

# news letter

## issue highlights

Volume XIV, Issue 2, Fall 2004

### articles

- 1 Accidental Deaths and Injuries in the Workplace**
- 3 A Way Out of Foreign Courts?**
- 6 Insurance and Indemnity on Construction Projects: A Look at California Practice**
- 10 How to Avoid Claims Under the Federal Labor Standards Act**

### case notes

- 5 Second Circuit Pummels Performance Sureties on Brazilian Petro-Fiasco**
- 8 New Jersey Courts Adopt Federal Government Escape Clause**
- 9 Reach of New Jersey Trust Fund Act Extended to Consultants**
- 11 Failure to Strictly Follow the Plans and Specifications: Two New York Courts Express Their Views**

### bulletins

- 12 Groundbreaking Women in Construction/ Florida Partner Appointed**

## Accidental Deaths and Injuries in the Workplace: More Than Just Paying Fines

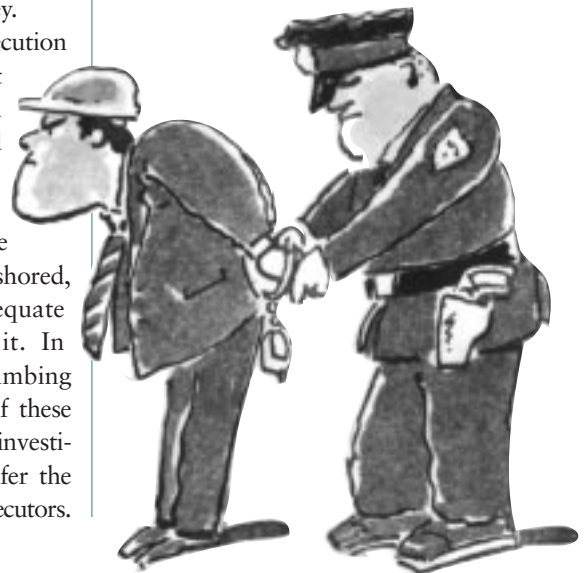
**H**undreds of workers die each year and thousands more are injured as a result of unsafe working environments. According to a *New York Times* survey, the United States Occupational Safety and Health Administration (OSHA) has investigated 1,242 death cases over the last 20 years and found, shockingly, that only 196 incidents were referred to federal or state prosecutors. Of the referred cases, only 81 resulted in convictions, with a paltry 16 actual jail sentences.

In New York and New Jersey, 716 people were killed on the job in 2001 and 2002. OSHA recommended prosecution in only three of those cases. In Florida, 722 workers died as a result of job site related injuries during that same time period, while in California, 993 workers were killed on the job in 2001 and 2002. Prosecution rates in those states are similar to those in New York and New Jersey.

A typical example of lax prosecution standards is illustrated by a recent case in Ohio. In June 2002, a plumber's apprentice was buried alive while working in a 10-foot-deep sewer pipe trench. Federal law requires walls of trenches that are five or more feet deep to be sloped or shored, or the trench must have an adequate metal safety box installed in it. In this case, the employer, a plumbing contractor, failed to follow any of these safety procedures. While OSHA investigated the case, it chose not to refer the matter either to federal or state prosecutors.

Currently, under federal law, it is a misdemeanor to commit safety violations that result in worker death. The maximum penalty is six months in jail, along with a \$500,000 fine. However, most cases do not even reach the courts because of workers' compensation plans. In order for OSHA to refer a case to prosecutors, it must determine that a

ILLUSTRATIONS: LIAM ROBERTS



party willfully committed the offensive act. “Willfully” means that the act was intentional or that the party demonstrated a complete indifference to safety regulations. To protect business owners, OSHA created a less serious category of wrongdoing called “unclassified.” Most owners, such as the plumber described above, are able to avoid prosecution by using this category as an escape clause.

But be forewarned. These statistics are likely to change in the near future due to a recent push on both the federal and state levels for more stringent enforcement of safety regulations, and harsher penalties for convicted parties. Project owners, contractors, supervisors and even foremen should be mindful of the changing laws and the new zeal to prosecute offending individuals.

For example, Senator Jon Corzine of New Jersey is proposing legislation that raises the maximum jail time for convicted parties from six months to 10 years. New York City (Manhattan) District Attorney Robert Morgenthau is also promoting legislation that increases the jail time for convicted parties to 15 years.

Not surprisingly, California is the pioneering state with regard to more stringent enforcement, and is also one of the 21 states that have their own OSHA guidelines. Recently, two California dairy farm workers drowned in a sump hole that had been negligently maintained by the owner and manager of the farm. A local prosecutor aggressively pursued justice for the families of the victims in this tragic case, and persuaded a grand jury to indict the farm manager for involuntary manslaughter, as well as level felony counts against both the manager and owner for failing to meet worker safety requirements. A felony is punishable under California law by a jail sentence of up to three years, plus a \$1.5 million fine.

In May 2003, the New Jersey Supreme Court overruled a lower court opinion dismissing a willful death claim. The case involved a worker who fell into a defective sand hopper and suffocated. The court ruled that the test for willful misconduct is twofold: the act or omission must produce substantial certainty that injury or death will result; and workers’ compensation coverage does not provide the victim and/or the family with an adequate remedy.

Prosecutors have begun to pursue not only owners, but also contractors, subcontractors, and even project supervisors and foremen. As a result of these recent initiatives, all in addition to the overriding need to avoid casualties, contractors must be aware of safety standards and be prepared to aggressively enforce them on the job. Measures should include:

- Developing comprehensive safety programs
- Safety programs that incorporate frequent safety meetings and periodic worksite inspections
- OSHA regulations that should be posted and followed at all times
- Documentation of all safety endeavors

In sum, contractors should no longer expect to easily avoid liability when they fail to provide their employees with safe working environments. Prosecutors are more aggressively pursuing offenders of OSHA safety regulations, and legislators are striving to increase the penalties for convicted offenders. The bottom line is not only to know safety standards but to make sure that they are followed! ⚙️



# A Way Out of Foreign Courts?

**M**ore and more contractors are looking to international work to supplement and at times supplant domestic work. While playing on the larger international stage may provide access to more profitable projects, such dealings provide exposure to more risk.

Aggressive risk management and attention to the inherent risks of international work are critical to profitable international projects. But what about the risks that disputes may not be resolved in a fair and unbiased manner? Can a contractor be certain that the hard work of risk mitigation and management is not lost through the application of a biased dispute resolution procedure?

International arbitration is the traditional method of resolving disputes related to international construction projects. Arbitration rules and administration are provided by any number of centers dedicated to the resolution of international disputes. Whether arbitration is administered by the International Chamber of Commerce, the International Centre for Dispute Resolution or other similar international organizations, while certainly not assured of a favorable result, a contractor is generally assured of an unbiased hearing. However, what if the foreign owner refuses to submit to such international arbitration and insists, as a condition of the contract documents, to resolve all disputes in the courts of that foreign jurisdiction? And, furthermore, what if that foreign owner is the govern-

ment that controls the local courts, or at the very least appoints the judges to the local courts? Can a contractor avoid those local courts and get a fair hearing? The simple answer is: maybe.

The International Centre for Settlement of Investment Disputes (ICSID) was established by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the Convention) sponsored by the World Bank. The Centre, came into force when the Convention



biased, court system, thereby encouraging more foreign investment. It remains today an independent international organization with close ties to the World Bank.

The jurisdiction of the Centre is stated in Article 25 of the Convention as follows:

The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that state) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally.<sup>2</sup>

**International arbitration is the traditional method of resolving disputes related to international construction projects.**

was ratified by 20 countries.<sup>1</sup> The Centre was established as an independent means of resolving investment disputes through binding neutral arbitration proceedings, eliminating the risk of exposure to a local, potentially

biased, court system, thereby encouraging more foreign investment. It remains today an independent international organization with close ties to the World Bank. From the above, it is clear that there are several requirements to utilize the Centre to resolve disputes. First, the dispute must arise "directly out of an investment." Second, the dispute must be between a



Contracting State (i.e., a state that has ratified the Convention) and a national of another contracting state. Third, the parties to the dispute must have consented in writing to submit the dispute to the Centre. If the parties are deemed to have consented to submit the dispute to the Centre, they are deemed to have submitted to the exclusive jurisdiction of the Centre unless otherwise stated.<sup>3</sup> Hence, once within the jurisdiction of the Centre,

there is little likelihood of competing actions in local courts.<sup>4</sup>

Disputes as to the jurisdiction of the Centre can and do arise on each of these three requirements and often encompass the first stage of the proceedings.<sup>5</sup> Often the question of whether a particular dispute arises out of an “investment” can be a significant issue for a contractor’s claim. Unfortunately, no universal approach can be cited as the determination of

simple contractual or commercial agreement falling outside such jurisdiction.

While the second requirement may appear to be quite straightforward (that the dispute must be between a Contracting State and the national of another Contracting State), it is not always so. It is, of course, easy to determine the Contracting States. However, oftentimes agreements are reached with political subdivisions or agencies of the Contracting State.

<sup>1</sup>As of November 2003, 154 countries have ratified the Convention. See [www.worldbank.org/icsid](http://www.worldbank.org/icsid).

<sup>2</sup>Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, art. 25, 575 UNITS 159, 4 ILM 524 (1966), 60 AJIL 892 (1966).

<sup>3</sup>Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, art. 26.

<sup>4</sup>It is possible, however, for consent to be given to a limited class of disputes, allowing for other related disputes between the parties to fall outside of the jurisdiction of the Centre and therefore, be the subject of parallel proceedings in other forums. See, e.g., *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, (ICSID Case No. ARB/01/13).

<sup>5</sup>Under the Convention, objections to the jurisdiction of the Centre and/or

the arbitral panel appointed pursuant thereto are to be decided by the arbitral panel itself. See Convention Article 42.

<sup>6</sup>See Convention Article 25.

<sup>7</sup>For example, the Treaty Between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment entered into force on October 20, 1994, 1991 WL 701302, provides that the Contracting State must consent to submission of a dispute to the Centre at the election of the investor. This consent could override the dispute procedure included in a specific agreement between the parties.

<sup>8</sup>Again, not surprisingly, the BITs may contain language that is less than clear as to the terms and conditions of consent to the jurisdiction of the Centre, and must be analyzed specifically in relation to the project at hand.

<sup>9</sup>News from ICSID, Vol. 20, No.1 (2003), see at: [www.worldbank.org/icsid/news/news\\_20-1.pdf](http://www.worldbank.org/icsid/news/news_20-1.pdf).

In such instances, the jurisdiction of the Centre will depend upon whether the Contracting State has designated that subdivision or agency as bound by the Convention.<sup>6</sup> It is not sufficient to assume that simply because an agency appears to be a part or subdivision of the national government and therefore the Contracting State that it is subject to the jurisdiction of the Centre. Here again, the BITs play an important role in determining what consent has been designated to the Centre.

The third requirement, not surprisingly, is also not as direct as one might initially believe. Although written consent of a Contracting State must be given, such consent is often not given in the parties' agreements (otherwise, it is unlikely to spark a jurisdictional challenge) but may be found in the BIT entered into between the Contracting State and the state of the investor.<sup>7</sup> If the applicable BIT does provide the necessary consent, it will likely override the dispute procedure (such as local court jurisdiction) provided for in the agreement between the parties. Hence, a close review of the ICSID rules, prior case rulings and the applicable BIT can be invaluable in determining whether one is restricted to a local and thus unfamiliar court proceeding or may invoke international arbitration.<sup>8</sup>

The relatively narrow jurisdiction of the Centre has kept the number of disputes submitted to the Centre for resolution to a minimum. To date, there have been only 156 cases submitted since the establishment of the Centre in 1966. The trend, however, is on the increase, as 15 new cases were submitted in the first half of 2003 alone.<sup>9</sup> No doubt this trend will continue as investors, and contractors, look to this valuable tool for fair resolution of international disputes. At a minimum, contractors entering into agreements with foreign governmental entities are well advised to assess the likely jurisdiction of the Centre in their particular circumstances (and thus the likelihood of avoiding potentially unfavorable local proceedings) in advance of the occurrence of a dispute. ❁

# Second Circuit Pummels Performance Sureties on Brazilian Petro-Fiasco

*USF&G v. Brasperstro Oil Services Co., et al (2d Cir. 2004).*

**E**mploying often scathing language, the United States Court of Appeals for the Second Circuit recently upheld the majority of an over \$370 million verdict against performance bond sureties USF&G and American Home Assurance Company (the Sureties). As the Court of Appeals noted, this long-litigated case has been hailed as “perhaps the most important in the field of surety law in several decades and as having [redefined] the ground rules . . . for surety companies.”

The case arose from the construction of two offshore oil and natural gas production facilities, with lump-sum, turnkey, engineering procurement and construction (EPC) contracts collectively valued in excess of \$328 million. Using industry standard AIA A312 performance bonds (governed by New York state law), and having collected premiums in excess of \$7 million, the Sureties guaranteed the EPC contractors' performance obligations to the Owner and its lenders. The projects quickly went south and ultimately went hundreds of millions over budget.

At trial and on appeal, the Sureties argued that their bond obligations were excused for a variety of reasons, including that the Owner's having made advance payments to the Contractor to keep it afloat constituted an unconsented to change in the guaranteed contract. In rejecting this argument, the Second Circuit found that the Sureties knew of and implicitly consented to the payments and that they were nevertheless necessary to mitigate the damages to which the Owner, the Contractor and the Sureties were exposed. Most fundamentally, the court found that “the direct and advance payments

[made by the Owner to the Contractor] were used for the sole purpose of completing the Contracts,” and thus, could not have prejudiced the Sureties since they would have been obligated to complete the Projects and incur these costs regardless.

Significantly, the Second Circuit repeatedly noted with disapproval the Sureties negotiating tactic of threatening to grind the Projects to a halt for months while it investigated, should the Owner declare the Contractor to be in default, noting that it “stretched the definition of ‘good faith and fair dealing’ [implied in all contracts] to the limits.” Quoting the trial court, the Second Circuit found that “[t]he Sureties only made a token effort to explore the possibility of taking over the Contracts[;] . . . did not seriously pursue the option of bringing in a replacement contractor [; and] . . . did not set about conducting any good faith investigation of their options under the Performance Bonds[,] but rather continued their efforts to prepare for litigation and to develop litigation positions while characterizing their activities as [an] ‘investigation.’”

Despite its scathing findings and its upholding of in excess of \$250 million of the trial court's award, the Second Circuit did overturn nearly \$100 million of the award for liquidated damages and attorneys' fees, finding these awards improper under the provisions of the contracts and under New York law. ❁

## EDITOR'S NOTE:

**While this case will be very useful in getting sureties to meet their performance bond obligations, it also, in part, explains why the surety market is contracting so dramatically.**

# Insurance and Indemnity on Construction Projects: A Look at California Insurance Law and Practice

**R**isk managers for construction project participants should have a thorough knowledge of insurance coverage and an understanding of indemnity issues in order to protect their companies' rights and interests. While construction

disputes are frequent, they are rarely about principles or ideals: monetary recovery or the avoidance of payment claims usually is the driving force behind these disputes. With the bottom line as the paramount concern, contractors and owners look for insurance coverage or indemnity. Indemnity is the obligation imposed on a party by contract or law to pay losses incurred by another party. Often, both insurance and indemnity play a part.

Therefore, it is critical that construction risk managers become acquainted with the key issues in insurance and indemnity, and know where to look for answers to the more complicated questions. Being aware of the types of insurance available is absolutely required. And when litigation arises, as it all too frequently does, risk managers must understand the duties of an insurer to defend an action and compensate the insured in the event of a loss, as well as the obligations of other parties to provide insurance and/or indemnity for that loss. This article will explore these three critical elements and examine how they have been interpreted under California law.

## Key Insurance Issues in Construction

### The Purchase of Insurance

The question of whether to buy, if that is a choice, is easily answered. The simple and honest answer is yes. Chances are you will need it. If you can't afford it, you probably should not be doing the work. Buy the best

coverage you can afford and look to pass on the cost, if possible.

More than likely, however, there will be no choice about whether or what to buy. In most situations, the construction contract sets forth the specific insurance obligations and indemnity provisions required for that project. Construction contracts often provide that the general contractor and subcontractors must have general liability policies, with stated policy limits, and name the owner as an "additional insured" on those policies. The additional insured endorsements are required because the owner and/or contractor wants to secure the protection of the contractual indemnity/hold harm-less clauses of

easy: simply maintain the policy, all endorsements and amendments that the insurer provides to you. For coverage that is provided by another party, the party that is afforded the protection of an additional insured endorsement must insist on the receipt of that endorsement (or a certificate of insurance from a licensed agent that states that the coverage exists), obtain a copy of the insurance policy and keep both in a safe place for long after the work has been completed.

### The Insuring Agreement

At the heart of every policy of insurance is the "insuring agreement." This language sets out the promise of the insurer to provide coverage to the insured as specified in the policy of insurance, and the exceptions or exclusions to such coverage. Usually the insuring agreement provides for coverage when the insured becomes "legally obligated" to pay as damages because of

**Indemnity is the obligation imposed on a party by contract or law to pay losses incurred by another party. Often, both insurance and indemnity play a part.**

the contract or subcontract. Without the protection of the additional insured endorsement, the indemnity agreement may be an "empty promise" in the event that the indemnitor files for bankruptcy protection or has such a large self-insured retention or deductible that it is unable to pay for the loss.

However, it is not just the purchase of the insurance that is critical but also the preservation of the evidence of that insurance. With first-party coverage, it is

"bodily injury" or "property damage" caused by an "occurrence."

Often, insurance carriers are reluctant to pay even valid claims against the policy. As such, the insurer may object to coverage and reserve all rights pending an investigation into the loss and a determination as to whether coverage exists, or has been excluded or waived by some act of the insured. The most common objections to coverage raised by insurers are:

- *This is a breach of contract action, not a negligence claim*—However, California courts have ruled that if a policy covers damages due to property damage, then there should be coverage regardless of how the claim is framed.
- *There is no property damage*—California courts have ruled that there is coverage even if the property suffers only “submicroscopic damage,” which has not caused substantial harm to other component parts of the structure. In addition, property damage may simply be a diminution in value, or a loss of use of the tangible property, or

pleted work of others and completed work performed on behalf of the insured by subcontractors.

- *The real damage is caused by the repair*—Damage to the work of others, even during the repair of defective work, is usually covered under the policies.
- *There has been no loss of use of the property*—The “impaired property exclusion” does protect the insurer to a large extent in most circumstances. If there has been loss of use, however, because of a sudden or accidental physical injury to the insured’s work, then the exclusion does

## An insurer’s obligation to defend arises at the time of the tender of defense.

bodily injury such as emotional distress involving physical injury.

- *There was no occurrence triggering coverage*—Policies now define an *occurrence* as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions”. This is much broader than the earlier definitions that limited coverage to only sudden incidents or events. As long as the damage is the result of an accidental event, i.e., not an expected or intended act, then coverage exists.
- *There was no legal obligation to pay*—If the payment is a result of a claim from a third party, the insurer must pay the damages.
- *It’s not our policy; it’s theirs*—California has adopted the “continuous trigger” theory, meaning that all insurers that issued policies that were effective during the period when damage potentially occurred must be available to defend an action and offer indemnity.
- *It is your work product*—This exclusion is designed to protect the insurer from paying for repair of the work of the contractor/insured. It is true that an insurer is not obligated to repair a contractor’s defective work, and that it is the contractor’s responsibility to perform the work in a workmanlike manner. In most current policies, however, the form language provides that work performed on behalf of the insured is covered. The effect of that language is that there will be coverage for the com-

not apply. For instance, if a crane fell in front of the main entrance to the project, there should be coverage.

- *The property has been ‘alienated’ by the insured*—In most construction defect cases involving mass production, the property has been sold. The courts have stated that this exclusion was not intended to apply to the work of a contractor on works for resale. Also, this exclusion does not apply to a contractor that never owned the project in question.
- *The loss relates to liability assumed under a contract*—Liability policies do typically exclude coverage for liability assumed under a contract, such as in an indemnity clause. But if it is an “insured contract”—and a subcontractor’s agreement to indemnify a developer against claims arising from the subcontractor’s work is defined as an insured contract,—then there is coverage for defense costs and indemnity.

### Types of Insurance and Indemnity Provisions

With respect to all insurance products relating to construction, one should initially draw the distinction between first-party and third-party products. An insurance product that provides coverage for claims by the insured for a loss suffered is first-party insurance. A policy that provides coverage for liability claims by third parties against the insured is third-party insurance.

### General Liability Policies

This type of insurance protects an insured from liability claims by third parties for defective work. This is the classic third party insurance policy that is at issue in almost all disputes regarding defective work. These policies typically provide both an obligation to defend and indemnify the insured for a covered loss. The duties are triggered by an “occurrence” causing “property damage” during the policy period.

### Builders’ Risk Policies

These first-party products usually insures an owner against all perils—such as fire, flood, or theft—during construction. Although typically purchased by the builder, the coverage inures to the benefit of the owner.

### Homeowners’ Policies

These policies typically provide both first-party and third-party coverage; first-party coverage for damage to your home from the covered perils as well as coverage for claims by third parties for accidents or injuries that occur at the covered premises.

### Workers’ Compensation Policies

These policies protect a contractor or subcontractor from claims by injured workers at a project.

### Professional Liability Policies or Errors and Omissions Coverage

Architects and engineers obtain this third-party coverage to protect them from liability for their professional negligence in connection with the design of a construction project. Like general liability policies, this coverage typically provides both a defense and an indemnification obligation. Unlike general liability insurance, however, these policies usually only cover “claims made” during the policy period, not claims for an “occurrence” during the policy period.

In most instances, the parties also will include indemnity provisions in the contracts that govern performance relating to a construction project. According to one California court’s analysis, the most common types of indemnity provisions are as follows:

Type I: This clause provides for indemnity for a party’s own negligence, both its sole and concurrent negligence. By law in California, however, a party cannot be indemnified for its sole negligence or willful misconduct. However, this does not prevent an owner and another party from negotiating a contract on a private work of improvement in which they allocate the risks

between them for design defects or claims arising from the construction contract.

Type II: This clause provides for indemnity for the actor's negligence and also for the covered party's "concurrent passive negligence," but not for the covered party's "active negligence." Usually, this clause works to reverse the effect of vicarious liability and to transfer liability back to the party at fault. An example of this would be a subcontractor's unsafe working conditions that have caused physical harm to a third party or property damage. The general contractor may be liable on a passive basis, but would be entitled to indemnity from the subcontractor.

Type III: This clause provides for indemnity arising out of the indemnitor's negligence but does not apply if anyone other than the indemnitor is liable. Any negligence by the indemnitee would bar recovery under this clause.

Obviously, the lines that separate these indemnity categories are a bit fuzzy. In addition, courts are not strictly bound by these categories. The application of any indemnity provision depends on the interpretation of the contract as a whole and the intent of the parties. The specific language used will be crucial to the court's interpretation and enforcement.

A party entitled to contractual indemnity should always demand that the indemnifying party provide a legal defense to any

claim. Under California law, all indemnity provisions require that a legal defense be provided, even if the contract does not specify it. The duty to defend—unlike the duty to defend under an insurance contract—only arises, however, after there is a determination that the indemnitor was negligent. The party entitled to defense will receive repayment only after such determination but will not counsel to defend while the case is pending.

### The Insurer's Duties—Defense and Indemnification

There is a wide gap between an insurer's obligation to defend against a claim versus the insurer's obligation to provide indemnity for a loss. Defense entails paying for legal fees and costs of an action. Indemnification means paying for the actual loss.

Any potential for coverage under a policy will trigger the duty to defend. A duty to defend also arises if there is an ambiguity in the policy regarding the scope of the coverage. Coverage may also exist when a contractor has asserted a claim for monies owed and is then faced with a claim of setoff for defective work.

An insurer's obligation to defend arises at the time of the tender of defense. If an insurer contests the obligation to defend, then the insurer can file a declaratory relief action to determine whether there is an obligation to defend. The insurer cannot, however, in the declaratory relief action,

force the insured to admit factual issues that may adversely prejudice the insured in the underlying action. Because of the detriment that may be caused to the rights of the insured when factual issues arise in the declaratory relief action that relate to the underlying action, the insured may be entitled to a stay of the declaratory relief action during the pendency of the underlying action.

If an insurer refuses to defend an action that is potentially covered under its policy, then the insurer may be subject to bad faith liability, including punitive damages.

### Conclusion

This article is a brief review of the many concepts that are central to an analysis of insurance and indemnity claims that arise on construction projects. Future articles will deal with these issues in more depth and examine current trends such as the increasing use of owner and contractor controlled insurance programs on large-sized projects. In addition, it should be remembered that this article relies exclusively on how California court cases and statutes affect these concepts. ⚙



**John D. Hanover** recently joined Peckar & Abramson as a partner in our Los Angeles office.

# New Jersey Courts Adopt Federal Government Escape Clause

## *Capital Safety, Inc. v. State of New Jersey, Division of Building and Construction*

**I**n this case, an appellate court ruled that a state agency, the Division of Building and Construction (the DBC), now known as the Division of Property Management and Construction, did not breach a contract by exercising a "termination for convenience"

provision. The contract was for asbestos removal from four floors of a state office building that housed employees of the Department of Labor (DOL). In the interest of safety, DOL employees were relocated, one floor at a time, as the contractor, Capital Safety, Inc. (Capital) performed the

work. Capital successfully removed the asbestos from the first and second floors, but then the DBC suspended the work because employees on the remaining floors could not be relocated.

Capital submitted a claim for damages incurred as a result of the suspension. The

DBC and Capital then entered into a supplemental agreement for the balance of the work, under which the DBC agreed to pay Capital \$150,000 as full compensation for damages incurred as a result of the suspension. The supplemental agreement also provided the DBC with the right to terminate the contract for convenience if Capital could no longer perform its duties, or if termination was in the public interest.

After Capital removed asbestos from the fourth floor, the DBC was unable to

**continued on page 12**

# Reach of Trust Fund Act Extended to Consultants

***Reliance Insurance Co. v. The Lott Group, Inc.***

**A** general contractor on public projects in New Jersey, The Lott Group, Inc. (Lott) obtained surety bonds from Reliance Insurance Company (Reliance), on three public projects pursuant to the New Jersey Public Bond Act. The individual principals of Lott had previously executed an indemnity agreement with Reliance. After the projects commenced, Lott began to experience financial difficulties, and could not pay for labor, materials and other project costs. Claims were made against the bonds, and one of the principals, Frank Lott sought financial

Cucinotti's solely owned management company for troubled businesses. Cucinotti was aware that Lott's projects were public and paid for out of public funds, but did not alert Reliance about the money in the DRG account. Cucinotti then used the funds in the DRG account to make payment for other than the bonded obligations, including \$300,000 that was transferred to a construction company also owned by Cucinotti.

that he and his companies were outside the scope of the act because they were not parties to the original construction contracts with the public entities. At a motion at the trial level, the court found that Cucinotti and his companies were liable.

On appeal, the appellate court noted that the purpose of the act was to protect those who have claims for labor material and other charges incurred in fulfilling the contract between the governmental body and the contractor. The court also noted that while the act was not explicit as to the extent of its coverage, that a duty existed throughout the contractual chain that required parties to apply payments only for purposes of the project; further, that all recipients who know the source of the funds are potentially liable for trust fund obligations. Based on the foregoing, the appellate court disagreed with Cucinotti's contention that he must be a signed party to the original contract in order to be held liable for damages, and ruled that the New Jersey Construction Trust Fund Act extends beyond those who are strictly in the direct contractual chain to those who come into possession of funds generated from public projects, with knowledge of the source. ⚙️

**[T]he purpose of the act was to protect those who have claims for labor material and other charges incurred in fulfilling the contract between the governmental body and the contractor.**

assistance from Reliance. Reliance not only paid the debts but also provided Lott with cash infusion.

Meanwhile, Lott pursued the services of a financial consultant, Steven Cucinotti, to assist in remedying Lott's financial difficulties. Following Cucinotti's advice, Lott deposited over \$600,000 in project funds into an account in the name of DRG, Inc.,

As a result of Lott's struggles, Reliance eventually sustained losses of over \$14 million. Reliance sought relief from Cucinotti, DRG and Frazier, claiming that the funds diverted from bonded obligations were subject to the contract-based constructive trust and similarly protected by the New Jersey Construction Trust Fund Act, making the companies and Cucinotti personally liable. Cucinotti argued



# How to Avoid Claims Under the Federal Fair Labor Standards Act

The Federal Fair Labor Standards Act (the Act), provides an unexpected liability for general contractors—notwithstanding their own full compliance. The Act requires every employer, among other things, to pay employees overtime wages for all hours over 40 worked during any given week. The problem is that the Act defines “employer” as “any person acting directly or indirectly in the interest of an employer in relation to an employee.” Unfortunately, case law interpreting the Act has broadened the definition of employer, with the result of creating unanticipated liability and a trap for the unwary general contractor. Violations of the Act carry tough penalties in addition to reimbursing claimants for the unpaid wages, including the payment of a claimant’s attorneys’ fees and perhaps liquidated damages, equal to the amount of unpaid wages.

Under very limited circumstances, a general contractor could be responsible for its subcontractors’ and even its sub-subcontractors’ violations of the Act for failure to properly pay its employees. Case law interpreting the Act provides that a *joint employer* relationship may be established based upon the following five factors:

- The nature and degree of control of the workers
- The degree of supervision, direct or indirect, of the work
- The power to determine the pay rates or the methods of payment of the workers
- The right, directly or indirectly, to hire, fire or modify the employment conditions of the workers
- Preparation of payroll and the payment of wages

While the traditional relationship between a general contractor and its subcontractors’ employees should not create

liability, general contractors are often included in enforcement proceedings because they typically have the deepest pockets. For this reason alone, claims are often filed against them, followed by an attempt to establish facts to create the *joint employer* relationship. Defending these often meritless claims takes time and money. Thus, the goal must be to avoid being sued and, in the event suit is filed, to minimize the damage by shifting the burdens and costs of defense to the entities that actually employ the claimants and control the payment of wages, and, therefore, have the ability to ensure compliance with the Act.

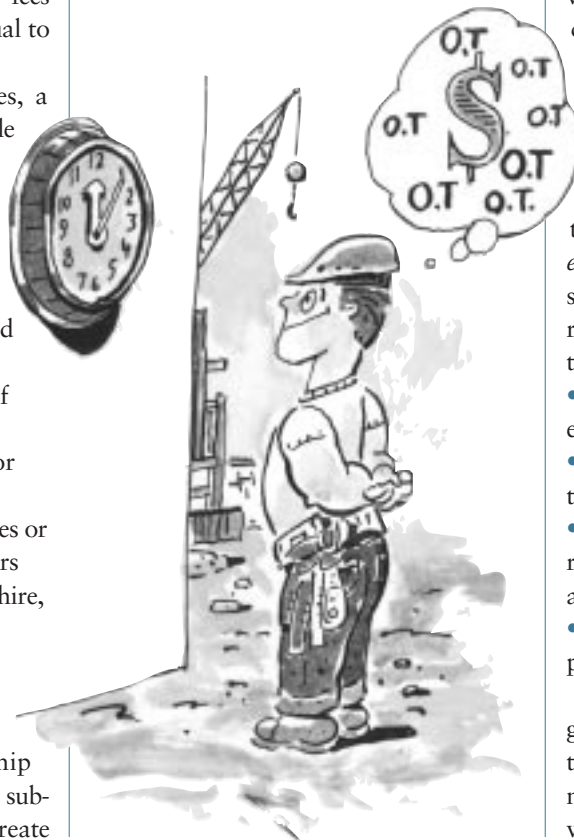
Initially, general contractors must insist on legally enforceable defense and indemnity subcontract provisions that are

sufficiently broad to include any claims asserted by subcontractors’ employees for violations of the Act. Further, all subcontracts should specifically require compliance with the Act and mandate that similar requirements be imposed upon sub-subcontractors. These subcontract provisions will allow general contractors to shift the defense obligations, as well as the risk of an award in favor of the claimants, to the entity employing the claimant. Once a claim is asserted, general contractors should withhold sufficient amounts from the subcontractors’ final payment to cover the cost of defending these claims.

Beyond this contractual protection, steps may be taken during the project to ensure that the *joint employer* relationship is not created. General contractors should observe the contractual chain of command, have as little direct communication with their subcontractors’ nonmanagerial employees except, of course, where necessary or legally required, i.e., life-safety issues, and must avoid even creating the appearance that they are exerting an excessive amount of control over their subcontractors’ employees. General contractors must also be careful to avoid participating in the hiring or firing of subcontractor employees. This is somewhat problematic because general contractors often administer orientation programs for all project participants, and obtain the contractual right to expel workers from the project for continuous rule violations, especially those relating to life-safety issues. While these rights alone should not create a *joint employer* relationship, general contractors should clearly identify and define their roles vis-à-vis non-employee workers on the project. Among the “do nots” are:

- Specifying the hours that subcontractor employees perform work
- Coordinating the work schedules for these individuals
- Mandating the pay scales beyond the requirement to comply with the Act and all other applicable laws and regulations
- Playing any role in the preparation of payroll or the payment of wages

While taking these actions does not guarantee that claims will not be filed, these preventative steps will certainly minimize the costs and risks associated with these lawsuits. ⚙️



# Failure to Strictly Follow the Plans and Specifications:

## New York Courts Express Views on Responsibility of Contractors and Construction Managers

***Edgewater Construction Co. v. 81 & 3 of Watertown, Inc.***

***Travelers Indemnity Company of Illinois v. 28 East 70th Street Construction Co.***

Two recent New York cases offer insight as to how courts view practical problems that frequently crop up on construction projects, and determine which construction project participants should bear liability for failure to follow the plans and specifications. In both cases, the results are a bit surprising—given the clear language in the contracts involved.

In *Edgewater Construction Co. v. 81 & 3 of Watertown, Inc.*, a New York appellate court effectively penalized a general contractor for requiring a subcontractor to correct work that did not fully conform to the design requirements. After about 75 percent of the foundation walls of a Sam's Club had been completed, the general contractor discovered that its subcontractor had installed Dur-o-Wall on every other course of below-grade masonry block, instead of on every course as the specifications mandated. In fact, there was no dispute that the specifications were crystal clear in requiring that Dur-o-Wall be installed on every course. However, it was also undisputed that the installation of Dur-o-Wall on every other course of below grade block was the standard building practice in the area and had no effect whatsoever on the structural integrity of the foundation. The amount saved by the subcontractor on materials in skipping every other course was \$619,200.

Seeking to give the owner exactly what the design called for, the general contractor directed its subcontractor to tear down what had been built and re-build the foundation walls with Dur-o-Wall on every course of block. The subcontractor complied at a cost of over \$500,000.

Afterward, the subcontractor sued the general contractor to recover the excess costs. The subcontractor argued that the omission was inadvertent, that the specification departed from the standard practice in the area, that the savings achieved by the omission were minimal, and that there was no practical effect on the building itself. Accordingly, the appellate court affirmed the verdict reached at trial in favor of the subcontractor, awarding it the costs to rebuild the foundation walls. To rationalize this result in legal terms, the court held that the subcontractor had *substantially* performed and was, therefore, entitled to recover its costs for having to redo what it had already done.

The doctrine of substantial performance provides that when the variation from the plans and specifications is trivial, the owner is only entitled to the difference in the value between what was specified and what was built (here, only \$619,200), and not to the cost of taking out the nonconforming work, installing work fully complying with the design, and restoring all the areas of the project affected by the re-work.

In *Travelers Indemnity Company of Illinois v. 28 East 70th Street Construction Co.*, the owner's insurance company brought a lawsuit to recover the money it paid for damage caused by a burst frozen water pipe. A report of the incident theorized that the pipe froze due to both an opening above the roll-down security gate and a lack of perimeter insulation around a duct and firestopping above the gate. A subcontractor of a trade contractor that the owner had retained had originally installed the gate, but an unknown contractor later had relocated the gate.

The owner's construction manager requested that the court dismiss the case against it, relying upon a provision in its contract stating that the construction manager was not responsible for the owner's contractors. Because that clause also dealt with *force majeure* events (such as fires, floods and "other matters beyond [the construction manager's] reasonable control"), and because there were the typical clauses requiring the construction manager to use "high-quality skill and judgment," and to "inspect the work," etc., the court held that the contract was ambiguous insofar as the construction manager's duty to supervise and inspect the work of contractors was concerned. Therefore, the court declined to dismiss the claim. ⚙

### EDITOR'S NOTE:

In the *Edgewater* case, the court was simply following a basic rule of damages in construction cases that holds that correction of defective work will not be required if "economic waste" would result. Economic waste comes into play when a building is still serviceable and correction would destroy a substantial portion of the work or involve substantial tearing down and rebuilding. In *Travelers*, while the court took pains to note that the construction manager could only be held responsible for its own failure to inspect and supervise the work, and not for the defective work performed by the trade contractors, the practical distinction is questionable. In the end, under the court's ruling, the construction manager was at risk as a consequence of the trade contractors' defective work.

## New Jersey Courts Adopt Clause

continued from page 8

relocate the third-floor employees. The parties attempted to work out an agreement on Capital's claim for delay damages but were unsuccessful. The DBC then terminated the contract for convenience. Capital then asserted a breach of contract claim contending, that the DBC did not have valid reasons to invoke the termination-for-convenience clause.

This issue was a matter of first impression in New Jersey. The court, therefore, referred to the wellspring of federal government contract decisions interpreting such clauses, and concluded that a public agency may invoke such a clause provided that it does not

act in bad faith. Under the federal decisions, the contractor's burden to prove bad faith "is very weighty," and requires a showing that the government official had the specific intent to injure the contractor, and was not simply making a business decision. Based on these standards, the court ruled that the DBC validly exercised its discretionary authority under the contract for ordinary business purposes that were reasonably within the contemplation of the parties at the time that Capital agreed to the clause. ⚙

### EDITOR'S NOTE:

It is inevitable that New Jersey courts will look to the federal decisions for guidance on government construction contracting

issues. Yet it is unfortunate in this instance that the state court moved in lockstep with the federal courts, rather than seizing the opportunity to craft a more businesslike resolution of such a controversial action. A termination for convenience provision is nothing more than an escape clause for the government. While changed circumstances can sometimes be a valid basis to cancel or renegotiate an agreement, the federal government has enjoyed the absolute power to cancel contracts whenever it is in its interest to do so, depriving the contractor of profit on the unperformed work. Given the planning devoted to a project and the commitment that contractors are required to make at the outset, contractors should be permitted a reasonable allowance for anticipated profits.

## Bulletins

# Groundbreaking Women in Construction

Conference—September 30, 2004, in San Francisco

**A**lthough women are increasingly recognized as leaders in the construction industry, women have traditionally had few opportunities to attend and benefit from the type of conference planned.

The conference will be a unique opportunity to honor the construction industry's pioneers, interact with our leaders and learn more about future opportunities. All facets of the construction industry will be represented including design and contract-

ing, finance and surety, and dispute resolution and legal.

Local and nationally recognized panelists, moderators, government leaders and keynote speakers will be participating in the conference.

For registration or sponsorship information, please don't hesitate to contact Jeff Conner at (415) 837-1968, x 4404, or at [jconner@pecklaw.com](mailto:jconner@pecklaw.com).

For more information about the conference, please visit [www.pecklaw.com/gwic2004](http://www.pecklaw.com/gwic2004). ⚙

## Florida Partner Appointed to Inaugural Certification Committee

**P**eckar & Abramson takes pride in announcing that the Board of Governors of the Florida Bar has appointed our partner, Melinda S. Gentile, to serve on the Bar's inaugural committee for Construction Law Certification. The committee will address and formulate the certification requirements for attorneys to be certified in the area of Construction Law. Mindy is in charge of our Fort Lauderdale office. ⚙

**Peckar & Abramson Newsletter**  
Volume XIV, Issue 2, Fall 2004  
*Charles F. Kenny, Esq., Editor*

**Peckar & Abramson, P.C.**  
Attorneys at Law

**New Jersey**  
70 Grand Avenue  
River Edge, NJ 07661  
Telephone: (201) 343-3434  
Facsimile: (201) 343-6306

**New York**  
546 Fifth Avenue, 17th Floor  
New York, NY 10036  
Telephone: (212) 382-0909  
Facsimile: (212) 382-3456

**San Francisco**  
250 Montgomery Street, 16th Floor  
San Francisco, CA 94104  
Telephone: (415) 837-1968  
Facsimile: (415) 837-1320

**Los Angeles**  
555 West Fifth Street, Suite 3000  
Los Angeles, CA 90013  
Telephone: (213) 489-9220  
Facsimile: (213) 489-9215

**Miami**  
One Southeast Third Avenue, Suite 3050  
Miami, FL 33131  
Telephone: (305) 358-2600  
Facsimile: (305) 375-0328

**Fort Lauderdale**  
401 East Las Olas Boulevard  
Suite 1600  
Fort Lauderdale, FL 33301  
Telephone: (954) 764-5222  
Facsimile: (954) 764-5228

E-mail: [mail@pecklaw.com](mailto:mail@pecklaw.com)  
Web site: [www.pecklaw.com](http://www.pecklaw.com)

© Copyright 2004 by Peckar & Abramson, Attorneys at Law. Permission to reprint granted with appropriate credit. This newsletter provides general information only. It is not legal advice and should not be used as a substitute for review with counsel of your specific situations.

Designed by Shostak Studios, Inc., NYC.

