TEN THINGS EVERY CONTRACTOR SHOULD KNOW ABOUT STAYING OUT OF LEGAL TROUBLE

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Construction contracting is a tough business. Aside from simply doing good work, the industry is highly regulated by very specific and often evolving laws. Small contractors, particularly those who contract with consumers or small businesses, are particularly at risk for disputes and litigation that threaten to delay or even eliminate the right to payment entirely. Even when the project is completed, contractors may remain at risk from construction defect claims for several years. The purpose of this article is to set forth some (but of course not all) potential problems that may lurk on any given project.

1. Beware if Carrying Only One CCB License Endorsement!

Proper licensure with the Oregon Construction Contractor's Board (CCB) is a critical issue that should be confirmed prior to entering into any contract. Contractors are required to hold a valid license and the proper endorsement when bidding "or" contracting for work and "continuously while performing" the work.

Failure to do so may create a complete defense to payment for failing to strictly comply with the licensure statutes. There are countless reported cases construing ORS 701.131 (formerly 701.065) that broadly enforce a complete defense to a contractor's otherwise valid claim to be paid for the entirety of its work. *See e.g. Remington Ranch LLC v. Hooker Creek Companies LLC*, United States Bankruptcy Court Adversary No. 10-3093-elp (2010) (The failure of the contractor to be licensed barred recovery on a $4.4 million construction lien).

License endorsement categories generally fall under "residential" and "commercial" categories, but there are also several sub-categories of each endorsement, generally related to quantity of work performed. Both types of endorsements – either residential or commercial – may work on "small commercial" projects. Given the apparent flexibility of the two basic endorsements and the requirement of having a bond for each, there is an incentive for some contractors to obtain only one endorsement to save the cost of the additional bond. But this is where contractors need to beware!

What constitutes a "residential" or "small commercial" project can be extraordinarily specific and may differ on a project-by-project basis. For example: If a convenience store owner leases a structure, the structure is not "large commercial" until it exceeds 12,000 square feet in area (or 20 feet in height as measured from the "top surface of the lowest flooring to the highest interior overhead finish"). ORS 701.005(17)(b). If the convenience store owner *owns* the structure, then the structure is a large commercial structure if it exceeds *10,000* square feet in area (or the same height restriction as above). *Id.* at (17)(a).

Some may find comfort in the definition of "small commercial" which includes projects of any size where "contract price of all construction contractor work to be performed on the structure as part of a construction project does not total more than $250,000." *Id.* at (17)(c). However, this definition may provide a false sense of security: Are change orders during the project included in the "contract price of all * * * work to be performed"? What if the owner hires multiple general contractors or acts as the general contractor? How is a subcontractor going to know the total contract price of all work?

In short, the only safe way to proceed is to pay the costs necessary to obtain <u>both</u> a residential and commercial endorsement. If a contractor is going to proceed with only one license endorsement under Oregon law, the contractor will need to do its homework to be sure that each new project is not at risk for exceeding its endorsement. Failure to do so may result in non-payment.

2. <u>Let Someone Else Have Responsibility for Design.</u>

Some contractors may unwittingly provide design services by including the designer, engineer, or architect's billings as part of the contractor's scope of services. Some contractors explicitly purport to provide "design services" as part of the work they perform.

Contractors should think carefully before assuming responsibility for design. Some reasons include:

- The contractor may not have liability insurance coverage for injury or property damages arising out of design problems.
- The homeowner may take the position that additional costs due to a poor or inadequate design should be borne by the contractor.
- If the design the contractor provides requires an architect's license (such as a commercial or multi-family building that exceeds 4,000 square feet or 20 feet in height from the top surface of lowest flooring to the highest interior overhead finish of the structure), the contractor may be considered to be providing "architectural services."
- If the contractor is not a licensed architect, the contractor may be fined and barred from asserting a lawsuit in Court under ORS 671.220. Note that a contractor that provides services consisting of the practice of architecture or engineering as part of its contract is required to disclose the name and license number of the licensed architect (or firm) or licensed engineer or land surveyor that will provide the design services. For architects, see ORS 671.030(2)(c) & (g); OAR 806-010-0078(3). For engineers and land surveyors, see ORS 672.060(12); OAR 820-010-0715.
- By including design in its contract, the contractor may be subject to a longer statute

of limitations to its customer (generally six years from the breach of contract) than the design professional is to the contractor (generally two years from date of discovery of the injury or damage). Thus, the contractor may be liable to its customer for a claim that has expired against the architect, engineer or landscape architect. Compare ORS 12.080(3) (six years for breach of contract) and ORS 12.135(3) (two years from discovery against the design professionals).

On the other hand, if the *owner* provides plans and specifications, then the owner generally impliedly warrants that the structure built according to the plans and specifications will be adequate for the owner's purposes. This concept is generally referred to as the Spearin Doctrine arising out of the case *United States v. Spearin*, 248 U.S. 132 (1918). If this doctrine applies, construction defects arising out of a faulty design or additional costs incurred to achieve the owner's objectives are more likely to be risks borne by the owner than the contractor. *See e.g. A.H. Barbour & Son, Inc. v. State Highway Comm.*, 248 Or 247 (1967) (Painting contractor was entitled to recover additional compensation where Owner specifications required rust to be removed from the Yaquina Bay bridge by sandblasting and additional work beyond sandblasting to remove the rust was required).

3. Know Legal Disclosures and Requirements.

There are a number of potentially applicable legal disclosures that must be made to the customer. Below are a few with potential significance to small contractors who deal with consumers. Each of these issues should be checked regularly, because many requirements (particularly state ones) seem to continually change every few years and indeed may change again soon. See e.g. SB 205 (2013 Legislative Session) (bill to authorize the CCB to change certain contract requirements presently mandated by statute).

a. CCB Statutory Form Requirements. In the case of contractors who deal with homeowners, a number of requirements apply, both as to the form of the agreement (see e.g. ORS 701.305) and various notices that must generally be given at the time of contracting. Failure to comply with these requirements may result in fines imposed by the CCB and the loss of lien rights (see e.g. ORS 87.037 & 87.093). The CCB website has a significant amount of information, including sample contract language and charts that outline when certain notices must be given. See http://www.oregon.gov/ccb/Pages/Contractor_Forms.aspx (3/6/2012).

There are several potentially overlooked notice requirements that may apply to contractors who enter into contract directly with homeowners for residential construction. One notice (required in new home construction transactions only) is the "Model List Of Accessibility Features" notice. This notice is intended to provide seniors and disabled persons with options to make their prospective home "more accessible" to a person with disabilities. See ORS 701.525-.530; OAR 812-001-0200(4). A copy of the notice is available on the CCB's website at: http://ccbed.ccb.state.or.us/WebPDF/CCB/Publications/Model%20Features%2012-04-07.pdf

A second notice is the moisture intrusion and water damage information and a home maintenance schedule that builders are required to provide to consumers as a part of a contract for new residential structure or zero-lot-line dwelling under ORS 701.335. A copy of this information and maintenance schedule can be found at: http://www.oregon.gov/ccb/Pages/Contractor_Forms.aspx#Other_Important_Forms (under the Residential Contractor Notices and Forms header).

A third important notice is the "Notice of Compliance with Homebuyer Protection Act" ("HPA"), which generally applies to "owners" who contract for the sale of a new residential home or a home with $50,000 or more in remodel costs that was completed within three months of sale. See ORS 87.007 for specific parameters and requirements of HPA. A copy of the notice and requirements for compliance with the HPA can be found on the CCB's website at:

https://ccbed.ccb.state.or.us/WebPDF/CCB/Publications/HPAform.pdf.

Note that, out of all the methods of compliance with the HPA, other than waiting 90 to 135 days after completion to close on the sale (depending on the circumstances), the most palatable method of complying with the HPA may be to provide the homebuyer with copies of lien waivers from all subcontractors and suppliers who might claim $5,000 or more. See ORS 87.007(2). The option of obtaining the homebuyer signature on a waiver of protections under the HPA is no longer available. Section 1, Chapter 77, Oregon Laws 2010 Special Session.

Failure to comply with the HPA requirements not only opens the "owner-contractor" to possible claims by injured homeowners under ORS 87.007 and Oregon's Unlawful Trade Practices Act under ORS 646.608(1)(zz), it also is a basis for the "suspension of, revocation of, refusal to issue or refusal to renew a license" by the CCB under ORS 701.106(1)(a).

b. Consumer Cancellation Rights. Many contractors are aware a homeowner has a short right to cancel any initial contract for the construction, improvement or repair of a residential structure or zero lot line dwelling. See ORS 701.310 (right to cancel by midnight the business day following the execution of the agreement unless waived or substantial work commences).

A less known requirement that residential "remodel or repair" contractors should know about, however, is the potential application of Oregon's "Home Solicitation Sales Act." This Act provides that if a seller of "goods" or "services" that are "primarily for personal, family or household use" solicits a "written agreement" "at a place other than the place of business of the seller," then the seller may be required to provide a statutory written disclosure of rights. See ORS 83.710(1)(a) (home solicitation sale definition, incorporates definition of goods and services from ORS 83.010).

The definition of "goods" generally includes most construction supplies because the definition includes goods to be "affixed" to real property "whether or not severable." "Services" explicitly includes "repairs, alterations or improvements upon or in connection with real property." Therefore, signing a home remodel contract at a coffee shop, for example, may result in application of this Act.

If the Act applies, a disclosure of the consumer's right to cancel the transaction by providing written notice within three business days must be provided directly above the signature line, among other requirements. ORS 83.730(1). A cancellation form must also be provided in duplicate (ORS 83.730(1)(c), although the homeowner needed not use the form to cancel (ORS 83.720(4)).

If the appropriate right to cancel disclosure is not provided, then the consumer may have a continuing right to rescind the contract after part or full performance. ORS 83.730. Further, the consumer may be able to keep services without paying for them, and unless the seller makes a timely written demand for the return of the goods, the consumer may be able to keep the goods without paying for them. See ORS 83.730(1) and (3).

The Act explicitly does not apply to contracts "for the sale or lease of a house or business property or the construction of a new house or business property." ORS 83.710(2)(c).

c. Warranties – State and Federal Requirements. Most Oregon contractors are aware of the requirement to "offer" a warranty for the construction or sale of a "new" residential structure or zero lot line dwelling to the owner. ORS 701.320. In the case of projects that meet the definition of "large commercial structure" (i.e. not a residential or small commercial structure), commercially endorsed general contractors must provide a two year warranty on building envelope and penetration components against defects in materials and workmanship. ORS 701.340.

Yet many contractors who do provide a warranty on materials may not be aware of additional Federal law requirements that may apply. For contractors who provide what may be considered a "consumer good" – a good that is "normally used for personal, family, or household purposes" – federal warranty law may apply.

This may apply particularly to those contractors who provide significantly more goods than services. *See e.g. Atkinson v. Elk Corp of Texas*, 48 Cal.Rptr.3d 247 (Cal. App. 2006) (roofing material supplied as part of a re-roofing contract retained their status as consumer goods in action against manufacturer); 16 CFR 701.1(d) (2012) (generally, thermal, electrical or mechanical equipment attached to realty and considered fixtures under state law may retain their status as consumer goods); 16 CFR 701.1(e-f) (2012) (materials purchased in connection with the improvement, repair, or modification of a home may be consumer goods, but materials already integrated into realty at time of contract or sold as part of a new construction or substantial improvement may not be). If so, special warranty requirements may apply. *See e.g.* http://www.business.ftc.gov/documents/bus01-businesspersons-guide-federal-warranty-law#intro (3/6/2013).

d. "Sewer Contractors." Every person offering to undertake or undertaking construction of "building sewer piping" must provide specific contract disclosures relating to insurance, bonding and permit information. ORS 701.348(1-2). "Building sewer" means that part of the system of drainage piping that conveys sewage into a septic tank, cesspool or other treatment unit that begins five feet outside the building or structure within which the sewage originates. *Id.* at (4).

4. Regularly Check Insurance Coverage with a Knowledgeable Professional.

All contractors must obtain and maintain commercial general liability insurance as a condition of obtaining a license from the CCB. Obtaining the "right" insurance is an important protection against the risks of doing business as general liability insurance generally serves two functions:

First, liability insurance may pay "covered claims," meaning claims that are based on certain types of personal injury and property damage as defined in the insurance policy. Second, and perhaps more importantly to the contractor paying the insurance premium, if the claim alleged against the contractor may be "covered" by the terms of the contractor's applicable liability insurance policy, then the insurance company is generally obligated to pay for the contractor's legal defense so long as the contractor complies with certain requirements (such as timely reporting of the claim and cooperation).

The problem is that most people (i.e. those who are not agents who sell insurance for a living) find it nearly impossible to comparison shop insurance policies and coverage options. A policy with an expensive premium may not even cover most of the risks the contractor faces because the policy language explicitly excludes those risks from what is a "covered claim."

For example, some common potential exclusions from "covered claims" include: Work performed on multi-family dwellings; Specified products, such as Exterior Insulated Finish Systems (known as EIFS) or other artificial stucco-like products; damage or injury caused by subsidence of soils (think landslides or failure of trench shoring).

Similarly, to protect valuable construction equipment or building materials stolen or damaged on the jobsite, a contractor may need additional types of insurance, such as Inland Marine insurance (for equipment) and Builder's Risk or Course of Construction Insurance (for certain types of damage or loss of the partially constructed project or unincorporated materials and supplies).

Every contractor should not simply renew its insurance when required, but rather take an active role. This includes not only asking its insurance agent what coverage is available, but also informing the agent of any significant

changes in the contractor's business, including specific types of projects, customers, new acquisitions of equipment, etc.

5. Avoid Hidden Costs of Someone Else's Insurance and Bond Requirements.

If the contractor is working under someone else's contract – often a sophisticated owner or an "upstream" contractor – the form should be carefully reviewed, particularly for insurance and bonding requirements. A bid for the work should exclude the cost of any insurance and bonding requirements, as those costs may not be fully known until the contract negotiation stage. In particular, some contracts require insurance that is prohibitively expensive or may not even be commercially available.

If a contract requires the contractor to post a bond (such as a performance and payment bond), the contractor needs to not only qualify for the bond and add the cost of the bond premium into its price, but also consider the lost opportunity of other work that may require a bond if the contractor does not have sufficient creditworthiness to qualify for multiple bonds.

6. Have a Workable Procedure for Changes.

Changes in the scope of work are to be expected. A provision that no work will be performed in the absence of written change order signed by each party may present problems if the contractor does not strictly follow its own contract.

In *Gregory v. Warren*, 51 Or App 547 (1981), the contractor Warren agreed to build a home on land he owned and then convey it to the Gregorys. The agreement contained a requirement that change orders must be in writing. The contractor inconsistently enforced the change order language, obtaining a change order for a $945 change, but not for substantial changes that were valued at $20,000 to $30,000. Despite not getting paid for the $20,000 to $30,000 change order, the judge compelled the contractor to convey title of the home to the Gregorys, stating in particular:

> *" [Y]ou [the contractor] indicated * * * that you just didn't have time to prepare changes or addendums, but yet Exhibit 7 shows you wrote out an addendum for only $945, and yet you want the Court to believe that [the] Gregorys had agreed to pay you 20- to $30,000. I can't accept that."*

While this case may be an extreme example, a contractor should formulate a workable procedure for dealing with changes that inevitably arise. One potential method may be to include a contract provision that reserves the right to refuse to do work without a signed, written change order, but otherwise provides that changes made at the owner's request shall be paid for on a time and materials basis. The hourly rates and mark up on materials or subcontractors should be set out in the agreement. The agreement should also provide a basis for time extensions based on changes, particularly where timeliness of performance will be an issue. Regular communication and documentation is a key to avoiding problems.

7. Claims for Changes Performed under Someone Else's Contract.

When working under someone else's form of agreement, the contract terms should be carefully reviewed for any notice and documentation requirements, as well as dispute resolution procedures. The contractor's failure to comply may waive a claim.

Whenever the owner or upstream contractor imposes various requirements for notice, timing and documentation of claims, a contractor should impose those terms on its own subcontractors. Otherwise, the contractor may get stuck paying a subcontractor for extra work or changes that the contractor is unable to collect from the owner or upstream contractor. Such terms can easily be incorporated by reference by what is called a "flow down clause" so long as the language is clear about what terms are incorporated by reference.

Similarly, if the work is on a publicly-owned project, the change order process should also involve obtaining confirmation that request for additional work comes from someone who has the budgetary authority of the public body and has followed the appropriate procedures to allocate additional funds to pay for the additional work. *See e.g. Wegroup PC v. State*, 131 Or App 346, 355 (1994) ("Persons who enter into public contracts are deemed to know the laws governing such contracts, and they assume the risk of nonpayment if they perform without insisting on strict compliance with those laws.").

8. Collecting Payments Owed to the Contractor.

Consideration should be given to the alternatives a contractor has to obtain payment from its customer. Some contractors who have had the unpleasant experience of using an attorney for collections subsequently insert an attorney fees clause in their agreement for future matters.

Given the potential reciprocity of these clauses, much more consideration is needed before including an attorney fee clause, such as whether the contractor is encouraging lawsuits for construction defects and the various alternatives. For example, properly preserving construction lien rights provides a basis for recovery of attorney fees. Claims under $10,000 may be recovered either in small claims court without attorneys (ORS 46.405) or by an attorney under ORS 20.082 upon satisfying certain conditions, which generally includes providing a pre-litigation demand.

9. Generally Shifting Risks From Contractor to Someone Else.

Oregon law is replete with examples showing that properly drafted contract language can help shift the risks of defective construction and accidents from the contractor to someone else (typically the owner or customer). Examples include a waiver or limitation of claims, disclaimer of warranties, or shortening of the time in which a claim may be made against the contractor.

Except for some limited statutory examples (*see e.g.* ORS 701.315 prohibiting the limitation of the right to file a Construction Contractors Board complaint, other than to require mediation and/or arbitration), many rights and remedies can be waived or minimized with properly drafted contract language. Such contract language may not be enforceable in every circumstance; however, the mere appearance of such clauses may have a "chilling effect" on potential claims or make those claims easier to resolve if lawyers get involved.

10. The Past Unresolved Conduct: A Problem that Reaches Beyond the Protections Afforded by Corporations and LLCs.

Attorneys representing any contracting business should be aware of ORS 701.102 and the CCB's implementation of ORS 701.068 before closing down the construction business or deciding to ignore a claim against the "defunct" business. The result may be very expensive for any new contracting business that shares an owner, officer or responsible managing individuals ("RMI") in common with the "defunct" business. In many circumstances, this can be true even if the owner, officer or RMI files personal bankruptcy.

The CCB has the ability to revoke, suspend or refuse to issue a license to a contracting business that owes a "construction debt" or "has had" a contractor license revoked, suspended or denied (such as in another state). ORS 701.102(2)(a). A "construction debt" includes debts arising out of a final award or order of the CCB, or a judgment award or civil penalty arising out of "construction activities" within the United States, or a failure to comply with Oregon's Worker Compensation laws. ORS 701.005(4).

What is surprising to many lawyers and contractors, perhaps because the concept partially defeats the general liability protections of a corporation or LLC, is that the "construction debt" against the "defunct" business may prevent an owner, officer or RMI of the defunct business

from obtaining a contractor's license for a new business until the "construction debt" is resolved.

In other words, an owner, officer or RMI of a defunct company may not be able to be anything other than an employee of the new contracting business (not an owner, officer or RMI) unless the "construction debt" against the defunct business is paid or otherwise resolved. ORS 701.102(2)(c).

This may be the case even if the owner, officer or RMI files and receives a bankruptcy discharge if the owner, officer or RMI was not personally liable for the construction debt. *See e.g. In re Ray*, 355 B.R. 253 (Bankr. Or. 2006) (Federal statute preempted ORS 701.102(2) where officer of defunct contracting company received a bankruptcy discharge of a debt owed by the defunct company that the officer also personally guaranteed).

Finally, if the "construction debt" arises out of a CCB order or award where a surety paid some, but not all of the order or award against the defunct contracting business, there may be additional concerns. A "new" company formed by an owner, officer or RMI in common with the defunct contractor may find the CCB taking the position that the new business will only be licensed if it obtains a bond that is up to five times the unpaid balance of the CCB order or award against the "defunct" contracting business. See ORS 701.068(4-5); OAR 812-003-0175. The CCB may seek to implement this statute even when the common person has received a bankruptcy discharge.

Conclusion. There are many other risks that exist for contractors, and these risks are continually changing as new case law is reported and statutes and regulations are re-written. Vigilance is critical.