ECKERT SEAMANS

Fall 2011
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Construction Law

In This Issue…

Dual shop operations require careful planning and implementation

As construction contractors seek to replenish their backlog in a struggling economy, many are looking into forming separate union and non-union companies to perform the same type of work in the same geographic area. This practice is known as "double-breasting." There are a number of advantages to the practice of double-breasting, so long as it is done correctly.

Double-breasting allows the contractor maximum flexibility to bid larger union projects, while competing for non-union jobs free from collective bargaining restrictions. Although this practice of maintaining "dual shops" is universally abhorred by unions, there is nothing improper about it when done correctly. However, lawful double-breasting requires careful attention to detail. Mistakes are common and a failure to properly establish and maintain a legitimate double-breasting operation can prove to be extremely costly.

If the double-breasted operation is not properly established, with the dual shops kept completely legally separate, the National Labor Relations Board will treat the union and non-union companies as one entity and, accordingly,

continued on page 3

An overview of indemnity clauses

When contractors and subcontractors review construction contracts, they usually focus on the clauses most near and dear: (1) **Price:** How much do I get paid?; (2) **Payment:** When do I get paid and is my payment dependent on the next party up the food chain getting paid (a "pay if paid" or "pay when paid" clause)?; and (3) **Scope:** What is my contractual scope of work and which of the specification sections and drawings are in my scope?

Almost always tucked near the end of the contract, replete with long run-on sentences and defined terms such as "Indemnifying Parties" and "Non-Indemnifying Parties" or "Indemnitees" and "Indemnitors" is a clause entitled "Indemnity." Many contractors and subcontractors, by the time they get to that term, will either not read it or start to read it and then stop halfway through. This is a mistake, but a mistake that is only realized if an accident or claim arises. It is at that time that this clause can have substantial, unintended consequences, such as putting the company at risk for a claim when the company bears no responsibility other than the fact that the work related to the accident was in its scope.

continued on page 2

An overview of indemnity clauses
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What should a prudent contractor do? First and foremost, it should read the Indemnity clause and attempt to understand the exposure and risk it would be agreeing to accept if it signs the contract. If the contractor has any doubt or concerns, it should consult its counsel or, at a minimum, its insurance broker. A competent insurance broker should be experienced in indemnity clauses and should know, at a minimum, if the risk posed by the indemnity clause is covered by the insurance required to be provided under the contract.

Here are some practical pointers for contractors and subcontractors to consider when making that initial determination if they need assistance in analyzing the clause or, if they cannot negotiate the clause, whether they should even sign the contract.

Indemnity is defined as the obligation resting on one party to make good a loss or damage another party has incurred. The scope of indemnity obligations runs the gamut from claims for personal injury and property damage to claims for money damages (consequential, incidental and other types of damages) from any conceivable event or breach of contract.

The various form contracts—AIA, EJCDC and Consensus DOCS—all contain different indemnity clauses, and the types of clauses, and their breadth and scope vary widely depending on the craftiness of the drafters and the perceived leverage of the party offering the contract.

Many courts have generally categorized indemnity clauses by one of three Types: "Type 1"; "Type 2"; and "Type 3." For purposes of this overview, this categorization is useful in providing a primer to contractors and subcontractors about indemnity clauses.

So there is no misunderstanding at the outset, an "indemnitor" is the party that is agreeing to indemnify another party and the "indemnitee" is the party that is getting the benefit of the indemnity. Also "active negligence" refers to an event or occurrence that caused the damage in which the indemnitee was directly involved or played some role. "Passive negligence" is where the indemnitee did not play a role and/or was not a cause of the damage.

"Indemnity is defined as the obligation resting on one party to make good a loss or damage another party has incurred. The scope of indemnity obligations runs the gamut from claims for personal injury and property damage to claims for money damages…"

With that in mind, the three general Types of indemnity clauses are:

Type 1 Indemnity Clause

A Type 1 indemnity clause provides "expressly and unequivocally" that the indemnitor will indemnify the indemnitee for, among other things, the "negligence of the indemnitee," and the indemnitee is indemnified whether its liability arises from its active or concurrent negligence. Stated more simply, one party will indemnify another party regardless of whether the party being indemnified was itself actively responsible for the damage. This means that the party that caused the injury is potentially being indemnified by a party that had no role in the injury.

Type 2 Indemnity Clause

A Type 2 clause requires the indemnitor to indemnify the indemnitee for his or her passive negligence, but not for active negligence. Examples of Type 2 clauses are: a clause providing for indemnity for the indemnitee's liability "howsoever same may be caused" or "regardless of responsibility for negligence" or "arising from the use of the premises, facilities or services of [the indemnitee]" or "which might arise in connection with the agreed work" or "from any and all claims for damages to any person or property by reason of the use of said leased property." In a Type 2 clause, an indemnitee will be indemnified only if it was at most a passive cause of the damage, but will not be indemnified if it was an active cause of the damage. Thus, unlike a Type 1 clause, if the indemnified party did not directly cause the damage, it will be indemnified.

Type 3 Indemnity Clause

This type of indemnity clause requires the indemnitor to indemnify the indemnitee for the indemnitee's liabilities caused by the indemnitor, but does not require that the indemnitor indemnify the indemnitee for the indemnitee's liabilities that were caused other than by the indemnitor. Under a Type 3 clause, any negligence on the part of the indemnitee, either active or passive, would bar indemnification from the indemnitor regardless of whether the indemnitor may also have been a cause of the indemnitee's liability.

Once the Type of indemnity clause is determined, some principles to apply are as follows. Avoid Type 1 clauses, if at all possible. Type 1 clauses put your company at great risk to be responsible for damages if anything occurs, even if it has no responsibility. Under a Type 1 clause, your company could find itself indemnifying a party that caused the damage, even though your company was not at fault. Type 2 clauses are more palatable but, if at all possible, do your best to negotiate to achieve a Type 3 clause. Under a Type 3 clause, if the indemnitee bears any responsibility for the loss, there is generally no indemnity.

If this does not seem complicated enough, it is also important to know that a number of states have "anti-indemnity" statutes which outlaw Type 1 clauses. Crafty attorneys will try to circumvent these statutes by way of terms that attempt to eliminate these statutory protections by compelling the contractor or subcontractor to agree to waive them or by providing that another state's laws (a state without such "anti-indemnity" statutes) applies. Depending on the state and its "anti-indemnity" statute, these terms may or may not be enforceable.

A final thought is to be sure that the insurance coverage provided in the insurance certificate corresponds with the indemnity you have agreed to provide. Many a contractor, when an accident occurs, has found its carrier denying insurance coverage, or reserving its rights to deny insurance coverage, because the policy did not cover an onerous indemnity clause. In the case of a catastrophic accident, this can put the company at risk.

Scott D. Cessar
Construction Law Group

Litigation history of a contractor as a factor in public procurement

Construction projects can be fertile grounds for disputes and litigation. This raises the issue of whether to hire a contractor with a history of filing lawsuits. In the private sector, an owner can simply decline to hire such a contractor. However, public owners are usually obligated by competitive bidding laws to hire the "lowest responsible bidder." Thus, their ability to bypass a litigious, but otherwise qualified, low bidder is somewhat unclear.

> *A contractor should carefully consider whether a dispute with a public owner is worth litigation, especially if there is a chance of more work with the same owner.*

In *Triton Services, Inc. v. Talawanda City School District*, Ohio's intermediate appeals court provided helpful guidance to public owners when the low bidder has a questionable litigation history. Triton was the apparent low bidder for the HVAC portion of a new high school project for the Talawanda School District. The school district had worked with Triton before, in 2007, on an elementary school project. In fact, Triton sued the school district after the parties disputed Triton's scope of work. The lawsuit was ultimately settled for "about 90 percent" of what Triton sought.

In the bid at issue, the school district became concerned when it learned that Triton failed to include glycol in the cost of its bid. This omission was estimated to add between $50,000 and $75,000 to the cost of Triton's work. Triton contended that the glycol was omitted because it was confused about whether it was part of Triton's scope of work.

The school district rejected Triton's bid on the grounds that Triton was not a "responsible bidder," which was at least partly based on the prior lawsuit brought by Triton against the school district. Triton, in turn, filed a lawsuit that asked the court to declare that it was the lowest responsible bidder, and to prevent the school district from awarding the contract to anyone else. After evidence was presented at a hearing, the trial court denied Triton's requested relief, and Triton appealed.

The appeals court agreed with the trial court's decision and set forth a flexible standard for public owners to follow. The court stated that "[t]he term 'responsible' is not limited to a bidder's financial condition, but pertains to many other characteristics of the bidder, such as its general ability and capacity to carry on the work, its equipment and facilities, its promptness, conduct and performance on previous contracts, its suitability to the particular task, and other qualities that would help determine whether or not it could execute the contract properly." Furthermore, the appeals court stated that whether a bidder is "responsible" will differ for any given project, and that a school district's discretion is "subject to a fluid, abuse-of-discretion standard." Based on the facts presented to the trial court, the appeals court found that Triton "did not show by clear and convincing evidence that the school board abused its discretion."

The lesson of Triton, thus, is that, at least under Ohio law, a contractor's litigation history may later have consequences in public procurement. Consequently, a contractor should carefully consider whether a dispute with a public owner is worth litigation, especially if there is a chance of more work with the same owner.

Jacob C. McCrea
Construction Law Group

Dual shop operations require careful planning & implementation
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will impose liability on the union company for violating the National Labor Relation Act's prohibitions against interfering with employees' collective bargaining rights and refusing to collectively bargain with the union. Such liability could result in awards of back pay, fund contributions, interest, attorneys' fees, liquidated damages, and/or other non-monetary remedies to the union.

Unions can be expected to aggressively challenge contractors that choose to operate a dual shop and will place heightened scrutiny on dual shop operations. Existing collective bargaining agreements may already contain legally enforceable clauses aimed specifically at defeating such efforts. It is important to obtain legal advice when acquiring, forming or maintaining a dual shop to determine whether such practices are appropriate and permissible for your business. We have represented a number of contractors over the years in the establishment and maintenance of dual shops.

Timothy D. Berkebile
Construction Law Group

Be mindful of who you hire: New GAO decision underscores potential conflict of interest problems with retaining former federal agency employees

When it comes to bidding construction projects, even a small advantage can yield big returns. This is particularly true of federal projects, where the morass of statutory and regulatory acronyms—FAR, DFARS, EFARS, CICA and more—is enough to make a contractor's head spin. Companies that routinely compete for federal contracts may consider hiring someone specializing in the federal procurement process. A former employee of the Army Corps of Engineers (ACE) or other agency may be able to give invaluable guidance to navigate the rocks and shoals of federal construction contracting. Be cautious, however, as a recent decision from the Government Accountability Office warns of the potential conflicts of interest such hiring may cause.

In *Appeal of PCCP Constructors*, B-405036 (GAO 2011), the GAO addressed a protest of two unsuccessful bidders for a design/build contract to construct permanent canal closures and pumps near Lake Pontchartrain, Louisiana. The permanent pump project was set to replace a temporary pump system that is essential to flood control in New Orleans. After a two-phase solicitation process, which established that the winning proposal would be selected on the basis of the "best value" to the government, CBY Design Builders, a Joint Venture of three contracting partners, was awarded the project for a price of $675 million.

In submitting its bid, the managing partner of the CBY Joint Venture, CDM, was employing a gentleman named Richmond Kendrick who, until August 31, 2010, was the Chief of Program Execution of the Hurricane Protection Office (HPO) for the ACE. Mr. Kendrick held the most senior civilian position at the HPO and had full authority for management decisions, including the permanent pump project.

Under the Federal Acquisition Regulations, federal agencies are to avoid, neutralize, or mitigate potential conflicts of interest so as to prevent an unfair competitive advantage to any contractor. FAR 9.504. Conflicts of interest are evaluated on a case-by-case basis, and when an agency conducts a meaningful investigation into whether a conflict exists, the GAO generally will not second-guess it. The ACE claimed to have conducted an investigation and determined that Mr. Kenrick's employment with CDM did not present a conflict.

The GAO, however, found that the ACE failed to conduct a meaningful conflicts check. In his role at the HPO, Mr. Kenrick had access to sensitive, non-public information concerning the permanent pumps project. He routinely discussed matters such as costs and risks of the project, performance requirements and proposal evaluations, including how individual proposals were evaluated in the first phase of the solicitation. There was no evidence that Mr. Kenrick was sequestered from the project during his time at the HPO, and the ACE did not attempt to determine whether he was sequestered after he became employed by CDM. Indeed, all evidence revealed during the GAO's assessment suggested that he provided sensitive information to CDM. The GAO determined, therefore, that the risk of an organizational conflict of interest was high.

The conflict of interest manifested itself most particularly in CBY's price for its proposal. During bidding, a "build-to-budget" process was used, by which the ACE set a budget of $700 million for the project and essentially asked contractors to provide the most "bang for the buck." The contractor that submitted a proposal that maximized the value to the government at the $700 million price point would be awarded the contract. All publicly available documents indicated that $700 million was the price for the project, and all contractors, save one, submitted a bid for that amount.

The lone exception was CBY, which submitted a bid for $25 million less than the amount stated by the ACE's solicitation. In the debriefing following the award, the Corps noted that this proposal offered "an advantage in price" and that the two losing contractor's bids did not "support a $25M premium." CBY lowered its price, however, because of the inside information provided by Mr. Kenrick. The GAO noted that Mr. Kenrick had access to internal ACE documents, emails and meetings in which the build-to-budget was discussed, and in which the acceptability of lower priced proposals was broached. Although all public documents suggested the $700 million was mandatory, Mr. Kenrick was able to relay to CBY that a lower-priced proposal might be received more favorably.

The GAO found that the solicitation misled contractors into believing that price would not be a factor in the evaluation process. Significantly, however, price only became a factor because of the inside information possessed by Kenrick.

In addition to these conflicts of interest, the GAO found that the ACE failed to take adequate measures to fully review and understand the details of CBY's proposal. In particular, the ACE failed to critically examine CBY's decision to use a pile method to build the foundation of the pump system. Essentially, the ACE accepted CBY's blanket statements that its foundation complied with the solicitation "with little or no independent evaluation of the supporting materials in CBY's supporting documentation volume." The GAO noted that testimony from the head officer at the ACE stated that, there was, at most, a "five-minute discussion" of CBY's foundation approach. In the end, the conflicts of interest and the questionable evaluation methods were just too much — the GAO directed the ACE to receive a new set of bids and to evaluate those bids fairly.

It would be improper to conclude that the GAO's decision means that the hiring of former federal agency officials will present a problem. And, as noted above, retaining such individuals can greatly benefit a contractor. Given the GAO's scrutiny of the Army Corps of Engineers' decision, however, other federal agencies may impose more stringent conflict requirements. In considering hiring policies, therefore, a prudent contractor should weigh the significant gains of adding a former federal employee against the potential for disqualifying conflicts of interest or, if it does hire such an individual, to consider walling him or her off on any implicated projects that would result in an appearance of impropriety.

Matthew J. Whipple
Construction Law Group

To owners and general contractors: Before termination, review the bond

Terminating a defaulting contractor or subcontractor is an unfortunate, but all too frequent, necessity for owners and general contractors. When this occurs, a surety is obligated by the terms of a performance bond to perform the contract of the departing contractor. But a number of recent decisions make it clear that owners and general contractors cannot take such coverage for granted. Strict compliance with the terms of the bond is essential—including advising the surety of the intent to declare a default and terminate the contractor's employment and—before hiring a replacement—giving the surety the opportunity to perform.

One of the most recent courts to confront this issue was the federal district court of Connecticut in *Stonington Water Street Assoc., LLC v. Hodess Bldg. Co.*, in which an owner filed suit against a surety for the surety's refusal to perform its obligations under the terms of a standard AIA A312 performance bond. The surety, National Fire Insurance Co., sought dismissal of the suit, arguing that Stonington, the owner and bond obligee, had failed to comply with certain conditions set out in the bond.

Paragraph 3 of the bond required three preconditions to the surety's liability, including:

a. The owner's proper notification to and request for a conference with the contractor and surety;

b. the owner's proper declaration of a contractor default and former termination after the expiration of 20 days after initial notification; and

c. the owner's agreement to pay the balance of the contract price to the surety or the replacement contractor in accordance with the terms of the original contract.

National Fire argued that Stonington's failure to notify the surety that the contractor had abandoned the project and Stonington's unilateral hiring of a replacement contractor was a breach of Paragraph 3, and that these failures to comply with Paragraph 3 relieved National Fire of any liability under the bond.

The court agreed, and dismissed Stonington's claims against National Fire.

This is only the latest of a number of decisions that instruct that satisfying each condition set out in Paragraph 3 is necessary to trigger surety liability. Absent unique circumstances—such as a state statute or agency regulation that override the bond terms—recovery will be barred without an owner's strict compliance with the terms of a performance bond.

Because of the ubiquity of AIA forms in the surety industry, all bond obligees—whether owners or general contractors dealing with subcontractors—would be well-served by a careful examination of any bond terms that impose notice obligations or other obligations on an owner considering termination and then to carefully follow them, even if they seem redundant. To do otherwise is to risk the loss of the protection of the bond.

Audrey K. Kwak
Construction Law Group

Waivers of consequential damages

In the vast majority of construction disputes, monetary damages are at the heart of the matter. In breach of contract cases, these damages can range from the basic—"direct or general" damages—to the more complex—"indirect or consequential" damages—and their effects can be crippling to even the most profitable businesses. This being the case, and to avoid the added risk of potentially costly litigation or arbitration proceedings, those savvy parties to a construction contract—whether owner, contractor or sub—should attempt to establish, at the outset, how much compensation must be paid, and under what circumstances, if the contract is breached.

In today's construction industry, it has become increasingly common for parties to contractually manage their risk in regard to "indirect or consequential" damages. As compared to "direct or general" damages, which are those damages that flow naturally from a breach of the contract, consequential damages are those damages that, while not flowing directly from the alleged breach, are incident to that breach. These damages can include lost profits, finance charges, damage to reputation and additional home office costs, however, the possibilities of compensable damages are potentially limitless. Thus, in the absence of an exhaustive list of consequential damages, suffice it to say that lost profits are typically considered to be the most common—and most costly—example of consequential damages in a construction dispute.

Modern courts and arbitration panels generally do not disfavor limitation of liability clauses that relieve the contracting parties from liability for consequential damages and, in fact, such provisions have become rather standard within the industry. For instance, the American Institute of Architects' (AIAs') Standard Form of General Conditions of the Contract for Construction (AIA A201-2007)—commonly considered to be one of the most influential forms in the industry—contains the following provision:

> § 15.1.6 CLAIMS FOR CONSEQUENTIAL DAMAGES
>
> The Contractor and Owner waive Claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes:
>
> 1. damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and
> 2. damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit except anticipated profit arising directly from the Work.
>
> This mutual waiver is applicable, without limitation, to all consequential damages due to either party's termination …

AIA Document A201-2007 § 15.1.6. Significantly, absent fraud or

continued on page 6

Waivers of consequential damages (continued)

unconscionability, provisions such as this are likely to be binding on the parties to the contract.

Beyond the obvious benefit of minimizing a party's risk exposure, in some circumstances, mutual waivers of consequential damages can also offer the increased advantage of lessening the cost of lengthy litigation or arbitration proceedings by providing the court or arbitration panel with the opportunity to adjudicate or dismiss part or all of a construction damages claim at an early stage in the case. This is more likely to occur where the scope of consequential damages is clearly defined within the terms of the contract. For this reason, those parties who are contemplating entering into a construction contract should consider having their legal counsel review the contract's language as it relates to consequential damages for this purpose. Indeed, by skillful drafting, setting forth specifically the consequential damages to be waived, many of the uncertainties regarding the awarding of damages that cause some courts and arbitration panels to resist or prolong making decisions as to consequential damages are eliminated.

Thomas P. Kemp, Jr.
Litigation and Construction Groups

United States Supreme Court Emphatically Affirms Federal Policy Favoring Arbitration

On November 7, 2011, the U. S. Supreme Court handed down a *per curiam* opinion in *KPMG LLP v. Cocchi, et al.*, No. 10-1521, a case arising from the fallout of the massive fraud perpetrated by Bernard Madoff. The nineteen plaintiffs had invested in a trio of limited partnerships known as the Rye Funds, which were heavily invested with Madoff. The defendants were the Rye Funds, the fund manager, and KPMG, the fund manager's auditor. KPMG's auditing agreement with the fund manager contained a clause mandating arbitration of all claims relating to the services provided by KPMG thereunder.

KPMG was sued on four theories, including claims arising under the Florida Deceptive and Unfair Trade Practices Act, negligent misrepresentation, professional malpractice, and breach of fiduciary duty. Each claim revolved around allegations that KPMG failed to apply proper auditing standards. The Florida courts refused to compel arbitration because the negligent misrepresentation and statutory claims did not arise under or derive from KPMG's obligations under the auditing agreement. The parties agreed that any claims that were derivative of the fund manager's rights under the auditing agreement were subject to the agreement to arbitrate.

The Supreme Court reversed and remanded the case to the Florida courts, finding that the "emphatic federal policy in favor of arbitral dispute resolution" mandates that courts compel arbitration of *any* claim which is subject to a binding arbitration agreement. This rule is inflexible, depriving courts of any discretion to weigh concerns over piecemeal litigation, and the inefficiency, expense and risks attendant to litigating related claims in different forums.

The case and the principle involved have great utility to those in the construction industry, where agreements to arbitrate are widespread and litigation involving multiple parties is commonplace. Where some but not all parties and claims are subject to arbitration, parties may use an arbitration clause to gain tactical advantage, to find a forum more favorable to their position, to increase the risks attendant to litigating claims against the client or, to extricate themselves completely from time-consuming, expensive litigation.

Cornelius "Neil" O'Brien
Alternate Dispute Resolution, Construction, Litigation and Public Transit Groups

Construction Law Group News

Awards

The Best Lawyers in America 2011®
Christopher R. Opalinski, Commercial Litigation and Litigation – Construction; **Scott D. Cessar**, Litigation – Construction

Additions

Thomas P. Kemp, Jr. joined the Construction Law Group as an associate attorney. Prior to joining Eckert Seamans, he served as a law clerk to the Honorable Nora Barry Fischer in the United States District Court for the Western District of Pennsylvania. Tom earned his J.D., *cum laude*, from the University of Cincinnati College of Law and his undergraduate degree from the University of Notre Dame.

Speaking

At the firm's annual CLE seminar in August, **Scott D. Cessar** led a panel discussion of Eckert attorneys – including **Christopher R. Opalinski, Mark A. Willard** and **Cornelius J. O'Brien** – all who have considerable experience in alternative dispute resolution as both advocates and as neutrals. They discussed best practices and procedures in ADR and on issues in the forefront in ADR.

On November 3, 2011, in five cities across the country, the ABA Forum on the Construction Industry presented THE Construction Contracts Program: Understanding and Negotiating the Critical Clauses in the Industry Form Documents. **Scott D. Cessar's** presentation was "Damages: Limitation on Damages and Waivers of Consequential Damages Delays, Liquidated Damages and No Damages for Delay."

Other

Christopher R. Opalinski and **Scott D. Cessar** visited a client in Mendoza, Argentina, where they spoke to the engineers and attorneys in an interactive discussion on construction law issues. They then traveled to Buenos Aires where they met with another client and attended its 40th year anniversary celebration.

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