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Fixing the Problem – Not the Blame

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Who is responsible for defective design under Texas law? The contractor, under the *Lonergan* case? The owner, under the *Spearin* case? A recent Fifth Circuit decision suggests that, in some cases, this may be the wrong question when design responsibility is disputed. The appellate court recently remanded a specific case back to the district court to determine whether the contractor or owner breached an implied duty to cooperate in discovering defects in design and subsequently pricing the change required to correct the problem.

INET won a competitive bid to provide rooftop air conditioning units ("Units") to passenger jetways at Terminal E of the Dallas/Fort Worth (DFW) airport. By submitting its bid, INET certified that it had satisfied itself with respect to plans and specifications. The Units were to use "30% ethelyne glycol/water" ("EG Water") supplied by DFW. INET also agreed to provide schematic drawings and the required components for a fully operational control sequence that would "provide auto defrost of the coils" within the rooftop units, through which the EG Water would cycle. At the pre-construction meeting, INET expressed a concern that the Units might not function properly with the EG Water, suggesting that the EG Water's sub-freezing temperature might cause ice buildup on the coils and prevent their proper operation. After INET received no response, it resubmitted the concern in two separate RFI's.

The contractor, owner and designer conducted "extensive discussions" about the problem and prepared at least two proposals to modify the control sequence program and the piping design. However, the parties never reached agreement on the pricing of the proposals or how to proceed. After the substantial completion date passed, DFW notified INET that DFW would begin to assess liquidated damages, since the rooftop units were not completed. DFW then made a claim against INET's performance bond and completed the work with a different contractor. A dispute ensued about whether the contract had been terminated or abandoned, and a federal lawsuit resulted.

The district court granted INET summary judgment, determining that DFW had breached the contract by supplying defective plans and specifications. On appeal, the Fifth Circuit reversed the district court's decision. Although the court stated that it was not disputed that the plans and specifications were defective, it expressed uncertainty about whether DFW had accepted all of the risk of defective design. The Court referenced contract clauses allocating

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responsibility for correct design to DFW, while also noting provisions requiring INET to carefully review plans and specifications, design a control sequence to defrost the coils and assume responsibility to make the system function properly.

Texas construction lawyers have long debated whether such a case should be controlled by *Lonergan* (a 1907 Texas Supreme Court case holding that the contractor is responsible for defective design) or *Spearin* (a 1918 U.S. Supreme Court case holding that an owner impliedly warrants the adequacy of design). In *INET*, however, the Fifth Circuit focused on contract language requiring the contractor to determine if there were any defects in the design that would require INET to submit a change order to the Owner in order to resolve any such defects once discovered. The Court found that after a defect was reported, the parties had a duty to work together to come up with an acceptable solution and a price for the change order. The Court stated further that a party's failure to cooperate in this process would be a material breach of contract. Because the appellate court could not tell from the record which party had breached this duty to cooperate first, it remanded the case to the district court, directing the trial court to determine who breached first.

The *INET* opinion offers a welcome respite from the debate about whether *Lonergan* or *Spearin* represents Texas law. It recognizes that defective design requires modifying the contract, which, in turn, demands a change order (or at least a written directive as to how to proceed). The contract required INET to bring defective design to the owner's attention, particularly since INET, by contract, could not depart from plans and specifications without DFW's written authorization. In short, instead of focusing on which party was responsible for the overall design, the Fifth Circuit focused on the parties' attempts (or failures) to resolve disputes on how to deal with the design defects.

Texas contractors - and for that matter contractors elsewhere where *Spearin* is better respected - are still well-advised to ask the owner to warrant the adequacy of plans and specifications, and to reject attempts to shift design responsibility away from the design professional and owner to the contractor. But *INET* goes further, warning Texas contractors to identify problems with design quickly, and to follow contract procedures for reporting any such defects to the owner and/or designer (for example following ConsensusDocs 200, ¶ 3.3.2 or AIA A 201 § 3.2.2). The contractor should take one further step, requesting or even suggesting a possible solution for consideration by appropriate designers. And the contractor should cooperate with the project team in finding and pricing any necessary changes to the original design. The key factor is that contractors have a duty to and should always reasonably take documented steps to cooperate in fixing a known design problem. The first party that fails to cooperate may be breaching the contract and ultimately may be liable for damages.

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Is ConsensusDocs Arbitration Final and Binding?
Charles Surasky, Senior Counsel, Smith Currie

For more than a hundred years the construction industry has been a leading user of arbitration to resolve disputes. Over the last decade, arbitration has lost some of its favor with the industry. This may be the result, at least in part, of the increasing use of discovery and

motions practice in arbitration; practices that substantially increase the cost of arbitration. This loss of favor is reflected in the addition of litigation as an alternative means of dispute resolution in ConsensusDocs 200 and other standard form construction contracts. Still many in the industry continue to prefer arbitration to litigation. One major advantage of arbitration is finality. ConsensusDocs 200's arbitration clause provides as follows:

> 12.5.4 An award entered in an arbitration proceeding pursuant to this Agreement shall be final and binding upon the Parties, and judgment may be entered upon an award in any court having jurisdiction.

While the finding of a judge or jury may be appealed, perhaps for years, the "final and binding" language is intended to severely limit appeals of arbitration awards. Not only can this save substantial attorneys' fees, it also allows companies to return their full attention to the business of building. But what does "final and binding" really mean?

The Federal Arbitration Act

What "final and binding" means is governed primarily by the Federal Arbitration Act or FAA, which was first enacted in 1925. The FAA applies broadly to all contracts that evidence a transaction involving interstate commerce. This includes virtually all construction contracts in the United States. For more than 50 years, federal courts treated the FAA as a procedural rule applicable only to federal cases. This limited the enforceability of construction arbitration agreements. In a 1983 decision, *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*[1] 460 U.S. 1 (1983), the United States Supreme Court established a federal policy favoring arbitration and of resolving any doubts as to the scope of arbitrable issues in favor of arbitration. Since the *Moses Cone* decision the FAA is recognized to preempt state laws that would otherwise prevent enforcement of a construction arbitration agreement.

In addition to making arbitration agreements enforceable in state and federal courts, the FAA also proscribes the circumstances under which an arbitration award can be corrected, modified, or vacated. These latter rules, which will be discussed further below, establish the extent to which an arbitration award is final and binding.

Clarification of an Award

An arbitrator's authority generally ceases when an award is issued. As used in this article, the term "arbitrator" includes both a single arbitrator and a three person panel. Issuing an award renders the arbitrator *functus officio*, Latin for office performed. There are, however, exceptions to this rule. The Construction Industry Arbitration Rules of the American Arbitration Association (Rule 51) give either party 20 days after transmittal of an award to request modification of the award. The arbitrator's is allowed to correct any clerical, typographical, technical or computational errors in the award. The arbitrator is not allowed to redetermine the merits of any claim decided by the original award. If an award is ambiguous, some courts have allowed the arbitrator to interpret or clarify, but not alter the merits of the award.

Confirmation of an Award

An arbitration agreement empowers the arbitrator to issue an award, but the arbitrator has no authority to enforce the award. Fortunately, enforcement is usually unnecessary. Most losing parties, having agreed to arbitrate, pay the arbitrator's award and move on. But not always. As is noted above, ConsensusDocs 200, paragraph 12.5.4 provides that an award is final and binding and that "judgment may be entered upon an award in any court having jurisdiction." If the losing party refuses to pay an award, the prevailing party must go to court. Or, the losing party may choose to file a motion to vacate. While the FAA gives the prevailing party one year

to apply for an order confirming the arbitration award, the losing party has only three months to file a motion to vacate. If a motion to vacate is filed, the prevailing party can file a cross-motion to confirm.

If the court grants the motion to confirm, it will enter judgment on the award. That judgment can then be enforced like any other court judgment. The judgment entered on the award is appealable, but appellate review will be limited to the FAA's grounds for vacating, correcting, or modifying an award discussed below. Neither the trial court nor an appellate court can alter the merits of an arbitration award.

Correction or Modification of an Award

The FAA provides three grounds for correction or modification of an award:

1. Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award.

2. Where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted.

3. Where the award is imperfect in matter of form not affecting the merits of the controversy.

The order may modify and correct the award, so as to effect the intent thereof and promote justice between the parties.

An action to correct or modify an award must be served on the adverse party within three months after the award is filed or delivered.

It is important to note that the FAA does not give a court the authority to review the evidence submitted to the arbitrator and reach a different decision on the merits. For the most part, a court's review is limited to defects or miscalculations that are evident in the award itself. This is true even if it is evident that the arbitrator made a mistake of fact or law in reaching the decision underlying the award. The main exception is the court's ability to correct an award where the arbitrator has ruled on a matter not submitted. For example, courts have removed attorneys' fees from awards in cases where the parties' contract contained no provision for attorneys' fees.

Vacating an Award

The FAA provides four grounds for vacating an award:

1. Where the award was procured by corruption, fraud, or undue means.

2. Where there was evident partiality or corruption in the arbitrators, or either of them.

3. Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

4. Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

An action to vacate an award must also be served on the adverse party within three months after the award is filed or delivered.

The authority to vacate an award does not give a court the authority to review the evidence submitted to the arbitrator and reach a different decision on the merits. The Supreme Court has held that under the FAA, the sole question for a court reviewing an arbitration award is whether the arbitrator, even arguably, interpreted the parties' contract, not whether the arbitrator got it right or wrong. A court cannot vacate an arguably correct decision even if the court is convinced the arbitrator got it wrong.

While a court cannot review the merits of an arbitrator's decision, it can look at whether the losing party received a fair hearing. The first three grounds listed above provide a statutory guarantee of due process, that is fair treatment, in private arbitration. A party seeking to vacate an award on the basis of corruption, fraud, or denial of a fair hearing will bear a high burden of proof—more than a mere preponderance of the evidence. Any doubts should be resolved in favor of upholding the arbitration award.

The last ground for vacating an award rests not on considerations of fairness, but on the contractual nature of arbitration. An arbitrator's authority to decide a dispute is based solely on the parties' contractual agreement to arbitrate. Arbitrators have no power to decide issues not submitted by the parties or matters beyond the scope of the parties' contract. Here also, the party seeking to vacate an award bears a high burden of proof. It is presumed that arbitrators do not exceed their authority.

In addition to the four grounds expressly stated by the FAA, some courts have recognized two additional grounds for vacating an arbitration award: manifest disregard of the law and violation of public policy. While the various federal circuit courts differ on what exactly constitutes manifest disregard, it is uniformly agreed that manifest disregard must go beyond erroneous application of the law or failure to correctly understand and apply the law. To manifestly disregard the law an arbitrator must act so as to deprive the losing party of a fair hearing and its rights under the contract. A number of federal circuits interpret manifest disregard as shorthand for the four grounds stated in the FAA.

Violation of public policy is a doctrine that originated from judicial review of labor arbitration agreements. The doctrine is based on a court's common law authority not to enforce a contract that violates public policy. To serve as grounds for vacating an award a public policy must by explicit, well-defined and dominant. It cannot be based on a single court's understanding of the public interest. It is at least questionable whether violation of public policy is a valid grounds for vacating a commercial or construction arbitration award. Several circuit courts look only at whether enforcement of an arbitration award would require one of the parties to violate public policy.

Conclusion

An arbitration award issued pursuant to the ConsensusDocs arbitration clause is not absolutely final and binding. The FAA allows appeals of judgments confirming arbitration awards and provides grounds for correcting, modifying, or vacating arbitration awards. But an arbitration award is far more final and binding than a decision by a state or federal trial court. A party seeking to avoid enforcement of an arbitration award bears a heavy burden of proof. It is not enough to show the arbitrator's decision was wrong, even seriously wrong. It is necessary to show by clear and convincing evidence that the award was the product of fraud or

corruption; that the complaining party was deprived of a fair hearing, or that the arbitrator went beyond the powers granted by the parties' contract. As a practical matter, an arbitration award is far less likely to be appealed than the decision of a court. manner.

Smith, Currie & Hancock LLP is a national boutique law firm that has provided sophisticated legal advice and strategic counsel to our construction industry and government contractor clients for fifty years. We pride ourselves on staying current with the most recent trends in the law, whether it be recent court opinions, board decisions, agency regulations, current legislation, or other topics of interest. Smith Currie publishes a newsletter for the industry "Common Sense Contract Law" that is available on our website: **www.SmithCurrie.com**.

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Navigating The "Flow-Down" Of Risk Through Multiple Contract Layers
Thomas J. Madigan, Partner, Pepper Hamilton LLP

As the name implies, flow-down clauses seek to "flow" (*i.e.*, allocate) obligations and risk from one contract tier to the next. The ostensible purpose is to ensure that the respective obligations of the parties line up, that is, that each party's obligation to its contracting partner is the same all the way up and down the chain, from the supplier to the subcontractor to the general contractor to the owner. In theory, this should avoid inconsistent contractual obligations and place the risk of nonperformance on the party actually performing the work. When precisely drafted and properly managed, flow-down clauses can fairly and effectively allocate the risk of performance through multiple layers of contracts and subcontracts. Too often, however, flow-down clauses utilize confusing or conflicting boilerplate language and are included without regard to actual differences in contractual responsibilities and scopes of work. When sloppily put together and not properly followed, they can create a confusing morass or stop the flow of risk in the middle of the stream, unable to reverse course or continue down river.

One commonly used flow-down provision is the "incorporation by reference" of upstream contracts and specifications. It is not uncommon to see these clauses purporting to reference the entirety of the prime contract and specifications, all addenda and supplementary contract documents, and make all of them "a part of" the lower-tier contract by reference. Whether due to time pressure or lack of sophistication, rather than identify and reference those portions of the upstream contracts that apply to the lower-tier work, each successive subcontract simply repeats the incorporation by reference. Whenever a lower-tier contract or supply agreement incorporates an upper-tier contract by general reference in this manner, there is significant risk that the terms of the lower-tier agreement conflict in some important respect with the blindly incorporated upstream documents. Pursuant to established rules of contract construction, these conflicts will often be resolved against the party that drafted the contract — which, in most cases, will be the upstream contractor. As a result, the incorporation may be ineffective and fail to "flow down" any provisions that are inconsistent with the terms of the lower-tier contract.

When it is important to ensure that obligations and remedies are strictly aligned, it should been done explicitly by restating or specifically referencing the pertinent provisions of the specifications in the material terms and conditions of the lower-tier contract, rather than by relying on broad incorporation of upstream documents "available for review." Subcontractors and suppliers are also well advised to avoid general terms of incorporation in favor of more precisely tailored language, either specifically identifying the particular parts of the upstream

contracts and specifications that apply or, at a minimum, including conditional language that limits the incorporation “to the extent the terms of the prime contract apply to the subcontractor's work.” This caution applies not just to apparent conflicts between express terms (for example, in the number of days in which payment is to be made or the length or extent of warranties), but to the exclusion of inapplicable terms, particularly with respect to the division of work. Inclusion of an order of preference clause that resolves conflicts between the documents is also advisable.

One area in which the coordinated flow down of obligations and remedies is most critical is changes in the work. Most, if not all, prime contracts and subcontracts employ a contractual mechanism for implementing changes that involves a linear, sequential process, starting with notice that the work is out of scope and ending with either an executed change order or directive to proceed while a claim is resolved through the dispute resolution process. These provisions should be consistent from contract tier to contract tier so that, if the process is followed, no additional or changed work should be performed at any level without notice and a change order or a directive to proceed with immediate submission and prompt resolution of a claim. However, during the hustle and bustle of construction, these procedures are not always scrupulously followed, particularly when a project has fallen behind schedule. In the rush to get back on schedule, the owner can resort to “just get it done and submit a potential change order (PCO)” directive. This “just get it done” directive is repeated down the line until it reaches the subcontractor expected to do the work; each tier thereby effectively increasing the scope of its work on faith that a change order will be granted. Unprocessed PCOs may continue to accumulate until the owner ultimately announces its intention to “settle up” at or near the end of the project — at which time it also reveals its claim of entitlement to offsets or back charges.

The general contractor who has “flowed down” the owner’s directives to proceed and submit PCOs is now in a precarious position. The subcontractor will assuredly argue that the general contractor has acknowledged that the work was out of scope and that it is entitled to a change order from the general contractor, regardless of the general contractor’s ability to obtain a corresponding change order from the owner. In such circumstances, the subcontractor has an argument that the general contractor has assumed the risk of nonpayment. Any attempt to rely on the subcontractor’s failure to follow the change order process will be vulnerable, as courts may not strictly enforce notice and authorization requirements that the general contractor itself has failed to abide. If the general contractor has repeatedly directed the subcontractor to perform work with the promise that it will be “sorted out” later, the contractual requirement of prior written authorization may be deemed to have been waived.

Similarly, a pay-if-paid clause may be of little use to the general contractor in this circumstance as their enforceability varies from jurisdiction to jurisdiction. Where disfavored, courts tend to treat them as timing mechanisms (establishing when payment is due, as opposed to whether it is earned), unless the clause clearly shifts the risk of nonpayment by making the receipt of payment from an upstream contractor (or owner) an express condition precedent to the obligation to make payment to downstream subcontractors or suppliers. In the event of an indefinite delay or outright refusal to make payment by an upstream party, a “reasonable” period for making downstream payment is inferred, but the obligation to pay is not excused. Even when the clause is drafted with sufficient precision to create a condition precedent to the obligation to make payment, it may not be enforced when the basis for nonpayment is the upstream party’s own failure to perform, as courts are reluctant to enforce conditional payment provisions in situations where the unpaid party bears no responsibility for the condition giving rise to the withholding of payment. *Quinn Constr., Inc. v. Skanska USA Building, Inc.*, 730 F. Supp. 2d 401 (E.D. Pa. 2010). *See also S. Main St. Redevelopment v. R/C Theatres Mgmt. LLP*, 2013 U.S. Dist. LEXIS 34391 (M.D. Pa. 2013); *McDermott v. Party City Corp.*, 11 F. Supp. 2d 612 (E.D. Pa. 1998) (where a party claiming that a condition precedent has not been satisfied is himself the cause of the nonoccurrence, he cannot claim

the nonoccurrence to his advantage); BRUNER & O'CONNOR § 8:49 ("Courts are reluctant to enforce conditional payment provisions in situations where the unpaid subcontractor bears no responsibility for the condition giving rise to the [owner's] payment defense."). Thus, a prime contractor facing a situation where the owner is asserting large offsets or withholdings against accumulated PCOs may not be able to utilize the pay-if-paid clause to proportionately withhold payment to subcontractors for unrelated work in an effort to mitigate its own loss. *Pencoyd Iron Works v. Axis Constr. Servs., LLC*, 2012 Phila. Ct. Com. Pl. LEXIS 23 (Pa. C.P. 2012) (recognizing that a contractor breaches contract if it receives payment from an owner specifically for the work performed by a subcontractor but withholds that money from the subcontractor under the auspices of a pay-if-paid clause); *Rainbow Roofing Co. v. Perrotto Builders, Ltd.*, 2013 Pa. Super. Unpub. LEXIS 3378 (Pa. Super. 2013) (owner withheld some payment from the general contractor, but had paid the contractor for the subcontractor's work, and the contractor was thus "required to pay [the subcontractor] the remaining balance on the subcontract because the [owner] paid for that work.")

While being a "team player" is generally a useful approach, contractors and subcontractors should require compliance with the contractual change order and claim resolution process. When confronted with a "just get it done" directive, the general contractor should follow the contract provisions and provide notice that it considers the requested work to be additional or changed and include an estimated cost to perform the work. From the subcontractor's perspective, in addition to providing written notice that it considers the work to be additional or changed and providing an estimate of the cost to perform, it should also notify the general contractor that it considers the "just get it done" directive to be an acknowledgement that the work is additional and a promise that a change order will be issued in accordance with the estimate provided, regardless of the general contractor's ability to obtain a change order from the owner and without offset by any withholdings or claims the owner may assert against the general contractor. The notice should also state that the subcontractor is proceeding with the work in reliance on this understanding and that, if there is any disagreement, the general contractor needs to notify the subcontractor immediately.

The initial urge of the general contractor may be to try to "finesse" the situation by passing down the "just get it done" directive with no commitment of payment beyond whatever it may eventually get from the owner. This can be a risky maneuver, as trying to play both sides against the middle in this situation may result in the general contractor bearing the risk alone. If the work is clearly changed, the general contractor should request a change order before proceeding. If there is a real urgency that makes this impractical, it should at least confirm in writing that it is proceeding in reliance on the assurance that the work will be paid for as additional. If there is a dispute over entitlement or cost, the general contractor should request that the owner issue a directive to proceed and promptly submit a claim on behalf of itself and the subcontractor(s) called on to do the work. It also should be clear about the situation with its subcontractors. If there is a question regarding whether the work is within the subcontractor's scope, or is otherwise not compensable, the general contractor should utilize the change directive process, instruct the subcontractor to submit a claim, and then timely and diligently prosecute that claim to the owner.

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New to the Defense Library Series! *Construction Litigation Desk Reference: A State-by-State Compendium*

The latest addition to the DRI Defense Library Series is this updated collection of state-by-state chapters, which focuses on the most important current issues in construction litigation. Topics addressed include: insurance (including "work product" and "your work" exclusions, "occurrence" defined, the duty to defend, and more); causes of action (including contract, tort, strict liability, warranty/strict liability, green building litigation, delay, and more); construction/materialman's lien; surety/bond issues; defenses (including statutes of limitation and repose, contributory and comparative negligence, waiver, estoppel, contractual limitations on liability and damages, economic loss doctrine and more); arbitration/ADR; and measures and types of damages, including consequential damages, delay and disruption, attorneys' fees, punitive damages, contract damages, and more). The authors include dozens of experienced defense attorneys and members of the DRI Construction Law Committee. The efforts of the authors and editors have resulted in a unique desk reference for construction lawyers. The reader of this new publication will not only gain an up-to-date overview of the current law in his or her jurisdiction, but will be able to research the law of other jurisdictions.

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ConsensusDocs Educational Track at the 2017 AGC Convention
Keeping You Ahead of the Curve

Three educational sessions, sponsored by ConsensusDocs, will help keep you ahead of the curve and improve your bottom line.

IPD, Lean, and Design Assist for the Rest of Us: Some projects call for pure IPD and LEAN, others don't. Looking at specific project histories this session will compare and contrast projects that made "pivot point" decision on delivering projects. The presenters will evaluate why those decision were made by the project stakeholders, and the techniques used.

Key Tips for General Contractors and Subcontractors to Unlock Contract Negotiations and Highlights from the 2016 ConsensusDocs: Learn how to unlock the most important contract issues from a General Contractor and Subcontractor's perspective so that you don't get stuck on your next contract negotiation. You will also learn highlights from the just

released ConsensusDocs standard contract updates that AGC endorses as well as tips to modify these standard contracts for your specific project.

Contract Killer Clauses and How the New ConsensusDocs Can Help: Learn common contract clause that inappropriately shift risk in contracts unfairly. Gain strategies to negotiate the worst causes. Learn how industry standard contracts like the just updated ConsensusDocs and the American Institute of Architects (AIA) can help or hurt you in leveraging industry standard contract documents to protect your bottom line.

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