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The newsletter of the ABA Forum on the Construction

UNDER CONSTRUCTION

CONTRACTORS CRIMINALLY LIABLE FOR THEIR SUBCONTRACTOR'S BAD WORK?

By Robert Smith

While there are a number of problems that a contractor can expect its subcontractors to create on any given project, few contractors expect that criminal charges and jail time are among those problems. A recent case in Minnesota, however, caused many contractors – and, in particular, the owners and managing agents of those contractors – to pause and ponder whether the faulty work of subcontractors could ultimately lead to criminal liability.

In *State v. Arkell,* the CEO and owner of Carriage Homes, John Arkell, was sentenced to 90 days in jail for violations of the Minnesota State Building Code that had been caused by subcontractors of Carriage Homes. After the Minnesota Court of Appeals upheld the trial court, the Minnesota Supreme Court reversed Arkell's conviction. See *State v. Arkell,* 672 N.W.2d 564 (Minn. 2003). Contractors throughout Minnesota breathed a collective sigh of relief.

The case arose out of a condominium development built by Carriage Homes. Carriage Homes hired subcontractors to build the development, but directly employed project managers to oversee and supervise the day-to-day operations. After completion, some of the foundation elevations of the units were lower than permitted under the building code, which caused storm water to pool in the units' driveways and garages.

The city's development director notified Mr. Arkell of the problem in a series of letters over two years. Mr. Arkell notified the subcontractors, who failed to fix the problem. When the problem remained unresolved, the county attorney charged both Carriage Homes and Mr. Arkell with three misdemeanor counts under a statute making it a misdemeanor to violate the state building code. Mr. Arkell was convicted on one of the three counts and ordered to pay a fine, pay restitution to the condominium owners and serve 90 days in jail. On appeal, Mr. Arkell asked the Minnesota Court of Appeals to overturn his conviction. He first argued that he did not have the requisite *mens rea* for a criminal conviction

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NEW DIVISION STEERING COMMITTEE MEMBERS

The Forum would like to welcome the following new steering committee members: *Division 1:* John P. Carpenter and Pamela Everett; *Division 2:* Stacy A. Butler; *Division 3:* Kristine A. Kubes, Joseph H. Jones and Jerome V. Bales; *Division 4:* Elizabeth M. Roat, Roy C. Fazio and John Willett; *Division 5:* Christopher M. Caputo; *Division 6:* Ursula L. Haerter; *Division 7:* Deborah S. Butera and Wm. Cary Wright; *Division 8:* Wendy Kennedy Venoit; *Division 9:* Aaron P. Silberman and G. Edgar James; *Division 10:* Christopher Montez; *Division 11:* John W. O'Neil, Jr. and Tony Larsel Nolen; and *Division 12:* Stanley J. Dobrowski and Calvin Gladney.

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Newsletter Editor
Patrick J. O'Connor, Jr.
2200 Wells Fargo Center
Minneapolis, MN 55402
612-766-7413
fax 612-766-1600
poconnor@faegre.com

Associate Editor
Elizabeth J. Anderson
3300 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402
(612) 672-8387
fax (612) 642-8387
elizabeth.anderson@maslon.com

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MESSAGE FROM THE

CHAIR ELECT

Doug Oles,
Chair-Elect

I am greatly honored to begin my term as your Chair-Elect by writing this column. If my scope of work proves similar to that of my recent predecessors, I will spend considerable time answering questions about how members can become more involved in our association. Therefore, under the principle of FRCP 33(d), I offer this article as a source from which the answer may be derived or ascertained.

1. Participate in Forum Programs. The Forum typically begins planning its national programs roughly 18 months in advance. Proposed outlines are vetted through an exhaustive review process aimed at ensuring that topics are fresh and written materials are both substantive and up to date. The results are some of the country's most highly rated construction industry presentations, offered at a variety of interesting cities across the United States.

Our next program in Tampa **(October 21-22, 2004)** will provide attendees with an extensive collection of ancillary contract forms created by some of the nation's most experienced construction practitioners. On **November 5, 2004,** the Forum will present its one-day program on Fundamentals of Construction in five new cities (Baltimore, Charlotte, Los Angeles, Minneapolis and New York). At our winter program in New York City **(January 27, 2005),** we will offer a comprehensive outline of liability insurance that every construction practitioner should know. At next year's Annual Forum Meeting on **April 7-9, 2005,** all twelve of our Divisions will join in presenting a wide selection of topics during the colorful French Quarter Festival in New Orleans.

In addition to their educational content, Forum programs provide valuable opportunities to "network" with leading corporate counsel and construction consultants from across the U.S. Those who attend regularly will develop friendships and professional relationships that can be invaluable when legal assignments involve other jurisdictions. With growing international participation
in our Forum events, the benefits of membership expand to forging professional connections in foreign countries as well. Speakers for each program are typically selected approximately one year in advance. Division leaders can inform their members about planned program topics and may invite members to volunteer as speakers. Speakers are generally required to submit a researched paper in support of their presentations, and in some cases non-speakers may contribute papers to a published program text. Since January 2002, each national Forum program has provided attendees with a CD-ROM disk in addition to printed text materials.

2. Read Forum Periodicals. As a past editor-in-chief of *The Construction Lawyer*, I should admit to being a bit biased in touting its value as America's premier quarterly law journal in the construction industry. What many readers do

Message from the Chair-Elect

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not know is that articles in *The Construction Lawyer* typically undergo rigorous editorial compression so that readers can benefit from their essential content without having to read too many pages (the same principle famously used on the front page of *The Wall Street Journal).* For an index to articles in past issues[1], please visit the Forum website, click on Publications, and scroll down to click on the Index.

In addition to *The Construction Lawyer,* the Forum publishes *Under Construction* three times a year. This newsletter provides important notice of upcoming programs, as well as reports on late breaking legal developments and reports on activities of the Forum's various Divisions.

3. Read Forum Books. Since 1997, the Forum has published a growing list of books, covering a broad range of topics for litigators, transactional lawyers, and everyone in between. Because the Forum is able to recruit authors from the industry's most experienced and articulate practitioners, our books have won critical acclaim and achieved consistently strong sales. For a list of currently available titles, please visit the Forum website and click on Publications.

4. Become Active in a Division. The Forum encourages each of its members to join and become active in at least one of its twelve Divisions. These Divisions promote education and exchanges of information in various areas of special interest for construction industry practitioners. At the Annual Forum Meeting in the spring, each Division hosts a breakfast meeting for its members. At that meeting, the Division discusses special projects for the coming year and often provides a guest speaker of interest to Division members. During the remainder of the year, a select Steering Committee organizes special projects and recruits interested members who volunteer to participate in them. Individual participation may consist of planning a program workshop, assembling a book, or providing short articles informing other members of new developments of national importance.

5. Utilize the Forum Websites. The Forum's principal website is found at www.abanet.org/forums/construction/home.html (with apologies to the Latin purists who might point out that the plural of "forum" is "fora"). All members should have this address readily accessible among their "favorite" websites. In addition, the CD-ROM from any of the Forum's national programs will give members access to an extensive "eLibrary" with links to literally masses of resources for news and research in the field of construction law.

6. Identify Yourself as a Volunteer. Each year, there are scores of new opportunities for members to volunteer for useful projects in the Forum. There are programs to organize, papers (and chapters of books) to write, and there are Division projects to organize. If you wish to participate in one of these projects, the best starting point is to join one of the Divisions and convey your interest to the Division Chair. If you have suggested contributions to one of our periodicals, contact an editor of that publication. If you would like to speak or contribute a paper to a program, contact one of the chairs for that program (the Division chairs can provide names of the program chairs). If your firm wants to be a sponsor of our Annual Forum Meeting, please contact the Forum Chair (Jim O'Connor), the Past Chair (John Heisse) or myself.

Adapting the famous words of President Kennedy, we will all prosper if we ask not only what the Forum can do for us but also what we can do for the Forum. If we join in maintaining the Forum as the nation's most active and thoughtful meeting place for education and innovations in construction law, we will be able to look back on our service with the same satisfaction voiced by President Reagan when he retired from public life: "not bad...not bad at all."

[1] If you do not retain your past issues of *The Construction Lawyer,* you can access them via Westlaw.

Associate Editor's Message

Elizabeth J. Anderson

I am honored to hold the position of Associate Editor. We will continually strive to inform you of upcoming events, publications and other Forum activities, and alert you of any recent developments in construction law. Please do not hesitate to contact me if you have something that you believe should be published in *Under Construction.*

Contractors Criminally Liable?

(continued from page 1)

because he did not intend to violate the building code. The Minnesota Court of Appeals rejected this argument, finding that the statute was a public welfare statute and that violation of the building code was a strict liability offense, which meant that proof of *mens rea* was not required in order to convict Arkell. Arkell also argued that, even if the statute did not require proof of *mens rea,* he could not personally be criminally liable because he had no control over the subcontractor that actually violated the code. The Court rejected this argument, applying the *responsible corporate officer doctrine.* Under that doctrine, a corporate officer can be found guilty for the crime of an employee or subcontractor when they are in a position to prevent the crime. It does not matter whether the corporate officer knew that
the crime was being committed or whether the corporate officer personally participated in the crime. The theory behind the doctrine is that corporate officers will pay closer attention to their company's activities if they are personally at risk for violations of the law.

Ultimately, the Minnesota Supreme Court overturned Arkell's conviction. The court held that the statute in question was not a public welfare statute that allowed for strict liability. The Court based its decision on the fact that strict liability statutes are generally disfavored and that legislative intent to impose strict liability must be clear before a court can do away with the *mens rea* requirement. In reaching its conclusion, the Court took into account the fact that the building code is often ambiguous, with varying interpretations by the code officials who regulate projects during construction. The court did not decide whether the *responsible corporate officer* doctrine applied.

Arkell appears to be the first reported case dealing with the issue of criminal strict liability for building code violations. At least one other court, however, has stated in dicta that violations of building codes are the type of public welfare statutes that are appropriate to be classified as strict liability crimes. See *State v. Young,* 965 P.2d 37, 45 fn. 7 (Ariz. Ct. App. 1998). Similarly, in *State v. Edelman,* 780 A.2d 980 (Conn. App. Ct. 2001), a conviction was affirmed for violating the building code without a showing of culpable intent, although the defendant in *Edelman* did not challenge whether *mens rea* was a requirement for conviction.

The odds of facing criminal charges for building code violations are remote, especially if the contractor is responsive to requests from code officials that deficient work be corrected. However, contractors should be aware that violations of the building code could potentially subject them to criminal liability, even if the violation was caused by a subcontractor. Further, under the *responsible corporate officer doctrine,* officers and owners of contractors could conceivably find themselves the target of criminal charges based on their subcontractor's building code violations.

ASSOCIATE EDITOR'S NOTE

The Supreme Court of Virginia upheld the criminal conviction under a construction fraud statute in *Holsapple v. Commonwealth,* 587 S.E.2d 561 (Va. 2003). The defendant was the manager and agent of a construction company that entered into a contract to build a home. Defendant had previously been convicted of construction fraud and sentenced to fifteen years in prison with all but fifteen months suspended. The home was built, but it was deemed uninhabitable due to faulty construction. The defendant also overcharged the home owner. Relying on Virginia statutory law, the court noted that the "relevant question is whether a builder or contractor obtained an advance based upon future work promised with a fraudulent intent not to perform or to perform only partially[.]" The court held that the defendant acted with gross negligence and "a specific intent to keep the advance of money and not complete the work[,]" sentencing him to 20 years in prison. See also, *United States v. MYR Group, Inc.,* 361 F3d 364 (7th Cir 2004) (multi-employer doctrine does not extend OSHA criminal liability to a company that allegedly improperly trained employees of another employer, as the trainer was not an employer at the worksite).

JOINT CHECK AGREEMENTS

By Edward Peterson

If money is due under the subcontract at the time the subcontractor files for bankruptcy, a bankruptcy trustee may demand that the general contractor pay the money directly to the trustee, and not by joint check to the unpaid supplier, irrespective of any joint check agreement. How well a joint check agreement stands up to these challenges will depend, in large part, upon how well the agreement was drafted.

Joint Check Payments as Avoidable Preferences:

Under the Bankruptcy Code, certain payments made to (or for the benefit of) a debtor-subcontractor's creditors may subsequently be recovered by the bankruptcy trustee as an avoidable "preference." In order for such a payment to be a "preference," several conditions must be satisfied. Among those conditions is the requirement that the debtor-subcontractor must have had an "interest" in the money paid.

Bankruptcy trustees frequently allege that joint check payments received by the debtor-subcontractor's suppliers before bankruptcy are avoidable preferences and, therefore, due to be returned by those suppliers to the bankruptcy trustee. In these cases, the critical issue often is whether the debtor-subcontractor had any "interest" in the proceeds
of the joint checks. The bankruptcy trustee will argue that, because the subcontractor was a joint payee on the joint check, the subcontractor had the requisite "interest" in the check proceeds. Suppliers and general contractors, on the other hand, will argue that that alone is not sufficient to give the subcontractor an "interest" in the funds.

The terms of the joint check agreement itself generally are determinative. If the agreement clearly states that subcontractor serves merely as a trustee or a "mere conduit" of the joint check payment, bankruptcy courts often find that the subcontractor does not have the necessary "interest" in the joint check proceeds so as to make it an avoidable preference. *See, e.g.,* *In re Unicom,* 13 F.3d 321 (9th Cir. 1994); *In re Golden Triangle Capital, Inc.,* 171 B.R. 79, 81-82 (9th Cir. BAP 1994). The parties' conduct also is relevant. Bankruptcy courts have found that a joint check payment is not preferential where the material supplier acted in reliance upon the joint check agreement in supplying the debtor with materials. *See, e.g., Mid-Atlantic Supply v. Three Rivers Aluminum Company,* 790 F.2d 1121, 1125-27 (4th Cir. 1986).

Joint Check Payments Unpaid when the Bankruptcy is Filed.

If a general contractor owes a payment under a subcontract at the time the subcontractor files for bankruptcy, the subcontractor's bankruptcy trustee likely will make demand upon the general contractor to pay the money directly to the subcontractor's bankruptcy estate, regardless of whether a joint check agreement is in place or not. Again, the critical issues will be whether the debtor-subcontractor has the requisite interest in the joint check and whether the general contractor has the contractual right to make payment directly, or by joint check, to the unpaid suppliers.

Practice Pointers:

- ***Write Joint Checks Only for Amount due Supplier***. Joint checks generally should be written only for the amount actually owing to the supplier. To the extent that any additional monies are owing to a subcontractor under the subcontract, the general contractor should write a separate check for the balance. Otherwise, if the joint check includes the payment of any money that will be retained by the subcontractor, the subcontractor has a much better argument that it has the requisite "interest" in the joint check.
- ***Make Suppliers Party to Joint Check Agreement.*** The general contractor may want to insist that the subcontractor's suppliers be made parties to the joint check agreement, and include language in the agreement stating expressly that the supplier is relying upon the joint check arrangement in agreeing to supply goods and services to the subcontractor.
- ***Define Subcontractor's Duties.*** The joint check agreement should impose an affirmative duty upon the subcontractor to endorse the joint check to the supplier upon receipt, grant the general contractor the power of attorney to endorse the check on the subcontractor's behalf if the subcontractor does not endorse the check, and prohibit the subcontractor from unilaterally revoking the joint check agreement.
- ***Subcontractor Serving as Trustee.*** The joint check agreement should provide that the subcontractor acknowledges that, to the extent it receives a payment by joint check, it shall hold in trust all funds due to the suppliers and serves merely as a conduit for the payment due to the suppliers.

AGC Publishes Amendments to Address Material Price Volatility in Fixed-Price Contracts

By Mark McCallum

Ken Simonson, Chief Economist, Associated General Contractors of America, has characterized 2004 as "the year of living dangerously for construction contractors." Quite simply, in 2004, the price, supply and delivery of many construction materials are project factors that few, if any, contractors can forecast with any degree of comfort and certainty. Because of various market factors, such as a weakened U.S. dollar and consumption of materials by robust, growing economies in China, India and other countries, volatility in material price and supply is the order of the day and, likely, the foreseeable future. Essential materials for construction that are experiencing sudden price instability include steel and steel products, copper, aluminum, cement, petroleum and natural gas, wood products, and gypsum. Such volatility in prices places significant and, in some instances, calamitous financial burdens on contractors working under fixed-price agreements. Unexpected price spikes for construction materials may obliterate the already thin margins of contractors, rendering some projects infeasible and even endangering contractors' abilities to be viable, on-going businesses.

As a general rule, the risks of material price increases in fixed-price agreements are borne by the contractor. Since this period of rapidly changing material prices was unexpected, many construction contracts executed prior to 2004 do not include provisions that would afford a basis for relief in circumstances where the contractor experiences impacts from sharp material price increases. In the absence of such provisions, a contractor may not have effective legal recourse. Legal arguments to excuse the contractor's performance due to price increases generally have met with little success; courts have been rarely swayed by contractor arguments asserting *force majeure,* commercial impracticability or mutual mistake to excuse performance.

Recognizing that the price of steel and steel products likely will remain unstable "for some time to come," the Board of Directors of the Associated General Contractors of America (AGC) adopted a Resolution on March 12, 2004 that, among other things, called for public and private owners to include "equitable adjustments" for material price increases in fixed-price contracts. AGC continues to urge that public and private owners consider including economic price adjustment clauses in construction contracts as a fair means to allocate the risk of unpredictable material price fluctuations that are beyond the control of either party and to avoid the inclusion of speculative contingencies in the contract price.

Use of such clauses are recognized and authorized in the public sector. For example, the Federal Acquisition Regulation (FAR) permits the inclusion of economic price adjustment clauses in fixed-price contracts in situations when "there is serious doubt concerning the stability of market or labor conditions that will exist during an extended period of contract performance" (FAR § 16.203-2). The determination to include these clauses in fixed-price contracts is left to the discretion of the contracting officer. Under the FAR, economic price adjustments fall into three general types: adjustments based on established prices; adjustments based on actual costs of labor or materials; and adjustments based on cost indexes of labor or material (FAR § 16.203-1). The FAR contains examples of standard clauses relating to adjustments based on established prices (see FAR § 52.216-2, Economic Price Adjustment-Standard Supplies, and FAR § 52-216-3, Economic Price Adjustment-Semistandard Supplies) and on actual cost of labor or material (see FAR § 52-216-4, Economic Price Adjustment-Labor and Material).

No standard clause for adjustments based in cost indexes is prescribed in the FAR. In addition to the FAR clauses, the Defense Federal Acquisition Regulation Supplement (DFARS) includes standard clauses to address adjustments for basic steel, aluminum, brass, bronze or copper mill products (DFARS § 252.216-7000) and nonstandard steel items (DFARS § 252.216-7001).

Although standard economic price adjustment clauses have existed

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AGC Publishes Amendments

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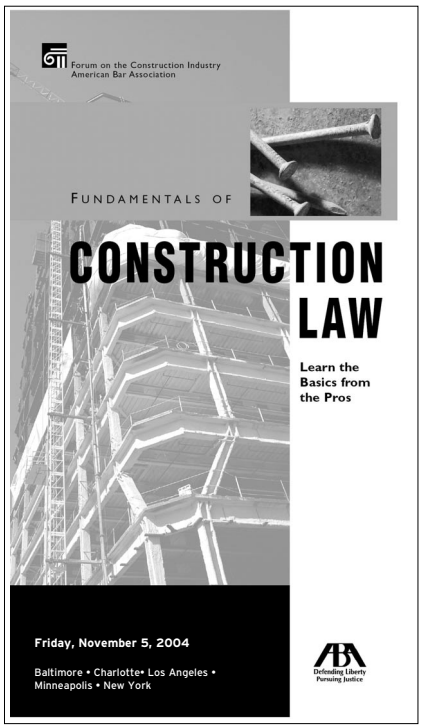
in the public sector, the families of standardized industry forms (those published by AIA, EJCDC, AGC, DBIA), which are used often in the private sector, have not included such clauses. With that in mind and at the urging of the AGC Board of Directors to provide a model clause for the industry, the AGC Contract Documents Committee developed on an expedited basis a standardized amendment to its fixed-price owner-contractor agreement and general conditions, AGC Document No. 200, 2000 Edition. Published in May as AGC Document No. 200.1, Amendment No. 1, "Potentially Time and Price-Impacted Materials," this standardized, three-page Amendment responds to market fluctuations, adjusting the price and time for delivery of construction materials that are listed in an attached schedule ("Schedule A").

The Amendment is intended to be completed and executed contemporaneously with the construction contract. This is important to note since compensation for any listed material is not to be duplicated in any contingency amounts in the construction contract (AGC 200.1, Paragraph 2.1). With respect to each material subject to the Amendment, Amendment 200.1 requires the parties to agree upon a method for establishing the "Baseline Price" of the material and a method for calculating an adjustment to that baseline price. Because the Amendment is intended to be flexible and to cover many different kinds of construction materials, calculation methods are merely suggested (established market or catalog prices; actual material costs; material cost indices; or other mutually agreed upon method) and no single method is deemed to be the default method. At the top of Schedule A are instructions that caution the parties to describe each material with specificity, to select an objective standard for calculating the baseline price, and, if a material price cost index approach is chosen, to select a cost index that most accurately reflects the listed material. These are important caveats to ensure the enforceability of the Amendment.

As do the FAR clauses, Amendment 200.1 allows for upward and downward adjustment of the baseline price. Either party may provide written notification to the other regarding adjustments. Such notification is to be given within 30 days of the date of the events that justify the equitable adjustment along with "appropriate documentation substantiating such adjustment (AGC 200.1, Article 3). Equitable adjustments are not retroactive—that is, price adjustments are permitted for only those materials delivered on or after the date of the written notice seeking the adjustment. Adjustments may not include any amount for overhead and profit, and the aggregate of all such adjustments are subject to a maximum percentage, as set by the parties, of the original contract price (AGC 200.1, Paragraph 3.3). The Amendment also permits the contractor, in situations where the contractor is not at fault, to receive a time extension and an equitable adjustment of the contract price in the event that the project is delayed due to the late delivery or unavailability of a listed material (AGC 200.1, Article 4).

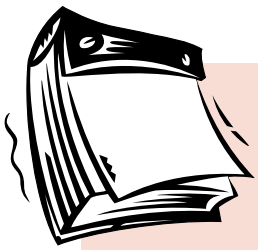
Copies of AGC Document No. 200.1 are available to be downloaded in PDF format from the AGC web site (www.agc.org/galleries/default-file/agc_200_amend.pdf).

Upcoming Regional Seminar Series



Editor's Note

For a recent case excusing a steel erector from performing due to improperly fabricated material, see *Miller v. Mills Construction, Inc.*, 352 F3d 1166 (8th Cir. 2003). While the impracticability analysis was unnecessary to arrive at this result, as material breach by a party generally justifies the other party's failure to perform, the Eighth Circuit noted that South Dakota recognized the doctrine of commercial impracticability, which provided another basis for relief.



Join Us for Our Fall Meeting in Tampa, Florida

WHEN: October 21 – 22, 2004

WHERE: Tampa Marriott Waterside

TITLE: Construction Contracts: Forms and Substance – The Array of Essential Construction Documents Beyond Design and Construction Agreements

TELL ME MORE: Join us in beautiful Tampa, Florida on October 21 and 22, 2004 for a day and a half program devoted to the construction contracts and documents beyond design and construction agreements. The presentations will focus on pre-construction and pre-bid agreements, financial performance agreements, environmental, consultancy and pre-construction services agreements, site related agreements, payment related agreements, equipment procurement and operation agreements, dispute resolution board agreements and procedures, dispute related agreements, and a presentation on ethics and avoiding conflicts when representing multiple parties.

OTHER UPCOMING PROGRAMS:

FUNDAMENTALS: LEARNING THE BASICS FROM THE PROS
November 5, 2004
Charlotte, Baltimore, New York, Los Angeles and Minneapolis

MIDWINTER MEETING
January 27, 2005
Waldorf-Astoria in New York, NY

ANNUAL MEETING
April 7-9, 2005
Sheraton in New Orleans, LA

For more information and to register for this terrific program, please visit www.abanet.org/forums/construction.

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American Bar Association
321 N. Clark Street
Chicago, IL 60610

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