ECKERT SEAMANS

Spring 2010
ATTORNEYS AT LAW
www.eckertseamans.com | info@eckertseamans.com

Construction Law

In This Issue…

PITTSBURGH, PA
BOSTON, MA
CHARLESTON, WV
HARRISBURG, PA
PHILADELPHIA, PA
RICHMOND, VA
SOUTHPOINTE, PA
WASHINGTON, DC
WEST CHESTER, PA
WHITE PLAINS, NY
WILMINGTON, DE

Termination for convenience clauses: An inconvenient truth

The concept of a "termination for convenience" of a contract developed in American law during the Civil War as a mechanism for the U.S. government to avoid costly military procurements that became unnecessary as a result of changes in war-time technology or the end of conflict. In the famous *Corliss* case, decided in 1874, the United States Supreme Court upheld the Secretary of the Navy's termination of a contract for ships where the Navy no longer needed the ships due to the end of the Civil War. As a result, the shipbuilder did not receive the full value of the contract, as it sought, but was paid only for the ships it had built as of the time of the termination.

Relying on *Corliss*, the federal government expanded on the use of termination for convenience clauses in procurement contracts during World Wars I and II in order to eliminate possible expectation damages to companies whose contracts might be prematurely terminated.

It was during World War II that the use of the term "convenience," in connection with such terminations, became common and accepted as the government provided, in its fixed price supply contracts, the following clause:

continued on page 2

In re Electric Machinery Enterprises, Inc.: Be sure that all of your project contracts are speaking the same language

As anyone familiar with the construction industry knows, large construction projects create an extremely complicated web of contractual relationships. Owners may contract with general contractors, construction managers, architects, and engineers. General contractors may contract with subcontractors, who contract with sub-subcontractors, who contract with material suppliers. If the project goes south and parties are forced to litigate, a crucial issue in resolving the dispute is often who contracted with whom for what. When assessing a party's obligations, the discrete contractual relationships are typically kept separate. For example, in most situations, a contractor cannot sue a construction manager for breaching the contract manager's contract with the project owner, even if that breach affects the contractor's performance under its contract. The two distinct agreements exist apart from one another.

However, in a recent case, *In re Electric Machinery Enterprises, Inc.*, 416 B.R. 801

continued on page 3

Termination for convenience clauses: An inconvenient truth (continued)

> **Termination for the convenience of the Government.** (a) the Government may, at any time, terminate this Contract, in whole or in part, by a notice in writing from the Contracting Officer to the Contractor that the Contract is terminated pursuant to this Article.

In the 1960s, the use of termination for convenience clauses began to be growingly used in civilian, commercial contracts. Some 40 years later, termination for convenience clauses are almost standard in construction contracts and subcontracts. Termination for convenience clauses are intended to provide the party with the superior bargaining power the option to terminate the contract, without need to prove a breach by the other party, and then also establish the amount of compensation to be paid. The standard clause, almost always, will exclude lost profits on the work yet to be performed at the time of the termination.

Here is an example of a termination for convenience clause:

> The Contractor may, at any time, terminate the Subcontract in whole or in part for the Contractor's convenience and without cause. Termination by the Contractor under this paragraph shall be by a notice of termination delivered to the Subcontractor specifying the extent of termination and the effective date.
>
> Upon receipt of the notice of termination for convenience, the Subcontractor shall immediately, in accordance with instructions from the Contractor, proceed with performance of the following duties regardless of delay in determining or adjusting amounts due under this paragraph:
>
> - Cease operation as specified in the notice;
> - Place no further orders and enter into no further subcontracts for materials, labor, services or facilities except as necessary to complete continued portions of the Subcontract;
> - Terminate all subcontracts and orders to the extent they relate to the Work terminated;
> - Proceed to complete the performance of Work not terminated; and
> - Take actions that may be necessary, or that the Contractor may direct, for the protection and preservation of the terminated Work.
>
> Upon such termination, the Subcontractor shall recover as its sole remedy payment for work properly performed in connection with the terminated portion of the Work prior to the effective date of termination and for items properly and timely fabricated off the Project site, delivered and stored in accordance with the Contractor's instructions. The Subcontractor hereby waives and forfeits all other claims for payment and damages including, without limitation, anticipated profits on the incomplete part of the Work or otherwise.
>
> The Contractor shall be credited for (1) payment(s) previously made to the Subcontractor for the terminated portion of the Work, (2) claims which the Contractor has against the Subcontractor under the Subcontract, and (3) the value of the materials, supplies, equipment or other items that are to be disposed of by the Subcontractor that are part of the Subcontract Sum.

In addition, termination for cause contract clauses will often provide that, if it is determined that the terminated party was not in breach, then the termination for cause shall be deemed to be a termination for convenience. This can be a potent contract tool in that it may negate the risk of an unsupported termination for cause, and ensuing litigation over the issue, as an unsupported for cause termination is converted, by operation of contract, into one for convenience.

This all, of course, leads to the central question, can a private contract really be terminated by one party just for convenience sake as the title of the termination for convenience clause connotes? Although you will want to check the law of the state which governs the contract, the short, and safe, answer is: most probably not.

The legal basis for the conclusion that one party may not have unfettered rights to terminate for convenience is that such a right would make the contract illusory because one party was obligated absolutely to perform, while the other was not, as it could terminate at will. Under such circumstances, one party was providing consideration for the contract to the other, but the other party actually was not as it could rescind its consideration, at will, by terminating the contract.

With this in mind, the better label for these clauses might be "termination without cause" as opposed to "termination for convenience," as a contract generally may not be terminated simply out of convenience to one party alone.

What then are valid grounds for the exercise of a termination for convenience clause? Courts reviewing convenience terminations generally focus on whether the grounds behind the termination for convenience were in bad faith or an abuse of discretion. Examples of upheld bases for a termination for convenience include changed circumstances, such as termination of an upstream contact for which the contract at issue was dependent. Importantly, courts have upheld terminations for convenience when one party determined that the other party would not perform and, as a result, would subject the exercising party potentially to a material loss or difficulty in fulfilling its obligations to others.

Examples of possible improper terminations for convenience would be to obtain a better price or to try to avoid an obligation to arbitrate an existing dispute.

The bottom line, thus, on termination for convenience clauses, is that they may serve as effective tools to protect one party from risk of loss from changed circumstances. They are not, however, absolute weapons that can be used by one party to arbitrarily terminate a contract. Such clauses, while they should be included in contracts, should only be exercised based on good faith reasons and under the appropriate circumstances, preferably with the advice of counsel who has consulted the case law of the forum to ensure that the basis for the termination is well-founded at law.

– Scott D. Cessar
Construction Law Group

In re Electric Machinery Enterprises, Inc.: Be sure that all of your project contracts are speaking the same language (continued)

(M.D. Fl. Bkrtcy 2009), the Bankruptcy Court for the Middle District of Florida has held that one contract may, in fact, influence another. The decision offers a comprehensive primer into multiple facets of Florida construction law, including exculpatory clauses and waiver of claims submission procedures. Significantly, it also addresses the ability of a contract between a construction manager and an owner to influence other contracts on a project.

> *"All parties to a construction project that enter into multiple contracts should ensure that each contract states harmonious terms and recites consistent responsibilities."*

The dispute centered around the construction of the Orange County Convention Center in Orlando, Florida. In this case, all parties agreed that the convention center was successfully constructed with no construction or design flaws. However, one of the three major electrical subcontractors for the project, Electric Machinery Enterprises (EME), filed a breach of contract suit against Hunt/Clark/Construct Two (HCC), a joint venture that acted as construction manager in charge for the project. Electric Machinery asserted that HCC failed in its coordination duties for the project, which resulted in drastic cost overruns for EME.

Pursuant to its contract with the owner, HCC was obligated to coordinate the work of the trade contractors for the convention center project. It solicited bids for various phases of electrical work, and Electric Machinery was one of the winning bidders. EME signed an Electrical Trades Subcontract with HCC, which discussed HCC's obligation to coordinate and schedule EME's work and the work of the other trade contractors. The schedule HCC proposed for the project proved to be inefficient and unworkable – the court referred to the project as "an inefficient mess in which trade contractors stumbled over each other." The result was chaotic schedule compression and, in the case of EME, the loss of significant amounts of work because the structure was not timely waterproofed. The concomitant increase in costs associated with the scheduling failures resulted in EME's bankruptcy.

EME filed claims against HCC for breach of its duty to coordinate under the electrical trades subcontract. In addressing the dispute, however, the court not only looked to the trades subcontract to determine HCC's duties, it also looked to the construction management agreement between HCC and the owner of the project. HCC asserted that the construction management agreement could not form the basis of EME's breach of contract claim. The court conceded this point, but held that the provisions of the construction management agreement established HCC's "role and responsibility with respect to the Project" and that "understanding the role that HCC had contracted to fill on the Project as the construction manager" would put its contract with EME into its "proper perspective."

Notably, the contract between EME and HCC did not expressly incorporate the construction management agreement. However, the trades contract did state HCC had a duty to coordinate the work of EME, and at various points it referred to the general conditions established in the contract documents governing the project. Further, the court noted that HCC intended to bind all contractors to the same system of scheduling and coordination. Without a uniform system governed by uniform guidelines – those contained in the construction management agreement – scheduling of the project would be impossible.

HCC asserted that although it owed a duty to *the owner* to coordinate the work of the trade contractors, it owed no such duty to EME or the other contractors and, thus, could not be responsible to EME for failing to do so. The court summarized HCC's position as asserting that "it had the right to do as it saw fit, without any limitations and with no repercussions." This position, the court held, was simply untenable. HCC had the duty to create and maintain an overall project schedule under the terms of its construction management agreement with the owner. This duty included the planning and coordinating of all trade contractors, including EME. The fact that HCC failed in this duty breached its contractual obligations to EME, even though the construction management contract was not incorporated into the trades contract. Rather, the court found that the construction management Agreement could clarify and supplement the duties under the trades contract, and that HCC's failures breached its contract with EME.

The court's opinion in *In re Electric Machinery Enterprises, Inc.* holds that even if a contractor is not a party to the construction management agreement between the construction manager and the project owner, the scheduling and coordination duties created therein may carry over into an agreement between the construction manager and the contractor. The construction management agreement may, in turn, increase the construction manager's contractual obligations to the contractor. The decision is a recent one, so it remains to be seen if other Florida courts or courts in other jurisdictions follow suit. In forming contracts, however, a construction manager should be careful to ensure that its agreement with one party is not extending its obligations beyond those contemplated by other contracts. Indeed, *all* parties to a construction project that enter into multiple contracts should ensure that each contract states harmonious terms and recites consistent responsibilities. Otherwise, you could be in for a surprise when a discordant contract chimes in with the last word.

– Matthew J. Whipple
Construction Law Group

Ambiguities in federal construction contract documents: What would a reasonable contractor do?

When it comes to ambiguities in construction contract documents drafted by a federal government agency with little to no input from the contractor, the law can be helpful to the contractor. A reasonable interpretation of an ambiguous contract specification by a contractor may well be upheld and may serve as the basis for an equitable adjustment in the contract price. A change in the work based on a different interpretation by the federal agency may well not be chargeable to the contractor and thus may constitute a constructive change that requires compensation to the contractor.

It is important to note that the contractor's interpretation need only be reasonable. It need not be the "best" interpretation or one "more reasonable" than that of the agency which drafted the contract documents and had the opportunity to use clearer language to avoid any misunderstandings. This rule of interpretation – known as *contra proferentem* – allows the contractor to both bid and perform its contract with the confidence that a latent error or ambiguity in the contract documents will likely not undermine its economic basis for undertaking the project.

In determining whether contract language is ambiguous or susceptible to more than one reasonable meaning, courts will examine the language of the contract documents, including all of the specifications and drawings, and read all of the language as a whole and in context. An interpretation is not reasonable if it explicitly contradicts some other part of the contract documents or renders other contract language unnecessary or meaningless. Courts also sometimes will look to extrinsic evidence such as the parties' prior knowledge or understanding of a particular term or provision or the custom and practice in the industry with respect to particular language. Oftentimes, reviewing courts may find language ambiguous where the agency omitted details for the particular construction or feature or where the agency should have known of more clear or direct language but failed to use it.

An important exception to this interpretive rule is that if the contract documents reflect a "patent" ambiguity or conflict, the contractor is obligated to raise the issue with the agency prior to bidding in order to resolve it. A patent ambiguity is one that is obvious, gross, drastic, glaring or substantial. If a contractor fails to inquire about a "patent" conflict or ambiguity, but instead proceeds in the face of that conflict, this failure will preclude acceptance of the contractor's interpretation of the contract – reasonable or not.

Drawing the line between where a latent or hidden ambiguity leaves off and a patent or obvious ambiguity begins is no easy task. While the courts recognize that a contractor is not a clairvoyant and cannot be charged with having to uncover hidden ambiguities, doubts or possible differences in the contract language, a "reasonable contractor" does not fail to inquire about terms or provisions of the contract documents that are obviously at odds or require some explanation to avoid a glaring conflict.

It was this precise tension that was discussed in the recent federal circuit case of *States Roofing Corporation v. Winter*, 587 F.3d 1364 (Fed. Cir. 2009). In *States Roofing*, a government contractor brought a claim against the Navy relating to additional costs incurred to perform roofing work at a naval facility. The dispute centered upon the contract documents' requirement for waterproofing the vertical parapet walls on the main roof and penthouses. The contractor bid the job based upon using waterproof paint on the parapet walls. The Navy objected and interpreted the contract as requiring three-ply felt flashing material. Drawing A38 pertaining to the parapet walls provided for "waterproofing membrane (three layers)," but the Navy admitted that it omitted the specification for the three "layer" waterproofing membrane.

Pointing to the prior use of waterproof paint on the parapet walls on the same roof, the use of such paint as a common practice, the use of the term "ply" – as opposed to "layer" – wherever flashing material was specified elsewhere in the specs, and the Navy's omission of a specification for the waterproof item, the federal circuit ruled that the contract documents contained a latent ambiguity on this item and the contractor's interpretation of the language was reasonable. Accordingly, the contractor was entitled to its additional costs as a result of implementing the Navy's change to a flashing material to waterproof the facility's roof.

Notably, one judge dissented and found against the contractor holding that the contract language was "patently" ambiguous. This dissenting judge stated that drawing A38 contained explicit indications (references to "fasteners" and three lines depicted along the parapet wall) showing that the three layer waterproofing membrane had "some substance to it, rather than being just paint." Accordingly, the judge believed the contract contained a "glaring" ambiguity regarding the meaning of the term "layers." "Because a reasonable contractor should have inquired about the meaning of the term," the dissent would have held that, because the contractor failed to make inquiry, the court should not accept the contractor's interpretation of the contract documents.

The *States Roofing* case underscores the fact that the "reasonable contractor standard" is not easy to define and is often subject to dispute. However, certain practical guidelines may be followed. First, a contractor should review the contract documents with care and reasonable diligence as it will be charged with knowledge of blatant or obvious errors. Second, a contractor should keep in mind that any possible claim may turn on, from a practical point, whether it knew or should have known of, or discovered, the ambiguity or conflict in the contract documents. And, if a contractor believes a section of the contract may be ambiguous or in conflict, it should seek clarification or, failing that, provide for the worst case in its bid.

– F. Timothy Grieco
Construction Law Group

Financially troubled projects: Perspectives for the contractor

In construction, as in life, one simply cannot account for every imaginable risk. The best that any party to a construction contract can do is plan accordingly, make informed decisions on the front end, and react quickly and appropriately when problems arise. Unfortunately, for many, the current economic climate has increased the severity of such problems, placing successful businesses and long-standing business relationships at risk. Once a problem arises, the effects often cascade throughout all levels of a project. It is important to watch for the subtle signs that project participants are in financial peril. When those signs first appear, you *must* consider taking steps to protect your business's interest in the project or, at least, limit its exposure. Every project is different and each set of circumstances requires a different analysis, but here are some concepts for a contractor to consider at the first hint of future problems. It is wise to engage legal counsel when problems first arise, as their involvement can greatly assist you in considering the following points and streamlining your recovery strategy.

Know the Project and the Participants

As a preliminary matter, it is imperative to investigate the project and the participants prior to entering into a construction agreement. Unfortunately, a long-standing, successful business relationship with an owner or a subcontractor is no longer adequate assurance that they will survive the project. If the owner collapses, the contractor could be left with large receivables that will never be paid. If a subcontractor folds, the contractor will be left to deal with mechanics' liens and/or bond claims filed by the subcontractors' subs and material suppliers. It would be wise for contractors to obtain as much information about the project and the financial condition of the owner and subcontractors as possible.

Know Your Contract

It is *always* important to understand your rights and obligations under a contract—especially when a job is in jeopardy. Pay-when-paid/pay-if-paid provisions, termination for cause/convenience provisions, suspension provisions, damage waivers, mechanics' lien provisions, and liquidated damages provisions, among others, should play an important role in shaping your strategy for dealing with issues as they arise. Emotional and/or sentimental decisions not supported by the contract may have unintended and detrimental consequences to the bottom line.

Preserve Your Mechanics' Lien or Payment Bond Rights

A mechanics' lien is a means of securing payment for labor and materials furnished by a contractor, subcontractor or materialman during the construction of a project. Once filed, a lien acts somewhat like a mortgage in that it can be foreclosed upon and the affected property sold at judicial sale to satisfy the debt. This is an extraordinary statutory remedy that has very specific technical requirements. In Pennsylvania, contractors must file a mechanics' lien within six months of completion of their work, while lower tier subcontractors and material suppliers must also serve formal notice of intent to file a lien at least 30 days prior to that. Because this security interest attaches to the property and is not brought directly against an individual or entity, it is often the only way for a contractor to protect its interests when a higher tiered contractor or the owner becomes insolvent, disappears or declares bankruptcy. While mechanics' liens are always subordinate to properly filed prior perfected purchase money and construction mortgages, in many other cases (renovations, for example), the order in which liens are filed determines the order in which claimants are paid out of the proceeds of any foreclosure sale. When all the proceeds are exhausted, those still owed money are out of luck. For this reason, and others explained below, it is almost always advantageous to file a mechanics' lien claim sooner rather than later, unless strong business reasons dictate otherwise. Likewise, on jobs that on which a payment bond is issued, it is absolutely vital that you timely assert claims pursuant to the terms of the bond.

Understand Basic Bankruptcy Principles Before Its Too Late

By the time a bankruptcy is filed, your ability to recover receivables may already be pre-determined. Therefore it is important to understand the basic effects of such a filing *before* receivables on a job have spiraled out of control. The most important aspect of any bankruptcy case, whether it is a reorganization (*i.e.*, a Chapter 11 filing) or liquidation (*i.e.*, a Chapter 7 filing) of debtor, is the "automatic stay," which prohibits a party from attempting to collect receivables that arose before a bankruptcy petition was filed (*i.e.*, pre-petition debt). Failure to observe the automatic stay can result in court ordered monetary sanctions. Notably, the automatic stay does not prohibit a party from seeking payment under a letter of credit or from guarantors who are not in bankruptcy, and, generally, payment bonds, so those forms of security can be useful in the event a bankruptcy is filed.

Many times, the only way a party lacking a secured interest can pursue pre-petition debt is to file a "proof of claim" with the bankruptcy court. A proof of claim should include all pre-petition debt owed to the party by the debtor, including contingent claims such as delay and deficiency damages. The bankruptcy court will set a deadline or "bar date" for filing a proof of claim. Failure to file a proof of claim prior to the bar date is typically fatal to a party's claim and results in the party not being able to share in distributions from the debtor's estate.

When a bankruptcy is filed, an "estate" is created. The "estate" consists of all the bankrupt entity's property, including uncompleted or "executory" contracts. While the non-bankrupt party to an executory contract is typically not required to perform in a Chapter 7 bankruptcy, the opposite is true in Chapter 11. As a result, contractors cannot just leave a job site upon hearing that a Chapter 11 bankruptcy has been filed. While common, clauses purporting to terminate a contract upon the filing of a bankruptcy are not enforceable. The good news in these situations is that work performed after the bankruptcy filing generally adds value to the bankruptcy estate and is paid on a priority basis. In some instances, the executory contract will be so valuable to the bankrupt entity that it will be "assumed" by the estate, resulting in all amounts (even pre-petition amounts) being paid in full. If the contract is "rejected" the contractor can walk off the

continued on page 6

Financially troubled projects: Perspectives for the contractor (continued)

job without being accused of breaching the contract.

Protect Against Liability for Preferential Payments

Unfortunately, receiving payment from a financially distressed entity does not completely alleviate the risks of bankruptcy. Under the Bankruptcy Code, a payment made by the bankrupt entity within the 90 days before the bankruptcy filing (called the "preference period") sometimes must be returned to the estate because it was a "preferential" payment to the detriment of other parties owed money by the bankrupt entity. Having to return payments can be a difficult pill to swallow for a contractor that is already facing losses due to unpaid pre-petition debts. In order to have a preferential payment returned to the estate, the trustee must file a lawsuit, called an "adversary proceeding" in the bankruptcy court. The lawsuit is initiated by the filing of a complaint, and the summons and complaint are then served on the creditor by first-class mail. Since these papers are not served by a sheriff, they can be easily overlooked among the numerous other documents and notices received during the course of a bankruptcy case. As a result, a contractor may not realize that it has been named the defendant in a lawsuit, which can lead to a default judgment. Consequently, it is extremely important that all bankruptcy notices and legal papers be carefully reviewed.

The only sure-fire way to avoid receiving a potentially preferential payment is to require payment in advance or C.O.D. If no credit is extended, the payment cannot be preferential. This is not a practical way to do business for most companies. If your company received payments within the 90 day preference period, be sure to save copies of related invoices, payment records and a copy of your account history with the debtor, as these records will be required for your attorney to successfully assert any defenses that may exist. One such defense is the legal principle that payments made in the ordinary course of business are not preferential. The classic example of this defense is where payments are made exactly as provided for in the contract. Settlements and lump sum late payments are not made in the "ordinary course of business" and therefore are generally considered to be preferential and may have to be returned. This is something that must be considered and analyzed when negotiating payments of past due receivables.

Importantly, collection pursuant to a mechanics' lien that has been properly perfected within the 90 day preference period cannot be attacked as a preferential transfer. Consequently, a contractor should consider recording the mechanics' lien as soon as possible, even if it is likely to be within the preference period. Recording the mechanics' lien is good business from an accounts receivable standpoint. A mechanics' lien cannot be a preference and the contractor will have a secured claim in the bankruptcy case.

Be Careful What You Sign: Understand the Release

Growing receivables breeds desperation. In a desperate moment a contractor may be tempted to blindly sign any piece of paper presented in exchange for promises of payment. While release and waivers pay an important and vital role in the payment structure of construction projects, these documents should be reviewed carefully before signing. A common tactic is to pressure contractors to sign releases that are overly broad and contain indemnifications, warranties and certifications that go beyond the contractor's contractual obligations. Needless to say, such items should be watched for and removed from any release before signing.

– Timothy D. Berkebile
Construction Law Group

– Harry A. Readshaw
Bankruptcy and Restructuring Group

Impending crackdown on misclassified independent contractors

If your company classifies workers as independent contractors, it is time to take a careful look at whether that classification will withstand scrutiny under federal and state laws. Both the Internal Revenue Service and the U.S. Department of Labor are making substantial efforts to combat the improper classification of employees, and their efforts will likely focus, in part, on the construction industry. The 2010 IRS budget strongly urges the IRS to increase the enforcement of applicable tax laws "in industries where misclassification of employees is widespread."

According to the U.S. Government Accountability Office, at approximately 22 percent the percentage of independent contractors in the construction industry was higher than in many other industries. Additionally, in 2009 the Department of Labor hired 250 new investigators in its Wage & Hour Division to enforce federal labor laws, and its proposed 2011 budget calls for $12 million to hire 90 additional employees to enforce federal labor laws. The Obama Administration has estimated that these enforcement efforts may produce $7 billion in additional revenue in the next ten years.

The misclassification of an employee as an independent contractor can have serious consequences in the form of liability for unpaid income tax withholdings, Social Security and Medicare contributions, unemployment compensation payments, workers' compensation insurance premiums, overtime, and other work-related benefits. In addition, in Pennsylvania employers can be criminally liable for violating the Workers' Compensation Act if they fail to carry appropriate workers' compensation insurance.

Whether an independent contractor should be classified as an employee turns on numerous factors, and the legal standards for independent contractors are not entirely consistent between the IRS, the Department of Labor and state law. Given the increased scrutiny of independent contractor relationships and the potential liability due to misclassification, employers must ensure that independent contractors are not, in fact, properly characterized as employees.

– Jacob C. McCrea
Construction Law Group

Prime contractor responsibilities for payroll reporting requirements of its subcontractors under the Davis-Bacon Act

A routine question we are asked by prime contractors is: What are our responsibilities, as a prime contractor, for verifying the compliance of our subcontractors with the requirements of the Davis-Bacon Act?

To begin, it is fundamental that a prime contractor is ultimately responsible if there is a shortfall with regard to the reporting requirements of its subcontractors. Payrolls and submission of certified payrolls must contain a Statement of Conveyance signed by the contractor or subcontractor or his/her agent who pays or supervises the payment of the persons employed under the contract.

Further, a prime contractor must perform a due diligence review of all of the certified payroll reports to assure that they are correct and that the proper rate is being paid by the subcontractor to its employees. The prime contractor's payroll officer plays a key role in determining whether the subcontractor is paying its workers consistent with the proper rate of pay. Initially it is recommended to match the time records with the payroll reports to assure that they correspond. If there is any suspicion that the apprentice list is in question, the prime contractor should take it upon itself to contact the Department of Apprenticeship Program to determine if the individual is listed as an apprentice.

The prime contractor's responsibilities, however, go beyond simply determining whether the subcontractor is paying the proper rate by performing a cursory review of the certified payable report. The regulations state that the prime contractor shall be responsible for the compliance set forth in 29 CFR 5.5 (b)(1) through (4). If the prime contractor has a suspicion of inaccurate reporting, it should confront the subcontractor to address the concerns and, if appropriate, report the subcontractor to the funding agency or to the Department of Labor.

Notably, there are Fair Labor Standard Act options that are available to go after the principals of a subcontractor who violate the Davis-Bacon Act, if the subcontractor files for bankruptcy as a corporate entity.

In addition, should a subcontractor falsify its reporting records, the subcontractor subjects itself to potential federal criminal charges for submitting false records to a federal agency.

We recommend to prime contractors that they incorporate, as part of their regular practice at the initial job meeting with all subcontractors, a discussion with the subcontractors of their Davis-Bacon Act reporting requirements and direct them to the Department of Labor, Wage and Hour Division, should they have any questions regarding when, what and how to accurately report, under 29 CFR 5.5, their obligations of filing a true and accurate Certified Payroll Report. The subcontractors should be advised that, if they violate the regulations regarding reporting to the federal government, it may result in a criminal offense, sanctions, possible jail time and personal liability to the principals of the company.

– Frank L. Botta
Employment and Labor Group

Is there insurance coverage for claims arising out of your subcontractor's "faulty" work?

The scenario is all too familiar. The contract is won. Work begins. A subcontractor is hired to perform a part of the work. Months after the work is complete, a claim is made against the contractor alleging faulty workmanship. Upon investigation, it is determined that the subcontractor's work was faulty, resulting in property damage. Faced with such claims in the past, the contractor would notify its commercial general liability ("CGL") insurer and demand coverage, arguing that while the policy contained a "your work" exclusion, which provided that the policy did not cover property damage to your work arising out of the contractor's work, the exclusion by its express terms did not apply to property damage arising out of work performed by a subcontractor. Historically insurers paid these claims.

In the last few years, however, the analysis has changed. Relying on the policy's definition of "occurrence," which generally provides that it is an accident or repeated exposure to substantially the same harmful conditions, insurers have argued that faulty workmanship is not an "occurrence" under the terms of the typical CGL and therefore there is no coverage for such claims. The state supreme courts that have decided this issue are split.

The latest court to weigh in on this subject is the Supreme Court of Mississippi. In *Architex Ass'n v. Scottsdale Ins. Co.*, a property owner claimed that the general contractor, Architex, failed to place rebar in the foundation of a hotel it had built using several different subcontractors. When Architex demanded that its insurer, Scottsdale, defend and indemnify it from the property owner's claims, Scottsdale refused, stating that there had been no "occurrence" that would trigger coverage under the policy. Architex then brought suit against Scottsdale for failure to defend and indemnify. The Circuit Court found that because Architex knowingly hired the subcontractor responsible for the foundation, the defective work was not accidental and therefore not an "occurrence" under the CGL policy.

In February the Mississippi Supreme Court reversed the lower court's ruling, holding that the defective work of a subcontractor constituted an "occurrence" and that "preclud[ing] coverage for the simple negligence of a subcontractor subverts the plain language and purpose of" CGL policies. The court also noted that because the insurer had not specifically excluded the work of subcontractors within its other policy exclusions, the policy covered the work of Architex's subcontractors. The high courts of Florida, Texas, Tennessee, and Wisconsin have similarly held that defective construction constitutes an "occurrence" that triggers coverage under a CGL policy.

However, several state courts faced with the same issue, including the Supreme

continued on page 8

Is there insurance coverage for claims arising out of your subcontractor's "faulty" work?

(continued)

Court of Pennsylvania, have reached the opposite conclusion. In *Kvaerner Metals v. Commercial Union Ins. Co.*, the insured was the general contractor in the construction of a coke battery that the owner claimed was damaged due to defective construction. The insured claimed that it was entitled to coverage under its CGL policy because the damage was the result of a decision made by one of its subcontractors.

The Pennsylvania Supreme Court found in favor of the insurer, holding that "that the definition of 'accident' required to establish an 'occurrence' under the policies [could not] be satisfied by claims based upon faulty workmanship." The court reasoned that defective construction does not comport with the "the degree of fortuity contemplated by the ordinary definition of 'accident'" and that holding otherwise would convert a CGL policy into a performance bond. The Supreme Courts of West Virginia, South Carolina, and Nebraska have similarly held that defective construction is not an "occurrence" that triggers coverage.

In those states where the courts have ruled that faulty workmanship does not constitute an "occurrence" or in states where the law is unclear, how can a contractor ensure that their insurance protects them from claims based a subcontractor's faulty workmanship? One option that may be available is to purchase supplemental insurance that specifically extends coverage for a subcontractor's negligence. Another option is to seek an endorsement to the CGL modifying the definition of "occurrence" to include faulty workmanship claims. However, these options may prove cost prohibitive, and the contractor may be required to rely solely on the indemnity provisions in its contract with the subcontractor, placing itself ultimately upon the mercy of the financial condition of the subcontractor.

Finally, even in those states that have ruled that faulty workmanship does constitute an occurrence, contractors should be aware that some insurance companies have added an endorsement to their CGL policies that excludes coverage for defective work performed by a subcontractor. ISO Form No. CG 22 94 10 01, entitled "Exclusion-Damage To Work Performed By Subcontractors On Your Behalf," makes clear that the policy does not cover liability for damage caused by work performed by subcontractors.

– David J. Strasser
Insurance Coverage Group

– Jessica Priselac
Construction Law Group

Construction Practice Group News

Join Eckert Seamans...

Join Eckert Seamans for a reception with Congressman John Mica, Ranking Member of the House Committee on Transportation & Infrastructure. Congressman Mica will discuss Congress' efforts in supporting innovative and cost effective ways to improve the nation's infrastructure. The reception will be held on Tuesday, May 4th from 5:00–6:30 in the new offices of Eckert Seamans in Washington, D.C. For additional information or to RSVP please contact Katy Mahoney at 202.659.6636 or kmahoney@eckertseamans.com.

Fifty state survey of prompt payment acts for construction contracts

Knowing whether a particular state has a public or private payment act can be very important to contractors, subcontractors, suppliers or even sureties. Easily finding this information can be difficult and time consuming. As a consequence, the Eckert Seamans Construction Group has put together a summary of the acts for all 50 states. The summary lists every state and indicates whether it has either or both private or public projects. The summary then provides for each state with either act a description of important notice periods and identifies the possible penalties for violations. Please visit our website to view the entire survey.

Client wins

A shipper of goods brought suit against a client that manufactures and erects wharf cranes installed on docks throughout the world in the Federal District Court for the Southern District of Texas, Houston Division, alleging that defects in the twist-lock pins attaching the spreader bar to the head block of a gantry crane failed, causing the spreader bar to detach, resulting in the hatch cover falling on the ship. According to the shipper, this resulted in over $900,000 in damages in the form of repair costs and lost revenue while the ship was being repaired.

After a four-day non-jury trial held in December, the court recently issued its 40-page findings of fact and conclusions of law entirely absolving our client of any liability and awarding to the plaintiff no damages whatsoever. Chris Opalinski was lead counsel with support from associate Paula Allan and paralegal Allison Mayer.

Cessar and Opalinski named among *The Best Lawyers in America*®

Scott D. Cessar and Christopher R. Opalinski were recently named among *The Best Lawyers in America*® for construction law. *The Best Lawyers in America*® is considered one of the leading referral guides to the legal profession in the U.S. Fewer than 34 lawyers were selected in Pennsylvania for construction.

ECKERT SEAMANS

Pittsburgh, PA 412.566.6000
Boston, MA 617.342.6800
Charleston, WV 304.346.5500
Harrisburg, PA 717.237.6000
Philadelphia, PA 215.851.8400
Richmond, VA 804.758.7760
Southpointe, PA 724.873.2870
Washington, DC 202.659.6600
West Chester, PA 610.738.8850
White Plains, NY 914.949.2909
Wilmington, DE 302.425.0430