Overreaching May Mean Client Gets Nothing

Because clauses related to liquidated damages, known as LDs, are so common in construction contracts, many people have come to assume that if the parties agreed to them in the contract, the LD clause must be enforceable. That is not always a correct assumption. The longstanding principle of LDs is that they must bear a reasonable relationship to the actual damages expected to be incurred by the party who will collect them. Stated differently, if an owner has the right to recover LDs for the late performance of a contractor, the owner must demonstrate that its LD formula and amount reasonably correlate to the costs it expected to incur from not having the facility available to it by the specified contract date.

Most of the reported case law on schedule-related LDs addresses disputes over excusable delays, such as whether the contractor was entitled to a time extension that would mitigate some or all damages. However, every now and then there is a case discussing the validity of the LD formula and amount. This issue's case, *Appeal of Sauer Inc.*, does just that.

The Case

The U.S. Army Corps of Engineers awarded a $33 million design-build task order to Sauer Inc. for work associated with the construction of the new 82nd Airborne Division headquarters building in Fort Bragg, North Carolina. The task order divided the work into three phases: construction of the new building; furniture installation and the move into the new building from the existing headquarters; and demolition of the existing headquarters building and construction of a parking lot for the new building. Each phase had a specific date by which it was to be completed, and the overall project was to be completed in 700 days. The task order specified LDs of $4,365.81 for each day beyond the deadline if the project was not completed on time.

Sauer finished the first two phases on time but was 33 days late in finishing the third phase. The Corps assessed LDs against Sauer for that delay in the amount of approximately $144,000. Sauer argued that this was inappropriate because the Corps had been able to occupy the new headquarters four months before the overall contract's completion date. It noted that the work associated with the new building (i.e., the first phase) represented 98.7% of the total construction-related costs and that phases 2 and 3 involved only minor work that did not affect the Corps' "beneficial occupancy" of its new headquarters.

If an owner has the right to recover liquidated damages for the late performance of a contractor, the owner must demonstrate that its LD formula and amount reasonably correlate to the costs it expected to incur from not having the facility available to it by the specified contract date.

The Corps rejected Sauer's position, primarily on the grounds that the LD provision was tied to completion of all three phases, not just the first phase. This prompted Sauer to appeal to the Armed Services Board of Contract Appeals.

The Appeal

Sauer filed a motion for summary judgment, arguing that there were no material facts in dispute as to its claim that the LDs should not have been assessed. In a rather lengthy and well-reasoned decision, the ASBCA largely agreed with Sauer's position.

The ASBCA referred to the principle that it was improper for the federal government to assess LDs after the date of substantial completion and that the government had the burden of not only establishing the date of substantial completion but also whether the period of time for which the government assessed the LDs was correct. It also noted that the terms "substantial completion" and "beneficial occupancy" are used interchangeably and that "beneficial occupancy" is associated with the owner using a facility prior to the completion of the contract. Given this, the first question the ASBCA evaluated was whether Sauer had substantially completed the project late so as to justify the LDs.

In deciding this question, the ASBCA noted that the Corps' original request for proposals did not divide the project into phases but instead had a single completion date for all work. The RFP was eventual-

ly revised to create the three phases. The Corps argued that by doing so, "the parties agreed that each phase would have functionally equivalent importance regarding performance" and that it was appropriate to have LDs tied to completion of the entire project.

The ASBCA rejected this argument. It found that simply dividing a contract into phases, without anything more, does not establish the functional equivalence or importance of each phase. The Corps offered "no evidence supporting a finding that completion of phase III was functionally equivalent to completion of phase I or, for that matter, phase II."

The ASBCA ruling stated:

"Other than its bare allegation that the existence of a phased contract establishes the singular import of each phase, the government offers no evidence that strict compliance to completion of all three phases truly was 'essential.' The task order provisions cited by the government do not speak to the parties' expectations regarding the owner's reasonable use of the facility, or whether the project was capable of adequately serving its intended purpose at the time the government claimed the right to assess liquidated damages."

Based on this, the ASBCA concluded that phases 1 and 2 were substantially completed on time and not subject to LDs. The ASBCA was unable to make a summary judgment determination on whether the third phase was substantially completed on time and concluded that more facts were needed to sort this out.

The ASBCA then turned to the issue of how to address the assessment of LDs, given that the Corps had only established one daily rate for the entire project as opposed to individual LD amounts for each phase, as would normally be expected. The Corps argued that the full $4,365.81 daily rate was appropriate, and Sauer argued that this rate was unreasonable relative to delays to phase 3.

The ASBCA agreed with Sauer, stating: "The government's assessment of the full amount of daily liquidated damages after substantial completion and acceptance of the first two phases is unenforceable." Consequently, it said, if the third phase was not substantially completed on time, the Corps would be entitled to "some measure of apportioned liquidated damages." The amount of the apportioned LDs would ultimately be subject to the evidence produced at trial.

Most owners know that when using distinct phases or milestones, they need to have separate LDs for each phase/milestone, particularly when there are discrete completion dates in the contract for them.

The Analysis

Two elements to this decision are particularly interesting. First, most owners know that when using distinct phases or milestones, they need to have separate LDs for each phase/milestone, particularly when there are discrete completion dates in the contract for them. The root cause of the dispute in this case was that the Corps failed to do this. It is hard to imagine that the owner's expected costs from late completion delaying its move to a new building would be the same as those arising from a delay in the contractor finishing the demolition of an old building and construction of a new parking lot. The ASBCA cited longstanding principles that the owner has the duty to demonstrate the reasonableness of its LD rate, and with the small amount of work associated with the third phase in this case, the Corps could clearly not use the full rate.

Secondly, Sauer and the ASBCA argued that the LD amount should be apportioned (i.e., reduced) for phase 3 delays. This is not what we would have expected. Schedule LDs reflect an agreed-upon amount of damages for delay. In this contract, there was no contractual agreement between the Corps and Sauer as to what the daily rate would be for delays to phase 3. As a result, we would have expected the LD clause to be rejected outright as being unreasonable, with the Corps having to then prove its actual damages.

While the parties could always have agreed during the contract as to what an appropriate rate should be, they did not. While we are almost sure this case will settle, it would be interesting to find out how the ASBCA would ultimately handle this question. **CE**

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Ambiguous Specs Do Not Protect Contractor

In the federal contracting world, contractors face an uphill battle in pursuing claims for increased costs during construction. For starters, the procedural timeline is fraught with delays and is costly in itself. Contractors are required to first submit their claims to the contracting officer for disposition, and then move to either a board of contract appeals or a court of federal claims for a lengthy trial process. And successfully proving legal theories against the government is usually very difficult.

This is demonstrated by this issue's case, *Appeal of CBRE Heery Inc.*, which involved a design-build contractor that finished a project late and was assessed more than $1 million in liquidated damages. While the design-builder was able to demonstrate that there were ambiguities in the specifications, it was unable to show that this was sufficient to earn it liquidated damages and cost relief.

Facts

The U.S. Army Corps of Engineers hired CBRE Heery Inc. to design and build a replacement medical clinic at Seymour Johnson Air Force Base in North Carolina. The contract contained a clause indicating that Heery was responsible for the professional quality, technical accuracy, and coordination of all designs. The contract further limited any liability by the Corps for the design by cautioning that neither the Corps' review, approval, or acceptance of Heery's work nor payment for any part of the contract was to be construed as a waiver of any of the Corps' rights. Additionally, the contract's order of precedence clause stated that the relevant codes, criteria, and standards took precedence over both the program for design (known as the PFD) and the drawings.

An issue arose over whether one of the rooms in the facility (1919) was considered a vault or a cage. This distinction was significant, as the requirements for doors and walls differed depending on the designation, with a vault having more rigorous criteria. The PFD was inconsistent with regard to its description of room 1919. On the one hand, the PFD indicated the department in which the room was located would include a "secure storage vault." On the other hand, the PFD used a code on that room that indicated it would be a cage. The PFD was also unclear as to whether room 1919 would store controlled substances (which, if so, meant the room had to be a vault).

While the design-builder was able to demonstrate that there were ambiguities in the specifications, it was unable to show that this was sufficient to earn it liquidated damages and cost relief.

The request for proposal's drawings were also inconsistent in describing this room. While the drawings labeled room 1919 as a "secure storage vault," the room's drawing had walls that consisted of dashed lines, indicating a cage. (Vaults were to be indicated in the drawings by solid lines.) And Heery's technical proposal included a drawing that showed a secure storage vault but with dashed-line walls.

Before starting work, the Corps and Heery held a 10-day design charrette to confirm the design requirements. The government's representative clarified that room 1919 was meant for the storage of narcotics, which required compliance with controlled substances vault standards. This led to an improved but not perfect clarification of the design. The parties replaced room 1919's dashed-line walls with solid-line walls on the drawings. But the drawings continued to refer to the room as a cage. At the end of the charrette, the Corps sent the contractor a PFD listing all the agreed-upon changes and room 1919 was given the code for secure vaults (SSV01). Heery's 35% and 65% design drawings labeled room 1919 as a "secure vault," assigned it the SSV01 code, and used solid lines for the walls. These changes were preserved in the final (100%) design that was approved by the Corps. Unfortunately, the individual door and wall drawings were still based on the room being a cage, not a vault.

Construction began, and Heery installed the door and walls in accordance with its final design. While the Corps' initial inspection did not bring up any concerns, at some point after installation the Corps determined that the door and walls were noncompliant. Under protest, Heery complied with the Corps' order to build the door and walls in accordance with the vault standards. Heery then filed a claim for its in-

creased cost and time. When the contracting officer denied the claim, Heery appealed to the Armed Services Board of Contract Appeals, arguing, among other things, that the Corps had constructively changed the contract documents by adding more work.

nized the significance of using the term "vault" in its design, particularly when coupled with the SSV01 room code.

The board reasoned that even if the Corps had ordered Heery to perform additional work, that should not have caused the contractor increased costs and delay. The reason was that the "change" was communicated to Heery at the design charrette stage. During the design charrette, the Corps corrected the drawings to use solid-line walls for the room, corrected the PFD to use room code SSV01, and informed Heery that the room would store controlled substances. In turn, Heery acknowledged these changes and included them in its three designs.

The board also ruled that the Corps' approval of the 100% design and the Corps' initial inspections, during which it did not object to the room, did not constitute a waiver of the design requirements. "Where the contract places on the contractor the burden of compliance, the presence or absence of a government inspector does not shift responsibility for the sufficiency of the work from the appellant to the government," the board stated in its ruling.

Here, the board stated that prior to the government's approval of the final design, Heery did not inform the Corps that the doors and walls were noncompliant with the design requirements. Moreover, the contract specified that government review, approval, acceptance, and payment could not be construed as waiving the government's rights.

Simply stated, an owner's inspection is not intended to function as the contractor's quality assurance/quality control process, and it is up to the contractor to ensure that it meets the contract's requirements.

Appeal

While the board agreed with Heery that the request for proposal's design documents were ambiguous as to whether room 1919 was a vault or a cage, it nevertheless concluded that Heery had failed to prove that there was a constructive change to the contract. The contract clearly specified the requirements for vaults used for the storage of controlled substances and that those vaults needed to comply with the Department of Defense's *Unified Facilities Criteria 4-510-01*, which in turn mandated compliance with controlled substances vault standards. The board was influenced by its reading of the design requirements and the process of the design charrette, during which it was made clear that the room was associated with controlled substances.

Heery unsuccessfully argued that the term "vault" had no legal significance. The board noted that *UFC 4-510-01* imposes particular requirements on the term "vault." The board stated that a reasonable design professional, the standard against which Heery was to be measured in its design role, would have recog-

Analysis

The board's decision in this case is not surprising. Ambiguities frequently occur in design-build requests for proposals and proposal documents. However, in this case, the ambiguity was clarified during a post-award and pre-commencement design charrette, and the results were accepted by the design-build contractor. This was reflected in its partial and final designs. It is unclear why the doors and walls were not changed, but it was likely inadvertence; mistakes happen. But this would not put the risk of that mistake on the owner.

Bear in mind, as with most federal decisions we report on, the government's acceptance of a contractor's partial and final designs, despite the design's noncompliance with the contract requirements, typically does not constitute a waiver of the government's right to insist upon proper performance. Many design-build contractors are frustrated by the reality of this situation. Simply stated, an owner's inspection is not intended to function as the contractor's quality assurance/quality control process, and it is up to the contractor to ensure that it meets the contract's requirements. **CE**

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Why Withhold Information from Bidders?

Public owners have long been reluctant to provide bidding contractors with certain project information such as historical geotechnical reports and as-built drawings. Why? They typically think the information is old and unreliable or that it is unimportant. Or they fear the bidders will claim they were misled by the information and then successfully pursue a claim.

Those reasons may sound good in theory, but they are poor in reality. The problem is the "superior knowledge" doctrine. This doctrine has been part of public-sector contracting for decades and essentially gives a contractor the right to recover against an owner when the owner fails to turn over relevant information to the contractor. This month's case, *Marine Industrial Construction LLC v. United States*, considers several superior knowledge claims raised by a contractor as it tried to defend against a default termination by the U.S. Army Corps of Engineers.

The Case

The project involved a hydraulic dredging procurement contract issued by the Corps for a waterway in Washington state in 2014. The Corps typically procured dredging services for this waterway every two to three years, and the procurements were all very similar. However, in this situation, the Corps made some major changes, including using a performance-based specification versus a design-based specification. In doing so, it also removed certain information, disclaimers, and warnings, such as those for sunken boats, fishnets, steel trolling wire, and machinery — all of which were likely to cause frequent downtime. It also left out precipitation information for the area and warnings that fast currents resulting from precipitation would likely carry large logs and trees that could damage equipment. The Corps also added a boat basin to the scope of work, and the basin was located on a portion of the waterway that had not been dredged in full since 1982.

Marine Industrial was the lowest bidder. It had more than 60 years of dredging experience and an excellent contract-performance rating on numerous government dredging contracts. Marine Industrial's price was 31% below the next-lowest bidder, and the Corps asked it to verify that its bid was valid. The bidder did so, and it was awarded the contract.

The project was almost immediately beset by problems and delays. There were several storms that disrupted the work as well as delays related to equipment problems and floating logs that damaged Marine Industrial's discharge pipes. Marine Industrial also experienced delays in the boat basin portion of the work caused by, among other things, debris that clogged its dredging equipment and allegedly unexpected clay in the basin that it had difficulty dredging.

Within four months of Marine Industrial starting the project, the Corps issued a cure notice and ultimately terminated the contract for default 156 days into the project. By this time, Marine Industrial had dredged about 16% of the total yardage required under the contract.

Marine Industrial sued the Corps in the U.S. Court of Federal Claims for having wrongfully terminated the contract, alleging that the delays it encountered were excusable. It sought almost $650,000 in additional costs caused by, among other things, the Corps' failure to disclose its superior knowledge and the existence of differing site conditions. The Corps responded by seeking more than $1 million for additional costs for procuring a replacement contractor and raised various defenses to the default termination.

The case is certainly a strong reminder that when one is changing longstanding specifications, one needs to consider whether the deleted or altered information could be material to the bidding contractors.

The Decision

Each party filed summary judgment motions on several aspects of the dispute, including the superior knowledge claims, and the court issued a 50-page opinion. The court started its analysis by citing the standard for determining a breach of contract under the superior knowledge doctrine. It stated:

> (Marine Industrial) must produce specific evidence that it: (1) undertook to perform without vital knowledge of a fact that affects performance costs or duration; (2) the government was aware (Marine Industrial) had no knowledge of and had no reason to obtain such information; (3) any contract specification supplied misled (Marine Industrial) or did not put it on notice to inquire; and (4) the government failed to provide the relevant information.

The court found that Marine Industrial met its burden on one of its major claims, that the Corps failed to disclose its superior knowledge that a

12 in. discharge pipe was required to complete the project.

Marine Industrial pointed to the fact that four of the five solicitations preceding 2014 required a minimum 12 in. diameter discharge pipe. And in fact, when the Corps resolicited for this project, it reinserted the 12 in. minimum discharge pipe size. Marine Industrial argued that the Corps withheld the pipe size information to increase competition on the solicitation, and that led Marine Industrial to believe that its pumps, with their 10 in. diameter discharge pipes, would be sufficient to move the described materials.

The Corps countered this argument by stating that there was no evidence that the Corps believed that a smaller-diameter pipe would not be sufficient. The Corps acknowledged that it eliminated the minimum pipe size requirement in an effort to create a performance specification-based solicitation, in which it would not dictate means and methods. However, it contended that Marine Industrial could have completed the project using its 10 in. pipe, although it would have taken more time.

The court concluded that Marine Industrial had met each of the four superior knowledge standards. Marine Industrial was unaware of the 12 in. minimum pipe size requirement from past solicitations because the Corps had removed that requirement in its 2014 solicitation. The Corps also removed the provision notifying bidders of the availability of prior dredging records, which would have presumably included the past solicitations with the minimum pipe size requirement. Marine Industrial "had no way to learn of this fact, even if it wanted to," the court stated. The court was particularly influenced by the Corps having reinstated the 12 in. minimum pipe size requirement in the reprocurement offer.

The court noted that because the government is required to only specify restrictive conditions "to the extent necessary" to complete the job and "assuming the government abided by the law in the years before and after 2014," the inclusion of a minimum 12 in. pipe size "necessarily implies this is the least restrictive means to complete the contract." It rejected the Corps' argument that a smaller pipe size could be sufficient to complete the project, stating that even if a narrower pipe size may have been sufficient under certain circumstances, it did not change the fact the government made pipe size vital to the contract and then failed to disclose it.

The court stated:

> Once the government sets a minimum requirement for a solicitation, it is not required to maintain that minimum requirement for every subsequent solicitation. Where, however, the government establishes a minimum requirement that it uses for several years — one it identifies multiple times as minimally "sufficient" — and then fails to inform bidders that it has removed the minimum requirement, the government impermissibly withholds vital knowledge.

The court found that the minimum pipe size affected the performance costs and duration of the contract, as evidenced by the significant delays and costs caused by clogs in Marine Industrial's 10 in. pipe.

The decision pointed out that although the difference between a 12 in. pipe and a 10 in. pipe may appear minor, a 10 in. pipe has a 31% smaller cross-sectional area than a 12 in. pipe. "This change affects the fluid velocity and pressure drop which, in turn, affects dredging performance," the court stated. "A smaller pipe would also increase the likelihood of delays due to clogs than would otherwise occur with a larger pipe."

The court summarily considered the other elements of the superior knowledge doctrine, finding that the Corps was aware that Marine Industrial had no knowledge of the 12 in. minimum pipe size on other projects and the failure of the Corps to indicate that pipe size would be important to completing the project — and the absence of prior dredging records — would not lead Marine Industrial to inquire about such a pipe size. It stated:

> The government's silence as to pipe size could mislead bidders to surmise a pipe size much smaller than 12 (in.) would be adequate, without knowing the government for years described 12 (in.) as the minimally 'sufficient' size.

Analysis

This case is not a garden-variety superior knowledge case, in which the information at issue is in a standalone document of some sort, like a set of as-builts. The Corps likely did not think about whether it should have disclosed the 12 in. minimum pipe size to comply with the superior knowledge doctrine.

How will this play out in future projects? The case is certainly a strong reminder that when one is changing longstanding specifications, one needs to consider whether the deleted or altered information could be material to the bidding contractors.

Interestingly, Marine Industrial won one other superior knowledge claim, related to debris in the boat basin, but lost two others, dealing with the excess floating logs and the basin clay. The court was heavily influenced by whether Marine Industrial did its job in investigating the site, as required by the contract documents, and based its decisions accordingly. Bidders should also remember that to win on a superior knowledge claim, the information you complain about cannot be reasonably discoverable from completing pre-bid investigations. **CE**

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Contractor's Site Conditions Claim Fails Due to Specific Disclaimers in Bid

When unanticipated soils are encountered on projects, contractors and owners may find themselves in opposite camps almost immediately. Contractors typically rely on differing site conditions, known as DSC, or changes clauses to seek recovery of excess costs. Owners sometimes rely on disclaimers in the bid documents and other exculpatory clauses alerting bidders that they are not entitled to rely on the information provided and that they bear the risk for any conditions encountered. While disclaimers are intended to shield owners from liability for geotechnical information furnished at bid time, DSC clauses may be at odds with those disclaimers, creating ambiguity.

In this month's case, we highlight a recent opinion from a New Jersey appellate court in *Scafar Contracting Inc. v. City of Newark* that interpreted the legal effect of certain disclaimers on a contractor's claim.

While disclaimers are intended to shield owners from liability for geotechnical information furnished at bid time, DSC clauses may be at odds with those disclaimers, creating ambiguity.

The Case

The disputes concerned an award to construct a combined sewer overflow facility for the city of Newark, New Jersey; the project involved extensive excavation. The request for bids included the removal of an estimated 7,000 tons of nonhazardous soil and 10,000 tons of hazardous soil. Scafar Contracting Inc. submitted a bid for approximately $10 million, which the city accepted. The contract between the parties contained a DSC clause that stated:

> Should concealed conditions encountered in the performance of the Work below the surface of the ground ... be at variance with the conditions indicated by the Contract Documents, or should unknown physical conditions below the surface of the ground ... differing materially from those ordinarily encountered and generally recognized as inherent in work of the character provided for in this Contract, be encountered, the Contract Sum shall be equitably adjusted by Change Order upon claim by either party made within twenty days after the first observance of the conditions.

The contract also contained several disclaimers regarding the accurate description of the site conditions contained in the RFB documents such as: 1) the information was provided for general purposes only and could not be grounds for a claim against the city; 2) the city did not warrant the accuracy of the information; 3) the information could not be relied on by the contractor, which was responsible for conducting its own independent subsurface investigation; and 4) the contractor could not draw inferences or conclusions from the information when planning the means or methods of construction.

Additionally, one provision of the RFB documents stated that a contractor's submission of a bid was an affirmative representation that the bid documents contained sufficient information to enable the contractor to form its bid:

> The submission of a Bid will constitute an incontrovertible representation by Bidder that Bidder has complied with every requirement … that without exception the Bid is premised upon performing the Work required by the Bidding Documents and applying any specific means, methods, techniques, sequences or procedures of construction that may be shown or indicated or expressly required by the Bidding Documents, that Bidder has given (the city's engineer) written notice of all conflicts, errors, ambiguities and discrepancies that Bidder has discovered in the Bidding Documents ... and that the Bidding Documents are generally sufficient to indicate and convey understanding of all terms and conditions for performing the Work.

The RFB documents contained test boring logs and a report that indicated the presence of brick, building debris, and metal fragments in the fill material. Silty clay and silty

sand were noted as being below the level of fill. While Scafar was completing the work, its efforts to install a cofferdam were hindered by subsurface debris, which Scafar alleged to extend deeper than in the logs and report. Scafar filed a $1.6 million claim based in part on having encountered DSCs.

Scafar was unsuccessful in its attempt to obtain a summary ruling on its DSC claims, arguing that the DSC clause entitled it to additional payment for its expenses. It also tried unsuccessfully to preclude the jury from seeing the exculpatory clauses. The jury found in the city's favor. Scafar appealed.

The Appeal

Scafar's appeal was primarily based on the argument that the trial court wrongly denied its motion for summary judgment, as contractual exculpatory clauses cannot trump DSC clauses. It also argued that by allowing the jury to see the exculpatory clauses, the trial court "tainted the verdict by confusing the jury as to the law." The appellate court dismissed both arguments and affirmed the lower court's ruling.

As to the motion for summary judgment, the appellate court found that a question of fact existed as to whether the subsurface obstructions that delayed installation of the cofferdam differed from those represented by the bid documents. It noted that the project manual disclosed that the site had been the location of warehouses, factories, and other structures and that the contractor would be expected to remove "old uncharted foundations, rubble from former structures, timber piling[,] and concrete pipe, concrete pipe supports, [and] timber cribbing ... that may contain debris such as tires, cinders, glass, ash, wood, metal and steel."

Other sections of the RFB stated that the soil comprised "9 to 17.5 feet of fill," which included "silty sand with gravel, brick, building debris, wood, and metal fragments." These representations were sufficient to require that the issue of whether there was a DSC go to the jury — the ultimate fact finder in the case.

The appellate court also found that another contract provision supported the trial judge's denial of summary judgment of any claim Scafar had against the city based on the bid documents:

> It is also understood and agreed that the Bidder or the Contractor will not use any of the information made available to [Bidder] … in any manner as a basis or ground of claim or demand of any nature against the [City or (its engineer)], arising from or by reason of any variance which may exist between the information offered and the actual materials or structures encountered during construction.

Scafar argued that if exculpatory clauses are allowed to "swallow the rule" with respect to DSC clauses, such an interpretation would "undermine the stability within the construction industry [which] … rel[ies] on the use of the DSC clause in exchange for lower construction costs." The appellate court concluded that DSC and exculpatory clauses may validly coexist in the same contract. Looking at New Jersey and federal precedent, the court noted that while general disclaimers of liability for inaccurate representations of site conditions will not defeat a DSC, specific disclaimers can. The court found that some of the disclaimers in the contract met that standard for specificity, particularly as to the right to rely upon the test results.

Analysis

The fact that the appellate court upheld the trial court's decisions is not surprising. Remember that summary judgments are granted based on undisputed material facts. The determination of whether a particular site condition meets the standard for being a DSC is factually intensive. One person could find that a DSC exists, while another person could find that the condition was reasonably expected to be encountered based upon information provided. This is not to say that the jury got the answer right. However, that is always the risk of going to a jury, and those jury determinations are not easily appealed.

The appellate court's decision cited the *Spearin* doctrine and acknowledged that when the government makes a positive statement of fact about the character of work to be performed, the contractor may reasonably rely on that information. However, the court also cited precedent that the contractor must also absorb expenses that would have been avoided if the contractor had been "conscientious in its investigation." Here, the court noted that the contractor did not conduct a site visit during its bid. This is also consistent with case law from around the country.

What is more challenging is the appellate court's discussion of exculpatory clauses. It was unclear as to which contractual disclaimers fit the specificity standard and which ones did not. From a practical perspective, it did not matter, as the jury's decision could have been based on the grounds that there was no DSC. But based on the language cited above, the disclaimers certainly seemed to the authors to be more general than specific. There is a lesson to learn from this: Beware of jury trials! **CE**

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Make Sure You Understand the Scope of Your Agreement to Arbitrate

One of the many challenges faced by all parties in the construction industry in drafting their contracts is the issue of dispute resolution. All else being equal, most general contractors and general engineering consultants strongly prefer arbitration over litigation relative to their disputes with owners. Many of arbitration's advantages, such as speed of resolution and the use of industry-experienced arbitrators, are highly desired by any party seeking money from its contracting counterparty. However, if your company or firm is defending a claim — and may be the one paying — the litigation process is typically the preferred route, as it is expected to take a longer time and cost more money for the party pursuing its claim.

But what happens to disputes between subcontractors and general contractors in which the owner might have some involvement or financial responsibility? If the prime contractor arbitrates the issue with the owner but must litigate the issue with the subcontractor, the prime contractor could face inconsistent results. And what happens if there is an issue with the subcontractor for which the prime contractor would like to arbitrate with the subcontractor, regardless of whether the owner is involved?

Many prime contractors have developed subcontracts that attempt to balance all these points. For example, some subcontract clauses give prime contractors the sole right to decide when and if to arbitrate. Some subcontracts explicitly narrow the type of disputes that a subcontractor can raise in arbitration. While the use of creative dispute clauses can certainly work, they sometimes create litigation over the very issue the parties have or have not agreed to arbitrate about. This month's case, *SR Construction Inc. v. Peek Brothers Construction Inc.,* is a prime example of this.

The Case

The project involved a medical center in Reno, Nevada, owned by Sparks Family Medical Center Inc., an affiliate of United Health Services of Delaware. UHS entered into a cost-plus with a guaranteed maximum price agreement with SR. This contract was based on standard forms created by the American Institute of Architects, including the AIA Document A201–2017, General Conditions of the Contract for Construction. After executing the prime contract with UHS, SR awarded a $3.1 million work order to Peek to complete the project's core and shell civil work. The work order was issued under a master subcontract agreement, or MSA, between SR and Peek.

The dispute between SR and Peek concerned $140,000 in additional costs for the building pad. Peek alleged that it bid the project assuming it would mass-grade the building pad to a few feet below the required elevation, dig the building footings and plumbing trenches, and then use the excavation spoils from the footings and trenches to backfill and grade the pad to the proper subgrade elevation. However, Peek apparently deviated from this plan after an SR employee directed Peek to import soil to elevate the pad before digging the footings and trenches. This enabled the pad to be elevated earlier than if the original sequence had been followed.

While SR rejected Peek's change order request, it passed Peek's claim for this work to UHS. UHS rejected the change orders and directed SR to initiate dispute resolution with Peek. Before SR could do so, Peek sued SR in a Nevada district court. SR filed a demand for arbitration with the American Arbitration Association, in which it named UHS and Peek as defendants. SR simultaneously moved to compel arbitration in district court.

Arbitration agreements are consensual, and it is up to the parties to clearly state when they do not want to arbitrate.

SR's motion to compel was based on the MSA's arbitration provision, which stated that there would be no arbitration between SR and Peek unless the prime contract had an arbitration requirement, and a dispute between SR and Peek involved issues of fact or law that SR was required to arbitrate under the terms of the prime contract. The prime contract's arbitration provision mandated arbitration for any unresolved claims, with the term "claim" being quite broad, and including any "disputes and

matters in question between" UHS and SR arising out of or relating to the contract. SR argued that Peek's $140,000 claim fit precisely within the scope of the MSA's arbitration agreement.

The district court denied SR's motion to compel arbitration. It held that the prime contract required arbitration only of disputes between UHS and SR and that Peek's dispute with SR was not arbitrable under the MSA because it did not involve UHS. SR appealed this decision to the Nevada Supreme Court.

The Appeal

The Nevada Supreme Court began its analysis by looking to prior Nevada case precedent holding that: "There is a strong presumption in favor of arbitrating a dispute where a valid and enforceable arbitration agreement exists between the parties" and that "Nevada courts resolve all doubts concerning the arbitrability of the subject matter of a dispute in favor of arbitration." It found that the AIA arbitration clause was broad, as it encompassed all disputes related to or arising out of the underlying agreement. As a result, "even matters tangential to the subject agreement will be arbitrable under a broad provision."

Peek tried to argue that the MSA's arbitration clause was narrow because the clause stated that a dispute is not arbitrable "unless two prerequisites are satisfied." The court rejected this position, because one of those prerequisites was whether the dispute "involves issues of fact or law which [SR] is required to arbitrate under the terms of the prime contract." As noted, the court found that the prime contract's arbitration clause was broad and expansive. This had the ultimate effect of making the MSA arbitration clause broad.

Contrary to what the lower court found, the Nevada Supreme Court concluded that the MSA clause did not limit its application to disputes relating to issues involving only SR and Peek. As a result, the court found it irrelevant that UHS was not a defendant in Peek's lawsuit and that Peek was not a party to the prime contract's arbitration agreement. "Under the MSA provision's plain language, if SR would have to arbitrate an issue of fact or law under the prime contract with UHS, then in turn, SR and Peek must arbitrate that same issue."

Separately, the Nevada Supreme Court was impacted by the nature of Peek's claim under the cost-plus guaranteed maximum price prime contract. Under the prime contract, UHS was only to compensate SR for "costs *necessarily* incurred by [SR] in the proper performance of the Work."

Peek argued that SR's mismanagement caused its additional costs by unnecessarily directing Peek to import additional material to elevate the building pad's subgrade."Peek's allegation amounts to a 'claim' about whether its costs were reasonably incurred, which involves issues of fact and law that SR would have to arbitrate with UHS when seeking reimbursement for those costs under the prime contract."

Finally, the court was influenced by the fact that the AIA prime contract included a consolidation-of-arbitration provision in matters involving common legal and factual issues. Specifically, SR could include subcontractors in its arbitration with UHS if SR determined that the subcontractor was relevant to the disputed matter. The MSA also had a consolidation clause, which provided that "the same arbitrator(s) utilized to resolve the dispute between any Owner and Contractor shall be utilized to resolve the dispute under [the MSA] provision."

The court found many common questions of law and fact between the Peek-SR dispute and the SR-UHS dispute. Among the questions noted in the opinion were: Who was at fault for importing the additional material? Did UHS direct SR to work faster, thus prompting SR's alleged request of Peek? Was importing additional material reasonable in view of the larger project timeline?

The court found that because it was likely that the Peek-SR dispute would involve the same witnesses and evidence as in the SR-UHS dispute, it had the power to order arbitration because of the mutual consolidation-of-arbitration provisions in the underlying contracts.

The Analysis

While this case focused on Nevada law, it provides the same type of analysis that would be involved in other states — given the strong federal and state support for enforcing arbitration agreements. Arbitration agreements are consensual, and it is up to the parties to clearly state when they do not want to arbitrate. Stated differently, courts routinely enforce arbitration clauses and compel parties to arbitrate, particularly with clauses like those found in AIA contracts, which are broad and intended to cover any dispute.

Finally, remember that this case involved a $140,000 dispute. The legal fees to get to this point alone must have been substantial, and the arbitration process has not even begun. It serves as a reminder that parties should have tight, understandable language around the disputes clause that says what they want so that substantial money and time are not spent on just getting to the dispute forum. **CE**


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Geotechnical Subcontractor Unable To Prove Negligence Against Inspecting Engineer

Design professionals performing inspection services are typically shielded from liability for claims brought by parties with whom they do not have contracts. However, exceptions to the general rule exist. Contractors and subcontractors occasionally find success in suing architects or engineers for negligence if those individuals exercised a significant degree of authority and control over the contractors or subcontractors. Whether a duty of care is owed to the party being supervised is usually determined by whether the architect or engineer had the right to authorize or withhold payments, administer the contract, reject nonconforming work, and/or approve specifications and designs. In this month's case, *Southeast Caissons LLC v. Choate Construction Co.*, a state appeals court addressed whether an owner's engineer committed negligence and bad faith in the performance of its inspections of a drilling subcontractor.

The Case

The disputes in this case arose from the construction of a 174,000 sq ft concrete parking deck for Wake Technical Community College (owner) in North Carolina. The deck was to be supported by cast-in-place concrete caissons installed in drilled shafts, which were to be drilled until hitting hard rock with sufficient bearing capacity. The owner engaged a contractor, Choate Construction, to construct the parking deck, and the owner also contracted with an architect and a structural engineer. The architect entered into a subcontract with Falcon Engineering for design-stage geotechnical investigation. The owner later entered into a direct contract with Falcon, whereby Falcon was to evaluate bearing capacity, observe drilling operations, and record drilled pier dimensions, reinforcement, and rock bearing materials. Falcon was to prepare inspection reports for each drilled shaft.

Southeast Caissons submitted a bid to Choate for the installation of the shafts. Choate included in its bid proposal a payment schedule that specifically included payment for "drilling in 'rock' or 'not in soil,' which was defined as "auger refusal or when a drill advances no more than 2 inches in five minutes with full torque and crowd force of the rig being applied." Importantly, the prime contract did not distinguish between drilling in different materials, and instead used one price for drilling to design depths.

Southeast's bid was not the lowest, and Choate initially awarded the shaft drilling to another subcontractor. Soon after, Choate learned that the lowest bidder could not meet the project schedule. Following a meeting with Southeast, Choate sent Southeast a formal subcontract that, like the prime contract, used one set price for both drilling in soil and rock (not in soil). Southeast did not sign the subcontract and the parties' negotiations over the next several months were unsuccessful. Southeast ultimately performed its work without a written subcontract.

Before the subcontract negotiations broke down, there was a predrilling meeting with representatives of the owner, Choate, Southeast, Falcon, the architect, and the structural engineer. Among other things, the parties discussed the process for determining when the shafts reached competent bearing material. It was agreed the shafts were to be drilled until Southeast hit hard rock, at which point Falcon would inspect the bottom of the drilled shaft to confirm the shaft was on hard rock that was suitable bearing material. During that meeting, Southeast asked when it would be paid a higher rock unit rate, as opposed to a soil unit rate. Southeast was told that only under limited circumstances would further drilling be necessary or required once the drill reached rock.

Working without an executed contract puts great risk on both parties.

During the course of the work, Southeast was required to drill into rock and submitted a claim for those additional costs. The claim was unresolved, and Southeast filed suit against Choate and Falcon. As to Falcon, Southeast alleged that the firm was negligent and acted in bad faith, as Falcon "'discontinue(d) the measurement of auger refusal on its field drilled shaft reports' thereby 'arbitrarily and capriciously denying (its) rock pay.'"

Falcon submitted a motion for summary judgment, arguing that its contract with the owner did not require it to record auger refusal in its inspection reports. Falcon acknowledged it had noted auger refusal on a few inspection reports but discon-

tinued the practice because Falcon's inspectors determined Southeast was not actually demonstrating true auger refusal. Additionally, Falcon argued that its contract did not confer upon it a duty to record or observe an entitlement to rock pay based on auger refusal. The court agreed with Falcon and dismissed Falcon from the case.

As to the dispute between Southeast and Choate, the case went to jury. The jury found that no contract existed between Southeast and Choate and that Southeast's claims should be dismissed. Southeast appealed to the North Carolina Court of Appeals.

The Appeal

The issue before the appeals court relative to Falcon was whether the lower court erred by granting Falcon's motion for summary judgment. Southeast argued that it had demonstrated genuine issues of material fact on its claims against Falcon for negligence and bad faith and that it was entitled to have the jury hear those facts. The appeals court rejected Southeast's arguments.

As to the negligence claim, the court first noted that Falcon and Southeast did not have a contractual relationship. Under North Carolina law, parties were historically required to be in privity of contract to sue for damages such as those raised by Southeast. However, more recent North Carolina case law evaluated this issue on construction projects and found that liability could be imposed on an architect or supervising engineer working on a construction project in the performance of its work for the owner in the absence of privity.

The appeals court noted that this case law was based on the fact that "the function of the architects encompassed considerably more supervisory control, including the right to authorize or withhold payments, administer the contract, reject nonconforming work, and approve specifications and designs." Therefore, while privity of contract is not necessarily required for a contractor or subcontractor to maintain a negligence action, "the imposition of such negligence liability must still be limited to those cases where the architect or engineer exercised a significant degree of authority and control over the contractor and subcontractor."

In this case, the appeals court concluded that Southeast failed to show Falcon exercised enough control or authority over Southeast's work to overcome the privity requirement. Falcon's role was to supervise the drilling and excavating for the caissons and determine whether adequate end bearing material had been met. Falcon did not design the plans and specifications for the project and did not have the authority to release, revoke, alter, or increase the requirements of the contract, control the contractor's means or methods, or stop work for the project. Furthermore, Falcon did not have authority to authorize or withhold payments. The project's architect had this broad supervisory control.

As to the bad faith claim, Southeast argued that Falcon provided disputed facts as to whether it gave a "'professional and unbiased, objective record of the work that was done on the job.'" Again, the appeals court rejected this. It observed that Southeast's argument assumed that Falcon had the contractual duty to be the final arbitrator of whether Southeast had reached auger refusal and make corresponding notations in its inspection reports.

The court found that Falcon's agreement with the owner did not place these duties on Falcon. Moreover, Falcon explained that although it had notated auger refusal during the beginning stages of the construction, Falcon ultimately determined that Southeast was not demonstrating true auger refusal and discontinued the use of this notation. Given this, the court found that the trial court did not err in determining Southeast's claim for bad faith failed as a matter of law and granting summary judgment.

The Analysis

Southeast waged an expensive battle on two fronts against two parties with whom it had no written contracts. As to its claims against Falcon, it was critical for Southeast to fit within the exceptions to North Carolina's view of how noncontractual parties can be liable to others for economic losses. It failed to do so, given the very narrow work that Falcon was charged with doing. Readers should remember that this result could have been very different in other states, such as California, which have a more expansive view of the economic loss doctrine.

While we did not discuss the court's findings of Southeast's claims against the general contractor, Choate, we note that there was a five-week jury trial that resulted in exoneration for Choate. A central issue for the jury, trial court, and the appeals court was how to determine what the "real" contract was between the parties, given that there was nothing agreed upon in writing. The jury found for Choate, and that is very hard to overturn. While Choate won this battle, it could just as easily have lost, depending on how the jury viewed the facts.

Needless to say, working without an executed contract puts great risk on both parties. **CE**

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