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NEW CONSTRUCTION

CONTRACTORS BEWARE: DON'T WAIVE GOODBYE TO YOUR MECHANIC'S LIEN RIGHTS

Introduction

The Court of Appeal in the Fourth District of California recently held that a general contractor's mechanic's lien rights were subordinated to a lender's deed of trust such that a mechanic's lien was extinguished when a lender foreclosed on its deed of trust. As a result, a general contractor lost its right to approximately $2.2 million in unpaid wages for work done on the project.

This decision is significant in a number of respects, but most notably because it cuts against California public policy, which strongly supports the preservation of laws which give laborers and materialmen security for their claims. In reaching its decision, the court concluded that neither the plain language of the California Constitution nor the California Civil Code prevented a general contractor from subordinating its mechanic's lien rights.

Background

DBN Parkside, LLC, purchased certain real property with a loan from BankFirst to construct a medical office complex. Thereafter, Moorefield Construction, Inc., entered into a contract with DBN for the construction of the project. After DBN and Moorefield entered into the contract, DBN entered into an agreement with Intervest-Mortgage Investment Company and Sterling Savings Bank (collectively, "lenders") whereby the lenders agreed to provide a construction loan to DBN secured by a deed of trust on the property.

As part of the lending agreement, Moorefield was required to sign and consent to a subordination clause whereby Moorefield agreed that "any and all payments made or payable to it" were subordinate to the loan and that "any and all liens for labor done and materials and services furnished pursuant to the Contract or otherwise" were subordinate to the deed of trust.

Throughout the course of the project, Moorefield submitted 16 payment applications that were all approved and funded by DBN. Subsequently, Moorefield submitted two final payment applications totaling approximately $2.2 million, but DBN defaulted on its construction loan agreement with the lenders. As a result, Moorefield recorded a mechanic's lien against the property for the two unpaid payment applications and filed a lawsuit to foreclose on the liens.

The trial court found that Moorefield's mechanic's lien was valid and had priority over the lenders' deed of trust because in the trial court's view, the subordination clause in the contract violated California public policy. Specifically, the trial court held that the subordination clause would deprive Moorefield of its mechanic's lien priority right that is a guarantee to a contractor under the California Constitution. The lenders appealed.

Decision

On appeal, the court of appeal reversed the trial court's decision and held that the subordination clause was enforceable. In making its decision, the court relied on the plain language of Section 3262(d) of the California Civil Code, which states:

> Neither the owner nor original contractor by any term of a contract, or otherwise, shall waive, affect, or impair the claims and liens of other persons whether with or without notice except by their written consent, and any term of the contract to that effect shall be null and void.

In holding that Moorefield could subordinate its mechanic's lien rights, the court reasoned that the plain language of Section 3262(d) prevents an owner or general contractor from waiving or impairing the claims and liens of other persons, not from waiving or impairing its own rights. In other words, Section 3262(d) does not prevent a general contractor from waiving its own mechanic's lien rights. Instead, Section 3262(d) only prevents a general contractor from waiving the rights of its subcontractor without the subcontractor's consent.

In reaching its decision, the court also considered Moorefield's argument that enforcing the subordination clause would be contrary to California public policy. Specifically, Moorefield argued that the court's interpretation of Section 3262 contradicts the purpose of the statutory scheme governing mechanic's liens. The court, however, rejected Moorefield's argument and stated that the general rule that mechanic's lien statutes should be interpreted in favor of the lien claimant cannot override the plain language of Section 3262.

Because the court concluded that the subordination clause was valid and not contrary to California public policy, the court held that Moorefield's mechanic's lien was subordinated to the lenders' deed of trust. Accordingly, the court of appeal reversed the trial court's judgment with instructions to enter judgment in favor of the lenders. When the lenders foreclosed on its deed of trust, Moorefield's mechanic's lien was extinguished.

Takeaways

This decision clearly holds that a subordination agreement, when a lender's deed of trust is in first position, takes priority over a general contractor's mechanic's lien. As a result, general contractors in California, and possibly elsewhere, must be cautious when reviewing their contracts for clauses subordinating or releasing their lien rights.

Although the court's decision in Moorefield is binding, labor associations, such as the American Subcontractors Association, have asked the California Supreme Court to grant a petition for review, or at a minimum to depublish the Moorefield decision. For the time being, if a contractor has any confusion regarding any subordination provisions, it should consult with legal counsel to understand the implications and alternatives in connection with signing such agreements.

Moorefield Construction, Inc. v. Intervest-Mortgage Investment Co., 230 Cal. App. 4th 146 (2014)

UNDER CONSTRUCTION

CLARIFICATION OF "NO DAMAGES FOR DELAY" EXCEPTION IN CONSTRUCTION CONTRACTS

Construction contractors often find themselves subject to "no damages for delay" clauses, which shield property owners by preventing contractors from recovering costs that accrue as a result of delays by owners. Such seemingly simple clauses can result in expensive ramifications for contractors if and when owners take actions that result in delays. For this reason, contracting parties can include an "active interference" exception, which allows contractors to recover for costs stemming from owner-induced actions that actively interfere with contractors' work. The Connecticut Supreme Court recently defined the kind of interference that plaintiffs must prove to recover delay damages in the face of a no damages for delay clause with an active interference exception. The court concluded that to establish active interference, a contractor must prove that an owner committed an affirmative, willful act that unreasonably interfered with the contractor's work. The court also clarified that a mistake, error in judgment, lack of diligence, or lack of effort is not the kind of interference sufficient to meet the standard.

This case involves renovations to a school in Bethel, Connecticut. When the city hired C&H Electric to perform electrical work and instructed it to commence, the city did not inform C&H that asbestos abatement work on the school remained unfinished. The city openly discussed the remaining abatement work at town meetings, but did not directly notify C&H, which worked for a number of months before the abatement work interrupted its electrical progress. When the asbestos contractor began abatement work, C&H was barred from certain areas of the school building and had to move its crews and equipment. Although C&H completed the work close to the deadline, it brought a claim for additional compensation against the city, arguing that the city actively interfered with C&H's work by ordering C&H to begin despite knowledge that asbestos abatement would affect construction. The contract expressly excluded any exercise of the city's rights under the contract from the definition of active interference, such as ordering changes in the work or rescheduling work, meaning that the city would only face liability if the delay was unreasonable.

The trial court ruled in favor of the city, holding that to prove active interference, a contractor must show that the owner acted in bad faith, or engaged in willful, malicious, or grossly negligent conduct, and that the city did not meet this stringent standard. On appeal, the Supreme Court of Connecticut affirmed the decision, but determined that the trial court applied the incorrect standard. The court clarified that a contractor must only prove that the owner committed an affirmative act that was willful and unreasonably interfered with the contractor's work but was not a mistake, error in judgment, lack of diligence, or lack of effort. The court concluded that the facts of the present case were insufficient to meet the active interference standard, even after lowering the bar. According to the court, because the record lacked evidence of city representatives having knowledge that unfinished asbestos work would affect C&H's work, the interference was not willful or unreasonable.

Although the clarified standard reduced a contractor's burden in proving active interference by a property owner, this case confirms that the standard is still difficult to meet. In Connecticut, contractors need not prove egregious actions by property owners, but must still be able to show that the actions were willful rather than mistaken. The rules regarding active interference vary by jurisdiction and are often dictated by statute. Contractors and property owners should be sure to understand these rules when negotiating and drafting no damages for delay clauses.

C and H Electric, Inc. v. Town of Bethel, 312 Conn. 843 (2014)

LIMITS TO THE "DEFEND-ONE-DEFEND-ALL" RULE IN CONSTRUCTION CONTRACTS

This case involves the interpretation of an Oregon statute regarding a subcontractor's duty to defend a contractor against claims. Sunset Presbyterian Church hired Andersen Construction Company, a general contractor, to construct a church. Anderson subcontracted with multiple subcontractors, including B&B Tile and Masonry Corporation. Each subcontract contained a provision requiring subcontractors to indemnify Andersen against claims and damages. After the work was finished, Sunset sued Anderson and the subcontractors, alleging property damages resulting from water intrusion. Andersen tendered the defense of the action to B&B and the other subcontractors, but the subcontractors declined to defend Andersen. Andersen then filed third-party claims against the subcontractors for breaching their duties to defend Andersen. Eventually, Sunset and Andersen settled, and Andersen assigned its claims against the subcontractors to Sunset, which settled all claims except the breach of duty claim against B&B. While some of Sunset's allegations implicated B&B's negligence, many involved allegedly defective work that was outside the scope of B&B's subcontract.

The trial court determined that B&B's contract with Andersen required B&B to defend Andersen against Sunset's allegations, but only against those that might involve B&B's negligence. Sunset argued that the duty to defend encompasses all of the claims in a complaint, in accordance with the "defend-one-defend-all rule," but the court disagreed. Looking to Oregon Revised Statutes Section 30.140, which voids provisions in construction agreements requiring indemnification for damage arising out of the indemnitee's own negligence, the trial court held that this statute voided the subcontract between Andersen and B&B to the extent that it required B&B to defend Andersen against allegations of negligence by Anderson and the other subcontractors. In light of ORS 30.140, the subcontract could only require B&B to defend Andersen to the extent that Sunset's allegations implicated B&B's work and B&B's possible negligence. The Oregon Court of Appeals agreed that ORS 30.140 limited a subcontractor's duty to defend a general contractor. The court looked to legislative history and case law addressing legislative amendments, specifically sources that discussed related policy issues. The court noted that the policy behind the legislation was to prevent contractors and owners from shifting exposure for their own negligence to subcontractors. Thus, requiring B&B to defend Anderson for Anderson's own negligence would be contrary to the policy behind the statute, and the subcontract could not require B&B to defend every claim against Andersen.

Similar to the *C and H Electric* matter, this case deals with the shifting of risk between parties and the case law and statutes that vary by jurisdiction. It is imperative that the parties understand that indemnification clauses will not always shield them from their own negligence because many states do not allow for indemnification of these claims. This case should ease the minds of subcontractors by clarifying that the price of working with contractors does not always include an obligation to defend a contractor for the contractor's own negligence. Again, all parties should take the time to understand the rules in their jurisdiction so that they can agree to contract terms that they understand and that can benefit them if a situation similar to this arises.

Sunset Presbyterian Church v. Andersen Const. Co., 268 Or. App. 309 (2014)

CONTRACTORS SHOULD EVALUATE WHETHER AN ENGINEER IS BOUND OR IS JUST BEING FRIENDLY

In a recent case in California, subcontractors found out the hard way that sometimes an engineer may be friendly without having any real legal obligations for subcontractor work.

A travel lift pier was planned for the Channel Islands Harbor at the end of Santa Barbara Channel in Oxnard, California. Marine project manager, Bellingham Marine, Inc., hired Major Engineering Marine, Inc., to construct the pier and hired Moffatt & Nichol to serve as civil engineer on the project. As part of Major's contract, Major promised that it would remove and replace the concrete on the pier if it did not meet the appropriate compression strength standard. Subsequently, Major hired State Ready Mix, Inc., to write the concrete mix design and prepare batches of concrete for the project. After being asked to do so by Major, Moffatt agreed to review and make approvals for Ready Mix's concrete mix design for the benefit of Bellingham, even though such was not part of Moffett's ordinary duties on the project.

During the project, Ready Mix delivered several batches of pre-mixed concrete to the site. After it was cast on the pier, the concrete did not pass laboratory tests for the necessary compressive strength. Major asked Ready Mix to investigate the issue. Ready Mix's technical personnel discovered the problem: the concrete application equipment had failed during the pouring and Ready Mix had chosen to manually apply the rest to finish the job.

The manual application had caused the mixture to deviate from what was specified in the project plan documents. Upon conclusion of the investigation, Major had to tear down and rebuild the affected portion of the pier at its own expense.

Major sued Ready Mix for Major's damages in removing and replacing the defective concrete. Ready Mix filed a cross-complaint for equitable indemnity and contribution against Moffett, stating that Moffett should have used reasonable care in reviewing Ready Mix's concrete mix and approving it. Moffett took the position that it had no contract with Ready Mix or with Major for responsibility of the concrete mix and also that Moffett owed no duty of care for the concrete mix. Both the trial court and the appellate court agreed with Moffett that there was no contract and Moffett had made no clear promise. Further, both courts determined that there were no facts showing that the concrete injured a person or caused damage to any other property, so Ready Mix could not recover from Moffett under an economic loss rule theory, either.

Finally, the courts determined that Moffett owed no duty of care to Major because Moffett's services did not create liability under the six-part test: (1) Moffett's services were gratuitous and intended to benefit its contract with Bellingham—not Ready Mix or Major, (2) Moffett's review and approval was not the cause of the bad concrete, (3) Moffett could not have known that the concrete would be nonconforming or would deviate from the approved mix design, (4) Moffett could not have predicted the structural soundness of the concrete, (5) Moffett did not control Ready Mix's performance or relationship with Major, and (6) Moffett was not the insurer and could not have prevented future harm. Essentially, both courts agreed that Moffett had no duty to "'sound the alarm' when [Ready Mix] submitted a concrete mix design that increased the risk of making substandard concrete."

Clearly, Ready Mix relied on Moffett's review of the concrete mix design before pouring the concrete. However, as this case demonstrates, it does not necessarily implicate a third-party engineer for liability related to the design. This case illustrates how subcontractors should carefully evaluate whether a third party on a project is lending services under an obligation or as a favor to other parties. If under the latter, a court might fail to find the party at fault if something goes wrong, and the party relying on the services may be left holding the bag.

State Ready Mix, Inc. v. Moffatt & Nichol, 232 Cal. App. 2d 1227 (2015)

GENERAL CONTRACTORS CANNOT ELECT BETWEEN BREACH OF CONTRACT OR UNJUST ENRICHMENT FOR THE SAME WORK UNDER A CITY CONTRACT

A Michigan municipality, Billings Township, let a contract to general contractor Lawrence M. Clarke, Inc., for the construction of a portion of the city's sanitary sewer system. Clarke bid on the project after some encouragement from potential subcontractor Kim S. Draeger, which had teamed with KD Equipment Leasing, Inc., and AIC, Inc., to submit a proposal to Clarke for the work. Draeger became Clarke's subcontractor and KD Equipment Leasing and AIC became Draeger's subcontractors. Together, Clarke, Draeger, and the subcontractors would perform work on two sections of the project. However, it was alleged that Draeger and its subcontractors did not perform the work completely or properly as the project was in progress. Clarke sued Draeger and its subcontractors, claiming recovery under either breach of contract or unjust enrichment. The defendants counter-claimed, also alleging breach of contract or unjust enrichment, among other claims.

The trial court awarded Clarke over $900,000 in damages. Importantly, the trial court elected to decide the case under a theory of quantum meruit because it determined that deciding this case under the existence of express contracts was problematic since Draeger's subcontractors, during some length of time on the project, had been legally dissolved after failing to file annual corporation fees and reports. Draeger appealed the decision. On appeal, Draeger argued, among other things, that the trial court should not have side-stepped legal remedies in favor of the equitable remedy of unjust enrichment to decide the case.

The appellate court reversed the trial court's decision on the contract question. The appellate court determined that, under Michigan law, unjust enrichment was not available at all if there was an express contract between the same parties on the same subject matter. Here, the parties had not made separate legal claims over different parts of the work, such as claiming an express contract governed part of the work and unjust enrichment theory governed the other part of the work. Instead, the parties alleged that their entire dealings were covered either under an express contract or under unjust enrichment. This appellate court reasoned: "[M]ere inconvenience in determining contractual obligations is not a reason to eschew contract law in favor of unjust enrichment principles." The court directed that the case return to the trial court for specific determinations as to which parts of the work were covered under actual contracts and which were not. The appellate court also directed that the assessed damages be redetermined.

While jurisdictions may vary, this case is an important reminder that even when contractual relationships are complicated or involve several subcontractor relationships, the existence of a contract may trump recovery under any unjust enrichment claim—especially between the same parties on the same work.

Lawrence M. Clarke, Inc. v. Draeger et al., LC No. 08–000227–CZ, 2015 WL 205182 (Jan. 15, 2015)

OTHER CONSTRUCTIVE THOUGHTS

On May 28, 2015, Kevin Collins and Nathan Sinning will present a seminar titled "Construction Law Update" at The Grand Long Beach in Long Beach, CA, in connection with the Construction Managers Association of America – Southern California Chapter.

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