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TRENDS IN REAL ESTATE AND TITLE INSURANCE

Be Aware of Construction Law Developments

The building boom could hit many parties in the head.

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WE ARE IN THE MIDST of one of the great construction booms in recent history. There are over 75 high-rise buildings under construction in New York City, with dozens of others being renovated or reconstructed.

The Freedom Tower, the Hearst Magazine Building, the Atlantic Yards Project in Brooklyn, and 505 Fifth Avenue are all underway. An overhaul of the Hudson Rail Yards on the Lower West Side is imminent, as the New York Sports and Convention Center or as another major redevelopment project.

If New York City's bid for the 2012 Olympics is successful, an Olympic village will have to be built. New York's tourist industry has rebounded, spurring the construction of several new hotels, including the Marriot Courtyard in Harlem — part of the $190 million Harlem Park Project. And a five-year, $13 billion rehabilitation project is in the works for New York City's public schools.

In such an environment, buyers and sellers of construction services must be mindful of recent developments in construction law. This article highlights a few of those developments.

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Lien Law Trust Fund Issues

Article 3-A of the New York Lien Law dictates how construction dollars must be preserved.[1] Monies flowing from owners to general contractors, from general contractors to subcontractors, and from subcontractors to lower tier subcontractors and suppliers are all captured by Article 3-A.[2]

At each tier, the amount paid to the provider of construction services or materials forms a trust, to be disbursed by the payer, or trustee, to the payee, or beneficiary.[3] Diversion of such trust funds is not only actionable, but also criminal, constituting theft.[4]

Recently, the New York Court of Appeals reminded us that construction lenders are also affected by Article 3-A. In *Aspro Mechanical Contracting, Inc. v. Fleet Bank, N.A.*,[5] the New York Court of Appeals held that a construction lender, Fleet Bank, diverted Lien Law trust fund assets by using payments from the owner to repay loans made by Fleet.

In that case, a developer agreed to build three properties in New York City. Fleet's predecessor loaned money to the developer and properly recorded a building loan mortgage. As part of the loan, the developer assigned its construction contract to Fleet. Thus, after the project began, the owner paid Fleet directly for the construction work done by the general contractor (and, indirectly, by the project subcontractors and suppliers).

When the subcontractors and suppliers did not get paid, they sued Fleet, claiming a diversion of trust fund assets. The Court of Appeals agreed, holding that since Fleet had not filed a statutory Notice of Lending, the contractor world had no way of knowing that the owner's payments were going into Fleet's pockets.

The point to bear in mind is that what got Fleet into hot water was not its decision to use trust fund assets to repay the debt owed by the developer — the Lien law allows a trustee to use trust fund monies to repay a lender that advanced money for the project — but Fleet's failure to file the required Notice.

Not all construction lenders are swept up by Article 3-A. *Le Chase Data/Telecomm. Servs., LLC v. Goebert*,[6] for example, held that a factor providing financing to a contractor could not be deemed a Lien Law trustee because there was no proof that the factor knew that the contractor "was involved in construction or that the funds [being paid to the factor] were trust assets."[7] Therefore, the factor was able to take advantage of Lien Law §72(1), which creates an exemption for those who receive trust fund assets

without notice that the transfer was a trust fund diversion.

Whether or not the factor should have been on notice that the transferred funds were trust fund assets, the absence of proof of actual notice doomed the unpaid sub-subcontractor's attempts to recover from the factor monies paid by the owner.

On the other hand, *Brooklyn Navy Yard Dev. Corp. v. J.M. Dennis Constr. Corp.*,[8] a recent decision by the Appellate Division, Second Department, reminds us that where there is a trust fund diversion issue, courts will study the finances of the fiduciary-contractor to ensure that a judgment in favor of trust fund beneficiaries will be enforceable.

In that case, the court required a contractor to post security in an action seeking to enforce a Lien Law trust. This result, and the payment that the contractor was required to make before there was any adjudication , should resonate among those for whom cash flow is an issue. It also illustrates the extent to which the courts are mindful of the goal of Article 3-A: to preserve a fund for the payment of those who improve New York real property.

Public Arena Developments

Given the public works projects here and on our doorstep, contractors must be aware of State Finance Law §137, which provides additional protections beyond what is provided by the Lien Law.

As a matter of public policy, a public works lienor's rights are limited to the funds received by the agency for the improvement, and to the extent the contractor is owed money. For example, a supplier who provides materials to a public project can only recover funds from the public agency to the extent that public agency has not paid the contractor.

To avoid leaving such a supplier exposed, the New York State Legislature enacted, 70 years ago, State Finance Law §137. This statute, modeled after the federal Miller Act,[9] requires contractors to obtain payment bonds on all public improvement projects. Given the limitations on public works lien rights, State Finance Law §137 provides protections that enable more economically vulnerable subcontractors to compete for public works.

However liberal the courts might be in interpreting State Finance Law §137 for the benefit of contractors, though, that liberality is not without limits.

Recently, one federal court had occasion to address a subcontractor's attempt to recover on a payment bond issued for a public school improvement project. In *Graham Architectural Products Corp. v. Riverview Architectural Products Corp.*,[10] a subcontractor fabricated, but did not deliver, certain specialty windows. Nonetheless, the subcontractor sought payment from the surety, arguing that the "diversion" and "tender" exceptions to the delivery requirement, as well as a purported exception for fabricated specialty projects, applied.[11]

The court agreed, as a matter of first impression, that the two recognized exceptions could apply to State Finance Law §137. But, on the facts, the court rejected the claim since the subcontractor elected not to deliver the goods and fell outside either recognized exception.

The subcontractor argued, nonetheless, that, because its products were specially made for this project, neither delivery nor tender was required. The court disagreed, holding that special treatment would not be accorded specialty products: having elected not to deliver the windows it manufactured, the supplier could not claim under the payment bond, no matter how unique the fabricated products were.

In another recent development involving State Finance Law §137, the Court of Appeals resolved a split between the First and Second Departments on whether a subcontractor's assignees can recover from payment bond sureties.

In *Quantum Corporate Funding, Ltd. v. Westway Indus., Inc.*,[12] the Court held that a subcontractor could assign to a factor a subcontractor's rights under a payment bond. As a result, a public works subcontractor has the comfort of knowing that if it needs the cash flow benefit of a factoring arrangement, its factor will be able to recover under the required payment bond. This, in turn, benefits both the factoring industry and the contracting industry, which depends in many cases on the availability of factoring.

The Erosion of 'West-Fair'?

In 1995, the Court of Appeals handed down *West-Fair Elec. Contractors v. Aetna Cas. & Sur. Co.*,[13] which struck "pay-if-paid" subcontracts. These subcontracts placed the risk of an owner's non-payment squarely on the shoulders of subcontractors.

In contrast to pay-when-paid subcontracts, where the general contractor conditions the timing of the subcontractor's payment upon the timing of the owner's payment to the general contractor, pay-if-paid subcontracts make payment by an owner a condition precedent to payment by a general contractor. If the risk of loss is shifted, the provision is void; if the subcontractor is merely required to wait a reasonable period of time to get paid, the provision stands.[14]

On March 8, 2005, the Appellate Division, First Department, issued what might fairly be regarded as an explosive decision on the *West-Fair* front: construction subcontracts governed by the law of another state that does not follow *West-Fair* will be enforced even if they contain pay-if-paid provisions.

In *Hugh O'Kane Elec. Co., LLC v. Mastec North Am., Inc.*,[15] the court held that a pay-if-paid clause in a subcontract governed by Florida law was valid, notwithstanding *West-Fair* and New York's public policy against such provisions, and even though the work took place in New York City.[16] The court reasoned that since the subcontract expressly followed Florida law, since the general contractor was domiciled in Florida, and since Florida does not follow *West-Fair*, New York would abide by Florida law under New York's choice of law rules.[17]

What makes the decision so powerful is the Appellate Division's rationale that the public policy underlying *West-Fair* "is not a deeply rooted tradition in this state."[18] This potentially opens the door to validating pay-if-paid provisions in subcontracts governed by the law of states that do not

follow *West-Fair*, even if the general contractor is not domiciled in another state.

Provided the general contractor can show some justifiable nexus to the state whose law governs the contract, then, under the logic of *Hugh O'Kane*, true pay-if-paid clauses might return to New York subcontracts. Whether domiciling in that other state is the only way to enjoy the benefit of an enforceable pay-if-paid clause will remain to be seen.

Another possible encroachment on *West-Fair* is New York's Prompt Payment Act.[19] That statute aims to clarify the payment obligations that exist between owners, contractors and subcontractors when they are parties to a private construction contract valued in excess of $250,000.

By making payment by the owner to the contractor a condition precedent for payment by the contractor to his subs (and the subs to their subs), the Prompt Payment Act might be seen as reviving the enforceability of pay-if-paid provisions. This is compounded by a provision in the Prompt Payment Act that states that although a subcontractor's performance shall entitle it to payment from the party with whom it contracts, where the contractor enters into a construction contract with a subcontractor "as agent for a disclosed owner," the payment obligation will flow directly from the owner as principle to the subcontractor.

Liability of Architects

In New York, privity of contract is generally not required for an architect to be sued by a third party (i.e. a party with whom the architect has not contracted) for a physical injury sustained as the result the architect's alleged negligence.

New York courts (as did other states) employed a test that differentiated between latent and patent defects — permitting a third party to recover for the former but not for the latter. That rule was abrogated in 1979, however, by *Cubito v. Kreisberg*.[20] In *Cubito*, the Second Department held, and the Court of Appeals affirmed, that the rule in New York is now that liability depends on whether the architect exercised due care in preparing his plans.[21]

The extent to which an architect may be held liable, under a negligent misrepresentation theory, for the purely economic damages of a third-party is treated differently and continues to be the subject of litigation.

Commonly, the issue arises when a contractor sues an architect (or other design professional) alleging that the contractor suffered an economic loss resulting from reliance on the architect's plans or specifications when submitting his bid. Whether the architect is liable to the contractor depends on whether the jurisdiction requires privity between them.

Courts in New York continue to follow the rule that in order to maintain a cause of action for negligent misrepresentation under these circumstances, there must be privity between the parties or, at minimum, a "bond between them so close as to be the functional equivalent of contractual privity." *Ossining U.F.S.D. v. Anderson LaRocca Anderson*.[22]

While some New York courts have found the functional equivalent of privity to exist between contractors and the design professionals on whose plans they have relied, others have been more reluctant to find functional equivalency. Compare *Reliance Ins. Co. v. Morris Assoc. P.C.*[23] with *Marcellus Constr. Co. v. Village of Broadalbin*;[24] *Williams and Sons Erectors, Inc. v. South Carolina Steel Corp.*[25]

One apparently unresolved issue in finding functional equivalency is whether a contractor, who is one of many to submit a bid based on an architect's plans, is part of a "definable class" that relies on the plans, or merely part of an intermediate class of persons who might presently, or in the future, rely on the plans.[26] Similarly, it is unclear what degree of contacts between the contractor and architect (e.g. pre-award meetings) will support a finding of functional equivalency.[27]

In other jurisdictions the privity requirement is eroding more rapidly. Most recently, in *Bilt-Rite Contractors v. The Architectural Studio*,[28] the Supreme Court of Pennsylvania considered the issue as a matter of first impression in that jurisdiction and, relying on the Restatement (Second) of Torts §552, found privity under these circumstances was not required at all.

Given the relative uncertainty of the law in New York, and developments in other states, architects practicing in New York should be mindful that they may find themselves liable to contractors based upon what is or is not contained in their plans and specifications. Appropriate contract language may, as in many cases, be the order of the day.

1. Article 3-A of the Lien Law is codified at N.Y. LIEN LAW §70 et seq.
2. Id.
3. Id.
4. Id. at §79-a
5. 1 N.Y.3d 324 (2004).
6. 785 N.Y.S.2d 222 (App. Div., 4th Dept., 2004).
7. Id. at 224.
8. 785 N.Y.S.2d 521 (App. Div. 2d Dept. 2004).
9. 40 U.S.C. §3131 et seq.
10. 303 F.Supp.2d 274 (E.D.N.Y. 2004), aff'd, 112 Fed.Appx. 123 (2d Cir. 2004).
11. Under the Lien Law, the diversion exception provides that if a supplier furnishes materials to a project but the contractor diverts those materials to another project, the subcontractor can still recover under Lien Law §5. The tender exception states that if the supplier tenders its materials but the tender is refused, the supplier can still claim its Lien Law rights.
12. 2005 WL 387205 (Feb. 17, 2005).
13. 87 N.Y.2d 148 (1995).
14. Id.
15. 2005 WL 526805 (Mar. 8, 2005).
16. Id.
17. Id.
18. Id. at *1.
19. See Article 35-E of the General Business Law, which became effective in January 2003.
20. 419 N.Y.S.2d 578 (App. Div,. 2d Dept., 1979), aff'd, 51 N.Y.2d 900 (1980).
21. Id.
22. 73 N.Y.2d 417, 419 (1989).
23. 607 N.Y.S.2d 106 (App. Div., 2d Dept., 1994).
24. 755 N.Y.S.2d 474 (App. Div., 3rd Dept., 2003).
25. 683 F.2d 1176 (2d Cir. 1993).
26. Id.
27. Id.
28. 866 A.2d 270 (2005).

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