1994 Newsletter Articles

Spring 1994

Alternative Dispute Resolution Provisions in Public Contracts: PLAYING BY HOUSE RULES

By Carol J. Patterson, Esq.

As the economy has declined in the past few years, firms in the construction industry have been forced to accept an unpalatable combination: lower fees and more onerous contract terms. Many of the hardest bargains are driven by public entities which hire design professionals and contractors on a competitive basis. Often the opportunity to modify the terms of public contracts through negotiation is extremely limited. Furthermore, as the New York Court of Appeals' 1993 decision in Westinghouse Electric Corporation v. New York City Transit Authority clearly demonstrates, anyone who signs on the dotted line and hopes that the courthouse may offer a reprieve from obligations which are especially one-sided is making a big mistake.

The central issue in Westinghouse was whether to enforce a contractual alternative dispute resolution ("ADR") mechanism that gave an employee of one of the contracting parties the power to make "conclusive, final and binding decisions on all questions arising under the contract" -- even though that employee was personally involved in the dispute. Westinghouse argued that this ADR provision was barred by New York public policy. The Court did not agree.

The employee was a Chief Electrical Officer of the New York City Transit Authority ("NYCTA") and he functioned as the Superintendent designated by the parties' agreement. The ADR provision of the contract provided that in the event of a dispute between Westinghouse and NYCTA "concerning a determination by the Superintendent," the parties were obligated to proceed with the contract ADR requirements, which authorized the Superintendent "acting personally, to decide all questions of any nature . . . related to or on account of this contract . . ." and his decision shall be "conclusive, final and binding on the parties." Presenting the dispute to the Superintendent for resolution could not be avoided; the contract made it a prerequisite to any legal proceeding.

Westinghouse had bid on and won a contract with NYCTA and the Metropolitan Transportation Authority ("MTA") for the sale, delivery and installation of power rectifier equipment for five substations for the New York City subway system. Over the course of the project, many disputes arose as Westinghouse claimed it was entitled to damages for delay and compensation for additional work. Westinghouse also complained that unresolved design problems and other restrictions on its work were an insurmountable obstacle to its timely completion of its contractual obligations. When it was unable to reach an agreement with the NYCTA Superintendent, Westinghouse wrote to advise him that it considered these problems to be a constructive stop work order. Three months later Westinghouse advised the Superintendent

that it was suspending work because of NYCTA's failure to address the problems identified in Westinghouse's previous letter. The Superintendent, in turn, responded that Westinghouse's suspension of work was a breach of contract. As a result, in accordance with the Superintendent's recommendation, Westinghouse was declared to be in default. Pursuant to the ADR provision, Westinghouse asked that the default declaration be rescinded and that its claim for millions of dollars of additional compensation be accepted. Not surprisingly, the Superintendent rejected both claims.

Westinghouse filed suit in federal court contending that NYCTA breached the parties' agreement. It argued that the ADR provision in the contract was invalid and violated New York public policy because it is a process which is predisposed to be biased. The argument emphasized that since the decision-maker is an employee of one of the parties to the dispute, it was unlikely that the contractor would receive a fair hearing.

The Court rejected Westinghouse's argument and ruled that the contract ADR mechanism was enforceable. This provision was simply one of the business risks Westinghouse assumed when it bid on the multi-million dollar contract with the NYCTA and MTA. Having accepted the benefits of the deal "with its business eyes open," Westinghouse could not seek to modify it after the fact. Accordingly, the Court agreed that Westinghouse was bound to follow the contractual procedure of presenting its claims to NYCTA's Superintendent for final resolution. Court review of that decision would, in accordance with the parties' agreement be limited to the question of whether the Superintendent's determination is "arbitrary, capricious or grossly erroneous to evidence bad faith."

Westinghouse is consistent with other decisions which reflect courts' reluctance to modify the terms of a commercial bargain. The Court of Appeals has rejected similar appeals to fairness and upheld "no damage for delay" clauses. Although public authorities have tremendous leverage in negotiating these agreements, courts reason that contractors can choose to avoid these provisions by refusing to bid for the work. This is precisely what many prospective bidders may decide to do now that it is clear that the ADR provisions which give a public agency extensive license to resolve disputes in its favor will be strictly enforced.

The Practical Implications of the Westinghouse Decision

A firm that cannot or is unwilling to avoid contracts with ADR provisions which shift the balance in favor of the owner by appointing one of its employees as the arbitrator of contract disputes, it is important to take steps to avoid being in the bind faced by Westinghouse. Of course, the best protection is to meet or exceed contract requirements and maintain a good relationship with the decision-makers representing the owner. Unfortunately, all the variables which affect a firm's ability to satisfy a client are not within its control. Problems will inevitably arise and it is important to address them promptly and effectively.

A carefully planned risk management program can be crucial in reducing risk when disputes are in their early steps. Effective risk management strategies include the following:

- Sensitize the project management team to the special requirements and risks of the contract at the outset so that they know that they must spot and report problems early while they are still manageable.

- Maintain open lines of communication with other members of the project team so that an acceptable resolution can be achieved before adversarial positions harden.

- Advise the client of problems which may lead to additional costs or delays in the work. The client may be in a position to persuade other parties to take action which will mitigate the difficulty.

- If other parties ignore a problem and attempts to make progress through discussion have been unsuccessful, it may well be necessary to make a written record to avoid liability or justify increased payments and/or a time extension in the future. Otherwise, a firm may face a client protesting "you never told me" when it attempts to explain the facts to rebut a claim or seek additional compensation.

Carol Patterson spoke on the requirements of the Americans with Disability Act at a recent workshop held at the offices of Teachers Insurance and Annuity Association in New York City. Ms. Patterson's presentation emphasized issues related to development of an effective program for compliance with the provisions of the Act that concern employment relationships.

Expand Your Practice, But Not Your Liability For Hazardous Waste Clean-up

By Michael K. De Chiara, Esq.

It's common procedure today for designers, engineers, construction managers and general contractors to look beyond the customary scope of their involvement on a project and seek to expand their responsibilities. But those who do so should beware that stepping outside the traditional boundaries sometimes means falling into a nasty trap filled with hazardous waste -- which you could be responsible for cleaning up.

Before signing a contract that enlarges your realm of responsibility, it would be prudent to assess the potential for assuming liability associated with hazardous waste remediation, and to learn how you can protect yourself from such an onerous situation.

The key to doing this is relatively simple: develop a basic understanding of federal and state laws that may allocate responsibility for environmental clean-up to owners, operators, managers and transporters of hazardous materials.

The Federal Laws

Federal statutes are clear as to liability for hazardous waste remediation on a construction project. Basically, if you own it, control it or manage it, you will have liability for any hazardous waste found at the site, generated at the site, or transported to or from the project site. The federal laws which impose liability for environmental clean-up are the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) of 1980 and the Superfund Amendments and Reauthorization Act (SARA), which amended CERCLA and became law in 1986. These statutes determine the obligation and the level of remedial responsibility by property owners, managers and operators of a facility as well as the other parties who arrange for disposal and treatment of hazardous materials. SARA created the Superfund, which is a multi-billion dollar fund the federal government may use to finance hazardous waste clean-up costs. Under CERCLA and SARA, liability for hazardous waste clean-up is absolute, retroactive and permits no reductions for extenuating circumstances. These are very onorous statutes.

Under CERCLA and SARA, the federal government can proceed in two directions. They can make those deemed responsible for hazardous waste remove the material, or the government itself can remove the hazardous material and assess the responsible party remediation costs to replenish the Superfund. CERCLA further states that parties responsible for the problem can be

assessed for injury to, destruction of, or loss of natural resources due to contamination. In addition, federal law assesses the responsible party for costs incurred during the investigation and monitoring of the hazardous waste problem.

CERCLA provides that the following parties are liable for costs of remediation: "...any person who by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment (emphasis added) of hazardous substances...at any facility...and any person who accepts or accepted any hazardous substances for transport to disposal...from which there is a release, or a threatened release which causes the incurrence of response costs, of a hazardous substance." Under this broad definition, there have been attempts to hold design professionals liable for the costs of hazardous waste clean-up. To date, these attempts have been unsuccessful.

Recent Case

Increasingly, there are attempts to extend CERCLA liability to design professionals. The courts have found that as long as construction professionals do not actively manage or operate project sites, they will avoid liability tied to contaminated materials, regardless of how they carry out their portion of the contract. A federal case, (Edward Hines Lumber Co. v. Vulcan Materials Co.), addressed the issue of whether a chemical supplier, designer and builder of the lumber plant, Osmose Wood Preserving, Inc., could be liable for the hazardous waste generated by the plant. In deciding the case, the Court of Appeals found that Osmose's design was defective, that the plant was built below standard, and that Osmose had poorly trained the plant's employees in the proper procedures for controlling toxic chemicals. However, the Court of Appeals found that despite these factors, Osmose could not be held responsible for the contaminated materials generated at the facility. In its analysis, the Court of Appeals concluded that under CERCLA, Osmose could not be held liable because under its contract it was neither an "owner" nor in any way an "operator" of the lumber facility. The Court of Appeals noted that: "the statute (CERCLA) does not fix liability on slipshod architects, clumsy engineers, poor construction contractors, or negligent suppliers of on-the-job training -- and the fact that Osmose might have been all four rolled into one does not change matters." There is no assurance that future courts will be so lenient.

A more troubling issue of liability arises when an engineering consultant, construction management firm, or general contractor's contract includes responsibility for the control of the project site or control of material transportation. In that event, the design professional or construction manager's role may more closely resemble that of an "operator" or "manager" of the facility. In such cases, you must consider whether the construction site may contain hazardous materials or whether any materials being transported to or from the sites are potentially hazardous materials. Even if your responsibilities only extend to arranging for the transportation and/or selection of a disposal facility for project materials, you may be held liable for contaminated substances found in those materials.

Similarly, design consultants, construction managers and general contractors undertaking "turnkey" projects, expanding their scope of project responsibility or stepping beyond their field of expertise can avoid liability if they have a rudimentary understanding of federal and state laws pertaining to hazardous waste related to the land-site usage and control of the project, and if they can contractually shift responsibility to other parties, such as the owner.

Engineering consultants and construction professionals broadening their range of services, especially into construction management, should do so fully cognizant of potential risks associated with hazardous waste remediation. Before agreeing to take on expanded responsibilities -- specifically the responsibility for making the arrangements to transport and/or dispose of construction materials from a job site -- design and engineering professionals should investigate the prior use of land and materials on a project site and consult with an attorney knowledgeable in this area so that their contracts can provide some protection. The prudent, professional who takes this small extra step will save his firm from potentially enormous future liabilities under CERCLA.

Taking the Risky Business Out of Design/Build

By Michael S. Zetlin, Esq.

Until the Renaissance, design/build was the accepted method of construction. But as projects became more complex, the construction process separated into two distinct practices and remained that way for hundreds of years.

Today, we again see design/build increasingly in use, especially on public projects, since public agencies prefer the "single-source responsibility" that the concept provides.

Although design/build offers numerous advantages, it also presents many potential problems. For one thing, it is illegal in many states unless it is carefully structured to avoid placing the design professional in a subordinate role to the contractor.

State licensing authorities fear that public safety may be put at risk unless an architect or engineer assumes the lead role in a design/build venture. Many states, such as New York, require the design professional to be an independent entity. Some states, such as New Jersey and Pennsylvania, allow a corporation to offer design/build services provided the corporation is controlled by design professionals and necessary registration requirements are met.

Moreover, a fundamental ethical issue arises in the use of design build: the inherent conflict of interest that presents itself when an architect or engineer designs a project while maintaining a stake in its profitability. Although the AIA's 1992 Code of Ethics and Professional Conduct addresses many of the issues that can arise in the course of a design/build process, other questions are left unanswered.

What is required of all parties is a thorough understanding of the nature of their obligations and services, and an assessment of the advantages and disadvantages of the process.

The benefits of design/build are clear: projects can be completed faster and for less money; it encourages collaboration between the parties involved; owners can look to one party for both design and construction responsibilities.

The risks for the design professional or contractor, however, can be formidable. A familiarity with those risks can prevent future questions of liability.

First, it is important to realize that, whether the design/builder is the design professional, the contractor, or both of those parties in a joint venture, the nature of the process significantly alters the design professional's relationship with the owner. Rather than that relationship being one of a trusted advisor to an owner, the architect or engineer in design/build assumes in many respects the role of a businessperson, and must balance aesthetic aspirations with business obligations.

During the bid or proposal process, it is critical that both designer and builder agree on the scope and nature of the project, and work closely together to determine a price. The safest way to ensure this agreement is to have both parties prepare detailed cost estimates, and to then discuss reasons for discrepancies and arrive at a mutually acceptable resolution.

Next, the division of duties must be clearly specified. It is not enough to assume that the design professional will be responsible for any items relating to design, and the builder for any items relating to construction. Indeed, design and construction functions overlap with certain categories, such as project administration and quality control.

To reduce the possibility of future misunderstandings, the design professional and the builder must carefully review each item of work and assign responsibility for it.

Scheduling is another area that can become quite complex in a design/build project. Where in a traditional project the design is largely complete before construction begins, design/build often proceeds on a fast-track basis. The design professional acting as the design/builder must make sure construction adheres to a strict schedule to avoid delays.

The issues of insurance and bonding are problematic. Insurance and bonds that both cover construction and professional design services can be difficult to obtain and expensive. Frequently, design/build contractors offer separate policies and bonds for the design work and the construction work. Often, however, owners insist on a single performance bond to cover all performance responsibilities.

In order to limit liability, the designer and builder should try to have the bonding company accept indemnification agreements from both parties with a specified ceiling amount. Additionally, the designer and builder should enter into indemnification agreements with each other to cover payments made to the bonding company due to the other party's fault or negligence.

The owner and design/build entity must also analyze the risks that can be anticipated for the project and carefully allocate those risks between themselves. For example, changed conditions, environmental concerns and other inherent risks that arise when construction proceeds simultaneously with design on a fast-track project are issues that should be understood and negotiated at the outset of the project. Too often owners, believing they have a guarantee of a fixed price for a completed project, are rudely surprised by the extras and claims for extras that surface on a project. Likewise, design professionals and contractors should embark on the venture with a thorough understanding of the risks they are taking on the project. The contract between the owner and design/build entity should address all risks being shifted and assumed by the parties.

The trend towards design/build is undeniable. Properly implemented, it offers owners, design professionals and contractors the opportunity for quality work performed profitably, expediently, and within budget. It is critical, however, for anyone involved in a design/build project to heed and address potential risks to achieve desired goals.

Summer 1994

An Ounce of Prevention: Some Legal Guidelines for CADD Users

By Carol J. Patterson, Esq.

CADD offers tremendous benefits to design professionals, owners and contractors because it enables all members of the project team to efficiently exchange information. When CADD data is transferred from one office to another, it is possible that information on the disc and even the underlying software can be altered without permission. Such modifications not only pose risks from a quality control standpoint, but they may also result in violations of the Federal Copyright Act which prohibits unauthorized copying or modification of copyrightable works, including architectural works and software programs. Well managed firms are not only aware of these potential problems, but take steps to avoid them.

Clarify Assignment of Project Responsibilities

Many potential problems can be anticipated and resolved before work begins. For instance, sophisticated owners may have their own CADD specifications. The cost of complying with the client's requirements needs to be evaluated in terms of inter-office compatibility. The parties should decide who will pay any translation costs which are involved because different members of the project team have different software or equipment.

As is the case with documents on paper, project documents on CADD must be properly coordinated. The risk of error in the project documents can be reduced if the various agreements among members of the project team assign responsibility for coordination so that each member of the team has a clear understanding of its duties.

Obligate Others to Recognize the Firm's Copyright and to Advise It of Any Changes in Its Work

Design professionals seeking to maintain ownership of the copyright in their work must be aware of the special risks associated with work product on a CADD system. It is not only necessary to include a copyright notice on CADD work product, but it is also advisable to obligate other parties who receive the discs to confirm that the notice will not be removed. To

minimize the risk of unauthorized copying and the addition of untraceable errors to the data on the disc, design professionals must also maintain record sets of their CADD work product and a complete list of the parties who receive their work. Before distributing CADD discs to clients, contractors, or consultants, design professionals should obtain assurances that their work product will not be changed without permission. Contracts or letters can obligate the recipients of CADD discs to promptly inform the author of any additional parties who may receive the discs and of any changes made to them.

Comply with the Terms of Applicable Software Licenses

Data on CADD is inaccessible without operating software. Although some firms create their own programs to satisfy the special needs of their practice, most design professionals work with programs that are commercially available. Use of a software program is subject to the terms of a licensing agreement.

For the price of a single copy of a program, a purchaser receives the right to copy the program on one work station and make a backup for archival use. A purchaser who makes additional copies for use at other work stations in the office is violating the terms of the licensing agreement and is subject to liability under the Federal Copyright Act. Remedies may include paying the software licensor's legal fees as well as damages. Since software companies count on multiple sales to recoup the cost of program development and to generate substantial profits, they are vigilant about enforcing their rights under the Copyright Act. Some software vendors conduct informal inquiries to confirm whether the number of programs in use exceeds the number of licenses purchased. Those firms who appear to have violated their licensing agreements by making unauthorized copies of the program may hear from the software vendor's attorneys.

Personnel who work with and have the ability to modify software programs should be sensitized to these issues. For example, the skilled head of the firm's CADD operations may be capable of developing and adding new files to an existing copyrighted software package to enable the firm to use digitizing technology to rapidly reproduce large numbers of floor plans for a project. This is a modification of the software program which could trigger a claim of infringement. So far, some courts have been willing to allow some latitude to program users who must modify a program to meet their own business requirements. However, if a modification is widely disseminated or if it may compete with the software producer's product, a finding of liability would be highly likely.

Finally, if a design professional develops its own software programs which will be transferred to clients or other members of the project team it is essential to reserve its copyright interest in the program. If the parties outside the firm have only a license to use the program for a limited purpose on completion of a specific project, the governing agreements should say so.

CONSTRUCTION SITE ACCIDENTS: IS THE ARCHITECT/ENGINEER LIABLE?

By Michael S. Zetlin, Esq.

All too often architects and engineers find themselves targeted as a defendant in a personal injury lawsuit brought by a construction worker injured during the construction of a project. The injured employee, precluded from pursuing an action against his employer because of workers' compensation rules, directs his claim against other parties who may be responsible for the circumstances leading to the accident. The first question asked by the design professional is "why am I named as a party when I had no responsibility for construction means or methods or for the project safety program?"

Standard design professional agreements and general conditions published by the American Institute of Architects ("AIA") and the Engineers Joint Contract Document Committee ("EJCDC") confirm that the contractor is solely responsible for construction means and methods. The EJCDC Standard Form of Agreement between Owner and Engineer for Professional Services, for example, provides:

> Engineer shall not, during such visits or as a result of such observations of Contractor(s)' work in progress, supervise, direct or have control over contractor(s)' work nor shall Engineer have authority over or responsibility for the means, methods, techniques, sequences or procedures of construction selected by Contractor(s), for safety precautions and programs incident to the work of Contractor(s). . . .

In the lawsuit brought by the injured worker, the worker claims that despite the design professional's contractual exclusion of responsibility for constructions means and methods and safety, the design professional in fact assumed responsibility for the safety program. The injured worker may also or alternatively claim that the design professional supervised the work of the contractor and should have recognized the safety hazard and implemented appropriate precautions.

Courts in many jurisdictions have dismissed wrongful death and personal injury claims against architects and engineers who had no responsibility supervising the contractor's work or for ensuring a contractor's compliance with a project safety program. In the recent decision of *Burns v. Black & Veatch Architects, Inc.*, 854 S.W.2d 450 (Mo. Ct. App. 1993), for example, a construction worker was injured when a dirt bank separating two trenches collapsed. Black & Veatch's specifications required that the contractor provide for shoring where necessary. The worker claimed that Black & Veatch had a duty to provide for an adequate trench protection system. The Appellate Court upheld the dismissal of claims against Black & Veatch, explaining that the contractor had exclusive responsibility for construction means and methods and it was the exclusive duty of the contractor to take all necessary safety precautions.

In another leading case, *Sykes v. Propane Power Corp.*, 224 N.J. Super. 686 (App. Div. 1988), the administratrix of the estate of a deceased chemical plant employee sued an engineer who was retained to assist in the development of detailed drawings for the layout and location of facilities involved in a chemical recovery plant in Newark. Several months after the engineer prepared and signed topographical plot and storage tank location plan drawing and process flow diagrams, the employee sustained fatal injuries when a chemical distillation unit in the plant exploded. Plaintiff claimed that the engineer (i) failed to equip the unit with an appropriate shut down system; (ii) failed to use a properly-sized "ruptured disc"; and (iii) failed to prepare a hazard evaluation study. Before trial, the court dismissed the claims against the engineer, reasoning that the engineer had not been hired to go through the plant as a safety engineer nor advise the owner of the chemical recovery plant about correcting hazards.

The decisions in *Black & Veatch* and *Sykes* emphasize the importance of incorporating appropriate language in a design professional agreement explicitly removing responsibility from the design professional for supervision or control over the contractors' construction means and methods and for the project safety program. Engineers and architects must also take great care during the course of the project to avoid assuming by their actions control over the contractor's means and methods or the safety program. If the design professional is called to attend safety meetings, the purpose of the design professional's attendance should be clarified in the minutes of the meeting or follow-up correspondence. To the extent the design professional does, in fact, assume a responsibility over particular construction means and methods (e.g., designing a particular shoring system), the design professional should ensure that a representative of the firm is on site overseeing that work or that the contractor explicitly assumes responsibility for that work. Without taking appropriate precautions, engineers and architects will find it difficult to extricate themselves from costly and threatening personal injury and wrongful death actions.

Lenders Provided New Weapon in Non-Recourse Financing Disputes

By Raymond T. Mellon, Esq.

In a recent decision, the United States Court of Appeals for the Second Circuit greatly expanded the potential liability of borrowers in non-recourse mortgage transactions. Previously, both lenders and borrowers assumed that the maximum extent of liability for failure to pay a non-recourse mortgage was recovery of the mortgaged property at foreclosure. While not binding in New York State Courts, the Second Circuit's decision in Travelers Insurance Company v. 633 Third Associates is persuasive and will force banks and borrowers to carefully reassess the possible liability that may arise with non-recourse lending.

The Travelers' decision concerned the issue of whether a failure to pay real property taxes constituted "waste" under New York law. Waste is a common law doctrine that

evolved to correct problems arising from divided ownership in the same property. The conflicting ownership interests between a landlord and tenant usually related to the benefits to be derived from the property. Landlords focused upon the property's long term benefits, while tenants sought to maximize the property's short term benefits. The doctrine of waste prevents a tenant, or someone in control of the real property, from exploiting the short term value of a property to the detriment of property's long-term value. New York codified the common law doctrine of waste in a statute which was construed to require a physical damage or deterioration of the property. A classic example of waste is where damage occurs to property that causes a decrease in property value. In Emigrant Industrial Savings Bank v. Midland Terrace Corporation, a landowner successfully recovered damages for waste from the defendants who removed trees, changed existing grade and contour, and removed great quantities of top soil. New York courts also recognized an action for waste by a mortgagee against a mortgagor who impairs the value of the mortgage. For example, in Syracuse Savings Bank v. Onondaga Silk Co., a mortgagee sued the landowner/borrower alleging voluntary and permissive waste and sought damages for impairment of the mortgage security.

In Travelers, the Second Circuit held that a mortgagor's intentional or fraudulent failure to pay property taxes, when such an obligation exists, constitutes waste under New York law. The facts relevant to the decision concerned a mortgagor/partnership's distribution of approximately $21 million to the constituent partners. $17 million dollars of the distribution was made after the partnership failed to pay the mortgage and real property taxes due on the property. While the mortgagee commenced a state foreclosure action, it also commenced an equitable action in federal court seeking recovery of the partnership distributions. The mortgagee alleged that the partnership distributions prevented the mortgagor from complying with its loan obligations, including the payment of property taxes. It was further alleged that the failure to pay real property taxes constituted waste under New York law which could be remedied in equity.

The Federal District Court dismissed the complaint in Travelers by holding that the mortgagee did not plead a valid cause of action for waste under New York law. On appeal, the Second Circuit reversed the District Court's determination and, for the first time ever, explicitly held that an intentional failure to pay real property taxes constitutes waste under New York law. In so holding, the Second Circuit adopted an expansive definition of waste that relied upon prior New York decisions that had only implied that an intentional failure to pay taxes would constitute waste.

The Second Circuit emphasized the narrow limits of its ruling: a failure to pay property taxes constitutes waste only where the failure is intentional or fraudulent and results in the impairment of the mortgage security. In explaining its holding, the Court reasoned that since an intentional failure to pay real estate taxes causes a lien to attach against the property, the security of the mortgage is thereby impaired. In contrast, the failure to simply pay the principal and interest on a mortgage does not constitute waste because the mortgage is not impaired.

Since non-recourse mortgages constitute a significant portion of real estate financing, the Travelers' decision may have a profound effect for the future of this type of financing. While not binding precedent in New York courts, the Travelers' decision contains sound reasoning and was issued by a respected court. Lenders will welcome the decision because it provides a powerful weapon to combat a faltering mortgagor's attempts to strip a property of its income stream before foreclosure. Such increased bargaining power may adversely impact upon a lender's disposition to restructure non-performing, non-recourse loans. The prospect of recovering monetary damages, in addition to the mortgaged property, may cause lenders to drastically alter their strategy upon a default of a non-recourse mortgage.

In contrast, the Travelers' decision does not offer much comfort to borrowers. Despite the Court's admonition on the limited scope of its ruling, borrowers will fear the assertion, whether frivolous or not, of actions for waste arising from a failure to pay property taxes. The qualification that the failure must be intentional or fraudulent may not provide sufficient protection against the assertion of waste claims by lenders. Borrowers will now also be subject to a lender's scrutiny concerning any distributions made from the mortgaged property's income. If a default in tax payments subsequently occurs, the lender may well claim that the distribution caused the intentional failure to pay real property taxes. At the very least, the Travelers' decision has the potential of reducing the incidence of non-recourse financing if the holding is adopted by New York State courts. In such an eventuality, non-recourse financing as it is currently known may disappear. In its place, lenders and borrowers may be limited to full recourse borrowing or hybrid recourse financing which caps recourse liability at an agreed upon amount.

The Future Is Finally Here -- Limited Liability Companies
Part 1 -- Limited Liability Partnerships

By Michael K. De Chiara, Esq.

This summer the New York State Legislature passed the Limited Liability Company Law which has been signed into law by Governor Cuomo. The Limited Liability Company Law (the "Law") is the most significant change effecting the way architects, engineers, contractors and real estate entities may be organized in the State of New York in the last fifty years. The Law creates two new entities: a Limited Liability Company ("LLC") and a Limited Liability Partnership ("LLP"). This is Part I of a two part series covering this new law, the focus of this article will be on LLP's, which combines the best features of a partnership (tax-based advantages) with some of the features of a professional corporation (liability-based advantages).

Traditionally, lawyers and accountants have debated the business form that an engineering or architectural firm should adopt. The argument has centered around the beneficial tax treatment afforded a partnership versus the liability protections afforded by a professional corporation. From a tax perspective, a partnership is the most flexible form from which to operate a service business, such as an engineering or architectural firm. Partnerships generally report their income on a cash basis, this permits the business the maximum flexibility in managing the income side of the annual balance sheet. Partnerships also allow other tax benefits -- primarily related to expenses and depreciation, to pass directly to individual partners. However, the tax-advantages offered by partnership form of business enterprise have always been accompanied by increased exposure to personal liability which has been the major negative attribute of the partnership form of business. Until the Limited Liability Company Law was enacted, the primary advantage offered by the professional corporation was the extra measure of

insulation from personal liability it afforded the individual shareholders for the liability they may incur as a result of their partner's professional negligence. Shareholders in a professional corporation are not vicariously liable for the negligent acts of other shareholders. This means that if your partner is in charge of a project and commits a negligent act, your liability, assuming you did not participate in the supervision of the project, is limited to your interests in the professional corporation. Your house and personal assets are not subject to capture in a suit for malpractice. In addition, as a shareholder of a professional corporation, you are not personally liable for the ordinary business debts and obligations of the corporation. In fact, the only difference from a liability perspective, between a professional corporation and a regular corporation is that the shareholders of a professional corporation are liable for malpractice, albeit with the limitations discussed above.

The Limited Liability Company law, which brings New York in line with 46 other states across the nation, means that professionals practicing in New York can combine the tax advantages of a partnership with the insulation from vicarious personal liability for malpractice advantages of the professional corporation. The LLP affords professionals the opportunity to come close to having the best of both worlds. You can be organized as a partnership and have the professional liability protections of a professional corporation. However, the LLP does not insulate the partners from personal liability for ordinary business debts and obligations.

	PROFESSIONAL CORPORATION	**PARTNERSHIP**	**L.L.P.**
TAX BENEFITS	• Taxed as a corporation • Shareholders also pays tax on profits • Generally accrual basis reporting	• Taxed as individuals (No double tax) • Cash basis reporting	Same as partnership
LIABILITY PROTECTION	• Shareholder insulated from liability for professional negligence of other shareholders	• Full liability for negligence of partners	Partners insulated from professional negligence of other partners

	PROFESSIONAL CORPORATION	PARTNERSHIP	L.L.P.
	• Shareholders not liable to ordinary business debts		

Forming an LLP

The Limited Liability Company law amended the Partnership Law of the State of New York to permit the registration of existing general partnerships which, heretofore, have provided professional services to become Limited Liability Partnerships. The new procedure to qualify an existing partnership as an LLP is set forth in new Section 121-1500 of the Partnership Law. It provides that any general partnership, all of the partners of which are licensed professionals, and which is currently rendering professional services, may register as a LLP by filing a registration with the Secretary of State, accompanied by a filing fee of $200. The registration is required to include: (i) the name of the registered limited liability partnership; (ii) the designated agent for service of process; (iii) if the registration is to be effective on a date other than time of filing, such date which is not to exceed sixty (60) days from the date of filing; and (iv) if all specified partners of the LLP are to be liable in their capacity as partners for all the specified debts, obligations or liabilities of the LLP, a statement to such effect. In addition, the name of a New York LLP must include the phrases "Registered Limited Liability Partnership," "Limited Liability Partnership" or the abbreviations "R.L.L.P.," "RLLP," "L.L.P." or "LLP". There are other technical requirements for registration, including a notice publication requirement, but they are essentially ministerial.