

## Construction Law Newsletter

### GETTING PAID WHEN THE PROJECT STALLS BEFORE CONSTRUCTION BEGINS



Winter 2005

With the increasing use of Design/Build as the project delivery system, the contractor is taking on greater financial risk for the project's upfront costs of design and other preconstruction services. The risk will quickly turn into a liability if the project stalls before construction begins due to factors not within the control of the contractor such as lack of project funding. The first line of protection to ensure payment for these upfront costs is through the parties' contract. But other traditional methods of ensuring payment of these fees, such as recording a mechanic's lien or serving a stop notice, may not be available to the contractor as demonstrated in the recent decision in *D'Orsay International Partners v. Superior Court (Jeffrey Stone, Inc.)*, (10-29-04) 04 C. D.O.S. 9721 (Cal. App. 2d Dist.).

In the *D'Orsay* case, the contractor, Jeffrey Stone doing business as Summit Builders, performed \$850,000 worth of preconstruction services, including contracting for design services, for a hotel project that defendant owner, *D'Orsay International Partners*, planned to build in Long Beach, California. Prior to the issuance of a building permit or the commencement of any construction work, *D'Orsay* terminated that project because it was unable to secure project financing. Mr. Stone recorded a mechanic's lien against *D'Orsay's* real property in Long Beach. Soon thereafter, Mr. Stone sued *D'Orsay* for breach of contract and other causes of action, including foreclosure on the me-

chanic's lien, to recover the \$850,000 in unpaid preconstruction services. Early in the case, *D'Orsay* requested that the court issue an order releasing the mechanic's lien on the basis that Mr. Stone could not record a lien because no construction had begun on the property. The trial court refused to grant the order. *D'Orsay* then appealed the trial court's ruling on this issue to the Court of Appeal.

The appellate court reversed the trial court's ruling and directed the trial court to order the release of Mr. Stone's mechanic's lien. The appellate court agreed with *D'Orsay's* argument that because no work had been performed at the site, there was no improvement to the property to which a lien could attach. The appellate court explained that it is essential to the recording of a mechanic's lien that some work has commenced on the property, even if that work is as little as the delivery of materials to the project site. The appellate court also rejected Mr. Stone's claim that his mechanic's lien was akin to a design professional's lien that can be recorded before construction begins and is expressly for the purpose of recovering payment of the design professional's fees should the project not go forward. The court made clear that the lien at issue was a mechanic's lien, not a design professional's lien, and therefore the rules for mechanic's liens applied.

By basing its decision on the

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well-settled principles underpinning mechanic's lien law, the D'Orsay court did not rule on whether a "contractor" providing design services may record a design professional's lien as added protection for recovery of payment of preconstruction services should the project not go forward as planned. But it did suggest that a contractor would likely not be entitled to do so because "contractor" does not fit within the narrowly statutory definition of a design professional as a "certificated architect, professional engineer, or licensed land surveyor who furnishes services pursuant to a written contract with the landowner...." (See, California Civil Code. §3081.1.)



How then is a contractor to ensure that it will recover payment for preconstruction services when the project ends before the start of construction? As noted above, the primary protection is to negotiate an appropriate clause in the contract with the owner. But this approach would not prevent suits against the contractor by its subcontractors and design professionals seeking recovery of payment for their preconstruction services while the contractor is pursuing its remedy against the owner. One way to keep the focus on the ultimate party responsible for payment – the owner – is for the contractor to include in each of its subcontracts, including agreements with design professionals, a flow down clause that incorporates the disputes procedures of the prime contract for claims arising from the owner's non-payment. The contractor should also require in its agreements with design professionals that they record design professional's liens whenever appropriate. Additionally, the contractor should consider requiring the assignment of the designer's right to foreclose on its design professional's lien should the owner fail to pay for the design services, and that any action by the design professional to collect payment from the contractor must be stayed until the completion of the foreclosure action against the owner.

As for its subcontractors, arguably the contractor could include a "pay if paid" clause for preconstruction services (only) that would pass the risk of the owner's failure to pay to the subcontractor. Although the California Supreme Court in *William R. Clarke Corp. v. Safeco Insur. Co.*, 15 Cal. 4th 882 (1997) ruled "pay if paid" clauses in subcontracts for private projects are unenforceable as an "impermissible indirect waiver or forfeiture of the subcontractor's constitutionally protected mechanic's

lien rights in the event of nonpayment by the owner," this rule would not apply during the preconstruction period. As confirmed by the D'Orsay court, contractors (and subcontractors) do not have any mechanic's lien rights prior to the commencement of construction. Accordingly, a contractor seemingly could include a "pay if paid" clause for preconstruction services without being at odds with the *Clarke v. Safeco* decision. The same would not be true for design professionals, however, because, as noted above, they do have lien rights for their preconstruction services.

In addition to carefully drafted and integrated contracts with the owner, subcontractors and design professionals, there are other methods a contractor could employ to ensure payment of its preconstruction services if the owner terminates the project before construction begins. For example, the prime contract could require that the owner secure a specially prepared payment bond to pay for preconstruction services in the event the project stalls and the owner refuses or cannot pay the contractor. Another protection would be to establish a special escrow account for the owner's advance of the estimated amount of the preconstruction fees together with special instructions for disbursement of these funds should the project terminate before construction.

In light of D'Orsay and the increasing frequency of contractors performing preconstruction services, a contractor must be proactive in mitigating a risk of nonrecovery of fees and costs incurred in the event the project stalls before any construction begins. ♦

— Robert M. Osier

### EMPLOYMENT LAW ALERT

#### Sexual Harassment Prevention Training Now Statutory Requirement

AB 1825, signed into law by Governor Schwarzenegger in September, imposes new obligations on employers to provide sexual harassment prevention training. Specifically, employers that employ fifty or more workers (defined as employees and independent contractors) must provide two hours of sexual harassment training and education to all supervisory employees by January 1, 2006. After that date, the training must be provided to each supervisor once every two years, and to newly hired or newly promoted supervisors within 6 months of their assumption of the supervisory position. The training must be presented in a classroom or other "interactive" setting by trainers or presenters "with knowledge and experience" in the area.

## COURT DEFINES SCOPE OF WAIVER AND RELEASE UPON PROGRESS PAYMENT



The California Court of Appeal recently issued a ruling that defines the scope of the Conditional Waiver And Release Upon Progress Payment under Civil Code section 3262(d)(1).

In *Tesco Controls, Inc. v. Monterey Mechanical Company*, 122 Cal. App. 4th 1467 (2004), defendant Monterey Mechanical Company was hired by the City of Chico to expand the City's wastewater treatment control plant. Monterey entered into a subcontract agreement with Stratton Electric, Inc. for the electrical work. Stratton, in turn, issued a purchase order to plaintiff Tesco for certain electrical instruments and controls for the project. The purchase order provided that Stratton would pay Tesco in monthly progress payments equal to 90 percent of labor and materials which had been placed in position. Subsequently, Monterey and Stratton entered into a joint check agreement for the benefit of Tesco under which Tesco would send its invoices to Stratton with a copy to Monterey, and Monterey would pay Tesco by joint check.

Tesco began shipping equipment to the project site in November 1998 and invoiced for its shipments. Tesco received one payment from Stratton directly, but another check from Stratton to Tesco in the amount of \$194,762, for work performed prior to January 31, 1999, failed to clear the bank. As of March 11, 1999, Tesco was owed \$468,946. On March 15, 1999, Tesco gave Monterey a lien waiver and release conditioned upon receiving a progress payment of \$50,000. The release covered labor, services, equipment and material furnished to Stratton through January 31, 1999. At the conclusion of the project, Tesco remained underpaid by \$194,762 (the amount of the bounced check) and filed an action against Monterey's payment bond. Monterey claimed that the waiver and release furnished by Tesco barred it from recovering payment for any work performed prior to January 31, 1999. Tesco argued that the waiver applied only to the extent of the work represented by the \$50,000 progress payment for which the waiver was furnished. The Court of Appeal agreed with Monterey. It held that Tesco, by executing the lien release dated March 15, 1999, waived its mechanic's lien rights, bond rights and stop notice rights for services rendered and materials supplied up to January 31, 1999. But the Court of Appeal allowed Tesco to recover the amount owed from Monterey on the basis that Monterey breached the joint check agreement under which it was obligated to pay Tesco the full amount of the Tesco invoice when nor-

mal progress payments were otherwise due.

The Tesco decision provides important guidance on the scope of a conditional waiver and release furnished upon receipt of a progress payment. It is now clear that the waiver and release -- which must follow the statutory language set forth in Civil Code section 3262(d)(1) to be enforceable -- applies to all labor, services, materials and equipment provided through the date set forth in the waiver and release (i. e., the "through date") regardless of whether the amount of the progress payment is sufficient to cover all work provided before that date. Contractors must accordingly take steps to confirm, prior to furnishing a Waiver and Release Upon Progress Payment form, that the amount stated in the release represents the balance due for labor, services, materials and equipment provided through the "through date", and that the progress payment check matches the amount stated in the release. The only exceptions to the scope of the release are retention extras furnished before the release date for which payment has not been received, and items furnished after the through date. ■

— Patricia A. Meagher



### EMPLOYMENT PRACTICES LIABILITY INSURANCE –

An Option to Consider

The construction industry faces its share of employment litigation, including claims of wrongful termination, employment discrimination and unlawful harassment by current and former employees, as well as job applicants. Moreover, most general liability insurance policies include language which excludes coverage for employment-related liabilities. Accordingly, construction contractors may wish to consider a policy designed specifically for this purpose – the Employment Practices Liability Insurance or "EPLI".

EPLI is usually obtained as stand-alone policy; some insurers, however, offer it as an endorsement to their Businessowners Policy. The scope of coverage and policy costs vary, but generally the policy reimburses a company for the costs of defending employee lawsuits and any resulting judgment or settlement. Civil or criminal penalties and punitive damages, however, are typically excluded. Some policies also exclude class actions or claims relating to strikes, lockouts or a reduction-in-force.



## DIR REAFFIRMS PREVAILING WAGE REQUIREMENTS FOR ON- HAUL AND OFF-HAUL TRUCKING

In response to inquiries by Associated General Contractors and the Engineering and Utility Contractors Association, the Department of Industrial Relations issued a letter dated January 6, 2005 that reaffirms DIR's position regarding the payment of prevailing wages to truck drivers.

**On-haul:** On-haul work is subject to prevailing wage requirements when it is performed by the general contractor, a subcontractor, or any of their employees. On-haul work is not subject to prevailing wage requirements when it is performed by bona fide material suppliers.

**Off-haul** Off-haul work is subject to prevailing wage requirements whenever any one of the following circumstances is present —

- the work is undertaken directly pursuant to Labor Code section 1720.3 because it involves the hauling of refuse;
- the work material is being hauled onto, within, or between public works sites;
- the off-haul work is a specification of a public works contract that the hauling be accomplished in a specific manner or to a specific location; or
- the worker is required to return tools, equipment or materials to a contractor's facility. ■

### Education and Training

Rogers Joseph O'Donnell & Phillips and  
Lorman Educational Services Present:

The Fundamentals of Construction Contracts,

February 10, 2005, San Francisco, CA

Construction Change Orders,

March 1, 2005, Oakland, CA

May 19, 2005, San Jose, CA

To register: contact Lorman at (888) 678-5565

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