



# COMMON SENSE CONTRACTING

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## Tools for Tough Times

**606** The current economic climate requires contractors, subcontractors, and owners to be very vigilant in managing financial risks. For contractors and subcontractors, cash flow is their lifeblood. Many operate on thin profit margins; so when the cash stops flowing, that firm is unable to perform. While owners may vary significantly, one thing all owners share when they enter the construction arena is the need to finish their projects (1) on time, (2) on budget, (3) in a quality manner, and (4) safely. If a contractor becomes insolvent, the owner's ability to achieve these objectives is jeopardized. (The same considerations apply to contractors and subcontractors. While this article focuses on owners and contractors, these principles apply at every tier in the construction process.)

### Front-End Planning Issues

Protecting against financial risks should begin before

## 2009 Construction Industry Update

# “Navigating Through Uncertainty”

February 19-20, 2009

The construction industry, like the country, faces uncertainty and change. Survival requires adaptation to new opportunities and obligations as well as prompt identification and better management of risks. The theme for Smith, Currie & Hancock's **2009 Update for the Construction Industry** is “*Navigating Through Uncertainty*.” Our program will include particular coverage of surety/financial issues as well as current information on trends in project delivery systems, LEED, Green Construction, and recent court and regulatory actions that will impact your bottom line.

The value of our 2009 program will be enhanced as each attendee will receive a copy of *Common Sense Construction Law, 4<sup>th</sup> Edition*, a hardbound desk book that will be published by John Wiley & Sons in January 2009. This book will also include a CD with 240 industry form documents from the AIA, ConsensusDOCS LLC, and EJCDC. In addition, the update seminar materials will include a manual covering recent developments and issues of interest to the construction industry. Finally if you need continuing education (“CE”) credits as a Florida licensed general contractor, this program will permit you to obtain six (6) hours of CE credit toward your renewal cycle requirement of 14 CE hours.

Mark your calendars and plan on attending this program to be held on **February 19-20, 2009** at the Hyatt Regency Hotel in Atlanta. Shortly, you will receive more detailed information on this program. In the meantime, if there are particular topics you would like to see us address in the program, please feel free to contact **Eric Nelson**, (404)582-8061 or [elnelson@smithcurrie.com](mailto:elnelson@smithcurrie.com), or any of the firm's attorneys.

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contract formation. Perhaps the most important thing any firm can do to protect against financial problems is to carefully choose the companies it does business with, and to request evidence of those companies' financial strength. Some owners "pre-qualify" prospective contractors before allowing them to bid. The prequalification process usually includes determining the bidders' financial strength. Similarly, contractors should consider "pre-qualifying" the owners, with this pre-qualification process to include performing the due diligence necessary to determine the owner's ability to pay, as well as the owner's reputation for making timely payments. Given recent developments in the financial world, a prudent contractor should also consider "pre-qualifying" the construction lender.

One thing that makes construction so interesting is the fact that each construction project is unique. This characteristic is true with regard to financial risks too. Prudent contractors and owners must assess the financial risks inherent in each project. Both parties should also take appropriate steps to "secure" their positions as much as possible. One vehicle for doing so is the construction contract.

### Creating Contractual Protection

Most standard construction contract forms give the contractor the right, at least in certain circumstances, to require the owner to demonstrate its ability to satisfy its financial obligations. See, for example, ConsensusDOCS 200, Paragraph 4.2 and AIA Document A201-2007, § 2.2.1. One way an owner can protect itself against the possibility of contractor insolvency is by requiring the contractor, and/or some or all of its subcontractors, to be bonded – i.e., to furnish payment and performance bonds. Some owners require alternative forms of security in lieu of bonds, such as a letter of credit, a parent company guaranty, or personal guaranties from the company's principals. Rarely does a contractor seek similar guaranties. However, an argument could be made that the contractor's need for such protection is even greater than the owner's, especially if the owner is a single-asset, or limited asset, limited liability company or corporation (LLC).

One of the main purposes of any contract is to identify and allocate various anticipated risks. Financial risk is one such risk. A common risk allocation tool used in subcontracts is the "pay-if-paid" or "pay-when-paid" clause. Depending upon which state's law applies, that provision may protect the general contractor from being obligated to pay its subcontractors if the owner does not pay the general contractor. Another example of a contract provision used to allocate risks is a contractual waiver of lien rights, which is enforceable in some states, but not others. Other examples include the contract terms relating to the amount and timing of payments, provisions relating to the amount of retainage and the timing of its release, and provisions giving the owner (or the general contractor, in the case of a subcontract) the right to make payments by joint checks (to ensure that downstream parties are paid) or to condition payments on the receipt of sworn statements that downstream parties have been paid. Provisions establishing remedies for nonpayment – such as the right to interest, the right to suspend work, and the right to terminate the contract – are also very important to consider.

A less obvious, but potentially more deadly, contract provision allocating financial risk is the changes clause contained in virtually every construction contract. Many construction contracts provide in the event of a dispute as to whether certain work constitutes extra work or as to the value of the extra work, the owner may direct the contractor to proceed with the work at the contractor's expense, with the issue of entitlement to be determined later. See, for example, AIA Document A201-2007, Article 7 (and the provisions therein regarding Construction Change Directives). Compare, ConsensusDOCS 200, Article 8, which provides that the parties will split the estimated cost until a resolution is achieved.

### Managing Financial Risks During Construction

Once construction commences, it is imperative for each party to manage financial risks. A prudent contractor should take affirmative steps to protect against the possibility of nonpayment by the owner, as well as the downstream risk that a subcontractor or supplier may fail to perform due to insolvency. A prudent owner should proactively guard against contractor insolvency and the dreaded possibility of paying for the same work twice. A good financial risk management program should consist of a number of elements, including the following.

**1. Require Financial Assurance ("Show Me The Money").** The importance of contract terms entitling the contractor to require the owner to provide financial assurance is discussed above. Exercising those rights appropriately is equally important. Many contractors don't know what to ask for in this regard. The new ConsensusDOCS family of documents provides two useful tools for this: ConsensusDOCS 290 (Guidelines for Obtaining Owner Financial Information) and 290.1 (Owner Financial Questionnaire). The owner should likewise exercise any rights the construction contract may afford it to verify the contractor's financial capacity whenever it is in doubt. Even if the owner does not have the right or ability to verify the contractor's financial strength during project performance, most contracts allow the owner to verify that the contractor is paying its subcontractors and suppliers.

**2. Preserve Lien and Bond Rights ("Use Them or Lose Them").** Statutory lien rights exist in every state but vary from state-to-state. These are examples of the government actually helping contractors and, in most states, subcontractors and suppliers receive payment. A contractor's right to place a lien on the property the contractor helped improve provides a form of security against nonpayment. However, the contractor must timely exercise its lien rights or risk losing them. On public projects, the general contractor is usually required to post a payment bond, which essentially serves as a substitute for subcontractors' and suppliers' lien rights, since public property generally cannot be liened. Again, these rights must be timely exercised or they may be lost. Conversely, owners need to act

to preserve and receive the advantage of any bonds or other forms of security they required by, among other things, being careful to strictly comply with all notice requirements and deadlines.

**3. Pace Payments and Progress.** In simplest terms, a construction contract is nothing more than an agreement by the contractor to perform construction work in exchange for the owner's agreement to pay money. Viewed in these simple terms, it is obvious that one way a party to a construction contract maintains optimal leverage over the other party is to tilt the balance of payments and construction progress in its favor. In other words, an owner can help ensure that the project will be completed within budget by withholding a contract balance which exceeds the value of the remaining work. Conversely, the contractor can help ensure that the owner will allow the contractor to complete the project and will pay for its work if the cost of the remaining work exceeds the contract balance. This article does not advocate that either side unfairly or unreasonably tilt this balance in their favor; but *both parties should* be careful to guard against that by making sure that construction progress and payments proceed at approximately the same pace.

**4. Ask for Money Owed.** Most firms like to avoid confrontation whenever possible. Some contractors make the mistake of failing to insist upon timely payments for fear of offending the owner. Generally speaking, a contractor is better served by professionally and courteously asking the owner to honor its payment obligations as they accrue.

**5. Consider Alternative Payment Sources.** If a party becomes insolvent or unable to satisfy its financial or other contractual obligations, there may be alternative payment sources available. These may include guarantors, sureties, construction lenders, and insurance carriers, as well as remedies created by statute, licensing laws, and manufacturer or other warranties.

**6. Protect Your Backside.** Both the owner and the contractor must remain mindful that it is not just one another they need to worry about. The owner needs to make sure it satisfies the requirements of its construction loan so that loan funds remain available to satisfy its payment obligations. In the current economic climate, an owner may also need to guard against lender insolvency. The contractor, on the other hand, must take affirmative steps to protect against subcontractor and supplier insolvency; these steps include most, if not all, of the above recommendations to the Owner.

**7. Know Your Rights, Obligations, and Deadlines.** Implicit in the admonition to enforce and honor your contractual and legal rights and obligations is the need to know what they are. Any owner or contractor must read and understand the contract, seeking legal and/or other professional assistance as required.

**8. Act Timely.** While construction is not an exact science (e.g., a two-by-four does not measure 2" x 4"), if the contract requires that some notice be given or action be taken within 7 calendar days, taking 7 work days to do so creates an unnecessary risk. Parties should act within the deadlines established by the contract and by law if at all possible, or they may risk losing their rights. This is particularly important when it comes to statutory rights such as lien rights, which are often strictly enforced, or if the other party may be prejudiced by an untimely action.

**9. Exercise Contractual Remedies.** Some key provisions used to allocate financial risks were discussed above. Having included such protections in their contracts, owners and contractor should not be afraid to use them. For the contractor, this may mean suspending work if the owner is not paying timely and if the contract gives the contractor that right. Again, withholding work is perhaps the contractor's ultimate way of exercising leverage. For an owner dealing with a nonperforming contractor or a contractor experiencing financial difficulty – or for a general contractor dealing with a subcontractor under similar circumstances – this may include taking whatever measures the contract allows (such as payment by joint checks, conditioning payments on the submission of appropriate lien waivers and/or sworn statements, etc.) to ensure that the payments continue flowing downstream to second and third tier subcontractors and suppliers. It may also even include termination of the contract in extreme circumstances. In this regard, parties should keep in mind that under the United States Bankruptcy Code, a contract cannot be terminated because the party has filed bankruptcy (even though many subcontract forms include such language); thus, if termination is justified on other grounds (which it usually is if the contractor or subcontractor is insolvent), the contract should be terminated prior to the filing of bankruptcy.

**10. Be Attentive.** The last point above is an appropriate segue way to this final point: remain alert, vigilant, and attentive. If a company is on the brink of insolvency, there are usually early warning signals. If, however, one is not careful to monitor the project and surrounding circumstances, it may miss the red flags and fail to react in time to protect itself.

## Conclusion

The explorer Ferdinand Magellan reportedly said “The fishermen know that the sea is dangerous and the storm is terrible, but they have never found these dangers sufficient reason for remaining ashore.” Today's owners and contractor find themselves in rough economic seas. Hopefully this article has provided a few useful tips to help navigate through the storm.

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## Federal Government Contracts: Opportunities and New Obligations

**607** The current economic situation is clearly uncertain. While it is difficult to predict all of the economic stimulus policies that the Obama Administration will adopt, it is reasonable to expect that federal government construction programs will be a major tool to infuse money into the economy and to create employment opportunities. In a period of decreasing commercial and local public construction demand and volume, federal government construction projects represent a viable option with far less financial risk (insolvency) than other owners.

Whether or not a company is now performing projects for the federal government, every firm viewing federal projects as a potential source of future work needs to appreciate that the federal government can be a tough customer. The most recent examples of that are newly adopted federal procurement regulations that will directly affect how your firm and its subcontractors manage their federal business. These new regulations are a legacy of the Bush Administration, cannot be ignored, and will potentially require revisions to any firm's subcontract and purchase order terms and conditions. In addition, many firms will need to adopt written codes of business ethics and related on-going training and compliance programs to address these newly imposed requirements.

Two major regulatory changes were issued in November 2008 and addressed the following topics:

- Business Ethics and Compliance. This regulation was issued on November 12, 2008 with an effective date of **December 12, 2008**. See 73 Fed. Reg. 67064-67093.
- Employment Eligibility and Verification. This regulation was issued on November 14, 2008 with an effective date of **January 15, 2009**. See 73 Fed. Reg. 67651-67705.

### Business Ethics & Compliance

The new business ethics and compliance program regulation (found in FAR Subpart 3.10 and FAR 52.203-13) combines statements of policy expectations applicable to all contractors and varying mandatory requirements depending on the dollar value and duration of the contract and the size of the contractor. The key aspects of the new regulations include:

#### Expectations Applicable to All

- All government contractors “must conduct themselves” with the “highest degree of integrity and honesty” and “should have” a written code of business ethics and conduct.
- To promote compliance with the written code, all government contractors “should have” an employee business ethics and training program suitable for the size of the company that will “facilitate discovery and disclosure of improper conduct” and “ensure corrective measures” are carried out.

#### Mandatory Requirements

Any contractor receiving a federal government contract in excess of \$5 million and a duration of 120 days or more

(“Covered Contract”) shall:

- Have a written code of business ethics and conduct and make a copy of its code “available” to each employee engaged in the performance of the Covered Contract;
- Exercise “due diligence” to prevent and detect criminal conduct;
- Promote an organizational culture that “encourages” ethical conduct and a commitment to compliance with the law; and
- Make a “timely” written disclosure to the agency Inspector General with a copy to the contracting officer, whenever the contractor has “credible evidence” of a violation of the civil False Claims Act (31 U.S.C. 3729-3722), or of federal criminal law involving fraud, conflict of interest, bribery or gratuity violations. A possible sanction for a failure to make a required disclosure is either suspension or debarment.

Except for small business concerns as defined by the Small Business Administration, every construction contractor performing a Covered Contract is required to establish an ongoing business ethics and awareness program and an internal control system within 90 days of contract award. The ethics awareness and compliance program shall include:

- Reasonable steps to communicate the contractor's compliance program standards and procedures to its employees and provide related training.
- An internal control system that includes standards and procedures to facilitate timely discovery of improper conduct, periodic risk assessments of criminal conduct, reporting mechanism such as a Hotline and disciplinary action for improper conduct or for failing to prevent or detect improper conduct.
- Mandatory disclosure of improper conduct to the federal government (Inspector General and Contracting Officer).

Contractors are required to flow down these requirements to subcontract and purchase orders in excess of \$5 million and 120 days duration and to verify their subcontractors' compliance.

### New Suspension/Debarment Sanctions Applicable to All Contracts

In what the FAR Councils described as a “sea change,” the existing program of encouraging contractors to make voluntary disclosures to the federal government when the contractor had reason to believe that a violation of a federal law had occurred in connection with the performance of a contract was eliminated. As indicated above, the new FAR clauses on business ethics and compliance impose a **mandatory disclosure obligation** on a contractor when it has “credible evidence” of a violation of the civil False Claims Act or federal criminal laws related to one of its contracts with the government. The Department of Justice lobbied for this change on the basis that the 20 year old program of voluntary disclosures was not working.

Requirements to make disclosures of wrongdoing are not new. For example, the current Anti-Kickback

Procedures clause at FAR 52.203-7 (JUL 1995) mandates a written disclosure to the agency Inspector General when the contractor has “reasonable grounds to believe” that there has been a violation of the prohibition on kickbacks. This is a mandatory clause in every contract in excess of \$100,000.00 (and the substance of the clause must be incorporated into subcontracts which exceed \$100,000.00). However, until the new regulation was issued in November 2008, there was no expressly stated sanction if a contractor failed to make a disclosure. That has **changed** with the revision of the grounds for debarment or suspension in FAR Subpart 9.4, Debarment, Suspension, and Ineligibility, to expressly include a failure to make a **timely written disclosure** to the government whenever the contractor has “**credible evidence**” of a violation of federal criminal law or the civil False Claims Act related to the contract.

The new grounds for debarment or suspension are not limited to those contracts awarded on or after the effective date (12/12/2008) of the new regulations. Rather, this sanction applies to **all existing contracts** and **retroactively to those contracts** on which the contractor has received final payment within 3 years prior to December 12, 2008.

This is a significant policy change that no contractor should ignore. The concepts of **credible evidence** and **timely disclosure** are not defined in the new regulations as the FAR Councils viewed them as being fact dependent. There is no reason to conclude that these changes are just formalities or that these new tools in the government’s arsenal will not be enforced. Contractors need to consider both the consequences of a suspension or debarment as well as the cost of simply responding to a proceeding in which suspension or debarment is threatened.

#### Employment Eligibility and Verification

While the employment of undocumented workers remains a major political issue, the FAR Councils have amended the FAR in response to Executive Order 13465 issued on June 6, 2008 to require the use of the Electronic Employment Eligibility Verification System (“E-Verify”) administered by the Department of Homeland Security, U.S. Citizenship and Immigration Services.

As a condition of receiving a contract on or after the effective date of this regulation, a new clause, FAR 52.222-54, applicable to all construction contracts in excess of \$100,000 (“Covered Contract”) requires a prime contractor to enroll in the E-Verify program within 30 calendar days of the award of a Covered Contract and to begin to use E-Verify within 90 calendar days of enrollment to verify the enrollment eligibility of any **new employee**. Employees, whether new or existing, who are assigned to the Covered Contract must be verified within 90 calendar days of enrollment or 30 calendar days of assignment to that contract, whichever date is later. There are exceptions for persons holding certain security clearances or credentials issued pursuant to Homeland Security Presidential Directive 12 (HSPD-12), Policy for a Common Identification Standard for Federal Employees and Contractors.

The new FAR clause also contains a flow down requirement to all subcontracts/purchase orders for construction and most services if the value of that subcontract exceeds \$3,000.00. (This is not a typo.) While

prime contractors are not responsible for their subcontractors’ hiring decisions or to verify the eligibility of a subcontractor’s employees, a prime contractor is expected to ensure that all covered subcontracts at every tier include an appropriately written clause incorporating the clause at FAR 52.222.54 and that all subcontractors use the E-Verify system.

This article provides only a general summary of two significant new procurement regulations. If you need further information on the new Ethics and Business Compliance Program regulations, the new E-Verify Program regulations, and possible revisions to subcontract or purchase order forms, please feel free to contact us.

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## Florida: Enforcement of Exculpatory Clauses

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Every contractor’s goal is to perform its work, be paid, and avoid liability. Many times contractors attempt to accomplish the goal of avoiding liability through the use of exculpatory provisions in their contracts. An exculpatory provision attempts to limit the liability of one party for damage that may occur in the future. Exculpatory provisions may address various topics such as liability for delay, injuries to persons or property, etc. Although a contractor cannot avoid *all* liability, it can avoid *some* liability with a carefully drafted exculpatory provision in its contract.

Two recent Florida cases analyzed two different exculpatory provisions, and reached two very different conclusions as to their enforceability. Florida contractors should consider these decisions drafting an exculpatory provision that will be enforceable.

#### Exculpatory Provisions In General

The law does not favor exculpatory provisions. Courts do not like to enforce exculpatory provisions that relieve a party of the obligation to use due care and shift the risk of injury to a party who may be less equipped to take the necessary precautions to avoid injury and bear the risk of loss. In determining whether an exculpatory provision is enforceable, a court will balance the policy disfavoring exculpatory provisions with the policy allowing parties the freedom to contract. Exculpatory provisions are generally valid and enforceable only if they are clearly written, unambiguous, and do not violate a public policy. To be enforceable, the provision must be sufficiently clear that one person will know what it is contracting away.

#### An Unenforceable Exculpatory Provision

As noted above, an exculpatory provision is

unenforceable where it violates any public policy of the state. In *Loewe v. Seagate Homes, Inc.*, No. 5D07-1683, 2008 WL 2695871 (Fla. Dist. Ct. App., 2008), Seagate Homes (“Seagate”) entered into a contract to build a residence. In the contract, the owners agreed to release Seagate from any liability for personal injury caused by Seagate’s construction practices regardless of whether the injury resulted from Seagate’s negligence, gross negligence, or intentional conduct.

Seagate substantially completed construction and the owners occupied the residence. Shortly thereafter, one of the owners (Mrs. Lowe) was injured when the bathroom closet door fell off its track and struck her in the eye causing permanent injury. Loewe sued Seagate for negligence. The trial court dismissed the owner’s action holding that the claim was barred by the contract’s exculpatory provision. On appeal, the appellate court reversed holding that the exculpatory provision was void because it violated public policy.

The appellate court reviewed several different public policies that the exculpatory provision violated. First, Seagate could not contractually escape liability for its own intentional tort. Second, Seagate could not contract away its responsibility to comply with the Florida building code. Third, Seagate could not contractually escape liability for Mrs. Loewe’s personal injuries caused by its negligence. The Florida legislature has already expressed a clear public policy to protect home purchasers from personal injury caused by improper construction practices. The court ultimately found the exculpatory provision void declaring that a builder should not be free to negligently, recklessly, or intentionally construct a residence in a manner that will unreasonably threaten the life, health or safety of its future occupants.

#### **An Enforceable Exculpatory Provision**

A contrasting result is illustrated by the decision in *Rosenberg v. Cape Coral Plumbing, Inc.*, 920 So.2d 61, (Fla. Dist. Ct. App. 2005). In that case, a general contractor, Monopoly, entered into a subcontract with Cape Coral Plumbing (Cape Coral) to install plumbing in a house that Monopoly was constructing. The subcontract between Monopoly and Cape Coral contained a provision stating that Cape Coral would not be responsible for damages incurred if water was turned on before Cape Coral could thoroughly test all plumbing.

After Cape Coral performed trim work on the plumbing in the house, a flood occurred causing \$70,000 in damage. Monopoly sued Cape Coral for breach of contract, violation of the building code, breach of implied warranty, indemnification, and negligence. The trial court entered summary judgment on all counts in favor of Cape Coral finding that the exculpatory provision in the contract shielded Cape Coral from liability.

The appellate court also held that the exculpatory provision was valid and enforceable as it was clear, unambiguous, and did not violate any public policy. However, the appellate court also ruled that the entry of summary judgment was premature as certain disputed factual issues potentially affected the application of the exculpatory clause. For example, it was unclear what

exactly caused the flood damage. The cause of the damage may not have triggered the exculpatory provision, which only limited liability under fairly narrow factual circumstances i.e., the damage was caused by the water being turned on before Cape Coral could thoroughly test the plumbing.

#### **Conclusion**

A contractor can limit its liability through the use of exculpatory provisions in its construction contracts. As a practical matter, it is very important that the exculpatory provision be clear and unambiguous and carefully tailored or limited in scope. It is equally important to make sure that the exculpatory provision does not contravene any of Florida’s numerous public policies. If the exculpatory provision is not clear, unambiguous, or if it violates public policy, the contractor runs the risk of receiving no protection from the provision.

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## **Notice of Default: When in Doubt, Don’t Leave it Out?**

### **609** Introduction

Your subcontractor is woefully behind schedule. The subcontractor is undermanned and seems to lack the capability necessary to complete the job on time. Adherence to the project schedule is critical and there does not appear to be enough time to terminate the subcontractor and replace it with a new firm. Therefore, you decide to ride with that subcontractor and supplement its work crews in a good-faith effort to remain on schedule.

Luckily, you insisted on a subcontractor performance bond, such as the AIA’s A312 – 1984 Performance Bond. In addition, you communicate your concerns to the surety that issued the bond, noting the efforts to take a cooperative approach by not terminating the subcontractor and requesting the surety’s assistance in addressing the sub’s poor performance. You ask the surety to attend on-site meetings with the subcontractor to discuss the work and the supplementation efforts. Ultimately, the sub defaults and you notify the surety of the default, demanding reimbursement for the costs of supplementation.

Having clearly communicated your concerns to the surety during the project and demonstrated cooperativeness by working with the subcontractor instead of terminating it when problems first arose, you might conclude that the surety would appreciate this approach. So it may be surprising when the surety refuses to pay on the bond. It may come as a larger surprise to find that some courts will agree with the surety. The reasoning? Although you may believe that the surety was aware of the subcontractor’s performance deficiencies, a failure to formally declare the subcontractor to be in **default** may preclude recovery from the surety. Even with similar bond language, the courts reach different conclusions regarding the necessity of a **declaration of default** as a prerequisite to a surety’s bond obligation.

## Score One for the Contractor

The Washington Supreme Court, in a decision that runs counter to holdings in several other states, recently held that notice of default to a surety is not always required to trigger the surety's obligation to pay on a performance bond. *Colorado Structures, Inc. v. Ins. Co. of the West*, 167 P.3d 1125 (Wash. 2007). The case involved Colorado Structures, the general contractor on a construction project; Action Excavation and Paving (Action), the sewer subcontractor; and Insurance Company of the West (West), the surety that issued the AIA A311 performance bond.

Action fell behind schedule on the project and continued to struggle with meeting an impending deadline. Colorado Structures wrote West, expressing its concerns that Action would not meet the established deadline. Months passed and Action remained behind schedule. Colorado Structures' contract with the owner imposed substantial liquidated damages if the work was not completed on time. Given the completion deadline and financial consequences of failing to meet it, Colorado Structures determined there was not sufficient time left to terminate Action and replace it with a new subcontractor. Instead, Colorado Structures decided to supplement Action's work

As it had done earlier, Colorado Structures communicated its concerns to West. Colorado Structures informed West of Action's breaches and the need to supplement its crews. Colorado Structures also sent numerous requests to meet on-site with West to discuss the breaches and efforts to mitigate the damages that would occur if the project did not come in on schedule. Unknown to Colorado Structures, West ceased writing bonds for Action and won a court judgment against Action's owners for an amount that covered any potential bond payments on the Colorado Structures project.

Despite the supplemental crews, Action failed to timely complete its work. Colorado Structures terminated Action after the subcontractor had achieved substantial completion and notified West of the default and termination. West refused payment on the bond, claiming that the terms of the bond required Colorado Structures to formally declare Action to be in default before substantial completion in order to trigger West's obligation to pay. West further claimed that the notification of Action's breaches and the measures taken to mitigate the resulting damages, while beneficial to West, did not amount to a formal declaration of default.

In holding for Colorado Structures, the Washington Supreme court closely scrutinized the language of the bond form and found that Colorado Structures had the option, but not the obligation, to declare a default once Action materially breached its contract. Colorado Structures' decision to withhold the declaration of default until after substantial completion, therefore, did not constitute a breach of the pre-conditions to the surety's bond obligations and did not bar the bond claim. The court's decision relied heavily upon the language of the bond, using general principles of contract interpretation to construe the obligations and conditions in the bond. While the court noted contrary decisions in other states,

the court stated that those decisions were "wrongly decided."

## Traditional Approach –Liability Contingent on Clear Default Notice

Colorado Structures would not likely have fared so well in other states. For example, a federal district court recently decided a case with similar facts. *Hunt Constr. Group, Inc. v. Nat'l Wrecking Corp.*, 542 F.Supp.2d 87 (D.D.C. 2008). In *Hunt*, the general contractor was faced with an excavation subcontractor that fell behind schedule. The general contractor tried several remedial measures and incurred additional costs as a result of the subcontractor's delays. Three months after the sub had completed its work, the general contractor sent a notice of default to the surety that issued the performance bond. The court held for the surety, finding that the surety's liability was conditioned upon a declaration of default. While the general contractor did in fact send the notice of default, the notice was sent after the subcontractor had completed its work. Thus, the surety had been deprived of its right to protect itself by remedying the defective performance.

Courts in Florida and Tennessee have also held that a notice of default is required to trigger liability on a performance bond. In the Tennessee case, the contractor sent several letters to the surety during the course of the project, complaining of the subcontractor's deficient performance. *Memphis-Shelby County Airport Auth. v. Ill. Valley Paving Co.*, No. 01-3041, 2007 WL 2904539 (W.D.Tenn. Oct. 3, 2007). While the letters described the deficient work, they did not declare default. The last letter sent, for example, stated that the contractor was willing to meet "one final time" to remedy the problems. The court found that this was not a clear, direct, and unequivocal **declaration of default**. Likewise, in *CC-Aventura, Inc. v. Weitz Co., LLC*, No. 06-21598, 2007 WL 2986371 (S.D.Fla. Oct. 10, 2007) the contractor (Weitz) wrote the surety during the course of the project. The letter indicated that the subcontractor's performance was deficient and demanded remedial action. However, as the letter threatened that the subcontractor would be held in default if it did not remedy the deficiencies, the court found that the letter was not an unambiguous notice of default. Instead, the letter served merely as a "warning shot" that did not put the surety on notice that the contractor now looked to the surety, and not the subcontractor, to undertake the work. The court determined that the surety was entitled to an unambiguous declaration that would have permitted it to preserve its rights under the bond.

## Practical Note

Carefully read the performance bond and understand the steps required to perfect your rights under the bond. Some standard bond forms such as the AIA bond form appear to require a **declaration of default**. However, all bond forms are not the same. If there is a default, strict compliance with the terms of the bond is strongly advised. While it appears that some courts may not require a formal notice of default to the surety, it is wise to send such notice. What appears obvious to you may, if not explicitly stated, become a valid defense to non-payment. Clearly state your demands to the surety, mirroring the language of the bond

and referring to specific provisions and terms of the bond. If you intend to declare default and have the surety take over, use unambiguous language. Contrary to the old adage, when it comes to correspondence with a surety – when in doubt, *don't* leave it out.

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## No-Damages-For-Delay Update

### 610 Introduction

As a general principle of contract law, exculpatory clauses—*i.e.*, clauses that relieve a party from liability for damages caused by the party's acts or omissions in the course of contract performance—are not favored. Consequently, where state legislatures have not officially declared a specific exculpatory clause void as against public policy, courts faced with the task of enforcing such clauses often rely on principles of contract interpretation or judicially-created exceptions to find these clauses unenforceable or to lessen an outcome that would result from literal application. This after-the-fact judicial analysis is almost entirely fact-specific and, therefore, seldom lends itself to bright line rules. As a result, even extremely sophisticated parties often walk away from the bargaining table unsure whether an exculpatory clause in their contract will be held enforceable.

In the context of construction projects and contracts, the issue of enforceability of exculpatory clauses presents itself frequently where a no-damages-for-delay clause is asserted as a defense to a delay claim. As in other areas that do not lend themselves to bright line rules, construction industry stakeholders—*e.g.*, owners, contractors, subcontractors, etc.—must be aware of trends in the area of judicial interpretation and application of no-damages-for-delay clauses to ensure they sit at the bargaining table informed and that, to the fullest extent possible, they walk away knowing how a no-damages-for-delay clause will be applied. To that end, this article examines two recent Ohio state court decisions—*Dugan & Meyers Construction Co., Inc. v. Ohio Department of Administrative Services*, 864 N.E.2d 68 (Ohio 2007); and *Cleveland Construction, Inc. v. Ohio Public Employees Retirement System*, 2008 WL 885841 (Ohio Ct. App. 2008)—and a Pennsylvania state court decision—*James Corp. v. North Allegheny School District*, 938 A.2d 474 (Pa. Commw. Ct. 2007) and comments on the concepts construction industry stakeholders should take away from these cases.

#### *Dugan & Meyers*

In *Dugan & Meyers*, the Ohio Supreme Court declined to extend the *Spearin* doctrine to bar application of an otherwise valid no-damages-for-delay clause where the delay was allegedly caused by significant defects in owner-provided plans and specifications. In so holding, the court reasoned that additional time was the exclusive contractual remedy for delays caused by plan changes and that the contract detailed the procedure to be followed for plan

changes. In rejecting the contractor's argument that the *Spearin* doctrine, which subjects the owner to liability for damages caused by the owner's defective plans and specifications, applies where a project is allegedly delayed as a result of plan changes, the court limited *Spearin*'s application to damages caused by the owner's "affirmative indications regarding job site conditions." Conversely, the dissent argued that at issue were not merely minor plan changes, but "a torrent of required design changes" necessitated by faulty plans containing "an excessive number of errors, omissions and conflicts in the design documents furnished to bidders by the state and incorporated into [the] contract." Because the delay was clearly caused by the owner's defective plans, the dissent would have applied *Spearin* to bar application of the no-damages-for-delay clause.

#### *Cleveland Construction*

Following Ohio's enactment of a statute invalidating no-damages-for-delay clauses (Ohio Rev. Code § 4113.62(C)), Ohio's Tenth District Court of Appeals interpreted the law as also invalidating clauses that bar acceleration claims. The court reached this decision even though Ohio law does not expressly invalidate such clauses and even though the parties' contract expressly precluded additional compensation for acceleration claims. In so holding, the court reasoned that the purpose of the statute is "to prevent owners from escaping liability when they have caused a project delay," that acceleration is a "natural consequence" of delay that the owner cannot, under Ohio law, avoid by contract, and that the statute does not simply address "delay damages," but "precludes the waiver of liability for delay." The court also indicated that it would apply this reasoning to preclude application of clauses barring or limiting recovery for other "impact costs" caused by delay, such as damages for inefficiency costs, loss of productivity costs, and unabsorbed home office overhead costs.

#### *James Corp.*

In *James Corp.*, a Pennsylvania Commonwealth Court applied the interference exception to avoid enforcement of a no-damages-for-delay clause where the owner (1) failed to obtain a required environmental permit prior to soliciting bids; (2) represented that the required permit was issued pre-bid; (3) instructed the contractors not to proceed until the permit was issued; (4) failed to issue a required schedule until four months after the project began; and (5) refused to adjust the project completion date. Although the court recognized that no-damages-for-delay clauses are typically enforceable under Pennsylvania law, it observed that "exculpatory provisions in a contract cannot be raised as a defense where (1) there is an affirmative or positive interference by the owner with the contractor's work, or (2) there is a failure on the part of the owner to act on some essential manner necessary to the prosecution of the work." Because the court held that the owner actively interfered with the project, it refused to enforce the no-damages-for-delay clause.

#### Comment

The contract at issue in *Dugan & Meyers* was entered prior to Ohio's enactment of legislation prohibiting no-

damages-for-delay clauses. Thus, although a no-damages-for-delay clause is not enforceable if included in an Ohio contract today, *Dugan & Meyers* is persuasive authority for the many states that still enforce no-damages-for-delay clauses. From *Dugan & Meyers*, construction industry stakeholders should take away the concept that the general rule established by *Spearin* and its progeny—where the contractor is bound to build a project in accordance with the owner’s plans and specifications, the owner is liable for damages caused by defects in its plans and specifications—may not trump or defeat an otherwise valid no-damages-for-delay clause where delay damages result from plan changes and where the contract provides, in the event of plan changes, the contractor’s sole remedy for delay is additional time. However, stakeholders should not overlook the strong dissenting opinion, which may be relied upon in other jurisdictions that have not yet decided the issue to argue that liability should rest with the owner where defective plans and specifications cause damages, including delay damages, even in the face of a no-damages-for-delay clause.

From *Cleveland Construction*, stakeholders should take away the concept that in jurisdictions that prohibit enforcement of no-damages-for-delay clauses or where the judicial trend is to severely limit the application of these clauses, courts are likely to broadly interpret the term “delay” where the result is an award of damages to the delayed contractor. For example, the *Cleveland Construction* court interpreted state law barring enforcement of no-damages-for-delay clauses as including clauses that eliminate or limit recovery for acceleration damages incurred as a result of a delay. Because of Ohio’s prohibition on enforcement of no-damages-for-delay clauses, the court declined to interpret the contract at issue in a manner that would preclude the contractor from recovering or limit the contractor’s ability to recover acceleration damages where the sole reason for acceleration was to make up lost time caused by the delay.

*James Corp.* exemplifies the application of an exception—the interference exception—to avoid enforcement of a no-damages-for-delay clause. The lesson construction stakeholders should take away from *James Corp.* is that whenever a no-damages-for-delay clause is potentially implicated, a legal analysis should be conducted to determine whether the clause is enforceable in the jurisdiction and, if so, what exceptions to enforcement are recognized and may be warranted by the facts.

*Dugan & Meyers*, *Cleveland Construction*, and *James Corp.* by no means provide construction industry stakeholders with all the lessons to be learned from decisions interpreting no-damages-for-delay clauses. However, the concepts from these cases allow stakeholders to come to the bargaining table more informed and to walk away with a better idea of how a no-damages-for-delay clause is likely to be applied.

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## Security Clearances – Just Say “No”!

**611** Federal security clearances are a necessary and vital means of controlling access to classified information created and used by numerous federal agencies. Security clearances are used to both control the access to classified information among and within different federal agencies, and to limit the flow of classified information between the federal government and non-Federal entities such as government contractors. The inability of a government contractor’s key personnel to obtain the security clearances necessary to perform a government contract oftentimes puts the contractor’s ability to receive a contract award or to perform a contract in jeopardy. As such, it is imperative for contractors who routinely compete for federal contracts requiring access to classified information to be aware of the ground rules for granting or denying security clearances and to understand the process for challenging a security clearance denial of a contractor’s key personnel or facility. Understanding how the security clearance system works puts a government contractor in the best position to handle a security clearance denial when one materializes.

A security clearance is simply a determination by the federal government that a person or facility is eligible to access or store classified information. There are two types of security clearances issued by the federal government—personnel security clearances and facility security clearances. A personnel security clearance allows an individual to access classified data or classified facilities such as a Department of Defense (“DoD”) base or laboratory. A facility security clearance is a determination by the government that a specific location such as an office, laboratory, or data storage center is secure enough to allow the use and storage of classified data at that facility. Security clearances can be issued by any one of the hundreds of federal agencies that routinely use classified data. Only the federal government can sponsor and grant a personnel or facility security clearance request. Security clearances are granted or denied based on the government’s determination that an individual or facility is not a security risk. The vast majority of security clearances are issued by the DoD, the Department of Homeland Security, and the Department of Energy. It is no coincidence that these three agencies account for the vast majority of government contracts calling for contractors to provide classified data analysis and storage services. DoD alone issues approximately 80 percent of all security clearances granted by the federal government. However, other departments such as the Department of State conduct construction projects, involving classified information.

In general, there are three levels of security clearance routinely used by the federal government—1) Confidential; 2) Secret; and, 3) Top Secret—with Confidential clearance being the lowest level of security clearance and Top Secret clearance being the highest level of security clearance. Many federal agencies also have different levels and

variations of clearance within the Confidential, Secret, and Top Secret categories of clearance which tends to create a confusing array of agency specific rules and regulations regarding the granting or denial of clearances across the Federal government. These varying agency-specific rules and regulations make it difficult to understand the numerous agency procedures in place to challenge the denial of a security clearance.

### Deny First and Ask Questions Later

The government very rarely grants personnel or facility security clearances in an expeditious manner. The process to obtain such clearances generally takes many months, sometimes years, and involves a lengthy application process and background investigation. The higher the clearance sought, the longer the approval process takes. It is estimated that the government receives approximately 40,000 requests per month for security clearances. Needless to say most of the federal security clearance adjudicating agencies are undermanned and overworked and constantly face a backlog of security clearance requests. As such, the policy generally followed by the federal government in adjudicating security clearance requests is to deny first and ask questions later. This policy is based on the Supreme Court decision in *Department of the Navy v. Egan*, 484 U.S. 518, 532 (1988) where the Court held that “security-clearance determinations should err, if they must, on the side of denials.” In other words, when there is any doubt regarding whether a personnel or facility security clearance request should be granted, the government will err on the side of caution and deny the request.

Personnel security clearance requests can be denied for more than a dozen reasons to include foreign influence, financial problems, personal conduct, alcohol or drug involvement, emotional or mental disorders, criminal conduct, and inappropriate sexual behavior. Facility security clearances can be denied for many of the same reasons as Key Management Personnel (“KMP”) of the facility must also be cleared to ensure the security of the facility itself. Failure of KMP to obtain a clearance will lead to a denial of the facility clearance request. Facility clearance requests can also be denied if the facility lacks adequate physical security methods to safeguard the classified data being held or discussed at the facility. Once a personnel or facility security clearance request is denied it is an uphill battle to justify why the government’s denial was improper and should be overturned.

### Security Clearance Denial Appellate Process

#### • Facility Security Clearances

No appellate process currently exists for a government contractor to challenge an agency’s denial of a facility security clearance request. In the event an agency deems a government contractor’s facility to be a security risk and not eligible for a clearance the contractor’s sole remedy is to administratively appeal the denial to the agency head or agency appeals board. If this appeal proves to be ineffective the contractor may then challenge the denial in federal court under the Administrative Procedure Act (“APA”) by alleging that the agency’s security clearance denial was arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law. *See* 5 U.S.C. § 551 *et seq.* APA administrative and judicial appeals are

extremely challenging and require the early involvement of competent counsel to structure the appeal.

#### • Personnel Security Clearances

On the other hand, personnel security clearance denial appeals have a structured appellate process which begins when an individual receives a security clearance denial notification, also known as a Statement of Reasons (“SOR”), outlining the agency’s rationale for denying the clearance request. The receipt of the SOR starts the appeals clock ticking. An individual has **only 10 days** from the date the SOR is received to provide written notice to the denying agency that the individual intends to file an administrative appeal. The individual then has 30 days from the date the SOR is received to file his or her appeal with the denying agency. Extension requests of this 30 day timeframe are routinely requested, and received by those seeking an appeal. Failure to file an administrative appeal with the denying agency within the appropriate timeframe will result in the forfeiture of all rights to appeal the security clearance denial.

If the administrative appeal is unsuccessful, an individual may challenge that decision at the DoD Office of Hearings and Appeals (“DOHA”) within 10 days of receiving the agency’s final decision. DOHA is staffed with administrative judges who adjudicate security clearance denials through an administrative hearing process very similar to a civilian bench trial. The government is represented during the administrative hearing by a government attorney and the appellant has the ability during the administrative hearing to submit evidence, call witnesses, and testify on their own behalf. Just as with a facility security clearance denial appeal, it is in the appellant’s best interest to have a capable attorney to structure a sound plan to challenge the government’s denial and to represent their interests during the DOHA hearing.

The consequences of a government contractor’s KMP or facility being denied a security clearance are potentially devastating. The worst case scenario is that the security clearance denial will cause the contractor to be ineligible to receive or perform government contracts requiring access to classified information. The importance of a government contractor putting its best foot forward in dealing with the administratively complex realm of security clearance applications, adjudications, denials, and appeals cannot be overemphasized. If you need further information, please contact me at Smith Currie’s Washington, DC office regarding the guidance necessary to navigate the federal security clearance arena.

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## Avoiding Alternative Equipment

**612** A supplier of goods cannot unilaterally deliver substitute goods where the contract between the parties clearly identifies a specific manufacturer. When a contract explicitly describes a specific manufacturer, attempted delivery of nonconforming goods may be

considered a breach of contract.

A court will interpret and enforce the contract in accordance with the plain meaning of the words as given by a reasonable person. In *Fox v. Wheeler Electric, Inc.*, 169 P.3d 875 (Wyo. 2007), the Wyoming Supreme Court interpreted that the district court did not err when it held that the parties' "contract required equipment from one particular manufacturer" even though the Contract Specifications provided that other manufacturers' equipment might be accepted.

### Factual Background

An operating contractor for a Dept. of Energy laboratory sent electrical subcontractors a Request for Proposal to upgrade fire monitoring systems. The proposal package contained Construction Specifications that identified equipment manufactured by a company called Digitize. Wheeler Electric, an electrical subcontractor, submitted a proposal relying on quotes from Fox, doing business as Fibertection, a fire alarm equipment supplier. Wheeler had provided Fibertection with a copy of the Construction Specifications for the project.

Fibertection submitted a bid to Wheeler that included language "in conformance with the plans and specifications." Additionally, Fibertection submitted an alternative bid to provide similar equipment from an alternative manufacturer at a lower cost. Both bids submitted by Fibertection to Wheeler were significantly lower than its competitors. Wheeler used Fibertection's bids in its proposal to the operating contractor and submitted both bids in its proposals package. The operating contractor awarded Wheeler the contract but rejected the proposal with the alternative equipment, indicating that it preferred Digitize equipment. Wheeler then issued a purchase order to Fibertection requesting that Fibertection order the Digitize equipment.

After receiving the purchase order, Fibertection attempted to order the Digitize equipment, but learned that the only authorized dealer in the state was its competitor. Unable to obtain the Digitize equipment, Fibertection instead ordered equipment from a third manufacturer. Fibertection informed Wheeler that it would be supplying equipment for the project from a different alternative manufacturer. Fibertection asserted that this alternative equipment was in full compliance with the plans and construction specifications, and that it was equal to or better than the Digitize equipment. Fibertection produced documentation to support this assertion. Wheeler passed the documentation on to the contractor with a request that the operating contractor approve the use of the alternative equipment. The operating contractor informed Wheeler that there was not enough time to review the equipment from the alternative manufacturer without compromising the project schedule and reiterated that it required the Digitize equipment as listed in the Construction Specifications.

Wheeler informed Fibertection that the operating contractor rejected the alternative equipment and that Fibertection would have to provide the Digitize equipment per the Construction Specifications. However, Fibertection could not provide the equipment. Therefore, Wheeler had no choice but to obtain the Digitize equipment from

Fibertection's competitor at a price appreciably higher than the Fibertection bid.

Subsequently, Wheeler sued Fibertection for breach of contract and the difference between the price it paid for the Digitize equipment and the Fibertection bid. Fibertection argued that its contract with Wheeler allowed it to provide either Digitize equipment or equipment from another manufacturer if it met the technical requirements for the project.

### Clear Language Establishes Intent

A court, when interpreting a contract, will focus on the intent of the parties forming the contract. The first step is to determine if the language of the contract is clear and unambiguous. If it is, a court will determine the intent of the parties based solely on the language in the contract and enforce the contract based on "the plain meaning its language would be given by a reasonable person." Fibertection did not dispute the fact that the contract required it to furnish Digitize equipment. However, it asserted that the contract also allowed it to supply any manufacturer's equipment that met the technical requirements of the construction specifications. The court, looking at the reasonable and plain meaning of the contract language, disagreed.

The first pages of the contract specifications stated that the subcontractor was to furnish, install, terminate and test "two Digitize 3505 control panels" and further identified Digitize software and a Digitize computer. The contract specifications also included the following language:

**"Approved Equal:** Whenever a product is specified by using a proprietary name, the name of a manufacturer, or vendor, the specific item mentioned shall be understood as establishing type, function, dimension, and quality *desired*. Other manufacturer's products will be accepted..., provided sufficient information is submitted...to demonstrate that products proposed are equivalent to those named."

**"Or Equal Material or Equipment Submittals:** All "or equal" materials, equipment or systems shall be identified and submitted for approval as required by the Subcontractor Requirements Manual."

The court stated that "[t]he contract provisions...plainly provided that equipment from a manufacturer other than Digitize was subject to [operating contractor's] approval. If it did not approve of alternative equipment, then Digitize equipment was required." The court determined that the word "desired" was not just a preference for the Digitize equipment but a requirement. The ability to approve or reject alternative equipment belonged to the operating contractor and not to Fibertection. Since the operating contractor did not agree to the alternative equipment or to any "or equal" equipment when forming the contract, Fibertection's failure to provide Digitize equipment constituted a breach of the contract.

Fibertection's attempt to rely on Article 2 of the Uniform Commercial Code for the proposition that "[g]oods or conduct including any part of a performance are 'conforming' or conform to the contract when they are in accordance with the obligations under the contract" also

failed. The court reasoned that Fibertection “again ignores the provisions of the Construction Specifications that, as already discussed, required Digitize equipment.” The alternative equipment did not meet the obligations Fibertection agreed to under the contract, nor did it obtain the necessary approval to provide alternative equipment.

#### Conclusion

A supplier will not be allowed to provide alternative equipment where the clear and ambiguously expressed terms of a contract specifically identify a particular manufacturer. The court will determine the intent of the parties from the unambiguous language and enforce the contract based on the plain meaning of the words as given by a reasonable person.

#### Practical Note

When drafting a contract to a supplier for specific equipment:

- State in clear and unambiguous language that the supplier is required to supply goods/services from a specific source.
- Make it plain that the choice to approve or reject alternatives belongs to the contractor.
- Ensure that there is nothing in the contract language suggesting that the supplier is entitled to make a unilateral decision to substitute another product for the one specified.

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## Upcoming Seminars

**Lien Law Seminar**, AGC of Georgia, January 8, 2009, Atlanta, Georgia. *S. Gregory Joy.*

**Contract Terminations: The Death Penalty** (Teleconference), American Bar Association, January 14, 2009. *Hubert J. Bell, Jr., Steven L. Reed.*

**Lien Law Seminar**, AGC of Georgia, February 11, 2009, Atlanta, Georgia. *S. Gregory Joy.*

**Smith, Currie & Hancock's 2009 Annual Construction Law Update Seminar**, February 19-20, 2009, Hyatt Regency Atlanta, Atlanta, Georgia. *Eric L. Nelson.*

**Making Sense of Standardized Contract Documents: What's Best for You?** National Utility Contractors Association, March 5, 2009, Phoenix, Arizona. *Charles W. Surasky.*

**Practical Construction Project Documentation: Risk Mitigation and Dispute Avoidance for Contractors**, Associated General Contractors of America, National Convention, March 5-6, 2009, San Diego, California. *Thomas J. Kelleher, Jr., Philip E. Beck.*

*This newsletter is intended to be a source of general information on new or current topics on construction law, government contracts and commercial law. It is not intended to render legal advice on specific problems. In assessing specific problems, advice and counsel should be sought from experienced professionals.*



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