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They are intended to highlight a specific area of the law. This communication is not legal advice. The reader should consult an attorney to determine how the information applies to any specific situation.

Bankruptcy Court Recognizes Preclusive Effect of State Court Default Judgment Entered Under the Michigan Builder's Trust Fund Act to Bar Subcontractor from Disputing Nondischargeability of Resulting Debt

by Joseph W. DeLave jdelave@dickinsonwright.com

In these tough economic times, the Chief Judge of the United States Bankruptcy Court for the Eastern District of Michigan recently delivered some welcome relief for contractors who are victims of fraud at the hands of their subcontractors. In the decision of *In Re Brunett*, 394 B.R. 425 (Bkrcty. E.D. Michigan October 8, 2008), Chief Judge Stephen Rhodes granted summary judgment in favor of Plaintiff Micco Construction in an adversary bankruptcy proceeding to preclude the discharge of a state court default judgment entered against the debtor, the principal of one of Micco's subcontractors.

In the underlying case, the debtor allegedly had diverted funds that he had received from Micco before paying the company's sub-subcontractors, laborers and material suppliers, thus violating the Michigan Builder's Trust Fund Act ("MBTFA"). In the subsequent bankruptcy proceedings, Micco argued that res judicata and collateral estoppel principles should preclude the debtor from challenging that the MBTFA had been violated as well as the amount of the debt represented by the default judgment.

Under well-established federal and Michigan law, the courts have held that the MBTFA imposes a trust on funds paid to contractors and subcontractors for products and services provided under construction contracts. Moreover, officers of a company may be held individually liable when they personally cause their company to violate the MBTFA. That violation, in turn, results in a nondischargeable debt under Section 523(a)(4) of the Bankruptcy Code, whether the debtor misappropriates funds or fails to properly account for them. None of these general principles were in dispute in the case. As issue in *Brunett* was whether Micco could rely upon the default judgment entered against the debtor in the state court action under the MBTFA when the debtor did not file an answer or otherwise participate in the proceeding, i.e., a "true default" situation.

Michigan courts have always accepted the proposition that when the defendant in the state court defends the suit, at least in part, collateral estoppel applies. In that case, the claim is recognized as having been "actually litigated". The bankruptcy courts in both the Eastern and Western Districts, however, were split as to whether Michigan courts would recognize collateral estoppel as applying in a true default situation. In *Brunett*, Micco argued that unless collateral estoppel is applied in both default scenarios, an unacceptable incentive to the defendant results.

For instance, a defendant contemplating bankruptcy could permit a default judgment to be entered in the state court proceedings to avoid a jury determination of fraud damages, thereby reserving the defense for a later day in the bankruptcy court when memories may have faded or evidence misplaced or destroyed. Likewise, a defendant with limited financial resources could decide not to defend the state court action because he was judgment proof. The absence of the threat of collateral estoppel permits the defendant to play a "wait and see" game. Only if faced with an aggressive judgment creditor would the defendant need to file for bankruptcy to avoid payment. If the creditor filed an adversary proceeding, the debtor could still defend the MBTFA claim and potentially obtain a discharge of the claim.



Bankruptcy Court Recognizes Preclusive Effect (Continued)

The *Brunett* decision takes away a defendant's incentive to do nothing in the state court proceedings by recognizing the preclusive effect of a default judgment in a subsequent bankruptcy proceeding, even in a true default situation. In its decision, the court determined that under Michigan law, (a) an issue is "actually litigated" in the prior proceeding if it is put into issue in the pleadings, and (b) the entry of a default judgment is equivalent to an admission by the defaulting party as to all of the matters well pled.

Unfortunately, if a subcontractor has absconded with trust funds and truly is judgment proof, the *Brunett* decision will not help contractors to recover those funds today. However, the decision is beneficial to those contractors who obtain a default judgment against the offending party and later are forced to preserve the judgment from discharge in a bankruptcy proceeding. Using *Brunett*, contractors can now protect their default judgment in the bankruptcy court without incurring substantial additional expense litigating the merits of the claim. Because a judgment is valid for ten years under Michigan law, that seemingly worthless piece of paper may someday bear some fruit when economic times turn around, particularly if the contractor has obtained a judgment against both the company and its principal.

Contractor Claims Against the Project Engineer Hang in the Balance after the Michigan Court of Appeals' Recent Decision in *Keller Construction, Inc. v. U.P. Engineers & Architects, Inc.* by Michelle L. Alamo malamo@dickinsonwright.com

Can a contractor sue the project engineer for damages when things go awry on the project due to the engineer's fault? Up until recently, the answer to that question was "yes." Under Michigan law, a contractor could file a suit against the project engineer to recover damages caused by the engineer's negligence despite the absence of a direct contractual relationship between the contractor and the engineer. In its recent decision in *Keller Construction, Inc. v. U. P. Engineers & Architects, Inc., et al.*, Case No. 275379, however, the Michigan Court of Appeals reversed existing precedent and held that, as a matter of law, a contractor cannot maintain a claim for damages stemming from the project engineer's negligence in performing its contractual duties on a project where such duties stem from either the engineer's contract with the owner or the contractor's contract with the owner. Only where the contractor can point to a breach of a duty separate and distinct from the engineer's responsibilities set forth in the project documents can a contractor maintain a claim against the engineer.

Keller Construction arose from the construction of a water treatment and distribution plant for the Village of Ontonagon in the Upper Peninsula. The Village entered into a contract with U.P. Engineers & Architects, Inc. ("UPEA"), to provide engineering and administration services for the project. Two years into the project, Keller Construction replaced the original contractor under its surety obligations. Keller subsequently experienced significant difficulties on the project allegedly due to UPEA's conduct causing it to incur substantial expenses, including an inability to hire local contractors. Keller settled its claims against the Village and then sued UPEA directly under several tort theories, including engineering malpractice and negligence. UPEA moved for summary disposition. In support of its motion, UPEA argued that Keller's malpractice and negligence claims failed because Keller had not identified a breach of a professional duty related to the design, specifications, or professional calculations for the project. The trial court agreed and dismissed Keller's claims.

The Michigan Court of Appeals affirmed the trial court, but on different grounds, holding that to maintain a cause of action for negligence, a contractor must allege the breach of a duty "separate and distinct" from the engineer's contractual and related duties under its agreement with the owner. In so doing, the Court of Appeals reversed Michigan's long-standing precedent permitting a contractor to bring a negligence claim against an engineer or architect for negligent performance of its contract with the owner. Under the new analysis announced by the Court of Appeals, "the threshold question is whether the defendant owed a duty to the plaintiff that is separate and distinct from the defendant's contractual duties. *If no independent duty exists, no tort action based on a contract will lie.*" Because Keller's negligence claims against UPEA ultimately arose from UPEA's contractual and related duties to the Village, not an independent duty owed to Keller, Keller's negligence and malpractice claims failed as a matter of law.

What does this mean in the contractor-engineer context? No longer can a contractor sue an engineer (or architect) for negligent performance of its contractual duties on a project. Instead, to maintain a negligence or malpractice claim against a project engineer or architect, a contractor must establish that the engineer or architect breached a duty separate and distinct from the duties owed by the engineer or architect to the owner. Given the breadth of most project contract documents, it is hard to imagine a scenario where an engineer will not be able to tie its responsibilities back to a contract document and only time will tell with respect to how Michigan courts will apply this new precedent, or whether this issue will ultimately be heard by the Michigan Supreme Court.

ADDENDUM — Keller Construction, Inc. v. U.P. Engineers & Architects, Inc.

Following the submission of Michelle Alamo's article on the Keller decision, the Michigan Supreme Court *denied* Keller Construction's application for leave to appeal the Court of Appeals' adverse decision on November 25. Without further explanation, the Michigan Supreme Court simply said that "we are not persuaded that the questions presented should be reviewed by this Court." Thus, current Michigan law no longer permits a contractor to sue an architect or engineer for negligence or malpractice on a project because the designer, as a matter of law, owes no legal duty to the contractor.

Licensed Builders Shed Consumer Protection Claims by Jeffrey M. Wesselhoff jwesselhoff@dickinsonwright.com

In a decision handed down in June, 2007, *Liss v Lewiston-Richards*, Michigan's high court clarified the application of the Michigan Consumer Protection Act ("MCPA") to licensed residential builders, finding that licensed residential home builders are exempt from the MCPA. The MCPA provides broad protections for consumers from unfair, unconscionable, and deceptive practices in trade or commerce, including misrepresentation and false promises. Significantly, MCPA claims raise the stakes in litigation, due to the MCPA's provision for, among other remedies, awards of treble damages and payment of the successful plaintiff's attorney fees by the defendant. As a result, plaintiffs regularly add claims under the MCPA to their complaints. However, the MCPA also provides an exemption for any "transaction or conduct specifically authorized under laws administered" by state or federal agencies, for example, the licensing regulations under the Michigan Occupational Code ("MOC"). In Michigan, residential home building requires a license under the MOC, and licensees are subject to regulation by the Residential Builders' and Maintenance and Alteration Contractor's Board. The Court found that the scope of the exemption encompassed licensed residential builders "who engage in the type of activities that define a residential home builder," and overruled prior decisions that found differently.

The specifics at issue. Liss entered into a contract with Lewiston-Richards, Inc. to complete construction on a residential home. After a dispute arose, Liss made allegations under the MCPA involving failure to complete the project, breach of warranty, and poor workmanship. The builder moved to dispose of the MCPA claims on the basis of the exemption for licensed activities. The motion was denied, and that denial of the exemption formed the basis of the subsequent appeals. On appeal, Liss argued that the builder's alleged misconduct (misrepresentations, poor workmanship, and unconscionable behavior) was not conduct specifically authorized under the MOC. In other words, because the MOC does not expressly authorize poor workmanship and unconscionable conduct in residential home building, that specific conduct is *not* exempt from MCPA claims, even if residential home building is generally an exempt activity. The Supreme Court was not persuaded, and reversed the lower courts and any contradictory precedent.

The Court's decision. The Court concluded that the relevant test is "whether the general transaction is specifically authorized by law, regardless of whether the specific misconduct alleged is prohibited." Here, the transaction at issue was the construction of a residential home. In parsing what "specifically authorized" means, the majority focused on the MOC's authorization of the action (i.e. contracting to build a home) as opposed to the authorization of the actor (i.e. the builder). The Court found that a licensed residential home builder is specifically authorized to contract to build home. Therefore, the exemption from claims under the MCPA for licensed activities applies to home building transactions as a whole.

What this case means for you. Licensed residential home builders are now clearly exempt from claims under the MCPA. Plaintiffs no longer have a basis to add the threat of treble damages and attorney fees to claims against such builders. The case may also have wider ramification, lending additional weight to those arguing for the exemption of other licensed and regulated industries from MCPA claims. It should also be noted the decision leaves open the question of whether the MCPA may be applied to unlicensed residential home builders.

Those damaged by licensed builders are not without recourse. Complaints may still be filed with Michigan's Bureau of Commercial Services Enforcement Division and new legislation adds more punch to that remedy. Of course, parties may still pursue all their remedies available under contract. This decision reinforces the importance of a well-drafted construction contract, which clearly defines in writing the scope and cost of the project, construction deadlines, how and when payment occurs, and how delays and disputes are handled.

Michigan Bolsters Residential Builder Licensing Laws including Licensing Requirements and Consumer Remedies By Leslee M. Lewis llewis@dickinsonwright.com

Recent Michigan legislation significantly changes residential builder licensing laws. Whether you are a residential builder, a maintenance and alteration contractor, a qualifying officer, a title company, a homeowner, an insurer, or a mortgage company, 2007 Public Acts 155-158 may affect you.



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**Michigan Bolsters Residential Builder Licensing Laws
including Licensing Requirements and Consumer Remedies (Cont.)**

Effective December 21, 2007, the new acts:

- **Require** restitution by a residential builder for licensing law violations. This significantly strengthens the effectiveness and threat of a builder licensing claim as a consumer protection remedy, since licensing violations include acts such as diversion of funds, failure to account for money, insolvency, abandonment of the project without legal excuse, workmanship not meeting the Michigan Residential Code, and willful and prejudicial disregard of plans and specifications.
- **Set** the time frame for residential builder licensing claims at 18 months from the latest of completion, occupancy, or purchase for alterations, or the later of closing or issuance of a certificate of occupancy for projects requiring one.
- **Beginning with the next license renewal cycle, require** a 60 hour pre-licensure course of study for new license applicants, and mandatory continuing education for currently licensed builders. (Among other more technical changes to licensing, the license term will be changed to 3 years, the applicant must state that it has a copy of the Michigan Residential Code and provide copies of the applicant's and qualifying officer's photo i.d., and a Builder Enforcement Fund fee will be collected.)
- **Require** a licensed residential builder, as part of a contract, to provide information on his or her individual license and any qualifying officer license.
- **Beginning** with the next license renewal cycle, require a qualifying officer to maintain an individual license.
- **Prohibit** lien filings by unlicensed residential builders.
- **Increase** criminal penalties for unlicensed residential builders (ranging from \$5,000- \$25,000 and 1-4 years in prison per violation, including a felony provision if the violation caused death or serious injury), and add aiding and abetting another in the unlicensed practice of the occupation as a violation of the licensing law.
- **Require** courts to notify the licensing body (Department of Labor and Economic Growth Bureau of Commercial Services, Licensing Division) of a conviction for unlicensed activity.
- **Allow** the Attorney General and county prosecutors to bring civil actions against unlicensed residential builders and require the court to order the builder to pay a fine to the Attorney General or prosecutor.

Effective June 1, 2008, the new acts:

- **Create** a Builder Enforcement Fund to prosecute unlicensed residential builders.
- **Require** courts to notify the licensing body of civil judgments against builders involving violation of the licensing act.
- **Authorize** forfeiture of a residential builder's assets by the Department of Labor and Economic Growth, county prosecutor or Attorney General for violation of the licensing act.

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