ALSTON+BIRD LLP

Construction Law Review

October 2008

California's Supreme Court Changes the Rules on Indemnity

Indemnity provisions are a central component in any construction contract. An issue that often arises under such provisions is when one party, the indemnitor, is obligated to assume the defense of the other, the indemnitee, or, more specifically, whether the duty to defend arises at the outset of a lawsuit before any determination of the indemnitor's fault.

Until the California Supreme Court's recent landmark decision in *Crawford v. Weather Shield Mfg., Inc.* (2008) 44 Cal.4th 541, California courts held that a party's duty to defend and indemnify was triggered by a finding of liability — which effectively negated any attempt to obtain an immediate defense under an express contractual indemnity at the outset of a case before determinations of fault are rendered. *See e.g., Baldwin Builders v. Coast Plastering Corp.* (2005) 125 Cal.App.4th 1339; *Heppler v. J.M. Peters Co.* (1999) 73 Cal.App.4th 1265; *Regan Roofing v. Superior Court* 24 Cal.App.4th 425 (1994).

Before *Crawford*, California case law had not previously been reconciled with the language of Civil Code § 2778, which governs the interpretation of indemnity clauses and provides in relevant part: "In the interpretation of a contract of indemnity, the following rules are to be applied, unless a contrary intention appears: . . . 4. The person indemnifying is bound, on request of the person indemnified, to defend actions or proceedings brought against the latter in respect to the matters embraced by the indemnity."

Relying on specific contract language, courts in other jurisdictions have found that there does exist a separate duty to defend against claims before determinations of liability are rendered. *See e.g., Stephans & Sons, Inc.*

Contents:

v. Municipality of Anchorage (Alaska 1981) 629 P.2d 71, 75-76; *Hauskins v. McGillicuddy* (Az. App. 1992) 852 P.2d 1226, 1234; *Westinghouse Elec. Corp. v. Metropolitan Dade County* (Fl. 3rd Dist. 1992) 592 So.2d 1134, 1135; *Pancakes of Hawaii, Inc. v. Pomare Properties Corp.* (Hawaii 1997) 944 P.2d 83, 88-89; *Urban Investment and Development Co. v. Turner Construction Co.* (Mass. App. 1993) 616 N.E.2d 829, 834; *Knipschield v. C-J Recreation, Inc.* (Wash. App. 1994).

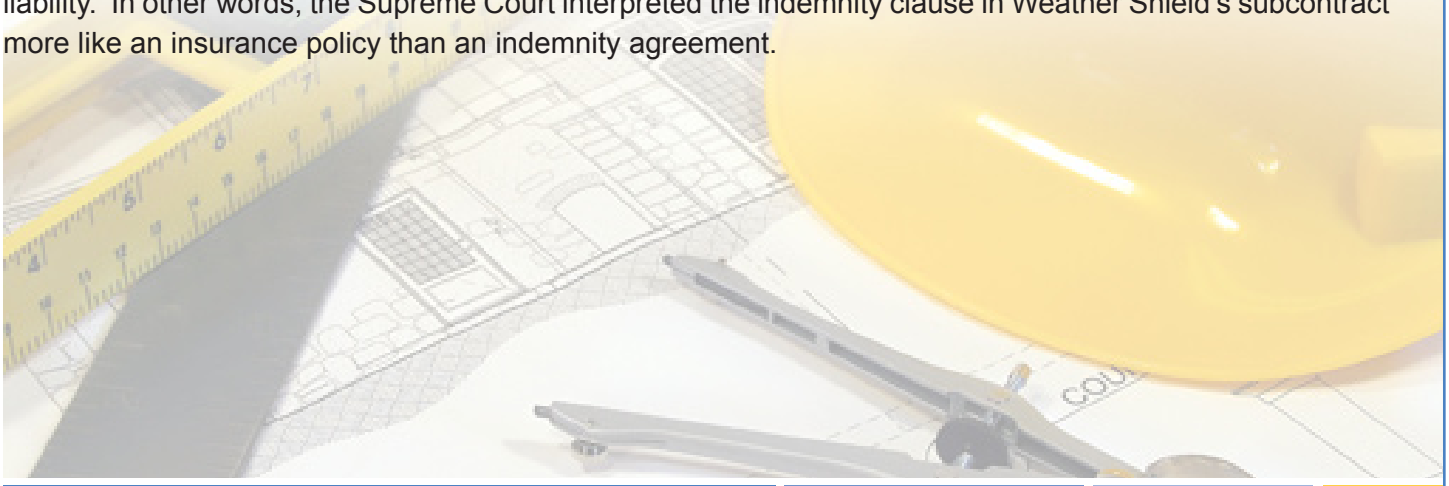
With *Crawford*, the California Supreme Court has now aligned California with those other jurisdictions. In *Crawford*, several hundred homeowners sued the developer and its subcontractors, including Weather Shield (the window manufacturer) and Darrow (the framer and window installer), for alleged construction defects. The developer cross-complained against the subcontractors for express contractual indemnity, and a declaration that the subcontractors had a "present" duty to defend the developer against the homeowners' lawsuit.

The indemnity clause in each subcontract required the subcontractor "to indemnify and save [developer] harmless against all claims for damages . . . loss, . . . and/or theft . . . growing out of the execution of [subcontractor's] work," and "at [its] own expense to defend any suit or action brought against [developer] founded upon the claim of such damage[,] … loss, … or theft." *Crawford* 44 Cal.4th 541 at 547.

Before trial, the developer and all subcontractors except Weather Shield and Darrow reached a settlement with the homeowners. The homeowners' claims against Weather Shield and Darrow were tried first to a jury, which found that Darrow was negligent but that Weather Shield was not. Darrow then settled all claims against it.

The developer's claim for indemnity against Weather Shield for its settlement payment and attorneys' fees and costs was tried next. Even though the jury found Weather Shield was not negligent, the trial court ruled Weather Shield had a duty to defend the developer from the outset of the homeowners' lawsuit. The court, therefore, awarded the developer a portion of its attorneys' fees and costs (approximately $134,000). The trial court ruled Weather Shield had no duty to reimburse the developer for its settlement with the homeowners. The Court of Appeal and Supreme Court affirmed the trial court's rulings.

Crucially, the Supreme Court held that, even though indemnity clauses are strictly interpreted in favor of the indemnitor (in contrast to insurance policies, which are strictly interpreted in favor of the insured), the subcontract provisions "expressly, and unambiguously, obligated Weather Shield to defend, from the outset, any suit against [the developer] insofar as that suit was 'founded upon' claims alleging damage or loss arising from Weather Shield's negligent role in the [project]." *Crawford*, 44 Cal.4th at 553. Weather Shield thus had a contractual obligation to immediately defend the developer without consideration of Weather Shield's liability. In other words, the Supreme Court interpreted the indemnity clause in Weather Shield's subcontract more like an insurance policy than an indemnity agreement.



In reaching its decision, the *Crawford* Court distinguished the case from the previous cases requiring a liability determination before a duty to defend is triggered; *see Baldwin Builders, supra, and Heppler, supra*, and specifically overruled *Regan Roofing, supra*. In so doing, the Supreme Court held the language in Civil Code § 2778 (quoted above), as well as the language in Weather Shield's subcontract, makes clear that "indemnity" involves two separate and distinct duties: the duty to defend — triggered upon tender of the claim — and the duty to indemnify in the event of liability.

While *Crawford* is a major development in the law of indemnity, its effect on California residential construction contracts entered into after 2006 is uncertain. California's legislature amended Civil Code § 2782 in 2005 and 2007 to modify the permissible scope of indemnity clauses in residential construction contracts entered into after January 1, 2006, and January 1, 2008. Further, Assembly Bill 2738 is now pending before California's legislature and, if passed, will again radically revise the landscape of indemnity law in the context of residential construction contracts, and specifically in connection with the duty to defend. For non-residential construction and other contracts in California, *Crawford* will have continuing and profound relevance, and should be carefully factored into a party's business and litigation strategies.

Given that courts will interpret specific contract language when determining when the duty to defend is triggered, all contractors, including those operating outside California, should consider *Crawford* when drafting or consenting to an indemnity clause. Without careful consideration, a contractor may be unaware of exactly what risks it is assuming. The contractor may be unpleasantly surprised when forced to immediately defend another party at the outset of a lawsuit before any finding the contractor is at fault.

– Kevin Collins & Jessica Sharron

This article was originally published in URS' Claims and Dispute Resolution Group's newsletter – The Claims Resourse (Summer 2008).

ANNOUNCEMENT

The Construction and Government Contracts Group Is Pleased To Announce The Merger of Alston & Bird LLP with Weston, Benshoof, Rochefort, Rubalcava, MacCuish LLP in Los Angeles, California. The Merger Adds 4 Partners and 2 Associates To Our Coast-To-Coast Construction and Government Contracts Group.

STATE AND FEDERAL CASE UPDATES

Alabama

Court of Civil Appeals Declines to Find Rescission in Homeowners' Demand that No Work Continue Without Written Consent, and Reverses Award for Mental Anguish Damages in Homeowners' Claim for Construction Defects

In *Baldwin v. Panetta*, a husband and wife retained a general contractor to build a lake house. There were numerous problems on the project involving claims of poor workmanship and inadequate supervision, causing the homeowners to send an email to the general contractor requesting a list of subcontractors, the status of payment to them, and instructing that no work be performed without homeowners' consent. Upon receipt of the e-mail, the general contractor stopped work and sued for breach of contract and to enforce a lien. The homeowners counterclaimed for certain damages, including mental anguish. At trial, the general contractor argued the e-mail constituted a stop work order that justified their cessation of work. The circuit court rejected the general contractor's argument and awarded the homeowners $57,200.17 in damages.

The Court of Civil Appeals confirmed the circuit court's ruling regarding the homeowners' email, finding that whether a communication is sufficient to constitute rescission of a contract depends on the totality of the circumstances. Citing precedent in Alabama, the court noted that an express recognition in the communication that the parties have continuing obligations under the contract is a significant factor in making the determination. Considering the circuit court's award of damages for mental anguish, however, the Court of Civil Appeals reversed the award to the homeowners. The court identified the three elements essential to recover compensation for mental anguish arising from the breach of a home-construction contract: (1) The breach must be egregious; (2) the defects must render the home virtually uninhabitable; and (3) the breach must necessarily or reasonably result in mental anguish or suffering. The homeowners' claim could not satisfy the second element of the claim because their complaints concerned mere aesthetic defects, which did not concern the structural integrity of the home. Examples of defects satisfying the second element would be: persistent leaks in the roof over the plaintiff's bedroom, cracks in the concrete slab or faulty wiring creating an imminent fire hazard. *Baldwin v. Panetta,* 2008 WL 4277343 (Ala.Civ.App. Sept. 19, 2008).

California

Mandatory Arbitration Agreements Do Not Apply to Fraud-Related Claims and Unconscionable Arbitration Provisions Are Unenforceable

In *Thompson v. Toll Dublin, LLC*, condominium purchasers sued the project developers for fraud based on concealment of wet, moldy and unhealthy conditions. Pursuant to their purchase agreement with defendants, plaintiffs signed documents, including a Title 7 Addendum and a Title 7 Master and Dispute Resolution Declaration. Plaintiffs also received a copy of Title 7, which addresses construction defect claims and contains a provision which expressly excludes fraud claims. The trial court ruled that the arbitration agreement did not apply to plaintiffs' fraud-related claims, and the California Court of Appeals affirmed the trial court ruling.

Affirming the trial court, the Appeals Court found that the addendum and master Declaration applied only to Title 7 claims — not to plaintiffs' fraud-based claims. The stated purpose of the addendum was to implement the requirements of Title 7. Although certain language in the addendum and master declaration *could* be interpreted to include non-Title 7 claims, such an interpretation in this instance would be unreasonable given the context of the entire arbitration agreement. The Appeals Court went further to rule that the arbitration agreement was unconscionable, finding that the arbitration provisions constituted a contract of adhesion and included both the procedural and substantive elements of unconscionability. *Thompson v. Toll Dublin, LLC*, 165 Cal. App. 4th 1360, 81 Cal Rptr. 3d 736 (2008).

California

The Legislature Has the Power to Award Construction Contracts without Complying with Competitive Bidding Requirements

The California State Contract Act (California Public Contract Code §§10100, et seq.) requires competitive bidding for most public projects. The California Legislature awarded a construction contract for the Capitol Park Safety and Security Improvements Project without competitive bidding. The court held that the legislature is not bound by the competitive bidding requirements, stating the contract did not violate the separation of powers doctrine (Article III, Section 3 of the Constitution) because the legislature retains powers necessary to its lawmaking functions, including the power to protect the safety and security of the legislature pursuant to Article IV, Section 7 of the constitution. A legislative assembly is vested with all the powers and privileges which are necessary and incidental to a free and unobstructed exercise of its appropriate functions, which includes the power to enter into construction contracts without competitive bidding. *Zumbrun Law Firm v. California Legislature*, 165 Cal.App.4th 1603, 82 Cal.Rptr.3d 525 (2008).

California

A Contractual Claims Procedure Supersedes the Claims Procedure Established by Government Code § 910

In *Arntz Builders v. City of Berkeley*, the city entered into a contract with a contractor on a $20 million library project. The contract provided that, if the contractor disagreed with the city's decision on a dispute, the contractor's sole and exclusive remedy was to file a claim in accordance with a detailed claims procedure. The contract stated that failure to file a claim as required would result in a waiver of the claim. After failing to adhere to the contract's claims requirements, the contractor filed a complaint against the city. In its answer to the complaint, the city asserted an affirmative defense that the complaint was barred by the contractor's failure to comply with the Government Code claims requirements as set forth in section §§ 900, et seq. of the Government Code. The trial court held the contractor was required to comply with both the contract's claims requirements and with the Government Code claim requirements. The appellate court reversed the trial court's decision, stating public agencies are allowed to establish different claims procedures by contract and, sometimes, such provisions amount to a claims procedure that takes the place of a claims statute. Government Code § 950.4 provides that a claims procedure established by agreement ". . . exclusively governs the claims to which it relates." *Arntz Builders v. City of Berkeley*, 166 Cal.App.4th 276, 82 Cal.Rptr.3d 605 (2008).

Georgia

Punitive Damages Are Justified Even where the Defendant Did Not Act with Conscious Indifference in Creating the Problem that Led to Damage if the Defendant Acted with Conscious Indifference in Failing to Correct the Problem

In *Wildcat Cliffs Builders, LLC v. Hagwood*, a landowner's property was damaged by erosion and run-off water when a developer working on an adjoining property improperly constructed two concrete retaining walls on the landowner's property and also graded over part of the landowner's property, which destroyed over forty of the landowner's hardwood trees. The landowner sued for trespass and nuisance, and the jury found in the landowner's favor, awarding him $90,000 in compensatory damages and $100,000 in punitive damages.

On appeal, the Georgia Court of Appeals affirmed the award of punitive damages. The Court of Appeals looked to O.C.G.A. § 51-12-5.1(b), which states that punitive damages are available in tort cases in which the defendant's actions are proven by clear and convincing evidence to show, *inter alia*, "that entire want of care which would raise the presumption of conscious indifference to consequences." The jury's finding that the developer did not damage the landowner's property with intent to cause damage was not at issue. Instead, the question was whether the developer's actions *after* the damage showed a "conscious indifference to consequences." The Georgia Supreme Court has specifically held that such a conscious indifference may exist where one party causes run-off water damage to another's property and subsequently fails to repair or ameliorate the damage. Therefore, the Court of Appeals stated that even where a defendant does not act with conscious indifference in creating a problem that leads to damage, punitive damages may be justified if the defendant acts with conscious indifference in failing to remedy the damage.

There was evidence here that, after creating the erosion and run-off water problems, the developer was put on notice of the damage to the landowner's property, yet made no effort to ameliorate the damage. Since the evidence showed that the developer had no interest in remedying or compensating the landowner for the damage, the Court of Appeals held that there was sufficient evidence to support a jury finding of conscious indifference to consequences. Thus, the court affirmed the award of punitive damages. *Wildcat Cliffs Builders, LLC v. Hagwood*, 663 S.E.2d 818 (Ga. App. 2008).

North Carolina

Failure to Make Permissive Appeal of Denial of Motion to Stay Pending Arbitration and Subsequent Engagement in Litigation Leads to Waiver of Arbitration Clause

In a case concerning a construction contract for two road projects in Raleigh, North Carolina, a general contractor's surety was successfully sued by a drilling subcontractor for lack of payment on both projects. Following trial, the surety appealed the trial court's denial of its motion to compel arbitration, asserted on the basis of the arbitration clause in the subcontract. Considering the appeal, the court noted that denial of a motion to stay pending arbitration is interlocutory in North Carolina, but it is immediately appealable under the North Carolina Uniform Arbitration Act (NCUAA), the Federal Arbitration Act (FAA), and under N.C.G.S. § 1-277(a) because it affects a substantial right. The court ruled that, while immediate appeal is permissive, not mandatory, the failure to appeal, and a party's subsequent engagement in "protracted litigation, including a full bench trial," is prejudicial to an opposing party. Citing *Cyclone Roofing Co. Inc. v.*

LaFave Co., 321 S.E.2d 872, 876 (N.C. 1984), the court found that the surety had effectively waived any contractual right to arbitration and denied the appeal. *Gemini Drilling and Found., LLC v. Nat'l Fire Ins. Co. of Hartford*, 665 S.E.2d 505 (N.C. App. 2008).

Oregon

If a Settlement Agreement Remains an Executory Accord, a Claim Enforcing the Agreement Is Equitable, and the Defendant Has No Right to a Jury Trial Under the Oregon Constitution

In *McDowell Welding & Pipefitting, Inc. v. U.S. Gypsum Co.*, a subcontractor brought a breach of contract action against an owner and general contractor. The defendants denied the subcontractor's allegation and asserted an affirmative defense alleging that the subcontractor had released its claims in a settlement agreement. The defendants also counterclaimed for specific performance of the settlement agreement. In response to the defendants' motion, the trial court agreed to bifurcate the trial and try the defendants' counterclaim first. The trial court then denied the subcontractor's request for a jury trial.

The Oregon Supreme Court upheld the trial court's decision to deny the subcontractor's request for a jury trial. According to the Oregon Supreme Court, the defendants' counterclaim was an executory accord claim that would have been tried to an Equity Court when the Oregon Constitution was adopted in 1859. Therefore, the subcontractor had no constitutional right to a jury trial. The Supreme Court defined "executory accord" as "an agreement for the future discharge of an existing claim by substituted performance." Because the defendants had not yet paid the settlement agreement, nor alleged that the underlying obligation had been extinguished, the Supreme Court reasoned that the settlement agreement constituted an executory accord. *McDowell Welding & Pipefitting, Inc. v. U.S. Gypsum Co.,* 2008 WL 4249397 (Or. Sept. 18, 2008).

South Carolina

Safety Hazards on a Construction Project Held Not to Constitute an "Emergency" Warranting Emergency Procurement without Solicitation of Bids

In *Sloan v. Department of Transportation*, after repeated delays on a road construction project, the Department of Transportation (DOT) terminated a contractor for convenience. With approval of the DOT Commission, the DOT procured a replacement contractor using an emergency procurement process in lieu of the low bidding process ordinarily required by statute. A taxpayer brought a declaratory judgment action challenging the DOT's decision to forego the normal bidding process on the grounds that no emergency existed. The trial court granted the DOT's motion for summary judgment, holding that the taxpayer did not have standing, the action was moot and the DOT complied with the applicable emergency procurement provisions.

The Supreme Court of South Carolina reversed. The Court held that (1) the taxpayer had standing because the case involved an unlawful expenditure of public funds; (2) the issue was not moot because it was capable of repetition and would usually evade review; and (3) no emergency existed to justify forgoing the normal bidding process because the alleged safety concerns purportedly requiring emergency procurement had existed throughout the project. *Sloan v. Department of Transportation*, 2008 WL 3890145 (S.C. Aug. 25, 2008).

Tennessee

A Signed and "Accepted" Proposal Does Not Constitute a Contract if the Signature Was Induced for Discussion Purposes Only

In *Thomas Builders, Inc. v. Patel, Et Al.*, a construction company sought damages for breach of contract after a businessman signed and "accepted" the construction company's proposal but then failed to use the company. After entering negotiations with a businessman interested in building a hotel, the construction company submitted a proposal to the businessman. The proposal contained four pages of printed specifications and three pages of hand-sketched drawings. Although the proposal did not contain a signature line, the businessman subsequently signed the proposal and wrote the word "Accepted" next to his signature. At trial, the businessman alleged that he signed the proposal to demonstrate his serious intention to continue discussions with the construction company. According to the businessman, a representative from the construction company called him and said that the construction company needed reassurance that he was seriously considering the company's proposal. The representative then asked the businessman to sign the proposal to demonstrate his intention to continue discussions with the company.

Because the construction company never directly disputed the businessman's testimony, the Trial Court and Court of Appeals held that no contract had been created by the businessman's signature. The Court of Appeals reasoned that the signature could not constitute acceptance of an offer to build a hotel because "asking someone to sign a 'proposal' in order to prove his 'seriousness' is not the same thing as making a contractual offer to build a hotel." The Court of Appeals further stated that the construction company "was not even *making* an offer," even though the court conceded that the proposal itself may have constituted an offer. *Thomas Builders, Inc. v. Patel, Et Al.*, WL 2938054 (Tenn.Ct.App. July 31, 2008).

Utah

Expert Testimony Regarding Compliance with Industry Standards is Not a Violation of the Parol Evidence Rule

In *Richins Drilling, Inc. v. Golf Services Group, Inc.*, the Utah Court of Appeals clarified what type of testimony fell within the parol evidence rule. On appeal was the judgment of the trial court in favor of the appellee on the appellant's breach of contract, unjust enrichment and mechanics' lien claims. The contract for well-drilling work between the parties stated that "[the appellee] shall not unreasonably withhold approval of all such work, when performed by [the appellant] in accordance with the generally accepted practices and methods customary in the industry." In determining what were "generally accepted practices and methods customary in the industry," the trial court relied on expert witness testimony. Based on this expert testimony, the trial court found that the appellant had breached the contract by going over the maximum contract price, using drilling methods not conforming to industry standards and finishing the project after the time for completion. None of these contract terms were specifically included in the contract but were instead incorporated into the contract through the term requiring "generally accepted practices and methods customary in the industry."

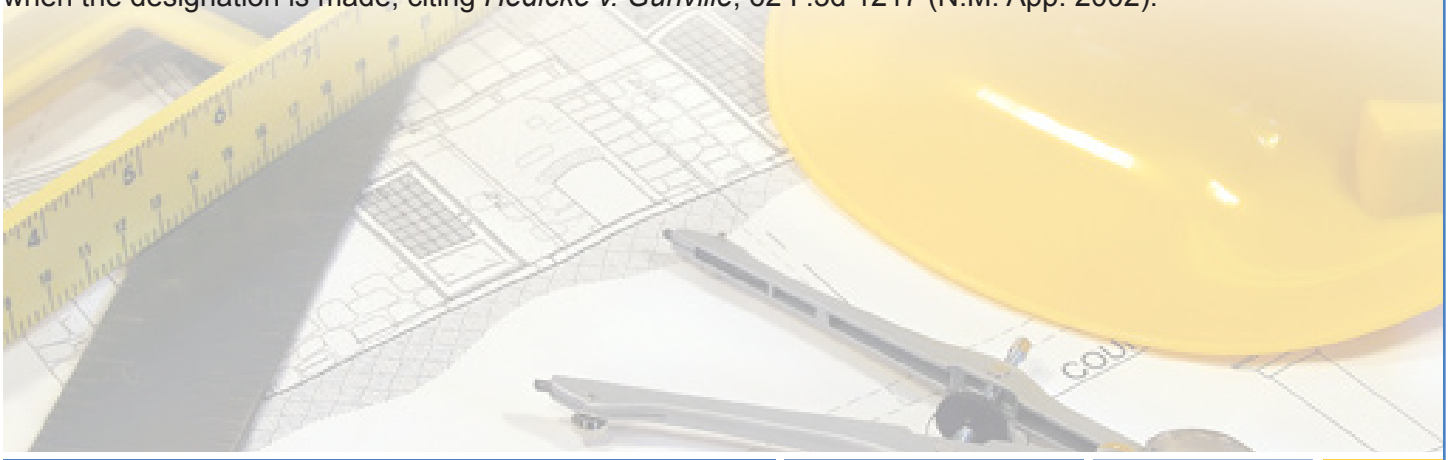
On appeal, the appellant argued that the trial court had violated the parol evidence rule by impermissibly adding these contract terms to the contract. However, the Court of Appeals found for the appellee on this issue and affirmed the judgment of the trial court. The Court of Appeals held that the appellant had mischaracterized the applicability of the parol evidence rule, which operates to exclude evidence of prior or contemporaneous conversations of the parties to a contract which would alter the terms of that contract. Rather, the Court of Appeals held that the appellant had "confused the applicability of the parol evidence rule with the trial court's interpretation of the contract." The Court of Appeals held that the expert testimony evidence was not evidence of any prior or contemporaneous agreement between the parties, but was evidence utilized by the trial court to interpret the express terms of the contract. Therefore, the Court of Appeals deferred to the trial court's interpretation of the contract and affirmed its decision. *Richins Drilling, Inc. v. Golf Services Group, Inc.*, 189 P.3d 1280 (Ut. 2008).

FEDERAL

Prevailing Party is that Party which Wins on the Heart of the Case, Not Necessarily the Party that Receives a Judgment Award

In the United Stated District Court for the District of New Mexico, following proceedings before a magistrate, the court considered the parties' opposing motions for attorney's fees. The subcontract's provision for attorneys' fees provided as follows: "Should either party employ an attorney to institute suit or demand arbitration . . . the prevailing party shall be entitled to recover reasonable attorney's fees, costs, charges and expenses expended and incurred therein." The parties disputed which side was the prevailing party. The plaintiff had secured a judgment for $31,700, but the defendant had won on every issue at trial and successfully shown inconsistencies in the testimony of the plaintiff, undermining the plaintiff's credibility. Thus, the issue presented to the court was how to determine, under the subcontract, which party actually prevailed at trial in order to properly allocate the award of attorney's fees.

The court first ruled that the decision of both parties to cite only New Mexico law in their motions and briefs reflected their intent to modify the choice of law provision in the subcontract, which originally provided that Oklahoma law controlled interpretation of the subcontract. Considering the term "prevailing party" under New Mexico law, the court cited to *Mayeux v. Winder*, 131 P.3d 85, 96 (N.M. App. 2006) for the proposition that "the party who wins the lawsuit — that is, a plaintiff who recovers a judgment or a defendant who avoids an adverse judgment" is the "prevailing party." The court noted, however, that designation of the "prevailing party" "need not be mechanic or formulaic" and "facts and circumstances of the case" should be considered when the designation is made, citing *Hedicke v. Gunville*, 62 P.3d 1217 (N.M. App. 2002).



Exercising the broad discretion accorded to the court under New Mexico law, the court determined that the defendant was the "prevailing party." In reaching its decision, the court essentially conducted an analysis of the equities. The court's opinion placed significance on the fact that the ultimate award of $31,700 was closer to the $30,000 defendant originally proposed to pay plaintiff under the subcontract than the amount sought by plaintiff at trial. The court noted that the defendant made efforts to pursue mediation prior to litigation, while the plaintiff rebuffed those efforts and was uncooperative with the defendant in resolving the matter before trial. Finally, the court emphasized that it found the plaintiff's testimony to be "wholly lacking in credibility" and adopted many of the proposed findings of fact and conclusions of law offered by the defendant. For the court, these factors showed that the defendant had won on "the heart of the case," even if the other side received a money judgment greater than the amount offered pre-trial. Consequently, the defendant received an award of the full amount of attorney's fees requested. *U.S. ex rel. Silva's Excavation, Inc. v. Jim Cooley Const., Inc.*, 2008 WL 3919030 (D.N.M. Aug. 6, 2008).

ANNOUNCEMENTS

Kevin Collins will be presenting his annual California Construction Law Update Seminar to the Southern California and San Diego Chapters of the Construction Management Association of America in Long Beach, California, on January 28, 2009, and in San Diego, California, on January 30, 2009.

John Spangler, Andy Howard and Donald Brown authored an update to "Chapter 29: Changed Conditions" of the *Construction Law Handbook* (Robert Cushman & James Myers eds., forthcoming).

Jeff Belkin and Donald Brown authored an article entitled "The Soldier of Fortune in Federal Court: An Analysis of the Federal Officer Removal Statute," published in the *Andrews Litigation Reporter: Government Contract*, Volume 22, Issue 6 (July 28, 2008). If you are interested in obtaining a copy of the article, please contact Jeff Belkin (jeff.belkin@alston.com).

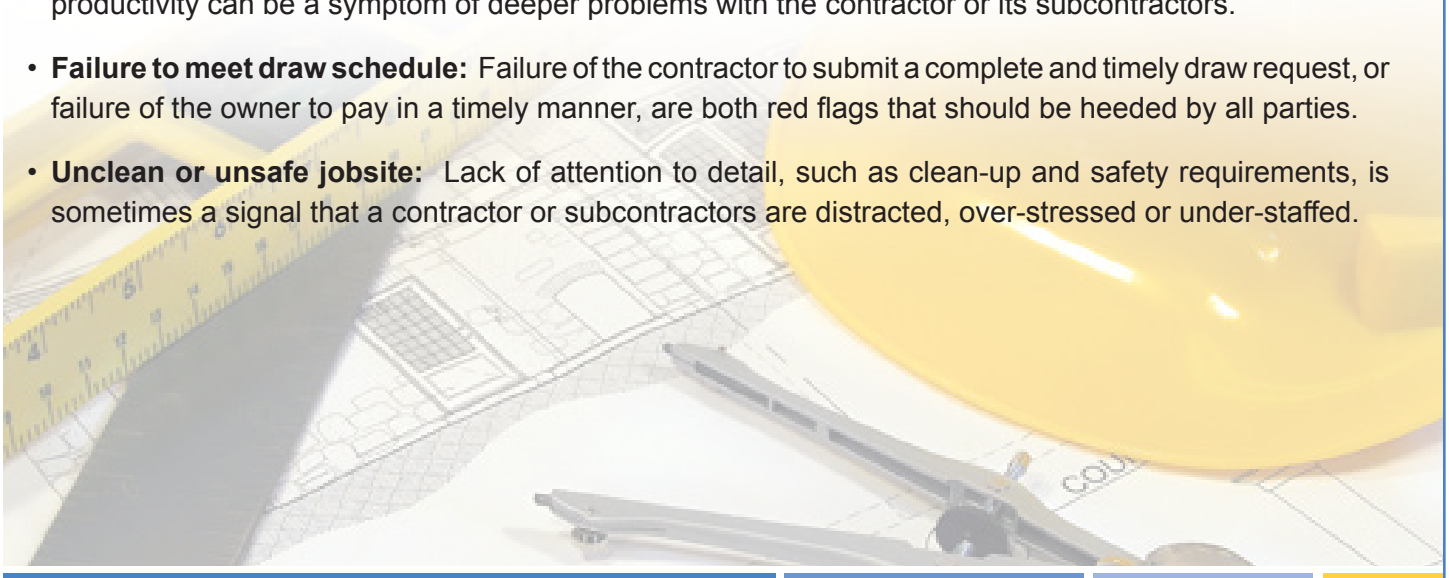
SURVIVING PERILOUS TIMES: CRISIS MANAGEMENT ON CONSTRUCTION PROJECTS

Under the current financial circumstances, it is wise for all owners, contractors and subcontractors to review the rules for crisis management on troubled construction projects. Below, we present three rules of thumb that can help keep a troubled project from turning into a full-fledged disaster.

1. Know the Early Warning Signs

Some warning signs on a project are more visible than others, but almost all share a common characteristic. That is, they signal an impending breakdown in the flow of money through a project and/or the inability of one or more participants to perform their obligations. There are several readily observable warning signs:

- **Falling manpower:** A daily manpower count can tell volumes about the health of a project. Inadequate levels of supervision or deficient staffing in one or more of the trades is a sure sign that a project is headed for trouble. A decrease in manpower is often one of the first symptoms of deep-rooted and less visible problems.
- **Late deliveries:** Like falling manpower, chronic late delivery of material or equipment is frequently a sign of worse problems to come.
- **Slow-down in the submittal process:** Delay in providing submittals can be a signal of problems among the lower-tier subcontractors. Slow-downs in the submittal approval process can signal difficulties within the design team that can have a ripple effect through the project.
- **Poor workmanship:** An increase in failed test results or project inspections can signal deeper problems related to quality of the workforce and supervision, as well as the financial health of the contractor and subcontractors.
- **Schedule slippage:** Frequent schedule updates and rigorous comparison to the as-planned schedule will identify schedule slippage before it becomes a major problem. A subbing schedule is often a result of the factors listed above.
- **Dropping productivity:** Like its close relatives, falling manpower and schedule slippage, a decrease in productivity can be a symptom of deeper problems with the contractor or its subcontractors.
- **Failure to meet draw schedule:** Failure of the contractor to submit a complete and timely draw request, or failure of the owner to pay in a timely manner, are both red flags that should be heeded by all parties.
- **Unclean or unsafe jobsite:** Lack of attention to detail, such as clean-up and safety requirements, is sometimes a signal that a contractor or subcontractors are distracted, over-stressed or under-staffed.



2. Avoid the Symptoms of Default and Abandonment

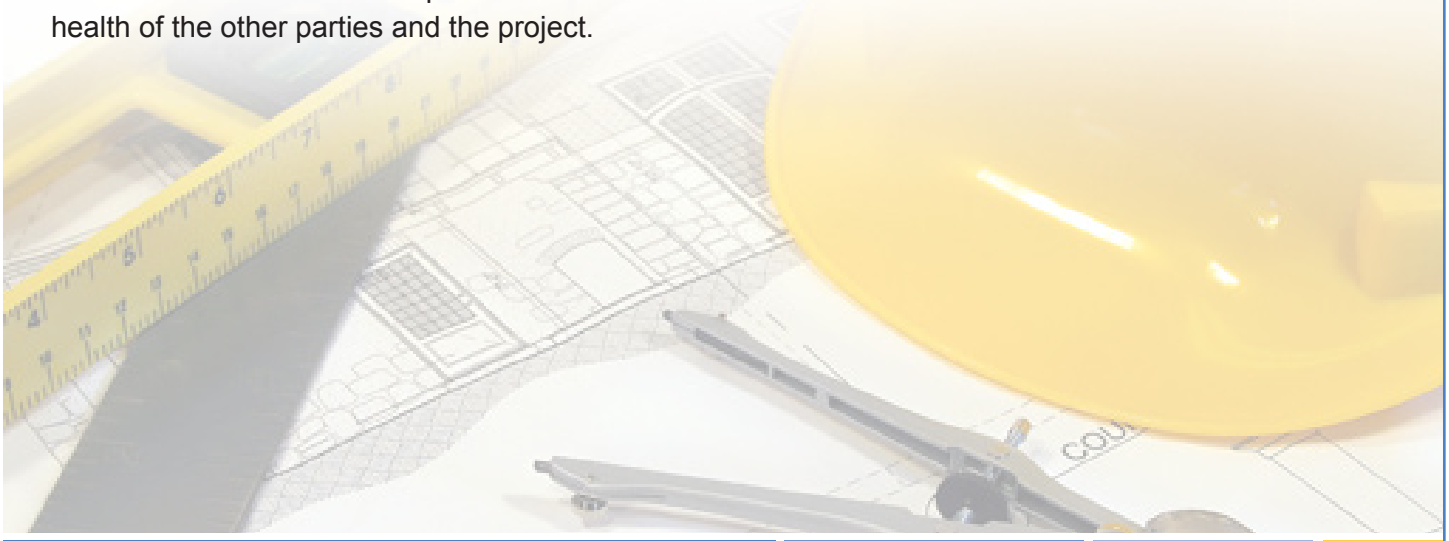
The visible warning signs listed above are often symptoms of the root causes that lead to project default and abandonment:

- **Interruption of the payment stream:** Money is the lifeblood of all construction projects. A steady flow of cash from lenders to owners, from owners to contractors and from contractors to subcontractors and suppliers is essential if a project is to be completed on time and within budget. Many different circumstances can interrupt this payment stream. Some of the more common causes include a loss of confidence, an inability to obtain funds, an inability to perform or even diversion of money to other projects. If any of these occur, immediate steps must be taken to prevent the project from slipping into deep trouble.
- **Difficulty on other projects:** Projects can be dragged down by difficulties experienced by the owner, contractor or subcontractors on other projects far away. Resource drain from other projects, or financial problems on another job, is among the most common causes of non-payment, default and abandonment.
- **Industry-wide problems:** Escalating costs or shortages of material and labor can manifest themselves as problems on numerous projects simultaneously. The result can be falling manpower, late deliveries, delayed performance and cost overruns. These problems can quickly derail an otherwise healthy project.

3. Develop and Follow an Action Plan

Particularly in uncertain economic times, all parties must respond immediately to the appearance of any of these warning signs. Developing an action plan, and detailing how the warning signs will be addressed before they appear, is a proactive means of preempting project failure:

- **Update lien waivers:** The lien waiver requirements of the contract should be checked, and all lien waivers should be current. If a pattern of waiving the requirement of lien waivers has been established, steps must be taken to revoke the waiver, and the requirement for lien waivers must be stringently enforced going forward.
- **Review "open book" and financial disclosure rights:** Contracts should be reviewed for "open book" disclosure requirements or requirements regarding financial arrangements such as Section 2.2.1 of AIA Document A201. Such provisions can be used to obtain valuable information about the financial health of the other parties and the project.



- **Check payment and retainage rights:** Once warning signs appear, the rights of the parties to withhold retainage and disputed payments becomes paramount. Care should be applied in exercising rights to withhold payment, since a flow of funds is required to sustain continued construction activity. At the same time, parties should exercise their contractual rights in a prudent manner to make sure their financial interests are protected in the event of abandonment or termination.
- **Verify the dispute resolution process:** Many contracts contain detailed dispute resolution clauses with time limits for notices, mandatory stair-step negotiations and other dispute resolution mechanisms. All parties should be aware of the consequences of failing to comply with these requirements. Use of informal dispute resolution mechanisms can also provide an effective means for exchanging information and resolving small problems before they become big ones.
- **Call on experts and professionals as needed:** If it becomes clear that a project is headed toward a rocky landing, the parties might benefit from the advice of experts and professionals to work through the issues at hand. For example, a scheduling expert can help to find ways to mitigate the damaging effects of delay, and other subject-matter experts can often suggest fixes that are more effectively implemented mid-stream than after the fact.
- **Check bonds and insurance:** The status of all relevant bonds and insurance policies, and in some cases the financial health of their issuers, should be checked. The project benefits whenever the parties can cooperate to move risks to an outside insurer.
- **Review contract terms and conditions:** This is often a good time for someone to take the time to read the applicable contract documents from beginning to end. Frequently, there are requirements built into the contract — relating to substantial completion, defective work, indemnities, staffing, recovery schedules and the like — that, if exercised in a timely manner, can mitigate the adverse effects of the "warning sign" events described above.

Even in the best of times, construction projects present many unexpected challenges. When times are uncertain, it is even more important to have an action plan, and to follow it when warning signals appear.

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