Federal Appeals Court Affirms Jury Award to Engineering Firm

READERS MAY recall that in 2012 we wrote about one of the country's largest engineering professional liability cases ever tried to a jury. (See "Florida Jury Exonerates Design Engineering Firm," *Civil Engineering,* June 2012.) In *Tampa Bay Water v. HDR Engineering, Inc.,* the jury decided in favor of the defendant, HDR, which meant that that firm did not have to pay more than $140 million in damages that Tampa Bay Water (TBW) said it incurred because of HDR's design of the C.W. Bill Young Regional Reservoir. The 2012 column suggested that the reasonableness of HDR's approach may have influenced the jury. This month we look at the legal issues that the U.S. Court of Appeals for the Eleventh Circuit recently addressed in affirming judgment in favor of HDR.

Soon after the reservoir project was completed, large cracks were discovered in the earthen embankments. TBW filed suit against HDR, alleging defective design, and against the general contractor, Barnard Construction, alleging defective construction.

HDR's design included the use of geomembranes within the embankment, and a protective layer of soil 2 to 3 ft thick was placed over them. A mixture of soil and cement, or "soil-cement," was then placed on top of that layer to prevent erosion of the reservoir's inner walls. TBW alleged that HDR's design was defective in that it failed to account for excess pore pressure. It argued that the layer of soil between the soil-cement and the geomembranes was trapping excess water and producing cracks.

TBW further alleged that Barnard Construction was negligent in constructing the reservoir because the soil in the intermediate layer was not properly blended. The soil, it contended, lent itself to the formation of lenses, pockets, and layers, which in turn made it possible for the excess pore pressure to develop.

In defending itself, HDR argued that the cracking was caused not by the soil-cement being pushed up but by the collapse of the cement. The protective soil layer on top of the geomembranes, it contended, was too thick, too loose, and too dry. When the soil became saturated with water, it became denser and lost volume, causing the soil-cement to collapse and crack. HDR thus placed the blame on Barnard.

Prior to trial, TBW and Barnard entered into a settlement agreement, and from this accord an extensive set of stipulated facts emerged that essentially absolved Barnard of liability. This agreement, however, did not dispose of TBW's claims against Barnard, and TBW intended Barnard to be a participant at trial to help it prove its case against HDR.

HDR moved to void the settlement agreement as collusive or to have judgment in Barnard's favor before trial so that Barnard would be an "empty chair" before the jury. The district court ordered TBW to show cause why, in light of the stipulated facts, judgment should not be entered in favor of Barnard. TBW argued that although the stipulations absolved Barnard of responsibility for excess pore pressure, it could still pursue Barnard because of the formation of lenses, pockets, and layers in the soil. The district court disagreed and dismissed Barnard from the case on the grounds that it was not liable to TBW.

When the jury found in favor of HDR, TBW appealed. The primary issue on appeal concerned the court's decision to allow HDR to present evidence that Barnard was responsible for the reservoir damage. According to TBW, Florida's comparative negligence statute and its estoppel principles should have barred this evidence because it had already been determined that Barnard was not liable to TBW. In essence TBW argued that a party cannot be sued twice for the same facts and issues and that the judge erred in allowing HDR to present evidence alleging that Barnard was at fault.

The Court of Appeals for the Eleventh Circuit agreed with the district court's determination that the issues were not identical and that HDR's "collapse upon wetting" theory had never been litigated. The summary judgment proceeding disposed only of TBW's "lenses and pockets" theory and never considered HDR's theory.

For example, HDR's "collapse upon wetting" theory sought to prove that Barnard caused the reservoir damage in an entirely different way. If Barnard had used thick, dry, and loose soil, the embankment would, according to HDR's theory, have collapsed. This theory attributed the damage to a flaw in Barnard's construction technique different from the one initially alleged by TBW and, according to the court, necessitated proof of a wholly different set of facts.

The appellate court also held that the issue of causation had not been litigated in the summary judgment. While that ruling found that, because of the settlement agreement, Barnard could no longer be held liable to TBW, this was not the same as a finding that Barnard's construction techniques had not caused the damage. The court held that HDR was not precluded from presenting its theory that Barnard was at fault for the reservoir's cracks based on the "collapse upon wetting" theory. It thus upheld the jury's verdict and found no error in the court's decision to permit evidence of Barnard's liability.

Having originally sought $140 million from its designer, HDR, TBW wound up having to pay HDR's attorney fees, $21 million. As readers of our earlier article will recall, HDR offered to settle by paying TBW $30 million, but that offer was rejected by TBW. **CE**

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Government Liable to Designer/Builder

OVER THE PAST several years an increasing number of public agencies have used design/build to obtain stimulus money for supposedly "shovel-ready" projects. Among the common concerns has been whether the requisite site investigation work has been done to allow competitive procurement or whether the bidders are to accept the site "as is" and assume the associated risks. This "as is" approach is challenging given the long-standing legal precedent favoring contractors under the Spearin doctrine—that is, the owner impliedly warrants the sufficiency of its design—and the differing site conditions clause. A recent case, *Drennon Construction & Consulting, Inc., v. Department of the Interior,* considered these issues on a federal road project in Alaska.

The Department of the Interior wanted to widen a road to a campground from one lane to two and to eliminate a blind curve. It obtained funding under the American Recovery and Reinvestment Act of 2009 and engaged an engineering firm, USKH, Inc., to prepare 100 percent design drawings and a geotechnical report. The department provided USKH with a digital terrain model based on earlier photogrammetric mapping. When USKH realized that the model contained inaccurate control points, it requested $25,000 to perform a more reliable and accurate survey. Concerned about the limited project funding, the department denied the request and instead decided to warn potential bidders of possible inaccuracies in the model, require the contractor to perform a survey before commencing work, and use disclaimer language to shift the risk to the contractor.

The department contracted with Drennon Construction & Consulting, Inc., to excavate the hillside and design and build a gabion wall along the two-lane road. Drennon conducted a survey demonstrating that the road could not be built as illustrated on USKH's drawings. The road needed to be shifted in the opposite direction, into the hillside. This would require additional excavation and the construction of a much higher gabion wall.

Drennon also encountered soil problems during excavation, as the hillside slopes collapsed as a result of the soil being "at or near [its] angle of repose." In essence, every "scoopful" excavated from the slopes caused a minilandslide. Drennon concluded that the hill could not be stabilized and halted work. Ultimately, the project was scaled back to eliminate the widening of the road. Only the gabion wall was to be constructed.

Drennon filed a claim with the Civilian Board of Contract Appeals seeking its costs during the suspension and for the gabions not used because of the project redesign. The company claimed that the project's design was defective and that the geotechnical information provided by the government in the solicitation, which Drennon relied on in pricing the job, did not correspond to the conditions actually encountered. The board agreed, finding that the department's bidding documents contained both design defects and representations about the site that materially differed from actual conditions.

Citing the Spearin doctrine, the board found that the Department of the Interior bore responsibility for the defective design. The decision noted that both the department and USKH knew the design was flawed prior to bidding. The design called for the road to be widened beyond the guardrail separating the road from a river, but such widening was not permissible because the stretch had been formally designated a scenic area. The correction involved moving the road into the hill on the opposite side, something that the board concluded a reasonable bidder could not have anticipated, particularly given that the area was covered with snow during the bidding period. It also rejected the notion that "weasel words" in the solicitation would shift this responsibility.

The board further noted that the solicitation called for the gabion wall to be "approximately nine feet high at most" and said that about 420 cu yd of gabions would be needed to build it. Because the road was moved into the hill, Drennon had to excavate much more of the hillside than it anticipated. In fact, the wall needed to be 15 ft high with 778 cu yd of gabions. While the department acknowledged that these differences required Drennon to change its construction means and methods, it argued that the use of the word "approximate" and the design/build nature of the relationship shifted the risks to Drennon. The board disagreed:

> The disclaimer that the design might have to be adjusted per a contractor-financed survey alerted bidders to the possibility that the design might have required a bit of tweaking, but cannot reasonably be read to impose on the contractor an obligation to construct the project in a manner significantly different from that envisioned in the contract.

The board also concluded that Drennon encountered a differing site condition. The soil borings were said to contain between 5.1 and 10.7 percent fines described as "slightly silty," and Drennon was advised that the hillside would be "composed of similar soils." The actual soils on the hillside, however, contained virtually no fines, and the slopes were in a state of incipient failure. As a result, the board found that it was impossible to keep the wall of the excavation open for any period of time, contrary to the conclusions in the geotechnical report.

While the lessons from this decision are many, one is particularly salient: owners who use "weasel words" instead of sound procurement management rarely win. CE

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Virginia Supreme Court Upholds Constitutionality Of $2-Billion P3 Project

AGAINST THE backdrop of scarce federal and state funding for infrastructure projects, state and local transportation agencies are using a wide range of contractual arrangements to enhance private-sector participation in project delivery (development through construction), asset management (long-term operations and maintenance), and project finance (debt and equity secured by revenues). Many public agencies have broadened the private sector's role to include financing, operations, and maintenance. Depending on the statutory authority for the process, many of these expanded services are classified under the general term "public-private partnerships," or "P3" projects.

It is far beyond the scope of this article to address the many features, challenges, and benefits of P3. But, as is true of all infrastructure projects, P3s must be properly funded. As citizens realize that with P3 undertakings the public will usually be called upon to provide funding through new or increased tolls, citizen groups are resorting to political and legal means to block projects.

Virginia, which has one of the most robust P3 programs in the country, provides an example. In the combined cases *Elizabeth River Crossings OpCo, LLC, v. Danny Meeks, et al.,* and *Virginia Department of Transportation v. Danny Meeks, et al.,* city residents and users of a tunnel beneath the Elizabeth River linking Norfolk and Portsmouth challenged the constitutionality of tolls exacted pursuant to a comprehensive toll concession agreement. The users argued that the tolls were analogous to taxes and that the agreement was an unconstitutional delegation of the Virginia General Assembly's power of taxation to the Virginia Department of Transportation (VDOT) and the project's concessionaire, Elizabeth River Crossings OpCo (ERC). (The delegation was through Virginia's P3 statute, the Public-Private Transportation Act [PPTA] of 1995.)

The toll concession agreement concerned a 58-year project under which tolls would be used to finance the modernization of the two-lane tunnel tubes under the Elizabeth River, the addition of a new tube, and improvements to the Martin Luther King Freeway extension, which in total were expected to exceed $2 billion. Financing for the project was obtained through federal and state loans, a large private investment by ERC, and direct payments from the Commonwealth of Virginia. The road users argued that the tolls were equivalent to taxes in that their primary purpose was to raise revenue. The Portsmouth Circuit Court agreed and granted the challengers partial summary judgment. On appeal, the Supreme Court of Virginia reversed the circuit court, ruling in favor of the VDOT and ERC.

The high court held that the tolls to be imposed were not analogous to taxes but rather were user fees. It reasoned that users would pay the tolls in exchange for a particular benefit not shared by the general public, that the drivers would not be compelled by the government to pay the tolls or to accept the benefits of the project facilities, and that the tolls would be collected solely to fund the project, not to raise general revenues. The court reasoned that the project facilities, even though at least 2 mi apart, were "integrated" because the improvements to be carried out would provide benefits to the project as a whole, including smoother overall traffic flow, an increase in traffic capacity, and a decrease in travel time.

On appeal, the road users also argued that the PPTA itself violated the state constitution because it authorized public and private entities to set toll rates on projects and that from these rates the private entities would derive a return on their investments. The road users argued that the PPTA impermissibly delegated rate-setting authority to the VDOT, a state agency, and to ERC, a private entity, and that neither possessed legislative powers.

The Supreme Court of Virginia did not find this argument persuasive and held that a private entity's mere involvement in making regulatory decisions or helping the VDOT set toll rates was not itself unconstitutional. This was because ERC did not have the ability to force the VDOT to enter into the agreement. Therefore, there was no delegation of power to ERC in determining rates. The court also held that the VDOT possessed the power to set rates in the form of tolls.

On its face, the decision affirms the constitutionality of public-private transportation projects developed under the PPTA, but its national significance and ramifications must be underscored. The lower court's ruling cast a shadow on all of Virginia's P3 projects, and if the state's high court had affirmed it, the ruling not only would have undermined key private financing for the VDOT's projects but also would undoubtedly have led to "copycat" suits in other states. Instead, the decision solidified Virginia's long-standing status as an early and sophisticated P3 user and may help other states meet similar challenges. What is more, other states may draw on the Supreme Court of Virginia's reasoning as they draft their own P3 legislation. Readers should note that a number of trade organizations, including the National Conference of State Legislatures and the American Road & Transportation Builders Association, filed amicus briefs in support of Virginia's position. **CE**

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Industry Groups Band Together to Overturn Decision In *Metcalf*

IT IS NOT often that a decision by a lower court has such broad ramifications that the American Institute of Architects, the Associated General Contractors of America, the Design-Build Institute of America, and Associated Builders and Contractors, Inc., decide that amicus curiae (friend of the court) briefs are in order. But the decision in *Metcalf Construction Company, Inc., v. United States,* rendered in December 2011 by the U.S. Court of Federal Claims, has prompted this response. The ruling sent shock waves through the U.S. construction industry, as it effectively eliminated not only the ability to assert differing site condition (DSC) claims on design/build and perhaps other projects but also the "good faith and fair dealing" principle that has been at the core of federal government contracting for decades.

On February 11, 2014, order was restored as the U.S. Court of Appeals for the Federal Circuit vacated the lower court's decision and reaffirmed that the government has a duty of good faith and fair dealing in its contract administration and that it cannot disavow prebid representations it makes regarding soil conditions.

The U.S. Navy awarded Metcalf Construction an approximately $50-million design/build contract to build 212 housing units at a U.S. Marine Corps base in Hawaii. The request for proposals (RFP) included a report that described the soils as having "slight expansion potential" and noted that this was relevant to certain features of the project, among them the concrete foundations. The RFP also stated that the soil report was for "preliminary information only," the contract obligating the designer/builder to conduct its own soil investigation after contract award. In a publication issued by the navy during the RFP phase, it was stated that a change order would be issued if the designer/builder found a "major discrepancy" between the actual site conditions and those in the soil report.

After winning the contract, Metcalf discovered that the swelling potential of the soil was moderate to high, not "slight," and it recommended some design changes. The firm promptly notified the navy, and the parties had protracted discussions. Metcalf wanted to implement its engineer's design recommendations, but the navy insisted that Metcalf adhere to the original specifications. After a year passed without resolution, Metcalf decided that the cost of waiting was too high, and it proceeded to overexcavate the soil and replace it with nonexpansive fill so as to comply with the original specifications.

The navy ultimately rejected the DSC claim, concluding that there were no material differences between the prebid and postaward soil conditions. As a result of this and to overcome the extensive delays already experienced on the project, Metcalf decided to use slabs of posttensioned concrete. This approach mitigated the additional time and cost of continuing to overexcavate and to import fill. Upon completion, Metcalf asserted $4.8 million in damages for the soil problems.

Another soil issue that plagued the project was the presence of chlordane, a contaminant. The RFP stated that although chlordane was present at the site, palliative measures would not be required because the levels were "acceptable." Metcalf later discovered soils with higher levels of chlordane than expected and incurred costs to implement remediation measures. The navy, however, refused to reimburse Metcalf for the remediation costs.

The trial court's ruling in favor of the navy on these issues was based on the notion that because Metcalf was required to investigate the soil conditions after contract award, the firm could not point to the representations in the RFP concerning the soil. The U.S. Court of Appeals for the Federal Circuit flatly rejected this, finding that the lower court misinterpreted the contract.

The appellate court distinguished between Metcalf's postaward obligation to investigate soil conditions and what it could rely upon during the bidding process. Citing decades-old precedent, the court stated that the DSC clause was incorporated into the contract to "take at least some of the gamble on subsurface conditions out of bidding." It also said that the phrase "for preliminary information only" was not an effective disclaimer. The phrase, the court held, "merely signals that the information might change (it is 'preliminary'). It does not say that Metcalf bears the risk if the 'preliminary' information turns out to be inaccurate."

The importance of the DSC issue in this case cannot be overstated, particularly with regard to design/build projects. The Design-Build Institute of America's amicus curiae brief, which was clearly reflected in the court's decision, focused on the fact that, as part of the design evolution process, designer/builders frequently supplement the information on site conditions contained in RFPs with their own geotechnical investigations. This is in contrast to what goes on during the bidding process, when the designer/builder will reasonably, as noted by the U.S. Court of Appeals for the Federal Circuit, rely upon owner-furnished information to take some of the risk out of bidding.

The appellate court's view of Metcalf's DSC claims had a bearing on its view of the government's implied duty of good faith and fair dealing. In next month's column we will discuss that aspect and consider the status of the case now that the lower court's decision has been overturned. **CE**

Note: Michael C. Loulakis was of counsel to the Design-Build Institute of America in the submission of its amicus curiae brief.

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Appellate Court Reaffirms Government's Implied Duty of Good Faith and Fair Dealing (*Metcalf* Part II)

AS WE REPORTED last month, the decision in *Metcalf Construction Company, Inc., v. United States* will have tremendous legal ramifications for years to come with regard to two critical industry issues: differing site condition (DSC) claims and the government's implied duty of good faith and fair dealing. We devoted last month's column to the DSC aspect of the case. This month we focus on the other key aspect of the decision: the appellate court's finding that the government still has a broad obligation to administer its contracts in good faith.

Because we reviewed the facts of the case last month, our discussion of the facts here will be relatively brief. In essence, Metcalf Construction, the designer/builder on a $50-million military housing project for the U.S. Navy, filed a $27-million suit that was based on DSC claims and the navy's bad conduct. The navy, Metcalf contended, not only failed to take any action on DSC claims for nearly a year but also managed the project as if it were in combat with Metcalf.

The trial court's decision provided a number of facts explaining the basis of Metcalf's bad conduct claim. The navy's chief inspector created major challenges for Metcalf, as he inspected and rejected items multiple times for no apparent good reason. For example, in rejecting a countertop that was $^{1}/_{64}$ in. off, he stated that "on any other job in the universe, he would not only accept [the] countertop but that it actually looked good.... {U]nfortunately, this is a war...no breaks." The trial court characterized the inspector as "a difficult and overzealous navy employee" and noted that "there was a retaliatory aspect to some of the noncompliance notices that the navy issued." The trial court also concluded that the navy's contracting officer was unqualified and had engaged in overbearing contract administration, including abuses in withholding payments to Metcalf.

Despite its factual findings relating to the navy's conduct, the trial court concluded that Metcalf had not proved that the navy breached its duty of good faith and fair dealing. Relying on its interpretation of precedent, the court opined that mere "incompetence and/or the failure to cooperate or accommodate a contractor's request do not trigger the duty of good faith and fair dealing." The court concluded that Metcalf had failed to prove that the navy's actions were undertaken to delay or hamper performance of the contract. It also found that Metcalf had failed to prove that the navy had taken a "specifically targeted action" against Metcalf, that is, a measure calculated to reappropriate the benefits of the contract.

The U.S. Court of Appeals for the Federal Circuit concluded that the trial court applied the incorrect legal standard to the good faith and fair dealing claim and had taken an "unduly narrow view" of the government's duty of good faith and fair dealing. It rejected the notion that contractors had to show "specific targeting" to prove a breach of the duty and instead discussed the duty in terms of whether the government's conduct was reasonable.

The appellate court also rejected the government's argument that Metcalf's good faith and fair dealing claim failed because Metcalf could not "identify a contract provision that the navy's inspection process violated." Stated differently, the government argued that the duty of good faith and fair dealing "cannot expand a party's contractual duties beyond those in the express contract or create duties inconsistent with the contract's provisions." The U.S. Court of Appeals for the Federal Circuit concluded that this interpretation "goes too far: a breach of the implied duty of good faith and fair dealing does not require a violation of an express provision of the contract." It held that the duty of good faith and fair dealing imposes obligations on both contracting parties not to interfere with the other party's performance and not to act so as to destroy the reasonable expectations of the other party regarding the fruits of the contract.

Readers should note that the appellate court did not comment on the appropriateness of the navy's behavior or on whether Metcalf had proved that the navy breached its duty of good faith and fair dealing. Instead, it vacated the trial court's judgment and remanded the case to the trial court, making it clear what standard that court would now have to consider in looking at the evidence.

Why is the good faith and fair dealing aspect of *Metcalf* so important? A look at the facts of the case says it all. Is it appropriate for the government to conduct itself in a retaliatory way, forcing a contractor to spend money dealing with the unreasonable interpretations of an inspector? Can the government abuse the payment process or delay rendering decisions on DSC or other claims? Traditionally, the duty of good faith and fair dealing has been the "catchall" to ensure that the government behaves reasonably and gives the contractor a remedy if the government's actions damage the contractor. The trial court's decision was part of a line of cases from the past decade that had undermined the ability of contractors to sue for breach of the implied duty of good faith and fair dealing. The U.S. Court of Appeals for the Federal Circuit's decision restores strength to this longstanding and critical theory of government liability.

Note: Michael C. Loulakis was of counsel to the Design-Build Institute of America in the submission of its amicus curiae brief. **CE**

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Seventh Circuit Court of Appeals Considers Design Professional's Limitation of Liability Clause

LIMITATION of liability clauses serve to establish a contractual ceiling on the amount of damages to be awarded if a plaintiff prevails in litigation between the contracting parties. Design professionals often use these clauses because their errors or omissions could expose them to damages far in excess of their fees for a project. While these clauses are typically enforced by the courts, they are frequently the subject of legal challenges, as evidenced by a recent case heard by the U.S. Seventh Circuit Court of Appeals involving a multimillion-dollar lawsuit against an architecture and engineering firm.

The disputes in *SAMS Hotel Group, LLC, v. Environs, Inc.*, arose from a project to construct a six-story Homewood Suites hotel in Fort Wayne, Indiana. The owner, SAMS Hotel Group, contracted with Environs Architects-Planners to provide architectural services for the project for a flat fee of $70,000. The contract limited the liability of Environs as follows: "The Owner [SAMS] agrees that to the fullest extent permitted by law, Environs Architects-Planners, Inc.'s total liability to the Owner shall not exceed the amount of the total lump sum fee due to negligence, errors, omissions, strict liability breach of contract, or breach of warranty."

After the hotel was completed, serious structural defects were discovered. The county building department condemned the structure, and the hotel was demolished before it ever opened. Incurring damages of more than $4.2 million, SAMS sued Environs for both breach of contract and negligence. The contention in both claims was that Environs provided a defective design and negligently performed its contractual obligations.

Environs defended itself in the negligence claim by adducing the "economic loss rule," which holds that a party cannot be liable in tort for purely monetary losses in the absence of any personal injury or damage to property. Without discussing whether the demolition constituted property damage, the district court granted summary judgment in favor of Environs, thereby barring the negligence claim under the economic loss rule. And while the district court found that Environs was liable for breach of contract in several respects, it capped SAMS's recovery to $70,000 pursuant to the limitation of liability clause.

SAMS took the decision to the Seventh Circuit Court of Appeals, arguing that the clause in question was unenforceable because it did not expressly refer to Environs' own negligence. SAMS contended that the clause should be stricken because it allowed Environs to "contract around" and evade responsibility for its own negligence. Like most states, Indiana has a line of cases requiring that, to be effective, indemnification, or "exculpatory," clauses must be specific. In other words, it requires that, to be enforceable, a clause must "clearly and unequivocally" manifest a commitment by the plaintiff to pay for damages resulting from the defendant's own negligence. SAMS argued that since the clause did not expressly refer to its agreement to pay for Environs' own negligence, it could not be enforceable.

The appellate court began its analysis by speculating on how the Indiana Supreme Court would answer the following question: Is a limitation of liability clause in a professional services contract that generally refers to liability for "negligence" and breach of contract and was signed by two sophisticated commercial entities enforceable in favor of the breaching party if the clause does not refer to that party's own negligence?

The Seventh Circuit Court of Appeals rejected SAMS's line of reasoning, beginning its discussion with the general premise that Indiana courts have long recognized and respected the freedom that parties have to enter into contracts. It stressed that the parties here were sophisticated commercial entities of equal bargaining power and that they were aware of the risks involved in designing and building a hotel. Moreover, the court noted that SAMS was not arguing that the liability clause it negotiated violated a statute, would tend to injure the public, was ambiguous, contravened public policy, or was inapplicable to the facts of the case. Rather, the court stated, "SAMS argues only that it should be excused from the terms of its bargain, even though the meaning of the language is clear and unambiguous."

The court thus refused to extend the specificity requirement in indemnification clauses to limitation of liability clauses, noting that the clauses serve different purposes. It reasoned that indemnity clauses can make it impossible to bring a claim against a party. Because limitation of liability clauses merely place a cap on damages, the court deemed it unjust to allow a party to escape a liability provision merely because it yielded a harsh result.

The clause in this case enabled the design professional to limit damages to the amount of the fee, $70,000. However, not all design professionals are able to persuade project owners to limit liability in this way. Consequently, clauses may limit the liability to available errors and omissions insurance coverage limits or to some higher dollar value—for example, two to three times the amount of the fee when the fee is small. Some architecture and engineering firms are also willing to assume the full risk of liabilities related to the design—that is, no cap on liability—for a more substantial fee. **CE**

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Court Holds Designers to a Higher Standard of Care

IT IS WIDELY understood within the design profession that the common law "standard of care" does not require perfection in preparing plans or drafting specifications. Rather, the defining legal benchmark of the duty owed to one's client is simply the level of skill and dili gence other architects and engineers would exercise under similar circumstances. This predominant standard is written into almost every contract. While most architecture and engineering firms would consider compliance with state and local building codes a legal requirement and, thus, part of the general standard of care, one firm recently argued that it met the standard of care when furnishing a design that did not comply with the state building code.

In *The School Board of Broward County, Florida, v. Pierce Goodwin Alexander & Linville,* a school board contracted with an architecture firm for major renovations to a high school. When the preliminary design plans were submitted, an independent peer reviewer raised red flags, noting that some of the plans failed to comply with the applicable fire codes. In particular, the reviewer believed that an exterior staircase was needed as an emergency exit from a third-floor balcony. The architecture firm disagreed and proposed an alternative solution.

The design contract required the architecture firm to render its services "in compliance with any and all applicable codes, laws, and ordinances." It further stated that the school board's chief building official would have the final authority in interpreting all applicable building codes, statutes, and regulations. On the basis of oral statements made by this official, the preliminary design plans went out for bids without the staircase. Once construction commenced, however, the chief building official determined that the design plans were not in compliance with code. The architecture firm redrafted the plans, resulting in a series of significant change orders and increased construction costs.

The school board sued the architecture firm for breach of contract, arguing that the appropriate standard of care involved code compliance. The architecture firm contended that as long as the final plans used for construction were compliant, it had met its contractual obligations. Furthermore, it argued that the appropriate standard of care was whether it performed its duties with ordinary and reasonable skill—that is, a negligence standard.

The trial court interpreted an indemnity provision in the contract as limiting any damages the school board could recover to those arising from the architecture firm's "negligent performance." Thus the trial court did not permit the school board to introduce evidence that the initial plans failed to comply with code. The trial judge also agreed that the jury should consider the case on the basis of whether the firm was negligent. Its members, having been told that they were not to decide whether the design plans complied with the code, found that the firm was not negligent.

The court of appeals reversed the decision and remanded the case for a new trial, finding that the lower court incorrectly instructed the jury. The appellate court agreed with the negligence-based standard of care definition, but it held that the trial court overlooked important contractual terms that assigned a "higher standard of care" to the architecture firm. In particular, the school board pointed to three separate contract provisions underlining the architecture firm's duty to comply with all applicable laws, statutes, rules, regulations, and building codes.

The appellate court held that the plain language of the contract required the architecture firm to deliver code-compliant design plans, rather than merely draft plans with "ordinary and reasonable skill." As the court saw it,

> The fact that all three sections specifically state that all design plans were to be in compliance with all applicable codes, and only once makes reference to 'customary professional standards,' persuades us that the architect committed itself to a higher standard of care.

The court rejected the firm's argument that as long as the final plans provided a code-compliant building, its professional duties were met.

The appellate court also revisited the trial court's interpretation of the parties' standard indemnity provision, which stated that "the [architect] shall indemnify and hold harmless the owner... from and against any and all liability... to the extent said losses...are caused by the [architect's]...negligent, reckless, or intentional wrongful acts." The court held that this indemnity provision was intended to apply to third-party claims, not claims between the school board and the architecture firm, and that the provision did not limit the damages the school board could recover only to those caused by negligence.

The court's interpretation that an architect can contractually commit itself to a higher standard of care is noteworthy, as insurers of design professionals often advise vigilance in this respect. Most design professionals, however, already consider code compliance to be within the general common law standard of care. Because building and zoning codes, ordinances, and regulations are frequently subject to differing interpretations, it is prudent to consider contractually defining the procedure by which a final authority will interpret such codes. In this case, had the parties required the chief building official to put his or her initial opinion in writing (prior to the bids coming in), this case might have had a different outcome. CE

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Tort Liability Expands for Project Architects in California

FOR DECADES the architecture and engineering community has enjoyed and relied upon certain legal protections afforded them when confronted with third-party lawsuits. Central to these protections is the "economic loss rule," which holds that a designer may not be sued for negligence by a third party with whom it has no contract for purely economic damages. We have discussed this concept in many of our columns, typically within the context of a contractor or subcontractor suing the architect or the engineer for such monetary damages as project delays. Courts around the country today are almost equally divided on whether the protections from the economic loss rule should extend to design professionals.

This month we consider a noteworthy decision by the California Supreme Court that expands the potential liability of project architects beyond those directly involved in the construction project (such as contractors). The court found that architects owe a duty of care to the ultimate purchasers of buildings and therefore can be liable for economic losses to those parties even if there is no contractual privity with those parties.

The case *Beacon Residential Community Association v. Skidmore, Owings & Merrill LLP* arose when a homeowners' association, on behalf of its members, sued a condominium developer (Beacon) and, among other parties, the developer's designers—Skidmore, Owings & Merrill and HKS—over construction design issues that, the plaintiff alleged, made the homes unsafe and uninhabitable for significant portions of the year. The designers had a contract with Beacon and were paid approximately $5 million for their design services. The association alleged that these designers performed their work in a negligent fashion that resulted in excessive water infiltration, inadequate fire separations, structural cracks, and other safety hazards. Chief among the alleged defects was "solar heat gain," which, the association argued, resulted from a design that lacked adequate ventilation and used low-cost, substandard windows.

The designers sought to be dismissed from the case early on by contending that they owed no duty of care to the association or its members. The trial court agreed and reasoned that as long as the developer had the final say in the design or any substitutions, "there is no duty owed by the architect to future condominium owners in the court's view." A California appellate court, however, reversed the decision, concluding that an architect owes a duty of care to homeowners in these circumstances under both common law and California's Right to Repair Act.

The California Supreme Court affirmed the appellate court's decision, beginning its analysis with an ominous observation: "The significance of privity has been greatly eroded over the past century." The court framed its analysis by relying heavily on a 1958 case that found a notary public who negligently drafted a will liable to the intended beneficiary of the will. In deciding that case, the court evaluated whether a duty of care was owed to noncontractual third parties by evaluating the extent to which the transaction was intended to affect the plaintiff; the extent to which the harm could be foreseen; the degree of certainty that the plaintiff suffered injury; the closeness of the connection between the defendant's conduct and the injury suffered; the moral blame attached to the defendant's conduct; and the policy of preventing future harm.

The high court in this case found that even though the designers did not actually build the project, they did conduct weekly inspections, monitored contractor compliance, altered design elements when issues arose, and advised the developer of any nonconforming work. "In other words," the court noted, "defendants applied their specialized skill and professional judgment throughout the construction process to ensure that it would proceed according to approved designs."

In applying the factors cited above from the 1958 case, the high court determined that a duty was clearly owed to the homeowners:

> Because of defendants' unique and well-compensated role in the project as well as their awareness that future homeowners would rely on their specialized expertise in designing safe and habitable homes, significant moral blame attaches to defendants' conduct.

As a result, the court held that the allegations in the complaint were sufficient and, if proved, established that the designers owed a duty of care to the homeowners' association. The court thereby rejected the notion that its holding would have the effect of making architecture and engineering firms liable "in an indeterminate amount, for an indeterminate time, to an indeterminate class." The court opined that architecture and engineering firms could limit their liability in proportion to fault by bringing a third-party claim or cross-claim for equitable indemnification.

This case clearly has severe negative ramifications for design professionals in California who perform design work on residential construction projects. While the architecture and engineering community was not successful in persuading the state's high court to rule otherwise, there remains the possibility of a legislative response. In the meantime, perhaps the only solace is that the court limited its holding to "principal" architects, explaining that any design professional who is subordinate to another would not have such a duty to future residents. **CE**

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Designer/Builder Responsible For Risks regarding Permits

WHEN A COURT is asked to decide who bears responsibility for cost overruns on a project, the contract is king, and the provisions therein that apportion risk will be enforced as written. But what happens when the contractual risks involve actions by third parties or circumstances beyond the parties' control? This month we highlight a recent decision assessing liability for millions of dollars of cost overruns caused by the actions of a third party.

The case *Bell/Heery v. United States* involved disputes between the designer/builder joint venture Bell/Heery (BH) and the Federal Bureau of Prisons (FBOP). The FBOP issued a request for proposals (RFP) regarding a federal correctional institution in New Hampshire. The RFP required the contractor to "cut and fill" the site. The RFP mandated that the cut and fill operations be performed in compliance with regulations promulgated by the New Hampshire Department of Environmental Services (NHDES).

The RFP further stated that the designer/builder would be responsible for "prepar[ing] the necessary documentation and forms required for the permits, and [should] apply for, pay for and obtain all such permits and submit the application(s) for the FBOP." It also stated that "[i]n preparing construction documents, the contractor is to consult with appropriate officials of the State." In no case were the "comments or recommendations of these officials to be implemented into the developmental documents without the approval of the FBOP." Finally, the RFP incorporated a standard provision of the Federal Acquisition Regulation:

> The contractor shall, without additional expense to the government, be responsible for obtaining all necessary licenses and permits, and for complying with any federal, state, and municipal laws, codes, and regulations applicable to the performance of the work."

BH's bid price was calculated on the assumption that the cut and fill work would be carried out in one step under a mass grading plan. On the basis of its experience, BH believed that the NHDES would approve a permit for a one-step plan.

After BH was awarded the contract, however, its permit application was rejected by the NHDES. That department would authorize only cut and fill operations confined to a 40-acre disturbance area, meaning that BH could grade no more than 40 acres of land at any one time. BH therefore revised its plans for the initial phases. Although the NHDES authorized BH to proceed with the initial phases, it required the joint venture to submit plans for the subsequent phases for review and approval. After BH commenced work, the NHDES imposed at least 10 additional limitations on the grading activities. These strictures caused BH's grading activities to proceed at a much slower pace and at a greater cost than BH had anticipated.

BH submitted a claim to the contracting officer for the $7.7 million in excess costs it incurred from the NHDES's restrictions. When the contracting officer denied the claim, BH filed suit in the U.S. Court of Federal Claims, alleging breach of contract and breach of the implied covenant of good faith and fair dealing and seeking relief under the doctrines of constructive and cardinal change.

The court dismissed BH's suit in its entirety, finding that the terms of the contract "clearly and unambiguously" placed the burden on BH for obtaining and complying with state and local permits for the construction project "without additional expense to the government." BH then took the case to the U.S. Court of Appeals for the Federal Circuit.

The thrust of its appeal was that its consultation with state agencies was to be made "in conjunction with" the FBOP's project management team. BH argued that the FBOP "completely disregarded its duty to work and cooperate with BH involving…site work changes dictated by the NHDES." It asserted that the FBOP breached the contract because it "never made any effort to engage the NHDES, or to otherwise resolve the problems caused by the NHDES's multiple changes" to the grading plans. It also presented evidence that the FBOP had stated in meetings with BH that BH would be treated fairly with respect to the extra work caused by the NHDES's decisions on permits.

The appellate court held that the FBOP could not have breached the contract because the risk for complying with the NHDES regulations was contractually allocated to BH. It also made the following observations:

> [T]he implied duties of good faith and fair dealing cannot form the basis for wholly new contract terms, particularly terms which would be inconsistent with the express terms of the agreement…. Because BH's complaint focuses on the frustrating conduct of the NHDES, an independent state agency, the allegations do not set forth a viable claim for breach of the implied covenant of good faith and fair dealing.

It is easy to sympathize with BH in this case. It appears that the NHDES took unreasonable actions in dealing with the permit limitations, and the effect on BH's work was substantial. Most contractors assume that the owner will try to mitigate difficulties associated with third-party agency permits. That obviously did not happen here, and the U.S. Court of Appeals for the Federal Circuit did not expand the FBOP's "consultation" duties to cover this problem. It is therefore of paramount importance that contractors and designer/builders understand whether they will be bearing the risks attendant upon dealing with difficult state or local permitting agencies. **CE**

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Public Owner Wrongfully Interfered with Contractor's Work

EXACTLY TWO years ago, we wrote about a stunning decision by a Texas appeals court that dismissed a contractor's $19-million jury verdict and directed the contractor instead to "take nothing" and to pay the owner $11 million in attorneys' fees. To effect this $30-million "swing" in legal results, the appeals court simply enforced a broadly worded no-damages-for-delay provision that the jurors had refused to enforce.

Many in the Texas contracting industry were distressed that the court would disallow the delay claim when there was evidence that the owner had actively interfered with the contractor's performance. As it turns out, that ruling was erroneous. In *Zachry Construction Corporation v. Port of Houston Authority of Harris County, Texas,* the Supreme Court of Texas has overturned that decision, recognizing five exceptions to the no-damages-for-delay clause.

The dispute arose from an approximately $62-million contract for the construction of a wharf on the Bayport Ship Channel for the Port of Houston Authority. The wharf was to consist of five sections, each of approximately 330 ft. Zachry was selected as the contractor in large measure because it proposed building the wharf "in the dry" by using a U-shaped wall formed through ground freezing to keep water out of the construction site.

The contract established Zachry as an independent contractor in sole charge of choosing the means and methods for the work. The contract also imposed a strict schedule, and Zachry's sole remedy for any delay on the project was an extension of time. Nine months into the project, the port realized that it would need two 1,000 ft berths to accommodate the ships it ultimately expected to service. A sixth section, this one of 332 ft, would have to be added. Zachry and the port began discussions on a change order. Zachry proposed a cutoff wall formed through ground freezing that would be perpendicular to the main wall and would divide the project into two phases. The port had reservations about this plan and refused to allow construction of the new cutoff wall. Since it had been designated an independent contractor, Zachry contended that the port had no right to determine the method and manner of the work. The port's decision ultimately delayed the project and allegedly cost Zachry tens of millions of dollars in damages from delays.

Zachry sued the port for the difference between the cost it would have incurred if it had been allowed to complete the wharf in the dry and the cost it actually incurred in working "in the wet." For its part, the port entered a claim for attorneys' fees. Under the terms of the contract Zachry was liable to the port for fees if any claim it brought against the port "does not prevail." After a three-month trial, the jury found that the port had breached the contract, and it awarded Zachry $19 million. As part of the award, the jury found that the port had delayed or hindered Zachry's work.

On appeal, the port won a reversal of the jury award. The port pointed to the no-damages-for-delay clause in the contract, which expressly addressed one of the commonly recognized exceptions in such clauses. According to the clause for this project, "Contractor shall receive no compensation for delay or hindrance of the work…EVEN IF SUCH DELAY OR HINDRANCE RESULTS FROM…THE NEGLIGENCE, BREACH…OR FAULT…OF THE PORT AUTHORITY."

The appeals court found this provision unambiguous, especially given the extensive use of capital letters to convey the parties' intent. The court refused to "rewrite" that provision, stating that it would deprive the port of the deal it struck when the contract was signed. The court underscored the fact that contracting parties are the "masters of their own choices" and are entitled to select the terms and provisions they desire.

The Supreme Court of Texas, however, reversed this ruling, finding that the no-damages-for-delay clause could not be enforced if intentional misconduct by the port caused the delay. The court cited generally recognized exceptions to the enforcement of no-damages-for-delay clauses. These exceptions apply when the delay (1) was not intended or contemplated by the parties to be within the purview of the provision; (2) resulted from fraud, misrepresentation, or other bad faith on the part of one seeking the benefit of the provision; (3) lasted for such an unreasonable length of time that the party delayed would have been justified in abandoning the contract; (4) was not within the delay scenarios addressed by the clause; or (5) was based on active interference, including "arbitrary and capricious acts" or "willful and unreasoning actions" carried out "without due consideration." The high court held that the clause could not be enforced as written and was void because, in contravention to public policy, it "would permit one party to intentionally injure another with impunity."

While courts in many jurisdictions have formally adopted and carved out these exceptions to the enforceability of no-damages-for-delay clauses, Texas's highest court had not yet done so. The decision is a victory for Texas contractors, and owners may have misgivings regarding the subjectivity surrounding active interference. Although in the past courts have usually required some evidence of malice or gross negligence, this decision can be seen as setting the threshold much lower. Indeed, an ill-considered decision by an owner may result in a finding of active interference. Finally, only time will tell whether the first exception (delays not intended or contemplated by the parties to be within the purview of the provision) will be the exception that swallows the proverbial rule. **CE**

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Is Owner's Right to Terminate For Convenience Absolute?

TERMINATION-for-convenience (T-for-C) clauses date back to the Civil War. They originated as a means of giving the government authority to swiftly cancel military procurements in the event of a sudden end to the war. The substance of these clauses has not changed significantly over the past 150 years. The owner has broad authority to terminate without cause, and its obligation is to pay the terminated contractor its costs incurred so far, along with nominal demobilization costs and a reasonable profit only on the work actually performed. The terminated contractor is not allowed to recover its "expectation damages" (what the contractor expected to receive in entering into the contract), such as anticipated or lost profits.

Because they are given only a limited payment remedy, some federal contractors have challenged the propriety of T-for-C clauses when termination is not simply a result of project cancellation. Those who win this argument use an "abuse of discretion" legal theory. This theory is hard to prove, as it requires a contractor to show that termination was intended to injure the contractor. Such a burden is rarely met. But what about the right of an owner to terminate for convenience in nonfederal cases? Is the power limitless if such a clause is broadly drafted?

Consider a recent appellate decision from Michigan, *Parlovecchio Building, Inc. v. Charter County of Wayne Building Authority.* Here the Wayne County Building Authority engaged Parlovecchio Building to serve as its representative on a project to construct a county jail. The parties' agreement contained the following T-for-C clause:

> Notwithstanding any provisions or language in this contract to the contrary, the Owner may terminate the contract whenever he/she determines in his/her sole discretion that such termination is in the best interest of the owner. Any such termination shall be effected by delivery to the OR [owner's representative] of a written notice of termination.

Six months into the contract, various news organizations began reporting that the building authority's contract with Parlovecchio was improper and "shady" because the president of Parlovecchio was a former employee of the building authority. Amid these allegations of "insider" dealing, the building authority terminated Parlovecchio's contract for convenience.

Parlovecchio challenged the action, contending that such a termination had to be made in good faith, at least on the basis of a material change in circumstances. Parlovecchio argued that being terminated for what amounted to nothing more than "political considerations" did not constitute good faith by the building authority in exercising the termination option. The parties moved for a ruling on the legal issues in advance of trial (a summary judgment), and the circuit court ruled in favor of the building authority. Parlovecchio sought to overturn the ruling in the Michigan Court of Appeals.

That court declined the invitation to read into the termination provision an implied duty of good faith. It determined that, given the express language in the clause, termination was at the "sole discretion of the owner." The court declared the provision was susceptible of only one meaning: "the building authority retained the right to unilaterally decide to bring the contract to an end, based on its own interests."

This Michigan ruling stands in stark contrast to the legal precedent set in Maryland that we wrote about in this column approximately five years ago in discussing *Questar Builders, Inc. v. CB Flooring, Inc.* (see "Court Rules in Favor of Subcontractor in 'Bid Shopping' Termination Suit," *Civil Engineering,* February 2010, page 96). That case involved a general contractor terminating a subcontractor for convenience after the subcontractor included pricing for change orders the owner had requested. Seeing that it could obtain a much lower price by reprocuring, the general contractor terminated the subcontractor, arguing that the T-for-C clause allowed it to do so for any reason whatsoever. On appeal the court disagreed and drew a distinction between the contractor's decision and decisions made by government entities. It declined to give private parties the "near carte-blanche power to terminate that courts have given the federal government."

The court then provided guidance as to the circumstances that would allow a general contractor to terminate for convenience. Since such clauses are risk-allocating tools, the general contractor could exercise its discretion to terminate if continuing with the contract would "subject it potentially to a meaningful financial loss or some other difficulty in completing the project successfully." However, the court also stated that good faith and fair dealing prohibit "a party from terminating its contract...to 'recapture' an opportunity that it lost upon entering into the contract." After entering into a contract, the parties "give up their opportunity to shop around for a better price."

At least five state courts have addressed the issue of whether an owner's right to terminate for convenience carries an implied duty of good faith. State courts in Kentucky and Maryland have responded in the affirmative, holding that the right to terminate for convenience in private settings is not boundless and must be exercised in good faith. Courts in New Jersey, Florida, and now Michigan, however, have construed those clauses broadly to infer that the owner's right to terminate at its "sole discretion" means just that, for any reason or no reason at all.

T-for-C clauses serve an important role for owners in a properly drafted contract. However, allowing this clause to be used by the owner (or in the case of *Questar* the general contractor) as an "option" to find a better commercial deal is bad policy, and many courts and juries would deem this conduct unacceptable. Therefore, such decisions as *Parlovecchio* should not convince anyone that the "sole discretion" words in the T-for-C clause will always prevail. The *Questar* case explains why. **CE**

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