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Construction Law

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Lawsuits arising from claim letters to the surety—A heavy burden to meet

When payment and performance problems arise on bonded projects, aggrieved owners and subcontractors often begin to either copy the surety for the general contractor on complaint and default letters or write to it directly advising it of the issues and problems. These letters are generally intended to put the surety on notice in an effort to gain its intervention or assistance in resolving some payment or performance issue. General contractors, however, often conclude that the letters are sent in order to interfere with their business and may result in the surety examining their bonding program and perhaps declining to continue to include them in its bonding program.

In these latter circumstances, aggrieved general contractors will say to us something like this, but likely in more colorful terms: "This letter is wrong. This party is trying to extort us. This will cause us harm by causing the surety to get involved into this project. The underwriter for the surety will see this letter and will not issue more bonds to us for upcoming projects, and we will not be able to bid more jobs."

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Small business advisory: Beware of inadvertent "affiliation"

In the competitive world of government contracting, small businesses have an edge: The federal government sets aside approximately 23 percent of its contracts annually for award to qualifying small businesses.

But despite this advantage, bidding on and performing a government contract is not easy, especially for an emerging small business, so many bidders naturally seek out the experience and expertise of larger businesses for mentorship. Small businesses should be aware, though, that though larger, more established businesses can permissibly advise them on a variety of issues, and even to a limited extent provide financial reinforcement in the form of contracts and lines of credit, unless steps are taken to keep their business operations distinct, such a relationship has the potential to create the impression that the companies are "affiliates"—and ultimately to threaten the designation of the small business as "small."

"Affiliation," in the world of government contracting, can include acknowledged affiliates (like parent and sister companies) as well as companies that share close ties, like common ownership, management, employment and even familial relations. When the government calculates a company's size, it adds the

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Lawsuits arising from claim letters to the surety— A heavy burden to meet

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What can the general contractor do in these circumstances?

At the outset, the general contractor should certainly send a careful and detailed letter in rebuttal to the surety explaining, on a factual basis with citations to the contract, why the letter is in error and why the general contractor's actions are justified and warranted. The letter should attach contemporaneous project documents in support. If needed, the general contractor should ask for a meeting to sit down and set forth its position and even get counsel involved. Consideration should also be given to sending a letter to the author of the letter to the surety demanding a retraction of the letter or threatening legal action against that entity otherwise.

But can the general contractor actually carry through on a lawsuit against the letter writer, be it an owner or subcontractor, assuming that it does not retract its letter and the general contractor is harmed? The answer is possibly yes, but the burden to sustain such a claim is a very high one.

In a recent case from the state of Washington, *Elcon Construction v. Eastern Washington University*, the Supreme Court of Washington considered a claim by a general contractor against an owner arising from the owner's sending of a letter to the surety advising of a termination of the general contractor for cause. According to the general contractor, the letter caused it harm by impairing its bonding capacity. As such, the general contractor brought a claim against the owner, based on intentional interference with contractual relations, because the letter was supposedly "intentional and vindictive." In its suit against the owner for sending the letter to its surety, the general contractor relied on the fact that an arbitrator ultimately ruled in favor of the general contractor that the owner was not justified in terminating the general contractor for cause.

The lower court dismissed the general contractor's claim for tortious interference against the owner for sending the copy of the termination letter to the surety. On appeal, the Supreme Court of Washington affirmed the dismissal of the claim. The Supreme Court held that, although ultimately its termination for cause was not upheld, the owner had acted in good faith in terminating for cause, based on information from its engineering consultant, and had an "interest" in advising the general contractor's surety. The Supreme Court further held that there was no evidence that the owner was motivated by "greed, retaliation or hostility" in sending a copy of the termination letter to the surety.

While the laws of the 50 states will differ, *Elcon* generally teaches that, so long as the letter to the surety is sent in good faith based on a reasonable disagreement grounded in some fact or law, the letter will not be the grounds for a cause of action against the authoring entity. In order to maintain such an action, the general contractor has a high burden to show an improper motive that is not based in fact or law. The best advice for general contractors, thus, is to spend their energy and efforts in responding to the letter to the surety in a detailed and factual manner in order to head off potential problems at the pass.

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Small business advisory: Beware of inadvertent "affiliation"

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revenues or employees of any affiliates. Thus, even if a company qualifies as small in its own right, it may exceed a size standard if it has any affiliates: For example, if a multimillion-dollar company owns a majority stake in a small business, the government will consider the small business's revenues to include those of its affiliate—even if the small business's revenues are a mere fraction of that.

The question of affiliation can arise pre-award by the contracting officer him or herself, or, in the event a contract is awarded to the allegedly affiliated small business, post-award by a disgruntled losing competitor. Such an inquiry must be taken seriously, as an adverse size determination by the local contracting agency can lead to the retraction of the award, leaving the small business with little recourse other than to appeal the determination, hopefully obtain a reversal, and regain the ability to bid on additional contracts as a small business.

Notably, certain relationships are encouraged under the Small Business Administration's (SBA's) formal Mentor-Protégé Program, designed to provide small business owners with the benefits of associating with a larger established business, including technical and management assistance, the ability to enter into joint-venture arrangements to compete for government contracts, financial assistance in the form of equity or loans, and the ability to obtain other forms of SBA assistance if in good standing in the program. A formal application and SBA approval is required to be entitled to these benefits, and annual reports must be submitted to maintain status in the program.

If you think your company may have an affiliation with another entity, measures should be taken to preclude such a determination. If you own a small business, be sure to review the SBA's affiliation guidelines, and to consult with counsel if you think that your small business might fall within their parameters.

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A primer on statutes of limitations, statutes of repose and limitations of actions

When a party first meets with its attorney to discuss a claim, one of the first things the attorney will want to discuss is the timing of when the claim occurred and what the contract says on the timing of bringing claims. The reason is simple: The laws of the states have built into them, by statute, timing mechanisms in order to bar stale claims, and contracts are often negotiated to shorten the time period in order to bring certainty to the parties. The issue of timing, thus, is a paramount one to be considered at the very outset.

"Statutes of limitations, statutes of repose and limitations of action can all bring certainty to knowing when potential liability has been forever extinguished."

There are three basic timing doctrines to consider, all of which are critical to the construction industry: (1) statutes of limitations, (2) statutes of repose and (3) limitation of actions.

All three timing doctrines are premised on bringing certainty to the parties and avoiding bringing stale claims that prejudice a party due to the lapse of time and the danger of the fading of memories, the loss of evidence, such as company records, and the disappearance of witnesses.

Statutes of limitations are laws enacted by the legislatures of the states that set time-certain periods in which claims must be brought, or they are lost. With reference to the construction industry, the most pertinent statute of limitation concerns the filing of an action for breach of contract. These statutes run in the various states from as short as two years to as long as ten years. If an action for breach of contract, such as for defective construction, is not brought within the time period set by statute, then the claim is subject to dismissal as time barred.

In many states, however, the running of the statute of limitations for breach of contract does not run from substantial completion, but from the date the breach is discovered. As such, if a defect in the construction is not discovered until three years after substantial completion, known as a latent defect, the statute may be tolled until the date of discovery of the defect. This is known as the "discovery rule."

Recognizing that this can lead to a potentially forever period of uncertainty for construction industry stakeholders, many states have enacted what are known as statutes of repose. These statutes, which are longer in duration than statutes of limitation, do what their name implies: provide repose to a contractor, design professional or manufacturer that, after a certain time period and no matter what is subsequently discovered, be it a latent defect or defective design, the claim is time barred.

Limitation of actions refer to contract provisions agreed to by the parties that shorten the time period and make certain that a claim must be brought within a specified period, whether discovered or not, or the claim is time barred. These provisions are most often found in supplier and vendor purchase orders for manufactured goods. Under the Uniform Commercial Code, adopted in some form in all states, these provisions are generally enforced and upheld.

There are various nuances to these three, claim-time limiting concepts embedded in the jurisprudence of the various states that must be considered in every instance. For example, in some states, the statute of limitations does not apply to governmental entities based on the doctrine of *nullum tempus occurit regi*, which translates from Latin into the principle that "time does not run against the King." Put simply, governmental entities in those states do not have to worry about the statute of limitations, as it does not apply to them in the context of a claim by them against a stakeholder on a construction project, be it a contractor, design professional or manufacturer.

With reference to statutes of repose, some states cover only contractors. Other states cover contractors, design professionals and even manufacturers. Other states' statute of repose will not cover manufacturers who only provide equipment without any design services. Those states require that the manufacturer also provide a design incorporating their equipment in order to avail themselves of the protection of the statute of repose.

One significant issue that arises in the context of the application of both statutes of limitations and statutes of repose is the trigger for the start of the time period. This issue can become very complicated when the job is phased and different substantial completion dates tie to the phases or, even if a phase is not substantially completed, the owner has taken beneficial occupancy of that phase of the job.

Statutes of limitation, statutes of repose and limitations of actions are all also subject to attack in an effort to enforce them based on other legal doctrines. For example, in some states, if the contactor is attempting to address the problem, the time period for bringing an action may be extended commensurate to the period of this effort. In addition, if the owner is able to show that the problem was somehow concealed by the contractor, design professional or manufacturer, this may also toll the running of the commencement of the statute until its discovery.

Statutes of limitations, statutes of repose and limitations of action can all bring certainty to knowing when potential liability has been forever extinguished. However, the application of each is not automatic, but must be considered in the context of the statutes and case law of the jurisdiction.

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Un-limited liability? The recoverability of liquidated damages in the context of contract abandonment

It's a common occurrence: A general contractor begins a project, and, for any number of reasons, abandons the project before final completion. The question is, in this circumstance, will a contractor still be potentially liable to the owner for damages for the delay in completion under the contract's liquidated damages clause? If so, for how long? If the project is never completed, will the contractor be liable forever? The Eighth Circuit Court recently addressed this issue in *Weitz Co. v. MacKenzie House, LLC*.

> *If a contractor remains on the hook for liquidated damages even after complete abandonment of the project, the question remains, for how long?*

Liquidated damages clauses are ubiquitous in construction contracts because it is difficult, if not sometimes impossible, to figure out the actual amount of damage suffered because of a delay in the completion of a project. These clauses generally provide that, if a contractor fails to complete a project before a specified date, the contractor will owe the owner a specified amount of damages, usually calculated on a per diem basis until the project is complete.

Courts are divided as to whether liquidated damages provisions apply when there is a complete abandonment of the project by the contractor once work has begun. The older approach to this question is that liquidated damages are not available in the case of complete abandonment, because the clauses are meant to address project delays, not abandonment. In addition, courts feared that owners could abuse this situation by taking their time to complete a project after the contractor's abandonment. Of the dozen or so states that have addressed this question, New York and Kentucky seem to be the only states that have recently upheld this older approach.

More and more, however, courts that have addressed this question in the last few decades have permitted the recovery of these liquidated damages in the case of contractor abandonment. The rationale underlying this new approach is that relieving a contractor of liability for delay under the liquidated damages clause upon abandonment actually encourages a contractor to abandon a contract if it thinks the project will not be finished by the completion date specified in the contract.

This trend recently played out in a case in the Eighth Circuit applying Missouri law. In *Weitz Co. v. MacKenzie House, LLC*, the owner M.H. Metropolitan hired Weitz as the general contractor on a multi-building apartment project. The project suffered delays, which Weitz attributed to its subcontractors. These delays led M.H. Metropolitan to withhold payment on two of Weitz's payment applications. Weitz stopped work because of the nonpayment, and, about three weeks later, M.H. Metropolitan terminated Weitz for cause and completed the project without Weitz. Weitz sued M.H. Metropolitan for the unpaid contract balances, and M.H. counter-claimed for breach of contract, seeking liquidated damages for each day the project was delayed until final completion, even after Weitz was no longer in control of the project.

The Eighth Circuit Court was confronted by Missouri Supreme Court precedent, consisting of only one case that was a century old, which followed the older approach to this question and held that owners could not collect such liquidated damages. The Court struggled with the antiquated Missouri precedent before ultimately rejecting it and following the modern approach, holding that M.H. Metropolitan was indeed entitled to liquidated damages for the delay in completion of the project.

If a contractor remains on the hook for liquidated damages even after complete abandonment of the project, the question remains, for how long? Would a contractor have to keep paying damages each day until an owner got around to finishing a project 10 years later?

The answer is no. Courts that have allowed the recovery of liquidated damages in the case of abandonment limit the period for which an owner can recover liquidated damages to a reasonable time necessary to complete the job, rather than until the date of actual completion. To recover, an owner must show that it took reasonable steps toward completing the project, that it acted with reasonable promptness and that the project was completed within a reasonable time. In addition, the owner cannot also abandon the project and subsequently turn around and seek liquidated damages from the contractor indefinitely.

The takeaway from this discussion of liquidated damages is twofold: Contractors should be aware that they may still be liable to the owner under the contract's liquidated damages clause for delays in the completion of a project, even if the contractor has abandoned the project and been replaced. Owners should be aware that they may still be able to recover these liquidated damages after a contractor has abandoned a project, but in doing so, owners should be prepared to show that they took reasonable steps to try to get the defaulting contractor to fulfill its obligations under the contract, that they got the surety involved, and that they hired a new contractor to finish the work with reasonable promptness.

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Private sector construction contract regulation: The state creeps in

The construction industry is no stranger to government regulation of its contracts. In the past half-century, the government has regulated public contracts to protect its own interests, especially if there is some compelling social policy on its agenda. Of course, few dispute the regulation of Home Improvement Contractors as necessary to protect consumers.

Gradually, some states have waded a little deeper into the relations between private contractors by prohibiting for example, contracting for prospective lien waivers. However, arguably these states had an interest in preserving their statutory lien schemes by preventing parties from circumventing their statutory intent through contract. In this case, the states' interest in protecting their registry systems is especially valid. So, the intrusion was arguably minimal.

U.S. Constitution. Art. I, § 10 states, "No State shall pass any Law impairing the Obligation of Contracts."

This article of the Constitution was not an outright ban on regulation of private contracts by the government, but served to set out a mercantile ideal that was fastidiously observed by the judiciary for a couple centuries.

This concept was strengthened through the fifth and fourteenth amendments (U.S. Const. Amend. XIV "No State shall deprive any person of liberty without due process of law."). For 50 years the courts interpreted such liberty to include the general right to make a contract in relation to a business.

Until recently, the concept continued to resonate. "Historically, the judiciary had opposed efforts by government to interfere with the private right to contract. Between 1899 and 1937—which includes the depths of the Great Depression—the Supreme Court invalidated 197 separate state or federal regulations based on their interference with contractually related rights. The judiciary rightly viewed its role as a defender of the fundamental right to contract." *See Andrew L. Schlafy, Judicial Interference with the Right to Contract.*

Certainly, these compelling mercantile ideals should apply, without reservation, to the sophisticated world of private commercial construction contracting. However, several states have recently adopted laws that void certain contract clauses concerning payment. Many of these clauses were once *de riguer* in a typical commercial construction contract.

In 2011, Massachusetts adopted a statute affecting private contracts. It required prompt payment and banned "pay-when-paid" clauses for contracts over $3 million. The obvious motivation was the poor economy of the time. This remedy would assist subcontractors in wringing money out of the general contactors much more quickly and with more certainty. Perhaps, however, economic expediency trumped Constitutional values.

Typically, these statutes are the result of negotiated agreements between trade groups. So, it can be inferred that the general contractors in Massachusetts agreed that it was inevitable that the subcontractor groups were likely to get the state legislature to support their position. So, they conceded the imposition of these strictures to mitigate their potential draconian effect.

In 2003, New York adopted a "prompt pay" requirement for its contracts. The statute also prevents contracting parties from choosing other states' law for their choice of law provision for a New York construction site.

The New York statute is notable in that it was adapted before the recession struck. However, it was adopted less than two years after the events of 2001, when the need for labor harmony in New York was presumably at it greatest extent.

Recently, Pennsylvania (2007) and Connecticut (1999) have imposed their own bans on prospective lien waivers in private construction contracts in many circumstances. This may be first steps toward greater regulation in these states.

The likelihood of these statutes being repealed in better economic times is nil.

Consequently, the door will be open to pin liability on contractors for driving their best bargain in a contract, or depriving them of the benefit of their bargain. Eventually, this will drive up costs for owners as contractors embed their potential greater liability in their bids and quotes.

The government's quest for commercial harmony by legislating contract terms comes at a price. As parties stop jockeying for a contractual advantage, undeserving parties are rewarded. This process will cause inefficiencies for everybody.

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In re: Rust of Kentucky, Inc.: Bankruptcy court offers relief to a subcontractor victimized by differing site conditions

In the recent decision *In re: Rust of Kentucky, Inc.*, 464 B.R. 748 (2012), the United States Bankruptcy Court for the Western District of Kentucky described a scene that seemed to transport the Battle of Agincourt to rural Tennessee. A subcontractor tasked with excavating over a million cubic yards of soil from a marina was forced to deal with artesianal waters, torrential downpours, porous soil and a once-in-a-century flood that created a soup of mud and muck that even Henry V could not have overcome. In the end, the fatally crippled subcontractor was driven into bankruptcy, and the Court was left to sort through the debris of differing site conditions and a claim for wrongful termination.

"Later soil samples revealed sandy, permeable clays, but the contract documents were not updated to reflect this new information."

Rust of Kentucky, Inc. (Rust) was an earthmoving contractor that, in 2009, entered into a subcontract with TMS Contracting, LLC (TMS) related to the reconstruction of a marina, fishing pond and park located in Clarksville, Tennessee. The most significant portion of the project involved the excavation of the marina and fishing pond, which would be performed "in the dry"— the incoming Cumberland River would be held back to allow the marina to dry out, and land-based equipment would be used to accomplish the excavation. Initial analyses of the soils conducted by project engineers indicated that the soil was stable with a relatively low moisture content, and this information was contained in the bid documents. Later soil samples revealed sandy, permeable clays, but the contract documents were not updated to reflect this new information. Rust relied on the engineer's expertise as reflected in the bid documents to conclude that no unusual dewatering methods would be necessary to successfully complete the excavation.

The timely excavation and completion of the project was contingent on stable, non-permeable soils and on performance during the summer, which would allow the excavated soils to completely dry prior to transport. Rust, however, received neither. After a delay in starting the project because TMS did not timely secure permits, Rust experienced months of "precipitation for the region [that] exceeded the norm and all reasonable expectations," which created, in the words of the court, a "deluge."

Moreover, Rust encountered a highly permeable layer of subsurface material that caused artesianal water to burst upward through the floor of the marina, which not only exacerbated the wet soil, but also destabilized various parts of the site. The millions of gallons of subsurface water created a feedback loop with the rainwater that left the project nearly unmanageable.

TMS ordered Rust to continue to perform, despite ever-worsening conditions that all parties acknowledged. Indeed, TMS forced Rust to continue work on the project under threat of default "even if they bury their equipment up to the axles," which, as the Court noted, actually happened, causing thousands of dollars of damage. At TMS' direction, Rust worked for months beyond the original contract date and into winter weather. This directive was issued while the Cumberland River continued to rise as a result of the rainwater, and Rust only stopped complying after it was forced to move to higher ground for safety reasons. Unmoved by Rust's efforts, TMS terminated the contract for cause, claiming the work was not moving fast enough. Shortly after the termination, however, in May of 2010, a "one thousand year flood" of the Cumberland River completely engulfed the work site and submerged everything under 20 feet of water.

Not only was the project sunk, but so was Rust's business, which declared bankruptcy and asserted two claims against TMS. First, the court examined Rust's claim for "differing site conditions." A differing site condition is generally a subsurface or other unknown physical condition at a site that differs materially for either (a) the information indicated on the contract (a "Type I" condition) or (b) the conditions normally encountered in the area (a "Type II" condition). Although not a term used by the Court, Rust's claim represented a Type I condition. In order to prove such a claim, the Court, borrowing from the Federal Court of Claims, stated that Rust was required to prove: (1) the contract affirmatively indicated subsurface conditions, (2) the contractor reasonably interpreted the contract documents, (3) the contractor reasonably relied on the contract representations, (4) the actual subsurface conditions differed from those represented, (5) the actual conditions were unforeseeable and (6) the contractor suffered excess costs solely attributable to the materially different subsurface conditions.

The court emphatically found that Rust met each of these elements. The Court noted that even though a bid addendum referred to "wet materials" in certain soil readings, the design drawings did not include a system for groundwater cutoff, and no specific notation of artesian conditions was given. The court observed that "Rust was not expected to anticipate a worst-case scenario, only for evaluating the available information and reasonably extracting from such information subsurface conditions." Notably, the Court examined the bids of other contractors related to dewatering of the site and found that Rust's bid was reasonable in relation to these other bids. It observed that

this similarity was a "significant indication" that the differing conditions were not foreseeable based on the bid documents, and that Rust's conclusions about the groundwater were reasonable.

Over and above the differing site conditions, claim, however, the bankruptcy court also acknowledged that Rust had been wrongfully terminated. All evidence indicated that Rust made every effort to complete its work, even after unreasonable and dangerous directions by TMS. Indeed, it was demonstrated that TMS ordered Rust to continue work in violation of a permit issued by the Army Corps of Engineers, which forbade any work after water levels reached a certain height. Further, the court stated that "TMS waived its right to declare a default or terminate the subcontract by pressing Rust to work beyond the required time of performance . . . under increasingly impossible conditions." In other words, TMS could not reserve a claim of default termination while simultaneously ordering Rust to perform additional work outside the original scope and duration of the contract. Rust was ultimately awarded $4.8 million for its increased costs that resulted from the differing site conditions and profit for the wrongful termination.

When conscientious contractors and subcontractors are faced with difficult site conditions that may be different from those anticipated, they may soldier on in the face of mounting problems, often while under threat from the party above them on the project. The Court in *Rust Consulting* acknowledged the extreme difficulties that may arise in the case of differing site conditions, and awarded damages accordingly. Although the compensation for Rust came after it was already forced into bankruptcy, the Court's holding does provide hope for contractors and subcontractors that may feel stuck in a problem they did not create.

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Controlling electronic discovery costs: cutting "big data" down to size

Big data is one of the hot electronic discovery buzzwords of 2012. Big data describes the growing volume, variety and velocity of information that exceeds the processing capacity of conventional database systems. Some real life examples of big data:

- 10,000 payment card transactions are made every second around the world.
- Walmart handles more than 1 million customer transactions per hour.
- 340 million tweets are sent per day. That's nearly 4,000 tweets per second!
- The Radicati Group, a technology market research firm, estimates that by 2013, 507 billion email messages will be sent each day.

Big data poses challenges for litigants by increasing the already expensive process of e-discovery, requiring an even bigger solution. Corporations spend millions of dollars to preserve and analyze huge amounts of data in order to locate information that is responsive to discovery requests and to isolate the relevant electronically stored information (ESI). As the associated costs of managing this data continue to grow, e-discovery vendors are developing new tools and best practices to help corporations manage the ever-increasing amount of data involved in discovery.

Earlier this year, the RAND Corporation Institute for Civil Justice (ICJ) completed a study titled "Where the Money Goes: Understanding Litigant Expenditures for Producing Electronic Discovery." The study addressed "one of the most persistent challenges of conducting litigation in the era of digital information: the costs of complying with discovery requests, particularly the costs of review." The ICJ found that the cost of document review is approximately 73 cents of every dollar spent on ESI production. The document collection and processing phases of complying with discovery requests represent about 8 cents and 19 cents, respectively.

The key to reducing the costs associated with ESI review and production is to reduce the number of documents involved in the process of document review. Two primary ways to reduce the number of documents are to develop a defensible document retention and destruction policy and to take advantage of predictive coding technology. These methods will reduce the number of documents that need to be reviewed by attorneys, thereby decreasing the overall cost of complying with discovery requests.

Developing a document retention and destruction policy that is actively enforced and audited is an effective way to reduce the number of documents involved in ESI production. The policy should define the use and storage of not only common storage media such as mainframes, servers, personal computers, backup tapes, etc., but also technologies such as smartphones, instant messaging and social media.

A defensible document retention policy that addresses retaining and deleting ESI should achieve three goals:

1. Preserve business records while they have a useful life.
2. Provide a defensible explanation as to why certain documents may no longer exist in the event that litigation does arise after documents have been deleted.
3. Limit the number of areas where ESI may be stored (thereby making the process of gathering ESI to comply with discovery requests more efficient and economical).

Outside of industry-specific regulations and litigation hold requirements to preserve information related to ongoing or reasonably anticipated litigation (as well as government investigations or financial audits), a company need only keep ESI as long as necessary for business purposes. For example, emails relating to a construction project should be retained for the duration of the project, but once the project is completed, the documents have served their business purpose and can be deleted. Remember, once information is subject to a litigation hold, or if you reasonably anticipate litigation, the information MUST NOT be deleted.

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Controlling electronic discovery costs: cutting "big data" down to size
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A defensible retention policy will classify information in accordance with a retention schedule that dictates how long each record classification should be kept and when it can be destroyed. The retention schedule should reflect a reasonable document disposal plan that serves legitimate business needs. The policy will also contain citations of applicable document retention regulations in order to ensure compliance with regulations and industry standards. Once a document retention policy is in place, it is critical for the organization to strictly and consistently follow the policy. Strict adherence to the policy is key to the defensibility of the process. The business will always want to be in a position to demonstrate how the elimination of documents is in compliance with a reasonable document destruction plan that serves legitimate business purposes.

Another hot electronic discovery buzzword of 2012 is Technology Assisted Review (TAR). TAR is also referred to as "predictive coding" or "machine learning." The use of TAR is also an effective way to reduce the number of documents involved in an ESI production. TAR is the use of computer technologies to categorize an entire collection of documents as responsive or nonresponsive to the litigation based on human review of only a subset of the document collection. As the ICJ categorized it, predictive coding allows computers to do the "heavy lifting" in document review by reducing the number of documents that must be reviewed by attorneys, thereby reducing the overall cost of document review and production. Although the technology for machine learning has been around for quite some time, it has only recently gained momentum in the context of reviewing documents for ESI production. Earlier this year, we saw the first two cases where the Court approved of the use of predictive coding technology: Da Silva Moore v. Publicis Groupe, No. 11 Civ. 1279 (ALC) (AJP), 2012 U.S. Dist. LEXIS 23350 (S.D.N.Y. Apr. 26, 2012) and Global Aerospace v. Landow Aviation No., CL 61040 (Va. Cir. Ct. Apr. 23, 2012)

"TAR is also referred to as "predictive coding" or "machine learning." The use of TAR is also an effective way to reduce the number of documents involved in an ESI production. TAR is the use of computer technologies to categorize an entire collection of documents as responsive or nonresponsive to the litigation based on human review of only a subset of the document collection."

If machines making responsiveness decisions on documents sounds like a complicated proposition, you are correct. The technology behind it is complicated, but the implementation of it is not. In fact, it is likely that you experience the use of predictive coding technology in everyday life when your email account identifies emails that are likely to be spam and it filters these emails for you. Also, when you shop or browse online, you experience predictive coding. Predictive coding is how a retailer takes what it learns about you with every website visit and uses the information to make predictions about what you might want to buy based on what others with similar preferences have purchased. The program uses predictive coding to decide whose preferences are "like" yours and which products are "like" the ones you have viewed online.

In the context of the review of a document collection, TAR ranks documents according to the likelihood that they will be responsive to a given request for production. The ranking is based on how the documents have been categorized by the attorney who reviews the documents. Through an iterative process of "learning" from the attorney's categorization of documents as being responsive or not responsive to the litigation, the predictive coding system feeds the likely responsive documents to the reviewer. As the review progresses, and the attorney continues to make responsiveness decisions, the documents that the machine has identified as being nonresponsive are set aside (much like when your email system identifies emails that you do not want to read as "spam" and sets them aside).

The nonresponsive documents will not be reviewed. Since the percentage of nonresponsive documents in a collection can be as high as 70 percent, predictive coding can provide real cost savings by eliminating the need to review the majority of the documents in the collection. The responsive documents in the collection will be identified through the process of predictive coding, reviewed by the attorney and produced to opposing counsel. The remaining nonresponsive documents will be sampled to ensure accuracy, but the majority will not be reviewed.

In addition to the potential for tremendous cost savings, there are other possible benefits to using TAR. Studies show that predictive coding is possibly more consistent and accurate than review by humans.

The rapid growth of the amount of electronically stored information that organizations generate has prompted companies to seek ways of meeting their electronic discovery requirements in a cost-effective manner. Because document review accounts for the majority of the costs of complying with discovery requests, many of these efforts have focused on reducing document review costs. Developing a defensible document retention and destruction policy and utilizing predictive review technology are two primary ways to help manage the amount of ESI involved in the discovery process, thereby reducing document review and processing costs.

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Court clarifies law regarding post-bid substitution of subcontractors

A recent case from the Commonwealth Court provides contractors greater latitude in substituting subcontractors when the sub's bid was included in a successful bid, but the contractor has *not* formally accepted the sub's bid. In *Ribarchak v. Municipal Authority of the City of Monongahela*, subcontractor Fisher Associates submitted a bid to general contractor Galway Bay Corporation (Galway). Galway included Fisher Associates' bid in its own bid to the Monongahela Municipal Authority (the Municipal Authority), which was soliciting bids for renovating a sewage treatment facility. Galway's bid was accepted by the Municipal Authority, but Galway never expressly accepted Fisher Associates' bid.

The contract between Galway and the Municipal Authority provided that subcontractors could *not* be substituted more than 30 days after the contract was awarded. Nevertheless, after more than 30 days had passed, the Municipal Authority consented to Galway's request to substitute another subcontractor for Fisher Associates. Fisher Associates, in turn, sued Galway, the Municipal Authority and its engineer (which was handling the bids) on the theory that it had a valid subcontract with Galway.

Both the trial court and the Commonwealth Court rejected all of Fisher Associates' arguments. The Court first rejected Fisher Associates' argument that Galway effectively accepted its bid by including it in its own bid. The Court found that Fisher Associates' bid was merely an offer to Galway. "A contract is only formed when an offer is accepted," and because there was no evidence "that Galway or the Authority conveyed to Fisher an acceptance of its offer," there was no contract between Galway and Fisher Associates. On this point, although the issue was not previously decided in Pennsylvania, the Commonwealth Court followed cases from Kentucky, New York, Washington, the District of Columbia and California that reached the same conclusion.

The Court also rejected Fisher Associates' argument that it could not be substituted for another sub because the prime contract's 30-day window for substitutions had passed. The Court found that Fisher Associates could not challenge Galway and the Municipal Authority's agreement to waive the 30-day window for substitutions, because Fisher Associates was neither a party to the prime contract nor a "third party beneficiary" of the prime contract.

The case is helpful in clarifying the legal position of a contractor that includes a sub's bid in its own bid and later discovers a material problem with the sub's bid. Provided that the owner consents to the substitution *and* the sub's bid has not been accepted, the contractor can substitute one sub for another without liability to the original sub because there is no contract between the contractor and the sub. Moreover, even if there is a clause in the prime contract limiting the contractor's ability to substitute subs, an aggrieved sub has no standing to object if the owner and contractor agree to waive the clause.

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PCBs are still considered a hazardous material

Construction and demolition contractors have many hazardous materials and conditions that they must consider and address, such as asbestos, lead paint and contaminated soil. Another material pervasive in building materials is polychlorinated biphenyl (PCB). The U.S. Environmental Protection Agency's (EPA's) September 2012 announcement regarding its settlement with the University of Massachusetts serves as reminder that PCBs are, and remain, on the list of hazardous materials for which contractors must be vigilant. This recent settlement may also serve to remind the EPA that PCBs remain a hazardous material for which the agency needs to be vigilant with respect to compliance and enforcement.

Recently, the University of Massachusetts Amherst has agreed to spend nearly $3 million over 15 years to remove and dispose of PCB-contaminated windows at an on-campus research facility under the terms of an administrative settlement with the EPA. The EPA said the PCB concentrations in caulk and window glazing at the Lederle Graduate Research Center were greater than 50 parts per million, which exceeds permissible levels in the Toxic Substances Control Act (TSCA).[1]

PCBs are man-made chemicals that persist in the environment and were widely used in construction materials and electrical products prior to 1978. PCBs can affect the immune system, reproductive system, nervous system and endocrine system and are potentially cancer causing if they build up in the body over long periods of time. Congress banned the manufacture and use of PCBs in 1976, and they were phased out in 1978 except in certain limited uses.[2]

Section 6(e)(2) of the TSCA, 15 U.S.C. § 2605 (e)(2) prohibits the manufacture, processing, distribution in commerce, or use of any polychlorinated biphenyl in a manner other than in a totally enclosed manner except as authorized by the EPA. The PCB regulations establish prohibitions of, and requirements for, the manufacture processing, distribution in commerce, use, disposal, storage, and marking of PCBs and PCB items. 40 C.F.R. § 761.20 prohibits concentrations of 50 ppm or greater, and PCB items with PCB concentrations of 50 ppm or greater present an unreasonable risk of injury to health within the United States. PCB products with a concentration less than 50 ppm are excluded under 40 C.F.R. § 761.3.

The contamination at UMass Amherst was first discovered in March 2009 during an environmental assessment of the building in preparation for an electrical upgrade. High levels of PCB were found in the compound at Tower A and the low-rise of the building. Subsequent testing showed higher levels of PCB at 82.2 to 14,000 ppm and concentrations of 82.2. to 129 ppm in the black sealant in the library and walkway. In order to correct the contamination problem, UMass Amherst developed an Interim Measures Plan to

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PCBs are still considered a hazardous material
(continued)

properly remove and dispose of all PCB-contaminated windows and compound.[3]

The PCB regulations separate PCB waste into two categories with different disposal requirements for each. During an assessment of the building, it is important to determine what types of PCB waste will be disposed of.[4] PCB-containing caulk is considered PCB *bulk* product waste if the concentration of PCBs in the caulk are greater than or equal to 50 parts per million. Under 40 CFR § 761.62, *PCB bulk* product waste must be disposed of in either a permitted solid waste landfill or a risk-based disposal approval process. If PCBs have contaminated the surrounding building materials or adjacent soil, these materials are considered PCB remediation waste. Under 40 CFR § 761.61, *PCB remediation waste* can be disposed one of three ways: (1) self-implementing cleanup and disposal, (2) performance-based disposal or (3) risk-based cleanup and disposal.[5]

A reminder to all contractors and demolitionists, PCBs may be present in building materials other than caulk used in windows, such as door frames, masonry columns and other masonry building materials used in buildings built between or renovated in 1950 through 1978. Products that may contain PCB include:

- Transformers and capacitors
- Other electrical equipment including voltage regulators, switches, reclosers, bushings and electromagnets
- Oil used in motors and hydraulic systems
- Old electrical devices or appliances containing PCB capacitors
- Fluorescent light ballasts
- Cable insulation
- Thermal insulation material including fiberglass, felt, foam and cork
- Adhesives and tapes
- Oil-based paint
- Plastics
- Carbonless copy paper
- Floor finish
- Fungicide[6]

Because PCBs can migrate from the contaminated material into the air, dust and other materials and soil, the EPA is concerned about potential PCB exposure to building occupants. Where PCBs have been found in the air, building materials or soil, contact the region's PCB coordinator for assistance.

[1] Anthony Adragna, *UMass Agrees to $3.5 Million Settlement with EPA over PCB-Contaminated Windows*, http://www.news.bna.com/txln/display/batch_print_display.adp (9/20/2012).

[2] *EPA Fact Sheet – PCBs in Caulk*, http://www.epa.gov/pcbsincaulk/caulk-fs.pdf (9/24/2012).

[3] *In the Matter of: The University of Massachusetts System*, TSCA-01-2012-0036, (June 4, 2012).

[4] *Current Best Practices for PCBs in Caulk Fact Sheet-Disposal Options for PCBs in Caulk and PCB-Contaminated Soil and Building Materials*, http://www.epa.gov/epawaste/hazard/tsd/pcbs/pubs/caulk/caulkdisposal.htm, (9/25/2012).

[5] *Contractors: Handling PCBs in Caulk During Renovation*, http://www.epa.gov/epawaste/hazard/tsd/pcbs/pubs/caulk/caulkcontractors.htm, (9/25/2012).

[6] *Basic Information: Polychlorinated Biphenyls*, http://www.epa.gov/epawaste/hazard/tsd/pcbs/pubs/about.htm, (9/25/2012).

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The Pennsylvania Superior Court rules on lien priority under the Mechanic's Lien Law

The Pennsylvania Superior Court, in *Commerce Bank/Harrisburg, N.A. v. Kessler*, recently interpreted language in the Pennsylvania Mechanic's Lien Law (the Law) in a manner that is very troublesome for construction lenders. The Law had been amended in 2006 (effective January 1, 2007) in a manner presumably intended by the legislature to afford protection to construction mortgage lenders vis-à-vis holders of mechanic's liens. The Superior Court's decision in *Kessler* narrowly interpreted the protection afforded by the amendment to the Law.

An understanding of the priority afforded to mechanic's liens under the Law is a prerequisite to understanding the impact of *Kessler*. Most liens have a priority, vis-à-vis other liens, based on their time of filing or recording. This is generally true of mortgage liens and it is true of mechanic's liens, which relate to the "alteration or repair" of an improvement. Mechanic's liens relating to the "erection or construction" of an improvement, however, date back and are assigned priority "as of the date of the visible commencement upon the ground of the work of erecting or constructing the improvements."

The 2006 amendment to the Law provided an exception (the Exception) to the rule for assigning a priority for mechanic's liens relating to the erection or construction of an improvement as of the date of the visible commencement of the work upon the ground. The 2006 amendment provided:

> "(c) Any lien obtained under this act by a contractor or subcontractor shall be subordinate to the following:
>
> (2) An open-end mortgage as defined in 42 Pa.C.S. § 8143(f) (relating to open-end mortgages), the proceeds of which are used to pay all or part of the cost of completing erection, construction, alteration or repair of the mortgaged premises secured by the open-end mortgage."
>
> 49 P.S. § 1508(c)(2).

Thus, the 2006 amendment provided a priority for certain open-ended construction loans vis-à-vis mechanic's liens. Those construction mortgages would have had priority, in any event (and without the aid of the Exception), over mechanic's liens filed in connection with the alteration or repair of an improvement, provided that the liens were filed after the mortgage was recorded. Without the benefit of the Exception, however, a mechanic's lien filed

after a mortgage was recorded and relating to "erection or construction" could trump an open-end construction mortgage if the work had visibly commenced prior to the recording of the mortgage.

At issue in *Kessler* was what was needed for an open-end mortgage to qualify for the Exception provided by the 2006 amendment to the Law. The *Kessler* court considered what is meant by the requirement that "the proceeds" of the open-end mortgage be used to pay all or part of the cost of completing erection, construction, alteration or repair of the premises secured by the open-end mortgage.

"Kessler*, thus, is good news from the construction contractor's perspective. Until* Kessler *is overruled or the Exception is amended, construction lenders can no longer rely on the superpriority that many of them thought that the Exception afforded their mortgages vis-a-vis mechanic's liens.*"

Kessler involved an open-end construction mortgage relating to an improvement that was acknowledged to be erection or construction. It was not disputed that (a) the work visibly commenced on the ground before the open-end mortgage was recorded, (b) the contractor filed a mechanics lien which dated back to a date before the recording of the mortgage and (c) but for the application of the Exception provided by the 2006 amendment, the contractor's lien would be senior to the mortgage. The question before the *Kessler* court was whether the mortgage qualified for the protection provided by the Exception. This boiled down to whether the "proceeds" of the loan were used to pay all or part of the cost of the erection, construction, alteration or repair of the mortgaged premises.

The contractor argued that all (100 percent) of the loan proceeds had to be used for construction in order for the Exception to be applicable. There was no dispute in *Kessler* that a portion of the construction loan proceeds were used for non-construction purposes (e.g., tax claims, closing costs and the satisfaction and payment of an existing mortgage and other liens). Therefore, if the Exception required that *all* of the loan proceeds be used for construction costs, the Exception would not have been applicable and the contractor's lien would be senior to the lien of the mortgage.

The *Kessler* court agreed with the contractor and held that all (100 percent) of the proceeds of the loan had to be used for construction purposes in order for the Exception to be applicable. The *Kessler* court was persuaded by the contractor's argument that holding otherwise would invite manipulation of the Exception. The *Kessler* court sought to avoid an interpretation that would allow a million-dollar loan with only a one-dollar construction component to qualify for the Exception. Interestingly, the *Kessler* court failed to mention the reverse situation of a million-dollar mortgage loan having only a one-dollar non-construction component, a situation which, under the *Kessler* holding, will result in the mortgage not qualifying for the Exception.

Many, if not most, loans that most people would consider to be "construction loans" involve one or more budgeted items for something other than construction costs (e.g., closing costs, lenders' attorneys' fees, interest reserves, etc.). It is questionable whether the legislature intended that a loan with any non-construction component, no matter how small, should not qualify for the Exception. Until *Kessler* is overruled judicially or legislatively, however, lenders and title insurers must contend with such a construction of the Exception.

At the very least, construction lenders involved in erection or construction projects must now pay closer attention to whether work visibly commenced on the ground prior to the making of the loan. These construction lenders can no longer assume that the Exception will automatically allow their mortgage to trump mechanic's liens which date back to a time prior to the recording of their mortgages. It may not be practical, however, for lenders to only make construction loans where work has not visibly commenced. Additionally, there may be uncertainty as to whether work has visibly commenced within the meaning of the Law.

In order to avail themselves of the protection of the Exception, lenders may elect, at least where the economics allow it, to only fund construction costs and refrain from funding the myriad of non-construction costs which, under *Kessler*, would make the Exception inapplicable. Even then, there is a question as to what construction costs are consistent with the Exception. Does the cost of "completing erection, construction, alteration or repair of the mortgaged premises" include only so-called "hard" construction costs, or does it also include "soft" construction costs such as architects' and engineers' fees? This question was not addressed by *Kessler*.

As a result, the upshot for the construction contractor is that most construction projects, including the way they are started and financed, may make the Exception practically inapplicable, maintaining the primary position of the construction contractor's lien.

Kessler, thus, is good news from the construction contractor's perspective. Until *Kessler* is overruled or the Exception is amended, construction lenders can no longer rely on the superpriority that many of them thought that the Exception afforded their mortgages vis-a-vis mechanic's liens.

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Construction Law Group News

Awards

Chris Opalinski and **Scott Cessar** were named to the list of the "Top 50 Attorneys in Pittsburgh" for 2012 as reported in *Pittsburgh Magazine*. Chris and Scott were the only two construction attorneys named to the list.

Both Opalinski and Cessar also were named as "Best Lawyers in America" for Construction Law for 2013.

Client wins

Chris Opalinski and **Tim Berkebile** were recently successful in a two-week jury trial in state court in Allegheny County, PA, where they represented an electrical contractor against a school district on a project that involved the construction of several new additions to a high school. The jury found in favor of our contractor client on all claims, including a claim for "Bad Faith" under the Procurement Code, and awarded the client more than $800,000. Based on the Bad Faith finding, our client is also entitled to a post trial award of attorneys' fees and penalty interest.

In a published opinion issued in June of this year, the Wyoming Supreme Court affirmed the decision of the trial court foreclosing a mechanic's lien against one of the nation's largest energy transmission companies and in favor of our client, a subcontractor who built a gas treatment plant on a pipeline. Based on this decision by the Wyoming Supreme Court, our client has now recovered almost $6 million and will be seeking recovery of additional damages in the trial next year of two remaining claims. **Scott Cessar** and **Audrey Kwak** represented our client, and Scott argued the case in January of this year before the Wyoming Supreme Court in Cheyenne, WY.

In September, **Tim Grieco** and **Tim Berkebile** were successful in a weeklong jury trial in Ohio enforcing, on behalf of our client, an oral contract to design and build an electrical substation for the client. The jury found in favor of our client, determining that an oral contract existed, and awarded damages of more than $400,000 to our client.

Scott Cessar and **Tom Sweeney** were successful in defending our client, a nationwide equipment supplier, in a five-day jury trial in Allegheny County, PA, which arose out of a fatality on a construction site. After three days of trial, the worker's family settled with the general contractor and the owner for $3.1 million. The general contractor continued with a claim of contribution against our client, requesting the jury to hold our client fully responsible for the accident in order to recover the $3.1 million paid in settlement. The jury came back with a complete verdict for our client finding that it was not negligent. **Jake McCrea** also helped in this matter.

Audrey Kwak was recently successful in litigation before the United State Small Business Administration Office of Hearing and Appeals in appealing the determination of the Contracting Officer, which concluded that our client, a small business enterprise, was improperly affiliated with a large company and, therefore, was not entitled to the small business set-aside. On appeal to the Office of Hearing and Appeals, Audrey was successful in persuading the SBA that the Hearing Officer's determination was erroneous.

Tim Grieco and **Matt Whipple** were successful in a weeklong jury trial in Ohio for a client based on claims of breach of contract by a labor broker relating to labor supplied to our client on projects in various locations across the United States. Not only did the jury find that the contract was breached by the labor broker and award damages, but also denied almost the entirety of the broker's claim for damages.

Additions

Kate Pomerleau has joined the Construction Law Group as an associate in the Pittsburgh office. She is a 2012 graduate of the *University of Pittsburgh School of Law, Magna Cum Laude* and a member of the Order of the Coif. Kate has worked the last three years at Eckert Seamans as an intern while attending law school. Kate also recently received news that she has passed the Pennsylvania Bar.

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