

# COMMON SENSE CONTRACTING

VOLUME 19, NUMBER 1

SPRING 2005

## Inside This Issue

- 494 Challenging a Past Performance Evaluation**
- 495 South Carolina: Arbitration of Condominium Defect Claims**
- 496 Davis-Bacon Act Disputes: The Importance of Documentation**
- 497 Expanded Veterans' Rights**
- 498 Construction Industry Retainage Practices**
- 499 Florida: Update on Economic Loss Rule**
- 500 Termination for Convenience Clauses – Federal and State Law Considerations**

## Challenging a Past Performance Evaluation

### **494** Overview

Your reputation is vital and precedes you in your personal and business relations. This is true in construction where contracts in both the private and public sectors are increasingly awarded on a competitively negotiated basis, which considers factors other than the lowest price. An important, non-price factor is the contractor's past performance history.

Private contract solicitations frequently request references and ask whether offerors have ever failed to complete a contract. The private sector's evaluation of past performance is somewhat informal as it depends upon information gathered from third parties on a case-by-case basis. In contrast, the federal government's approach to collecting information on contractor past performance is more structured. For example, the Department of Defense maintains a contractor performance evaluation database

## Notice to Florida Licensed Contractors

For many contractors licensed in Florida, August 31, 2005, is the deadline for obtaining your mandatory continuing education ("CE") credits. Smith, Currie & Hancock LLP is an approved course sponsor (Provider No. 0000998) by the Florida Construction Industry Licensing Board (FCILB), and we are planning several programs between now and the end of August, 2005. Currently, we have courses scheduled for Atlanta, Georgia, on August 4-5, 2005 and Birmingham, Alabama, on August 25-26, 2005. We also plan to schedule at least two courses in Central/South Florida in the mid-July to mid-August period. These courses will provide up to 14 hours CE credit including the mandatory business practice, worker's compensation, and workplace safety hours. In addition, if several of your key personnel hold Florida licenses, an in-house program may be more cost-efficient. If you are interested in more information on these FCILB sanctioned courses, please contact Tom Kelleher at Smith, Currie & Hancock LLP, 404/582-8016; fax: 404/688-0671 or e-mail: [tjkelleher@smithcurrie.com](mailto:tjkelleher@smithcurrie.com).

known as the CONSTRUCTION CONTRACTOR APPRAISAL SUPPORT SYSTEM (“CCASS”). It allows contracting officers within the military agencies to review evaluations which have been prepared on an established format. CCASS is described in the Department of Defense Federal Acquisition Regulation Supplement, and contractors are able to confirm that their evaluations have been submitted and obtain copies. A comparable system is also available to the civilian agencies within the federal agencies.

### Challenges to Evaluations

Because past performance is important in obtaining future contracts, when a poor performance evaluation is received, federal government contractors have challenged or requested that agencies review and change their performance ratings. Until recently, an agency’s voluntary change was the only way to erase a poor performance rating from a contractor’s past performance history. Consistent with that, the boards of contract appeals have declined to exercise jurisdiction over a requested review of a past performance evaluation. *TLT Construction Corp.*, ASBCA No. 53,769, 02-2 BCA ¶ 31,969. In general, the boards have declined such matters reasoning that evaluations are administrative matters and because boards do not have authority to issue injunctive relief (a directive to change the evaluation). However, as a result of the

United States Court of Federal Claims’ decision in *Record Steel and Const., Inc. v. U.S.*, 62 Fed. Cl. 508 (2004), a contractor may now have available to it at least one forum to obtain a third party review of that evaluation and revision of the past performance evaluation rating.

The *Record Steel* case involved a contract for the design and construction of an Offutt Air Force Base dormitory. The primary issue in the claim before the court involved whether over-excavation in the foundation area was a mandatory requirement or merely a recommendation. The government argued that over-excavation was a contract requirement. Ultimately, the court rejected the government’s argument and held that the contractor was entitled to recover the additional costs of over-excavation.

The court also addressed past performance. The government had issued a performance evaluation which gave Record Steel an overall “Satisfactory” rating, but incorporated elements in the report that were scored as “Marginal.” Record Steel wrote a letter and requested the contracting officer’s representative to re-evaluate and correct its marginal scores to represent its performance accurately, and the government denied the request. As part of its appeal, Record Steel requested the court to review and correct the adverse elements in the agency’s past performance evaluation.

### Just Published!

## ***Common Sense Construction Law – Third Edition***

The attorneys at Smith, Currie & Hancock LLP have practiced construction law for four decades and presented hundreds of construction law seminars across the nation. Our consistent goal has been to provide a practical perspective to the legal issues affecting the construction industry.

Given that philosophy, our firm is proud to have been engaged by the Professional, Reference and Trade Group of John Wiley & Sons, Inc., to author *Common Sense Construction Law – 3rd Edition, A Practical Guide for the Construction Industry Professional*.

We believe that this 600-plus page hardbound book captures that experience and approach by combining checklists, charts, and sample forms with a common sense approach to the analysis of the complex questions facing industry participants on a daily basis. In addition to the printed materials, each copy of the book includes a companion CD-ROM containing documents from the following organizations:

- \* American Institute of Architects – 29 sample documents and contracts
- \* Associated General Contractors of America – 62 sample documents and contracts
- \* Engineers Joint Contract Documents Committee – 92 documents and contracts

Copies of *Common Sense Construction Law* are available for \$85.00 and volume discounts are also available from John Wiley & Sons, Inc.. To order call 1-800-CALL-WILEY or log onto [www.wiley.com](http://www.wiley.com). For orders of 10 or more books, please call Jeff Gould at 201/748-6306.

The court's decision held that it could review and correct past performance evaluations because its Tucker Act jurisdiction extends to claims including non-monetary disputes on which a contracting officer has issued a decision. The Federal Acquisition Regulation ("FAR") defines a claim as a written demand by a contracting party seeking as a matter of right the payment of money or other relief arising under or relating to the contract. The court found that Record Steel's letter requesting that its marginal ratings be re-evaluated and changed was a request seeking relief relating to the contract pursuant to a claim of right. The contracting officer's representative denied the request and stated that no changes would be made to the original performance evaluation. The court found that this denial could be treated as a final decision even if it lacked the standard language stating that it constituted a final decision. Alternatively, the court concluded that when the contracting officer's representative denied the request to reconsider the evaluation, that denial effectively made the evaluation a "final action" which was also reviewable under the Administrative Procedure Act, 5 U.S.C. § 706(2)(A)-(D) ("APA").

Accordingly, the court held that it had jurisdiction to review contractor performance evaluations when the pertinent requirements of the Contract Disputes Act ("CDA") had been met or under the APA. The court concluded that Record Steel had submitted a proper claim for non-monetary relief and that a final decision had been rendered on that claim giving the court jurisdiction under the CDA.

### Commentary

A contractor may appeal a final decision denying a claim to either the boards of contract appeals or the U.S. Court of Federal Claims. However, as noted above, the boards have declined to review past performance evaluations stating that they are administrative matters that do not arise out of a contract or regulation. In addition, the boards have consistently held that they lack authority to issue injunctive relief. The decision in *Record Steel* concluded that the court had jurisdiction to issue injunctive relief directing a change in a record such as a past performance evaluation. This single decision implies that a contractor may obtain relief (revision of a past performance evaluation) at the Court of Federal Claims which is unavailable at the boards. How this ruling will be applied in the future is not certain. Since the Court of Federal Claims decisions are not binding on the boards, and one judge's opinion is not binding on other members of that court, a decision by the United States Court of Appeals for the Federal Circuit may be required to finally resolve this issue. Similarly, it is possible that the federal agencies may seek to effectively

reverse the *Record Steel* decision by regulation or special contract provision.

Until then, contractors should make certain that any request to re-evaluate and change a past performance evaluation is submitted as a claim under the Contract Disputes Act for non-monetary relief and that the contracting agency is requested to issue a final decision on the claim.

Thomas E. Abernathy, IV  
404/582-8013  
teabernathy@smithcurrie.com

## South Carolina: Arbitration of Condominium Defect Claims

### 495 Overview

The United States Court of Appeals for the Fourth Circuit recently held that, under South Carolina law: (1) a condominium association that sued the general contractor in negligence for violation of its common law duties as a builder was not required to arbitrate its claims based on an arbitration clause in the prime contract between the general contractor and the developer (owner) because the association was not a party to the prime contract, and did not seek a direct benefit of that contract; and (2) an arbitration clause in a master deed between the developer (owner) and the condominium association was not binding on the association's claim against the general contractor, because the general contractor was not a third party beneficiary to the master deed. Although the court placed some limitations on its ruling as explained further below, this decision unquestionably will be a hindrance to contractors in South Carolina who wish to force a condominium association to arbitrate defective construction claims against the contractor.

### Background and Analysis

In its holding in *R.J. Griffin & Co. v. Beach Club II Condominium Ass'n, Inc.*, 384 F.3d 157 (4<sup>th</sup> Cir. 2004), the court affirmed the decision of the United States District Court for the District of South Carolina denying the general contractor's motion to compel arbitration. The owner, Drake Development Corporation IV ("Drake"), hired a general contractor, R.J. Griffin, in 1995 to build a forty-five unit condominium in North Myrtle Beach known as The Beach Club II at Windy Hill. The prime contract contained a broad arbitration provision in the general conditions. In addition, Drake filed a master deed for the property following completion of construction, and it too contained a broad arbitration provision which applied to any disputes the condominium association might have with Drake

regarding the common elements. The contractor, R.J. Griffin, however, was not a party to the master deed and was, in fact, not referred to in the deed at all.

After construction was completed in 1996, the condominium association discovered numerous alleged construction defects relating to water intrusion in the building's common elements and sued R.J. Griffin in state court, asserting claims for negligence and breach of the implied warranty of good workmanship. R.J. Griffin then filed a complaint in federal district court under the Federal Arbitration Act and South Carolina state law to compel the condominium association to arbitrate its claims. R.J. Griffin claimed the condominium association was bound by the arbitration clauses in the prime contract and the master deed, despite the fact that the condominium association was not a signatory to the prime contract and R.J. Griffin was not a signatory to the master deed.

R.J. Griffin's main argument was that the arbitration clause in the prime contract was enforceable against the condominium association through the doctrine of equitable estoppel. Essentially under this doctrine, a nonsignatory to a contract who relies upon the contract terms in order to sue a party to that contract may not avail itself of the contract, while at the same time trying to avoid the contract's arbitration provision. R.J. Griffin argued that because the prime contract was the source of its alleged duties and warranty to the condominium association, the association was seeking a direct benefit from that construction contract. Therefore, the condominium association was equitably bound by the arbitration provision contained in the construction contract.

The court did not agree with the contractor's argument, instead finding that under South Carolina common law the legal duties R.J. Griffin allegedly violated arose from its role as the builder of the condominium. These duties, the court said, were not dependent on the terms of the prime contract, but are imposed upon all builders under South Carolina common law. The court stated that the condominium association's claims in this situation did not hinge on any rights it might have under the prime contract. The court did point out, however, that its decision does not mean a nonsignatory may use artful pleading to avoid arbitration when, in substance, it is attempting to hold a party to the terms of a contract. The court, as an example, said that if the condominium association had brought a negligence or breach of implied warranty claim because the owner had contracted with R.J. Griffin for blue paint but instead received brown, R.J. Griffin would have a case for arbitration. This is because R.J. Griffin's failure to provide the correct color of paint would violate a duty created solely by the contract. However, the condominium association alleged

multiple violations of South Carolina's building codes, which the court treated as extra-contractual causes of action.

In its final point, the court rejected R.J. Griffin's argument pertaining to the arbitration provision in the master deed, holding that the general contractor was not a third party beneficiary to the master deed. The court found that the arbitration provision in the master deed governed disputes between the owner and the condominium association concerning the common elements, and that there was no indication of an intent to extend the arbitration benefit to any third party not bound by the deed. Moreover, the court rejected R.J. Griffin's contention that the condominium association is equitably estopped from avoiding the arbitration clause in the master deed, holding that the association is not attempting to hold R.J. Griffin to any term of the master deed.

#### Comment

Contractors performing work in South Carolina on condominiums or other buildings where an owners' association could potentially come into play need to be aware of this decision and keep the risk in mind when evaluating South Carolina projects. The ability to force a condominium association to arbitrate its claims against a general contractor is certainly not something that can be taken for granted in light of this recent development. At a minimum, both the general construction contract and the terms of the deeds need to be carefully coordinated if the desire is to have any claims arising out of or related to alleged defects in the construction exclusively addressed in an arbitration.

*Myra V. Whitener*  
704/334-3459

*mwhitener@smithcurrie.com*

---

## Davis-Bacon Act Disputes: The Importance of Documentation

### 496 Overview

Many different circumstances can delay or disrupt a construction project, placing intolerable risk and expense on the contractor. Factors such as adverse weather, differing site conditions, strikes, regulatory issues, and material cost escalation, to name a few, can have a major impact on the progress of the construction project and the contractor's bottom line. However, a contractor that keeps detailed records and promptly responds to owner inquiries concerning these problems will be better prepared to successfully resolve the matter without a costly dispute than a contractor, which keeps few records

and does not bother to explain the problem to the owner.

One example of a regulatory issue that can impact the progress of a federal construction project is the government withholding of progress payments due to an alleged violation of the federal Davis-Bacon Act (“DBA”), 40 U.S.C. § 3141, *et seq.*, and its “related Acts.” The DBA requires that each federal contract over \$2,000 for the construction, alteration, or repair of public buildings or public works contain a clause setting forth the minimum wages to be paid to various classes of laborers and mechanics employed under the contract. Under the provisions of the Act, contractors or their subcontractors are to pay workers no less than the so-called locally prevailing wages and fringe benefits. In addition to the DBA, Congress has added prevailing wage provisions to approximately 60 statutes which assist construction projects through grants, loans, loan guarantees, and insurance. These “related Acts” involve construction in such areas as transportation, housing, air and water pollution reduction, and health. Under the DBA and its related Acts, the government may withhold amounts from progress payments due to a contractor to remedy alleged violations.

#### Risks of Poor Documentation

The recent decision of the United States Court of Appeals for the Federal Circuit (“Federal Circuit”) in *Copeland v. Veneman*, 350 F.3d 1230 (Fed. Cir. 2003) (“*Copeland*”) highlights the fact that the practices of thorough record keeping and prompt response to owner inquiries are just as applicable to cases involving government withholding of payment for alleged violations of the DBA as they are to cases involving changes, differing site conditions, delays, and disruption. In *Copeland*, a contractor who failed to keep adequate records and promptly respond to government inquiries concerning the government’s withholding of progress payments due to alleged DBA violations was not excused from a termination for default, even though it was later shown that the government’s withholding was erroneous and likely caused the default.

The relevant facts of *Copeland* were as follows. The contractor was awarded a construction contract by the National Forest Service to construct and reconstruct hiking trails. The contract amount was \$112,900. The contractor was to be paid a series of progress payments. During performance of the contract, various employees of the contractor complained of DBA wage violations. In response, the contractor provided the contracting officer with incomplete documentation that did not fully address the employees’ complaints. In part, the contractor

erroneously asserted that the DBA was not applicable to it as it was not an “union” contractor.

Based upon the employees’ allegations and the incomplete documentation provided by the contractor, the contracting officer decided to withhold a substantial amount of the contractor’s progress payment and referred the matter to the Department of Labor (“DOL”) to investigate a potential DBA violation. Subsequently, the DOL requested that the contracting officer withhold a total of \$37,905 pending a final resolution. Although this request was made in July 1992 the DOL took no further actions on the alleged violation for over two years. In the interim, the contracting officer withheld additional amounts to bring the total amount up to \$37,905.

#### Effect on Performance of Work

During the months following the progress payment withholdings, Forest Service inspectors found that the contractor’s progress on the contract was gradually becoming more delayed and it eventually terminated the contract for default in September of 1992. Contractor appealed this default termination to the Department of Agriculture board of contract appeals (“Board”) arguing that its delay was excusable because it resulted from the Forest Service’s erroneous DBA withholding.

Although the contractor’s appeal was timely, the Board dismissed the appeal pending resolution of the alleged DBA violations before the DOL. In 1999, approximately 6 years after the initial dismissal of the appeal of the default by the Board, a DOL administrative law judge found that only \$3,951 should have been withheld due to DBA violations. Subsequent to this determination, the contractor reinstated its appeal at the Board. After a hearing in 2000, the Board held that the contractor had not demonstrated that the Contracting Officer “inappropriately withheld monies” in 1992. A dissenting board judge urged that the Board reverse the default as the 1999 DOL determination showed that the withholding was “grossly excessive”. The contractor appealed this adverse decision to the Federal Circuit. In its review, the Federal Circuit focused on whether the amount withheld was based on the Contracting Officer’s “reasonable judgment” that the withheld amounts were needed to protect the employees’ interests.

The Federal Circuit acknowledged that there was a serious question as to the propriety of the withholding given the difference in the amount (\$3,951) actually verified by the DOL in 1999 as compared to the \$37,905 withheld by the contracting officer in 1992. However, despite the vast difference between the actual violation and the withheld amount, the court found that the burden was on the

---

contractor to show that the amount withheld by the government was unreasonable. The court held that to carry this burden, the contractor would have to show that the contracting officer acted unreasonably based on the information she had *at the time of the withholding* (1992).

After reviewing the facts of the case, the court held that the contractor did not meet this burden of showing that the contracting officer acted unreasonably. The court reached this conclusion because it found that the contractor had ample opportunity to provide data to the contracting officer to demonstrate that the claims were not true or to establish that the figure owed was a lesser amount, but the responses provided by the contractor were not adequate and provided only the “sketchiest” of data. This was highlighted by the fact that the contractor could not verify that it had actually made the contested payments when the Forest Service asked it to do so.

Thus, the court found that the Forest Service’s withholding could not be deemed excessive or unreasonable at the time it was made in light of the sparse documentation provided to it at the time by the contractor. Absent any meaningful submission by the contractor, the contracting officer could rely upon the DOL’s preliminary determination.

### Conclusion

It is clear from the facts of *Copeland*, that the amount withheld from the contractor’s progress payments by the contracting officer was far too high in light of the size of the project and the actual DBA violations shown. It is also likely that this high withholding finally impacted the contractor to an extent that caused it to delay the project and eventually led to its termination for default. However, by failing to keep detailed records and promptly respond to the government’s inquiries, the contractor lost its ability to later challenge the government’s decision. In sum, detailed record keeping and a policy of fully and promptly responding to the inquiries of the owner or contracting officer concerning the potential problems, has been proven effective in other contexts, would likely have made the difference for the contractor in this situation involving the government’s DBA withholding.

James B. Taylor  
404/582-8048  
jbtaylor@smithcurrie.com

---

## Expanded Veterans’ Rights

**497** The Uniformed Services Employment and Reemployment Rights Act (“USERRA”), covers every individual in the country who serves in or has served in the uniformed services and applies to all employers in

the public and private sectors, including Federal employers. The law seeks to ensure that those who serve their country can retain their civilian employment and benefit, and can seek employment free from discrimination because of their service. USERRA provides enhanced protection for disabled veterans, requiring employers to make reasonable efforts to accommodate the disability.

A new law, the Veterans’ Benefits Improvement Act, an amendment to USERRA, requires employers to notify all employees annually of their legal rights under USERRA. The DOL has issued a form notice that can be used by employers to comply with this new requirement which went into effect on March 10, 2005. The form notice can be viewed and printed at : <http://www.dol.gov/vets/programs/userra/poster.pdf>. Posting this form notice in a location customarily utilized for providing notices to employees satisfies the employer’s notice obligation.

Other USERRA modifications that went into effect December 10, 2004, expand the maximum period for which employer-sponsored health coverage must be continued for individuals on military leave from 18 up to 24 months. This continuing coverage is available to employees out on military leave at their own expense. It is not required to be paid by the employer.

Catherine M. Hobart  
404/582-8045  
cmhobart@smithcurrie.com

---

## Construction Industry Retainage Practices

Dennis C. Bausman, PhD, CPC, AIC  
Clemson University

**498** (Editor’s Note: Clemson University’s Construction Science and Management Department has recently completed an extensive study of the costs and uses of retainages in construction contracts. The study, which drew on over 1,000 responses from industry participants (owners, design professionals, contractors, construction managers, and subcontractors), found a major disconnect between the views of many owners and contractors on the use and costs of contract retainages. The survey’s author, Dennis C. Bausman, an Assistant Professor in Clemson’s Construction Science and Management Department, graciously provided the following executive summary of that study for publication in this newsletter. It is provided in this newsletter solely for informational purposes. Professor Bausman also advised that a complete copy of the study is available for \$35.00 at [www.fasaonline.com](http://www.fasaonline.com).)

## Executive Summary

The value of new construction in the United States approaches 900 billion dollars. On a significant portion of this work the practice of holding retainage from the payments to contractors and subcontractors is common. The practice is commonly perceived to provide a level of financial protection to the party withholding retainage as well as an added incentive for proper and timely performance of the work. However, in an industry where profit margins are thin and cash management is essential, withholding retainage can create a financial strain on contractors and their delivery partners. This study investigated current retainage practices in the construction industry and also examined the benefits and detriments of these practices. A national sampling involving 1,036 architects, general contractors, subcontractors, public owners, construction managers, and private owners provided input for this study.

The findings of the study are that owners and their agents (architects and construction managers) do not believe that retainage provides a financial buffer for overvaluation of the work during construction, in part because they believe that retainage encourages front-end loading. In addition, they view retainage as having marginal impact on contractor performance and believe it provides minimal incentive to ensure quality work. This limited impact on performance may be in part because at-risk builders, as well as architects, believe that retainage treats good and poor performers the same, thereby providing minimal incentive to perform. However, owners and their agents firmly believe that retainage encourages the correction of defects, expedites closeout documentation, and ensures completion of the punchlist. In essence, they view retainage as providing effective leverage for the correction of deficiencies and closeout of the project as opposed to providing financial protection or having a substantial impact on performance during the construction period.

However, this perceived protection has a price. The findings of this study support the assertion that retainage policy influences the contractor's and subcontractor's willingness to bid, as well as the price for their portion of the work. Retainage reduces competition and increases the cost of the project. General contractors submit that the increase in contract price is 2.2% while subcontractors claim an average escalation of 3.6%.

Retainage is also perceived to have an influence on project relationships. At-risk builders (general contractors, construction managers at-risk, and subcontractors) feel that eliminating, or reducing, retainage facilitates project relationships and encourages the alignment of project

goals. In contrast, owners and their agents do not believe the implementation of retainage has an adverse influence on the contracting team. However, the only subset of the owners group that has extensive experience with 'zero' retainage projects are representatives of the federal government's agencies. They support the at-risk builders' position. The majority of these federal government's agencies believe the elimination of retainage has a favorable impact on project relationships. As the construction industry continues to evolve toward an operating environment where effective Owner-Architect-Contractor relationships are essential to reach project objectives, retainage policy may take on added significance.

Contributing to the negative influence is perceived retainage abuse. At-risk builders assert slow payment of retainage is a serious problem. They submit that they do not receive full payment of retainage on approximately 10% of their projects and sometimes have to wait 1 to 2 years after completion of the work for receipt. Even construction managers, as owner's agents, view slow payment of retainage as a concern and surprisingly, owners themselves did not claim it was *not* a serious problem. Compounding this problem is that contractors and owners may use retainage to induce settlement. Contractors may use it as leverage against subcontractors to induce settlement on unfavorable terms. And even some of the owner's agents concur with at-risk builders that retainage is often used as leverage by the Owner to resolve contractor claims or changes for extra work.

Despite the polarization on retainage policy the continuing efforts of the American Subcontractor's Association (ASA), the American General Contractors (AGC), and the American Specialty Contractors Association (ASC) at the federal and state level have yielded results. Federal agencies are more likely to embrace a zero retainage policy and the average retained percentage on public work, at both the federal and state level, is significantly lower than the average of 7.6% on private work. However, this disparity may lessen in the future because, as evidenced by this study, even private owners do not oppose reducing retainage to 5%.

This study found additional evidence that the industry is moving toward a more balanced approach to retainage policy that addresses the legitimate needs and concerns of the parties. While alternatives to *traditional* retainage practice still have limited application, support is present on several fronts. This study confirmed that all of the parties support the release of retainage for work completed early in the life of the project and legislation to ensure prompt payment. Additionally, none of the parties oppose statutes limiting the maximum percentage of retainage. This study

also found that the owner's agents (along with at-risk builders) support the use of escrow accounts and do not oppose the payment of interest on retained funds. Changing attitudes coupled with legislative initiatives affecting both the public and private sector are reinforcing, and in some cases mandating, the acceptance of alternatives to *traditional* retainage practice.

---

## Florida: Update on Economic Loss Rule

### 499 Overview

The "Economic Loss Rule" is a "court-created doctrine which prohibits the extension of tort recovery for cases in which a product has damaged only itself and there is no personal injury or damage to 'other property,' and the losses or damage are purely economic in nature. *Southland Construction, Inc. v. The Richeson Corp.*, 642 So. 2d. 5, 7 (Fla. 5<sup>th</sup> DCA 1992). As reported in previous issues of this newsletter, Florida courts have adopted the rule and applied it in various cases. (For example, see Article 443, Spring, 2003 of this newsletter.) However, the courts' "pronouncements on the rule have not always been clear and, accordingly, have been the subject of legitimate criticism and commentary." *Moransais v. Heathman*, 744 So.2d at 973, 980 (Fla. 1999). To address the concerns and resulting confusion arising from the prior imprecise applications of the economic loss rule in Florida, the Florida Supreme Court in *Indemnity Insurance Co. v. American Aviation, Inc.* 2004 WL 23973861 (Fla. Dec. 23, 2004) ("*American Aviation*") has attempted to articulate a clear framework for the future application of the rule. While not a construction case, the basic principles in *American Aviation* can be applied in claims for economic losses arising out of the context of construction projects.

### Factual Background

The cause of action in *American Aviation* arose from the alleged negligent maintenance and inspection of an aircraft's landing gear. The relevant parties to the lawsuit and their respective involvement were as follows: (1) American Aviation, Inc. ("American"), a service company that performed maintenance and inspection of aircraft; (2) Profile Aviation Services, Inc. ("Profile"), the party that purchased the aircraft, which was maintained and inspected by American; and (3) Indemnity Insurance Co. ("Indemnity"), which had insured the aircraft.

On or around November 22, 1996, American's FAA-certified mechanics, pursuant to a contract to which Profile

and Indemnity were not parties, performed the required maintenance and inspection on the landing gear of the aircraft. After completing the work, American's mechanics certified in the aircraft's logbook that the inspection was done in accordance with the aircraft's maintenance manual and FAA regulations. Relying on the representation in the logbook regarding the November 1996 work, Profile purchased the aircraft. On May 14, 1999, that aircraft was severely damaged when the landing gear failed to extend during a landing. The alleged cause of the failure was that the components of the landing gear were improperly installed. The only damages suffered by the parties were economic losses.

Profile and Indemnity filed separate complaints in the United States District Court for the Middle District of Florida seeking recovery in tort, asserting claims for negligence, negligence per se, and negligent misrepresentation. Both plaintiffs alleged that American had negligently inspected and maintained the aircraft. The district court dismissed the tort claims, finding them barred by Florida's Economic Loss Rule. Both parties appealed the decision to the United States Court of Appeals for the Eleventh Circuit. Having difficulty determining the appropriate application of the Economic Loss Rule under Florida law, the Eleventh Circuit certified five questions of law to the Florida Supreme Court.

### Florida Supreme Court Decision

Prior to addressing the questions of law certified by the Eleventh Circuit, which, ultimately, led to the court crafting a more precise framework for the application of the Economic Loss Rule, the Florida Supreme Court extensively reviewed the rule's origin and purpose as well as its application under Florida law. In so doing, the court recognized that in Florida the Economic Loss Rule has been applied in two separate circumstances: (1) when the parties are in contractual privity and a party seeks to recover damages in tort for matters arising from the contract; and (2) when there is a defect in a product that causes damage to the product but causes no personal injury or damage to other property. Each of these circumstances has its own justification for the application of the Economic Loss Rule. The following is a brief overview of the origin and purpose for each of the circumstances where the rule has been applied.

### Contractual Privity Economic Loss Rule

According to the Florida Supreme Court, "[t]he prohibition against tort actions to recover solely economic damages for those in contractual privity is designed to prevent parties to a contract from cir-

cumventing the allocation of losses set forth in the contract by bringing an action for economic loss in tort.” The assumption underlying this rule is that “parties to a contract have allocated the economic risks of nonperformance through the bargaining process.” A party who attempts to circumvent the contractual agreement by making a claim for economic loss in tort is effectively seeking to obtain a better bargain than it originally made. To preclude such unilateral reallocation of contractual risks, courts apply the Economic Loss Rule to bar tort actions where the breach of the duty giving rise to the action exists only by virtue of a contract. In other words, under this application of the rule “breach of contract alone, cannot constitute a cause of action in tort ... and it is only when the breach of contract is attended by some additional conduct which amounts to an independent tort that such breach can constitute negligence.”

### Products Liability Economic Loss Rule

The Economic Loss Rule as applied in the product liability context has a distinct origin and purpose. As noted by the Florida Supreme Court, “[i]n contrast to the contractual privity economic loss rule, which developed to protect the integrity of the contract, the products liability economic loss rule developed to protect manufacturers from liability for economic damages caused by a defective product beyond those damages provided by warranty law.” That is, without the “protections” of the Economic Loss Rule a product manufacturer’s liability for economic loss caused by a defective product would no longer be limited to just those consumers who are in contractual privity with the manufacturer (i.e. under a warranty theory), but would extend to every consumer who subsequently obtained possession of the product. Thus, in the products liability context the Economic Loss Rule serves to limit tort liability to injury caused to persons or damage caused to property other than the defective product itself.

### Florida’s New Framework for the Rule

As described above, in *Indemnity Insurance Co. v. American Aviation*, the Florida Supreme Court was asked to determine the applicability of the Economic Loss Rule in a case where there was no privity of contract between the parties and the defendant was not a product manufacturer or distributor. After reviewing the origin, purpose and application of the rule under Florida law, the Florida Supreme Court determined that the Economic Loss Rule should **not** be extended to this case to preclude an action against

the defendant.. In support of its holding, the court referred to cases where it had permitted recovery for purely economic loss and explained that those situations:

[S]erved as reminders of the distinct limitations of the economic loss rule. Today, we again emphasize that by recognizing that the economic loss rule may have some genuine, but limited, value in our damages law, we never intended to bar well-established common law causes of action, such as those for neglect in providing professional services. Rather, the rule was primarily intended to limit action in the product liability context, and its application should generally be limited to those contexts or situations where the policy considerations are substantially identical to those underlying the product liability-type analysis.

In light of the above considerations, the court determined that the Economic Loss Rule, as applied in Florida, should be expressly limited because “actionable conduct that frustrates economic interests should not go uncompensated solely because the harm is unaccompanied by any injury to a person or other property.” Accordingly, the court set forth the following framework for the application of the Economic Loss Rule:

1. When the parties have negotiated remedies for nonperformance pursuant to a contract, one party may not seek to obtain a better bargain than it made by turning a breach of contract into a tort for economic loss. In other words, the court reaffirmed the contractual privity Economic Loss Rule.
2. A manufacturer or distributor in a commercial relationship has no duty beyond that arising from its contract to prevent a product from malfunctioning or damaging itself. Said differently, the court reaffirmed the products liability Economic Loss Rule. Please note that the “other property” aspect of the rule is still viable (i.e. a negligence claim can be asserted when the defective product damages “other property” even when there is no personal injury).
3. The exceptions to the privity of contract or products liability applications of the rule are still applicable and are reaffirmed. These exceptions include tort claims for professional malpractice, fraudulent inducement, and negligent misrepresentation, or free standing statutory causes of action.
4. Claims for economic loss that do not fall into either of the two categories – privity of contract or products liability – should be decided by traditional negligence principles of duty, breach, and proximate cause.

---

## Comment: Application to Construction Relationships

The Florida Supreme Court's holding in *Indemnity Insurance Co. v. American Aviation*, may have significant implications for certain members of the construction industry in Florida. That is, engineers, designers, inspectors and others members of the industry similarly situated may now be liable to third parties, with whom they have no contractual relationship, for purely economic damages. As alarming as this may sound, it is not at all certain whether this will create a flood of new litigation as the litigants will still have to satisfy the traditional elements of a negligence claim. As noted by Justice Cantero in his concurring opinion: "The 'duty' prong remains a strong filter in these cases – virtually as strong as the [economic loss] rule itself."

Ramsey Kazem  
404/582-8065  
rkazem@smithcurrie.com

---

## Termination for Convenience Clauses – Federal and State Law Considerations

### 500 Overview

Termination for convenience clauses have a long history in federal government contracts. In effect, the termination procedures and limits on recovery have been viewed as a substitute for breach of contract damages. *See, G.L. Christian & Assoc. v. United States*, 160 Ct. Cl. 1, 10-11 (1963). The concept of a termination for convenience was developed principally as a means to reduce the procurement effort and related liabilities at the conclusion of the two World Wars in the Twentieth Century. As a general rule, a termination for convenience clause entitles the federal government to terminate the contract when that action is in the "Government's interest." Subject to certain limitations and exceptions, the contractor is entitled to be paid the cost of performance through the termination, on a reasonable profit on that cost and its settlement expenses associated with the termination process. However, as a general rule, the contractor is not entitled to recover its lost anticipated profits or consequential damages such as unabsorbed overhead, which continues past the termination date. Consistent with the limitations of liability in the federal Termination for Convenience clause, the government's standard default clause (FAR § 52.249-10 Default (Fixed Price Construction)) provides that an erroneous default of a contractor "will be the same as if the termination had been issued for the convenience of the Government."

Even with this background and the treatment of the

termination for convenience clause as a mandatory clause in federal government contracts, a continuing question is whether there are any limits on the federal government's right to terminate a contract and limit its liability under the terms of a termination for convenience clause. Seeking to address the question of the breadth of the "Government's interest" in terminating a contract, the United States Court of Appeals for the Federal Circuit has moved away from a requirement that a termination for convenience can only be justified when there is a change of circumstance. Rather a challenge to the application of a termination for convenience clause seems to be limited to situations where the federal government had entered into a contract with no intent to perform it. *Krygoski Const. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996). To support a claim that the federal government's termination for convenience was in "bad faith", the federal circuit adopted the standard of "clear and convincing" as the burden of proof and equated that to the "irrefragable proof" standard previously articulated by that court. *Am Pro Protective Agency, Inc. v. United States*, 281 F.3d 1234 (Fed. Cir. 2002). While the Federal Circuit has not completely eliminated the potential for a bad faith termination (breach) claim against the federal government, the bar has been set very high. At the present time, it seems clear that the federal government does not have to demonstrate a "change in circumstance" to avail itself of the protection afforded it under the standard termination for convenience clause.

For various reasons, many contractors elect not to compete for federal government contracts. However, practices and provisions, which develop in the context of federal construction projects, often migrate to state and local contracts and even to the contracts used on private projects. One example is the very widespread use of various versions of a "Differing Site Conditions" clause in construction contracts. Similarly, many owners and contractors now employ versions of a "Termination for Convenience" clause in their prime contracts and subcontracts. If such a clause is utilized, the contract drafter needs to consider whether or not the interpretation of that clause under state law will mirror the principles set forth by the Federal Circuit in deciding federal government termination for convenience disputes. This is especially important if the termination for convenience clause is contained in a subcontract relating to the performance of work on a federal government construction project.

### Terminations for Convenience – State Law Interpretation of Rights

As seen by the four decisions noted below, state courts are not consistent in strictly following the principles and policies reflected in the decisions of the Federal Circuit. In

fact some states seem relatively hostile to the practice of allowing a party to convert a wrongful termination for default to a termination for convenience.

### Grounds for Termination

One key issue in the recent state court decisions is whether a “change of circumstance” is necessary to justify a termination for convenience. Decisions from New Jersey and Kentucky illustrate different answers to that question.

Relying heavily on federal law, the New Jersey appellate court in *Capital Safety, Inc. v. State of New Jersey*, 369 N.J. Super 295 (Ap. Div. 2004), found that the state did not act in bad faith in issuing a termination for convenience after an asbestos removal project had been delayed for several months, where the state would have faced substantial delay damages if the project continued. The court stated that avoidance of these damages was in the interests of the owner and upheld the termination for convenience.

In *Ram Engineering & Const. v. Univ. of Louisville*, 127 S.W. 3d 579 (Ky. 2003), a protest was filed challenging the award of a contract for the site preparation for construction of a football stadium. The University and the protester entered into a stipulated dismissal of the protest that called for the project to be re-bid. The contract was terminated for convenience. On re-bid, the awardee again won, and sued for the difference between its original price and its revised lower price in the re-solicitation. The Kentucky Supreme Court held that a contract issued under the Kentucky Model Procurement Code was subject to the obligation of both parties to perform the contract in good faith and therefore a termination for convenience could only be justified by a change in circumstances. The stipulated dismissal was not a change in circumstances.

### Wrongful Default Termination

As noted above, the federal government contracts expressly provide that an erroneous or wrongful termination for default shall be deemed to be a termination for convenience, i.e., constructive termination for convenience. In some states, similar assertions have had less success.

In *Ry-Tan Construction, Inc. v. Washington Elementary School Dist.*, 93 P.3d 1095 (Ariz. Ct. App. 2004), the court rejected the argument by the defendant School District that its improper cancellation of the contract should be regarded as a constructive termination for convenience, precluding breach damages. The court instead held that the constructive Termination for Convenience Doctrine was developed to protect the federal government and a constructive termination for convenience would only be applied to a state contract where there was a change in the circumstances of the bargain or in the expectations of the parties. The court stated that a termination for convenience

“whether constructive or actual. . . is not an open license to dishonor contractual obligations.” Similarly, in *Milgard Corp. v. E.E. Cruz*, 2004 U.S. Dist. LEXIS 12401 (S.D.N.Y. July 2, 2004), the court would not allow an unjustified termination for default of a subcontractor to be converted to a termination for convenience where the terminated subcontractor suffered prejudice. Specifically, the prejudice suffered by the subcontractor in this case was the loss of bonding capacity.

### Comment

These decisions illustrate that termination for convenience clauses can be and are being widely employed on contracts in the private sector and on local and state contracts. When utilized, care must be exercised to consider how state law applies to the specific contract relationship. The federal norm regarding this type of clause may not be followed in every state. Contract and subcontract language needs to be evaluated in light of these differences. In addition, a party drafting a contract should consider the effect of state law or court decisions addressing choice of law clauses in construction contracts and subcontracts.

*Thomas J. Kelleher, Jr., 404-582-8016*

*James B. Taylor, 404/582-8048*

[tjkelleher@smithcurrie.com](mailto:tjkelleher@smithcurrie.com)

[jbaylor@smithcurrie.com](mailto:jbaylor@smithcurrie.com)

## Common Sense Contracting Electronic PDF Edition

For over 18 years, Smith, Currie & Hancock attorneys have been pleased to write and publish a practical newsletter for our clients and friends in the construction industry. During that period of time, we have continually sought to improve the newsletter’s value to you. Consistent with that goal, our newsletter is now available in an electronic (pdf) format. All that you need to read and print copies of the newsletter is a copy of the **Acrobat** software program. A no cost version of that software is available at [www.adobe.com](http://www.adobe.com). If you wish to receive future issues of our newsletter in an electronic format, please provide us the e-mail address which should be used for that purpose. You may e-mail that address to [schnewsletter@smithcurrie.com](mailto:schnewsletter@smithcurrie.com).

Receiving the newsletter in an electronic format will ensure quicker delivery, facilitate distribution of copies within your organization, as well as reducing our mailing expense. We urge you to consider and utilize this option.

## UPCOMING SEMINARS

**Form Contracts and General Conditions of the Contract for Construction**, April 19, 2005, Lorman Education Services, Tallahassee, FL. For registration information call: 800/678-3940. *F. Alan Cummings, S. Elysha Luken.*

**Tricks, Traps and Ploys Used in Construction Scheduling**, April 27, 2005, Lorman Education Services, Jacksonville, FL. *Joseph C. Staak and S. Gregory Joy.*

**Tricks, Traps and Ploys Used in Construction Scheduling**, April 29, 2005, Lorman Education Services, Atlanta, GA. *Joseph C. Staak and S. Gregory Joy.*

**Recent Developments in Georgia Construction Law**, May 5, 2005, Atlanta Electrical Contractors Association, Atlanta, GA. *Philip E. Beck.*

**Mold Remediation: Skills and Strategies to Successfully Cope with a Mold Outbreak in Retail Environments**, May 12, 2005, Retail Construction Expo, Georgia World Congress Center, Atlanta, GA. *Philip E. Beck and James K. Bidgood, Jr.*

**Construction Delay, Acceleration and Inefficiency Claims**, June 8-9, 2005, Federal Publications, Inc., Las Vegas, NV. *Reginald M. Jones.*

**Risk Allocation Management Saves Money**, June 13, 2005, American Water Works Association, San Francisco, CA. *Philip E. Beck.*

**Public Works Construction: Legal Dynamics in Public Contracting**, June 17, 2005, Lorman Education Services, Atlanta, GA. *Thomas J. Kelleher, Jr., Joseph C. Staak, and S. Gregory Joy.*

**AIA Contracts**, June 17, 2005, Lorman Education Services, Jacksonville, Florida. *F. Alan Cummings and S. Elysha Luken.*

**The Fundamentals of Construction Contracts in Georgia: Understanding the Issues**, June 23, 2005, Lorman Education Services, Macon, GA. *S. Gregory Joy, Gene J. Heady, and Ramsey Kazem.*

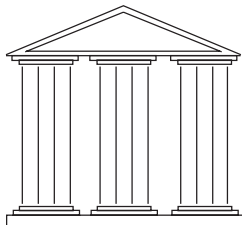
**The Fundamentals of Construction Contracts in Georgia: Understanding the Issues**, June 24, 2005, Lorman Education Services, Atlanta, GA. *S. Gregory Joy, Gene J. Heady, and Ramsey Kazem.*

**AIA Contracts**, July 15, 2005, Lorman Education Services, Pensacola, FL. *F. Alan Cummings and S. Elysha Luken.*

**The Contractor's Perspective on Construction Defects**, July 15, 2005, The Seminar Group, Atlanta, GA. *Philip E. Beck.*

**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.*



### Smith, Currie & Hancock LLP

233 Peachtree Street, N.E.  
Suite 2600  
Atlanta, Georgia 30303-1530  
404/521-3800

PRESORTED STANDARD  
US POSTAGE  
PAID  
PERMIT NO. 4866  
ATLANTA, GA

Address Service Requested