Owner Loses, But Who Wins?

AS ANYONE EXPERIENCED in change-order negotiations knows very well, one of the central issues between the parties is the extent to which a contractor will release its claims for events arising out of, or related to, the change order. Generally, owners want broad releases, and contractors want narrow releases. Some form of release ultimately gets incorporated into the change order, and if the parties are later at odds over a future issue, they will debate whether the contractor's rights to claim for that issue are covered by the release.

What does a court consider in deciding whether a release is effective? This month's case, *Meridian Engineering Company v. U.S.*, offers some helpful guidance on the subject.

The Facts

The dispute involved a September 2007 contract between the U.S. Army Corps of Engineers and Meridian Engineering Company for the construction of a flood-control project in Nogales, Arizona. The project was troubled by delays caused by a variety of factors, including the Corps giving Meridian electronic drawings and survey files later than planned. One of the major problems was that the project experienced substantial flooding. Between late June and mid-December 2008, which included the monsoon season, there were apparently 14 flood events, with the site at one point experiencing flooding for 47 days during a 54-day period.

The Corps and Meridian executed several contract modifications to address a number of project issues. Each modification contained language that purported to have Meridian broadly releasing its rights to bring additional claims. However, the parties did not resolve all project issues, particularly those relative to the costs associated with the 2008 floods.

In April 2010 Meridian submitted a request for equitable adjustment (REA) to the Corps, including a claim for approximately $900,000 related to the 2008 floods. The Corps never agreed to the REA, which led Meridian to file suit with the U.S. Court of Federal Claims (CFC) in 2011.

The litigation history between the parties is long and complicated. There were two trials before the CFC, and Meridian did prevail on some of its claims. However, the CFC ruled against Meridian on its claim related to the 2008 floods, finding that the claim was barred by the defense known as "accord and satisfaction." The Corps had argued that this defense should apply because of the releases that were part of two specific contract change orders.

> One of the central issues between parties is the extent to which a contractor will release its claims for events arising out of, or related to, a change order.

Meridian appealed to the U.S. Court of Appeals for the Federal Circuit, which concluded that the CFC's analysis of the accord and satisfaction defense was insufficient. It stated that the CFC had to consider whether the parties intended to have the flood claims released. The Federal Circuit remanded the case to the CFC for consideration of these issues.

The Decision

In redeciding the case based on guidance and instruction from the Federal Circuit, the CFC focused on whether the subject matter of the modifications involved the flood damages and whether the parties had come to a "meeting of the minds" that the releases established in those modifications "constituted full and complete satisfaction of all obligations and liabilities" for all flood-related claims.

The two modifications at issue involved the Corps's addition of a new access ramp and delays pertaining to the late electronic drawing and survey files. The relevant portion of the release language stated:

> It is further understood and agreed that this adjustment constitutes compensation in full on behalf of the Contractor and its Subcontractors and Suppliers for all costs and markups directly or indirectly attributable for the change ordered, for all delays related thereto, for all extended overhead costs, and for performance of the change within the time frame stated.

On the basis of the guidance given to it by the Federal Circuit, the CFC concluded that the subject matter of these modifications only related to the specific costs associated with the new access ramp and the survey drawing delays and did not cover the flood damage claims. It found that the floods were "too attenuated from the access ramp and survey delays to be within the subject matter of these releases." The CFC was influenced by the fact that both modifications predated a significant portion of the days when the site experienced flooding.

The CFC also rejected the Corps's request for a broader reading of the release language. The Corps argued that the flood damages were suffered as "an indirect result" of the delays from the items in the modifications, in part because these other delays forced Meridian to work during the extended monsoon season. The CFC found this argument unpersuasive because there

were many delays that pushed the project into the monsoon season, not just the items from the two modifications.

In considering the meeting of the minds question, the CFC also agreed with Meridian. There was evidence that both parties had considered the merits of the flood damage claims after the execution of the two modifications. Among other things, the CFC noted that the Corps, in response to Meridian's REA, internally circulated a draft modification recognizing the partial merit of the flood-event claim. "While this modification was never issued, and although Meridian did not learn of this document until discovery … the draft of this document and its internal circulation are enough to show continued consideration by the Corps of Meridian's claim."

The Analysis

It is hard to imagine, based on what is reported in this decision, how the CFC found that there was an accord and satisfaction in the first place and why it needed the Federal Circuit to explain how to analyze this situation. The discrete subject matters of each modification seemed quite clear, and the release language did not broaden the subject matter to other issues (such as the flood events). The result might have been different if, for example, there had been contract modifications that "rolled up" a number of contested claims. Had there been, the owner could have argued that the negotiations specifically contemplated releasing a broader swath of claims. No such negotiations were identified in the opinion.

> Generally, owners want broad releases, and contractors want narrow releases.

Because the CFC finally reached the best possible conclusion for the engineering firm—that the releases were not valid—Meridian was awarded virtually the entire amount of its damages, plus interest.

However, as is often the case with disputes that go through litigation, it is worth considering this question: Was this really a victory? Almost 10 years of litigation (including three trials and an appeal) and the presumably substantial attorneys' fees point to the answer. **CE**

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Spearin Does Not Apply If Design Is Considered Performance Based. So, Who Decides?

THE AGE-OLD DEBATE over whether the government is liable for the designs it furnishes continues to be a hotbed of litigation. The issues at play in these cases typically turn on concepts like the *Spearin* doctrine, which espouses that the government impliedly warrants that its design is free from defects. In order for such a warranty to spring to life, the government must have supplied design specifications as opposed to less-detailed performance-based specifications.

When courts attempt to decide whether an implied warranty exists, they often look to the amount of discretion provided to contractors to choose means and methods. Readers are well aware that design specifications, which describe in precise detail the materials to be used and the manner in which the work is to be performed, leave little to no room for deviation; the contractor is required to follow them as a road map.

But the *Spearin* doctrine does not apply to performance-based specifications, through which the contractor is free to employ its own means and methods to achieve an end product that is acceptable to the client.

A recent decision, *James Talcott Construction Inc. v. United States*, sheds light on how the U.S. Court of Federal Claims considered a contractor's $1-million claim for an allegedly defective design specification on a federal military housing project.

The Case

In 2010, the federal government awarded a contract for construction of housing at a Montana military base to James Talcott Construction. The government issued a notice to proceed in June 2010 and stipulated a March 2012 completion date. Talcott began by placing concrete.

The contract called for a crawl space that would enclose wooden floor joists and subfloor decking. Talcott used untreated wood for the sheathing and the joists; this untreated wood required moisture levels to be maintained below 19 percent.

The government's design also incorporated sloped surfaces to divert water away from the foundation and into sump basins and trench drains. To prevent groundwater vapor from entering the crawl space, the design called for a 20 mm thick polyethylene sheet to cover the soil beneath the sheathing.

The facts presented at trial indicated that the concrete, wood, and soil remained exposed to snow and rain before Talcott enclosed the subfloor with sheathing. Talcott allegedly did not install temporary ground-vapor barriers despite the presence of moisture on-site.

> The rights afforded under the *Spearin* doctrine are not unlimited.

In early 2011, workers discovered considerable mold growth in the crawl space under one of the buildings, where the humidity levels measured close to 80 percent. Talcott performed mold remediation and completed its work. However, the work extended into July 2012, 145 days after the required completion date.

Talcott submitted a request for equitable adjustment (REA) to the government, seeking additional time-related costs and other monies stemming from the mold issue. Talcott's primary contention was that the design documents were flawed and resulted in the mold problems. Specifically, Talcott argued, the design did not contain a plan or procedure to prevent mold and failed to ventilate the crawl spaces. Talcott also contended that the government breached the contract by failing to disclose its superior knowledge relating to mold growth in those areas.

The government claimed Talcott's poor construction methods caused mold to grow in the crawl spaces and denied Talcott's REA. This prompted Talcott to file suit in the U.S. Court of Federal Claims.

The Decision

The court first considered Talcott's claim that the government's design documents were flawed, thus entitling Talcott to schedule relief and associated costs. The court began its analysis by noting the distinction between the types of specifications: "[w]hile there are two types of specifications, design and performance, only a design specification creates an implied warranty," it stated. In this case, the court determined that the specification for the finished structure was a performance-based specification. Looking at the contract, the court found Talcott responsible for the means, methods, and sequence of construction, as evident in this passage:

> The contract structural drawings and specification represent the finished structure. They do not indicate the method of construction. The contractor will provide all measures necessary to protect the structure during construction. Such measures shall include, but not be limited to, bracing, shoring for loads due to construction equipment ... [N]or will the [U.S. Army Corps of Engineers'] structural engineer be responsible for the contractor's means, methods, techniques, procedures, or sequences of construction.

Because Talcott was free to employ

its own means and methods to complete an acceptable finished product, the government did not breach its warranty of the plans and specifications, the court found. The court's decision also stated that the government could not have accepted the housing units in the condition they were in, "especially [with] mold that covered floor joists, decking, walls, grade beams, and even appearing grass-like in the soil."

The court also dismissed Talcott's claim that the government possessed "superior knowledge" relating to mold growth in the crawl spaces. The court relied primarily on the fact that Talcott was aware that damp conditions would result in mold growth due to Talcott's performance as a subcontractor on a separate, earlier phase of the housing construction, during which mold was found in crawl spaces. The court held, "Talcott was aware of mold growth while working as [a] subcontractor in other phases of construction. . . . [W]e find that Talcott knew, or should have known, that damp site conditions would inevitably lead to mold growth in the crawl spaces."

The court also found that the government provided Talcott with a geotechnical report during the bidding process that purportedly should have informed Talcott of the potential for mold growth. And the court added that even without the geotechnical report, Talcott was obliged under federal regulations to have performed a thorough site investigation before construction, which in the court's view would have informed Talcott about the potential for mold.

The Analysis

Talcott's other claims for damages due to the remediation were denied on the basis that Talcott did not perform its contractual duties in a workmanlike manner. The court was also persuaded that "simple steps could have been taken to adequately dry out the crawl spaces by installing temporary ventilation and/or dehumidification, which would reduce the humidity level in the crawl spaces."

This decision underscores that the rights afforded under the *Spearin* doctrine are not unlimited and that courts will evaluate whether allegedly defective designs are performance-based specifications before determining the existence of implied warranties. In situations like the *Talcott* case, in which contractors had discretion as to how to build the end products, contractors will not meet their burden of proof in demonstrating that the owners are responsible for their damages. **CE**

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Court Examines Engineer's Liability Under Design-Build Agreement

DISPUTES between contractors and engineers on design-build transportation projects—particularly on large, complex ones—have been a hot topic for several years. The disputes typically arise from differences between the preliminary design developed for the proposal and the final design ultimately approved for construction. Sometimes the problem manifests in terms of the costs related to material quantity increases. Other times the problem is because the preliminary design is not workable or acceptable to the owner, known as a design "bust."

Because the owner is largely insulated from these risks under the design-build process, bidding contractors are required to price in the contingency needed to account for design development. The problems are exacerbated because of the competitive procurement environment for design-build transportation projects, where low price is typically given far more weight than any other selection factor in deciding who wins the job. They are also made more difficult when owners compress the amount of time for design-build teams to develop their technical and price proposals.

Contractors and their design engineers often have intense and spirited contract discussions about the engineer's responsibility for proposal-related problems. Most knowledgeable contractors and designers establish parameters around these concepts in their teaming agreements. However, when there is a design bust, questions and disputes inevitably arise. Did the engineer meet its standard of care in the proposal design? Did the contractor underestimate the contingency needed to cover the potential problem?

There are only a handful of reported cases addressing this issue. This month's column discusses the most recent one, a Massachusetts Superior Court decision published late last year, *The Middlesex Corporation Inc. v. Fay, Spofford & Thorndike Inc.*

The Case

The dispute involved a design-build contract awarded by the Massachusetts Department of Transportation (MassDOT) to the Middlesex Corporation for the Kenneth F. Burns Memorial Bridge. MassDOT procured Middlesex through a typical two-phase, best-value method, by which short-listed proposers submitted technical and price proposals in response to a request for proposals (RFP). The RFP contained preliminary design documents that consisted of conceptual designs, sketches, and other technical requirements. The procurement time period was highly compressed. MassDOT delivered the RFP to the short-listed proposers on December 2, 2011, and proposals were to be submitted on February 10, 2012.

In anticipation of pursuing the project, Middlesex entered into a teaming agreement with Fay, Spofford & Thorndike Inc. (FST) (now part of Stantec). The agreement called for FST to, among other things, prepare an additional preliminary design to enable Middlesex to prepare its cost estimate. The teaming agreement also required FST to prepare an independent estimate for Middlesex to use in assessing quantities, provide its professional opinion on Middlesex's construction estimate for quantities, and comment on specific items that might be subject to quantity increases.

However, the teaming agreement specifically stated that FST "shall not have risk associated with estimate quantities and/or construction pricing." Moreover, the teaming agreement required Middlesex to verify FST's quantities and include an "appropriate degree of contingency" in its bid for "additional cost resulting from the post-award design development and finalization process."

Middlesex was the successful proposer, with a price of $89.76 million, which was $3.5 million lower than the next-lowest proposer. As contemplated in the teaming agreement, Middlesex awarded a contract to FST to complete the design and provide other professional services in support of construction.

After the project was completed, Middlesex sued FST in Suffolk County, Massachusetts, Superior Court for approximately $2.2 million. The basic claims by Middlesex were that FST failed to properly perform its services under the teaming agreement and that this resulted in Middlesex spending more money than it should have to perform the work.

The Decision

The court rejected all but one of Middlesex's many claims. The following quote aptly describes how the court viewed Middlesex's position:

> Underlying most of Middlesex' claims for breach of this Agreement is a contention that the preliminary design work done pre-bid would allow Middlesex to develop a fixed price bid with the same precision as a bid made on final contract drawings provided by the owner in a traditional construction project. That is not what the Teaming Agreement required.

Citing the teaming agreement, the court concluded that FST's prebid design work was preliminary in nature, "no greater than what was required to respond to the RFP, and sufficient to allow Middlesex to prepare cost estimates." The court was influenced by

the fact that Middlesex paid FST approximately $300,000 for its proposal-related services under the teaming agreement, but its subcontract to perform the design work was approximately $8.6 million. This demonstrated that there was a substantial amount of time needed for design development.

One of the biggest claims raised by Middlesex involved a $1-million overrun it allegedly experienced in structural steel. Middlesex subcontracted the steel work for $18 million based on 85,000 lb of steel, but the actual weight was greater. One reason for the increase was that FST and its bridge subconsultant incorporated stringers into the bridge's posttensioning system. FST failed to alert Middlesex that these were added to the proposal drawings. The court concluded that while FST should have done so, Middlesex did not prove that it was damaged. Middlesex did not use the proposal drawings in obtaining its subcontract price and effectively had a contract that was based only on an estimated quantity of steel. Because Middlesex carried $20 million in its cost estimate for all structural steel costs, and it only paid $19 million, there was no harm done, the court concluded.

One significant question considered by the court was what contingency Middlesex had in its bid; it found nothing directly identified as a contingency line item. Based on the evidence presented, the court concluded that "the Project was aggressively bid without clear definition of how much was included in the bid price to reflect a profit margin or allowance for contingencies."

The decision also noted that those experts who testified at trial concerning industry standards related to bidding on a design-build project had come to a consensus that a contingency fee of roughly 10 percent is typical. The court ultimately concluded that it was unnecessary for it determine the proper contingency percentage, as it found that in design-build projects, "weights, complexities and therefore construction costs invariably increase after the contract is awarded as design development proceeds to the final approved-by-owner construction design."

The one claim that the court recognized was associated with pavement design drawings. MassDOT had issued an addendum that increased the thickness of the asphalt to be laid at various locations. FST's asphalt cross sections, which Middlesex used for cost estimating and obtaining paving subcontractor bids, did not include these changes, so Middlesex issued a $126,000 change order to its paving subcontractor to address them. The court concluded that, even though a designer does not have an obligation to be perfect, FST should be held responsible for this mistake.

The Analysis

Middlesex raised many other claims involving interesting facts about design development and whether the engineer should have included more in its proposal. The court rejected those claims as well. As is obvious from the case result, this court was reluctant to shift the risks associated with design development to the engineer under the terms of this teaming agreement.

Contractors generally have a difficult time proving liability against designers for proposal-related mistakes. It may be because of the challenge in demonstrating the standard of care for designs that are not 100 percent signed and sealed. Other times, it is because of the ambiguity of contingency calculations and bidding decisions. And it can be, as in this case, because there appears to be no adverse effect from a design error and no financial impact on the contractor. **CE**

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When "Substantial Completion" Is Clear as Mud

ONE OF THE MOST important milestones in construction contracts is the date of substantial completion. Contracting 101 tells us that parties should clearly and expressly define their respective rights, duties, and obligations so that there is no ambiguity on this point. But what happens when the contract definition can have more than one meaning? A California appellate court recently grappled with whether to rely on the parties' substantial completion definition and date as the start of the limitations period, ultimately deciding a lack of clarity meant it could not.

The Case

The disputes in *Hensel Phelps Constr. Co. v. Superior Court of San Diego County* arose when Hensel Phelps entered into a prime contract with the owner and developer of a mixed-use project in San Diego. The parties used a modified version of a construction contract published by the American Institute of Architects (AIA). The project, a residential condominium tower, would eventually be managed and maintained by Smart Corner Owners Association, who was not a party to the original contract.

The contract obligated Hensel Phelps to achieve substantial completion within a certain time period. The substantial completion date is defined in the contract as: "that stage in the progress of the Work" when five events occur: (1) the work is sufficiently complete so that the building can be used for its intended purpose, (2) a temporary certificate of occupancy has been issued with no material conditions, (3) all utilities have been properly installed and approved by the utility companies, (4) the architect has issued its certificate of substantial completion, and (5) the contractor has certified that all remaining work ("as mutually determined by contractor, architect, and owner") will not interfere with the owner's use or enjoyment of the project and is capable of being completed within 60 days after the architect issues the certificate of substantial completion.

The contract further describes that substantial completion will only have occurred when all "designated or required governmental inspections and certifications have been made."

The project architect signed a certificate of substantial completion on May 24, 2007. The certificate was also signed by the owner's representative and countersigned by Hensel Phelps, acknowledging that the punch list attached to the certificate would be completed in 60 days.

The City of San Diego granted a temporary certificate of occupancy and began to perform required inspections. The project passed final alarm, sprinkler, and underground inspections in late June 2007. However, it failed its final electrical inspection in early July and did not pass the final structural inspection until July 17. Notwithstanding this, the owner recorded a notice of completion on July 10, and the City of San Diego began issuing certificates of occupancy for 24 individual condominiums on July 6.

The appellate court was not persuaded that the parties' definition or the certificate should trigger the statutory limitations period.

Fast-forward 10 years to July 6, 2017, when Smart Corner provided notice to Hensel Phelps of a construction defect claim. The notice identified numerous alleged defects in the project windows, doors, railings, private decks, waterproofing, concrete, bathtubs and showers, plumbing, venting, roof, and parking structure. Hensel Phelps declined to participate in an alternative dispute resolution. So Smart Corner sued for construction defects. Hensel Phelps sought a ruling from the court that the claim was barred by a 10-year statute of repose.

The statute of repose was enacted in California (as in most states) as an absolute outside date after which no claims can be brought against any party on a project. The California statute provides that the 10 years starts from the earliest of: (1) the passing of final inspections, (2) the recordation of final completion, (3) the date of occupancy, or (4) one year after termination or cessation of the work.

Hensel Phelps argued that the clock began to run on Smart Corner's claims on May 24, 2007, when the project architect issued its certificate of substantial completion under the contract. Smart Corner first argued that Hensel Phelps could not apply the contract's definition of substantial completion to the statute. Second, it argued that even if the contract definition were to trigger the statute, there was a factual dispute as to whether the contractual definition was satisfied on the date of the certificate.

The trial court denied Hensel Phelps's motion for summary judgment, finding no case law to support its argument that the AIA contractual definition begins the running of the 10-year clock on the statute of repose. Moreover, the court was concerned that several important inspections had not yet been completed until well after the certificate of substantial completion was issued.

The Appeal

Hensel Phelps challenged the trial court's decision on appeal. It argued that AIA contracts are widely used and respected in the construction industry and that the substantial completion date is a very important concept—understood by all project participants. Hensel Phelps cited the use of AIA certificates of substantial completion dating to 1963.

Importantly, Hensel Phelps argued that without reliance on the contractual definition of substantial completion—or the executed certificate—it would be impossible for contractors to ever have objective or verifiable certainty as to when substantial completion occurs for purposes of the statute.

The appellate court was not persuaded that the parties' definition or the certificate should trigger the statutory limitations period in the California code. It stated that while the certificate may be considered as part of the evidence, "[t]he date of substantial completion is an objective fact about the state of construction … to be determined by the trier of fact." The court determined that the contractual date should not govern, as it is not reflected or mentioned in the California code.Instead, the court declared that parties to a construction contract should "not arrogate to themselves the ability to conclusively determine when the statutory limitations period begins to run."

The Analysis

Ultimately, this decision underscores that the triggering of substantial completion—and hence statutes of limitation and repose—must be determined on a case-by-case basis in California. The court was not inclined to issue what it considered a bright-line rule that a signed certificate of substantial completion conclusively establishes the date for purposes of commencement of the statute. Notably, and not surprisingly, the Associated General Contractors of America filed an amicus brief in support of Hensel Phelps, but to no avail.

For some readers, it may be difficult to imagine that an executed AIA certificate of substantial completion could mean anything but a finite date on which all parties agreed an event occurred. But the appellate court considered the contractual standard as too dependent on the "judgment and discretion of the owner." Ironically, however, that is precisely the party who elected to file suit beyond the date of the architect's certificate.

From the court's perspective, not every project is going to involve the use of a standard form, so it did not want to rule that contractual definitions will govern the running of the statute. It remains to be seen if private parties in California will now modify contract language to stipulate the substantial completion date for purposes of the state's statute of repose. CE


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Will Pandemic-Related Construction Delays Be Compensable?

AN ENTIRELY NEW body of case law will unquestionably emerge from construction disputes related to the impacts of the COVID-19 pandemic. Last month we addressed the legal framework that courts will likely employ in resolving litigation related to these disruptions. The article, "Construction Industry Impacts in the COVID-19 World," was published online as part of *Civil Engineering*'s special coverage of the pandemic (news.asce.org/civil-engineering-special-coverage-covid-19).

The contract clauses that we anticipate will receive the most scrutiny will be related to force majeure or other, comparable provisions dealing with excusable delays, suspension of work, changes in laws, material cost escalation, safety/health requirements, protection of work, and notice requirements.

In what appears to be a preview of the newly evolving epidemic-related case law, the Civilian Board of Contract Appeals recently issued a decision evaluating a contractor's $1.2-million request for equitable adjustment relating to the 2014 Ebola outbreak in Sierra Leone. The result was not a good one for the contractor.

The Case

In 2013, the Department of State awarded a firm-fixed-price contract for $10 million to Pernix Serka Joint Venture (PSJV), of Lombard, Illinois, to build a rainwater capture and storage system in Freetown, Sierra Leone. The contract included an "excusable delays" clause that followed the Federal Acquisition Regulations (FAR). This clause provided for force-majeure-type scenarios that would entitle the contractor to time extensions only (but no money) for delays due to "acts of God," governmental acts, fires, floods, epidemics, quarantine restrictions, strikes, freight embargoes, or unusually severe weather.

For the contractor to request a time extension for any of those reasons, the delay had to be through no fault or negligence of the contractor and had to meet at least one of three prerequisites: (1) it could not have reasonably been anticipated; (2) it could not have been overcome by reasonable efforts to reschedule the work, or (3) it could not directly and materially affect the final date of completion.

The State Department issued a notice to proceed on December 17, 2013, and the contract required project completion 11 months later, by November 17, 2014. By August 2014, PSJV had completed approximately 65 percent of the project.

At that time, an outbreak of the Ebola virus had spread from Guinea to Freetown, Sierra Leone. Concerned about the virus's impact on the project and the safety of its personnel, PSJV contacted the contracting officer seeking instructions or a joint consensus on how best to proceed. The contracting officer responded via email providing little to no guidance, saying, "I can't at this time tell you to leave the [p]ost due to current conditions. I do understand that the situation there is [going] downhill fast. … It is up to you to make a decision as to if your people should stay or leave at this time. … [B]ut the decision for your people to stay or leave for life safety reasons rests solely on your shoulders."

On August 7, 2014, PSJV sent the State Department a notice of delay because of the Ebola crisis. The next day, the World Health Organization declared the outbreak an "international public health emergency" and airlines suspended flights. Some contractor and subcontractor personnel were asked to leave Sierra Leone because of the threat of the virus and the increased risk of not being able to leave the country later. Given the worsening conditions, PSJV decided to temporarily shut down the project work site.

In response, the State Department sent a letter stating:

> We are aware and acknowledge your concerns … about the impact of the Ebola [o]utbreak. … Since you are taking this action unilaterally based on circumstances beyond the control of either contracting party, we perceive no basis upon which you could properly claim an equitable adjustment from the [g]overnment with respect to additional costs you may incur in connection with your decision to curtail work on this project.

PSJV submitted an order-of-magnitude cost proposal for the additional life-safety measures needed to complete the project. The State Department rejected it, saying that PSJV had a potential for only a time extension for this event, not costs.

PSJV ultimately returned to the project in March 2015. The State Department granted a time extension for the 195 additional days requested by PSJV resulting from the Ebola outbreak.

In 2017, PSJV submitted a certified claim for $1,255,759 ($608,891 for life-safety measures to maintain a safe work site and $646,868 in disruption and demobilization costs).

The Ruling

The State Department moved for a quick resolution by the Civilian Board of Contract Appeals, arguing on summary judgment that because the contract at issue was a firm-fixed-price contract, PSJV assumed the risk of any unexpected costs not attributable to the government.

The board began its analysis by agreeing with the government that fixed-price contracts are simply that: fixed. The board pointed out that the FAR clause at issue (52.249-10) specifically addresses what happens in the event of an epidemic—that the contractor is entitled to more time but bears the risk of additional costs. Notably, the board saw no other clause in the contract that shifted the financial risk of an unforeseen event to the government. The ruling was particularly harsh in that it affirmed that the government had no duty whatsoever to provide

the contractor with direction on how to proceed in light of an epidemic.

PSJV pursued several other legal theories that it maintained shifted the risk of increased costs to the government, including the cardinal change doctrine, the constructive change approach, and suspension of work theories. Each was rejected out of hand.

The board stated that a cardinal change is a breach that occurs when the government makes a change in the contractor's work "so drastic that it effectively requires the contractor to perform duties materially different from those found in the original contract." Here, the board found that the work itself did not change; what changed was the outbreak and "the host country's reaction to the outbreak." This is true even though State Department records reflected internal discussions debating whether to issue a suspension of work.

The board said the constructive change doctrine applies when a contractor performs work beyond the contract requirements without a formal order due to some fault of the government. The board found no constructive change because the government provided no direction whatsoever. The suspension of work argument was dismissed because the contractor had not made reference to it in its original claim.

The Analysis

While it may not follow logically that the financial costs of a force majeure should be exclusively shouldered by one party, that is exactly how the clause works under FAR. The board stated that the firm-fixed-price contractor should have accounted for the possibility of an epidemic in its bid. However, in the "lowest-bid wins" contracting world of federal contracts, that logic does not align with reality. Considering an unforeseen weather condition to be a force majeure is one thing—contractors know how to address and manage that type of risk. But how can a contractor price a "black swan" event that is truly unforeseeable?

We suggested in last month's article some ways that contractors might be able to obtain cost relief for a pandemic like COVID-19. Now might be a good time for the industry to reassess the responsibility of owners for the financial impact of force majeure events.

The owner ultimately gets the benefits of the project for the multiple decades of its useful life. Contractors have no meaningful way to absorb the costs of an unimagined event on a given project. Does it make sense that the contractor and its supply chain bear this risk? **CE**

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What If the Levee Breaks? Board Balances Safety against Economic Waste

IN THE FEDERAL contracting world, damages awarded for construction defects are typically determined by the cost to repair or replace the defective work. However, when the requested repair is clearly disproportionate or unreasonable, given the value of the installed work, there is a question about whether making the repair would constitute economic waste.

Rooted in the concepts of equity and justice, the economic waste doctrine centers on the idea that forcing a contractor to bear the financial burden of ripping out perfectly good work to meet the hypertechnical requirements of a contract should not be permitted. It is a defense that is not often litigated and very difficult to prove, as we see in this month's Armed Services Board of Contract Appeals (ASBCA) case, *Appeal of Buck Town Contractors & Co.*

The Dispute

The U.S Army Corps of Engineers awarded a contract to Buck Town Contractors & Co., of Kenner, Louisiana, to construct part of a hurricane protection levee in St. Charles Parish, Louisiana. The placement of geotextile fabric by a subcontractor to Buck Town was integral to the levee construction. The contract included specific requirements regarding the installation, namely that seams and overlaps between the sections of fabric be installed perpendicular, not parallel, to the centerline of the levee. The fabric was also to meet contractually specified quality-control testing requirements.

Buck Town was required to ensure quality control and adherence to the contract specifications. The contract also specified that nonconforming geotextile work would be subject to remedial measures at the contracting officer's discretion "at no additional expense to the Government." The contract additionally included an inspection clause that placed the burden of replacing or correcting nonconforming work on the contractor.

During construction, Buck Town's subcontractor "installed some of the geotextile rows using overlapped, partial-length pieces of geotextile, when the end of a geotextile roll was reached in the middle of installing a row," according to the case summary. This practice was documented repeatedly in the daily quality-control reports and was observed by inspectors. This meant that some seams were parallel to the center line of the levee. The fabric was later covered with 7 ft of soil.

During the installation, Buck Town and the Corps submitted daily quality-control reports documenting the work. The Corps's quality-assurance and engineer reports occasionally included pictures of the noncompliant installation yet deemed the work "acceptable." The contracting officer visited the jobsite and observed the geotextile installation.

The Corps did not identify the geotextile installation as noncompliant until Buck Town began installing geotextiles on a separate levee reach under a separate contract. Upon learning of the method of overlapping, the Corps required Buck Town to pull apart the first levee, replace the geotextile, and install a second layer of geotextile. Buck Town did so under protest.

After Buck Town completed the levee reconstruction as directed by the Corps, the Corps then argued that Buck Town failed to fully comply with the geotextile testing protocol. The Corps again required Buck Town to pull apart the levee and install yet another layer of geotextile fabric. Buck Town argued that this would constitute economic waste because, on average, the levee met the contractual requirements for strength. Buck Town then commissioned an engineering report to support its contention.

Buck Town ultimately submitted a claim to the contracting officer for approximately $3 million for all costs associated with the Corps's directives. When the contracting officer denied the claim, Buck Town appealed to the ASBCA.

The Decision

With respect to the first reconstruction, the board agreed with Buck Town that the Corps had constructively waived the geotextile seam requirement, even though the contracting officer claimed no actual knowledge of the noncompliant work. The board noted that in order to successfully allege constructive waiver, a contractor must demonstrate four requirements. First, that the contracting officer possessed knowledge of work outside the scope of the contract. Second, that action or inaction by the contracting officer indicated acceptance of the noncompliant work. Third, that the contractor acted in reliance on that acceptance. And finally, that there would be inequity if the initial acceptance was retracted.

For Buck Town, proving the contracting officer had knowledge was the key hurdle. The board recognized it was legally possible for a contracting officer without "actual" knowledge of the noncompliance to nevertheless be charged with what is called "constructive" knowledge (i.e., knowledge you are presumed to have, regardless of whether you have it). Here, the board reasoned that there was ample evidence that the contracting officer knew or should have known about the parallel seams. The contractor's and Corps's quality-control reports, coupled with the Corps's description of the work as "acceptable," along with the presence of the contracting officer at the jobsite during the work in question all pointed toward constructive knowledge.

Buck Town fulfilled the remaining requirements because this constructive knowledge as well as the direction it was given to proceed with work indi-

cated that the Corps had accepted the work. Buck Town relied on that acceptance to its detriment by installing the fill over the fabric, and the board found that it would be inequitable if the contracting officer required a correction of the already installed fabric.

With regard to the second reconstruction, Buck Town alleged that the Corps's direction constituted economic waste. The board observed that while the government usually has a right to demand strict compliance with contract specifications, there are exceptions in which work "is acceptable for its intended purpose" and obtaining strict compliance would be economically wasteful. In order to prove an economic waste defense, the board stated that the contractor had to show that the work substantially complied with contract specifications, the work was adequate for its intended purpose, and the cost of correction was economically wasteful.

Considering all this, the board declined to find for Buck Town. Buck Town's expert witness did not convince the board by a preponderance of evidence that the average strength of the levee satisfied the contractual requirements of geotextile strength. Rather, the board agreed with the Corps's expert that the contract required individual tests to meet contract requirements, highlighting the expert's characterization of levee systems as "only as strong as their weakest links."

The Analysis

This decision gives important guidance to owners and contractors. The board rejected Buck Town's economic waste argument in part because of the implications for public safety. The board noted that the potential damage from a levee failure could result in the loss of hundreds of thousands of structures, property damage in the billions of dollars, and substantial loss of life—potentially rivaling the damage incurred during Hurricane Katrina.

However, owners should take notice of the fact that Buck Town proved that the Corps had constructive knowledge of its means and methods and thus waived the contract requirements. It is very unusual to prove government waiver, as knowledge is not often imputed to government actors only by their review of the work. But the board found that it would be unfair to saddle Buck Town with the costs of the first reconstruction when, based on what everyone should have known at the time, Buck Town's approach to the geotextile installation seemed acceptable. **CE**

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Limiting Contingent Payment Clauses: A New Trend?

ONE WAY general contractors seek to limit their exposure to the risks of owners not paying them is by including pay-if-paid clauses in their contracts. These clauses state that a subcontractor will not be paid unless the prime contractor is paid. Because of the harshness of such a provision, several states have declared pay-if-paid clauses unenforceable. When they are allowed, they are typically enforced only when the parties meet a certain threshold, such as expressly agreeing that payment by the owner to the general contractor is a condition precedent to the subcontractor being paid.

Another way general contractors seek to limit their risk is through pay-*when*-paid clauses. These provisions differ in that they deal only with timing. Pay-when-paid clauses link the timing of the subcontractor's payment to the time when payment is made by the owner, as long as that is within a reasonable time.

This month, we highlight a recent California appeals court decision striking down a general contractor's pay-when-paid provision as patently unreasonable.

The Case

California's North Edwards Water District wanted to build a water treatment facility that would remove arsenic from its water. It engaged Clark Bros. Inc. as the general contractor to build the plant. It was a public project and not subject to mechanic's liens, so state statute required Clark to obtain a payment bond. The bond was intended to provide a distinct remedy to the subcontractors in the event of nonpayment by Clark. Insurance company Travelers issued the bond at Clark's request.

Clark subcontracted with Crosno Construction to build two 250,000 gal. steel reservoir tanks at the site for $630,000. The subcontract included a pay-when-paid clause in case the district delayed making payments. The clause stated, in part, that if payment was not forthcoming by the owner, Clark or its sureties had a reasonable time within which to make payments to Crosno. The clause went on to detail that a "reasonable time" would mean sufficient time for the contractor to litigate with the owner. The relevant section read:

> If Owner … delays in making any payment to Contractor from which payment to Subcontractor is to be made, Contractor and its sureties shall have a reasonable time to make payment to Subcontractor. 'Reasonable time' shall be determined according to the relevant circumstances, but in no event shall be less than the time Contractor and Subcontractor require to pursue to conclusion their legal remedies against Owner.

Crosno worked on the project for nine months, at which point it was ordered to halt all work because of a dispute between Clark and the owner. At the time it stopped work, Crosno had fabricated the steel, primed the steel in its shop, transported the steel to the site, erected the tanks, and almost completed coating the steel in the field. Most of its invoices were unpaid, leaving a total of $562,435 outstanding. Crosno filed a stop-payment notice with the district and made a claim on the payment bond. Travelers denied the bond claim as premature, citing the pay-when-paid clause in Crosno's subcontract and claiming that Travelers was not obligated to pay until the end of the litigation between Clark and the district. Crosno then sued the district, Clark, and Travelers.

At the trial, Crosno sought an early ruling that the surety was liable under the bond. It argued that the pay-when-paid provision in its subcontract was unenforceable because it was at odds with a state statute protecting against the imprudent or unknowing waiver of rights. Specifically, the statute requires a signed written waiver and release by a subcontractor in order to affect or impair its rights under the payment bond. Because there was no written waiver by Crosno, it argued that the clause requiring it to wait for Clark and the district to end their litigation violated the statute.

The appellate court decisively agreed with the lower court's analysis that the clause at issue impermissibly waives the subcontractor's payment rights.

The trial court agreed with Crosno, relying in part on the reasoning in a recent California Supreme Court case declaring pay-*if*-paid provisions void because they are against public policy.

The Appeal

On appeal, the court framed the legal question as relating to whether a surety may use a pay-when-paid clause as a defense "to delay its bond obligation to a subcontractor until some unspecified point" in time. The appellate court decisively agreed with the lower court's analysis that the clause at issue impermissibly waives the subcontractor's payment rights.

While careful to clarify that not all pay-when-paid clauses in subcontracts are void, the appeals court determined that the fact that the pay-when-paid clause defined "reasonable" as dependent on a potential, unknown, future litigation "impaired or affected" the rights of the subcontractor to receive payment within a reasonable time. The appeals court also said the timing of the

litigation between Clark and the owner illustrated why such a clause was unreasonable: the owner and Clark were still involved in a lawsuit almost three years after Crosno initially sought recovery.

Travelers's arguments were likewise unpersuasive. The surety argued that voiding the pay-when-paid clause would effectively make contractors and their sureties "financers of … projects when the owner delays making payment." The court did not mince words in response to the surety's protest, stating: "[T]hat is precisely the point."

Likewise, the court noted that the statutory scheme reflects an express preference to provide expedient enforcement procedures to subcontractors over prime contractors, who are required to insure against the risk of owner nonpayment. Finally, the court was not convinced that the surety should be able to rely on the subcontract provisions just because its bond incorporates the subcontract.

The Analysis

This ruling was of such importance to the industry that both the American Subcontractors Association and the Construction Employers Association filed briefs attempting to persuade the appeals court to rule in their respective favors. While we will, of course, report on any subsequent appeal to the California Supreme Court, it is noteworthy that just a few months ago, a New York state court issued a similar ruling.

That court ruled that a pay-when-paid provision was not enforceable when a subcontractor had to wait for more than two years to receive payment. Instead, the provision could only be enforced to the extent that the delay in payment was for a reasonable amount of time after the work was completed. To hold otherwise would be to obliterate any difference between a pay-when-paid and pay-if-paid, according to the court.

Suffice it to say, subcontractors face substantial financing risk when they depend on general contractors getting paid by owners. Notably, neither the New York nor the California decision defined what would be considered a reasonable amount of time for a general contractor to withhold payment under a pay-when-paid provision. Three years was essentially found to be unreasonable in California (although the case was decided because of the uncertainty of the payment) and "well over two years" was held to be unreasonable in New York. **CE**

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Contractor Required to Rip Out Work Despite Inspection Approvals

IT IS NOT UNUSUAL for federal government construction contractors to have claims arising from the failure of the government's construction inspectors to catch noncompliant work. The law has been fairly clear on this point: The presence of a government inspector does not typically shift responsibility for the sufficiency of the work from the contractor to the government. While this probably seems fair, what happens if an inspector is present during performance and does not object to nonconforming work? Can the government later insist on strict compliance with the contract? This month's case, *Appeal of Watts Constructors*, offers an answer.

The Case

The disputes in this case arose from the U.S. Army Corps of Engineers' construction of a facility for satellite communications in California. The construction contract was awarded to Watts Constructors in the amount of $38,914,500. Watts subcontracted the entire scope of the electrical work to Helix Electric Inc. The electrical specifications relevant to this dispute provide:

> "Wiring Methods: Provide insulated conductors installed in rigid steel conduit, IMC (intermediate metal conduit), rigid nonmetallic conduit, or EMT (electric metallic tube), except where specifically indicated or specified otherwise or required by *NFPA 70* to be installed otherwise."

(*NFPA 70* is the National Electrical Code published by the National Fire Protection Association.)

The Corps had an "institutional preference" for using rigid conduit to run electric power cable in buildings because it believed that conduit-installed power lines would last longer. Helix apparently knew of the Corps' desire but had its own preference for a less expensive power cabling, called flexible metal-clad cable. Despite its concerns that the Corps might not permit the use of MC cable, Helix identified portions of the contract specifications that it believed permitted the use of this type of cable throughout the buildings.

For example, Part 2 of the "Interior Distribution System" section of the electrical portion of the contract's specifications is titled "Products" and lists required specifications for several dozen identified electrical distribution products. One of the products listed is MC, and the applicable subsection states: "Metal-Clad Cable, UL 1569, *NFPA 70*, Type MC cable." Additionally, in Part 3 of the contract, labeled "Execution," specifications in Section 3.1, "Installation," include installation instructions for various items, including MC.

The drawings, however, refer only to conduit. Moreover, one legend referencing wiring clearly depicts that conduit was to be used throughout.

The Corps had been on-site and inspected the wiring installation before the walls were enclosed and made no objection to the use of MC.

Helix largely completed three of the buildings, accounting for approximately 60 percent of the wiring, with MC before the Corps directed Helix to stop.

The Corps had been on-site and inspected the wiring installation before the walls were enclosed and made no objection to the use of MC. However, the Corps representative who had been conducting the inspections was not primarily performing a quality-assurance function for electrical work but was focused on other disciplines. Once the Corps' QA electrical engineer inspected the job and discovered the MC cable, the Corps directed Helix to rip out and replace all the MC with conduit. Helix complied. This entailed demolishing walls already placed.

Helix submitted a certified claim of $415,120 to Watts, and Watts passed the claim through to the Corps. When the contracting officer denied the claim, Helix, through Watts, appealed to the Armed Services Board of Contract Appeals.

The Appeal

At trial, Helix's project manager conceded that the legend applied to all electrical lines, that nothing in the drawings indicated the use of MC as acceptable, and that the drawings required conduit. However, Helix argued that a portion of the drawings allowed for MC because one drawing sheet depicted a solid line connecting outlets, and Helix believed this allowed for "generic" conduit. Additionally, Helix introduced evidence that one of the Corps' QA representatives who had conducted inspections believed that the specifications allowed for MC.

The board concluded that MC did *not* qualify as conduit as referenced in the contract. It did so by applying well-established contract interpretations, namely, that contracts should be read as a whole to harmonize and give meaning to every word, leaving no word superfluous. Construing the contract as Helix requested would render the specific references to "conduit" meaningless.

Helix also argued because of the government's acquiescence to its use

of MC and the government inspectors' beliefs that MC was permitted, the Corps was required to interpret the contract as being "in harmony."

The board noted that the failure of Corps' inspectors to halt the use of MC early in the contract —before the closure of walls and near completion of the wiring work — was "troubling." Nevertheless, the board found that it was Watts' responsibility to comply with the terms of the contract. Moreover, absent affirmative misconduct (not alleged or proved in this case), the Corps' failure to enforce the terms of a contract did not prevent it from later enforcing those terms. Finally, the board found that the Corps did not waive compliance with the strict terms of the contract and that it was entitled to later reimpose any requirements on the contractor.

The Analysis

The board decision makes no reference of whether Helix argued that the Corps' actions constituted economic waste. When work of this nature is required to be ripped out and replaced to achieve strict compliance with the specifications, contractors are at times successful in proving that there was a more cost-effective way to resolve the dispute. However, because the contractor took a gamble on its selection of materials, installing more economical cable as opposed to the more rigid conduit, economic waste would have been difficult to prove.

Additionally, it is doubtful the board would have been sympathetic to that argument, since it noted that Helix simply "saw what it wished to see" when it reviewed the plans and specifications and used MC instead of the required rigid conduit. While the court noted it would have been "far better" had the Corps' inspectors caught the issue, it indicated that their inaction did not change the meaning of the contract.

Some interesting takeaways from this decision include the importance of using the request for information process as a matter of course to clarify the contract if an ambiguity exists. Additionally, most contracts have order of precedence clauses, meaning that to the extent that there appears to be a conflict, one trumps the other — for example, detailed specifications usually take priority over boilerplates and drawings.

Finally, even though government personnel observe noncompliant work without objection, the government always has the right to come back and insist on strict compliance with the contract. **CE**

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The Road to Default Termination Is Littered with Risk

MAKE NO MISTAKE, the decision to terminate a contracting party for default is one of the most costly decisions an owner or general contractor can be faced with — and it is fraught with all kinds of contractual, legal, and financial risk. First, the terminating party has to consider the potential costs of re-procurement and assume that it will pay dearly to obtain a bid from a new contractor bold enough to take on a partly finished project. As a close second, the terminating party has to contend with a vast array of post-termination damages it may face due to the default.

A termination will undoubtedly affect project financing and will significantly affect the project schedule. Additionally, a decision to terminate will very often mean "buying yourself a lawsuit" if the terminated party holds a different view of how and why the business deal soured. With so much on the line, it is no wonder that the propriety of a termination for default can be one of the most hotly contested issues in construction litigation.

Recently, in *Conway Construction Company v. City of Puyallup*, an appellate court in Washington state addressed whether an owner had jumped through the appropriate procedural hoops in terminating its general contractor for default. Like so many cases involving termination, the owner had failed to properly dot its i's and cross its t's in making its decision and so ultimately lost the case.

The Case

The City of Puyallup, Washington, contracted with Conway Construction Co. for road improvements. During construction, the city became concerned about the quality of Conway's pavement concrete, alleged defects in utilities, and other construction defects. The city also observed purportedly unsafe work conditions, such as a lack of trench shoring. The city reported those concerns to the Washington State Department of Labor & Industries. On March 9, 2016, the city issued a notice of suspension and breach of contract, within which it identified nine items that it deemed to be material breaches of the contract, including the allegedly defective work and safety concerns. The city informed Conway it had 15 days to cure the breaches.

Conway denied any wrongdoing. On March 21, the city informed Conway that it still needed to remedy the nine items, that they remained uncorrected, and that additional reports of safety violations were being received. Conway again denied any wrongdoing. On March 25, the city terminated Conway's contract for default. The following month, the Department of Labor & Industries issued a citation to Conway for a "serious" safety violation endangering Conway workers.

Conway sued the city, seeking to have the default termination overturned and converted to a termination for convenience (in other words, a no-fault termination). Conway later amended its lawsuit to pursue breach of contract and unjust enrichment claims against the city. In a bench trial, the court ruled in favor of Conway, and the city appealed.

The Appeal

The city raised several issues on appeal. Its primary argument was that the trial court used the wrong legal test to determine whether the city properly terminated the contractor for default. The city also argued that the contract entitled it to an offset for Conway's allegedly defective work.

The U.S. Court of Appeals first addressed the propriety of the termination itself. The city and Conway had presented different legal standards by which the termination should be evaluated. The city argued that the trial court should have used the following two-prong test: Was Conway in default, and if so, was the city satisfied with Conway's efforts to remedy the breach? Conway argued that the city had to meet a different second prong: Did Conway neglect or refuse to correct the rejected work?

The contract was silent on the matter of how long the contractor would have to remedy the breaches (the cure period), stating simply that the city was entitled to terminate the contract for good cause. It listed a series of those potential causes, including the contractor's failure to comply with state or local regulations. However, the Washington State Department of Transportation specifications were also part of the contract documents. Those specifications explicitly stated that the contractor would have 15 days to cure an alleged default prior to termination based on that default.

The city argued that based on the contract's order-of-precedence clause, the contract should prevail if it conflicted with the WSDOT specifications. The court, however, held that the contract and specifications were not in conflict with each other because the contract itself was silent on the issue of a cure period. Rather, the specifications served to supplement the contract. The court also noted that in the city's contemporaneous default letters to Conway, the city had in fact identified a 15-day cure period, leading the court to conclude that the city contemporaneously understood that the specifications were operative and that the contract and specifications complemented each other.

While the specific findings of the trial court were somewhat unclear from the Court of Appeals' decision, the court suggested that Conway — despite denying wrongdoing — did not neglect to or refuse to correct the allegedly deficient work. The court rejected the city's argument that the corrective work needed to be entirely completed within 15 days to the satisfaction of the city.

On the issue of the city's cited safety concerns, the court relied on the trial

court's finding that, in practice, the city "essentially deferred the safety issue" to the Department of Labor & Industries. The trial court found that Conway worked directly with the Department of Labor & Industries and had addressed the safety issues in question. The appeals court took no issue with this finding, holding, "Conway had 15 days to cure the identified safety breach. It did so by working with (the Department of Labor & Industries) to address the safety concerns and then by notifying the city about its actions." The decision makes no reference, however, to the (post-termination) April notice of safety violations by the Department of Labor & Industries.

Next, the city appealed the trial court's ruling that denied its claim for damages for replacing the defective work it discovered after it terminated Conway. The city cited the contract, which contained a setoff clause that would apply even if the owner had terminated the contractor for convenience. The court concluded that because the city actually breached the contract by terminating it and did not provide Conway an opportunity to cure the alleged defects, the city was not entitled to post-termination damages.

The Analysis

This decision provides several helpful reminders for owners encountering performance problems or contractors facing unsubstantiated allegations of defaults and/or notice to cure letters. First, courts will appropriately view terminations for default as drastic remedies that require not only full justification but strict procedural adherence to contracts. As is evident here, courts apply a high standard of proof to determine if an owner has followed proper procedures in making its termination decision. A default termination based on a generally subjective belief that a project is incurably off course will not suffice.

Second, clear communication is integral to avoiding costly, time-consuming performance disputes — particularly when it comes to developing a "get well plan" on a troubled project.

Finally, readers should note that evidence of bias against a contractor will always loom large in a termination for default case. Therefore, terminating parties should expend every effort to develop solid legal, factual, and well-documented outlines prior to terminating and make every attempt to work with the parties alleged to be in default. **CE**

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Who Bears the Risk When Contracts Do Not Turn Out as Expected?

WE TRY TO AVOID headlines that are as vague as this one, but it seemed a fitting way to discuss this month's case, in which the first sentence of the court's decision states: "Contracts do not always turn out the way a party expects." That is quite an understatement.

Most of our columns discuss this precise situation: One party expected something from a contract, failed to achieve its expectations, and then asked a court to help. We suspect that most readers evaluate our description of the dispute, and then have a strong sense of which party should win or lose. Let's see how you will do with this month's case, *D2 Excavating Inc. v. Thompson Thrift Construction Inc.*

What are the lessons learned from this case? One easy one is that litigation is unpredictable, and you never know what a court will do.

The Case

Thompson Thrift Construction Inc. was the general contractor on a new apartment complex in Corpus Christi, Texas. It solicited a bid from D2 Excavating Inc. for site grading and excavation. Thompson sent D2 documents that included proposed contract terms, a topographical survey of the site, and the planned final elevations. This included Thompson's standard template subcontract, which stated, among other things, that: "This is a balanced site. It shall be this subcontractor's responsibility to balance site. Change orders for import/export will not be accepted." Balanced, in this type of project, means that the amount of soils excavated will equal the amount needed to grade the site, thus minimizing the amount of soils to be imported or exported.

Despite what Thompson represented in the subcontract, Thompson did not actually determine whether the site was balanced. The site was impacted by two months of heavy rain and, D2 later claimed, Thompson was eager to begin construction as soon as the rain ceased. So rather than physically examining the site, D2 used a software program to determine that the site was balanced, the inputs for this analysis coming from the topographical survey Thompson provided. After performing its simulations, D2 agreed to do the excavation and signed the subcontract.

Shortly after D2 began excavating, it became clear that the site was not balanced and that D2 would have to remove soil from the site. The parties disagreed over why this was the case. Thompson argued that the imbalance was due to D2's inaccurate computer analysis, D2's excess import of fill, or D2's over-excavation. D2 argued that the topographical survey was flawed. The parties negotiated, and Thompson ultimately agreed to cover D2's costs for the additional work and issue a written change order once all the work was done.

Based on this, D2 continued excavating. Thompson repeatedly asked D2 to re-excavate and regrade areas that other subcontractors' activity had disturbed. While D2 did this, it eventually became concerned that Thompson would not actually pay for this work. The parties negotiated again, and when it became clear that Thompson was not going to pay additional amounts for the removal of soil, D2 stopped working, with 98.6% of the excavation having been completed.

D2 sued for breach of contract in a Texas federal court, asking for approximately $258,000 for excess excavating work. Thompson filed an unsuccessful motion for summary judgment, which argued that D2 bore the risk that the site might be unbalanced. The court found for D2 on all its claims and also awarded D2 more than $350,000 in legal fees. Thompson appealed this decision to the 5th Circuit Court of Appeals.

The Appeal

The primary issue before the 5th Circuit was Thompson's argument that D2 bore the risk that the site might be unbalanced and could not recover additional monies for any excess excavation work. Regrettably for D2, the 5th Circuit agreed with Thompson.

The court looked first to Texas case precedent interpreting an 1899 contract to construct a building in San Antonio. This case found that "the party doing the work bears the risk that it will end up being more difficult than anticipated unless the contract shifts that risk to the buyer of the services." As stated by the court, this rule "flows from the basic contract principle that 'where one agrees to do, for a fixed sum, a thing possible to be performed, he will not be excused or become entitled to additional compensation, because unforeseen difficulties are encountered.'"

In assessing the facts of this case, the 5th Circuit determined that the excavation subcontract did not allocate to Thompson the risk that the site would be unbalanced. Rather, it placed this risk on D2. The court looked at

the language of the subcontract, in which D2 agreed that it had "visited the Project site, become familiar with local conditions under which the Work is to be performed and correlated personal observations with requirements of the Contract Documents." D2 also represented under the subcontract that it would "evaluate and satisfy itself" about a number of conditions, including "the location, condition, layout, and nature of the Project site and surrounding areas." Finally, the subcontract stated that D2 would not be "entitled to an adjustment in the Contract Price or an extension of time resulting from (its) failure to fully comply" with those conditions.

On the basis of these provisions, the 5th Circuit found that, "Someone has to bear the loss of additional costs … and the excavation contract did not shift those costs to Thompson."

D2 argued that the subcontract did not explicitly state that D2 assumed the risk. The court did not find this compelling. "(E)ven if the language we just cited does not assign the risk to D2, the contract must say that Thompson assumed the risk that the project would require removing more dirt than the plans predicted. It does not."

The 5th Circuit acknowledged that a valid modification of the contract by a change order could have made Thompson liable. However, it stated that change orders, like any modification, must satisfy the normal requirements of a contract: "a meeting of the minds supported by consideration." The oral change order between Thompson and D2 lacked what is called "consideration," or the exchange of legal value. "D2 acknowledges that the alleged consideration was its exporting excess soil," the court stated. "The original contract already obligated D2 to do so without any compensation beyond the contract price. Hauling the dirt, therefore, cannot serve as consideration. The oral change order is void."

The primary issue before the 5th Circuit was Thompson's argument that D2 bore the risk that the site might be unbalanced and could not recover additional monies for any excess excavation work.

The Analysis

We wonder how many civil engineers would expect that result. We surely did not. The language in the subcontract about visiting the site, et cetera, is standard language in many construction contracts and has rarely been used to defeat claims in situations like this. That it was done here is particularly unusual, given other findings by the lower court — and cited by the 5th Circuit — that Thompson itself never checked to see that the site was balanced when it made that representation in the subcontract and that D2 did not physically examine the site, in part because of the rain and schedule pressures.

It would be one thing for D2 to have done nothing to verify that the site was balanced. There are some courts that would find that a party like D2 would have to show some reasonable due diligence. But one might ordinarily think that the steps D2 took before signing the contract — such as running a computer simulation using data furnished by Thompson — would be deemed sufficient to shift the risk of the problem to Thompson. Obviously, this court did not.

The other troubling piece of this decision is the fact that the parties agreed during the course of the project that the over-excavation was extra work and that D2 would be paid. Consideration certainly is a necessary component of every contract. But the parties clearly seemed to have a meeting of the minds on this issue, and D2 relied upon what Thompson said when it continued to do work. Looking at the equities, it would certainly seem that this should have turned the result in D2's favor.

What are the lessons learned from this case? One easy one is that litigation is unpredictable, and you never know what a court will do. Another is the potential precedential value of this case. The 5th Circuit Court of Appeals is just one level below the U.S. Supreme Court. Decisions by U.S. Circuit Courts of Appeals carry a great deal of weight, and while this decision was based on Texas law, who knows how it may be used in the future? Readers should keep in mind that Texas law does have some variants on both Spearin Doctrine liability and differing site condition remedies that need to be understood if one is doing business there.

Finally, if a potential client like D2 came to our office before signing the contract and presented this to us, what would we advise? Visit the site, come hell or high water? Before this case, probably not. The computer modeling would probably have been enough of a reasonable investigation. Now? We probably would recommend a visit. **CE**


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