



RECENT COURT DECISIONS OF RELEVANCE TO CONTRACT DOCUMENTS

June 2014

**Hugh Anderson
EJCDC Legal Counsel
608-798-0698**

hugh.anderson@aecddocuments.com

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- 1. Issues:** (A) Differing site conditions: enforceability of disclaimers of geotechnical information in design-build contracts. (B) Owner's duty of good faith and fair dealing in contract administration. *Metcalf Construction Co., Inc., v. United States*. United States Court of Appeals, Federal Circuit (2014).

Summary (A): The request for proposals for this Marine Corps housing project at Kaneohe, Hawaii, included a soils report that stated that the soils at the site had only a slight expansion potential. The RFP correctly indicated that the report was relevant to certain features of the project, such as concrete foundations. The RFP was somewhat disjointed in that it attempted to distance the owner from the soils report (describing it as a "reconnaissance" report "for preliminary information only") but also confirmed the applicability of the standard DSC clause, and affirmatively stated in a written question-and-answer document that "major disparities" from the Government's soils report would be "dealt with by change order."

The contract documents required the design-builder to continue the soils investigation as part of its scope of work. It did so, ultimately learning from a retained expert that the soils were in fact moderately to highly expansive. This discovery resulted in a lengthy delay in the project, during which the owner would not provide monetary relief or allow a change in design to account for the difficult soils. The design-builder finally took matters in its own hands by excavating, removing, and replacing the bad soils, and by using post-tensioned concrete that would not be affected by expansive soils. Additional costs were approximately \$4.8 MM.

During a protracted dispute process, the Government took the position that because of the continued investigation responsibility, the design-builder did not have the right to rely on the Government's soils report. A lower court agreed that the investigation duty "nullified" the site condition representations and related RFP provisions. In a baffling decision, the lower court stated that the contractor could "rely" on the soils report for "bidding purposes" but did not have a DSC claim with respect to what it learned from its own investigation during the course of the project.

Decision on (A): The appellate court cleared up the confusion and inequities created by the lower court and the Government. Although the design-builder had contractual site investigation duties, it was entitled to rely on site representations in the RFP. The court emphasized the fundamental purpose of the DSC clause (which originated in US government contracts): to "take at least some of the gamble on subsurface conditions out of bidding." The Government, not the contractor, was accountable for the risk of errors in the Government's soils report. The court also reaffirmed longstanding judicial opposition to attempted disclaimers and pre-contract investigation requirements.

Summary (B): The design-builder raised numerous concerns about overzealous inspections, lengthy delays by the Government in reacting to site conditions (in

addition to the expansive soils there was also a substantial chlordane contamination problem), and administrative incompetence. The Government took the position that these complaints were meaningless except to the extent that an express contract provision was violated.

Decision on (B): The appellate court held that “every contract imposes a duty of good faith and fair dealing.” This duty does not require that an express provision of the contract is violated; rather it is a supplement to the express provisions, intended to prevent “conduct that frustrates the other party’s rights to the benefits of the contract.”

Comment: This case was closely followed in construction law circles. AGC, ABC, and DBIA submitted amicus briefs in support of the design-builder. The decision has been widely hailed as restoring the basic principles of site conditions risk allocation, which according to some had been eroding sharply on federal projects. It is especially important for design-build contracting, clarifying that by taking on investigatory duties the design-builder is not absorbing or “buying” the risk of flaws in prior work done by or for the owner.

The portion of the decision regarding good faith and fair dealing has been taken as a warning to the federal government to ease up on overreaching contract administration practices. Such practices may be rooted in a commendable desire to protect the project budget, but must be kept in balance.

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2. **Issue:** Is “unused” equipment “new” for purposes of a standard contract clause requiring that contractor furnish new equipment? *Reliable Contracting Group, LLC, v. Department of Veteran Affairs*. U.S. Civilian Board of Contract Appeals (2013).

Summary: \$20 MM contract for the design and construction of a utility plant and electrical distribution system at a Veterans Affairs hospital in Miami. The contract’s standard (federal) general conditions required that all equipment to be incorporated in the work must be “new.” The generator specification gave the government the option of attending a test of the generators at the factory.

A supplier furnished three emergency generators that had been manufactured four years earlier, purchased by another entity, and placed in enclosures, but never run, other than factory testing and pre-startup activities. The generators required some cleaning, rust removal, painting, and filter changes, which the supplier was prepared to undertake.

The VA’s contracting officer rejected the generators, commenting to the general contractor that “it is inconceivable to me that you would have ever considered

pulling off such a deception on the Government.” The contractor replaced the generators with indisputably new machines, and eventually made a claim on behalf of the subcontractor/supplier for \$1.1 MM, representing costs of removal and replacement.

Decision: The board of contract appeals rejected the claim. The board held that the contract unambiguously required new generators, and that by reading the general conditions provision and the specification together, “new” in this context meant capable of being factory tested—a condition that the original generators could not meet, because they had long since left the factory.

Comment: The board’s actual decision is narrowly framed and fully supported by the contract provisions. However, some of the excerpted project correspondence suggests that there are genuine issues regarding what is “new.” For example, the contracting officer stated that “previous ownership makes [the equipment] used.” If equipment is unused but has passed through multiple owners, is it unquestionably not new? Also of interest is the date of manufacturing. If an item is manufactured and stored for a period of years, does it lose its newness? Do the same principles that apply to equipment also apply to materials? As one commentator noted, it is common for contractors (especially subs) to purchase materials for one job, then store the surplus for later use. From a sustainability and resource standpoint, an overzealous interpretation of “new” could result in unnecessary waste.

EJCDC C-700, Standard General Conditions of the Construction Contract, requires that “All materials and equipment incorporated into the Work shall be of good quality and new...” GC-7.03.B. It is probably not practical to attempt to expand on this statement in the general conditions. Specification writers, however, may want to keep in mind the issues in the *Reliable Contracting* case.

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3. **Issue:** Enforceability of a teaming agreement. *Cyberlock Consulting, Inc. v. Information Experts, Inc.* United States District Court, Eastern District of Virginia. (2013).

Summary: Information Experts (IE) competed for two federal contracts from the Office of Personnel Management. With respect to the first contract, IE entered into a teaming agreement with a subcontractor, Cyberlock. Attached to the teaming agreement was the specific subcontract that the two would enter into if IE were successful in landing the contract. IE was awarded the contract, and the same day IE and Cyberlock entered into the subcontract that had been attached to the teaming agreement.

With respect to the second federal procurement, IE again entered into a teaming agreement with Cyberlock, agreeing to enter into a subcontract assigning 49% of the prime contract work (if obtained) to Cyberlock. Some of the terms of the possible subcontract were described, but without great specificity; no subcontract document or form was attached to the second teaming agreement. IE again won the award of the prime contract. IE and Cyberlock attempted to negotiate a subcontract for about a month. IE eventually ended the negotiations and proceeded without Cyberlock.

Cyberlock sued IE in federal court, claiming that IE had breached the second teaming agreement by failing to subcontract 49% of the work to Cyberlock.

Decision: The federal district court noted that under the applicable state law (Virginia's), mere agreements to agree are not enforceable, and held that the second teaming agreement fell into that category. Among the points made:

- Setting out the terms of a future transaction is not sufficient to create a binding contract.
- Using the term “teaming agreement” suggests that the parties did not intend the document to be binding—should have used “contract” or “subcontract.”
- Contractual objectives and agreed frameworks for negotiation are not sufficient to create a binding contract.
- Words such as “exert reasonable efforts,” “contemplated,” and “anticipated” all confirmed the conditional nature of the second teaming agreement.
- The clause providing for termination if negotiation of a subcontract was unsuccessful undercut the notion of a binding and enforceable contract.

Comment: This court's ruling on whether a document is merely an agreement to agree sets very strict standards. Although the decision implies that actually attaching the intended subcontract may be sufficient to create a binding agreement, it is not clear if that would be the case if some provisions were left open. For example, attaching a standard published document, by its nature incomplete as to some items, might not suffice.

Before striving to draft teaming agreements that would survive the test of a strict court, contract authors (whether of published forms or actual specific agreements) must ask whether the objective is to smooth the path ahead for two willing parties, or to create a steel-trap agreement. If the latter, then the best course is to incorporate a completed and executed contract (whether a subcontract, subconsulting agreement, or other) that is contingent on achieving the award of the prime contract.

4. **Issue:** Payment bond: Necessity to comply with statutory notice requirement. *Niles-Wiese Construction Co., Inc. v. Westfield Insurance Co.* Supreme Court of Minnesota (2013).

Summary: Subcontractor Safety Signs, LLC, furnished labor and materials in support of a municipal airport project in Owatonna, Minnesota. The general contractor, Niles-Wiese Construction, failed to pay Safety Signs, and indeed appears to have defaulted on the prime contract and gone out of business. The Minnesota statute controlling payment bond claims states in relevant part that:

[N]o action [lawsuit] shall be maintained on the payment bond unless, within 120 days...[the claimant] serves written notice of claim...by certified mail upon the surety that issued the bond and the contractor on whose behalf the bond was issued **at their addresses as stated in the bond...**

(Emphasis added.) Safety Signs served notice on the surety without problem. Safety Signs sent the notice to the defunct contractor at an address stated in the subcontract. That address was not the same as the contractor's address "stated in the bond." After the lawsuit commenced, the surety raised the defense that under the requirements of the statute, the subcontractor was not entitled to maintain a suit on the payment bond because it had failed to satisfy the notice requirement as to the contractor.

The issue ultimately reached the Minnesota Supreme Court.

Decision: The Minnesota Supreme Court held that claimants must comply with the statutory notice requirement. Although there are various circumstances in which "substantial compliance" with a requirement may be sufficient, such is not the case when a statute unambiguously establishes a prerequisite for a lawsuit. The court acknowledged that the statute created a "trap for the unwary." The court confirmed that even though the surety itself had been properly served with notice of the claim, the surety was entitled to raise the lack of service on the contractor as a defense.

Comment: This case is a classic tale of form over substance. The surety received notice, was not prejudiced as to any substantive defense, and presumably had collected a premium on the bonds. The contractor was out of the picture and not in a position to respond to a notice regardless of the address to which the notice was sent. Yet there was no payment bond recourse for the unpaid subcontractor.

The EJCDC payment bond form provides a place for entering the Contractor's address. If that address differs from an address included in a subcontract or purchase order, or used by the Contractor in project correspondence, an unpaid Minnesota sub or supplier could fall into the same trap that caught Safety Signs.

It is doubtful that contractual notice requirements would be enforced as strictly as a statutory requirement. In many situations the key question is whether lack of formal notice created any prejudice (unfairness). Often it can be shown that the party entitled to formal notice did in fact have actual notice of the relevant facts and circumstances. Nonetheless it is well worth the effort to comply carefully with all notice requirements, and to routinely keep good records of such compliance.

5. **Issue:** Standard contract requirement that contractor obtain necessary permits. *Bell/Heery, a Joint Venture, v. United States*. United States Court of Appeals, Federal Circuit (2014).

Summary: \$238 MM federal design-build prison project. The standard federal contract allocated to the design-builder all costs and duties with respect to obtaining construction permits.

The project required a massive cut-and-fill operation to level the site for the new facilities. The design-builder expected to obtain a single-step permit from the New Hampshire Department of Environmental Sciences for "Alteration of Terrain." The design-builder would excavate the soils and directly transport them to their final location. Instead, the state agency took the position that the work would require numerous separate permits, necessitating multi-step cut-and-fill operations, all subject to a set of unanticipated permit conditions that would greatly increase the expense of the cut-and-fill work. The federal government had no control over the state permit and did not attempt to intervene or assist the design-builder in obtaining less burdensome permit conditions.

Citing various contract provisions, the design-builder sought additional compensation from the Government. The dispute eventually reached the same federal appellate court that decided the Hawaii DSC case discussed above.

Decision: The court of appeals held that the design-builder had failed to present a claim for which relief could be granted. The court therefore affirmed the dismissal of the claim.

At the heart of the court's decision was the clarity of the permit requirement. Both the duty to obtain the permit and to bear the associated costs were clearly allocated to the design-builder, both in the general conditions and in permit-related specifications. None of the clauses cited by the design-builder (such as a clause about consultations between design-builder and the owner) in any way negated the permit requirement.

The court also commented on the duty of good faith and fair dealing. Because at its core the problem was the conduct of an independent state agency, not a federal agency, the court held that no claim of lack of good faith was viable.

Comment: The contractor might have fared better under an EJCDC contract. Although EJCDC also shifts permit duties and costs to the contractor, it recognizes a duty on the part of the owner to collaborate (GC-7.08):

Unless otherwise provided in the Contract Documents, Contractor shall obtain and pay for all construction permits and licenses. Owner shall assist Contractor, when necessary, in obtaining such permits and licenses.

It also should be noted that good project planning might have identified the importance of the Alteration of Terrain permit, and addressed the associated risk allocation issues. As a general matter it is reasonable to shift the permit duties and costs to the contractor as construction “expert.” At a more sophisticated level such as on a \$238 MM project, generalized allocations may not fit the project needs.

By the same token, the design-builder obviously took an enormous risk by committing to a contract price that assumed permission to conduct operations in a single step. One of the issues for design-build delivery is setting the price (whether as a stipulated sum or a cost-plus subject to GMP) too early in the process.