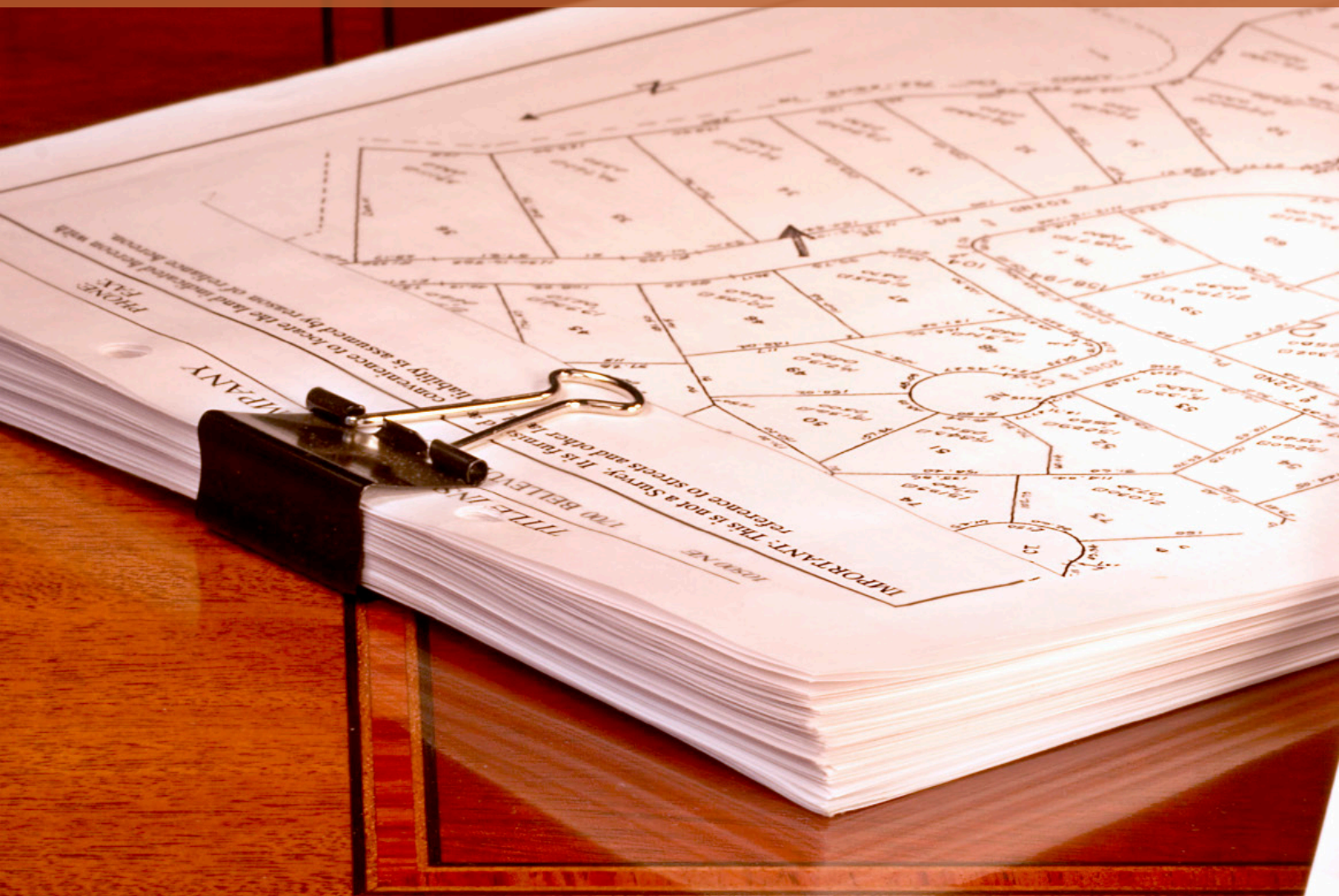


WRITING AND REWRITING SUBCONTRACTS FOR CONSTRUCTION WORK



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Preface

The author alone is responsible for the contents that follow. Don't blame the sponsor.

Please understand also that views expressed here may not (alas) always be shared by judges in actual cases.

And if you yourself, Dear Reader, find anything here that displeases you, then I pray (to paraphrase Chaucer) that you attribute it to shortcomings in my knowledge, not my intentions. We try to do our best.

In the effort, we use our own experience, the teachings of others, and the guidance of legal precedents.

Legal authorities will be referred to in the text, underlined, but without full citations, which can be found at the end, in a table of cases. Think of the underlined references as hyperlinks, operated manually instead of electronically.

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Introduction

This is about subcontracts - - subcontracts for construction work.

The plan is to review the essential components of such subcontracts, of which there are really only two: provisions delineating what work is to be done and provisions stipulating how much is to be paid and when.

We'll also examine a couple of the more important subsidiary features: provisions concerning changes and provisions concerning disputes and claims.

We do not plan to cover any of the many other provisions often found in subcontracts, which can include provisions concerning some or all of the following: enumeration of contract documents, time of start and time of completion, default termination, convenience termination, various exculpatory clauses, anti-assignment provisions, insurance requirements, and so forth.

Only the typical subcontract will be examined, by which we mean a formal, written subcontract. None of the following topics will be discussed:

- oral subcontracts
- contracts written but never signed
- letters of intent
- promissory estoppel
- bidding practices
- "bid shopping"
- "buying out the job"

Before getting down to specifics, however, a few general observations may be in order - - some Do's and Don'ts.

1. Some Do's and Don'ts for Subcontracts

Here are a few suggestions for producing subcontracts that are both understandable and workable. These are of course just the author's ideas. Others may disagree, even others with more wisdom or experience.

1. **Don't** ever believe paperwork is a cure-all.

No written agreement, no matter how painstakingly put together, can avoid or resolve, or even anticipate, any and all possible problems. Worse, provisions inserted to help in one particular scenario can sometimes turn out to hurt in other scenarios.

2. **Do** make sure you know as much as you can about the other party to a prospective contract.

If you don't already know the other party very well, then find out. The internet makes it easy even if the party's reputation is not well known in the industry. For some, you could trust a handshake (though not a recommended businesslike practice). For others, no amount of paperwork is worth the paper it's written on. People count more that paperwork.

3. **Don't** try to "reinvent the wheel" when drafting agreements.

Stay close to the tried and true. Familiar provisions have acquired familiar meanings in industry practice and court decisions. Benefit by the experience (and mistakes) of those who have gone before. Don't copy slavishly, but mine worthy ideas from previously used forms. Some good sources are the following:

- American Institute of Architects Form A401, aia.org
- Consensus DOCS, consensusdocs.org
- American Subcontractors Association, asaonline.org
- Associated General Contractors of America, agc.org
- AmJur Legal Forms 2d, "Building Contracts"

4. **Don't** over-do. Prefer brevity and simplicity. Avoid prolixity and complexity. Strive for clarity.

Every unhappy experience seems to inspire additions and insertions in contract forms. The document swells in size. The new matter is often grafted on, as sub-clauses, "provided that's," "exception to's," "however's," "notwithstanding's," or like

qualifications. The prose gets tangled up. Instead of cutting problems out, ambiguities and inconsistencies are woven in.

Reading such bulky work-products, one wishes subcontracts could make do with a simple reference to something like “the usual stipulations,” or “uniform customs and practices,” or industry-adopted “standard terms.”

And as for prose style, Montaigne wondered why, though we can make ourselves understood well enough in everyday discourse, we get tongue tied when writing wills or contracts. Will Rogers’s cynical answer was, so lawyers can earn a living getting paid to decipher what other lawyers have written.

Legal documents don’t have to be unreadable. To sharpen drafting skills, recommended reading is a superb monograph, by Howard Darmstadter, titled, Hereof, Thereof, and Everywhereof: A Contrarian Guide to Legal Drafting (ABA 2002).

Also worthwhile are Plain English for Lawyers, by Richard C. Wydick (Carolina Academic Press 2005); and various books and articles by Bryan A. Garner.

- 5. **Do** review carefully draft documents presented to you.

You won’t often have the bargaining power to negotiate material changes. But you need to understand, and to make sure your client understands, what your side is getting into. In extreme situations, an informed decision has to be made whether or not to walk away.

Lawyers need to go beyond the typewritten draft and apprise their clients of provisions that may be imposed by law or that may be nullified by law. For example, statutes may prohibit limitations of remedies or choice of out-of-state law or certain indemnification agreements. Depending on the jurisdiction, case law might either nullify or enforce “pay when paid” provisions.

- 6. **Don’t** over reach. Don’t take advantage of greater bargaining power to gain an “edge.” Be fair.

This last counsel is surely a radical idea, bound to be controversial. But contracts that are too one-sided can have unintended consequences - - higher prices, less desirable subs, poorer quality work, more litigation.

A contract should be a protocol for working together, not a charter for future litigation.

Moving on from philosophical generalities, let’s now proceed to some specifics.

2. Scope of Work Problems and How to Avoid Them

Nothing is more central to a subcontract than to delineate the scope of work. By definition, a subcontract is simply an agreement to perform work embraced within another contract. The other contract could actually be another subcontract, but typically it is the contract between the project owner and a prime contractor.

In theory, a subcontract could be for 100% of the overall work of the main contract, but 100% subcontracts are exceedingly rare, sometimes even forbidden. Normally, then, a subcontract will be for only *part* of the overall work.

It is therefore essential to delineate clearly what work is to be done by the particular subcontractor and not left to the prime contractor or to other subs. There shouldn't be any overlaps or, worse, any gaps. The parts have to fit together neatly, like the pieces of a jigsaw puzzle.

Missing Pieces of the Jigsaw Puzzle

Avoiding gaps by preparing a careful scope of work is obviously a job for construction experts, not lawyers. Nevertheless, lawyers can contribute some helpful hints. Here are a few ways lawyers can help:

- Emphasize the need for the utmost care and quality control in preparing, reviewing, and double-checking the “scope of work” portion of the proposed subcontract.
- Alert clients to potential problem areas, with horror stories from past litigations.
- Point out why incorporation by reference can sometimes fall short.
- Explain the inadequacies of “catch all” phrases.
- Remind clients to go beyond the “bricks and mortar” items of the work and of the need to give attention to ancillary matters, like equipment and services, etc.

Incorporation by Reference

Incorporation by reference to drawings and specifications from the main contract is standard procedure for subcontracts, as it should be. But it can sometimes fall short.

On any sizeable project, there are apt to be separate sets of drawings for the architectural, structural, and mechanical aspects of the project. Specifications are set forth in separate sections, e.g., excavation, concrete work, structural steel, roofing, plumbing, etc. These natural divisions make it easy to parcel out different parts of the work to different subcontractors. And a convenient way to do so is by incorporation by reference: the scope of work for the concrete sub references the corresponding section of the specifications, and there are equivalent references for other trades -- masonry, carpentry, and so forth.

So far, so good. Nevertheless, problems can arise.

A recurring problem area is where work items covered in different sections of the drawings or specs intersect. This may not be a worry for a spec writer or draftsman preparing contract documents for a single, prime contractor. But when the prime parcels out work among different subs, by simply incorporating the spec sections or drawings for the particular trade ... well, it's a frequent source of disputes.

And in the real world, it's only natural for subcontractors of a particular trade to focus on the particular drawings and specs for their type of work. They won't have Q.A. teams combing through all the other drawings and specs to spot problem areas - - no matter what general admonitions or catch-all phrases are slapped into the subcontract.

So it's up to the prime contractor's team to spot those problem areas, and to address them, specifically.

Specific Inclusions, NIC's, and Catch-Alls

Catch-alls don't work very well, don't head off disputes. Phrases like "all related items," "all required items," "all typically included work," "everything else customary in the trade," - - phrases like those just provide lawyers and law courts with material to split hairs about.

Catch-alls are no substitute for a carefully delineated scope of work. And to get there it is necessary first to go through all the drawings and specs, to identify those trouble spots where different items of work intersect, and to then clarify things explicitly.

The subcontract needs to explicitly identify such items as either specifically included or as specifically excluded, i.e., as not-in-contract (NIC) items.

Ancillary Equipment and Services

While naturally the main focus will be on the items of work to be performed (or not to be performed) by a given subcontractor, attention also has to be given to ancillary equipment and services. The subcontract should leave no room for argument about who

is to provide which of those items, and who is to pay. Some examples of ancillary equipment or services that may need to be addressed are the following:

- ✓ Cranes, hoists, elevators, scaffolding
- ✓ Water, electric power, lighting, heating
- ✓ Trailers, toilets, storage facilities, staging areas
- ✓ Site security
- ✓ Clean-up, debris removal, hazardous materials removal

Salvage

Speaking of “removals,” another subject often overlooked is salvage. It may not come up very often, but disputes can come up, on demolition or renovation jobs, about things like copper items, fixtures, and even bricks. And lest anyone think salvage can never be an issue for new construction, think about the salvage value of lumber from site-clearing.

3. Paying and Getting Paid

Progress Payments

Subcontracts typically provide for progress payments, as the work goes along. Most often, these are at monthly intervals, but other timing is sometimes agreed. For example, payment of set amounts could be synchronized with completion of specified portions of the work.

Written payment applications are the norm. See, e.g., AIA Form G 702. Payment applications can be reviewed preliminarily, in draft, or “pencil copy.” Then, assuming accord, the payment application can be presented in final form.

For lump-sum contracts, progress can be measured against an itemized breakdown of the lump-sum price, by applying percentages of completion to each item. For unit-price contracts, obviously units have to be counted or measured. Which sounds easy, like simple arithmetic. Nevertheless, disputes can arise, as to the counts or as to the methods of counting or measuring. Disputes also arise when there turn out to be wide variances between original estimates and ultimate quantities.

Payment increments and timing can generally be whatever the parties agree upon ... generally, but not entirely. This is one of those areas where freedom of contract is constrained by law, both statutory law and case law.

“Prompt Payment Act” legislation can enter in, not only for public but also for private contracts. See, e.g., NY State Finance Law sec 139-f; NY General Municipal Law sec 106-b; NY General Business Law sec 756-a. Among other things, such laws provide minimum turn-around times for contractors to pay subcontractors their share of payments received from project owners.

Retainage

From amounts approved as earned for each progress payment it is standard practice to withhold some stated percentage until the entire work is complete or has reached a certain specified stage of completion. Retainage is supposed to give the contractor or subcontractor (as the case may be) an incentive to go the distance and finish the job, failing which, it accumulates a fund to apply to remedy defective or incomplete work.

The amount of retainage will be stated in the subcontract. It’s usually 5% or 10%. But here too statutes can play a role. See, e.g., NY Gen Bus Law sec 756-c; NY State Fin Law sec 139-f (2) ; NY Gen Mun Law sec 106-b (2).

Statutes like those forbid prime contractors from retaining a higher percentage from subs than owners are retaining from the prime. They also impose outer time-limits for release of retainage by owners, like 30 days after final approval of work on the main contract. NY Gen Bus Law sec 756-c.

That outer limit can turn out to be a long wait for a subcontractor whose work was finished early on in a multi-year project. Whether such a sub can negotiate for an earlier release of its retainage, measured, say, from satisfactory completion of that sub's work, is iffy. One factor is whether the nature of that sub's work is such as to present any genuine risk the owner could find fault at the very end of the project, for example, at final testing and start-up. And, of course, much also depends on the sub's bargaining power.

Pay When Paid

Contractors rarely if ever have enough working capital to finance an entire project from start to finish. That's almost a truism. For, the more capital they have, the bigger the jobs they will undertake. And for various reasons, credit lines are not a complete solution either. Consequently, contractors rely on progress payments from owners, so they can pay for labor and materials as the job goes along. And, in the meantime, until progress payments come in from the owner, contractors depend on subs and suppliers working or delivering on credit.

That business model leads naturally to "pay when paid" clauses in subcontracts: the sub is to be paid when the contractor gets paid by the owner -- not before. There is nothing inherently evil in such arrangements. And "pay when paid" clauses have been common in subcontracts from time immemorial.

But what if the owner *never* pays? Well, some might say, you take the good with the bad; it's a case of the sub sharing the pain as well as the gain.

In fact, that's pretty much what the highest court of New York once said, in the Mascioni case. The court there saw no inequity in "pay when paid," because the prime had gained no benefit at the expense of the sub: the prime hadn't gotten paid either.

Nor was the Mascioni court swayed by the sub's argument that the word "when" was merely a "timing" provision, unlike the word "if." That was a distinction without a difference, said the court; "when" could be "never." (You know, like "When hell freezes over," "When pigs fly.")

The Mascioni case was decided in 1933. It represented the law in New York for many years thereafter. Then things changed. A series of cases starting in 1975 discovered a distinction between "when" and "if." They held "when" was merely a "timing" provision. They didn't say for how long. (So we have no idea when, but presumably it's only a matter of time before hell freezes over and pigs learn to fly.)

Anyway, after the judges changed the meaning of the word “when” (judges after all, like the character in the Alice story, *can* make words mean whatever they want), subcontract forms were hurriedly revised, to change “when” to “if,” or to add even more explicit legalistic wording, like “condition precedent,” so as to leave no room for doubt that, yes, if the owner didn’t pay, then the sub would not get paid.

It was a “nice try.” But it didn’t work for very long. Then all of those new and improved subcontracts, with their “if” type clauses, came to naught, no matter how clearly worded. It was no longer a question of wording. The very concept of “pay if paid” was declared to be completely invalid. In a 1995 court decision, West-Fair, New York’s high court judges, perceiving a long-unnoticed conflict with New York’s lien law, decided it was against public policy to make sub’s payments depend on owner payments.

Well, that’s where New York wound up, changing what had long been the rule in New York. So, however worded - - “pay when paid,” “pay if paid,” “condition precedent” - - such clauses became unenforceable. In New York, subs can’t be made to go unpaid merely because the owner doesn’t pay the prime contractor.

And that’s not just the rule in New York. Such contingent payment clauses have become unenforceable in a few other places too, whether by judicial pronouncements or by special statutes. Here are some of them:

<i>California</i>	<u>Wm R Clark</u>
<i>Delaware</i>	<u>Del Code 6 sec 3507</u>
<i>North Carolina</i>	<u>Am Nat’l Elec</u>
<i>South Carolina</i>	<u>S C Code sec 29-6-230</u>
<i>Miller Act</i>	<u>US f/u/o Walton</u>

Nullifying these clauses, however, remains a minority rule. Contingent payment clauses continue to be enforced in most states, including, to cite a few representative samples, the following:

<i>Florida</i>	<u>DEC Elec</u>
<i>Illinois</i>	<u>Premier Elec</u>
<i>Ohio</i>	<u>Mechwart</u>
<i>Pennsylvania</i>	<u>C.M.Eichenlaub</u>
<i>Texas</i>	<u>Lakin Enterprises</u>

Needless to add, even in states that find no fault with contingent-payment clauses in principle, the wording of the particular clause must make *clear* that the sub will not be paid unless the owner pays the prime - - “unless and until,” might be a lawyers locution. And in fact a number of such states have embraced the “pay if” versus “pay when” distinction - - a distinction sensible to lawyers if not to grammarians. (But then Strunk and White didn’t have to deal with the law courts.)

Two or three other points need to be mentioned in this context.

To be distinguished from the fact-pattern where the owner should have paid but didn’t is the fact-pattern where the owner does not pay because, say, a claimed extra is denied or disputed. Even in states that won’t enforce “pay when paid” or “pay if paid,” courts will not force contractors to pay subs in that situation, where entitlement is in dispute because, say, the owner does not agree the work in question is truly extra work. See, e.g., Burmar ; Suntech .

Ditto, where the owner hasn’t paid because the owner finds fault with some work done by the sub itself. See, e.g., Sturdy Concrete; RP Brennan.

Conversely, if the owner does not pay because of some dispute that does *not* involve the sub, then the “condition precedent” of owner payment can be found to be excused under orthodox contract law principles, even in states that do otherwise enforce contingent payment clauses.

But let us next suppose that under the facts and the applicable law the sub *is* entitled to be paid but is not. What to do? That question takes us to our next topic.

Suspending Work for Non-Payment

Suspending work for non-payment is a time-honored self-help remedy. But it is a remedy that comes with high risks; it can stir up problems, both legal and practical.

First, the legal angles.

Stopping work when the payments stop seems only fair. It seeks to re-balance things that are getting out of balance. So courts don’t interfere up front and only rarely condemn afterwards. That’s the general rule. And it’s so old and so well established as to have attained the status of “black letter law” in legal treatises and texts. See, e.g., Simpson on Contracts sec 125; Williston on Contracts sec 1626; Restatement of Contracts sec 276, illustr 5.

The courts do insist that the unpaid amounts be not genuinely in dispute. See, e.g., Turner Concrete. Stopping work is not condoned when used as a pressure tactic to coerce concessions concerning disputed amounts.

Those general, judge-made rules, however, inspire a common practice in writing contracts and subcontracts: to reverse those general rules, by inserting “limitation of remedy” clauses, whereby the right to stop work for non-payment is waived. Such “limitation of remedy” clauses have been upheld by the courts. See, e.g., Geo Colon Cont’g; Guerini Stone.

But the courts don’t always have the last word. Legislatures have weighed in. See, e.g., NY Gen Bus Law sec 757 (2), making such contract clauses “void and unenforceable.” That particular statute applies only to private jobs, however; the lawmakers evidently don’t want low and slow payments by public contracting agencies to slow down work on public jobs.

While safeguarding the right to suspend work, such statutes may also require giving an advance warning and an opportunity to cure. See, e.g., NY Gen Bus Law sec 756-b (2) (b).

Similar requirements for advance warning and an opportunity to cure are found in some subcontract forms, like AIA Form 401 art 4.7 (2007), which also sets forth criteria to gauge when non-payment reaches a point where suspension of work is warranted.

So much for the legal angles. Now for some practical pro’s and con’s.

Stopping work is a drastic step. It can precipitate an irreconcilable break, resulting in a “default” termination followed by litigation, with charges and counter charges, and the downside risk of an unfavorable outcome for high stakes.

And even if things are patched up before such dire consequences ensue, there are added costs - - demobilization, remobilization, acceleration to make up for lost time. Such added costs might be provided for in a subcontract (see, e.g., AIA Form 401, art 4.7) but if not, are a “tough sell” for a sub to get them written in.

As a practical matter, before taking the drastic step of stopping work, advance warning is always a good idea, even if not required by statute or contract clause. This is not just to “make a record” for future litigation. An advance warning might sometimes be enough to coax an overdue payment from the prime contractor.

Of course, if the prospects for payment look really bleak, stopping work might be the only way to avoid further losses.

Whatever the prospects, before stopping, consideration should also be given to what if any security for payment may be available.

Security for Payment

Security for payment can come in different forms.

Letters of credit are used for sales of equipment, especially in international transactions, including specially manufactured equipment to be installed in construction projects. But LOC's are not commonly used for subcontracts.

Personal guarantees are sometimes seen. Perhaps, these deter some shenanigans possible with corporate entities. But in the event of major calamities, one wonders what real value is added by the signature of the president, say, of a failed corporate contractor or upper-tier subcontractor. The president of a small company is likely also to be broke; the president of a large company, not likely to have personal assets for a mega-project taken on by such a big company.

Payment guarantees direct from project owners to subcontractors are also possible, but rare.

The classic forms of security for payment are two: mechanics liens and labor-and-material payment bonds.

Mechanics Liens

Concerning mechanics liens, the two most important points are these:

One. Mechanics liens are purely creatures of statute.

. The statutes create lien rights, determine what's lienable and when, and prescribe protocols for claiming and enforcing these liens.

Two. The subcontractor's lien will not always cover the full amount the contractor owes the subcontractor.

Having nailed down those fundamental points, we now indulge in a brief digression about the history of mechanics liens. It may deepen understanding. Anyway, it's fun.

"Lien" is one of those French words adopted by English lawyers, supposedly because of the Norman Conquest (A.D.1066) but retained, one suspects, because foreign words are thought to add a certain cachet. It's a fancy word for a plain object. It means a line, a line you use to tie something up.

Picture a repairman tying up a wagon until the owner pays for the repairs. Only, if instead of a wagon, the work is done on someone's house, well, you can't tie up the house and lot - - not literally anyway. To tie them up figuratively (and legally) mechanics liens were invented.

That was back in the 1700s, when people who worked on houses, because they used tools, were called “mechanics.” A ditty from 1788 begins as follows:

Come muster, my Lads, your mechanical Tools,
Your Saws and your Axes, your Hammers and Rules,
Bring your Mallets and Planes, your Level and Line,
And Plenty of Pins of American Pine. ...

An early impetus for mechanics lien laws was the desire to promote private development in a large tract of marshland we now call the District of Columbia. Some say these early enactments were championed by none other than Thomas Jefferson and James Madison. See, Freeform Pools.

The original, “Ur” statute dates from 1791, in Maryland. Pennsylvania followed, in 1803. Nowadays, mechanics lien laws are in the statute books of all states.

In some places these liens are called “construction liens.” See Uniform Lien Act sec 382. The word “mechanic” is still used in the construction industry, to denote skilled workers. To the laymen, however, the word now connotes the guy who works on your automobile.

The various state enactments differ considerably in the details, but there are common, overall patterns.

The New York pattern treats the subcontractor’s lien as “derivative.” It derives from the prime’s rights. So the sub’s lien can never be valid for more than the owner owes the prime contractor, even if the prime owes a greater sum to the sub.

The Pennsylvania pattern theoretically treats the sub’s lien as a “direct” lien against the owner’s property; however, the owner can take steps to limit its liability, by one or more of the following devices: filing the prime contract; obtaining a surety bond from the prime; conditioning payments to the prime on proof the subs have been paid.

As for what work qualifies for a lien, most of the work subcontractors do at the worksite will be lienable, but not items like home-office overhead and not claims for loss of anticipated profit. See, e.g., Goldberger-Raabin.

Lien rights are often afforded to the next tier down, i.e., to subs of first-tier subs. Beyond that, statutes vary. See, e.g., NY Lien Law sec 5 (public jobs) (lien rights stop with subs of first-tier subs; no liens for subs of second-tier subs).

To assist subcontractors, a New York statute (Gen Obligations Law sec 5-322.2) commands that every subcontract for private construction must set forth the full name of the owner, the street address and block and lot number for the property. The statutory command seems to be routinely ignored, however.

Lien statutes typically set time limits for filing, after which lien rights are lost.

“File a lien,” by the way, is common shorthand for the more correct “file a *notice of lien*.”

Liens are not available against public property. Lawmakers recoil in horror at the prospect of a sheriff’s sale of a city hall building or the like.

For public projects, however, New York has a quasi-mechanics lien, called a “public improvement lien.” It doesn’t attach to the publicly owned real estate but to the money due the prime contractor from the public owner.

Because of their impact on property rights, liens and lien procedures have raised constitutional questions, which however, are beyond the scope of this paper.

Going beyond legal issues, the decision of whether or not to file a lien, implicates practical considerations, which require business judgment.

Filing can actually be counter-productive. It will prompt the owner to stop payment to the prime contractor. The money held back can of course serve as security for the sub. But holding money back cuts off cash flow the contractor could use to pay the sub. On the other hand, if the sub forgoes filing, the cash flows, but can then be dissipated by the contractor before the sub gets paid. That’s a dilemma faced by a sub in deciding whether or not to file a lien.

Then too, liening the job can have long term consequences for relations between the sub and the prime contractor.

Lien statutes can forbid waiving lien rights in advance, for example, in the subcontract or at the time it is signed. See, e.g., NY Lien Law sec 34. Lien waivers can, however, be validly signed after payment is made or in exchange for payment. Some contract forms require such lien waivers at the time of payment. The lien waivers can then serve as evidence the sub has been paid, and thereby give the owner some comfort level that no lien will be filed against its real estate, at least not for the payment covered by the lien waiver.

When a lien is filed, and the claim is disputed, the lien can be removed from the real estate (or from the public payment in the case of one of those “public improvement” liens) and shifted to a surety bond. Bonding procedures vary from state to state.

Payment Bonds

Labor-and-material payment bonds are common for public contracts and are also sometimes used for private construction projects.

Typically, these payment bonds have a licensed corporate surety company back up the prime contractor's obligations to pay for labor and materials for the project.

Owners don't require these surety bonds out of solicitude for subs and suppliers. Private owners hope subs and suppliers will look to these bonds instead of filing liens against their real estate, or, if a lien is filed, that it will be promptly and easily removed with a lien-release bond provided by the payment-bond surety. Public owners don't have to worry about liens against their real estate. But the thinking is that the security offered by these payment bonds will induce subs and suppliers to work expeditiously, on credit, and maybe even for lower prices, without having to factor in the risk of non-payment.

Subcontractors, however, need to keep in mind that these payment bonds are *conditional* undertakings. The surety pays only "if" the principal obligor, the prime contractor, does not pay what *ought* to be paid.

Payment bonds are not demand instruments. They don't operate like documentary letters of credit. They are not blank checks. They don't pay for genuinely disputed amounts. They don't serve as "all risk insurance" that will pay subs for defective work or materials. They are not financial guarantees of a profitable job.

Payment bonds do apply to most of the work subcontractors do at the jobsite, also to the work of sub-subcontractors. Except for immediate subcontractors, however, there are notice requirements. Lower-tier subs have to give written notice of their claims within prescribed time limits. See, e.g., Miller Act 40 USC sec 270a et seq.(90 days); NY State Finance Law sec 137 (120 days from last work for which claim is made).

There are also time-of-suit limitations, typically shorter than otherwise applicable statute of limitations. Miller Act (one year from last work) NY SFL sec137(one year from completion and acceptance of entire project).

Parties' efforts to postpone or pre-condition resort to these bonds by clauses in the subcontract requiring claimants to first exhaust other remedies may be nullified by statute. See, e.g., NY Gen Obligations Law sec 5-322.1(2).

Information about the statutory bond for a particular public project can be obtained from the public contracting agency for the project.

Information about the existence and terms of a payment bond for a private project can be harder to come by. Private owners are supposed to file a copy of the bond (if there is one) with the local county clerk, for contracts exceeding a certain sum (100K) per a New York statute (Gen Obligations Law 5-322.3). But don't count on it.

"Labor-and-materials" payment bonds, as the very name signifies, are for labor and materials. They are not supposed to cover loans (or disguised loans). However,

lenders have been allowed to prosecute bond claims as assignees of claimants who did furnish labor or materials. See, Quantum.

Attorneys fees for prosecuting bond claims are normally not awarded. See, e.g., F.D.Rich. This is just an application of the “American Rule,” which generally denies imposing attorneys fees on a litigant merely because it lost the case.

There are, however, various statutory pegs, on which, in certain situations, attorneys fees can be awarded. New York’s payment-bond statute, for example, provides for such awards in exceptional cases, for resisting the claim without basis in law or fact. See, e.g., NY SFL sec137. Generally applicable statutes and procedural rules also provide sanctions for multiplying litigation vexatiously or with false claims or legally frivolous defenses.

4. Changes

An old proverb teaches, It's a foolish plan that allows for no changes.

Changes are common in construction projects -- the owner wants an add-on; the architect gets a better idea; difficulties are found with the site; conflicts are encountered where different facets of the work interface; major items of equipment or special materials that were specified have become unavailable.

Nor are all changes extras. Work items can be deleted, because of budget shortfalls or because of any number of other reasons.

Then too, some changes might entail both additions and deletions -- something is deleted and replaced with something else.

Subcontract Changes

For subcontracts, changes can come in one of two different ways: changes in the main contract or changes purely in the subcontract itself. An example of the latter might entail the shifting of some item of work between the sub and the prime contractor or between one sub and another.

While changes are to be expected, maybe they don't really have to be provided for in advance, when subcontracts are entered into. Maybe changes could be dealt with, or tried to be dealt with, later on, when the need arises. But experience teaches otherwise. So "Changes" articles have become standard features in subcontracts. Including such provisions leaves no room for argument that changes can be ordered (a point perhaps of more practical importance for deletions than for extras). And while "Changes" articles can't anticipate particulars of course, but they can at least set forth general guidelines for handling and pricing changes that may come up

Changes Articles

Changes articles in subcontracts may be simple or elaborate.

The nub of it of course is an explicit stipulation that the prime contractor may order, and the subcontractor must comply with, changes in the work.

Having already made clear that changes may be made, common formulations are nevertheless wont to add, "without invalidating" the subcontract. Which seems to add nothing but a verbal tic. (Or maybe it rules out arguments for re-pricing the unchanged work?)

Also seemingly redundant, but also common, is an explicit statement to the effect that changes may be made in the subcontract for changes made under the prime contract.

More meaningful (because it can avoid misunderstandings) is the addition of wording spelling out explicitly that changes may not always be for additional work but can also be for deletions of items of work from the subcontract.

To keep things within bounds, however, the explicit power to order changes is often explicitly limited to changes within the general nature and scope of the work - - or words to that effect. Presumably, then, a carpentry sub may not be forced to do plumbing work or a bricklayer compelled to build forty storeys instead of four.

Changes on public works contracts may be limited to a stated percentage of the original contract price, to prevent change-orders from being used to circumvent competitive bidding laws.

Invariably, it's a must for change-orders to be in writing. The requirement for a writing is of course designed to avoid surprises and misunderstandings. Unfortunately, the written change-order regimen sometimes slips in practice. The paperwork lags behind the work in the field, or is completely neglected after a time. Misunderstandings follow, then disputes, then litigation. See, e.g., Jos. F Egan, holding strict compliance was waived by the parties' course of conduct. Cf. CSA, insisting on strict compliance even though the time to protest had expired before the agency told the contractor it had changed its mind about considering the item an extra.

Changes articles almost always say something about pricing. Pricing may be linked to pricing prescribed in the main contract. Or, there may be exact parameters, e.g., stated percentages for profit and overhead. Or, more simply, price proposals may be called for in advance, and failing agreement, provision made for proceeding at the offered price under protest.

Sometimes the disagreement is not just about price, but about whether the item of work is or is not really an extra. Which brings us to our next topic: disputed work.

Disputed Work

Disputed work is work that is ordered as contract work but which the sub contends is really extra work. In such event, the subcontract will usually provide that the sub has to proceed with the work in question, but may do so "under protest," to reserve the right to claim extra payment.

For disputed work, exacting notice and protest protocols are usually prescribed, and requirements for meticulous record-keeping for time and materials. Such requirements are rigorously enforced by the courts, generally, though perhaps more

rigorously for public than for private contracts. Compare. A.H.A. (public job, strict enforcement) with Barsotti (private job, course of conduct can waive)

Waiver issues aside, compliance with claim protocols has also ordinarily been required of subcontractors. See Morelli Masons.

For subcontracts, however, an anomaly may be developing. While rigorously enforcing notice and protest protocols for disputed-work claims under prime contracts, there have been cases where a court has declined to enforce equivalent protocols for disputed-work claims under subcontracts. See, e.g., American Architectural.

The court's rationale there was that allowing such protocols to be interposed as pre-conditions to claims by subcontractors would hinder subcontractors from collecting under payment bonds, at least compulsory payment bonds mandated by statute for public works jobs.

Considering that the subcontractor-claimant agreed to those very protocols, the ease with which the court swept them aside wants another explanation. Perhaps, the explanation is that these compulsory payment bonds are not really for the benefit of claimants at all, but for the benefit of public contracting agencies. The idea is that facilitating payment (albeit from others) helps move their projects along more smoothly.

Nullifying the actual terms of the underlying contract to favor bond claims is, however, the antithesis of orthodox surety law principles. The surety, after all, is by definition merely a backup for the principal obligor, here the prime contractor, whose obligations are bounded by the written subcontract, pre-conditions and all.

Legal principles aside, there can be unfortunate consequences if a court nullifies claim protocols for subcontracts but strictly enforces them for prime contracts. It could cause a practical pinch for the prime contractor. If the sub hasn't complied with the notice and protest provisions of the subcontract, the prime might not have been alerted to comply with the equivalent provisions of the prime contract. Then, if the item in dispute is ultimately determined to be truly extra work, the contractor could wind up having to pay the sub for the extra, but not be able to collect from the owner.

We'll take a broader look at claims and disputes between subcontractors and contractors in our next chapter.

5. Disputes and Claims

Not every issue in dispute will really be between subcontractor and prime contractor. Sometimes, the prime is merely in the middle, and the real argument is between sub and owner. A sub might complain of increased costs caused by something the owner did or failed to do, or that some item of work the owner wants is really an extra.

Subcontractors, however, normally cannot sue owners directly. In legal jargon, there is no “privity of contract” between sub and owner. See Barry. In plain English, you don’t get to sue someone for breach of contract if you have no contract with them. (Suits on other legal grounds are a different matter.)

Of course, a subcontractor might sue the prime contractor, and in an appropriate case, the prime might bring the owner into the lawsuit, as a third-party defendant. That linkage won’t work, though, if the owner is the federal government or a sovereign state. Such entities are normally not amenable to suit in ordinary courts, only in special state or federal claims courts. Also, if the prime and sub are not really at odds, they may prefer not to be adverse parties in a lawsuit (and pay two sets of lawyers).

But if the prime contractor just goes ahead and sues the owner, on behalf of the subcontractor, the lawsuit can run into another obstacle. Unless the prime has already paid the sub for the claim, it will be objected that the plaintiff in the lawsuit (the prime contractor) has in fact suffered no damages.

That’s exactly the objection that dead-ended such a lawsuit in the Degnon case, in New York. In the realm of federal contract claims, an analogous episode unfolded, also coming to a dead end, in the Severin case.

The Degnon court, however, went on to suggest that the suit might have been viable if the prime had explicitly agreed to be “liable over” to the sub and to enforce the claim against the owner “for the benefit” of the subcontractor.

Thus was born the “pass through” agreement.

Pass-Through Agreements

In a pass-through agreement, the prime contractor explicitly agrees to pursue a claim against the owner for the benefit of the sub and - - here’s the key - - to pay over to the sub what the prime gets from the owner for the sub’s claim.

That's the gist of it, though it's usual also for the sub to agree to accept what the prime gets from the owner in "full settlement," in other words, for the sub to "liquidate" its claim against the prime for the amounts the prime gets from the owner. Hence, these pass-through agreements are also often called "liquidating agreements."

The label chosen perhaps reflects how you look at it. Contractors may prefer the comfort of "liquidating agreement"; subcontractors, the hope of "pass-through." Some veteran practitioners occasionally call them "Degnon Agreements," which is neutral, though the allusion to the eponymous Degnon case probably eludes many nowadays.

Call them what you will, these arrangements have long been a well-recognized practice. See Ardsley; Schiavone.

The usual arrangement sees subs claims passed upstream, to the owner. But downstream pass-throughs are also possible, whereby owner's claims are passed down, to a subcontractor. See, e.g., Lambert.

Upstream or down, it bears emphasis that these pass-throughs make sense only when the ultimate liability is at the end of the line - - on the part of the sub for a downstream claim; on the part of the owner for an upstream claim. Pass-throughs make no sense when the true liability is on the part of the prime contractor.

More elaborate versions of pass-through agreements can include provisions for paying expenses, or sharing expenses if, as is often the case, the package includes claims of the prime contractor or of more than one sub.

There are sometimes also provisions for keeping the sub promptly informed as the claim progresses.

Settlements can pose difficult problems. Who has the final say, what happens if sub and prime don't agree, may the sub carry on in the name of the prime, how to divvy up the proceeds of a lump-sum settlement - - these are some of the problems that can come up.

There is of course always an implied obligation to handle the claim in good faith. The prime has to make a good faith effort to advocate the sub's claims. See TGI. The prime has to take all reasonable steps for an eventual recovery. See Martin. The prime is not supposed to simply "go through the motions" or to "take a dive."

Pass-through agreements are often ad hoc arrangements, entered into only after a particular claim arises. However, non-claim-specific pass-through agreements may also be included right in the original subcontract. It's become increasingly common to see such pass-through agreements inserted into subcontract articles dealing with delays or in subcontract disputes articles.

Disputes Articles

Subcontracts don't have to contain any special provisions dealing in advance with possible future disputes. Absent such provisions, disputes would be dealt with in the ordinary law courts, according to their rules. You might call that the "default setting." However, subcontracts very often do contain special provisions concerning disputes.

Though a standard feature in subcontracts, there is no standard "one size fits all" disputes provision. Disputes provisions come in a wide variety.

It might be something as minimal as a jury-trial waiver. More and more lately one sees "forum selection" clauses (designating a particular court or locale) or "choice of law" clauses (stipulating to the law of a particular state). Forum-selection provisions and choice-of-law provisions can come in handy when the contracting parties are from different states. Though there are exceptions, such clauses will normally be honored by the courts. See M/S Bremen; Atlantic Marine.

Statutes, however, may restrict the parties' ability to script their own choice of law or forum. See, e.g., NY Gen Business Law sec 757, which nullifies choice of out-of-state law for construction contracts. See also La. R.S. 38:2196.

Then too, forum-selection provisions in subcontracts sometimes conflict with forum-selection provisions in payment bonds, which typically designate the place where the project is situated as the place for lawsuits. Some courts rule the bond controls. Other courts rule the subcontract controls. An effort to reconcile, or even to catalog, the divergent case law on the point would take us beyond the plan of this paper.

Suffice to say here that subcontractors should be wary of forum-selection clauses that might force them to litigate in places "unusual, uncomfortable, and distant" from the place where the project is situated.

Multi-Party Disputes

Multi-party disputes are perhaps the rule rather than the exception for construction projects. And corraling all the players into the same forum can be a real challenge. Not all of them may have agreed to, may not even be agreeable to, the same dispute-resolution procedures. Some of them might not even be subject to suit in the same forum as others.

For court cases, joinder, consolidation, and impleader are usually available under modern codes of court practice. But if the project owner is a sovereign state or the federal government, those procedures can't do the trick. Neither states nor the federal

government can normally be brought into lawsuits in ordinary law courts; no matter how many other interested parties are involved there; such sovereign entities normally cannot be sued except in special tribunals.

Multi-party disputes get even harder to deal with when alternate-dispute-resolution (“ADR”) provisions are in the mix. For example, the subcontract might call for arbitration, the prime contract for a different sort of ADR or none at all, leaving matters up to the regular law courts. To co-ordinate discordant disputes procedures, different approaches have been used.

Co-ordinating Disputes Procedures

One such approach is incorporation by reference. To work at all, the subcontract must specifically incorporate the dispute-resolution mechanisms of the main contract. A broad, general incorporation by reference to the main contract is normally interpreted as incorporating only those provisions concerning the construction work to be performed. See, e.g., Guerini Stone ; S.Leo Harmonay ; Dart Mechanical; Industrial Window.

Moreover, the particular disputes mechanism incorporated has to be compatible with other provisions in the subcontract, or brain-teaser puzzles may inadvertently be created. See, e.g., Pearl Street (court left to arbitrators to figure out whether conditions precedent to arbitration set forth in main contract applied to subcontract arbitration).

Another approach to co-ordinate things inserts into the subcontract a stipulation to the effect that the subcontractor will automatically be bound by determinations made between owner and contractor, under the dispute resolution procedures of the prime contract. See, e.g., HRH (subcontract arbitrators directed to follow results between prime and owner).

Such coordinating provisions operate of course only when claims or disputes involve the owner, not when purely between contractor and sub.

Provisions are also sometimes inserted automatically de-activating subcontract ADR procedures (like arbitration) in the event the dispute involves the owner or others. Going a step further, such a provision might explicitly call for the sub to discontinue a pending proceeding in deference to a later-commenced proceeding between owner and prime.

Of course, if all parties, either in their respective original contracts or thereafter, have agreed to arbitration, on equivalent terms, e.g., all are agreeable to American Arbitration Association, consolidation of arbitrations may be feasible. See Sullivan County. See also AAA Rule 7.

Some contract forms expressly permit consolidation of arbitrations and even joining parties who did not previously agree to arbitration if they consent. See AIA Form

A401 art 6.3.3 and 6.3.4.(2007). Other contract forms, however, explicitly negate consolidation. See AIA Form A401 art 6.2.46 (1997)

If some of the parties to the dispute are agreeable to arbitration, but others are not, there may be no way to get them all into the same forum. It's extremely rare for a court to excuse a party from having to go to arbitration because other interested parties cannot be brought into the arbitration.

"Vouching in" has been tried. Vouching in is an old procedure originally designed for situations where parties beyond the territorial jurisdiction are invited to participate in litigation. However, vouching in has been held to be effective only when the underlying litigation is in a regular law court, not in arbitration. See Perkins and Will.

Another way of "simplifying" things that has been attempted (Believe it or not) was by inserting provisions in subcontracts that would have made the prime contractor itself the "sole arbitrator" of disputes with its own subs. The attempt was rejected by a court. See American Architecturals. No surprise there. Though comparable provisions have been upheld which made public contracting agencies arbitrators of their disputes with their prime contractors. See Westinghouse.

Which latter set-up is just the sort of situation that intensifies the need to synchronize dispute-resolution mechanisms of the subcontract with those of the main contract.

Arguably justifiable as another way of coping with such mis-match scenarios are provisions sometimes seen in subcontracts which give the prime contractor the unilateral option to invoke arbitration or not. Lacking mutuality, such one-sided options seem unfair. But they have been upheld. See Sablosky. They do, however, enable the prime contractor to opt for court if that is the only forum where both owner and sub can be brought in.

Arbitration or Court ?

When it comes to dispute-resolution, the big decision is whether to leave things up to the law courts or to opt instead for arbitration.

There are pro's and con's.

Parties Problems with consolidating or otherwise coordinating multi-party disputes have already been discussed.

Costs The up-front costs for arbitration can be considerable - - admin fees, deposits for arbitrators. Admin fees are scaled to the size of the claim or counterclaim; deposits depend on the arbitrators' rates, and estimated number of hearings.

Motions can ratchet up costs. Dispositive motions addressed to the arbitrators, before hearings begin, used to be almost unheard of, but are becoming more and more common. Unless such motions end the entire case, they just add another layer of expense, and delay.

Documents Voluminous documents are inherent in the nature of these cases, both in hard-copy and e.s.i. Consequently, the time and expense of document production and management should not be much different in arbitration than in court cases. In arbitration, however, there is usually less formality about document requests and objections.

Depositions are mentioned in arbitration association rules for large complex cases. AAA Rule L-4 (f). In practice, however, pre-hearing depositions for discovery purposes are never taken. Skipping depositions represents significant savings, at the pre-hearing stage, in lawyers fees and transcript costs. Once hearings get under way, however, hearing transcripts can wind up costing as much or more as deposition transcripts would have. Hearing transcripts are not obligatory, but are highly desirable, especially in a long-running case, with hearings spread out over time.

Site Inspections can be vitally important in construction cases. Arbitrators are much more amenable to site inspections than are law court judges, especially in jury trials. The difference seems more a matter of logistics than logic.

Scheduling Unlike jury trials, arbitration hearings don't have to run continuously, on consecutive days. Which is a good thing. Without pre-trial depositions, the actual hearings are when you get to hear exactly what the other side has to say. The intervals between hearings then allow time to prepare for the next sessions.

Scheduling is more flexible in arbitration, and the parties and attorneys have more in-put in agreeing on mutually convenient dates.

Evidence The rules of evidence are relaxed in arbitration. This can be disconcerting to those whose style relies heavily on invoking exclusionary rules. Experienced practitioners regard the relative ease of introducing evidence as a welcome convenience - - but they never assume that just because some evidence is admitted "for what it's worth" they have made a convincing showing.

Expertise Jurors are not supposed to be experts in construction work, and any prospective juror who seemed to be would doubtless be rejected. Judges can't be expected to be construction experts either. Arbitrators, on the other hand, are supposed to bring to the process their knowledge and experience in the construction industry. Many do. Paper credentials are not always reliable indicators, however. So there is always some risk of disappointment. The risk can be mitigated with a panel of three, instead of a single arbitrator.

Decision time Arbitration hearings usually get going sooner than the case would have been called for trial on a court calendar. In complicated cases, however, hearings have been known to stretch out over a year or more.

Decision form In construction contract cases, arbitrators' decisions, or "awards," are usually itemized. Lengthy opinions, giving reasons, are rare.

Appeals There are no appeals from arbitration decisions. And grounds for vacating decisions are very narrowly circumscribed.

Sureties Whether sureties can or cannot be compelled to arbitrate, or will be permitted to participate, are questions that have been answered differently by different courts in different jurisdictions or at different times. Even where not made to participate, however, sureties are generally held to be bound by the results of bona fide arbitration involving the surety's bond-principal, as to the underlying claim, though not as to any special surety defenses. See, e.g., F&D v. Parsons and Whitemore.

An important CAVEAT here is that arbitration does not stop the clock running on time-to-sue limitations for claims against the surety. See, e.g., Windsor Metal. The usual way for a subcontractor to preserve its rights against the contractor's surety is to timely file suit against the surety. The lawsuit can then be temporarily stayed, pending the outcome of the arbitration.

Administration Parties are free to fashion their own arrangements for arbitration. Law codes allow as much. See, e.g., NY CPLR 7504.

There seem to be trends in these matters. In former times, private arrangements seem to have been quite common. Then for many years they were rare for construction cases. In recent years, however, they may have begun to make a come-back. Private arrangements can avoid some of the administrative burden and expense.

Another possible advantage for private arrangements over arbitration organizations is that you don't have to gamble on picking arbitrators based on paper credentials. You get to pick someone with a well-known and well-earned reputation, someone like Bob Rubin in New York (constructiondisputes1.com) or, until a few years ago, the late Harry McCue in San Diego (one of the best of the best).

To make private arrangements, however, all parties and their attorneys have to be able to work cooperatively and expeditiously, which requires considerable "know how" and a genuine desire to proceed without delay.

Consequently, most parties find it convenient to rely on established arbitration and mediation organizations -- like the American Arbitration Association or JAMS. Those organizations have prepackaged rules and facilities already in place, like the AAA's Construction Industry Arbitration Rules.

Whether private or organizational, the basic question remains: Which is preferable, court or arbitration? There's really no one answer. So much depends on the particulars of the case, the character and aims of the participants, the dollar amounts at stake, the competence of the arbitrators available, the qualities of the judges and jurors in the court venue.

Well, no one said this stuff was easy. But then that's what makes it so interesting.

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