SPRING/SUMMER 2014

WILLIAMS MULLEN

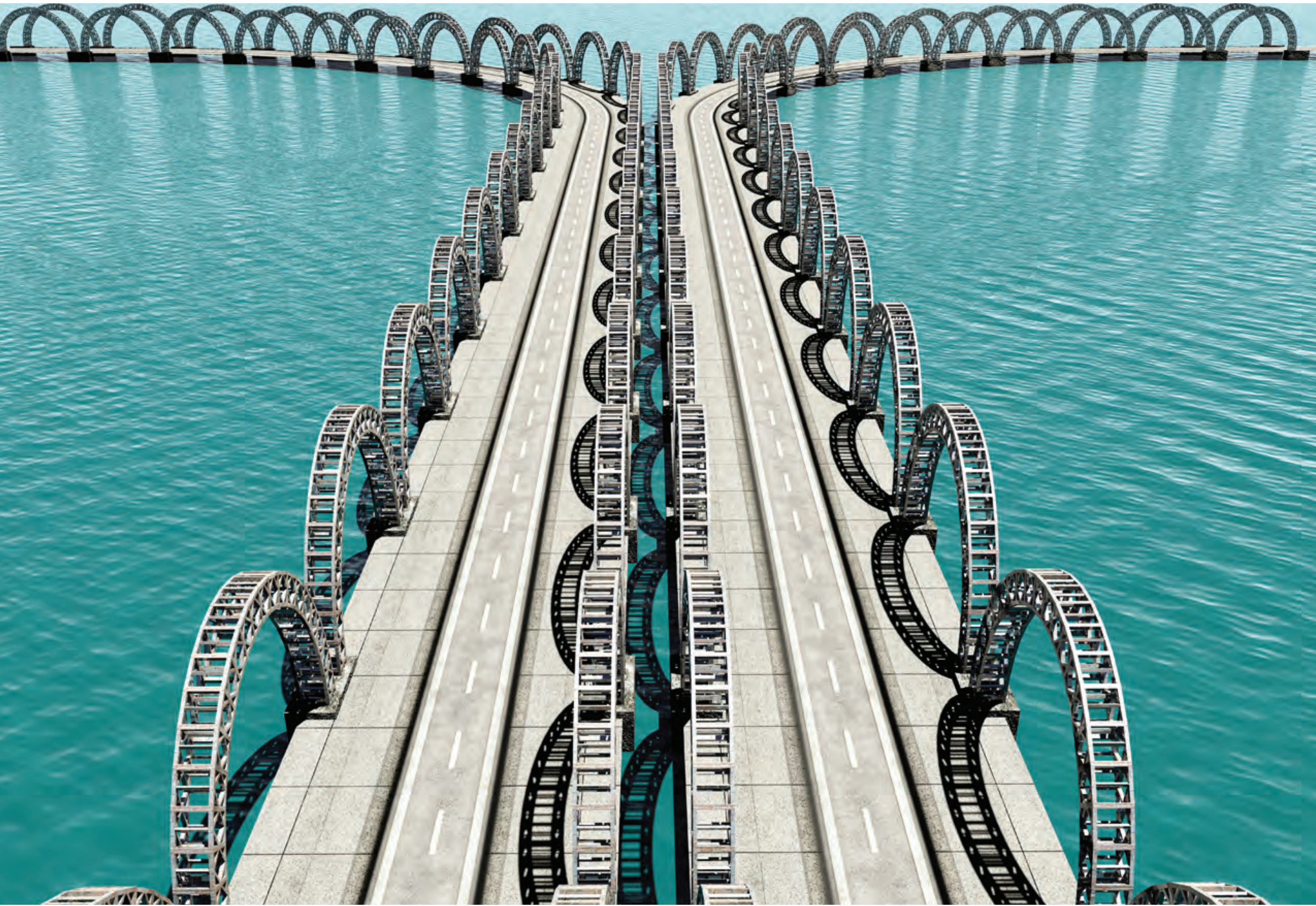
Construction Industry News

CONSTRUCTION

GOVERNMENT CONTRACTS

INFRASTRUCTURE

PUBLIC-PRIVATE PARTNERSHIPS



CGL Insurance – Does Your Insurance Cover Construction Defects?

WILLIAMS MULLEN
finding yes®

WILLIAMSMULLEN.COM | DC | VA | NC

WELCOME

Robert K. Cox

INSIDE

CGL INSURANCE & DEFECTS...4
Does Your Insurance Cover Construction Defects?

NO SURE THING.................. 10
Does Your Arbitration Agreement Inadvertently Expose You To Liability For An Unlimited Time?

CONTRACT QUICKSAND...... 12
Understanding Common Contract Provisions That Will Impact Your Business.

THE NUCLEAR OPTION........ 14
Allegations of Bad Faith Against the Government in the Claims Process.

FEDERAL CONTRACTORS.... 18
Federal Government Contractors on the Horns of A Dilemma – The Mandatory Disclosure Rule, The FAR And The False Claims Act

Yes, that is me looking for feedback from you on our newsletter and monthly construction alerts. Send your comments to Bob Cox at bcox@williamsmullen.com and let me know your thoughts on the topics, format, print copy versus e-mail, whatever you consider important. Our goal is to make our communications the most useful to you.

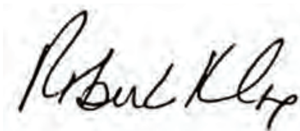
As for the newsletter at hand, we have a good mix. The first article on CGL Insurance and Coverage for Work Defects is a downsized version of the full article first published in the American Bar Association's "Construct" newsletter this past February. Hal Johnson, Alex Burnett and Katie Temple co-authored this article.

John Burns wrote our second article on the statute of repose and how some states' statutes limiting the time to bring a lawsuit may have a loophole for arbitration proceedings. Steve Test authored our third article, "Contract Quicksand", on common contract clauses that oftentimes get short review before contract signing, but afterwards can sink your boat.

Will Wozniak's article looks at the pressures and counter pressures on federal government contractors who think the contracting officer's actions go beyond business disagreements.

Continuing with the federal government contractor theme, I wrote about the disconnect among the federal government's statutes, regulations and policies to encourage and enforce ethical conduct in federal government contracting. I thought about titling the article "No Good Deed Goes Unpunished".

There you have it. Send me your comments or I will keep the same picture in for the next issue.



On the afternoon of April 11, Williams Mullen's Construction Practice Group sponsored the ABA Construction Law Forum's 2014 Community Service Project – a rehabilitation and landscaping of a portion of the New Orleans City Park. Established in 1854, City Park is one of the oldest urban parks in the country. Its 1300 acres contain gardens, walking and biking trails, tennis courts, an 18 hole golf course, and an antique carousel. The Park relies heavily upon volunteers to help maintain the Park's beauty. Our April 11 project included landscaping, planting, and mulching projects throughout the Park.

As the ABA's annual Community Service Project Sponsor, Williams Mullen organized, coordinated and funded this high visibility and successful event which included more than 50 Construction Attorney volunteers. We are pleased to be a part of this important project to help keep a local community park beautiful, and we are glad to support the ABA's Community Service programs.

Williams Mullen's Construction Practice Group sponsored the ABA Construction Law Forum's 2014 Community Service Project – a rehabilitation and landscaping of a portion of the New Orleans City Park.

CGL INSURANCE & DEFECTS

Does Your Insurance Cover Construction Defects?

BY HAROLD E. JOHNSON, W. ALEXANDER BURNETT, AND KATIE T. TEMPLE

State courts are split on whether commercial general liability (CGL) insurance covers property damage from defective workmanship. Here's a primer on the split and how you can protect yourself.

Consider the following real-life scenario. An individual contracts with a general contractor to build a new house. The contractor, the named insured on a CGL policy, hires a subcontractor to install stucco onto the exterior of the house. Several years after completion of the project, extensive water damage results from defective installation of the stucco, requiring the homeowners to spend more than $500,000 to correct the defective construction and the resultant property damage to other parts of the house. The homeowners sue the contractor, which then tenders the claim to its CGL insurer. Arguing that the defective stucco installation does not constitute a covered "occurrence" under the policy, the insurer denies coverage and the contractor is left unprotected. The contractor files bankruptcy, leaving the owner to bear the burden of the defective construction. Each of the parties in this example has a stake in the contractor's right to insurance coverage for defective work under its CGL policy. However, there is no national consensus as to whether such coverage exists. Rather, the answer varies on a state-by-state basis.[1] The jurisdictional split in authority raises certain liability concerns for owners and contractors–especially those who conduct business on a multistate or national level or frequently use subcontractors who operate across state lines. A court's interpretation of whether defective construction constitutes an accidental "occurrence" depends on the view adopted by the jurisdiction in which the policy was delivered; and the jurisdictions vary in those views.

THE GENERAL FRAMEWORK OF STANDARD CGL INSURANCE

CGL insurance provides liability coverage designed to protect the policyholder against third-party claims for bodily injury or property damage arising out of the policy holder's business operations. The standard CGL policy contains three basic components: (1) a general grant

of coverage, called the "insuring agreement"; (2) exclusions from the grant of coverage, which bar coverage for certain types of claims or losses; and (3) policy conditions and miscellaneous provisions. While CGL insurance is not a construction-specific product, most contractors, recognizing the risks inherent in the construction business, obtain this liability coverage to guard against third-party claims. Most CGL insurance policies are written on standardized forms developed by the Insurance Services Office (ISO).[2]

BROAD COVERAGE UNDER THE INSURING AGREEMENT.

In a CGL policy, the insuring agreement establishes the scope of coverage without regard to limitations imposed by exclusions or conditions contained elsewhere in the policy. The standard language states that the insurer "will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage'" caused by an "occurrence" that takes place in the "coverage territory." Almost all CGL policies use extremely similar if not identical language to define the terms "bodily injury," "property damage," and "occurrence." The term "bodily injury" typically means "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time." "Property damage" is defined typically as "[p]hysical injury to tangible property, including all resulting loss of use of that property" or "[l]oss of use of tangible property that is not physically injured." The term "occurrence" is commonly defined as an "accident, including continuous or repeated exposure to substantially the same general harmful conditions" and this definition essentially limits coverage to "fortuitous" events, or those that happen by accident or chance. It is not uncommon that CGL policies lack a definition for "accident," requiring courts to look to the ordinary meaning and usage of the word when determining what constitutes an accident within the definition of an "occurrence."[3]

> "The "Your Work" exclusion includes a subcontractor exception that may place any damaged work that is performed by a subcontractor on the insured's behalf outside the scope of the exclusion."

EXCLUSIONS FROM COVERAGE: THE BUSINESS RISK EXCLUSIONS.

CGL insurance limits the broad scope of coverage provided under the insuring agreement by including various exclusions and conditions that shift certain risks back to the insured. Coverage disputes resulting from defective construction most often implicate the "Your Work" and "Expected or Intended Injury" exclusions. These exclusions are often referred to as the "business risk" exclusions because they purport to eliminate coverage for certain risks inherent in a contractor's business.

Under the "Your Work" exclusion, coverage does not apply to "'property damage' to 'your work' arising out of your work or any part of it and included in the 'products-completed operations hazard.'" The standard CGL policy defines "your work" as "[w]ork or operations performed by you or on your behalf" and "[m]aterials, parts or equipment furnished in connection with such work or operations." Some courts have relied upon this exclusion to deny coverage for defective work, explaining that the exclusion reflects a key principle of the "business-risk doctrine"–a contractor should be held responsible for the quality of its own work.[4]

The "Your Work" exclusion however, includes a subcontractor exception that may place any damaged work that is performed by a subcontractor on the insured's behalf outside the scope of the exclusion. Nonetheless, as explained below, courts are split as to whether the subcontractor exception establishes a right to coverage for construction defect claims that would otherwise be excluded.

The "Expected or Intended Injury" exclusion reinforces the fortuity requirement inherent in the definition of "occurrence" by excluding coverage for "bodily injury" or "property damage" that is "expected or intended from the standpoint of the insured."[5] Courts have interpreted this language to mean that coverage does not

The other line of cases, representing the minority view, has reached the opposite conclusion—defective workmanship does not constitute an accident; thus, coverage does not apply to property damage arising from defective construction. Within the minority position, three secondary schools of thought have emerged: (1) Construction defects do not constitute "occurrences" because they are not "accidents"; (2) construction defects do not constitute "occurrences" because to apply coverage would impermissibly transform CGL insurance into surety or performance bonds; or (3) construction defects do not constitute "occurrences" because they arise out of intentional acts and any resultant damage is therefore a foreseeable consequence.

apply to any property damage or bodily injury that is foreseeable to the policyholder.[6]

Insurers frequently invoke this exclusion for claims of property damage resulting from defective construction, arguing that the damage is a foreseeable or expected result of faulty workmanship. The contractor often responds by asserting that it did not expect or intend faulty workmanship (a reasonable argument in and of itself) and thus, the resultant property damage or bodily injury does not constitute a foreseeable result. If the property damage were the result of a subcontractor's defective work, this may bolster the policyholder's argument against application of the exclusion because the contractor is further removed from the work.

THE JURISDICTIONAL SPLIT OVER WHETHER CONSTRUCTION DEFECTS ARE "OCCURRENCES"

CGL coverage disputes involving claims of property damage resulting from defective workmanship are commonplace in courtrooms across America. Surprisingly, although the policies at issue in these cases often contain almost identical language by way of the standardized ISO forms, courts' interpretations of the policies lack any such uniformity. **Two primary views have emerged from the split between authorities. One line of cases, representing the majority position, generally holds that construction defects may be accidental and thus may trigger coverage for "property damage" caused by an "occurrence."** Under this view, the decisions generally fall into two schools of thought: (1) Construction defects constitute "occurrences" as long as the property damage was not expected or intended by the insured; or (2) construction defects constitute "occurrences" to the extent that property other than the work performed by the insured was damaged.

Jurisdictions are split on whether the definition of occurrences includes construction defects, with many courts increasingly overturning precedent and finding in favor of contractors who see their CGL insurance as a backstop for any unforeseen damages.

See a survey of cases from various jurisdictions following the majority or minority rule in the footnotes following this article.

COURTS HOLDING CONSTRUCTION DEFECTS CONSTITUTE "OCCURRENCES."

Recent decisions reflect the growing trend among states to adopt the position favoring broader coverage. The Supreme Court of West Virginia's recent decision in Cherrington v. Erie Ins. Prop. & Cas. Co. illustrates the reasoning generally applicable to the majority view. In Cherrington, the plaintiff hired a general contractor

to build a new home. The contractor, who was the named insured on a CGL policy, used a subcontractor to perform a substantial amount of the construction. After completion of the project, the homeowner discovered defects in the house. These included an uneven concrete floor, water seeping through the roof and chimney, a sagging support beam, and cracks in the drywalls throughout the house. The homeowner sued the contractor and the contractor tendered the claim to its insurer; however, the insurer denied coverage.

The Supreme Court of West Virginia reversed longstanding precedent and held that the CGL policy did cover the property damage. Discussing the occurrence requirement, the court emphasized that its earlier case law was "incongruous with the policy's express language providing coverage for the acts of subcontractors."[8] In a complete reversal from its previous holdings, the court held that construction defects can constitute an occurrence unless the claimed damages or injuries are "deliberate, intentional, expected, desired, or foreseen."

The court found that the "Your Work" exclusion, by its plain language, excludes coverage for any work done by the insured, but this does not apply to work performed by subcontractors, as clearly expressed in the subcontractor exception. The court reasoned that when a general contractor becomes liable for property damage resulting from a subcontractor's defective workmanship, the primary purpose of the subcontractor exception is to preserve coverage otherwise negated by the "Your Work" exclusion. The court also determined that the lower court improperly applied two other "business risk" exclusions to exclude coverage—the "Impaired Property" and "Product Recall" exclusions.

Construction Defects Constitute "Occurrences"	Construction Defects **Do Not** Constitute "Occurrences"
> Connecticut	> Arkansas
> West Virginia	> Colorado
> 2nd Circuit Ct of Appeals	> South Carolina
> North Dakota	> Alabama
> Georgia	> Hawaii
> Indiana	> Illinois
> Mississippi	> Iowa
> Montana	> Kentucky
> Florida	> Nebraska
> Missouri	> New Hampshire
> Tennessee	> New Jersey
> Texas	> North Carolina
> Kansas	> Ohio
> Minnesota	> Pennsylvania
> Wisconsin	> South Carolina
> South Dakota	> Virginia
> Arizona	
> California	

The Cherrington decision demonstrates the fundamental points that courts use to support a finding of broader coverage: (1) Contractors do not intend their work product to be faulty or defective, nor do they expect their work to result in property damage; so defective workmanship constitutes an "accident" within the meaning of the term "occurrence." (2) To hold that the "Your Work" exclusion applies to eliminate coverage for a subcontractor's defective workmanship would directly contradict the express language of the "subcontractor exception," rendering the exception superfluous. (3) Contractors have a reasonable expectation that CGL coverage applies to third-party claims for property damage resulting from construction defects because a contractor's liabilities commonly will involve or relate to their construction work.

COURTS HOLDING CONSTRUCTION DEFECTS DO NOT CONSTITUTE "OCCURRENCES."

The states that have maintained the minority position generally hold that coverage does not apply to defective construction claims on the ground that faulty workmanship does not constitute an "accident" within the definition of "occurrence." Courts in these states typically do not distinguish between construction defects that are a product of the policyholder's own faulty workmanship and defective construction that was performed by the insured's subcontractors.[9]

Although the common law definitions of "accident" reflect some variations from state to state, they generally incorporate the concept of fortuity–an accident is something that is unexpected, unintentional, or happens by chance.

The Supreme Court of Kentucky, for example, heavily relied on the fortuity doctrine to guide its application of the ordinary meaning of "accident" to the facts of the case.[10] Noting that control and intent are both fundamental aspects of the concept of fortuity, the court recognized that it would be a rare case indeed where a contractor subjectively intended to build a defective work product. The court emphasized, however, that because a contractor maintains control over a construction project, any argument that defective workmanship that occurred during construction is a "fortuitous, truly accidental, event" and thus a covered "occurrence" must fail. Similarly, the court rejected the argument that "any claim of poor workmanship would fall within the policy's definition of an accidental occurrence so long as there was not proof that the policyholder intentionally engaged in faulty workmanship." The court explained that such a conclusion would turn CGL policies into performance bonds or guarantees.

Other courts have reached similar conclusions, emphasizing that CGL insurance "is not intended to substitute for a contractor's performance bond, the purpose of which is to ensure the contractor against claims for the cost of repair or replacement of faulty work."[11] Further, a subcontractor's faulty or defective workmanship constitutes a business risk for which CGL insurance is not intended to provide coverage.[12]

SUGGESTED PRACTICES FOR HANDLING COVERAGE FOR DEFECTIVE WORK

The split in how different states interpret CGL coverage for construction defects creates substantial uncertainty for contractors and exposes them to potential liabilities for which they may not be prepared. While there is no foolproof way to navigate the murky waters related to these issues, careful attention to the evolving insurance trends and the terms of insurance contracts can help reduce the risk of uninsured exposure for construction defects.

First, both project owners and contractors should become familiar with the laws regarding CGL coverage for construction defects in the various states where they operate. Additionally, contractors should contact their attorneys and insurance brokers regularly to make sure they learn about changes in insurance laws that might affect them. Contractors should also discuss their CGL policy with their insurance brokers to try to eliminate any gaps in insurance coverage in the event of a loss or defective work claim. Contractors located in states that hold the minority view (that CGL policies do not cover construction defect claims) may be well served to supplement

[1] Facts similar to French v. Assurance Co. of Am., 448 F.3d 693 (4th Cir. 2006).
[2] In this article, references to policy language are taken from the standard CGL form CG 00 01 12 07, which is ISO's most recently published form.
[3] (ISO Form CG 00 01 12 07 at Section I, 1.a.)
[4] (See, e.g., Auto-Owners Ins. Co. v. Home Pride Cos., Inc., 268 Neb. 528, 537, 684 N.W.2d 571, 579 (2004) ("The reasoning for the 'your work' exclusion is to discourage sloppy work by making contractors pay for the losses resulting from their own defective work and preclude transforming liability insurance into a performance bond.")).
[5] (ISO Form CG 00 01 12 07 at Section I, 2.a.)
[6] (See French v. Assurance Co. of Am., 448 F.3d 693 (4th Cir. 2006)).
[7] (See Scottsdale Ins. Co. v. R.I. Pools Inc., 710 F.3d 488 (2d Cir. 2013) (applying Connecticut law); Cherrington v. Erie Ins. Prop. & Cas. Co., No. 12-0036, 2013 W. Va. LEXIS 724 (W. Va. June 18, 2013); Capstone Bldg. Corp. v. Am. Motorists Ins. Co., 308 Conn. 760, 67 A.3d 961 (2013)).
[8] (Cherrington v. Erie Ins. Prop. & Cas. Co., No. 12-0036, 2013 W. Va. LEXIS 724, at *35–39 (W. Va. June 18, 2013))
[9] (See Ark. Code Ann. § 23-79-155 (a)(2)(2011); Colo. Rev. Stat. § 13-20-808(3) (2010); S.C. Code Ann. § 38-61-70(B)(2) (2011)).
[10] (Cincinnati Ins. Co. v. Motorists Mut. Ins. Co., 306 S.W.3d 69 (Ky. 2010))
[11] (Nabholz Construction Corp. v. St. Paul Fire & Marine Ins. Co., 354 F. Supp. 2d 917, 922 (E.D. Ark. 2005); see also Kvaerner, 589 Pa. at 335, 908 A.2d at 899).
[12] (Bennett & Bennett Constr., Inc. v. Auto Owners Ins. Co., No. 27284, 2013 S.C. LEXIS 170 (S.C. July 17, 2013))
*States that follow the Majority rule: See K & L Homes, Inc. v. Am. Family Mut. Ins. Co., 2013 ND 57, 829 N.W.2d 724, 736 (N.D. 2013); Am. Empire Surplus Lines Ins. Co. v. Hathaway Dev. Co., 288 Ga. 749, 752, 707 S.E.2d 369, 372 (2011); Sheehan Constr. Co. v. Cont'l Cas. Co., 935 N.E.2d 160, 171-72 (Ind. 2010), modified on other grounds, 938 N.E.2d 685 (Ind. 2010); Architex Ass'n, Inc. v. Scottsdale Ins. Co., 27 So. 3d 1148, 1162 (Miss. 2010); Revelation Indus. v. St. Paul Fire & Marine Ins. Co., 2009 MT 123, 350 Mont. 184, 199, 206 P.3d 919, 929 (2009);

their CGL insurance with builder's risk insurance, professional liability insurance, or other types of coverage, either through endorsements to a CGL policy or via independent policies. Owners and developers should take similar steps prior to commencing any new projects to ensure there will be insurance coverage in the event of a construction defect.

Second, whenever possible, owners and contractors should require all contractors downstream to obtain performance bonds and warranty bonds. A performance bond assures that a contractor will perform the terms of its contract and protects the owner and any upstream contractors from financial loss, up to the value of the bond's penal sum, should the contractor fail to perform the contract in accordance with its terms and conditions. A warranty bond (also known as a maintenance bond) assures that a contractor will uphold the terms of its warranty during the specified warranty period. The surety company issuing the bond will add another layer of protection from defects in a contractor's work to help bridge gaps in insurance coverage–or in the event that a contractor files bankruptcy.

Finally, owners and contractors should always use written contracts, and they should ask their attorneys to update their contract forms regularly to stay current with trends in insurance law. Rather than simply requiring a subcontractor to carry CGL insurance, these provisions should be tailored to require downstream contractors to procure coverage for defective work. For example, it may be advisable to require the subcontractor to maintain specific types of insurance in addition to CGL coverage, such as performance bonds or builder's risk policies that would cover the subcontractor's defective work. This is especially true when the subcontractor is based in a jurisdiction that follows the minority rule excluding coverage for construction defects under CGL policies. All form contracts should also require contractors and subcontractors to name the owner and contractor as additional insureds under the subcontractor's policies. And, form contracts should include language that requires subcontractors to indemnify and defend owners and contractors from the subcontractor's negligence as well as from defects in the subcontractor's work. Indemnification laws also vary from state to state, so attorneys must ensure that the indemnification provision does not exceed the scope of permissible indemnity in the states where the contractor operates.

By thinking through these issues at the inception of a project, owners and contractors can reduce (though perhaps not eliminate) the risk of exposure to uninsured liabilities for construction defects.

United States Fire Ins. Co. v. J.S.U.B., Inc., 979 So. 2d 871, 888 (Fla. 2007); Columbia Mut. Ins. Co. v. Epstein, 239 S.W.3d 667, 672-73 (Mo. Ct. App. 2007); Travelers Indem. Co. of Am. v. Moore & Assocs., Inc., 216 S.W.3d 302, 308 (Tenn. 2007); Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1, 4 (Tex. 2007); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 281 Kan. 844, 859, 137 P.3d 486, 495 (2006); Wanzek Constr., Inc. v. Emp'rs. Ins. of Wausau, 679 N.W.2d 322, (Minn. 2004); Am. Family Mut. Ins. Co. v. Am. Girl, Inc., 2004 WI 2, 268 Wis. 2d 16, 43-44, 673 N.W.2d 65, 78 (2004); Corner Constr. Co. v. United States Fid. & Guar. Co., 2002 SD 5, 638 N.W.2d 887, 894-95 (S.D. 2002); Lennar Corp. v. Auto-Owners Ins. Co., 214 Ariz. 255, 262-64, 151 P.3d 538, 545-56 (Ariz. Ct. App. 2007); Century Indem. Co. v. Hearrean, 120 Cal. Rptr. 2d 66, 98 (Cal. Ct. App. 2002).

*States that follow the Minority rule: See Town & Country Prop., L.L.C. v. Amerisure Ins. Co., 111 So. 3d 699, 706 (Ala. 2011); Essex Ins. Co. v. Holder, 372 Ark. 535, 540, 261 S.W.3d 456, 460 (2008); General Sec. Indem. Co. of Ariz. v. Mountain States Mut. Cas. Co., 205 P.3d 529, 535 (Colo. Ct. App. 2009); Group Builders Inc. v. Admiral Ins. Co., 123 Hawaii 142, 148, 231 P.3d 67, 73 (Ct. App. 2010); State Farm Fire & Cas. Co. v. Tillerson, 334 Ill. App. 3d 404, 777 N.E.2d 986, 991, 268 Ill. Dec. 63, 68 (2002); W.C. Stewart Constr., Inc. v. Cincinnati Ins. Co., 770 N.W.2d 850 (Iowa Ct. App. 2009); Cincinnati Ins. Co. v. Motorists Mut. Ins. Co., 306 S.W.3d 69, 76 (Ky. 2010); Auto-Owners Ins. Co. v. Home Pride Cos., Inc., 268 Neb. 528, 535, 684 N.W.2d 571, 577 (2004); Concord Gen. Mut. Ins. Co. v. Green & Co. Bldg. & Dev. Corp., 160 N.H. 690, 693, 8 A.3d 24, 28 (2010); Firemen's Ins. Co. of Newark v. National Union Fire Ins. Co., 387 N.J. Super. 434, 447-49, 904 A.2d 754, 762-63 (N.J. Super. Ct. App. Div. 2006); Production Sys., Inc. v. Amerisure Ins. Co., 167 N.C. App. 601, 607, 605 S.E.2d 663, 666 (N.C. Ct. App.); Westfield Ins. Co. v. Custom Agri Sys., Inc., 133 Ohio St. 3d 476, 2012 Ohio 4712, 979 N.E.2d 269 (2012); Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Comm. Union Ins. Co., 589 Pa. 317, 335, 908 A.2d 888, 899 (2006); L-J, Inc. v. Bituminous Fire & Marine Ins. Co., 366 S.C. 117, 123, 621 S.E.2d 33, 36 (2005); Hotel Roanoke Conference Center Comm'n v. Cincinnati Ins. Co., 303 F. Supp. 2d 784, 786-89 (W.D. Va., 2004).

NO SURE THING

Does your arbitration agreement inadvertently expose you to liability for an unlimited time?

BY JOHN D. BURNS

The great Scots poet Robert Burns married the daughter of a brickmason, so it is no surprise he seems to have understood one of the essential truths of construction law: Nothing is certain in construction except uncertainty. There are no sure things.

But if there is one thing that should be a sure thing in construction law, it is the statute of repose. While the time period[1] and type of claim to which it applies[2] differ from state to state, every state has some version of a statute enforcing the idea that once a certain amount of time has passed after work has been completed, a contractor or architect should be able to move on without being concerned about whether old errors or liabilities will pop up and result in a lawsuit. In North Carolina, that time period is six years. North Carolina General Statute §1-50(a)(5)a. states, "no action to recover damages based upon or arising out of the defective or unsafe conditions of an improvement to real property shall be brought more than six years from the later of the specific last act or omission of the defendant giving rise to the cause of action or substantial completion of the improvement."[3]

The public policy behind such a statute is clear. Building professionals should not have to face what a North Carolina court called "potential open-ended liability for an indefinite period of time."[4] If any flaw or injury related to an improvement to real property could give rise to a cause of action that lasts forever, contractors would face the difficulty of defending cases based on facts and conditions that occurred several years prior.

So, it must be a sure thing then: if you build anything in North Carolina, you won't face a claim more than six years after completion. Right? Wrong. The ubiquity of arbitration agreements in modern contracts has imperiled this sure thing in some states, including North Carolina. One recent case shows how. A second-tier sitework subcontractor on a shopping mall project completed its work in early 2005, and the shopping mall opened in the fall of that year.

However, in the spring of 2012, Seven years later, the subcontractor found itself facing a motion to compel its participation in an arbitration arising from an alleged flaw in its work. Despite case law that held the statute of repose to be "an unyielding and absolute barrier" that gave a defendant a "vested right not to be sued" on old claims,[5] the trial court compelled the client to arbitration.

The basis for this ruling is that the statute of repose in North Carolina states that "no *action* to recover damages" could be brought more than six years after substantial completion. The claimant contended, and the court and arbitrator ultimately agreed, that under prior North Carolina decisions, "an arbitration is neither an 'action' nor a 'judicial proceeding,' but a non-judicial out-of-court proceeding which makes an action or judicial proceeding unnecessary."[6] Since it was not an action, the arbitration claim could not be barred by the language of the statute. The result? The subcontractor ended up facing a large liability that, in the absence of an arbitration agreement, would likely have been defeated on the first day of court.[7]

Because arbitration provisions are found in nearly every contract, particularly on substantial construction jobs, such rulings should sound a strong note of caution for building professionals, particularly those who are involved in projects as subcontractors. If, as in North Carolina, such timing rulings are left up to the arbitrator, significant expense can be incurred before any ruling is had on the issue, and the arbitrator may, under the logic in cases like *Cameron* or *Broom*, rule that the statute does not apply.

Short of lobbying for every state to change its laws, there is only one way to ensure the statute of repose protects against stale claims in arbitration: build it into the contract, ideally in the arbitration provision itself. For the protection of the contractor, the arbitration provision of any construction contract should state that, in any arbitration proceeding conducted thereunder, any statutes of limitation or repose of the forum state should be deemed to apply to claims brought in arbitration as if the case were brought in a court of law.

Alternatively, the contract could be drafted with its own repose or limitations provision, setting forth the date before which any claim must be brought. Like an arbitration clause, such a provision should be enforceable against both parties, provided it could not be deemed to be an unconscionable abuse of one party's bargaining power over the other.

What any building professional should *not* do is assume it is a sure thing that a statute of repose will automatically bar stale arbitration claims. Keeping in mind what Robert Burns said about the best laid schemes of mice and men, careful wording before the contract is executed can help resolve that uncertainty.

[1] The American Institute of Architects (AIA) provides a handy guide to the Statutes of Repose in each state as of 2011, which can be found at: http://www.aia.org/aiaucmp/groups/aia/documents/pdf/aias078872.pdf. That listing shows that 23 states have a Statute of Repose of 10 years. The longest is Iowa, at 15. The shortest is Tennessee, at 4.
[2] Some states apply a statute of repose only to claims arising from contract; others apply it to tort claims as well. For this reason, careful review of any claim is strongly advised before decisions are made based on the application of the statutes of repose or limitation.
[3] Virginia's Statute of Repose, which is five years, has similar wording. Code of Virginia §8.01-250.
[4] Monson v. Paramount Homes, Inc., 133 N.C. App. 235, 240, 515 S.E.2d 445, 449 (1999).
[5] Black v. Littlejohn, 312 N.C. 626, 633, 325 S.E.2d 469, 475 (1985).
[6] Cameron v. Griffith, 91 N.C. App. 164, 165, 370 S.E.2d 704, 704-05 (1988). The Cameron court was discussing the application of a statute of limitations to a securities claim. The distinction between statutes of repose and statutes of limitation did not persuade the court or the arbitrator.
[7] While the issue might have been revisited in any hearing on a motion confirming an ultimate arbitration award after the arbitration was concluded, the matter settled on confidential terms.
[8] See, for example, Scott v. Delaware Tech &Comm'ty. Coll., 1985 Del. Ch. LEXIS 400 (Mar 5, 1985) (finding arbitration barred by statute of repose referring only to "actions").
[9] Broom v. Morgan Stanley DW, 169 Wash. 2d 231, 236 P. 3d 182 (2010).
[10] R.C.W. § 7.04A.090

Understanding Common Contract Provisions That Will Impact Your Business.

BY STEPHEN G. TEST

Commercial construction contracts are complex documents intended to anticipate all possible events that can arise in project development, design, construction and completion, and then fairly allocate those risks between the parties. Standard form documents, such as AIA, EJCDC and Consensus all provide excellent forms ready to use for nearly all types of projects. Typically though, the drafting party, whether the owner/developer, the designer, the general or the subcontractor, will modify standard provisions in these forms intending to shift the risks and burdens associated with common issues, including forum selection, choice of law, dispute resolution, recovery of costs and fees and waivers of claims and damages.

FORUM SELECTION

Be watchful for a provision that provides for resolution of disputes in a location other than the location of the project, perhaps the home town of one party or the home state of a party's corporate office. To protect general contractors, the Virginia General Assembly enacted §8.02-262.1 which requires that Virginia must be the forum of any arbitration required under a contract where a Virginia-based business contracts to do work in Virginia. Any contract provision calling for arbitration outside of Virginia is unenforceable. This statute is preempted by the Federal Arbitration Act though so it will not apply to projects involving federal law or claims involving interstate commerce. No such statute applies when litigation is chosen as a dispute resolution mechanism. The United States Supreme Court just decided that forum selection clauses were enforceable in Atlantic Marine Construction v. United States District Court.

CHOICE OF LAW

In addition to selection of a location for dispute resolution, contracts usually contain a provision where the parties agree to use the law of a particular state for interpretation and enforcement of the contract. For example, a contract for a project in Roanoke may require the application of the laws of Massachusetts rather than those of Virginia. The selected jurisdiction must be reasonably related to the purpose of the agreement. If that is the case and it is not against a public policy of Virginia, a Virginia judge will be required to resolve claims by applying the laws of the selected foreign state. Those laws may vary dramatically from those of Virginia in substantive areas such as indemnification, burden of proof and calculation of damages or the Statute of Limitations.

ONE-SIDED ARBITRATION CLAUSE

Usually, arbitration provisions are mutually agreed on and fully enforceable. Sometimes, the clause is drafted to give the power of selection of litigation or some method of ADR to one party. In effect the parties have agreed that there is no agreement to arbitrate or litigate. If a dispute arises, and one party files a claim in court or in arbitration, the party with the power of selection can move to stay or dismiss the claim and demand that it be filed in a forum of its own choice, thereby controlling the process to its advantage.

ATTORNEY & CONSULTANT FEES

Resolving construction disputes is expensive. Virginia follows the "American Rule" which provides that a party may only recover its attorney's fees if the contract makes specific provision for recovery or it is allowed by statute. If you want to recover attorney's fees as the prevailing party, be certain to provide for it in your contract, and consider adding language to include recovery of consultant or expert witness fees.

WAIVER

You should always carefully read any contract, looking for key terms like "waiver" and "release". Often you will see that certain claims or rights are "waived" entirely or are made subject to stringent conditions precedent. In Virginia, a waiver is the intentional relinquishment of a known right, claim or privilege. Common waivers, include:

- "Pay if Paid" – you only have the contractual right to claim and recover payments from the other party if the other party has received funds to pay you as a condition precedent;
- Consequential damages – those damages that are a consequence of a breach of contract (acceleration, delay impacts, loss of use, lost profits, etc.), leaving only the right to collect direct damages – those that result directly from the breach (costs of repair or replacement, etc.);
- No damages for delay, leaving only the right to extension of time to complete
- Right to file and enforce a mechanic's lien;
- Claim is waived if a particular form of notice is not timely made;
- Claims are waived by acceptance of payment

CONCLUSION:

Virginia courts can be counted on to enforce construction contracts as written, allowing parties the freedom of the marketplace to contract at arm's length. Courts generally will not set aside a contract or strike a provision or term absent fraud or violation of public policy. Your time and treasure are well spent reviewing your contracts closely to understand their impact and enforceability.

THE NUCLEAR OPTION

Allegations of Bad Faith Against the Government in the Claims Process.

BY WILLIAM A. WOZNIAK

The Federal government is a contracting partner with unequalled power and discretion. Thus, it is not surprising that businesses contracting with the Federal government sometimes find themselves in situations where it appears that the Government is "out to get" them. Indeed, what is best for the Government is not always best for the contractor, so Government employees are often required to make tough decisions that a contractor may vehemently disagree with. When you are the party without the leverage and on the receiving end, those decisions can be perceived as intentional and spiteful. Although the vast majority of Federal officials simply are attempting to carry out their duties in the best interest of the Government, the Federal government and the contractors that support it are made up of people. Consequently, the darker side of human nature could occasionally impact the decisions and actions of the Government vis-à-vis a contractor. If personal animus does seep into a government official's actions or decisions, the contractor may desire to bring a claim that the official has acted in "bad faith."

A contractor that encounters a government official it believes is acting in bad faith is in a very difficult position. Utilization of the disputes process is by no means an easy avenue to relief and is not for the faint of heart. When you add in a claim of bad faith, there is an inherent tension between a contractor's desire to resolve a claim inexpensively and efficiently through the contracting officer and the allegation that the contracting officer, or the agency he or she supports, has acted so improperly as to amount to bad faith. Moreover, Federal Courts and Boards of Contract Appeals "have long upheld the principle that government officials are presumed to discharge their duties in good faith." Bruce E. Zoeller, ASBCA No. 56578, June 27, 2013, 2013-1 B.C.A. ¶ 35,353 (quoting Road & Highway Builders, LLC v. United States, 702 F.3d 1365, 1368-69 (Fed. Cir. 2012). Thus, the tension a contractor feels is increased by this presumption and the burden the Courts place upon the contractor to overcome it. Accounting for that presumption in the context of the Federal claims and disputes process requires unique factual and strategic considerations. Before pushing that nuclear bomb button, a contractor must understand the steep climb that it faces, as well as the impact on the disputes process of an allegation of bad faith.

THE HIGH BURDEN FOR BAD FAITH

A contractor must be able to

distinguish between the general frustrations of doing business with the Government versus something pernicious that may create the basis for a bad faith claim. Allegations of bad faith are extremely serious, and, as such, the Courts impose a heavy burden on a contractor alleging bad faith to overcome the presumption that Government employees discharge their duties in good faith. The Federal Circuit recently stated the test as follows: "a challenger seeking to prove that a government official acted in bad faith in the discharge of his or her duties must show a 'specific intent to injure the plaintiff' by clear and convincing evidence." Road & Highway Builders, LLC v. United States, 702 F.3d 1365, 1368-69 (Fed. Cir. 2012) (citing Am-Pro Protective Agency v. United States, 281 F.3d 1234, 1239 (Fed. Cir. 2002)). Clear and convincing evidence is more stringent than the preponderance of the evidence standard, but a somewhat lower threshold than the beyond a reasonable doubt standard. Id.

In practice, contractors that are successful in alleging bad faith typically have relied on a "smoking gun" to establish that the Government acted with the requisite animus and specific intent to injure. For instance, in North Star Alaska Hous. Corp. v. United States, 76 Fed. Cl. 158 (2007), the record was "littered with statements made by key government officials exhibiting animus toward North Star." In that case, North Star was awarded a contract to design and build a 400-unit housing project for soldiers and their families at a base in Alaska. The United States Army's Chief of Housing for the State of Alaska utilized a colorful sports metaphor to describe the strategy he wanted in administering the contract with North Star:

> Just follow the Miami Hurricane's Game Plan. Blitz [North Star's President] the first time he takes the handoff from [North Star's Site Manager]. Force them to go for the short gains. Keep them out of the red zone. On offense, exercise good ball control and mix up the plays to throw off their timing. Try to draw them offsides and into a penalty situation. And always remember that you have home field advantage.

North Star, 76 Fed. Cl. at 190. Army personnel made other statements that the Court relied upon to establish bad faith, including: (1) telling a North Star employee regarding the cost of carpet that "I'm going to figure out a way that I can take it right out of your pay;" and (2) writing an internal email stating "I recommend installing a trap door in front of your desk which you can release when [North Star's site manager] is standing on it in front of your desk. Connected to a chute to the Chena River." Id. Relying on these statements and the testimony of former government employees, the Court found that "the record provides a virtual rancid cornucopia of electronic messages and other communications evidencing a specific intent by key government officials to injure North Star." Id. at 193.

Unfortunately for contractors that truly experience bad faith actions, not all Government officials clearly document their personal animus towards contractors. Indeed, the level of brazenness seen in North Star is certainly not the norm. The typical situation is substantially more subtle and requires the contractor's close consideration as to whether the intent to injure actually exists and, if so, whether the contractor will be able to meet the evidentiary burden necessary to establish it.

THE TENSION BETWEEN BAD FAITH AND THE DISPUTES PROCESS

A recent Armed Services Board of Contract Appeals ("ASBCA") case highlights an additional layer of difficulty for a potential bad faith claim. The disputes process set forth in the Federal Acquisition Regulation ("FAR") requires claims to be submitted to the contracting officer for decision. FAR 52.233-1. It is the contracting officer's decision on a claim that is appealed to a Board of Contract Appeals. 41 U.S.C. § 7103. In CCI, Inc., ASBCA No. 57316, Mar. 14, 2014, 2014 ASBCA LEXIS 65, the contractor submitted a request for equitable adjustment ("REA") asserting a differing site condition that the contracting officer denied. Subsequently, the contractor converted its REA to a claim, and the contracting officer made a final decision once again denying the contractor's claim. Id. at *71. The contractor appealed the contracting officer's decision to the ASBCA and, as part of its appeal, alleged that the contracting officer had acted in bad faith in denying its REA. Id. at *92.

The Board pointed out that "[a] contractor's submission of a proper CDA claim in writing to the CO for

> A contractor must be able to distinguish between the general frustrations of doing business with the Government versus something pernicious that may create the basis for a bad faith claim.

decision is one of the prerequisites to the Board's CDA jurisdiction." Id. at *94. As such, "[t]he Board does not have jurisdiction to consider a new claim raised for the first time in a party's pleadings." Id. Quoting its decision in Shaw Environmental, Inc., ASBCA No. 57237, 12-1 BCA ¶ 34,956, the Board summarized as follows:

Whether a claim before the Board is new or essentially the same as that presented to the CO depends upon whether the claims derive from common or related operative facts. The assertion of a new legal theory of recovery, when based upon the same operative facts as the original claim, does not constitute a new claim. In determining a claim's scope, we are not limited to the claim document but can examine the totality of the circumstances. However, the contractor must submit a clear and unequivocal statement that gives the CO adequate notice of the basis and amount of the claim.

CCI, No. 57316, at **94-95 (internal citations omitted).

Although the contractor alleged that it had challenged the propriety of the government's conduct in its REA and claim and, thus, its bad faith allegations were based on the same operative facts that it presented to the contracting officer, the Board found that the contractor's claim to the contracting officer did not specifically allege that the government had acted in bad faith or include operative facts that were in any respect tantamount to a bad faith claim. Id. at **72 & 93. Bad faith requires a specific intent to injure, and the contractor had not made those serious allegations. Id. at 95-96. Ultimately, the Board held that it lacked jurisdiction to entertain the contractor's bad faith claim because it did not submit such a claim to the contracting officer for decision. Id. at *96.

The decision in CCI highlights the difficult strategic decisions facing a contractor that believes it may have a bad faith claim. Contractors that truly desire to resolve a claim amicably and without incurring great expense may view allegations tantamount to bad faith as contrary to that goal. Indeed, accusing the contracting officer of bad faith in a claim to that very same contracting officer essentially ensures that the claim will be denied. In short, a claim based on allegations of bad faith is a nuclear bomb option that is likely to destroy any likelihood of success for an REA and a claim. At that point, the contractor is simply going through the procedural motions with the understanding that it will necessarily have to appeal the contracting officer's final decision to a higher authority. (What Contracting Officer is going to agree that he or she has acted in bad faith?) However, the CCI decision requires the contractor to make the determination to proceed with allegations based on bad faith early in the process or potentially lose the opportunity to raise it before a Board of Contract Appeals. Thus, prior to submission of its claim, the contractor must weigh any lingering hope of a contracting officer's positive final decision against its potential success on a bad faith claim.

We know allegations of bad faith are not trivial and will not be taken lightly. The heavy burden that Courts place on a contractor bringing such a claim affirms the seriousness of such allegations. Contractors that believe that a Government official has acted to harm them must consider that heavy burden early in the claims process to determine if bad faith truly exists and, if so, whether the impact on the claims process makes a claim for bad faith the right mechanism to achieve the desired relief.

Construction today is hard enough. That's why you want a law firm that tries to find practical business solutions, not more problems. We work hard to turn complicated into simple. Whether we're drafting contracts, negotiating on your behalf, resolving disputes or closing out projects, we never forget that the goal is to grow your business. To find out more about our Construction, Government Contracts, Infrastructure and Public-Private Partnership practices, visit **williamsmullen.com**

WILLIAMS
MULLEN
finding yes®

Tysons Corner • Washington, DC • Charlottesville • Newport News • Norfolk • Raleigh • Research Triangle Park • Richmond • Virginia Beach • Wilmington

Federal Government Contractors on the Horns of A Dilemma – The Mandatory Disclosure Rule, The FAR And The False Claims Act.

BY ROBERT K. COX

The policy of the federal government calls for its contractors to conduct themselves with the highest degree of integrity and honesty. FAR 3.1002. The federal government promotes and enforces this policy through the Mandatory Disclosure Rule, including the use of contract clauses such as the Contractor Code of Business Ethics and Conduct, FAR 52.203-13, with internal organization and disclosure requirements for covered contractors, and the False Claims Act. Recent federal court rulings show, however, that a contractor complying with the Mandatory Disclosure Rule can be in jeopardy of liability under the False Claims Act, as well as potentially lose its attorney work product and attorney-client privileges over the documents and reports generated in complying with the Mandatory Disclosure Rule and FAR. When compliance with the Mandatory Disclosure Rule can open the trap door to the pit of liability under the False Claims Act, there is a real need for harmonization of the Mandatory Disclosure Rule and the False Claims Act. Otherwise, those well-intentioned policies and statutes will put the federal government contractor on the horns of a dilemma.

The federal Mandatory Disclosure Rule is a four page Rule that packs a wallop for federal government contractors. The Rule requires covered contractors to have real internal compliance programs, to cooperate with the federal government in investigating fraud and corruption in their contracts, to disclose to the Contracting Officer and the Inspector General if the contractors become aware of fraud or corruption in their contracts with the federal government, and to report significant overpayments to the Contracting Officer.

In the recent case of Michael Saunders v. Unisys Corporation, Case No. 1:12-cv-00379, (E.D. Va. 2014), before the lawsuit had commenced, the government contractor, Unisys Corporation, made two reports to the Office of the Inspector General of the Department of Defense disclosing "unacceptable" time billing practices for a government contract to provide radio-frequency identification services to the U.S. Army for tracking movement of Army supplies. Unisys's disclosure reports did not reveal allegations or transactions of fraud, and the federal court noted that Unisys denied the "unacceptable" billing practices resulted in Unisys

overbilling the federal government.

The plaintiff, Michael Saunders, was a former employee of Unisys who initiated a False Claims Act lawsuit against Unisys alleging the "unacceptable" billing practices that Unisys had previously disclosed had resulted in $13 million in overbillings to the federal government. The former employee also alleged that Unisys had retaliated against him by firing him after he demanded Unisys disclose the alleged overbillings to the Inspector General.

> "A contractor complying with the Mandatory Disclosure Rule can be in jeopardy of liability under the False Claims Act, as well as potentially lose its attorney work product and attorney-client privileges."

Unisys filed a motion to dismiss the False Claims Act count contending that its previous disclosure reports to the Department of Defense Office of Inspector General triggered the public disclosure bar against False Claim Act lawsuits. The public disclosure bar prevents private relators, such as the Plaintiff in Unisys, from pursuing False Claims Act lawsuits if substantially the same allegation or transactions alleged in the False Claims Act lawsuit were previously disclosed publicly.

The federal court ruled that Unisys's disclosures of "unacceptable" time billing practices to the Department of Defense, Office of the Inspector General did not trigger the public disclosure bar. The court reasoned that Unisys's disclosures to a governmental official were not public disclosures because the disclosures were not placed in the public domain, e.g. on a website, or otherwise made available to the public. The disclosures did not reveal an allegation or transaction of fraud. Although discussing accusations of unethical billing, the disclosures were silent on transactions of fraud or whether Unisys had been accused of fraudulent billing. Because Unisys's disclosures did not trigger the statutory public disclosure bar, the Plaintiff relator's False Claims Act lawsuit could proceed, and the complying contractor remained at risk.

In another recent qui tam lawsuit, United States ex. rel. Harry Barko v. Halliburton Company, et al., Case No. 1:05-cv-1276 (D.D.C. 2014), the federal court considered whether the attorney-client or attorney work product privileges applied to documents and investigation reports generated by internal investigations to comply with the Mandatory Disclosure Rule and FAR. In ruling that the traditional privileges against discovery did not apply, the federal court rationalized that the investigation and resultant documents and reports were required and generated in response to Halliburton's legal obligations as a federal government contractor to comply with the Mandatory Disclosure Rule, FAR and internal policies to investigate allegations of fraud in its federal government contracts. The court further noted a number of factors, including that non-lawyers conducted the investigations and generated the documents and reports, and, because of the legal obligation to comply with the Mandatory Disclosure Rule and FAR as a government contractor, the investigations were more in the ordinary course of business and not in response to attorney direction, in obtaining legal advice or in anticipation of litigation.

In both cases, a federal government contractor taking action to comply with the Federal Mandatory Disclosure Rule and FAR ran afoul of the False Claims Act or lost fundamental privileges against discovery. Such results would seem to clash with the federal government's policy to promote open and forthright contracting through the Mandatory Disclosure Rule and FAR. Congress should consider these case results and harmonize the statutes to take federal government contractors off the horns of their dilemma.

WILLIAMS MULLEN

Construction Industry News

8300 Greensboro Drive
Suite 1100
Tysons Corner, VA 22102
Telephone: 703.760.5200
williamsmullen.com

"Williams Mullen Construction Litigation is ranked First Tier Nationally in the 2014 Edition of *U.S. News - Best Lawyers*' 'Best Law Firms!'"

WILLIAMS MULLEN
finding yes®