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California Court of Appeal Recognizes Modified Total Cost Theory of Damages

***Dillingham-Ray Wilson v. City of Los Angeles* (2010) 182 Cal.App.4th 1396.**

A recent California Court of Appeal case unequivocally establishes the modified total cost theory of damages as a viable remedy for California contractors. Accordingly, where no contractual requirement exists for a contractor to document its actual costs, that contractor may be able to recover for work it performed in good faith using the modified total costs method.

The City of Los Angeles initiated a competitive bidding process for work at the Hyperion Wastewater Treatment Plant. Contractor Dillingham-Ray Wilson ("DRW") was awarded the public works contract. The language of the contract was fairly typical to construction projects, allowing the City to retain up to 10 percent of each progress payment and hold those funds in an interest-bearing escrow account. Also, it permitted the City to deduct liquidated damages from progress payments for contractor delays.

Once construction began, the City issued over 300 change orders containing more than 1,000 changes to the plans and specifications. In most cases, the City requested an estimate of the cost of work and directed the contractor to begin work, stating that the parties would negotiate a lump sum payment at a later date. However, upon project completion, the City refused to pay the contractor a lump sum for the outstanding change order work, assessed liquidated damages against DRW, and refused to release retention funds from escrow.

DRW filed suit against the City for breach of contract. The City cross-complained and claimed that DRW was liable for liquated damages. The City filed motions in limine to preclude DRW from presenting evidence to support its modified total cost claim to the jury and from proving its damages with engineering estimates (the best evidence DRW had available). The trial court granted these motions, thereby excluding $25 million of DRW's claims. It found that DRW's evidence in support of the modified total cost theory was insufficient and ruled that the modified total cost theory was not recognized in California, based on its interpretation of *Amelco Electric v. City of Thousand Oaks* (2002) 27 Cal.4th 228.

Once the case proceeded to trial, the jury determined that the City had breached its contract with DRW, awarding over $12 million in contract damages and $15 million in prompt payment penalties to DRW. DRW appealed.

On appeal, the appellate court disagreed with the trial court and found that the modified total cost theory was recognized as valid in *Amelco* and that DRW could potentially recover under this theory, depending on interpretation of the contractual requirements for documentation of the actual costs of change orders. Under the total cost method, damages are determined by subtracting the contract amount from the total cost of the contractor's performance. Under the modified total cost method, if the contractor is responsible for some of its increased cost of performance, then those costs are subtracted from the contractor's damages to arrive at the modified total cost.

The court also reconciled California Public Contract Code section 7105 (related to change orders by public entities) with the common law requirement that only the best evidence of damages, not exact proof, is required.

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The court found that section 7105 impacts the *measure* of damages, but not the *method of proof* of those damages, and that therefore, DRW could potentially use engineering estimates to prove its damages.

The court remanded the issue of whether DRW's contract required it to document its actual costs on the change orders issued by the City to the trial court for further proceedings. If DRW was not contractually required to document its actual costs (which DRW contended was not possible), DRW could use engineering estimates to prove its claims under a modified total cost method, provided those estimates were the best evidence available.

New York Court Grants Preliminary Injunction to Contractor Requiring Bank to Continue Funding Construction Project

***Destiny USA Holdings, LLC v. Citigroup Global Markets Realty Corp*. (2009) 889 N.Y.S.2d 793.**

A noteworthy recent ruling in the Appellate Division of the New York Supreme Court may have implications for institutional construction lenders as well as environmentally sustainable construction projects. The ruling not only compelled a lender to make progress payments in accordance with the terms of the construction mortgage, but also established that a "green" project was so unique that it had no established market value, making calculation of damages impossible. Also of note was the court's willingness to look to external economic conditions and thereby determine that the severe credit crunch in early 2009 made access to alternative funding unlikely.

In 2005, Citigroup decided to provide approximately $155 million in financing to Destiny USA Holdings, LLC ("Destiny") for the first phase of a "Destiny USA" expansion project. The project involved the development and construction of a very large shopping center/tourist destination.

In February of 2007, Citigroup and Destiny entered into an Amended and Restated Building Loan and Security Agreement. The agreement provided that loan advances were to be made after Destiny Holdings had submitted its monthly draw request, provided that various conditions were met. Citigroup could only deny the draw if it determined that a "deficiency" existed whereby the money required to complete the mandatory improvements exceeded the money yet to be advanced and other available funds.

Construction began, Destiny duly submitted draw requests, and Citigroup funded those requests. However, in April of 2009, when the 27th draw request was submitted, Citigroup sent Destiny a deficiency notice alleging $15 million in deficiencies related to Tenant Improvements. Subsequently, when Destiny failed to cure those deficiencies within 10 days, Citigroup declared the loan in default.

In June of 2009, Destiny filed a complaint against Citigroup alleging breach of contract and seeking a declaratory judgment, specific performance, and preliminary and permanent injunctions. A party seeking an injunction must establish three elements: (1) a likelihood of success on the merits, (2) irreparable injury if the relief is denied, and (3) the equities are in the plaintiff's favor.

The appellate court upheld the trial court's decision to grant a preliminary injunction requiring Citigroup to fund pending draw requests. The appellate court disagreed with Citigroup's argument that an injunction was inappropriate because Destiny could have sought a replacement loan and avoided any irreparable harm. The court cited to the project's unique "green" character and unprecedented nature and scope as elements making it particularly difficult to calculate damages, necessitating an injunction. The court also took judicial notice of the economic conditions prevailing at the time Citigroup ceased making the loan advances as supporting Destiny's argument that funds to replace the loan proceeds were probably not available elsewhere.

Two Supreme Court justices dissented, finding no authority under New York law entitling a party to a preliminary injunction requiring a lending institution to loan money, and flatly rejected the majority's view that the project was unique or that plaintiff would suffer injury to its reputation if the injunction were denied.

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