LePatner Report

CORPORATE CONSTRUCTION COUNSEL

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A QUARTERLY FOR THE DESIGN, CONSTRUCTION AND REAL ESTATE INDUSTRY FOR OVER 29 YEARS

RAISING THE BAR?

Standard of Care in a Green, BIM World

by Joseph P. Seaman, Esq., LEED AP

As owners and real estate investors focus more on environmentally friendly and advanced building technologies, the design and construction industry must evolve to meet those challenges with sustainable design and Building Information Modeling (BIM). While owners and design professionals are cognizant of the economic benefits of sustainable design and BIM, they may be unaware of how these relatively new concepts legally affect the standard of care applied to design professionals.

Is it reasonable for owners, design professionals and the legal system to assume that as sustainable design and BIM are increasingly adopted, that design professionals must master these new skill sets and thereby raise the standard of care for all design professionals?

Standard of Care. In the absence of a contractually defined standard of care, design professionals (e.g. architects and engineers) must perform to the standard of care applicable to all design professionals; i.e. to exercise the same degree of care and competence exercised by a reasonably skilled member of the profession within the community in which the design professional practices. The American Institute of Architects (AIA) has also included a similar standard in its most recent AIA B101-2007 Standard Form Agreement between Owner and Architect. New York law further requires design professionals to keep abreast of generally accepted practices and new ▶

The Lien Waiver Loophole

How To Minimize the Risks of Liens and Claims on Your Next Project.

By Sean W. McBride, Esq.

Construction projects are regularly financed in such a manner that, as a condition to regular release of funds based on certified requisitions, the CM, general contractor and subcontractors execute periodic lien waivers and releases. The owner and lender expect lien waivers and releases provide certainty that the property remains lien-free and protected against contractors' claims for work performed to the date of the payment under the requisition. Unfortunately, owners and their lenders could be in for a surprise. A recent decision of an intermediate New York appellate court refused to uphold executed lien waivers and releases received in exchange for the owner's payment. As a result of that decision, LePatner has redesigned the periodic lien waivers and releases to provide greater certainty to our clients that when the contractor is paid, that ends any claims that may be raised for additional funds.

Lien waivers and releases of liens (contemplated by Lien Law Section 34) are typically provided at the time of submitting a requisition for payment for work performed or materials supplied. In New York, as in virtually every state, a waiver and release given by any potential lienor is unenforceable unless provided for by statute. New York Lien Law §34 essentially provides that any contract, agreement or understanding which purports to restrict or prohibit the right of the contractor to file or enforce a lien "shall be void as against public policy and wholly unenforceable." The statute is designed to protect subcontractors and materialmen who, the legislature has recognized, often lack the economic leverage to resist owners and general contractors who call on them to waive valuable rights prior to performance and payment for work. Section 34, however, enforces the right of the owner to have the contractor and subcontractor execute "a written waiver of the right to file a mechanic's lien executed and delivered by a contractor, subcontractor, material supplier or laborer simultaneously with or after payment for the labor performed or the materials furnished has been made to such contractor, subcontractor, materialman or laborer." ▶

Both articles in this issue of the LePatner Report have been condensed for print publication. Full versions, with citations, are available at LePatner.com.

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Are Waivers and Releases Upheld by the Courts?

Despite the language of the statute, such periodic lien waivers are generally restricted and disfavored by the courts, as part of the tendency to bend over backwards to protect contractors. Thus, in New York, courts will disregard lien waivers if they do not exactly conform to the requirements set by law. For example, a waiver is void if not provided in writing and signed by the releasor, if given prior to the time of performance, and/or if it is premised on a requirement that a prime contractor be paid first (also called "pay when paid" provisions). Even if the lien release an owner receives satisfies these requirements, however, courts may, as subcontractors argue, view them as mere "receipts" for payment.

> ...one is left wondering what the contractors agreed to when they signed their lien waivers and releases, if not to waive their right to make claims for prior work.

This presents a real problem for lenders and developers who rely on lien waivers as a means of guaranteeing priority of loans, as well as for owners and construction managers who seek to maintain guaranteed and fixed-price construction costs.

The problem is illustrated in the recent appellate court decision: *Spectrum Painting Contractors, Inc. v. Kreisler Borg Florman General Constr. Co., Inc. et al. al.* In its decision, the Court declined to uphold the waivers and releases signed by the CM and each and every trade contractor on the construction of two new residence halls financed by New York State. The trade contracts required execution of lien releases as a condition precedent to payment for work performed. Notwithstanding, the Court held, "While the release and waiver of lien forms executed by the trade contractors are applicable to the claims and liens of the trade contractors, it is not clear from the language of these documents that, in executing them, the trade contractors were waiving the right to make claims for prior work." The appellate court went on to conclude: "the majority of the trade contractors were contractually required to submit these forms as a condition precedent to their entitlement to and receipt of progress payments. The circumstances surrounding execution of these documents reveal an issue of fact regarding whether the documents constituted mere receipts for payment actually received."

The appellate court relied on *Ess & Vee Acoustical & Lathing Contrs. v. Prato Verde, Inc.* for the proposition that where a lien release is not clear, the contractor has not waived the right to make claims for prior work. In other words, lien releases must explicitly and carefully explicate certain elements in order to withstand judicial scrutiny.

These elements simply are not dictated by statute, and the courts have not explicated what, exactly, is required. Even where the lien releases in question do satisfy the elements seemingly required under *Spectrum* and *Ess & Vee*, however, the courts are likely to interpret lien releases in the context of an ongoing construction project on which subcontractors may not have been paid fully for all work performed in the prior month's requisition. How is that possible?

For a given requisition, paying contractors for base contract work is relatively straightforward, while paying contractors for change order work may be trickier. Change orders can cause delays which can extend the contractors' general conditions costs. Contractors often claim that they won't know how much a delay has cost them until after the change order work is completed and the delay has been calculated. Owners rightfully despise this game because they don't know what the "alleged" delay costs are until months after the work has been performed, and then they are typically rammed through by the contractors under threat of further delays unless the additional claims are paid.

The contractor requires no judicial intervention, no judgment, and no ruling in order to file a mechanic's lien, which effectively encumbers real estate and obtains priority over virtually all other parties. It is this power, with or without a valid basis, and without judicial oversight that necessitates lien waivers and releases on construction projects as a means to contest a lien's validity.

In *Spectrum*, the owner is left wondering what the contractors agreed to when they signed their lien waivers and releases, if not to waive the right to make claims for prior work. The Court refused to uphold the lien releases and the case proceeded to trial, forcing a settlement of the issue of the contractors' right to payment for alleged extra work which had not been covered by the executed lien waivers. The shield became a sword: what began as a means of protecting the contractor and owner became a weapon to demand payment from the owner for alleged extra costs. In fairness, it may not be the contractor's fault that extra work was required.

The lesson of the *Spectrum* case is that protective language in the contract and in the lien waivers and releases that they execute on a periodic basis. Among other provisions, construction contracts must now require that unless the change order work is approved in writing by the owner, the change order cost is not payable by the owner. The lien waivers and releases must carefully be drafted to deprive the contractor of the claim that what was tendered by them each month was a "receipt" and not a waiver and release.

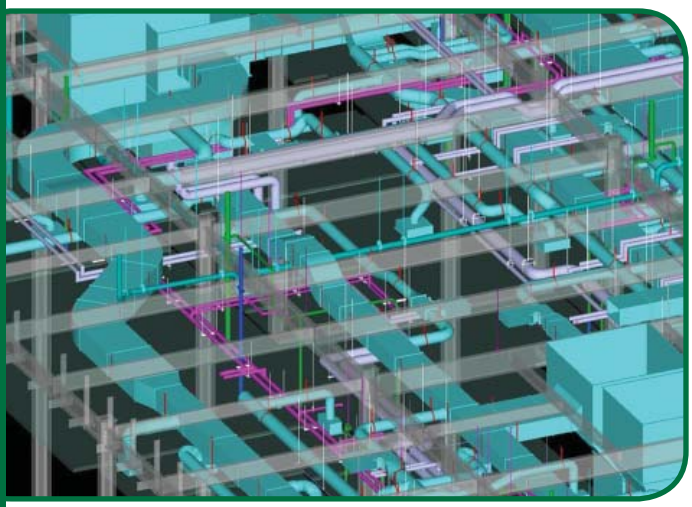
LePatner has developed other solutions to protect the owner from claims that the owner expected in good faith, an in reliance on contracts it signed, would be enforced by courts. Thus, the **LePatner C3 Model™** offers solutions to ineffective lien releases. Designed to streamline the construction process and return control to owners, the C3 Model controls the cost of a construction project by requiring coordinated design documents prior to construction, thereby reducing the need for costly change orders that turn lien releases into mere receipts. C3 Agreement provisions require timely submission, approval, and implementation of change orders, thus ensuring that trade contractors are paid in full, on time, every time, while ensuring that lenders and owners do not face claims for extra work months long after the extra work occurred. In so doing, the C3 Model insists on design team and contractor accountability and returns control of a construction project to the owner by mitigating change orders and delay claims that invariably result in costly and lengthy litigation. ▲

Visit LePatner.com to learn more about our LePatner C^3 Model.

Standard of Care continued from p1

developments in the field. In 1890, in *Hubert v. Aitken*, the New York Court of Appeals affirmed the judgment of a lower court holding an architect liable for failing to properly size a chimney flue for steam heat, a new technology which had become common at the time. The Court's ruling seems to imply that sustainable design and BIM will soon be the benchmark for the standard of care for design professionals.

The common law standard of care is a relative, subjective standard that measures a professional's competence against that competence prevailing in the profession within the same geographic area. As practice within the design professions evolves, so does the benchmark for the standard of care. Historically, the roles of those who designed versus those who built were clearly defined and linear. In recent decades, the advent of the fast-track process with its overlapping design and construction phases diverged from the traditional design-bid-build process. Arguably, the quality and completeness of the design professional's drawings declined as a consequence of fast-track projects, and the standard of care benchmark experienced a relative decline. Today, do BIM and sustainable design raise the benchmark for the professional standard of care? Currently, the bench-



mark for design professionals, as applied to BIM and sustainable design, is unclear. However, one can easily argue that with the proliferation of sustainable design and a significant increase in BIM implementation, the standard of care is undoubtedly evolving.

Sustainable Design Has Arrived. Over the past five years, "sustainability" and "sustainable design" have become buzzwords branded into the American social conscience. At the forefront is the United States Green Building Council (USGBC) and its Leadership in Energy and Environmental Design (LEED) rating system, which has established a methodology to measure the "sustainability" of a building's design. The USGBC also created a process for individuals wishing to become a LEED Accredited Professional. To date, over 140,000 professionals have obtained LEED accreditation in order to burnish their sustainability credentials. The AIA embraced green design with new edicts included in the AIA (2007) documents and its cannons of ethics, mandating that architects recommend and advocate sustainable design alternatives. Additionally, federal, state and municipal governments have passed laws mandating that certain public buildings be designed, renovated and constructed to minimum green and or LEED standards.

Where are we now? – A Crossroads. With the USGBC's LEED rating system and accreditation process now mainstream, more is expected of design professionals today than even ten years ago. But should design professionals who are also LEED APs be measured against the practicing professional in its community or against the LEED AP professional practicing in its community? To further complicate matters, LEED APs can now be accredited in one or more of several LEED rating systems, which are based on different building types. The AIA's edict to advocate and encourage sustainable design strategies has become commonplace for the design professional.

As the design professions have evolved, the standard of care has been flexible enough to adapt as well. But, in the past, change has been far more incremental compared to this rapidly evolving climate. The truth is that there are risks to all parties if a project fails to achieve its sustainable design goals. Although there is no case law discussing liability for failing to obtain stated sustainable design goals, design professionals are keenly aware of the issue and will not contractually "guarantee" a specific LEED certification outcome. Because designing and constructing a LEED building require closer collaboration and coordination between the design professionals and contractors than on a non-LEED project, responsibility for the failure to obtain a specific LEED rating, for instance, will likely fall on one or more of the parties. Further, the enactment of statutes mandating sustainable design strategies will also likely raise the benchmark for the standard of care. A design professional who fails to meet statutory mandates may be subject to a higher standard of negligence *per se*.

Add BIM to the Mix. BIM is a digital project delivery process driven by advanced 3D technology that makes it possible for design professionals, owners, builders and construction managers to collaborate and produce a dynamic model database containing fully integrated design, construction cost, and building management information. BIM promises to reduce the number of errors, omissions and change orders normally associated with a traditional 2D design and coordination process.

However, BIM may further blur the roles of design professionals and builders. Although a complete and fully coordinated set of construction documents is one goal of the BIM process, the ability of multiple parties to manipulate the model raises questions of professional liability. Setting aside licensure and intellectual property issues for the moment, the BIM revolution poses issues with respect to the Spearin Doctrine and the standard of care owed by the design professional to parties with whom it is not in privity. This potential liability to third-parties may, in turn, have implications on professional liability insurance.

Privity and the Spearin Doctrine. The Spearin Doctrine, established in the early part of the twentieth century and

approval in February 2010.

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applied by most states, holds the owner or the design professional liable for any deficiencies contained in the construction documents. The contractor is entitled to reasonably rely on the accuracy and sufficiency of the construction documents. If the construction documents prove to be defective or incomplete, the contractor is entitled to compensation for the additional cost incurred to perform any corrective work required.

With the advent of BIM, the line between design professional and contractor may become sufficiently blurred that it becomes increasingly difficult to determine who is ultimately responsible for the defects. At what point may the contractors reasonably rely upon the documents? Do the design professionals take responsibility for modifications to the design by the contractor? The application of the Spearin Doctrine here may be trying to force a square peg into the proverbial round hole. As the relationships among the parties have evolved, so will the law. However, there is no case law yet on point to provide guidance. Therefore, it becomes increasingly important for the parties to clearly define their respective roles and expectations in the project agreements.

In a BIM world, the parties agree to collaborate more intensively during the design process before construction begins as opposed to the traditional design-bid-build approach where design professionals design the project without much, if any, contractor input. By using BIM, the end product does not change (drawings and specifications are still issued to contractors for bidding), but design professionals will be required to undertake an additional level of coordination with the builders during the design process to ensure that the construction documents are fully coordinated, error free, and code compliant. In a BIM world, failure to do so will potentially impute negligence.

Requiring a complete set of fully coordinated drawings, vetted and verified by the contractor before construction begins as the basis for a complete construction cost, will also serve to mitigate the risks inherent in the BIM and sustainable design processes. For public projects, the agreements should expressly state the laws mandating sustainable design, rather than relying on boilerplate language requiring that the project be designed and built pursuant to all applicable laws.

Implications of Going Green and BIM on Liability Coverage. Typically, a design professional's errors and omissions (E+O) insurance policy will cover any design defects, even those related to sustainable design. However, the E+O carrier will exclude from coverage any liability it considers resultant from warranties or guarantees made by the insured. Insurance carriers consider BIM a 3D version of 2D CAD, and its use does not materially affect E+O coverage. Sustainable design however poses warranty issues that may be excluded from traditional E+O coverage. Consequently, the contract language becomes critical when establishing sustainable design goals for a project. Language must be drafted to ensure that liability for the design professional's services are covered under the E+O policy. For example, the contract could establish a desired range for LEED certification rather than stipulating that the project will achieve a particular LEED rating.

Furthermore, because the LEED certification process relies on efforts by both the design professional and the builder in documenting a project's design and construction, the standard of care for determining whether a design professional is liable for failing to meet the stated objectives may become elusive. But owners can mitigate that risk by insisting on contract language that clearly establishes the roles and responsibilities of the parties with respect to sustainable design, BIM, and documentation of the project which will define the standard of care expected on the project. However, be forewarned that attorneys and insurers of design professionals and contractors will often attempt to beat back any perceived attempt by an owner to elevate their clients' standard of care beyond the legal limits.

Conclusion. The implementation of BIM is merely a technological evolution of the design process. The AIA's edict that architects shall promote sustainable design has gained traction. However, in the near term, the applicable standard of care is in flux. Eventually, as these services become the norm for design professionals, the standard of care will evolve accordingly. Until they become commonplace in the industry, owners must protect themselves through their contract language by clearly establishing roles, responsibilities and standards of care for all of the parties. ▲

Firm News

LePatner has been retained by a major developer to provide all the design and construction agreements for a major new ground-up commercial and flagship retail project in SoHo.

Barry LePatner was named as a top real estate lawyer in NYC by the *New York Observor* and regularly contributes to their "Ask the Expert" column.

Barry LePatner was recently interviewed by GlobeSt.com to spread the word about the growing need for construction industry reform. He was also interviewed on "The Federal Drive", a Washington DC radio program, setting out the problems of governmental agencies who are not fully versed in how the construction industry operates and prices projects.

"Taking on Design Projects in Another State" by Ron Feingold and Alicia Bond was published in the Dec. 2009 issue of *Under Construction*, in conjunction with the ABA Forum on the Construction Industry.

Brad Cronk was interviewed for an article on how to control healthcare construction costs in the April issue of *hfm* (Healthcare Financial Management) magazine.

LePatner successfully completed the ULURP process for its client, converting an industrial building to mixed-use commercial units and loft dwellings, securing City Planning Commission approval in February 2010.

Quote of the Quarter

Wisdom consists in being able to distinguish among dangers and make a choice of the least harmful.
- *Niccolo Machiavelli*

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