial on the issue of damages.

under the indemnity agreement. Such was the case in New Jersey recently in *Centennial Insurance v. Horizon Contracting*.

3 strikes and you're sued

Horizon Contracting Company defaulted on three different public construction projects bonded by Centennial Insurance Company and, after paying claims to the public owners, Centennial sued Horizon's owners under their indemnification agreement. The owners defended the lawsuit by contending that Centennial had breached its obligation of good faith and fair dealing under the indemnification contract when it asked a subcontractor if the sub would stay on the job after Horizon's contract was terminated by the government.

Horizon's owners contended that this conversation was evidence of a conspiracy between the government and Centennial to terminate Horizon. Horizon's owners also argued that Centennial was at fault for failing to investigate and assert the defenses Horizon had against the government's termination of Horizon's contract.

A judge unimpressed

The federal judge in New Jersey was unimpressed by these arguments, and ruled that the indemnification agreement between Horizon's owners and Centennial required Horizon's owners to reimburse Centennial for all losses resulting from claims against the Centennial bonds. The judge ruled that, because Horizon's owners had refused to take advantage of their right under the indemnification agreement to post collateral with Centennial and direct it to raise Horizon's defenses to the government claims, Centennial was entitled to summary judgment of liability in its favor

and against Horizon's owners under the indemnification agreement.

The judge also ruled, however, that Horizon's owners were entitled to put Centennial to its proof as to the amount of the losses it had actually suffered on the bond claims, and she refused to grant Centennial summary judgment for the total of its payments to the government. She ruled that Horizon's owners were entitled:

- ✓ To a chance to show whether Centennial had collected from the government the contract balances which would have been due to Horizon under the completed contracts, and
- ✓ To offset those balances against the total of Centennial's payments to the government.

When Centennial presented a number of conflicting spreadsheets summarizing its damage claims, the judge ruled Centennial would have to have a trial on the issue of damages, where evidence of checks issued by Centennial and payments Centennial received from the government would be received in order to determine how much Horizon's owners really owed under their indemnity agreement.

Paperwork makes the difference

Disputes like this demonstrate why it is important for all parties involved in construction projects to maintain organized files of carefully preserved documents such as invoices and canceled checks until all disputes respecting a project have been fully resolved. Although few people enjoy doing paperwork, it's often the many forms and documents involved in a disputed project that make the difference in court. *T*

Fill in the blank: The dangers of preprinted legal docs

Contractors often seek to keep attorneys' fees in line by using preprinted forms for seemingly administrative activities such as collecting payments from project owners and filing mechanics' lien claims. Reliance on such preprinted legal forms without consulting a knowledgeable construction lawyer can prove costly, as illustrated by the recent Kansas case *Buchanan v. Overlay*.

From building to bankruptcy

Mr. and Mrs. Overlay hired contractor Douglas Buchanan to build a new house for them in Wichita. After most of the work was done, the Overleys began complaining about the quality of the workmanship, and they stopped paying Buchanan.

In turn, Buchanan filed a mechanics' lien statement, proceeded to arbitration of his claim and obtained an award on the contract. When the Overleys did not pay the arbitration award, Buchanan had the award confirmed as a judgment in the trial court, and the Overleys filed bankruptcy to thwart collection by Buchanan.

In the bankruptcy case, the parties agreed to lift the stay of bankruptcy so Buchanan could sue to foreclose his mechanics' lien, and Buchanan filed the foreclosure action. The Overleys defended the foreclosure lawsuit — Buchanan's only remedy for collecting the debt at this point — by contending that his lien notice was defective because it did not contain a verification of his name and address for service of process as required by the Kansas lien laws in effect when the form was recorded.

Address not found

The lien notice filed by Buchanan consisted of a preprinted, notarized form summarizing his claim, with attached invoices from suppliers and subcontractors detailing the cost of materials and labor they provided to the project.

In its ruling, the Kansas Court of Appeals noted that using such attached invoices was a perfectly proper way of documenting project costs, and that the total stated in the notarized lien notice form was fully supported by the attached invoices. However, the court ruled that, even though a number of the

attachments did set out Buchanan's address, which would have been sufficient for service of process on him, the notarized lien notice form did *not* set forth Buchanan's address for service of process as required by Kansas lien law.

Accordingly, because of his failure to follow the formalities of the lien law, the Court of Appeals reversed the judgment of lien foreclosure that had favored Buchanan. And, because of the Overleys'

bankruptcy, Buchanan lost out on the ability to collect the \$49,285.63 owed on his notice of lien.

Penny wise, form foolish

This case is a clear example of a contractor being penny wise but form foolish. In an effort to save the moderate fee it might have cost to have an experienced construction lawyer prepare proper lien documents, Buchanan wound up costing himself any legal recourse he might have had against an owner who refused to pay up. *T*

Failure to negotiate dooms damage limitation clause

Becoming commonplace across the construction industry are boilerplate professional service contracts, in which architects and engineers insert clauses limiting their liability for professional errors and omissions to the amount of their fees under the contract.



But the ability to enforce these provisions when a professional error or omission causes losses substantially exceeding that professional fee varies from state to state. A recent California case, *Greenwood v. Murphy*,

illustrates one sticking point regarding this matter — a failure to negotiate.

Plans are prepared

Peter Greenwood, an architect and civil engineer, does business in California as Artek Design Group. Craig Murphy was expanding and remodeling a house in Larkspur, California, and Artek prepared plans for the revisions.

Later on, Artek and Murphy verbally agreed that Artek would prepare plans for construction on some property Murphy owned in Mill Valley, Calif. Murphy and Greenwood signed a written agreement respecting Artek's services for the Mill Valley project, which contained a preprinted clause limiting Artek's liability for errors and omissions to "the Fee or \$1,000.00, whichever is less."

Greenwood promised to finish the Mill Valley plans in two weeks, and he knew Murphy was pressed for time because of the high interest cost on his loans for the Mill Valley project. Delays in completion of the final plans for the Mill Valley property caused a 16-month delay in issuance of an occupancy permit, and Murphy sued Artek for the additional interest he had to pay on the outstanding loans during the delay period.

What the court learned

When the case went to court, Greenwood defended with the assertion that, despite increased loan charges of \$85,250.06 caused by Greenwood's delay in completing the plans, Murphy was

limited by the terms of the contract to \$1,000 in damages for his losses.

The court ruled that the damage limitation clause would be enforceable under California law, but only if it was actually bargained for between parties of relatively equal economic power. The court, however, learned that the written contract was presented to Murphy by Greenwood only after the Mill Valley building inspector had failed to appear to inspect reinforcing bar placement in the foundation before concrete was poured under Greenwood's direct supervision. Seizing upon this circumstance, Greenwood had forced Murphy to sign the document as presented under the threat that Greenwood would refuse to sign off on the

foundation work, further delaying occupancy of the completed house.

Under these circumstances, the court ruled, the damage limitation was forced on Murphy, rather than bargained for by him, and it would not be enforced. The California Court of Appeal affirmed the trial judge's refusal to enforce the damage limitation, and approved the award of \$85,250.06 in favor of Murphy for the increased interest cost during the period of delay in completing the plans.

Now *that's* bargaining power

As this case demonstrates, bargaining often has a legal power all its own. After all, if an agreement is signed under duress, it's not really an agreement at all. **7**

Construction Law Quickcase

Roofers Edge v. Standard Building **Existential defense costs general contractor dearly**

As lines of credit tighten, payment squabbles between general contractors and subcontractors become all the more likely. And parties who find themselves unable to fulfill their payment responsibilities may turn to desperate, sometimes even bizarre, measures to escape their obligations.

Standard Building Co. Inc. was the general contractor on a project in Georgia. Standard accepted a \$37,500 bid from Roofers Edge for the metal roof installation work on the job. Roofers Edge performed the work and billed Standard for the full amount, but Standard was either unable or unwilling to pay the bill.

Consequently, Roofers Edge filed a lawsuit to collect the \$37,500, and Standard filed an answer denying it had contracted with Roofers Edge for the work. Furthermore, Standard denied that Roofers Edge had performed the work. In closing argument at trial, however, Standard did admit to owing Roofers Edge \$37,500 but contended that Standard was owed an unspecified setoff. The jury awarded Roofers Edge \$36,350.85 in damages for nonpayment plus \$44,287.17 in attorneys' fees for bad faith denial of both the existence of the contract and the performance of the work.

On appeal to the Court of Appeals of Georgia, Standard argued the fee award was unjustified because its mere refusal to pay does not constitute bad faith. The Court of Appeals ruled the fee award was, in fact, justified based on the unwarranted denial of the existence of the subcontract and performance of the work.

Ultimately, Standard's "existential" defense and delaying tactics cost it more than twice what paying for the work in the first place would have.

