

PERSPECTIVES ON REAL ESTATE LAW

LEGAL GROUNDS

JUNE/JULY 09

Construction delays:
Duties and damages

Criminal attacks on tenants
What is the scope
of landlord liability?

Know your rights
Retail tenant bankruptcy

Court rejects LOL clause
in construction contract

Dealing with the credit crisis



CONSTRUCTION DELAYS: DUTIES AND DAMAGES

Construction project delays can have repercussions for owners, contractors and subcontractors, all of whom stand to face escalating costs with every day the project runs over schedule. As a result, performance delays rank among the top issues in construction litigation. Owners can better manage their risks, however, if they understand the liability landscape of construction delays.

Inexcusable vs. excusable delays

Performance delays are generally classified as inexcusable or excusable. *Inexcusable* delays are attributable to contractors or their subcontractors or materials suppliers. Examples include defective work or machinery, failure to coordinate subcontractors, and late materials.

Contractors are usually liable to owners for inexcusable delays. Depending on the terms of the construction contract, they may be liable for liquidated damages. Nonpunitive liquidated damages clauses are typically enforceable if they provide for damages in a reasonable amount. Otherwise, the owner may be able to recover foreseeable costs incurred because of the contractor's delay, including interest, rental expenses and possibly lost profits, depending on the terms of the contract. An owner also may be able to demand

accelerated performance, withhold payment or terminate the contract for breach.

Excusable delays, on the other hand, are unforeseeable at the time the contract was executed and beyond the contractor's control. In other words, they aren't the fault of any party and are caused by outside forces, such as unusually severe weather, labor strikes or unavailable materials. In such cases, the contractor isn't liable for damages for the resulting late completion. And, if the delay was the owner's fault, the contractor may be entitled to additional compensation for increased costs. The contract should spell out the details about how such delays are handled.

Compensable delays

Owners are liable for what is known as "*compensable* delays." A contractor may be able to recover damages for extra costs incurred because of delays caused by the owner or a party acting on the owner's behalf, such as an architect or engineer.

The owner's liability stems from the contract and from the owner's implied duty of cooperation, which encompasses the duty to coordinate and schedule all contractors' work and the duty not to delay, hinder or interfere with that work. A court could find an owner liable for delays due to:

- » Obtaining permits,
- » Errors and omissions in plans and specifications,
- » Failure to respond to contractor requests for information,
- » Failure to make proper and timely inspections or progress payments, or
- » Ordering a hold on the work.

The delay need not have completely prevented the contractor from working on the project. The contractor can recover damages if the owner's actions forced it to perform its work in an inefficient manner or out of sequence.



Some delays — known as *noncompensable* — are unforeseeable and attributable to neither party. A contractor is entitled only to an extension of time for noncompensable delays.

Concurrent delays

Concurrent delays occur simultaneously or overlap, with both parties bearing some of the responsibility for the delays. To be characterized as “concurrent,” the delays must affect work on the project’s critical path, therefore affecting the completion date.

Generally, the owner and contractor are liable for their own costs and can’t seek recovery from the other party. Some courts, however, have allowed the parties to apportion damages based on relative fault.

Owner defenses

It may be possible to avoid paying damages for a compensable delay. If the construction contract contains a “no damages for delay” clause, for example, the contractor forfeits any claims against a party liable for damages related to delays. The contractor’s sole remedy is an extension.

Note that the clause applies only to delays contemplated by the parties at the time of contracting. It also excludes damages related to bad faith or gross negligence on the owner’s part. And a court might disregard the clause if the contract makes “time of the essence.”

Even where the contract doesn’t bar damages, it likely imposes a notice requirement obligating the contractor to

provide written notice to the owner of delays. A contractor that doesn’t comply can’t subsequently pursue a claim against the owner. Be sure to work with your attorney when drafting your contract: There are a number of exceptions to enforcement of no-damages-for-delay clauses which are a matter of state law.



Think ahead

The parties to a construction contract can agree that certain events will be deemed excusable, inexcusable or compensable. By negotiating these and related terms on the front end, an owner can reduce its risk of liability. Work with your attorney to ensure your next construction contract has your project fully protected against delays. [1]

Owner delays come with high costs

A contractor was recently awarded more than \$1.1 million in delay damages even though the owner didn’t breach their contract. In *City of Gillette v. Hladky Construction, Inc.*, the owner’s project specifications required precast concrete exterior panels produced by a manufacturer certified by the Precast/Prestressed Concrete Institute *prior to the start of production*. Although the contractor’s bid named a panel manufacturer that had not yet been certified, it won the contract.

After the contract was signed, the owner informed the contractor that it must provide the certification *prior to ordering the panels*. The contractor submitted two change order requests to allow substitution of a certified manufacturer. Neither was approved.

The contractor sought damages caused by the specification change and subsequent delays. The jury found that the owner didn’t breach the contract but nonetheless awarded damages based on the breach of its implied covenant of good faith and fair dealing.

WHAT IS THE SCOPE OF LANDLORD LIABILITY?

When a landlord enters a relationship with a tenant, it owes the tenant more than mere maintenance and space. Courts have held that landlords also must afford tenants some degree of protection from criminal attacks. But there are limits.

The Oregon Court of Appeals recognized that, while a landlord and tenant have a “special relationship” that establishes a duty of care, its scope is limited to taking reasonable steps to warn or otherwise protect a tenant from foreseeable, unreasonable risks of physical harm posed by another tenant on or off the premises.

Tenant-on-tenant violence

Miller v. Tabor West Investment Co., LLC involved an attack on Donald Miller by Homer Woods. Both lived in Barrington Square Apartments, and both had a history of mental illness.

The on-site property manager was aware when it rented to Woods that he had recently been released from Oregon State Hospital after a multiyear commitment for an assault. The property manager also knew that Woods was on medication to “keep him mellow.” However, of vital importance to the outcome of this case, there was no evidence that the defendants were aware of any of the details of Wood’s mental condition, or that he was prone to violence.

During his first two months in the complex, Woods refused a request from the property manager to turn down his music, instead turning up the volume and throwing items out of his apartment onto the lawn. The property manager also witnessed Woods talking to himself and, on one occasion, pushing Miller, although Woods and Miller often visited each other several times daily without incident. The day after the pushing, Woods assaulted and seriously injured Miller at a 7-Eleven store adjacent to the property.

Miller sued the owner of the complex, alleging it was negligent in 1) failing to properly investigate Woods’ background, 2) renting to Woods despite knowledge of his mental illness and violent history, and 3) failing to warn vulnerable tenants or take other precautions to protect them from Woods.



The scope of a landlord’s duty

The court of appeals began by recognizing that the landlord/tenant relationship is “a type of special relationship” that creates a duty on the part of the landlord toward the tenants. As such, the court concluded that the principle of *general foreseeability* applied to the particular circumstances.

Specifically, the landlord/tenant relationship imposes an affirmative duty on a landlord to take reasonable steps to warn, or otherwise protect, a tenant from “foreseeable unreasonable risk of physical harm” posed by another tenant, on and off the premises (such as evicting a physically abusive tenant).

Landlord let off the hook

The court went on to consider whether the landlord’s failure to warn Miller about Woods’ history or to take measures to protect Miller from Woods created a foreseeable risk that Miller would be attacked by Woods. It noted that a third-party criminal offender’s criminal history and propensity for violence, as well as the plaintiff’s vulnerability, if known to the landlord, are relevant to the foreseeability analysis.

But the court found that the landlord didn't know any of the details of Woods' mental illness and hospitalization or, most significantly, his propensity to violence.

It cited an Oregon Supreme Court holding that a physical assault by a third party may be legally unforeseeable if the defendant's conduct constituted "mere facilitation" of the third party's intervening intentional criminal acts. Here, the court held that giving a lease to someone who had been in the hospital for an assault committed years earlier was legally insufficient to amount to "foreseeability" that Woods would attack Miller. The landlord didn't know that Woods had been adjudged "guilty except for insanity" and previously determined to be a danger to the community.

In the absence of more specific knowledge of the risk posed by Woods as possibly violent, the court concluded that the landlord's conduct was indeed mere facilitation. Thus, the attack wasn't a reasonably foreseeable consequence of the failure to warn or protect Miller.

Protect yourself

The court suggested that the landlord could have been liable if it had known that the attacker's criminal history involved a random, unprovoked attack against a neighbor or stranger. The bottom line? Landlords who discover, or should reasonably discover, such information must take proactive measures to protect their other tenants. A criminal background check is a good idea at a minimum. [1]

Know your rights

RETAIL TENANT BANKRUPTCY

The media are bursting with dire predictions about more retail closings in the coming months and years. With the likelihood of retail tenant bankruptcy climbing dramatically, landlords should review their rights under the U.S. Bankruptcy Code.

When the tenant files for bankruptcy

Immediately after a tenant files for bankruptcy, you must continue to perform the lease obligations, assuming the lease doesn't expire before the filing.

In either a Chapter 11 or 7 bankruptcy case, the tenant generally has 120 days to accept or reject a lease involving nonresidential real estate property. The court can extend this term another 90 days; further delays will require your approval.

When the tenant assumes or assigns its lease

To assume the lease, the tenant must cure any and all lease defaults including prepetition rent due. The tenant may pay the pre-filing overdue rent in a lump sum or come to an agreement with you on a payment schedule for the debt. The tenant also must provide you adequate assurance of future performance of the lease.

To assign the lease, the tenant first assumes the lease and then proposes an assignee. If the proposed assignee doesn't satisfy the lease's use provisions, you must decide

whether to object on nonconformity grounds. If you do, the judge will determine whether any assignee could reasonably comply with the provision. If the judge finds the provision unreasonable, you could end up saddled with an undesirable tenant, although the original tenant must provide you adequate assurance of the assignee's future performance.



In a shopping center context, "adequate assurance" means assurance that:

- » The financial condition and operating performance of the proposed assignee and its guarantors will be similar to that of the tenant and its guarantors,
- » Any percentage of rent due under the lease won't decline substantially, and
- » Assumption or assignment of such lease won't disrupt any tenant mix or balance in the shopping center.

Adequate assurance also means that the assumption or assignment of a lease is subject to *all* of the lease's provisions, including (but not limited to) radius, location, use or exclusivity provisions — and that such assumption or assignment won't breach any such provision in any other lease, financing agreement or master agreement relating to the shopping center.

When the tenant rejects the lease

If a tenant rejects its lease, the breach is considered to have occurred immediately before the bankruptcy filing date.

The tenant must surrender possession and need not pay rent going forward. In such cases, you'd typically be left with an unsecured claim against the tenant for pre-filing rent due.

The bankruptcy code provides for a cap on landlord damages in the event the lease is rejected — usually the greater of one year's rent or 15% of the rent owed under the lease over the balance of the lease term, not to exceed three years, plus any unpaid rent due.

Immediately after a tenant files for bankruptcy, you must continue to perform the lease obligations, assuming the lease doesn't expire before the filing.

The importance of vigilance

If you suspect a retail tenant that has missed a rent payment will soon be filing for bankruptcy, you can take immediate measures that might secure greater protection and keep you out of the tenant's bankruptcy court proceedings. Even if a landlord didn't see bankruptcy coming, it must act promptly to enforce its rights to rent, guard against undesirable lease assumptions or assignments and possibly evict bankrupt tenants. [1]

COURT REJECTS LOL CLAUSE IN CONSTRUCTION CONTRACT



The Georgia Supreme Court has overturned a lower court decision that applied the limitation of liability (LOL) clause in a contract between an owner and an engineering firm. The court's opinion in *Lanier at McEver, L.P. v. Planners and Engineers Collaborative, Inc.* offers some insight into what you should consider when drafting such clauses.

Lanier developed an apartment complex according to plans specified by Planners and Engineers Collaborative (PEC). After completion, Lanier uncovered physical damage attributed to a negligently designed storm water system.

Lanier sued PEC, alleging its defective design had caused approximately \$500,000 in damages. Their contract included an LOL clause that limited PEC's liability to Lanier, all construction contractors and subcontractors on the project, and any third parties to PEC's total fees, which totaled only \$80,514. The trial court and the court of appeals found the clause constituted a permissible cap on damages.

The high court disagreed, ruling that the clause was prohibited by a state statute that declares indemnification clauses in construction contracts void and unenforceable as against public policy. While the clause didn't exculpate PEC of all liability, it imposed a duty on Lanier to indemnify PEC for any judgment in excess of the fee, including judgment amounts on third-party claims for which PEC was solely negligent.

The court noted several alternative methods by which PEC could have drafted its LOL without violating public policy. PEC could have restricted damages to only those between the contracting parties, Lanier and PEC. Or the contract might have provided that the parties agreed to shift the risk to an insurer under an insurance clause that encompassed the indemnification clause. At the very least, an LOL clause shouldn't have included language extending it to third-party claims.

The difference between a permissible and a prohibited clause can prove significant to the financial outcome, as shown by the disparity between Lanier's damages and PEC's fees. But, as the Georgia court and decisions from other states indicate, not every restriction on liability is prohibited.

DEALING WITH THE CREDIT CRISIS

Money is tight in the commercial real estate market, and many buyers are finding it difficult to secure the necessary financing to close their deals. If you're having trouble breaking through the frozen credit markets, you may be able to get the property you want by assuming the seller's loan.

Details in order

As the buyer, you'll likely need to create a single-purpose entity (SPE) to carry out the transaction. Loan assumptions usually involve securitized loans, and securitized loan documents typically impose strict requirements for the structure of the borrower.

The lender will want your entity to exactly mirror the details described in the loan documents. Where the loan documents require multiple levels of SPEs, a single-member limited liability company, with your existing entity serving as the single member, is often accepted by the servicer.

Loan assumption process

If you're pursuing a transaction with a loan assumption, you'll begin by requesting copies of all loan documentation for the property. Carefully review the terms and conditions, particularly any requirements for loan assumption. If you can satisfy those terms and conditions, you can then contact the loan servicer.

The servicer will provide an information package that, among other things, details the required deliverables and fees. The package also should include a timeline for the process. The process generally runs eight to 10 weeks in normal circumstances. You'll need to alert the servicer about any time restrictions, such as those associated with like-kind exchanges.

Then, you can complete the assumption application and make specified deposits. The servicer also may require certain indemnification from you before proceeding. Additionally, you'll need to identify your authorized representatives and provide certain documentation, including formation documents, biographical data on your principals and guarantors, the purchase agreement with the seller, tax data and financial statements. You may also need to verify your expertise in real estate management.



Keep in mind that most loan agreements today are non-assumable by their terms, and that the lender may or may not release the original borrower from the loan obligations if it consents to the assignment of the loan.

Terms and modifications

The lender and the servicer will likely insist that the original loan terms remain unchanged, but some modifications may be possible. The servicer may agree to modify equity transfer provisions if the existing restrictions on transfers are inoperable with your business' structure.

It may be necessary to modify the loan documents if they contain mistakes or require conforming of some kind, such as updating the name of the property management company.

Food for thought

A loan assumption transaction is complicated but could prove a viable financing option under current economic conditions. Consult your attorney if you think it might be right for you. [1]