COLORADO CONSTRUCTION MONITOR

An Update from Sherman & Howard's Construction Industry Practice Group

SHERMAN & HOWARD L.L.C.

ESTABLISHED EXCELLENCE

SUMMER 2014

SHERMAN & HOWARD CONSTRUCTION INDEX SUMMER 2014

110.2

decrease  increase

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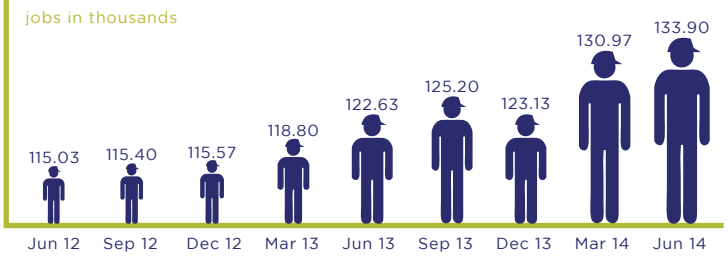
Denver's construction activity approaching historic peak of 2007

Construction activity in the greater Denver area has been steadily increasing over the past 17 quarters and we don't anticipate much slowing down for the remainder of 2014 and into 2015. Construction employment in Colorado has grown by a robust 9% since this same period last year and totals 135,600 jobs, but still remains over 20% below the peak levels of 2007. Colorado's job growth is roughly twice the pace of the national economy, but availability and shortages of craft labor present a significant hurdle to meeting real demand.

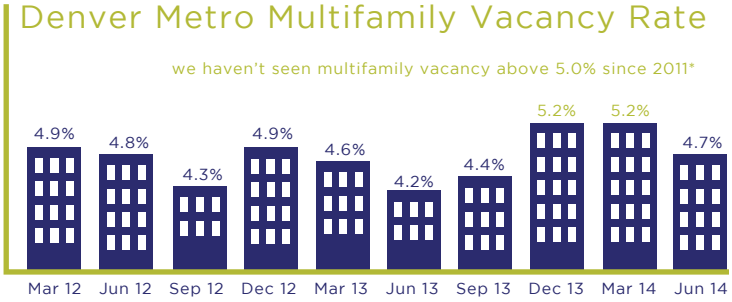
Company expansions within and into the Denver metro region continue to drive growth and push vacancy rates to some of the lowest levels the region has ever seen. Additionally, Denver is attracting investment in large-scale projects, which should accelerate property sales in key employment hubs and generate further demand for construction. We expect these factors will continue to keep construction activity elevated above normal levels.

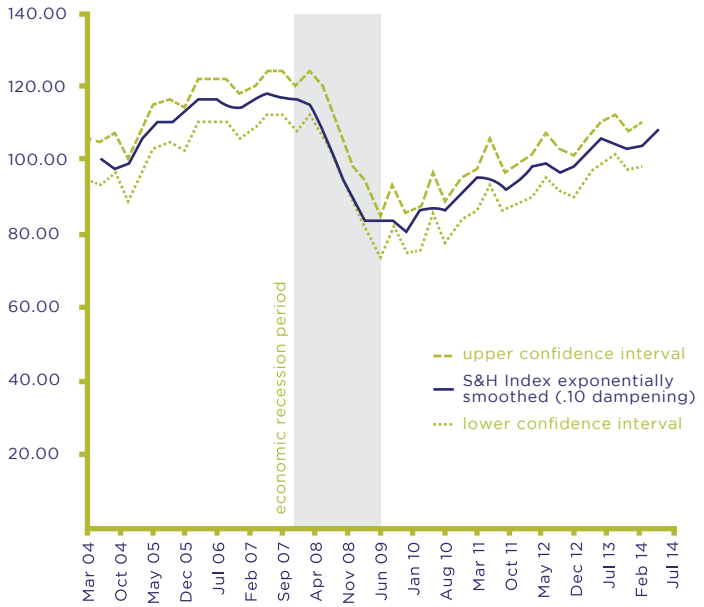
Sherman & Howard's Construction Index currently sits at 110.2, a number not seen since 2007-08, and indicates a healthy and growing market locally against a baseline value of 100. Based on current activity, we should see continued above baseline market performance for the foreseeable future.

Total Colorado Construction Labor



Denver Metro Multifamily Vacancy Rate





Sherman & Howard expects next quarter's index to trend slighty upward.

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Although Sherman & Howard makes efforts to forecast accurately using the most current information, the factors and trends tracked by the Construction Index are based on a mathematical regression model that is imperfect and does not measure every possible factor of influence. Nevertheless, we trust the Index and accompanying Colorado Construction Market Update we issue will serve as a valuable tool for evaluating construction and development opportunities in the Denver area and in the broader Colorado construction market, and for making informed business decisions. Some of the factors used to calculate the Index may be periodically adjusted by various reporting agencies. We regularly monitor those factors and adjust the Index accordingly.

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For additional questions please contact
Bret Gunnell or Blane Harvey at 303.297.2900

Sherman & Howard L.L.C. is a super-regional firm with a national practice. While the firm serves a broad range of clients, including individuals, privately held businesses, multi-national corporations and government entities, our Construction Industry Practice Group is one of the largest, if not the largest, dedicated construction law practice in the Rocky Mountain region and features lawyers who focus exclusively on construction. Our attorneys include former architects, engineers, contractors and government attorneys as well as experienced arbitrators and mediators of construction disputes.

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Market Update

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Sherman & Howard's Construction Index currently sits at 110.2, a number not seen since 2007-08, and indicates a healthy and growing market locally against a baseline value of 100. We are forecasting an increase in activity for the next period based on recent Index activity. Here are some important highlights of what is behind the numbers from our perspective:

Major Projects:

- South Denver - Prime West Development is constructing a 16 story, 310,000 sq. ft. speculative office building anchored to One Belleview Station. The completed LEED Gold building is expected in spring 2016, and is one of the few Transit Oriented Development (TOD) office projects currently planned.

- Denver International Airport – DIA's south terminal hotel and transit center is taking shape with expected completion in 2015/2016. Connecting the airport to downtown Denver should spark additional supporting development along the transit line and act as a catalyst to continue the "aerotropolis" plan surrounding DIA.

- Union Station – July brought about the transition of Denver's landmark Union Station into a bustling mixed-use, transit-oriented hub and boutique hotel. Construction took approximately a year and a half to complete and has already spurred additional development in the area. It will be interesting to see if this new hub will generate new and speculative development patterns in downtown Denver.

- Denver Health – Ground breaking will occur soon on two projects for Denver Health, including a 250,000 sq. ft. administration building to be located at 601 Broadway St. and a clinic facility located at 1339 S. Federal Boulevard.

- Cherry Creek – The $115 million dollar development of 250 Columbine in Cherry Creek will provide approximately 80,000 sq. ft. of office, 70 luxury condominiums, 30,000 sq. ft. of retail and an additional 300 parking spaces. Construction is expected to be complete by May 2015.

- Downtown Denver – Construction already is underway on several office and residential projects in and near downtown Denver. Among them is the $100 million dollar development at 1801 Wewatta St. that will break ground in late 2014 or early 2015, and include 100,000 square feet of office space and a 150-room hotel.

Lending:

The July results from the Federal Reserve Board's survey of senior loan officers showed a continued easing of lending standards and terms for many loan categories amid a broad-based improvement in demand for financing. This continues the trend of 13 straight quarters of reported easing of lending standards for commercial real estate loans and 17 of 18 quarters in which lending standards for financing commercial and industrial development have eased. Analysts are beginning to question what impacts additional industry regulation will have on this trend as smaller and regional banks, that typically fund many of these loans, are continuing to face additional burdens of compliance.

Office/Industrial Verticals:

- Office – New construction in the office market is up dramatically over the last year with a little over 1.7 million square feet under construction as of the end of the second quarter. The Metro Denver market continues to see absorption as the direct vacancy rate has fallen to 10.8% and average lease rates continue to see a slight bump upwards. We are seeing a majority of this development in the Central Business District and Cherry Creek submarkets, with eight buildings totaling just under one million square feet. It is important to note the number of projects completed to date lags slightly below prior years' averages.

- Industrial – The Denver industrial market sector ended the second quarter of 2014 at unprecedented levels, with vacancy at a historic low. The second quarter direct vacancy rate was reported at 3.4%, which is 1.7 percentage points below this same period from last year. Asking lease rates are hovering at the highest levels ever recorded and construction activity is approaching pre-recession levels. Companies are expanding again, further tightening the limited amount of space available and decreasing vacancy. Through the second quarter there was 1.31 million square feet of industrial space under construction, with 2014 bringing some of the highest levels of new construction we have seen since the mid 2000's. Labor shortages may determine whether and how fast the market can address the increased demand for construction.

Infrastructure

The United States Senate finally passed the Highway Trust Fund extension bill on August 1st, securing much needed funds for state infrastructure projects across the country. Passage of the bill avoided what otherwise would have been a deep cut in transportation funding by 28%, jeopardizing "100,000 active transportation projects" and "700,000 construction jobs across the U.S.," according to Transportation Secretary, Anthony Foxx. The priority and funding given to the bill come at the expense of extending unemployment benefits for over 3.2 million Americans. Unfortunately, it is only a temporary solution, as H.R.-5021 calls for a $10.8 billion extension of current transportation policy and funding through only May 2015.

Although Colorado has been successful in passing many of its projects with limited federal resources, including the FasTracks mass-transit plan in the Denver metro area and the I-70 Twin Tunnels expansion in Idaho Springs, some of the state's future projects could be in jeopardy until we have a clearer picture of the long-term funding that will be available. Assuming a new multi-year bill passes next year, analysts expect the highway and bridge market should stabilize and then show stronger growth three to four years down the road as new infrastructure projects move through the pipeline.

The recently passed Water Resources Reform and Development Act of 2014 identifies and funds several billion dollars of new water infrastructure projects across the U.S. The bill creates the Water Infrastructure Finance and Innovation Authority (WIFIA), a five-year pilot program that provides low-interest federal loans and loan guarantees for major water infrastructure projects. This bill has several provisions that will strengthen Colorado's waterways and the state's ability to develop future storage and conservation projects.

Residential:

Colorado has seen a massive ramp-up in residential construction this year and analysts predict this market sector will remain hot in the near term. Denver currently has around 7,000 multi-family units under construction, with another 6,000 in planning/entitlement. We anticipate a temporary slowdown in residential and multi-family construction as the market adjusts to and absorbs this new product, although we do not see this pace slowing from a long-term perspective until vacancy rates begin to creep above 6.5%. Denver has not yet recovered from the lack of new units during the economic downturn and analysts predict it could take another four to five years to make up for the shortage of units constructed during that period.

Transit Oriented Development (TOD) areas seem to be a major focus for this sector, but the state has yet to address the risk of construction defect litigation that inhibits growth in affordable unit and condo construction.

The insurance market has responded by pricing or shedding this risk, based on substantial losses experienced in recent years associated with new, for-sale housing units, such as condominiums. The Denver Regional Council of Governments studied the issue last summer and reported the construction defect issue is weighing heavily upon developers, builders and subcontractors despite the need and demand for more multi-family housing. Although a controversial piece of legislation (Senate Bill 220) was introduced and rejected around this very issue at the end of the 2014 legislative session, it is clear there is growing support for reform among government officials in the greater Denver area and it is likely we will see new legislation reintroduced again early in the 2015 session.

Costs:

Cost increases for construction materials are beginning to accelerate, and Colorado has finally caught up to the U.S. average after several years of being below the average. According to CDOTs cost index, the first half of 2014 has brought significant price increases in every measured sub group for horizontal construction (Earthwork, Hot Mix Asphalt, Concrete Pavement, Structural Concrete and Reinforcing Steel), with earthwork costs rising by 16% in the second quarter alone. Based on other material cost surveys for the region, the trend is being seen across the board and will continue through the end of this construction season and into 2015. We expect the cost of construction materials to experience at least a 4-5% increase in 2015 and 3-4% annual increases thereafter for the foreseeable future.

Condominium Construction Defects Legislation Introduced

By John Mill, Rebecca Fischer and Chris Mosley

FOREWARD (Bret Gunnell):
Local government officials recognize the risk of construction defect litigation is impeding much-needed condominium construction. This Construction Advisory (published May 2014) discusses proposed reforms introduced as Senate Bill 220 late in the 2014 legislative session. Although the Bill was defeated, we expect similar or perhaps even more ambitious reforms to be re-introduced early in the 2015 session.

Proposed legislation to reduce the cost of construction defect claims and encourage condominium construction has been introduced in the Colorado legislature. The long-awaited bill, Senate Bill 14-220, sponsored by Sen. Jessie Ulibarri (D-Commerce City) and others, was introduced on April 30, just one week before the current legislative session ends on May 7. If the bill becomes law, it could reduce the number of construction defect claims filed against developers, contractors and others involved in condominium projects and other types of common interest communities and would result in more claims being decided by arbitration instead of jury trial.

Background

The bill is the culmination of months of discussion and study by various people and organizations that have an interest in the development of condominiums and other communities governed by the Colorado Common Interest Ownership Act (or "CCIOA")[1]. In October 2013, the Denver Regional Council of Governments issued a study that concluded construction defect claims add $15,000 to the cost of every condominium unit[2]. The same study reported that in 2012 and 2013 (through the report date), no permits were issued for new condominium construction in downtown Denver[3]. Various organizations and public officials have supported legislative action to address construction defect claims and encourage new home construction.

What the Bill Does

- **Promote Alternative Dispute Resolution.** The bill would result in more arbitration of construction defect claims involving homes in CCIOA communities. Many CCIOA declarations recorded for those communities include provisions requiring arbitration of construction defect claims. However, after an alleged defect is discovered, it is common for a homeowners' association ("HOA") to amend the declaration to delete the arbitration provision and then sue in court and demand a jury trial. This is permissible under current law if the declaration or bylaws governing the community do not restrict amending or deleting an arbitration provision[4]. Senate Bill 220 would change existing law to provide that any amendment to a CCIOA community's declaration, bylaws or rules and regulations that would modify or delete a requirement for arbitration or mediation would not apply to construction defect claims based on alleged acts or omissions that occurred before the amendment. Thus, if the declaration or bylaws contain an arbitration provision, in most situations the parties involved in constructing the project (and their insurers) could be more confident that any claims would go to arbitration and not litigation. The bill also says that claims will be resolved by the arbitration service provider specified in the declaration, bylaws or rules unless the HOA proves the arbitration service provider is unqualified.

- **Require More Pre-Claim Disclosure to Unit Owners.** Currently, before serving a construction defect lawsuit, the HOA must provide information to all unit owners regarding the nature of the action, the relief sought and anticipated fees and expenses[5]. Some view these existing disclosures as inadequate. The proposed legislation would require more disclosure to unit owners before an HOA serves a notice of claim or hires experts. The disclosures would address attorneys' fees, expert fees and other costs of pursuing the claim; the claim's impact on marketability and value of units and the ability to get financing; the duration of the claim process; and the likelihood of success on the claim. These disclosures would have to be drafted by someone other than the HOA's construction defect attorney. The bill also requires that contracts for the sale of homes in CCIOA communities notify buyers that disputes may be required to be resolved by binding arbitration.

- **Require Majority Vote to Commence an Action.** The bill would put in statute a requirement that a simple majority of unit owners consent to filing a construction defect action. This provision may conflict with the voting provisions in some declarations, which currently may be drafted to require 67% (or some lesser supermajority) of unit owners to approve filing a defect action.

Prospects and Potential Impact

The bill's prospects in the legislature are unclear. It has substantial support and substantial opposition. Being introduced so late in the session, the bill's prospects for passage appear low, but the bill may help frame the future debate on construction defects.

Arbitration has long been a favored method of dispute resolution under Colorado law[6]. CCIOA expressly allows a common interest community's declaration, bylaws or rules and regulations to require disputes be resolved by binding arbitration[7]. Many construction-related contracts contain arbitration provisions. Accordingly, many contractors and others in the construction industry are expected to support the bill.

If the bill passes and becomes law, the most significant impact is likely to be that more defect claims will go to arbitration instead of litigation. Some lawyers believe that defect claim arbitration awards generally are lower than jury verdicts. Arbitration sometimes is less expensive than litigation. For these reasons, the bill may tend to reduce the total cost of construction defect claims.

The bill's impact on the insurance industry remains to be seen. It is possible insurers will view the legislation favorably to the extent they believe its provisions will reduce the overall cost of construction defect claims. If so, the bill may induce insurers to expand construction coverage operations in Colorado. However, like other aspects of the bill, the reaction of the insurance industry to the bill is not yet clear.

For the reasons stated above, passage of the bill could be good news for developers and their lenders and investors. To the extent the bill can lend some certainty to the process of planning, negotiating and budgeting for development, the real estate industry and its buyers should benefit.

Conclusion

Developers, contractors, insurers, attorneys and others interested in common interest community construction defect claims will want to monitor what happens with Senate Bill 220. Sherman & Howard's construction, real estate and insurance recovery groups will be closely following the bill and its impact on real estate development, construction defect claims and insurance.

Footnotes

1 C.R.S. §§ 38-33.3-101 through -402.

2 Economic & Planning Systems, Inc., Denver Metro Area Housing Diversity Study at 43 (Oct. 29, 2013), at http://www.drcog.org/documents/123065-Report 102913_final.pdf.

3 *Id.* at 18.

4 *See Eagle Ridge Condominium Ass'n v. Metropolitan Builders, Inc.,* 98 P.3d 915, 918 (Colo. Ct. App. 2004), *abrogated on other grounds*, *Ingold v. AIMCO/Bluffs, L.L.C. Apartments*, 159 P.3d 116 (Colo. 2007). At least one district court has distinguished *Eagle Ridge*, and held it did not apply, where a declaration expressly required the consent of the developer and contractor to amend or delete the arbitration provision.

5 C.R.S. § 38-33.3-303.5(2)(b).

6 *See, e.g.,* C.R.S. § 13-22-201 through -230 (Uniform Arbitration Act); *City and County of Denver v. District Court*, 939 P.2d 1353, 1361 (Colo. 1997) (arbitration long recognized as "a convenient, speedy and efficient alternative to settling disputes by litigation") (citation omitted).

7 C.R.S. § 38-33.3-124(3).

Whether for Cause or Convenience, Termination Can Be Tricky

By David Frommell

FOREWARD (Bret Gunnell):
Even in good economic times when there is plenty of work to go around, the decision to terminate a contractor or subcontractor for performance concerns is like playing a game of high-stakes poker. This Construction Advisory (published January 2014) serves as a reminder to proceed cautiously, ideally with the benefit of good legal advice, before exercising termination rights under a construction contract.

Termination of a construction contract is tricky and fraught with risk. Whether the termination is for cause or for convenience, the contract must be followed to the letter for a termination to be valid. Virtually every well-written construction contract contains a variety of termination provisions. Such provisions are infrequently exercised because the result is often catastrophic for the project, as well as everyone involved. Because contract terminations usually result from unexpected circumstances, the use of termination provisions typically signals the onset of increasing disputes.

The distinctions between termination for cause and termination for convenience are significant. When a contract is terminated for cause, the owner typically is entitled to stop paying the contractor and to seize the contractor's materials and equipment for use during contract completion. Additionally, the terminated contractor may become liable for the costs of contract completion above the original contract amount. A termination for default creates seismic impacts on the contractor's ability to obtain future work, and may negatively affect the contractor's bonding capacity and credit rating.

In stark contrast to termination for cause, termination for convenience is intended to allow both parties to a contract to walk away reasonably satisfied. Although the agreed contract language governs in any particular case, the contractor typically is entitled to receive payment for work completed, including reasonable profit. In addition, the contractor may recover the reasonable expenses of termination such as demobilization costs and penalties for breaking other contracts, such as lease or supply agreements. From the perspective of the owner, a termination for convenience can be beneficial because the contractor typically is not entitled to anticipatory profits or consequential damages resulting from cancelled work.

Importantly, where a termination for cause is unjustified and deemed wrongful, most contracts will convert the termination to one of convenience. In the absence of a contractual provision allowing for such a conversion, courts generally recognize the doctrine of "constructive termination for convenience," which judges apply to prevent owner abuse of default terminations. The conversion of a default termination to one for convenience exposes the owner to significant additional costs, and often involves expensive litigation. Proper termination for cause reduces the owner's exposure to such costs, whereas improper termination for cause provides opportunities for a contractor to recoup otherwise lost expenses. Below are a few examples of termination situations to consider. Although discussed in the context of the owner-contractor relationship, they apply equally to the contractor-subcontractor relationship.

Pretext
An owner cannot terminate for default as a pretext to other considerations. In one example, a federal government agency terminated a navy cap supply contract for default after a Senate committee investigating textile procurement implied the contract should be terminated. The agency proceeded to mechanically terminate for default at the suggestion of the Senate

Another example of pretext involved termination of a contract to develop a stealth plane for the Navy. The contractor was terminated for default after the program's funding was cancelled by the Secretary of Defense. Although the Navy terminated because the contractor was behind schedule and over budget, the trial court determined the Navy had a broader objective of abandoning the program altogether, and converted the termination to one for convenience. The appeals court reversed, finding the Navy's concerns regarding the contractor's schedule and budget performance to be fundamental elements of the contract. Thus, pretext

appears to be limited to situations where the basis for termination is wholly unrelated to the performance of the contract.

Waiver and Delay

An owner can waive its right to terminate for default by unreasonably delaying termination of the contract. However, courts tend to be lenient, allowing owners a reasonable time to evaluate the circumstances surrounding a default to determine whether termination is in the owner's best interest. A simple delay in termination is not enough to establish waiver. Instead, an owner must allow or encourage a contractor to continue performance beyond the substantial and/or final completion dates without any comment or reservation of rights. To avoid the risk of waiver, owners must be diligent in their communications and reservations of rights in the event of a material breach by a contractor.

Revocation of the Right to Complete

In an unreported case, an owner suspended a construction contract pending an investigation into the contractor's claim of differing subsurface conditions. The owner reserved all rights of termination, thereby avoiding a waiver argument. At the same time, the owner also determined the contractor would not be allowed to complete the work and directed the contractor to demobilize regardless of the outcome of the investigation. A year later, after determining the contractor's differing conditions claim lacked merit, the owner terminated the contract for default. The owner's revocation of the contractor's right to complete the work and direction to demobilize was found to constitute termination for convenience.

As shown by the examples above, contract termination involves complex factual scenarios which ultimately may be interpreted by a court or arbitrator. A clear and thorough understanding of a contract's termination provisions prior to commencing performance yields great benefits when litigating after contract termination. Owners seeking to terminate must follow the contract to the letter, including use of the proper terminology, allowance for any stipulated notice and cure periods, and timely initiation of claims with bond sureties. Contractors threatened with the risk of default termination should carefully document all facts, circumstances and correspondence surrounding contract performance, and inventory

Attorneys

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