



# COMMON SENSE CONTRACTING

VOLUME 22, NUMBER 2

SUMMER 2008

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## Georgia Public Works: Design-Build Project Delivery

**591** Are city and county governments in Georgia authorized to use the design-build project delivery method for water and wastewater capital improvement projects? If so, what are the procedures?

The short answer is "yes." Procurement by cities and counties of water and wastewater capital improvement projects is governed by the "Georgia Local Government Public Works Construction Law", set out in O.C.G.A. Title 36, Chapter 91 (the "law" or the "construction law").

## Notice to Florida Licensed Contractors

For many general contractors, 2008 is the deadline for obtaining your mandatory fourteen (14) hours of continuing education ("CE") credits to maintain your Florida contractors license. These CE requirements include one hour of workplace safety, one hour of wind mitigation, one hour of laws and regulations, one hour of workers' compensation, one hour of business practice, one hour of advanced code, and eight hours of general topics. Smith, Currie & Hancock LLP is an approved course sponsor (Provider No. 0000998) by the Florida Construction Industry Licensing Board (FCILB) for all required hours. **The absolute deadline for completion of these hours for many licensed contractors is August 31, 2008.**

To assist FCILB licensed contractors to obtain all 14 of these CE credits, we have scheduled three opportunities to attend FCILB courses in August of 2008. These courses are as follows:

- August 6-7, 2008** – Atlanta, Georgia
- August 14-15, 2008** – Birmingham, Alabama
- August 27-28, 2008** – Tampa, Florida

In addition, for those contractors needing less than fourteen (14) hours of CE credit, we are planning a one-day program in Atlanta, Georgia on August 22, 2008. This program will have a total of seven (7) hours of CE credits including one hour of wind mitigation, one hour of advanced code, one hour of laws and regulations, and one hour of business practice.

Flyers with course details and registration forms will be mailed out in the near future using address data provided by the FCILB. However, if you wish to update your mailing address, receive the info by fax, or have any questions, please contact Tom Kelleher at 404/582-8016 or at [tjkelleher@smithcurrie.com](mailto:tjkelleher@smithcurrie.com).

This law governs all contracts for public works construction entered into by a governmental entity, with certain exceptions such as sole source awards, contracts less than \$100,000.00, contracts performed by inmate or free labor, emergency projects, certain self-performed projects, and contracts involving federal assistance or funds to the extent compliance with federal laws or regulations differ from requirements of Georgia law.

This law applies to any “governmental entity”. This term includes a county and municipal corporation. A city, town, or village is a municipal corporation. This construction law applies to all public works construction by a governmental entity. Public works is defined as building, altering, repairing, improving, or demolishing of any public structure or building or other public improvements of any kind to any public real property other than state, county, and municipal road systems. “Public works construction” does not include routine operation, repair, or maintenance of existing structures, buildings, or real property.

Governmental entities may utilize any construction delivery method. All public works construction contracts that place the bidder or offeror at risk for construction and require labor or building materials in the execution of the contract are to be awarded on the basis of competitive sealed bidding or competitive sealed proposals. Ordinarily design-build contracts will be awarded based upon competitive sealed proposals since there necessarily would not be a design specification for such a project. In that case, the law requires that the request for proposals shall include conceptual program information describing the requested services in a level of detail appropriate to the project delivery method selected.

A governmental entity may restrict the number of prospective bidders or offerors by adopting a process for mandatory pre-qualification of bidders or offerors. The criteria for pre-qualification must be reasonably related to the project or the quality of work and must be available to any prospective bidder or offeror for each project requiring pre-qualification. The process must include a method of notifying prospective bidders or offerors of these criteria and a procedure for a disqualified bidder to respond to the disqualification to a representative of the governmental entity. This last provision does not require establishing a formal appeals procedure. A pre-qualified bidder or offeror cannot later be disqualified without cause.

A public works construction contract subject to the statute, except those exempted, is unlawful unless the governmental entity has complied with the competitive award requirements of the construction law. Any contractor

which performs work knowing that the contract was awarded without complying with the notice and competitive award requirements shall not be entitled to receive any payment for its work.

Although the statute provides that governmental entities have the authority to reject all bids or proposals and to waive technicalities and informalities, this authority may not be exercised to waive the requirement that a bid meet the requirements and criteria set forth in the invitation for bids. Likewise, an award based upon competitive sealed proposals must be made to the responsible and responsive offeror whose proposal is determined to be the most advantageous to the government entity, taking into consideration the evaluation factors set forth in the request for proposal. These evaluation factors shall be the basis on which the award decision is made.

It is unfortunate, but true, that certain members of the governing authority of a governmental entity may wish to favor one bidder or offeror over another. This sometimes leads to waiving solicitation requirements in order to determine a bid or proposal to be responsive, although it failed to comply with a requirement or criterion in the IFB or RFP. The Georgia Supreme Court considered the tension between responsiveness to material terms of the solicitation and the authority to waive technicalities and informalities in *R. D. Brown Contractors, Inc. v. Board of Education of Columbia County*, 280 Ga. 210, 626 S.E.2d 471 (Ga. 2006). In that decision, the court found that solicitation requirements that a bidder submit a bid bond and a list of subcontractors with its bid could be waived by the governmental entity. In essence, the court found that a requirement established by state or federal law or regulation is material and failure to comply with such a requirement is not a technicality or informality which the public owner may waive. These requirements are distinguished from those that are established by the governmental entity soliciting bids or offers which may be waived as a technicality or informality.

The design-build project delivery method is gaining favor among Georgia local governments for capital improvement projects. It shifts design responsibility to the contractor although it may encourage innovation and efficiency. Contractors considering submitting an offer in response to a design-build RFP should weigh the increased liability exposure and additional risk carefully.

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## Federal Government Contracting: New Obligations and Risks

**592** In recent months, the nature of obligations and risks that may face a federal government construction contractor are clearly changing. One rapidly evolving area relates to corporate ethics and compliance. (See Article 576 in the Winter 2008 issue of our newsletter for additional information.) The second involves the basis for obtaining time extensions for weather delays and the third relates to screening undocumented workers using the federal government's E-Verify System. The following articles provide a summary of these trends and developments.

### Proposed Compliance Programs for Federal Government Contractors

On May 16, 2008 the Federal Acquisition Regulation (FAR) Councils issued a second Proposed Rule to FAR Case 2007-006, Contractor Compliance Program and Integrity Reporting (73 FR 28407). This proposed rule effectively modifies the proposed regulation published in the *Federal Register* at 72 FR 64019.

While the new proposed rule includes changes affecting contracts for "commercial" items and contracts performed "entirely" outside of the United States, the more critical provisions for construction contractors include:

- Suspension or debarment for a knowing failure to disclose an overpayment on a federal government contract.
- Suspension or debarment for a knowing failure to report a violation of the Civil False Claims Act or violation of a Federal criminal law in connection with the award or performance of any federal government contract.
- These disclosures and reports regarding a violation of the civil False Claims Act or federal criminal law are to be made in writing to the agency Inspector General with a copy to the contracting officer.

The proposed regulation does not expressly identify the agency Inspector General as the recipient of the notice of "overpayments". In addition, the proposed regulation does not provide guidance regarding the concept of a violation of federal criminal law "in connection with" the award or performance of a contract. In essence a contractor is apparently expected to have some knowledge of federal criminal laws which comprised Title 18 of the United States Code. The relevant chapters of Title 18 total in excess of 375 pages in print.

The comment period on this proposed regulation ends

on July 15, 2008. If you would like further information on this topic and possible comments, please feel free to contact us.

### Weather Delays on COE Projects

Traditionally, many Corps of Engineers contracts have contained a weather data clause that typically sets forth statistical information reflecting monthly averages of rainfall and rain days. This data was then used as baseline information to determine time extensions for unusually severe weather. Based upon the recent use of a very different "severe weather" clause in some Corps of Engineers' contracts, that practice may become history. The following is the text of that clause:

### Time Extensions for Unusually Severe Weather (Nov 2005) (Ref. FAR 52.249-10)

(a) This provision specifies the procedure for the determination of time extensions for unusually severe weather in accordance with the contract clause entitled DEFAULT (FIXED-PRICE CONSTRUCTION). In order for the contracting officer to award a time extension under this clause, the following conditions must be satisfied:

- (1) The weather experienced at the project site during the contract period must be found to be unusually severe. Unusually severe weather is defined as hurricanes, floods, tornados, or earthquakes.
- (2) The unusually severe weather must actually cause a delay to the completion of the project. The delay must be beyond the control and without the fault or negligence of the contractor.
- (3) The contractor's progress schedule must reflect completion of the project within the specified contract duration including all weather except that as defined as unusually severe in (a)(1).

(b) Upon acknowledgement of the Notice to Proceed and continuing throughout the contract, the contractor will record on its daily Contractor Quality Control report the weather experienced each day, including the occurrence of unusually severe weather as defined in (a)(1). For a time extension to be granted under this clause, unusually severe weather must prevent work on critical path activities for 50 percent or more of the contractor's scheduled workday. The contracting officer will convert any qualifying delays to calendar days and issue a modification in accordance with the contract clause entitled DEFAULT (FIXED PRICE CONSTRUCTION).

If the "severe weather" clause is included in the contract, the concept of unusually severe weather is stated to be

limited to situations when a hurricane, tornado, flood, or earthquake affects work on the critical path. For example, even if multiple days were lost due to rainy conditions affecting site work, entitlement to a time extension would depend upon showing that a “flood” or “hurricane” caused the contractor to be delayed. In addition, the COE’s apparent intent is that the delay is to be contemporaneously recorded on the Contractor’s Quality Control report.

While seemingly precluding the use of statistical averages to determine weather delays, this clause does not answer all questions. For example, who determines what is a “flood”? If a hurricane is downgraded to a tropical storm, is it no longer the basis for relief for severe weather? Finally, the requirement to record the event (lost working day on a critical path activity) has some history in federal government construction contracting. For further information, please feel free to contact us.

### E-Verify System Mandated for Government Contractors

On June 6, 2008 President Bush issued an executive order entitled “Economy and Efficiency in Government Procurement through Compliance with Certain Immigration and Nationality Act Provisions and Use of an Electronic Employment Eligibility Verification System”. In essence, this executive order directed the adoption of a new provision in the Federal Acquisition Regulation (FAR) to require certain contractors and subcontractors involved in the performance of federal government contracts to utilize the E-Verify System to verify the employment eligibility of certain categories of employees.

Following that executive order, the FAR Councils issued a proposed regulation on June 12, 2008. (See 73 FR 33374, June 12, 2008). The proposed FAR provision contains the following key sections:

- Requires the insertion of a new clause in all federal government prime contracts except those that do not exceed the micro-purchase threshold (usually \$3,000.00) or those for commercially available off-the-shelf items.
- Requires the contractor to enroll in the United States Citizenship and Immigration Service’s E-Verify System within 30 days of contract award.
- Requires the use of the E-Verify System to verify employment eligibility of **all new** employees that are hired after enrollment in the system.
- Requires the use of the E-Verify System to confirm the employment eligibility of **all existing** employees who are directly engaged in the performance of the covered federal government contract.
- Requires that prime contractors flow down a clause to

all subcontracts for construction in excess of \$3,000.00 that include work performed in the United States to impose comparable requirements on the subcontractors.

The proposed clause will not require a contractor to perform an additional employment verification on employees who were previously verified through the E-Verify program. Nothing in the proposed clause would appear to eliminate or preclude base or installation specific background checks on employees prior to that employee being allowed on the installation or federal government facility.

The comment period for this proposed regulation ends on August 11, 2008. If you would like additional information on this proposed regulation, please feel free to contact us.

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## Faulty Workmanship – Accident or Intentional?

**593** One may state with a reasonable degree of certainty that no contractor intends to construct a building with faulty workmanship. Certainly, if any defects are present in a structure, they must be accidental. On the other side of the coin, the manner in which a contractor constructs a building could very well be (and in fact may have likely been) the result of intentional acts and decisions. One does not “accidentally” design and construct a building a certain way. Rather, such decisions are likely the result of deliberate, intentional, and considered decisions on the part of the contractor. In an insurance context, the above conundrum has sparked endless debates, confusion and conflicting laws regarding whether faulty workmanship is accidentally and, therefore, contemplated under an insuring agreement.

### Defects and Insurance – What Is Covered in Georgia?

When a contractor is confronted with an allegation of faulty workmanship, the contractor may elect to place its insurance carrier on notice of the claim. Upon receipt of any claim, the insurer must answer two questions: (1) Is the contractor entitled to coverage for the claim? and (2) Does the claim have merit? In deciding whether the contractor is entitled to coverage for the claim, the insurer turns to the main insuring agreement in the policy, which contains the basic grant of coverage to the contractor.

The main insuring agreement under a commercial general

liability (CGL) policy generally covers “property damage” caused by an “occurrence.” The term “occurrence” is typically defined by the CGL policy as meaning “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” However, an “accident” is not defined by the CGL policy.

In Georgia, the courts have construed the term “accident” to mean “an event which takes place without one’s foresight or expectation or design.” See, e.g., *Moss v. Protective Life Ins. Co.*, 203 Ga. App. 389, 417 S.E.2d 340 (1992). Alternatively, Georgia courts have defined the word “accident” in an insurance policy as meaning “an unexpected happening . . .” *Thrift-Mart, Inc. v. Commercial Union Assurance Cos.*, 154 Ga. App. 344, 346, 268 S.E.2d 397 (1980) (emphasis added). Substantially similar definitions of an accident are found throughout every jurisdiction. Coverage, then, depends in part on whether faulty workmanship is an “accident,” as interpreted and defined by the courts.

In a case decided by a Georgia federal district court approximately four years ago, *Owners Ins. Co. v. James*, 295 F. Supp. 2d 1354 (N.D. Ga. 2003), the insured was a residential builder who was faced with a claim by a homeowner, who alleged that the home built by the contractor was experiencing heavy water intrusion and damages. The insurer challenged the contractor’s right to coverage for such a claim on a number of grounds, and among those grounds was a contention that the claim did not allege an “occurrence” under the subject policy.

The federal district court in *Owners* agreed with the insurer. The court looked carefully at the allegations which were being made against the builder in that case, which all arose out of the installation of the stucco. According to the court, these acts were not “accidents” within the meaning of the policy. In that regard, the court in *Owners* found that the “occurrence” definition as it exists in most policies should only be held to include “only injury resulting from accidental acts and not injury accidentally caused by intentional acts.” (emphasis in original). In other words, the manner in which the stucco was installed was not “accidental.” It was intentionally and deliberately installed in a certain manner by the contractor. The fact that the contractor did not expect and anticipate the damage to occur as a result of his deliberate acts did not make those acts “accidental.”

In other words, there are arguably two kinds of negligence: (1) the negligence that arises when someone tries to do something a certain way and negligently fails to do so, and (2) the negligence that arises when someone makes a deliberate, but negligent, choice. With the *Owners* decision in mind, insurers may contend that claims falling

in the second category of negligence do not allege an “accident” and, therefore, do not allege an “occurrence” for which coverage is owed.

More recent decisions, however, show that insurers will have some difficulty with that argument. Two more recent Georgia cases – issued by the state courts of Georgia – have seemed to find an “occurrence” almost as a matter of course where there is an allegation of negligence against the insured. For example, in *Sawhorse, Inc. v. Southern Guaranty Ins. Co. of Georgia*, 269 Ga. App. 493, 604 S.E.2d 541 (2004), the Georgia Court of Appeals specifically held that a claim of “faulty workmanship” does constitute an “occurrence” when there is no proof that the insured intended for the faulty workmanship to occur. Similarly, in *Custom Planning & Development, Inc. v. American National Fire Ins. Co.*, 270 Ga. App. 8, 606 S.E.2d 39 (2004), the Georgia Court of Appeals – citing the *Sawhorse* decision – again noted that “where faulty workmanship causes damage to other property, there may be an occurrence within the policy meaning of occurrence from such faulty workmanship, which was negligently performed, which would create an issue of fact as to an accident within [a] policy.”

#### Other States

The conflicting law on the issue of whether faulty workmanship may constitute an occurrence is not limited to Georgia. Recent decisions in Texas further exemplify this difficult issue. In *Courtland Custom Homes, Inc. v. Mid Continent Cas. Co.*, 395 F.Supp. 2d 478 (S.D.Tex. 2005), a residential home builder and general contractor sought coverage for alleged faulty workmanship related to foundation problems, damage to the wooden support structure, wood rot and resultant mold. The *Courtland* court noted that both the contractor’s intent and the reasonably foreseeable effect of his conduct bear on the determination of whether an occurrence is accidental. In turn, the court opined that the contractor intended to use the material it selected for construction. Accordingly, the court held that the claims were not accidental, but rather allegations that the contractor has failed to perform its work in a good and workmanlike manner.

A year later, an appellate court in Texas issued a 72-page conflicting decision in *Lennar Corp. v. Great American Ins. Co.* 200 S.W.3d 651 (Tex.App.-Houston [14 Dist.], 2006). Most notably, the *Lennar* court discussed that insurers generally rely on the “business risk” doctrine to argue that defective construction cannot constitute an “occurrence.” Specifically, the business risk doctrine embodies the exclusions generally applicable to contractors in a CGL policy. These business risk exclusions are designed to exclude coverage for defective workmanship

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by the insured causing damage to the work itself. *Weedo v. Stone-E-Brick, Inc.*, 81 N.J. 233, 405 A.2d 788, 791 (N.J. 1979). Therefore, this doctrine recognizes that the consequences of poor workmanship are generally a “business risk” to be borne by the contractor as opposed to an insurable risk. In turn, many courts are reluctant to find that poor workmanship qualifies as an “occurrence.”

However, the *Lennar* court concluded that defective construction can constitute an “occurrence” under the standard CGL policy because (1) coverage for “business risks” is ordinarily eliminated through exclusions - not through the “occurrence” requirement in the initial insuring agreement; and (2) coverage for some “business risks” is not eliminated when the damaged work, or the work out of which the damage arose, was performed by subcontractors. The *Lennar* decision is strong opinion for contractors, providing an opportunity for coverage for faulty workmanship that damages other property or damages the work itself if the faulty work was performed by a subcontractor.

In the end, there is conflicting authority on the issue of whether faulty workmanship can constitute an “occurrence.” Coverage may turn on the jurisdiction where the matter is pending or on the most recent decision issued by that forum. The fact remains, however, that the most recent decisions in Georgia and Texas suggest that faulty workmanship can constitute an occurrence, leaving coverage to be determined by the construction-specific exclusions in the policy.

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## Georgia: Construction Defects and Personal Injury

### 594 Editor’s Note

*As discussed in the prior article, issues related to construction defects often include claims for the cost of repairs to the actual work. However, claims for personal injury may also arise. In that situation, the defendants may seek to rely on a state’s statute of repose to assert that any and all claims related to defects in the work are time barred. The 2006 Georgia decision illustrates the application of a statute of repose to benefit the builder.*

### Factual Summary

Taylor fell through a plate glass window at the Athens Brew Pub. As is normal when one falls through

a plate glass window, Taylor was severely injured by glass shards. Taylor alleged that the window should have been made of tempered, or safety glass, not plate glass, due to the window’s size and proximity to the floor. S&W Development installed that window, and other windows, as part of a 1990 renovation project. In 1995 and 1996, S&W Development replaced some of the windows installed in the 1990 renovation. Unfortunately for Taylor, the one he fell through was not one of the windows replaced in the 1995/1996 renovation project. *Taylor v. S&W Development, Inc.*, 279 Ga. App. 744, 632 S.E.2d 700 (2006).

The trial court granted summary judgment to S&W Development based on the statute of repose. Under Georgia law, no action arising out of any deficiency in the construction of an improvement to real property “shall be brought against any person performing or furnishing...construction of such an improvement more than eight years after substantial completion of such an improvement.” O.C.G.A. § 9-3-51(a)(3). When Taylor brought the action in May 2004, he was out of time because the window had been installed 14 years earlier.

Taylor tried two arguments to get around the statute of repose. First, Taylor argued that it was not a defective construction claim, but rather, a failure to warn claim, which is continuous and not limited by the statute of repose. Second, Taylor argued that during the 1995/1996 renovation S&W Development failed to warn the owner that the window had been installed in violation of applicable law because the window was plate glass, not tempered or safety glass. Therefore, Taylor was inside the statute of repose when measured from the 1995/1996 renovation.

Neither the trial court, nor the Georgia Court of Appeals bought Taylor’s arguments. The Georgia Court of Appeals noted that statutes of repose are beneficial to public policy, and that courts are unable to make exceptions to the statutes, no matter what the result may be. The court reasoned that the General Assembly included exceptions in other statutes of repose (namely, the products liability statute of repose). And if the General Assembly had intended to exclude failure to warn claims from the construction defects statute of repose, then it would have done so. Because the General Assembly did not provide exclusions to the construction defects statute of repose, the court did not read an exception into the statute. Therefore, Taylor’s claim was a construction defects claim based on the installation of a window in 1990, which failed because Taylor filed the claim outside of the eight year statute of repose.

### Practical Points

This decision illustrates the practical benefit of a statute of repose in the context of building construction by

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providing overall closure. Generally, one cannot avoid the effect of a statute of repose by calling its claim something else. The court noted that “Taylor cannot escape the application of the statute of repose by framing his claim as a breach of a duty to warn or repair.” If there is a claim that is essentially a defective construction claim, the statute of repose will apply no matter how a plaintiff tries to dress up the claim.

The *Taylor* case is clear about two things: 1) a claimant cannot get around the statute of repose by calling it something else, and 2) the statute of repose begins at substantial completion of the work that is the subject of the lawsuit, not unrelated, later-performed work. Therefore, if the project has phases, it is important to clearly document the date of substantial completion of that phase. That date could be far earlier than the date of completion of all of the work.

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## Subcontractor Quotes – What Is a Firm Offer?

### 595 Introduction

A general contractor’s first goal for any construction project is to submit a successful bid that will secure the contract while allowing the contractor to make a reasonable profit. In pursuit of that goal, virtually every general contractor solicits quotes or bids from subcontractors for portions of the labor and materials in order to determine the cost of completing the project. In industry practice, the numbers provided by the subcontractors generally are considered “firm offers” binding a subcontractor to the terms contained therein if its bid is selected. This allows general contractors to rely on the subcontractors’ bids to create an overall bid for the entirety of the project with some measure of security with regard to the numbers they are relying on. A recent decision by the Third Circuit Court of Appeals, however, demonstrates clearly that the industry practice of considering a subcontractor’s bid to be a “firm offer” can be overridden and invalidated by the terms contained within the terms and conditions of the subcontractor’s bid. *Fletcher-Harlee Corp. v. Pote Concrete Contractors, Inc.*, 482 F.3d 247 (3<sup>rd</sup> Cir. 2007).

### Factual Background

In *Fletcher-Harlee*, the general contractor solicited bids for a project, and stipulated that all subcontractors

must agree to be accountable for the prices and proposals submitted. In response to Fletcher-Harlee’s solicitation, Pote Concrete submitted a written price quotation for supplying concrete to the job. Pote’s price quotation, however, did not comply with Fletcher-Harlee’s requirements and explicitly stated on its face that it was for informational purposes only, did not constitute a firm offer, and should not be relied upon.

Despite the express provisions of Pote’s price quotation, Fletcher-Harlee elected to rely on Pote’s numbers in preparing its bid and subsequently was awarded the contract. When Fletcher-Harlee approached Pote to put Pote’s numbers into a formal contract, however, Pote increased its price for the work. Consequently, Fletcher-Harlee used a different concrete subcontractor at an additional cost of \$200,000. Fletcher-Harlee then filed claim against Pote for breach of contract and promissory estoppel to recover the damages incurred as a result of Pote’s failure to adhere to the terms of its price quotation. The United States District Court for the District of New Jersey held that Fletcher-Harlee was not entitled to recover under either theory and dismissed all of its claims against Pote.

In upholding the district court’s decision the Third Circuit held that the express terms of the document submitted by Pote supersede the industry practice of considering all bids to be “firm offers.” The plain language of Pote’s “price quotation” stated that it was not a “firm offer”, and the terms of the document are given greater weight than the tradition of industry custom. Accordingly, the bid submitted by Pote was deemed to not be a “firm offer”, which means that it could not give rise to a breach of contract claim.

Further, the dismissal of Fletcher-Harlee’s claim that Pote should be bound by the terms of its price quotation based on the theory of promissory estoppel was also upheld by the Third Circuit. The theory of promissory estoppel states that a defendant may be bound to the terms of a promise made to the plaintiff if the plaintiff reasonably relies on the defendant’s promise and is harmed as a result. In this case, Pote explicitly stated that its price quotation should not be relied on and was for informational purposes only. The Third Circuit held that Fletcher-Harlee reliance was not reasonable since its reliance was in direct conflict with the terms contained within Pote’s price quote. Since Fletcher-Harlee’s reliance on Pote’s contract was unreasonable the Third Circuit held that the district court was correct in dismissing the claim.

### Comment

The scope of this decision is quite narrow since it only deals with bids or price quotations containing express provisions stating that it is not a firm offer and should not

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be relied upon. However, the potential consequences of this decision for contractors are quite far-reaching. As a result of this decision, contractors must be aware that the industry practice of treating each bid as a “firm offer” can be overridden by the terms and conditions contained within the bid itself. Therefore, the contractor must be diligent in examining not just the numbers contained within the bid submitted by its subcontractors, but also the terms and conditions placed on those numbers by the terms contained within the bid itself.

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## Texas: Pay-If-Paid Clause

**596** A Texas statute signed into law in the summer of 2007 significantly changed the enforceability of contingent payment clauses, sometimes known as “pay-if-paid” clauses in that state. While the enforcement and applicability of the new statute has yet to be tested, contractors and owners should definitely be on guard when performing contracts that contain contingent payment clauses where Texas law applies. This article will touch on some of the practical points of the new statute.

Texas Business and Commerce Code § 35.521 enacts sweeping changes affecting the enforcement of contingent payment clauses. Under a traditional pay-if-paid clause, payment to a lower-tier subcontractor is contingent on payment to the higher-tier firm by a third party, usually the owner. For illustrative purposes, we’ll use the example of an owner, general contractor, and subcontractor throughout this article.

In a typical situation involving a contingent payment clause, the general contractor’s subcontract will condition payment to the subcontractor on the general contractor’s actual receipt of payment from the owner. Thus, in practice, even if the subcontractor has fully performed the required work under its subcontract, it may not be paid until the general contractor is paid by the owner.

Many state courts and legislatures have struggled with these clauses as applied to the lower-tier firms. Some courts have distinguished between clauses where payment to the subcontractor is expressly contingent on payment by the owner and where such clauses simply impose a “reasonable time” requirement for the general contractor to pay the subcontractor. For courts in these jurisdictions, including Texas, if the contract uses the term “condition

precedent” and acknowledges that the subcontractor is assuming the risk of non-payment by the owner, then the clause is interpreted as a true contingent payment clause. If the clause does not explicitly use such language, then it is often interpreted as giving the general contractor a reasonable time to pay the subcontractor, regardless of whether the owner pays the general contractor. *Midamerica Construction Mgmt., Inc. v. Mastec North America, Inc.*, 436 F.3d 1257 (10<sup>th</sup> Cir. 2006).

The new Texas law effectively allows a subcontractor to nullify enforcement of a contingent payment clause in certain limited situations. For example, a general contractor may not enforce such a clause for materials and labor provided after the general contractor receives notice from the subcontractor objecting to enforcement of the clause and that notice becomes effective (“Objective Notice”). That is where the new law becomes somewhat complicated as the subcontractor must wait until the 45<sup>th</sup> day after it submitted its pay application to the general contractor before sending the Objection Notice. The Objection Notice does not become effective, typically, until ten days after the general contractor receives it.

There are some interesting ramifications to this provision of the statute. For example, assuming the subcontractor sends the Objection Notice on the 45<sup>th</sup> day, and the general contractor receives it that same day, there are 55 days between when the subcontractor submitted its payment application, and when the contingent payment clause becomes unenforceable. Interestingly, the clause is only unenforceable for materials and labor provided *after* those 55 days. The statute makes no mention of the labor and materials provided prior to and during the 55 days. Thus, under a strict reading of the law, the clause is still enforceable against the subcontractor for all labor and materials provided up until the 55<sup>th</sup> day.

The new law does afford the subcontractor some relief for the labor and materials provided prior to and during the 55-day period by way of lien rights. Specifically, the law provides that a contingent payment clause cannot be used to invalidate the perfection or enforceability of otherwise valid lien rights.

The law also provides a number of exceptions which allow for enforcement of the contingent payment clause. One major exception is if the owner’s failure to pay the general contractor is due to the subcontractor’s failure to perform adequately under the contract. Another is if the contract is solely for design services or construction or maintenance of highways, roads, bridges, and other projects considered to be civil engineering in nature. Thus, design professionals and certain public works contractors cannot object to the enforceability of a contingent payment clause.

One other notable exception to the law, which allows enforceability of contingent payment clauses, is if the clause is interpreted as setting a reasonable time restriction on the general contractor's payment to the subcontractor. As discussed earlier, Texas makes a distinction between contractual clauses that condition payment to the subcontractor absolutely on payment by the owner to the general contractor, and clauses where even if the owner fails to pay, the general contractor must pay the subcontractor within a reasonable time. In these "reasonable time" clauses, the subcontractor cannot object to the enforceability of the clause. This is most likely because the general contractor must pay anyway.

In summary, under the new law subcontractors in Texas are afforded certain relief from the enforcement of a contingent payment clause. There are potential pitfalls that subcontractors must be wary of, for example, the timing requirements regarding the notice of objection. There are also ambiguities, such as the question of payment for the work performed during the 55-day period before the notice of objection becomes effective, which not only may weaken the law's effectiveness for unpaid subcontractors but also leave general contractors confused as to their contractual obligations to subcontractors in contracts with a contingent payment clause. It is likely that Texas courts will have many opportunities to sort out the nuances in the coming years as both general contractors and subcontractors test the applicability of the new law.

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## Who Is a "Subcontractor" Under the Miller Act?

**597** Everyone who is in business is presumably in business to make money. Those in the construction industry are no different. Given the nature of the business contractors, subcontractors and material suppliers are constantly dealing with new people or companies, many of whom are unfamiliar. Accordingly, every contractor, subcontractor or material supplier wants some assurance or protection regarding payment. On private jobs, there are mechanic's lien rights. On public jobs, however, such is not the case. Since 1894, Congress has enacted laws to offer those furnishing labor and materials for federal construction projects some protection. Currently, the Miller Act is the federal statute which provides this protection. (40 U.S.C. § 3131, et seq.).

### What Does the Miller Act Do?

The Miller Act ("Act") requires a contractor on a federal

project for the construction, alteration or repair which exceeds \$100,000.00 to provide "[a] payment bond with a surety...for the protection of all persons supplying labor and material in carrying out the work provided in the contract." 40 U.S.C. § 3131(b)(2). The Act allows every person who furnishes labor or material for work provided in a contract by a contractor for which a payment bond is furnished to file a lawsuit on the payment bond, if they are not paid in full within 90 days of the last date labor was performed or materials were supplied. Additionally, the Act allows for anyone with a direct contract with a **subcontractor**, express or implied, to also bring a lawsuit, if that party is not paid in full. 40 U.S.C. § 3133(b)(1).

### An "Act of Congress"

Congress elected not to define the term "subcontractor" in the Miller Act. But subcontractor is such a common term, does it really need to be defined? Leave it up to the federal courts and lawyers and the answer is resoundingly: YES. However, many of the federal courts have had differing opinions as to who is a subcontractor. In 1944 the Supreme Court made it as clear as mud when it expressed that in the Miller Act 'Congress used the term "subcontractor" in the technical sense to apply to "one who performs for and takes from the prime contractor a specific part of the labor or materials requirements of the original contract, thus excluding ordinary laborers and materialmen.' *Clifford F. MacEvoy Co. v. United States ex rel. Calvin Tomkins Co.*, 322 U.S. 102 (1944). Perhaps it will truly take an "Act of Congress" to define who is a subcontractor, but Congress hasn't acted yet.

### Recent Decision

Recently, the Third Circuit of the United States Court of Appeals, found that a second tier firm that arranged for fabrication and delivery of structural steel and provided other services based upon a purchase order was a subcontractor for purposes of the Miller Act. *U.S. ex rel E&H Steel Corp. v. C. Pyramid Enters.*, 509 F.3d 184 (3<sup>rd</sup> Cir. 2007). In rendering its opinion the court focused on the relationship between the general contractor and the steel supplier. The court determined that for the project before it, there were not a large number of subcontracts awarded. The "purchase order" with the steel supplier was the largest subcontract (7.8% of the total project costs). Based upon the size of the purchase order (subcontract), the court determined that the general contractor could have requested the steel supplier to provide a bond. The court acknowledged in the opinion that it was taking a very liberal interpretation of the Miller Act, based upon precedent set by the Supreme Court.

### Practical Significance

This broad reading of "subcontractor" is important as

many very small lower tier firms are used to satisfy or fulfill the government's goals on small business type subcontracting. In that context, the main things the courts will look at include the following:

### Substance over Form

It does not necessarily matter whether there is a "purchase order" or "contract," such is not the controlling fact as to whether one is a supplier or a subcontractor. Instead, the courts will look to the relationship of the parties.

Answering yes to most of these questions will likely mean that the material supplier will be deemed a "subcontractor" by the court.

- Does the material supplier perform or take from the prime contractor a specific part of the labor or materials required by the original contract?

In other words:

- Does the material supplier take a role in design?
- Does the material supplier submit shop drawings?
- Does the material supplier assist in the submittal selection?
- Does the material supplier have a substantial and important relationship with the prime contractor?
- Does the material supplier stay in communication regarding installation or other aspects of the materials supplied?
- Is the material supplier responsible for a large percentage of the materials supplied?
- Can the prime contractor require the material supplier to post a bond, or would the prime contractor have recourse against the material supplier for financial loss?

### Summary

The end result is that "titles" in a traditional sense may not matter under the Miller Act. A material supplier may well be a subcontractor. If a prime contractor is reliant on the material supplier and the material supplier is taking an active role in the construction of the project through design, submittals or shop drawings or has a large percentage of the materials to be supplied, it is an error to assume that the material supplier is not a subcontractor.

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## North Carolina: Challenges to Liquidated Damages Clauses

**598** The best offense is a good defense. Even though this adage is frequently used within the context of sports, it can also be applied to negotiating contracts for construction projects. It cannot be over-emphasized that it is important to prepare a good defense by negotiating for beneficial terms in a construction contract, especially when liquidated damages provisions are an integral part of the contractual equation. Liquidated damages will almost always be upheld by a court of law after they have been set forth under the terms of a contract. This can be a very costly lesson to learn for those who do not devote adequate time to negotiate a more favorable liquidated damages provision.

As a matter of first impression, the decision handed down by the North Carolina Court of Appeals in *Seventeen HB Charlotte Corp. v. Shrine Bowl of the Carolinas* ("*Shrine Bowl*") addressed the issue of liquidated damages and held that, "[T]he burden [of persuasion] falls on the party seeking to invalidate a liquidated damages provision." 641 SE 2d 711, 714 (N.C. App. 2007). This decision can have significant implications for the unsuspecting party. A party to a construction contract needs to fully appreciate the importance of a liquidated damages clause when negotiating a contract.

In *Shrine Bowl*, Shrine Bowl of the Carolinas, Inc. (the "Defendant") and Seventeen HB Charlotte Corporation ("HB Charlotte") entered into a contract that included a provision for liquidated damages. After an apparent breach of the contract, HB Charlotte filed its complaint and moved for summary judgment on 1) all issues of liability and 2) the enforceability of the liquidated damages provision. The Mecklenburg County Superior Court granted HB Charlotte's motion for summary judgment on all issues of liability and denied the second motion on the enforceability of liquidated damages. The trial court decided that the liquidated damages provision was enforceable, and therefore declined to hear evidence regarding the actual losses incurred by HB Charlotte.

The Defendant did not appeal the entry of summary judgment on the issue of liability, but it did appeal the trial court's decision to uphold the liquidated damages clause. After hearing the parties' arguments, the Court of Appeals came to the conclusion that the parties had different understandings of the concept of liquidated damages.

The Court of Appeal's assertion emphasizes the importance of understanding the significance of entering into a liquidated damages provision on a construction project. Parties should be aware that they will be required

to pay liquidated damages even if the party entitled to the damages did not receive any actual injury. The Court of Appeals stated that “[t]he general rule is that the amount stipulated in a contract as liquidated damages for a breach, if not a penalty, may be recovered in the event of a breach even though no actual damages are suffered.” Once liability for damages is established, the amount of damages is fixed through a liquidated damages provision in the contract. Therefore, a “misunderstanding” about the significance of a liquidated provision in a construction contract can lead to a loss of large sums of money.

The Court of Appeals’ defended its decision to uphold the liquidated damages provision by focusing on several basic tenets of contract formation. First, it rested its decision on the fundamental principle of freedom of contract. The court reasoned that a court should uphold

the terms of a contract where both parties to the contract have negotiated the amount of damages that will be recoverable in the event of a breach. Second, from a public policy perspective, the court rationalized that the burden of invalidating a liquidated damages clause should be placed on the party trying to invalidate it because that party had initially agreed to a liquidated damages provision. In the court’s view, “[t]he purpose of a liquidated damages provision is to *obviate* the need for the nonbreaching party to prove actual damages.”

#### Comment

The decision in *Shrine Bowl* essentially puts a party that wants to bid on a project that calls for liquidated damages behind the metaphorical eight ball. The contractor or subcontractor wants to secure the business, and probably feels like it has to agree to a liquidated damages

## Upcoming Seminars

**Ethics Plans and Programs**, New Jersey AGC, July 7, 2008, Edison, New Jersey. *Steven L. Reed.*

**Common Sense Construction Law for Florida Licensed Contractors**, AGC of East Tennessee, July 9-10, 2008, Chattanooga, Tennessee. *Thomas J. Kelleher, Jr., Joseph C. Staak, Philip E. Beck, Kirk D. Johnston and John M. Mastin.*

**The Masters Institute in Construction Contracting**, Federal Publications, July 15-17, 2008, Hilton Head, South Carolina. *John F. Butler.*

**What to Do When Construction Projects Go Bad**, Lorman Education Services, July 30, 2008, Jacksonville, FL. *S. Elysha Luken.*

**Southeast Building Conference**, Florida Homebuilders’ Association, July 31, 2008, Orlando, Florida. *Thomas J. Kelleher, Jr., Joseph C. Staak and S. Gregory Joy.*

**Common Sense Construction Law for Florida Licensed Contractors**, Georgia Branch of the AGC, August 6-7, 2008, Atlanta, Georgia. *Thomas J. Kelleher, Jr., Joseph C. Staak, Philip E. Beck, and John M. Mastin, Jr.*

**Resolving Problems & Disputes on Construction Projects**, National Business Institute, Inc., August 7, 2008, Atlanta, Georgia. *Philip E. Beck, James K. Bidgood, Jr.*

**ABA Annual Meeting – Construction Division Seminar on Terminations**, American Bar Association, August 11, 2008, New York, New York. *Hubert J. Bell, Jr., Steven L. Reed.*

**AIA Contracts**, Lorman Education Services, August 14, 2008, Jacksonville, Florida. *S. Elysha Luken.*

**Common Sense Construction Law for Florida Licensed Contractors**, ABC of Alabama, August 14-15, 2008, Chattanooga, Tennessee. *Thomas J. Kelleher, Jr., Philip E. Beck, Joseph C. Staak, Kirk D. Johnston and John M. Mastin, Jr.*

**The Hidden Risks of Green Buildings**, Lorman Education Services, August 19, 2008, Tallahassee, Florida. *James K. Bidgood, Jr., Gene J. Heady.*

**The Hidden Risks of Green Buildings**, Lorman Education Services, August 20, 2008, Jacksonville, Florida. *James K. Bidgood, Jr., Gene J. Heady.*

**Short Courses For Florida Licensed Contractors**, August 22, 2008, Smith, Currie & Hancock offices, Atlanta, Georgia. *Thomas J. Kelleher, Jr., Joseph C. Staak, and John M. Mastin, Jr.*

**Common Sense Construction Law for Florida Licensed Contractors**, August 27-28, 2008, Tampa, Florida. *Thomas J. Kelleher, Jr., Joseph C. Staak, S. Gregory Joy, and John M. Mastin, Jr.*

**Do These Things Give Me a Fair Shake? ConsensusDOCS and Subcontractors**, American Bar Association, September 12, 2008, Chicago, Illinois. *Philip E. Beck.*

**ConsensusDOCS Seminar**, Carolinas AGC, September 16, 2008, Greensboro, North Carolina. *Philip E. Beck.*

**What is Green Building & Leed Accreditation?** ABC of Florida, September 24, 2008, West Palm Beach, Florida. *James K. Bidgood, Jr.*

**What is Green Building & Leed Accreditation?** ABC of Florida, September 25, 2008, Miami, Florida. *James K. Bidgood, Jr.*

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provision in order to have a chance at successfully bidding on the project. However, the contractor or subcontractor may also tend to underestimate the amount of time or money it will take to complete the project, and faces the dangerous position of paying a substantial amount in liquidated damages. How does a contractor or subcontractor avoid this dilemma?

First and foremost, it is crucial to negotiate for beneficial terms on liquidated damages provisions before entering into a contract because it will be difficult, if not impossible, to change the provision after the contract has been executed. A contractor or subcontractor can secure beneficial terms by negotiating for a completion date that leaves room for error and that accounts for time missed due to unforeseen circumstances. Remember, it is all about building a good defense. If a contractor or subcontractor has not prepared a good defense through contract negotiation, it has left itself very little room to go on the offensive once a conflict arises.

However, the reality of negotiating a contract for a construction project is that a contractor or subcontractor may not have the leverage to negotiate for liquidated damages provisions before entering into the contract. Contractors and subcontractors want to avoid the stigma that they are either concerned about completing a project on time or that they will be difficult to work with on the project. Therefore, a contractor or subcontractor may have to use alternative methods to accomplish beneficial liquidated damages provisions. One solution is to consider seeking a clause that limits the contractor's total liability under the contract including liquidated damages to a maximum value such as the contractor's fee or some percentage of the contract price. Therefore, while not negating the enforcement of the liquidated damages provision, the exposure is capped.

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**Supervisory Editors:** Thomas J. Kelleher, Jr., and Charles W. Surasky.

*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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