

## **WHEN A DISGRUNTLED OWNER'S CLAIM FAILS, LEGAL FEES OF \$84,000 INCURRED BY A SERVICE PROVIDER BECOME THE PROBLEM OF AN ASSOCIATION THAT DID NOTHING WRONG**

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Dealing with disgruntled homeowners is a part of doing business for community associations, managers, vendors and service providers. There is an ever present risk that some irrational owner will initiate a vendetta that pulls the Association and others into litigation. Even when there is no merit to the accusations and claims, many thousands of dollars may be spent defending before settlement or trial ends the dispute. This may be common knowledge. What is not often known, however, is how those costs may be reallocated after the fact among the defendants depending on their relationships and the contracts they have with each other. In a case that involves these high stakes issues the Ridgeway East Homeowner Association learned first hand that ignorance is not bliss.

The Ridgeway East Homeowner Association (Association) was like many other condominium associations. It was professionally managed (Manager) and when an owner became delinquent in the payment of assessments it turned to non-judicial foreclosure as a tool to cause payment. The

Association directed the Manager to hire a professional foreclosure trustee (Service Provider) to process the paperwork and, if necessary, conduct the sale. In 1987, a lien was recorded against Ms. Vrba's property for delinquent homeowners' fees owed to the Association. When the delinquency was not paid, the lien was foreclosed on and sold at a trustee sale.

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Following the non-judicial foreclosure conducted by the Service Provider, Ms. Vrba sued the Association, the Manager and the Service Provider. The Manager was able to extricate itself from the lawsuit by summary judgment. Ms. Vrba's remaining claims included that the Service Provider had been negligent and had

misrepresented to her the foreclosure proceedings would be delayed. The case against the Association and Service Provider was tried by a jury on the questions of whether the Service Provider had been negligent, and had misrepresented to Ms. Vrba the foreclosure sale would be postponed. The jury found in favor of the Association and Service Provider.

The Service Provider then sued the Association and Manager seeking reimbursement of \$84,000 in attorney fees and costs expended by it to successfully defend against Ms. Vrba's lawsuit. The Service Provider did not claim that the Association or Manager had done anything wrong to Ms. Vrba. It simply claimed that the Association and Manager had acted as the agents of each other and that they "requested" the Service Provider to act on their behalfs as a non-judicial foreclosure trustee. The Service Provider claimed it was entitled to indemnification as the agent of the Association and Manager.

Should the Association and Manager be held liable to the trustee service for legal fees incurred in successfully defending the lawsuit of a disgruntled former owner? The general rule of law in litigation is that each party bears its own legal fees. There are, however, significant exceptions.

None of the parties to this litigation did anything wrong. They were vindicated with respect to the hostile former owner's claims. Yet the stakes were higher than ever when liability for legal fees became an issue among those who had done nothing wrong. Had there been a contract between the Service Provider and the Association addressing recovery of attorneys fees, the Association would have had the opportunity to protect itself. Conversely, an unwary association might have voluntarily assumed liability for such fees. In the Ridgeway case because there was no contract, seven years after the original lien was filed the appellate court sent the case back down the trial court

level to determine what the relationship was between the Service Provider and the Association. Association liability for the Service Provider's fees would ultimately turn on whether the Service provider was an agent of the Association or independent contractor.

Why is this case significant? It illustrates how vulnerable associations can be when disgruntled owners sue the Association, the Manager and Service Providers. A jury determined that the former owner's claim had no merit. No one did anything wrong, yet more than \$80,000 became an issue to be sorted out using the law of agency and indemnification. These are two areas of the law where directors are generally ill prepared to protect themselves and their Associations. Nevertheless, Boards often sign contracts allocating liabilities they don't understand.



When a contract contains a section with terms such as indemnification, hold harmless, duty to defend, agent or independent contractor, that is a red flag to alert directors that they should have counsel review the contract suitability to the circumstances and appropriate balancing of the risks involved.

*Fidelity Mortgage Trustee Service, Inc. v. Ridgeway East HOA* (1994) 27 Cal.App.4th 503.

## Contract Concepts: The Basics

On a regular basis, associations, managers, vendors, contractors and others enter into contracts which they only partially understand. An agreement reduced to writing creates a document which helps the parties understand their mutual expectations. Particularly where there is an ongoing relationship, if all goes as expected, there is little or no need to look back at the written documents. If all does not go as expected, the parties may be surprised to find that the contract contains provisions agreed to which one, the other or both did not understand. There may be serious consequences.

This article addresses common vendor and service provider contracts. (Major repair contracts should be addressed with the assistance of counsel and an architect or engineer.) Directors of associations addressing maintenance and vendor contracts should scrutinize the basic provisions.

At the outset, understand that in this day of computerized agreements, there is no such thing as “The Standard Contract”. Frankly, parties routinely proffer proposals and agreements all of which may be described as “standard” but any of which should be changeable to be sure the contract “tells it like it is” and balances the rights and obligations of the parties. What follows are categories of information which, at a minimum, should be addressed in every contract.

**✓ Recitals.** At the beginning of many contracts there is a section which permits the parties to include a preamble of agreed facts, circumstances and/or goals that set the stage for the agreement that follows. This is perhaps the most often overlooked opportunity for anyone entering into a contract. By reciting the basic circumstances and most pertinent facts, this section tells an abbreviated story. The recitals not only help a reader to understand the contract itself, but the facts may become admissions in any later dispute.

**✓ Parties.** The identity and legal status of all parties to the agreement must be clearly set forth. This should not only include names but also full contact information. The liaisons or other persons key to the performance should be identified. Don’t overlook the significance of stating the legal status of the parties. Are the parties corporations? Have you checked to be sure all corporations are in good standing with the State? Is one of the parties a contractor who is required to be licensed? If so, the license number should be checked with the Contractor’s State License Board and the number should be stated on the contract. Be sure the name on the license is identical to the contractor’s name on the contract.

**✓ Specifications and Scope of Services.** This is the part of the contract that should be most important to you. It is what you get in return for the association's money. Sales pitches, advertisements and discussions do not equate to an enforceable scope of work or service. You should always be specific, but the more complicated the job, the more expensive, the longer the time frame and/or the more intrusive it is - the more important it is to be *very* specific. If you want to avoid proposals or bids that leave you comparing "apples to oranges," draft your scope of work before you solicit vendor proposals or bids. Do your homework. And listen if your manager recommends a consultant or someone else to assist in defining the scope of work.

**✓ Payment.** Directors tend to focus on the bottom line cost and not pay enough attention to the logistics of payment. How much will be paid and when? Is the amount fixed? Is it proportionate to the value delivered? How will extra charges be handled? Is there an up front charge and if so how much is too much? Will a portion of payments be retained pending completion of the job? Watch carefully for payment cycles and revise them to fit your pattern of decision-making. Boards typically meet monthly. Payment cycles shorter than thirty days may trigger late charges or interest. Be sure the timing works for you.

With the exception of banks, the companies an association contracts with should not be in the business of lending money. It's rare that they will extend credit willingly, but if they are put into the position of not receiving timely payment, most parties ask for late charges and/or interest at a high rate. Typically these can easily be revised to be sure you have the economic incentive to make payment but not end up facing exorbitant late charges or high (possibly usurious) interest rates.

**✓ Liens.** The general rule is that those who contribute labor or materials to the improvement of property have the right to assert a lien against that property. Contractors, subcontractors, material providers and even architects and engineers are among those who can use their lien powers "to sue your property" if they are not paid. Statutes in this area of the law are intended to protect those with lien rights and can have harsh consequences to the property owner who does not competently manage risks associated with construction. If an association pays a general contractor in full but the general does not pay a subcontractor, that subcontractor can file a lien for which the association will be responsible - even though it would be a double payment by the association! What are the contractor's obligations to keep the property free of liens by others? Does the association have the right to issue checks jointly to the general and a subcontractor or material supplier? Must the contractor provide partial lien releases from all involved as incremental payments are made? Safeguards should be built into any contract where lien rights exist. (The Contractor's State License Board has an excellent website that includes information about liens and how to protect the property owner.)

**☑ Delay.** What is the consequence of delays? In some instances a brief delay will make no difference, but in others the financial impact could be great. Who bears what risk and for which types of delay?

**☑ Insurance.** Initially parties will try to avoid a problem before it occurs. However once a problem occurs, insurance is the first line of defense. Has the association confirmed the contractor, vendor or service provider has liability insurance and worker's compensation insurance? Is there insurance to cover other risks inherent in the particular relationship (such as errors and omissions insurance and professional malpractice insurance)? Can the association be added as an additional insured on a contractor's policy? Does the manager fit within the definition of insured on the association's policy? If something goes wrong, whose insurance will be primary? Directors should feel comfortable consulting with the association's insurance agent on these subjects.

**☑ Indemnification.** Frequently "standard" contracts have provisions for the association to "indemnify, defend and hold harmless" the other party to the contract in a variety of broad circumstances. These words are, perhaps more than any others in the agreement, packed with potential risk. Sections related to indemnification and related concepts are often identified by a variety of labels, some of which may appear benign. Make no mistake about it, however, these types of provisions may put the association into the role of insurer to the other party - complete with duty to pay the other party's legal fees and to pay out damages on behalf of the other party even if the association did nothing wrong! It may be that you can transfer such risks to an insurer but you have to be alert to them first. If a contract includes any combination of the concepts of indemnification, holding harmless and defense, you need to consult with counsel and perhaps your insurance agent.

**☑ Disputes.** State whether legal fees and costs will be recoverable and under what circumstances. Remember, this can be a "double-edged sword." With every contract a Board signs, thought should be given to the forum and method by which disputes will be resolved if they arise. By default, silence on the subject means that if the parties cannot resolve their differences directly, they will likely turn to the legal system and inevitably the courts for resolution. In most instances, however, mediation or arbitration will provide a more efficient and cost effective method to resolve differences. Do not wait until a problem arises to attempt to mutually decide who will provide alternative dispute resolution ("ADR") services. You should have a comfort level with the provider and process you specify. Don't assume that the well known American Arbitration Association is right for you in any particular circumstance. You may want to specify JAMS, Resolution Remedies or some other provider of ADR services. Most have web

sites but there is no substitute for asking people around you if they have had a positive experience and will make a recommendation.

**☑ Default/Termination.** Sooner or later all business relationships come to an end. The beginning of the relationship is the best time to describe the procedures to be used to wrap up the “loose ends” at the end. These provisions will vary greatly depending on the nature of the relationship and its duration. What notices are to be given to whom? How will final payments be made? Will records be transferred? Will the association be responsible to pay for the costs associated with closing services? Are there differences between termination “for cause” and “without cause?” What constitutes a default? Will “lost profits” become an issue? Think through these concepts at the same time as you consider Alternative Dispute Resolution.

**☑ Miscellaneous.** Most contracts end up with a number of provisions that are important enough to include but do not get much attention. For example, clarification of the other party as an independent contractor or the agent of the association may be a simple sentence but can have significant consequences if there are third party liability claims. Will the term of a contract automatically renew? Is the entire agreement contained within the four corners of the written agreement? If a lawsuit is filed, which county will it be filed in? Can the contract be assigned? If one section of the contract is found to be unenforceable, is the balance of the contract still in effect? These types of provisions are often characterized as “boilerplate,” but depending on the type of problem that may arise, can become very significant.

**☑ Signature and Date.** Be sure the signature block identifies the capacity in which the individual is signing. It is wise to be sure related Board minutes clearly confirm that it is the Board that has authorized entering into the contract. Individuals signing on behalf of the Association should specify their capacity. President? Secretary? Managing Agent? Two signatures on behalf of a corporation provide the presumption that it is a valid corporate act and are preferable to one.

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There is no substitute for planning ahead and using counsel to assist with contracts. The concepts listed above are but a few of the considerations that should go into even the most basic contracts. Ideally every association has a relationship with an attorney who can efficiently review proposed contracts and make recommendations. Legal counsel alone, however, is not substitute for a well informed Board that actively participates in the formation of contracts.



## INDEMNIFICATION / HOLD HARMLESS / DEFENSE

### Red Flag Words You Cannot Ignore

If you sign a contract containing a provision such as this, you may be putting your Association into the role of insurance company to the vendor or service provider. You may be opening yourself up to liability you never dreamed of, even if you or the Association does nothing wrong.

**Indemnification:** The Client agrees to the fullest extent permitted by law to **hold harmless** and to **indemnify** Provider, Provider's partners, servants, agents, and employees (collectively the "indemnitees"), and to **defend** the indemnitees using the counsel satisfactory to the Provider, from and against all claims, liabilities, losses, damages, judgments, awards, and costs arising from or connected with the Work and/or the performance of the Work described herein, but only if such claim, damage, loss, or expense is caused in whole or in part by passive or active negligence, by Client, or Client's employees, agents, contractors, subcontractors, disgruntled homeowners, aunts, uncles, or any party directly or indirectly employed or retained by them, regardless of whether or not it is caused in part by the passive or active negligence of a party indemnified hereunder. However, this provision shall not apply to the liability of any indemnitee arising out of said indemnitee's sole negligence or willful misconduct.

Often provisions similar to this are included in the standard contracts of reputable vendors and service providers. The sections are often put there by the other party's attorney. It may well be that the party whose contract includes the provision does not know what this section means. It is possible to balance some of these concepts with appropriate companion provisions such as insurance, limitations of liability and alternative dispute resolution. Legal counsel should be consulted about such sections so that risk management can be appropriately addressed.

**GOTCHA!** In each of the following examples the association could have averted a significant problem by addressing simple contract basics before it signed on the line. Do you know what the association should have done as part of the contacting process? Will you check next time before you sign on the line?

**The Suspended Corporation.** When the State forms are sent to the former manager or the invalid address of a former director who has moved, they go unresponded to. The State then suspends the corporation. The association has just contracted to perform expensive deck repairs and an irate owner learns the corporation has been suspended. The owner threatens to litigate. A suspended corporation lacks the legal capacity to enter into contracts and has no standing to appear in court as a plaintiff or defendant!

**Worker's Comp Surprise.** The Association enters into an agreement with a contractor without confirming the validity of the contractor's license. Months after the job is complete, the Association's insurer performs an audit of contractors hired by the association and discovers the discrepancy. The insurer retroactively levies an expensive workers compensation premium against the Association.

**Unlicensed Contractor Equals Uninsured Liability Claim.** A landscaper who is not licensed to work on tall trees nevertheless has an employee climb to the top of a tree to perform pruning. The employee falls and is seriously hurt. The worker (employed by an unlicensed contractor) is deemed an employee of the owner of the property. The worker sues the association. The association's liability insurer refuses to defend saying it is a workers compensation claim. The association has no workers compensation on the landscaper's employees.

**No Scope of Work Means Claim Debatable.** The Association procures bids to "paint" the buildings. The low bidder proposal (which, when signed, became the contract) describes the work as a complete two coat paint job. The low bidder's proposal is signed but two years later the paint job is failing. The painter says the association got the two coat job it paid for with one coat being a sweep of the spray gun one direction and the second coat being a sweep back. In looking back at one of the higher bids it is noted that the scope of work includes a description of the preparation, the brand and type of paint to be used and a minimum thickness of the paint coating that would end up on the building. Does the association have a breach of contract claim against the first painter?

**No Additional Insured Status Means No Insurance Coverage At All.** A pest control company performs routine chemical treatment around several units. There is no request that the contractor add the association as an additional insured on its policy, although this could be done at no additional cost. The contract with the association is simply the signed proposal. A resident dies unexpectedly and the family sues the association with a claim that is somewhat unclear but based on the use of the chemical. The Association's insurer refuses to defend pointing out the exclusion for claims arising out of exposure to toxic chemicals. The pest control company's insurer refuses to defend the association as well because it is not an insured.

## Resources To Verify With Whom You are Contracting

**CALIFORNIA CONTRACTORS STATE LICENSE BOARD:** <http://www.cslb.ca.gov/consumers/>

- At that site you can
- (1) confirm a contractor is properly licensed
  - (2) review the basics of what must be in a construction contract
  - (3) review dispute resolution options offered by the Board

**CALIFORNIA SECRETARY OF STATE:**

At this site you can confirm that corporations (the other party and your Association) are in good standing and able to enter into contracts: <http://kepler.ss.ca.gov/list.html>

If you are dealing with a partnership you may also find them registered at the same website: <http://kepler.ss.ca.gov/list.html>

**COUNTY FICTITIOUS NAME FILINGS.**

You may find that the entity you are dealing with uses a name different from its legal name or the individual who is conducting the business. This is called a fictitious name. Businesses using fictitious names are required to register at the county level. Many counties have interactive web sites where information is available to verify who is the responsible party behind a fictitious name. Generally you can write to the county and for a small fee the clerk will send you a copy of the fictitious name statement that identifies the business and the individual who is using the fictitious name.

A few web sites, such as San Francisco, permit you to check the name on its interactive web site: <http://services.sfgov.org/bns/start.asp>

**CALIFORNIA DEPARTMENT OF CONSUMER AFFAIRS**

This umbrella organization maintains a web site where a you can verify a wide range of licenses including architects, engineers, pest control operators, alarm companies, locksmiths and security companies. [http://www.dca.ca.gov/r\\_r/r\\_rdca.htm](http://www.dca.ca.gov/r_r/r_rdca.htm)