

Renovation of Cooperatives and Condominiums: Insurance and Lien Protections in Light of Today's Laws Governing Coop/Condo Construction

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One of the unique features of performing construction work in a cooperative or condominium apartment is that the work must usually be performed pursuant to an alteration agreement. The alteration agreement addresses what, where, when and how construction work is to be performed. An alteration agreement is typically entered into between the shareholder of a coop or unit owner of a condo (collectively referred to as “owner”) and the coop or condo board or its managing agent. It may also be enacted when the coop or condo board performs renovations in the common spaces of its building. Most of the provisions contained in an alteration agreement are geared toward protecting the condo or coop and its residents (the “building”) from claims arising from the owner’s construction. As such, the owner takes on an added layer of liability which is not usually involved in undertaking construction of one’s property. It is, therefore, all the more important to ensure that proper protections are incorporated into the owner’s design and construction agreements.

Two of the primary ways that the owner can protect itself and the building from liability arising from renovations are (1) professional liability insurance requirements in owner-design professional agreements, and (2) requirements for removal of liens in both owner-design professional and owner-contractor agreements. This article focuses on how these two areas of law pose liability to owners and discusses practical steps that can be taken in order to protect themselves and their building from unnecessary liability exposure.

Design Professional Liability Insurance

Disputes arising from coop and condo renovation projects often begin with contractors claiming that the owner’s design team caused problems to delay and increase the costs of the project. These claims often involve allegations of defective design and construction plans and negligent acts, errors and omissions in the performance of the design professionals’ construction administration services. Whether these claims are authentic or fabricated, such claims can result in extensive delays to the project schedule and substantial increased costs to the owner.

Additionally, in the case of individual unit renovations, the building’s board, residents and managing agent, do not want to become embroiled in a problem project and will soon enough shut it down – pursuant to the terms of the alteration

agreement – rather than assist the unit’s owner in completing it. Moreover, buildings often have “construction seasons” which can last as few as five months. Extensive delays can push a project’s completion into the following “season” resulting in additional increased costs from the design and construction team. Owners must therefore ensure that their design team maintains adequate insurance coverage to protect them should claims arise on their projects.

Most owners assume that design professionals provide insurance that automatically affords coverage for design errors, omissions, delays, and other professional negligence that may occur on their project. However, most states, including New York, do not require design professionals to maintain professional liability insurance. As a consequence, it is the responsibility of each owner to ensure that its design professionals have current insurance in place to balance the risk associated with the potential for professional liability problems.

When retaining design professionals, owners and their counsel should ask to review all professional liability policies as to (1) the aggregate limits of liability afforded by the insurer, (2) the available limits of liability for the annual policy in the event a pending claim on another project has reduced the original limits of liability, and (3) the amount of the deductible maintained by the insured.

Owners should be warned to carefully scrutinize the design professional’s liability insurance. Often, the policy wording contains numerous exclusions which could preclude coverage for many types of claims customarily asserted by an owner against a design professional. These might include claims involving project budget estimates, representations as to design features, and fee recovery claims. Additionally, there is usually no coverage for failure of the design professional to meet a particular contractual requirement, such as guaranteed costs for the project, unless the claim arises from its negligent act, error, or omission.

Furthermore, unlike most other types of insurance coverage, Part 71 of the New York State Insurance Regulations permits insurance companies to sell professional liability policies containing a provision “that reduces the limits of liability

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stated in the policy by the costs of legal defense.”¹ Not surprisingly, such a provision is contained in virtually all design professional liability policies written in New York.

At the outset of each project, unit owners and their representatives should define the goals that will determine project success. A complete investigation of project goals might include budgetary, scheduling, and building concerns. By identifying all risks and other issues relating to the project, owners and their representatives can require the design team to secure coverage which properly protect the owner and building. Such protections will ensure that should design errors and omissions or other losses arise on the project, the owner will be properly and fully protected.

Mechanics’ Liens

Most alteration agreements require unit owners performing construction work to immediately remove any liens that may be filed on the underlying property or common spaces of the building. Since removing mechanics’ liens and protecting the building from claims can be expensive and time consuming, unit owners should ensure that their agreements with the design and construction team properly protects them and minimizes the likelihood that mechanics’ liens will be filed on their building.

Three steps can be taken by the owner to reduce its liability exposure with respect to mechanics’ liens: 1) agreement provisions, 2) lien waivers, and 3) retainage.

The New York State Lien Law enables an individual or entity owed money for labor or materials furnished in connection with the improvement of real property to file a mechanic’s lien. Although filing a lien does not create any entitlement to payment – that is determined by basic contract law – the Lien Law affords security to those providing labor or materials by allowing them to encumber private land where the work was completed.

Although an owner can post a surety bond or deposit money or security with the court to discharge a mechanic’s lien and seek redress from the contractor, this process can be expensive and often takes several weeks or months before the lien is discharged. Moreover, as principal of the lien discharge bond, the owner can ultimately be responsible for paying the underlying sum to the surety if the subcontractor prevails in its suit to foreclose on the bond. Therefore, if the proper provisions are included in the owner’s agreements, the owner should look to the design professional or contractor to bond off the lien. This is especially true if the owner has already paid the contractor for the labor and material the unpaid subcontractor has furnished.

Three steps can be taken by the owner to reduce its liability exposure with respect to mechanics’ liens. First, the owner-

design professional agreement and the owner-contractor agreement should contain clear provisions requiring the discharge of any liens filed on the project by the design professional or contractor. So long as the owner has paid for the work in question performed on the project, it should not undertake the risk of discharging such mechanics’ liens since failure by the design professional or contractor to discharge the lien should constitute a material breach of the agreement for which the owner should be entitled to all costs, including attorneys’ fees, related to discharging the lien.

Second, although “no lien” contract provisions are void and unenforceable as against public policy, the Lien Law permits a contract condition whereby a contractor receiving payment is required to waive all rights to file a lien with regard to payment received. This is known as a waiver of lien and is typically exchanged exclusively with contractors. The owner should require the contractor to execute the waiver of lien simultaneously with the delivery of payment for labor and material already furnished. For additional protection, each waiver of lien should contain a representation that the contractor will defend, indemnify and hold the owner harmless from and against all disputes, claims, losses, damages, and expenses caused by any lien filed by, or on behalf of, the contractor and its subcontractors and material suppliers.

Finally, the owner should withhold a specified percentage of funds during the course of the project until the contract work is complete and accepted. This retainage will ensure that there are funds available at the end of a project to resolve claims by unpaid lienors. A typical retainage provision might permit the unit owner to withhold ten percent of project payments until substantial completion is achieved. These retained sums can also be used as leverage to compel the contractor to pay the lienor or discharge the lien. Retainage percentages and release dates should be spelled out in the construction agreement.

These measures safeguard owners by providing an effective mechanism for the discharge of liens. More importantly, they give the owner maximum leverage against the contractor and lienor. When properly incorporated into the owner’s agreements, these provisions operate in concert to provide an effective front against liens filed on an owner’s real property.

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¹ NY State Ins. Reg. 107; 11 NYCRR 71. Part 71 creates an exception to the general prohibition against the practice of allowing insurance companies to reduce the limits of liability for legal defense costs.