New Jersey Law Journal

VOL. CXCI– NO.12 – INDEX 1007 MARCH 24, 2008 ESTABLISHED 1878

Real Estate
Title Insurance &
Construction Law

The Absence of Privity On Construction Projects Poses Difficulties

Courts likely to continue to refrain from permitting recovery without privity

By Robert S. Dowd and Edward S. Kiel

With the downturn in the economy and the probability of more bankruptcies and insolvencies for contracting parties on construction projects in New Jersey, creative lawyers and their clients will seek opportunities to assert claims against entities up and down the contracting chain with whom they are not in privity. This article addresses the viability of such claims: (i) by subcontractors, sub-subcontractors and suppliers against, respectively, general contractors and owners on payment claims; and (ii) by owners against subcontractors, sub-subcontractors or suppliers on negligence claims for defective construction or materials.

The sequential chain of contracting on New Jersey construction projects, and the corresponding payment obligations among the parties, were acknowledged almost forty-five years ago by Justice Hall in *Hiller & Skoglund, Inc. v. Atlantic Creosoting Company*, 40 N.J. 6 (1963): Accordingly, the prime contractor expects to pay his subcontractor from installment payments received from the owner and the materialman depends on the subcontractor to make payment out of the money the latter has received. Each party in the chain fully realizes what business practice requires of him and business stability depends on conformity even when the going becomes rough. The law should be framed accordingly.

Since that time, appellate courts in New Jersey have consistently held that an owner or general contractor is not liable to either subcontractors or sub-subcontractor's material suppliers based on third-party beneficiary or quasi-contract causes of action. I*nsulation Contracting & Supply v. Kravco, Inc*., 209 N.J. Super. 367 (1986); *F. Bender, Inc. v. Jos. L. Muscarelle, Inc*., 304 N.J. Super. 282 (1997).

In *Insulation Contracting*, the general contractor, Kravco, retained a subcontractor, Peyton, to do the framing, wallboards and painting. Peyton, in turn, retained a sub-subcontractor, Insulation Contracting, to supply and install the insulation on the project. At the time Kravco terminated Peyton for nonperformance; Insulation Contract-ing had substantially completed its work but had received only 14 percent of the payment due. The court examined third-party beneficiary principles under *Broadway Maintenance Corp. v. Rutgers*, 90 N.J. 257 (1982) and concluded there was nothing in the contract documents to indicate that Insulation Contracting was a third-party beneficiary.

Conferring such beneficiary status on sub-subcontractors was inconsistent with the pattern or custom and usage within the construction industry. The Appellate Division rejected the remaining claims, holding that a sub-subcontractor cannot recover against a general contractor or an owner on theories of unjust enrichment, restitution, or quasi-contract. This holding rests on the absence of any reasonable expectation by the sub-subcontractor of payment from the general contractor or owner and the recognition that the sub-subcontractor's predicament fundamentally arose from the failure of the subcontractor to pay the sub-subcontractor as agreed.

The court in *F. Bender* expanded this holding. The court cited *Insulation Contracting* with approval, declaring that to permit a sub-subcontractor to recover against a general contractor or owner on

Dowd and Kiel are attorneys specializing in commercial litigation with Cole, Schotz, Meisel, Forman & Leonard in Hackensack.

a common-law quantum meruit claim "would create havoc in the construction industry." Id. at 284-285. Permitting such a claim would in effect create a common-law mechanic's lien. The court emphasized that the sub-subcontractor already possessed a statutory lien right against the owner's property.

The court affirmed the privity requirement for payment claims on New Jersey construction projects, stating:

If plaintiff has a dispute with the party with whom it contracted, it must resolve this problem without looking to those parties further up the chain, unless plaintiff has protected its rights by filing a mechanics lien. There might be some rare causes to justify equitable exceptions, but this is not the case here.
Id. at 287.

There may be exceptions to this general rule where an owner or general contractor has dealt directly with, respectively, a subcontractor or sub-subcontractor/material supplier in a way that created a direct contractual relationship between the parties. *Onorato Construction, Inc. v. Eastman Construction Company*, 312 N.J. Super. 565 (App. Div. 1998).

Another exception may be where the contract between the owner and a general contractor expressly grants rights and remedies to subcontractors. *Wasserstein v. Kovatch*, 261 N.J. Super. 277 certif. den. 133 N.J. 440 (1993). Additional exceptions may be found where the facts demonstrate that an owner has misled a subcontractor, induced a subcontractor to change its position, or engaged in fraud to a subcontractor's detriment. See, generally, 66 Am. Jur. 2d Restitution and Implied Contract §33.

Finally, there may be egregious circumstances where the owner has actively and unjustifiably interjected itself in the contractual dealings between a general contractor and a subcontractor that may permit a subcontractor's claim against an owner for tortious interference with a subcontract. Such claims, however, will not be sustained merely because the owner's actions pursuant to its contract with the general contractor had a detrimental impact on the subcontractor. *Avon Brothers, Inc. v. Tom Martin Construction Company, Inc.*, 2000 WL 34241102 (App. Div. 2000) (unpublished); See also, *First Mortgage Corporation of Virginia v. Felker*, 279 S.E. 2d 451 (Ga. App. 1981) and *J.C. Penny Company, Inc. v. Davis & Davis, Inc.*, et als., 279 S.E. 2d 461 (Ga. App. 1981).

Privity between the parties continues to play a critical role in determining the viability of an owner's claim for repair, replacement, or other purely economic losses. An owner may recover in negligence against a party with whom it does not have a contract for personal injury or consequential property damages arising from an accident. It is doubtful, however, that an owner can maintain a negligence action to recover economic loss from defective construction or materials, particularly on a commercial project.

In *Juliano v. Caston*, 187 N.J. Super. 491 (1982) certif. den. 93 N.J. 318 (1983), Judge Pressler held that the doctrine of privity did not bar the homeowners' negligence action against a subcontractor for defective construction. The Juliano court ruled that the homeowners could recover for the purely economic loss of the cost of replacement or repair, stating:

"It appears that the nature of the damages here may be limited to replacement and repair of defective workmanship, a category of damages customarily referred to as "economic loss" and that category of damages which, under the Weedo principle, is ordinarily designated by the insurance scheme as the builder's rather than his carrier's risk. We see, however, no impediment, conceptual or practical, to recovery of this category of damages in a negligence action by the purchaser against a subcontractor."

Since the *Juliano* decision, New Jersey courts have been reluctant to expand or follow its holding. Indeed, subsequent cases have been careful to limit the reach of the decision to the specific facts of the case. For example, in *New Mea Construction Corp. v. Harper*, 203 N.J. Super. 486 (App. Div. 1985), the court addressed homeowners' claims against the builder for breach of contract and negligent workmanship, including a claim against the builder's principal for negligent supervision. The court held that the loss alleged was of a nature more normally associated with a contract action, rather than personal injury or consequential property damage arising from an accident.

The court distinguished *Juliano* in that the homeowners in *New Mea* could sue the builder for breach of contract and the court did not need to "invent" an independent tort cause of action against the builder's principal.

Similarly, in *Kornblith v. Rothe*, 1991 WL 7674 (D.N.J. 1991) (unpublished), the court found that the owner's claims for failure to construct its commercial project according to the contract specifications were essentially breach of contract claims and therefore could not serve as a basis for a negligence cause of action against the developer's general contractor. Once again, the court declared that it would leave the creation of such a new negligence cause of action to the New Jersey Supreme Court.

In *Saltiel v. GSI Consultants, Inc.*, 170 N.J. 297 (2002), the New Jersey Supreme Court chose not to create such a cause of action in a case involving a general contractor's suit for negligence and breach of contract in connection with defendant's failure to properly design the specification for artificial turf for athletic fields. The curt held that the cost of reconstructing these athletic fields was not the type of damages ordinarily alleged in a tort case, such as personal injury or consequential property damage arising from a traumatic event.

Based on the cases decided since *Juliano*, it is likely that New Jersey courts will continue to refrain from permitting an owner on New Jersey construction projects to recover economic loss damages from subcontractors and others with whom it does not have privity of contract, especially on commercial projects. ■