BRADLEY ARANT BOULT CUMMINGS LLP **Third Quarter 2012**

CONSTRUCTION AND PROCUREMENT LAW NEWS

Recent federal, state, and local developments of interest, prepared by the firm's Construction and Procurement Group:

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CBCA Imposes Damages for Prime Contractor's Failure to Self-Perform at Least 50% of Contract Work

Recently, in what apparently is a case of first impression, the U.S. Civilian Board of Contract Appeals (the Board) in *Singleton Enterprises v. Department of Transportation* awarded contract damages to the Federal Highway Administration (the Government) for a prime contractor's failure to self-perform at least 50% of the contract work. While this decision does not have precedential effect (which means it is not binding on the Board in subsequent cases), it is nonetheless noteworthy because this case likely will be looked to for guidance in future cases involving the imposition of damages for breach of self-performance requirements. These requirements are common in Federal procurements, and the agencies administering Federal contracts are increasingly insistent on enforcement of the requirement. The stated rationale is to assure the general contractor's "adequate interest and supervision of the work."

The contract, which was a firm fixed price contract awarded to the prime contractor for a base price of $634,241.40, contained a provision requiring the prime contractor to self-perform work equivalent to at least 50% of the project work. The Board concluded that the prime contractor breached the contract by failing to meet this self-performance requirement and then turned its attention to the Government's proposed calculation of damages, which the Government calculated to be $22,538.17. The Government essentially calculated its damages by removing from the prime contract amount the premium (*i.e.*, the difference between the total price of the subcontractor's work and the total contract price) that the Government was paying to have the prime contractor perform the subject work.

At the outset of its examination of the Government's proposed damages calculation, the Board stated:

> The imposition of damages for failure to meet the 50% threshold is a matter of first impression for this Board. No cases that have been brought to our attention are directly on point, either as to the propriety of assessing damages for this particular breach or how to calculate

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> those damages. That said, after consideration, we find that the Government, as any contracting party, has a right to the benefit of its bargain and, thus, the right to recover damages due to a breach. There is no provision in this contract which prohibits the Government from seeking damages for the breach in issue or which provides a specific remedy for this type of breach.

The Board found that under these circumstances an assessment of damages was warranted and that the method of calculation used by the Government was reasonable and appropriate.

In this particular case, the damages were relatively inconsequential given the size of the contract. However, the damages calculation for breach of the self-performance requirement could be quite substantial, depending on the size of the contract, the nature of the dispute, and the actual percentage of work completed by the contractor. For example, the VA clause on this issue imposes a penalty of 15% on the amount of the work which was not properly self-performed. Where the self-performance shortfall is, say, $40,000,000 (as it may be on a large hospital job), the penalty is obviously substantial.

It should also be noted that failure to satisfy self-performance requirements can potentially open a contractor up to liability under the False Claims Act if the contractor falsely certifies the percentage of work that it is self-performing. Keep in mind that each and every time a contractor submits a payment application to the Federal Government directly, it is certifying compliance with the terms and conditions of the contract. Moreover, it is likely that the Government will latch on to the Board's decision in investigating whether self-performance requirements have been met and then use breaches of self-performance provisions as an offset against legitimate claims by contractors.

By Robert J. Symon and Aron C. Beezley

Construction Defect Complaint Alleging Negligent Misrepresentation May Trigger Insurance Coverage

Insurance companies routinely – and incorrectly in many states – deny coverage for construction defects cases by arguing that construction defect claims do not allege covered occurrences and, even if they do, various exclusions eliminate coverage. Before engaging in extended disputes over these coverage denials, business insureds should carefully scrutinize the complaint for alternative grounds for coverage. A recent insurance coverage case arising out of a lawsuit between a residential buyer and seller, *USAA Casualty Insurance Co. v. McInerney*, demonstrates the favorable impact of an alternative claim on coverage. The court in *McInerney* required the insurance company to defend a home seller from the home buyer's lawsuit because the complaint alleged negligent misrepresentation, even though the complaint also alleged admittedly non-covered claims.

This case arose out of problems with a leaking basement in Illinois. The sellers' home disclosure informed the buyer of flooding or reoccurring leakage problems in the basement that had been corrected by new drains and landscaping. The sellers also disclosed that "[o]n rare occasions, we have experienced slight seepage." Less than a year after the sale closed, the basement sustained water infiltration, flooding, and mold growth that rendered the basement uninhabitable and allegedly constituted far more than "slight seepage." The buyers sued the sellers, claiming that the sellers negligently misrepresented the potential for basement flooding. The buyers also alleged breach of contract, violation of the Residential Real Property Disclosure Act, and fraudulent misrepresentation. The buyers claimed that the flooding damaged their house and personal belongings, and also caused mold-related illnesses.

The sellers submitted the buyers' lawsuit to their liability insurer, but the insurer denied coverage and instead sued the sellers to obtain a ruling on coverage. The insurer argued that the complaint did not allege an occurrence, and, even if it did allege an occurrence, the occurrence was excluded from coverage because it resulted from intentional acts or arose from the sales contract. The sellers did not dispute the insurer's intentional acts and contract exclusion defenses, but argued that the buyers' claim for negligent misrepresentation was a covered occurrence not excluded under the policy.

The Illinois appellate court held that a negligent misrepresentation claim is not excluded from coverage as long as the insured did not expect or intend the injury. The court held that the complaint alleged an occurrence by alleging negligent misrepresentation and that the relevant exclusions did not eliminate that coverage. The complaint alleged an occurrence because the damage arguably was not expected or intended. The contract

exclusion did not bar coverage because the disclosure report was not a contract and the buyers' lawsuit sought compensatory damages rather than contract-based relief.

Thus, the court seized on a single count – negligent misrepresentation – as the grounds for requiring the insurer to defend the entire case against the home seller. As the court explained, "if the underlying complaint against the insured contains several theories of recovery and only one of the theories is potentially covered, the insurer must still defend the insured [and] may become obligated to defend against causes of action and theories of recovery that the policy does not actually cover."

Construction defect complaints allege many alternative theories of recovery and one of those may be an "occurrence" (although many insurers may contest the point). Although insureds and insurers typically battle over exclusions to coverage, such as the "your work" and "faulty workmanship," exclusions, alternative bases for coverage may be available that avoid these disputes. Business insureds facing construction defect claims should search for alternative bases for coverage in complaints asserted against them. A single allegation, such as one for negligent misrepresentation, can be sufficient to trigger coverage for a claim that, from the insurer's perspective, is otherwise uninsured.

By Katherine Henry

Know Your State Law to Better Assess Risk

The recent Illinois case *1324 W. Pratt Condominium Association v. Platt Construction Group, Inc.* reminds contractors to be mindful of state policy considerations which may affect their risk assessments when constructing condominiums or high profile projects.

The case involved the construction and sale of an eight unit residential building in Chicago, Illinois. The project developer contracted with a general contractor for construction of the building, who then hired a number of trade subcontractors to perform the majority of the work.

After completion of the building in March 2005, the developer sold the eight units in the building as condominium units, entering into real estate contracts with each of the individual condominium unit owners. The general contractor and trade subcontractors had no direct contracts with the individual unit owners and were not involved in the sale of the units.

After sale of the condominium units, the developer became insolvent and entered bankruptcy. Shortly thereafter, leaks developed in the condominium building. The condominium association alleged that these leaks caused structural damages to the building and also caused mold to grow throughout the building with resultant medical problems for some of the owners. Because the developer had gone out of business, the condo association notified the general contractor of the leaks and requested that it repair the problems. The general contractor ignored these requests; so, the condo association sued the general contractor and some of its subcontractors asserting various causes of action, including breach of the implied warranty of habitability.

The general contractor first asked the Illinois trial court to dismiss the case because it had no contract with the unit owners or the condo association. While the trial court accepted this argument, on appeal the Illinois appeals court held that the implied warranty of habitability is meant to protect homeowners from improper construction and therefore, the implied warranty applied against the general contractor even when there was no contract between the general contractor and the unit owner.

On its second visit to the trial court, the general contractor attempted to rely on a provision in the real estate sales contract between the developer and the individual unit owners whereby the unit owners "disclaimed" the implied warranty of habitability. Again, the lower court accepted the general contractor's argument and ruled in favor of the general contractor. The unit owners again appealed.

Upon review, the appellate court noted that the real estate purchase contracts were between the individual unit owners and the developer; the general contractor was not a party to the contract. The court then noted that disclaimers of the implied warranty of habitability are strictly construed under Illinois law, as a matter of public policy. Here, the disclaimer of the implied warranty of habitability was only between the "Purchaser" and the "Seller" – between the unit owners and the developer. The court held that by its plain terms, this disclaimer could not apply to the general contractor. Therefore, the general contractor could still be held liable for breach of the implied warranty of habitability.

This case reminds contractors to be careful when constructing multi-unit residential buildings and other properties that may be subject to important "policy considerations" under a given state's law. To remain profitable, it is important that contractors put in place effective contractual mechanisms for assigning and disclaiming risks that will be effective under the applicable law. To do so, contractors must have a solid understanding of the legal structures under which they operate. While there is no "sure" answer here, the contractor might have been successful in having its contractual partner agree to place a disclaimer favorable to the contractor and its subcontractors in the condominium sales contracts.

By Luke Martin

If Your Warranty Fails, Will You Be Liable For Consequential Losses?

Two important elements of any commercial contract are the warranty and the exclusion of consequential losses. In the context of the sale of goods, warranty provisions will typically cover defective products and the seller's liability will be limited to the replacement or repair of the goods and may not cover so-called "consequential" damages. However, when a warranty fails of its essential purpose, contractual limitations on recovery of consequential losses can be compromised.

"Failure of essential purpose" of a warranty is a legal term that describes the situation where a warranty provides insufficient remedies to a purchaser. In a construction setting, the most typical example of this is the purchase of a piece of commercial equipment that is in some way defective. When the defect is discovered, the purchaser contacts the seller and requests that the seller fulfill its warranty obligations by fixing the equipment. Courts have held that a "limited repair or replace" warranty fails of its essential purpose when the seller is not able to fix the equipment in a reasonable amount of time, even if numerous attempts at repair are undertaken.

A warranty can also fail of its essential purpose when a volume purchaser discovers a "serial defect"- *i.e.*, a defect present within a large number of similar units. Even if the seller replaces the products under warranty, the warranty may still fail of its essential purpose if the purchaser is required to absorb the cost of uninstalling the products and shipping them back to the seller (as well as absorbing the resulting loss in production or cooling or other output). The theory behind this doctrine is that mere replacement of the defective products does not sufficiently compensate the purchaser – in legalese, the purchaser is deprived of the "benefit of the bargain."

When a warranty has failed of its essential purpose, the purchaser may be allowed to recover consequential losses despite a contractual exclusion of the same. The Uniform Commercial Code ("UCC"), which governs the sale of goods and is adopted in some form by every state, specifically addresses failure of a warranty and consequential losses. Section 719 of the UCC expresses the following rules: first, if a warranty fails of its essential purpose, all "normal" remedies (including recovery of consequential losses) become available to the purchaser; second, if a consequential loss exclusion is unconscionable, it is not valid. The interplay between these provisions begs the question: if a warranty fails of its essential purpose, thereby allowing the purchaser the full range of remedies available for breach of contract, does a consequential loss exclusion remain valid if it is not unconscionable? In other words, is a contractual consequential loss exclusion automatically extinguished when a warranty fails of its purpose?

The majority of states hold that the two UCC provisions are dependent – that a consequential loss limitation is automatically extinguished when a warranty fails of its purpose and the purchaser is allowed to recover consequential losses despite the contrary limitation in the parties' contract. The logic of this position is that the balance of risk inherent in a contract between two parties is materially altered when a warranty fails to serve its purpose. The majority states include Alabama, Delaware, Idaho, Illinois, Massachusetts, Michigan, Ohio, South Dakota, and Wisconsin. The minority of states hold that the two UCC provisions are independent – that a contractual limitation on recovery of consequential losses remains valid even when a warranty fails of its purpose. The logic of this position is that the balance of risks was negotiated between the parties and it should not be disturbed. Minority states include some behemoths in commercial contracting: California, New Jersey, New York, North Carolina and Tennessee. Some states, such as Mississippi, have not explicitly addressed this issue.

In order to better protect against liability for consequential losses, manufacturers and sellers of equipment and materials should consider including a contractual provision explicitly stating that the consequential loss

exclusion functions independently from the terms of the limited warranty. The provisions should state that the parties agree the consequential loss exclusion will remain in place even if the warranty fails of its essential purpose. Even in the majority rule states, this type of contractual clause has a good chance of holding up in a court of law because the UCC can be modified or overwritten by a contractual agreement. The following are two sample clauses, which can be added to consequential loss exclusions:

> *"This disclaimer and exclusion shall apply even if the express warranty set forth above fails of its essential purpose."*

> *"Customer acknowledges and agrees that Seller has set its prices and entered into the Agreement in reliance upon the disclaimers of warranty and the limitations of liability set forth herein, that the same reflect an allocation of risk between the parties (including the risk that a contract remedy may fail of its essential purpose and cause consequential loss), and that the same form an essential basis of the bargain between the parties."*

Of course, the purchaser, whether contractor or owner, faced with this effort by the equipment supplier, should be diligent in attempting to negotiate more favorable terms.

By Vesco Petrov

Owner's Approval of Means and Methods may not Relieve Contractor of Liability

When faced with a risky means and methods issue—excavating near an existing structure, for example—contractors frequently seek or otherwise receive input (whether they want it or not) from the owner or its on-site representative. In other cases, the contractor may simply take comfort in the fact that the owner is observing the means and methods in progress and is not objecting to them. In either case, the contractor may assume that so long as the owner somehow "buys in" to the contractor's plan and the contractor properly executes it, the owner will bear some or all of the risk if something goes wrong. This is not a sure assumption.

Generally, a contractor is solely responsible to implement the owner's design concept through means and methods of its choosing, so long as the owner or owner's designer does not dictate in the design that the contractor employ specific means and methods. Moreover, inspection provided by or for the owner generally does not guarantee the contractor's performance or relieve its obligation to perform work in accordance with the drawings and specifications. It is common for contracts to spell out these principles. The AIA A201 (2007), for example, provides that the "Contractor shall be solely responsible for, and have control over, construction means, methods, techniques, sequences and procedures and for coordinating all portions of the Work under the Contract, unless the Contract Documents give other specific instructions concerning these matters."

While these are generally well understood principles, the analysis is less obvious when the owner has somehow indicated its approval of the means and methods. An older but frequently cited case out of Iowa, *Shepherd Components, Inc. v. Brice Petrides-Donohue & Associates, Inc.*, illustrates why a contractor should not assume that it is off the hook in these cases. *Shepherd* involved sewer system improvements that required excavation near an existing structure. Although the contracts for the project clearly assigned sole liability for means and methods to the contractor, the owner's engineer, upon request for consultation from the contractor, provided its approval of the contractor's proposed method for protecting the adjacent property during excavation. The contractor installed sheet piling designed to retain the soil supporting the existing structure but—thinking it would solve a separate vibrations problem—deviated from the plan by excavating some material from the existing structure-side of the sheet piling. Signs of a potential failure quickly appeared. The contractor consulted the engineer and proposed a new plan to him. Although the engineer apparently did not formally approve this second plan, he was intimately aware of the plan and discussed it with the contractor in several meetings. The contractor followed the new plan without objection from the engineer. Nevertheless, a significant failure occurred and the owner of the existing structure sued the contractor and engineer.

Despite these "bad facts" for the engineer, which made it appear that he at least tacitly approved the plan, the court focused primarily on the terms of the contracts at issue and the customary lines of responsibility discussed above. Under its contract with the owner, the contractor had sole authority over means and methods. In contrast, while the engineer's contract with the owner

contained a duty to inspect the construction site, he had no authority to control means and methods. At trial, the property owner and contractor argued that the engineer should be primarily liable for the failure based on his negligence in failing to object to the plan or propose a plan of his own, especially given his involvement in the situation. Nevertheless, the court found that the engineer's on-site involvement did "not change the fact that [he] had no legal duty to interfere with [the contractor's] judgment on which construction procedures to utilize." In the end, the contractor was left holding the bag.

Understandably, contractors may view the owner's engineer as a good source of input, and there is nothing inherently wrong with seeking such input. However, the lesson of *Shepherd* is that contractors should not assume that the owner or owner's engineer has taken responsibility for a means and methods issue just because the engineer has observed, participated in, or even approved the method.

By James Warmoth

Magic Words Make For Bad Law

Homebuilders in Ohio, and those litigants who might be influenced by the Supreme Court of Ohio, should take note of the recent decision in *Jones v. Centex Homes* that the duty to build in a workmanlike manner is non-waivable as a matter of law. This decision flies in the face of the industry practice of disclaiming common law implied warranties and substituting limited express warranties in their place. The court achieved this result by claiming that building in a workmanlike manner was a "duty" rather than an "implied warranty." It appears that this has been in the law in Ohio for close to thirty years, yet the Ohio Legislature hasn't acted to fix this problem.

One of the first things lawyers learn is that the civil law draws its duties largely from contract and tort. While most people in our industry are quite familiar with contracts, many have heard of torts but aren't quite sure what the term means. Tort duties are duties that do not arise under contract, but arise because of the nature of society. They are those that a "reasonable person" would undertake in exercise of ordinary care to those around her. In the non-construction context, this means driving one's car at a reasonable rate of speed to protect other drivers or not driving while intoxicated. For our industry, it might mean not building weak scaffolds near public walking areas or leaving open excavations where the public would be likely to walk into them. Generally, it has not meant taking on duties to specific homeowners with whom the builder has a contract because the contract is the best way for those two parties, dealing at arm's length, to define their responsibilities to one another. If a homeowner wants a warranty, he or she can ask for one in the contract. For this reason, the law recognizes that promises regarding the quality of construction and directed at the homeowner, *i.e.*, warranties, spring from the contractual relationship and would not exist without it. Several states recognize that a party who promises to do something in a contract also has a duty to do that act reasonably — that is, contract duties can give rise to tort duties. Other states reject this view and adopt the economic loss rule, holding that purely economic damages arising from a contract may not also have a remedy in tort.

Why on earth should one care about this discourse on contracts vs. torts? In the Ohio case, the court focused on the builder's characterization of the duty to build in a workmanlike manner as an "implied warranty," in keeping with the general rules of the construction industry. Indeed, the court appears to have no problem with the notion that implied warranties can be waived and replaced by contract, but it claimed "that issue is not squarely before us." In Ohio, the obligation of a builder to provide a habitable home is a duty that arises from the contract, but is not an "implied warranty." Therefore, the duty cannot be waived in the way a warranty can. One supposes that a mere deviation from plans and specifications might not support this tort duty if the deviation were not "unreasonable" or was not alleged to make the home uninhabitable.

However, in practice, this is a harmful rule for construction businesses. First, by placing the duty in tort (specifically, negligence), the court takes away builders' ability to avoid a lengthy trial, as almost every negligence suit inherently turns on jury-decided questions. Second, the Ohio court changes the legal risks by not allowing parties, contracting at arms' length, to alter this particular tort duty in their contracts. Our advice to those building homes or condominiums in Ohio is to review your risk allocation clause, attempt to insure this particular risk, and, where possible, place strict notice limitations on a homeowner asserting a habitability claim. Finally, talk to your lawyer about other potential ways to limit this risk.

By Jonathan Head

Bradley Arant Lawyer Activities:

David Taylor spoke at the International Council of Shopping Centers "College" in Philadelphia on March 2nd on the topic of "Managing Construction Disputes."

Eric Frechtel, **Steven Pozefsky** and **Aron Beezley** co-authored an article on the first known court challenge of a U.S. Department of Veterans Affairs ("VA") denial of an application for inclusion in the VA's VetBiz Vendor Information Pages Verification program which was published in the April/May 2012 issue of *Federal Construction Magazine.*

Michael Knapp, **Ryan Beaver**, **Brian Rowlson**, **James Warmoth** and **Monica Wilson** recently attended the ABC Carolinas Construction Conference in Wilmington, NC, where the Charlotte office was recognized as the ABC Carolinas Associate Member of the Year for 2012.

Ralph Germany was named a *Mid-South Super Lawyer* in the area of Construction Litigation for 2011. **Alex Purvis** was also named a "Rising Star" in the area of Insurance Coverage.

Brian Rowlson recently authored an article that was selected for publication in the Florida Bar Journal and will also be published in the next Division 7 newsletter for the ABA Forum on the Construction Industry.

Arlan Lewis spoke at the ABA Forum on the Construction Industry's 2012 Annual Meeting in Las Vegas, NV in April on "Federal Contracting for Small, Minority and Women-Owned Businesses."

David Taylor spoke at the American Bar Association's ADR National Meeting in Washington, DC on April 19th on the topic of "Selecting Neutrals."

Doug Patin, **Bill Purdy** and **Mabry Rogers** were honored in the "International Who's Who of Construction Lawyers 2011."

David Pugh was recently named as a member of the Board of Directors for Design-Build Institute of America's South Central Region.

David Taylor spoke on May 4th at the Tennessee Chapter of American Society of Professional Engineers in Nashville on "Contract Clauses that Can Bite Back."

Ryan Beaver, **Ralph Germany**, **Michael Knapp**, **David Pugh**, **David Taylor** and **Bryan Thomas** recently spoke at the Bradley Arant Boult Cummings LLP 2012 Construction Contract Claims Legal 101 seminars in Birmingham on May 11th, Nashville on May 18th, Charlotte on June 15th and Jackson on June 22nd.

Stanley Bynum attended the ABA Section of International Law's Spring Meeting from April 17th to 24th in New York City.

Keith Covington spoke on the latest developments at the National Labor Relations Board and the Department of Labor at two recent membership meetings sponsored by the Associated Builders and Contractors. Keith's presentation included discussion of the new NLRB posting rule, the NLRB's new rules on union election procedures, and the proposed changes to the DOL's labor persuader reporting rules.

Jim Archibald, **Axel Bolvig**, **Ralph Germany**, **John Hargrove**, **Rick Humbracht**, **Russ Morgan**, **David Owen**, **Doug Patin**, **David Pugh**, **Bill Purdy**, **Mabry Rogers**, **Wally Sears**, **Frederic Smith**, **Harold Stephens** and **David Taylor** were recognized in *The Best Lawyers in America* for 2013.

Jim Archibald, **Axel Bolvig**, **John Hargrove**, **Doug Patin**, **Mabry Rogers**, **Harold Stephens, Wally Sears** and **Robert Symon** were recognized as Super Lawyers for 2012. **David Bashford** and **John Mark Goodman** were recognized as Rising Stars.

Mabry Rogers and **Bill Purdy** were recognized in *Chambers 2012* edition in the area of Construction Litigation. **Doug Patin** and **Bob Symon** were recognized in the area of Construction. **John Hargrove** was recognized in the area of Labor & Employment.

For more information on any of these activities or speaking engagements, please contact Terri Lawson at 205-521-8210.

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