



Construction Newsletter

A Summary of Important Recent Construction and Insurance Developments

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GOOD FAITH USE OF A TERMINATION FOR CONVENIENCE CLAUSE

Construction contracts commonly include termination for convenience clauses. Generally speaking, a termination for convenience clause permits the owner to terminate its contractor (or a contractor to terminate its subcontractor) at its discretion. Although courts have long recognized the validity of termination for convenience clauses in public contracts, courts have not always upheld such clauses in contracts between private parties. When courts have not upheld them, the reason has typically been that the power of one of the parties to escape its obligations under the contract means that the party with the power of termination has not made a binding promise to do anything, but only an *illusory* promise, and thus the contract must fail for want of consideration.

The law of private contracts is, of course, governed by state law. Recently, the Maryland Court of Appeals issued an important ruling on the validity of termination for convenience clauses in private construction contracts, holding in *Questar Builders, Inc. v. CB Flooring, LLC*, 978 A.2d 651 (Md. 2009) that such clauses in private contracts “may be enforceable, subject to an implied obligation to exercise the right to terminate in good faith and in accordance with fair dealing.”

Questar Builders, Inc. (“Questar”) was the general contractor for the construction of an apartment and townhome complex in Owings Mills, Maryland. It solicited bids for carpeting, and CB Flooring, LLC (“CB”) was the low bidder. As the project progressed, a dispute arose over the type of carpeting to be installed, with Questar demanding a more expensive carpet than that upon which CB had based its bid. CB sent a proposed change order to Questar seeking an adjustment in the contract value of approximately \$100,000.00. Questar refused to adjust the contract and, instead, announced that CB had breached the subcontract and purported to terminate CB for cause. CB subsequently filed suit against Questar.

The trial court determined that there had been no breach of the subcontract by CB. On appeal, however, Questar argued that the subcontract’s termination for cause language contained a fallback provision that converted termination for cause into a termination for convenience if a court or arbitrator determined that the termination for cause was improper. Questar reasoned that it should escape liability be-

cause the termination for convenience language effectively converted the termination to one for convenience.

The Court of Appeals focused its attention on whether the termination for convenience clause in the subcontract transformed a promise to perform into an illusory promise. The court first noted that Maryland courts prefer interpretations of contracts that make the contract effective rather than illusory. The court further noted that one means by which the court can accomplish this objective is to place a general obligation of good faith and fair dealing on all parties to the contract. If the contractor cannot exercise its right to termination for convenience at its absolute discretion, but instead must act reasonably, the contractor has made a real promise that limits its rights.

Accordingly, the court viewed the termination for convenience clause in the Questar/CB contract not as “the right to terminate based on a whim,” but rather as a tool for allocating economic risk reasonably. Thus, “Questar was permitted to terminate only if, in its discretion, it determined that continuing with the Subcontract would subject it potentially to a meaningful financial loss or some other difficulty in completing the project successfully.”

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COLORADO ADOPTS MINORITY RULE FOR WAIVER OF DAMAGES TO NON-PROJECT WORK UNDER AIA CONTRACTS

In most construction projects using AIA contract documents, owners typically waive the right to sue contractors for damage to their property resulting from fire or similar incidents during construction, agreeing instead to put an insurance policy in place that covers the value of the property. Often a construction project will involve a renovation to an existing structure or the erection of a new structure adjacent to an existing one, such that property not within the contractor's scope of work could be damaged by fire that begins in the new structure. In the majority of states, if the owner covers the new structure by adding an endorsement to the coverage for the existing structure, the owner will be deemed to have waived its right to sue the contractor for fire damage to the original structure. In *Copper Mountain, Inc. v. Industrial Systems, Inc.*, 208 P.3d 692 (Col. 2009), however, the Supreme Court of Colorado declined to adopt the majority view and found that the owner had not waived its right to sue the contractor for fire damage to the original structure.

Colorado's position places it in the minority of states that have considered the issue of whether extending coverage under an existing policy to additional property results in a waiver of claims for damage to the original property.

Using standard AIA documents, Copper Mountain, Inc. ("Copper"), the owner of a ski resort, contracted with Amako Resort Construction (U.S.), Inc. ("Amako"), a general contractor, for the renovation of a ski lodge at the resort. During the performance of certain welding work, a fire broke out damaging both the work under construction and portions of existing buildings that were not being renovated as part of Amako's scope of work. Although Copper's Ski Areas Property Coverage ("SAPC") insurance policy covered the damage to all damaged structures, the policy required Copper to pay a \$1,000,000 deductible. Copper sued Amako, seeking to recover the cost of paying the deductible.

However, a significant obstacle potentially stood in the way of Copper's recovery. Under paragraph 11.4.7 of the General Conditions, Copper and Amako had agreed to "waive all rights against... each other and any of their subcontractors... for damages caused by fire or other causes of loss to the extent covered by property insurance obtained pursuant to" the terms of the General Conditions. Under paragraph 11.4.1, Copper was required to obtain "insurance written on a builder's risk 'all-risk' or equivalent policy... comprising the total value for the entire Project..." As a practical matter, Copper had no claim against Amako for fire damage to any portion of the project because Copper was required to insure the project, and Copper waived all claims for fire damage to insured portions of the project.

As for Copper's ability to recover for fire damage to the portions of Copper's property that were damaged by fire but were not being renovated as part of the project, paragraph 11.4.5 specified that if "the Owner insures properties... at or adjacent to the site by property insurance under policies sepa-

rate from those insuring the project... the Owner shall waive" its rights against the Contractor as it waived them in paragraph 11.4.7. In fact, Copper had not insured its adjacent property under "policies separate from those insuring the Project," but instead extended its existing SAPC policy with an endorsement to cover the project. Consequently, Copper argued it could not be said to have waived its rights against Amako for damage to property that was not part of the project.

The Supreme Court of Colorado considered whether Copper waived its right to sue Amako for damage to property outside

Amako's scope of work and concluded that Copper had made no such waiver. The Court held that because the project was covered by an endorsement to the SAPC policy, which covered the damaged portions of the non-project property, the two properties were not covered by separate policies, and thus Copper had not waived its rights to bring claims against Amako for fire damage to the non-project property.

The Court's ruling appears at first glance to be a straightforward application of the plain text of a standard AIA provision. What makes this case notable, however, is that Colorado's position places it in the minority of states that have considered the issue of whether extending coverage under an existing policy to additional property results in a waiver of claims for damage to the original property. The dissenting justices, agreeing with the majority of other states, argued that the waiver provisions of paragraph 11.4.7 trump the inferred non-waiver language of paragraph 11.4.5. The dissenters stated that what matters for purposes of waiver is not whether the damaged property was part of the project.

Paragraph 11.4.5 is silent on the waiver issue when project and non-project properties are covered under the same policy, and, in light of the waiver language in paragraph 11.4.7, the dissenters refused to read non-waiver into such a situation. Nonetheless, contractors and owners in Colorado should be aware that the rule that applies in most other jurisdictions is not applicable in the Centennial State.

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The Court of Appeals concluded that "the right to terminate for convenience...provides adequate consideration for the other party to the contract, protecting that party's expectations in a binding enforceable agreement and prohibiting the terminating party from yanking out arbitrarily the carpet from underneath the agreement." Provided that the terminating party acts reasonably, a termination for convenience clause is a permissible and effective tool for allocating risk. Accordingly, if private parties wish to allocate their economic loss by using a termination for convenience clause, they may now do so in Maryland, as long as they act in good faith.

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UPDATE: IN VIRGINIA, WRITTEN NOTICE MEANS WRITTEN NOTICE

In the January/February 2009 issue (Volume XIV Number 1) of the Katz & Stone, L.L.P. Construction Newsletter, we alerted readers to the recent case, *AMEC Civil, L.L.C. v. Commonwealth*, 74 Va. Cir. 492 (Va. Cir. Ct. 2008) (“*AMEC I*”). In *AMEC I*, the court held that a statutory requirement to provide written notice of a claim was satisfied when the party entitled to receive the notice had actual notice of the claim. As the court in *AMEC I* noted, “the purpose of the notice requirement can effectively be realized even if the notice is not in writing.” The decision in *AMEC I* was appealed to the Virginia Court of Appeals, which recently reversed the trial court on the issue of actual notice as a substitute for written notice.

In this case, AMEC Civil, LLC (“AMEC”) contracted with the Virginia Department of Transportation (“VDOT”) for the construction of several bridges and sections of roadway in Mecklenburg County, Virginia. After the project was complete, AMEC sought \$24 million in cost overruns for differing site conditions, acceleration damages, extra work and other charges. Virginia Code § 33.1-387 permits a contractor to bring a “civil action” against the state, provided an administrative claim has been submitted to, and denied by, VDOT. The submission of the administrative claim is a condition precedent to a contractor’s right to bring a civil action. Specifically, Va. Code § 33.1-386(A) authorizes a contractor to bring an administrative claim, with the proviso that “written notice of the contractor’s intention to file such claim shall have been given to the [VDOT] at the time of the occurrence or beginning of the work upon which the claim and subsequent action is based.” As a condition precedent to litigation a contractor must bring an administrative claim that satisfies the notice requirements of Va. Code § 33.1-386(A).

In *AMEC I*, the court held that VDOT’s actual notice of AMEC’s claims satisfied Va. Code § 33.1-386(A)’s notice requirement, notwithstanding the statutory requirement that written notice be provided. The Virginia Court of Appeals, *Commonwealth v. AMEC Civil, LLC*, 54 Va. App. 240 (Va. Ct. App. 2009) (“*AMEC II*”), reversed *AMEC I* on the issue of notice, noting that in Va. Code § 33.1-386(A), the written notice requirement must be construed strictly, and actual notice of claims was not a substitute for the statutorily-required written notice.

For each of the claims made by AMEC, the court reviewed the available evidence to determine whether AMEC had provided the proper notice to VDOT. As the court noted, Va. Code § 33.1-386(A) requires a particular kind of notice that announces (i) in writing (ii) the contractor’s intent to file a claim (iii) at the time of the occurrence or beginning of the work upon which the claim and subsequent action is based. The *AMEC II* court found that AMEC had not satis-

fied Va. Code § 33.1-386(A)’s notice requirement for part of its acceleration claim and five of its other six claims.

For example, AMEC claimed charges related to drilled shaft work. The *AMEC II* court noted that correspondence between AMEC and VDOT in 2000 indicated concerns related to the drilled shaft work and, despite beginning work on the drilled shafts in 2001, AMEC did not provide written notice to VDOT of its intent to assert a claim until 2003. As such, AMEC did not satisfy the statutory requirement that notice be given at the “time of the occurrence or at the beginning of the work upon which the claim and subsequent action is

AMEC did not satisfy the statutory requirement that notice be given at the “time of the occurrence or at the beginning of the work upon which the claim and subsequent action is based.”

based.” As another example, AMEC claimed acceleration damages based on written notice to VDOT in April 2004 of an intent to file a claim for damages “incurred to date” and not “correctly and fully addressed by Work Order No. 39.” The court in *AMEC II* held that such notice was not sufficient for acceleration claims prior to April 2004 (because the notice was not given at the time the claim occurred) or

for acceleration efforts after April 2004 unrelated to alleged inadequacies of Work Order No. 39 (because the notice was limited to damages related to the inadequacies of Work Order No. 39).

The court in *AMEC I* also noted that certain meeting minutes and memoranda exchanged by the parties constituted written notice for purposes of Va. Code § 33.1-386(A). The *AMEC II* court acknowledged that Va. Code § 33.1-386(A) “does not require the sophistication of a legal pleading,” elaborating that meeting minutes, memoranda, and even contractor invoices could conceivably constitute proper notice, provided such documents clearly indicated the contractor’s intent to file a claim and were issued within the time required by Va. Code § 33.1-386(A). The *AMEC II* court overruled the *AMEC I* court, however, finding that no meeting minutes expressed such an intent and noting that AMEC’s invoices were issued much later than permitted by Va. Code § 33.1-386(A).

In August 2009, AMEC filed a petition for appeal to the Virginia Supreme Court. Although we will continue to provide future developments in this litigation, it appears that – for the time being – when a statute requires written notice, Virginia courts will require such notices to be in writing.

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of a general contractor’s failure to post a Notice of Commencement at the project. Thus, the decision in *Rey Coliman Contrs., Inc.* is in line with accepted case law in Georgia requiring courts to strictly construe the lien statute in favor of the property owner and against the materialman, making clear the importance of strict adherence to the statutory requirements for filing a lien.

STRICT ADHERENCE TO THE STATUTORY REQUIREMENTS NECESSARY TO PERFECT A LIEN IN GEORGIA

In *Rey Coliman Contrs., Inc. v. PCL Constr. Servs.*, 296 Ga. App. 892 (Ga. Ct. App. 2009) a supplier, Rey Coliman Contractors, Inc. (“RCC”), was denied enforcement of its lien rights for having failed to properly perfect its lien under Georgia law. Specifically, RCC furnished materials and labor to a subcontractor on a construction project for which PCL Construction Services (“PCL”) was acting as a general contractor. RCC argued that certain actions necessary to perfect its lien were made inapplicable due to PCL’s having failed to comply with a certain requirement of the lien statute. The Court of Appeals of Georgia, however, found such argument unavailing and affirmed the trial court’s granting of summary judgment in favor of PCL, thus dismissing RCC’s lien suit.

Specifically, the court deemed RCC’s lien ineffective because RCC failed to provide PCL with a timely “Notice to Contractor” to perfect a lien as required by Georgia’s mechanic’s lien statute. Under the statute, any party that has a right to a lien, but does not have privity with the general contractor, must send to the general contractor a notice containing certain required information. Such a requirement is nullified, however, where the owner, agent of the owner, or contractor fails to file a “Notice of Commencement” with the clerk of the superior court in the county in which the project is located, or fails to provide the same to the subcontractor or supplier when requested to do so in writing. Generally, the Notice of Commencement contains some of the information necessary for filing a lien. In the instant case, PCL properly filed the Notice

of Commencement and it was undisputed that RCC never requested a copy of such notice from PCL.

RCC relied upon a different section of the mechanic’s lien statute requiring that a copy of the Notice of Commencement be posted at the project. Although there was disagreement between RCC and PCL as to whether this notice was actually posted, the court accepted RCC’s contention that the notice was in fact not posted as required for the purposes of PCL’s motion for summary judgment. The court determined that a general contractor’s failure to post the Notice of Commencement at the project does not excuse a lien claimant’s failure to provide a Notice to Contractor. Essentially, the Court of Appeals of Georgia ruled that failing to fulfill the requirement to post the Notice of Commencement was of no consequence. In support of such a determination, the Court of Appeals of Georgia postulated that if the legislature had intended for the failure to comply with the posting requirement to carry the same consequences as the failure to file or provide copies of such notice, then the legislature would have explicitly stated such intention in the statute.

While Georgia’s mechanic’s lien statute states that the failure either to properly file the Notice of Commencement or to provide a copy of the same to a subcontractor or supplier when requested excuses a supplier from having to provide the general contractor notice of its lien claim, the same cannot be said

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