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Email from America

A special supplement on Construction and Engineering law in the U.S.

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MAYER BROWN ROWE & MAW

Email from America (It may not be Posh but it's cool)

We can't pretend it's on the same scale of magnitude as exporting the Beckhams to LA but M,B,R & M has done its bit for global teamwork by asking a galaxy of our construction and engineering colleagues in Houston and Chicago to answer our questions on construction and engineering law in the States.

So, if you missed Victoria's TV programme here's another piece of good fortune. We hope the answers will be of particular interest to potential newcomers to the U.S. construction and engineering market.

1. ***How does the construction and engineering industry deal with the fact that each state has its own courts, and contract and tort law are matters of state law and may or may not be the same? How, for instance, are choices made about the law applicable to the contract and the state court that has jurisdiction?***

Probably as a result of both the widespread use of standard construction contract forms and the legal profession's tendency to "borrow" the common law of sister states when analyzing complicated construction-related issues, construction law has evolved toward near uniformity within the fifty states. There are, however, significant differences, both statutory and common law, that in a given situation can have a dramatic impact on one or more of the parties to a construction project. Statutory examples include differing statutory deadlines and notice requirements under state lien laws[1], and limitations on the amount and duration of retainage withheld from contractors' or subcontractors' payments. Common law examples include the existence and effect of implied contractual covenants, such as the implied covenant to provide sound plans and specifications, to not unreasonably impede the progress of the project, to reasonably coordinate and schedule the project, to avoid a "cardinal change" to the contract, etc.

In order to select a (hopefully) predictable body of law to govern the contract, the parties will normally include a "choice of law" (or "governing law") provision in the contract. As long as the law so chosen has a "significant connection" to the contract's performance, the choice will be upheld by a judge or arbitrator as the law by which the contract will be interpreted and construed. As the "customer" or "buyer", the owner typically insists on the state's law it is most comfortable with, namely that of its principal place of business, as the governing law. However, the law of the state of the location of the project, of the principal place of business of the project's principal financier or the contractor, would also be logical choices. Notwithstanding the parties' selection of an applicable body of law, however, certain laws of the state of the location of the project will override the contract's governing law provision by statute or public policy (e.g., lien laws are always determined by the laws of the location of the project and some states have laws that may limit the enforceability of certain contractual indemnity provisions).

1 (Editor's note) Lien laws generally allow contractors to register an unpaid debt for improving a property, against the property (subject to complying with relevant procedures). They do not generally apply to public projects (federal or state/local government).

In addition, the construction contract will often include, either as part of a dispute resolution clause or separately, a "choice of forum" clause, typically selecting the court of competent jurisdiction of the location of the project as the exclusive forum for disputes arising out of the contract. The selection of the court of competent jurisdiction of the location of the project will normally be upheld. Choosing a distant forum, such as the owner's principal place of business, may result in due process or service of process issues if the contractor does not have a registered agent in that jurisdiction. Since many states now enforce contractual provisions which waive jury trials, many choice of forum clauses also include a jury trial waiver provision. A jury trial waiver provision is often used in lieu of an arbitration clause, in order to allow for discovery and appeals.

Since most construction disputes will involve multiple parties, including but not limited to owners, contractors, subcontractors, designers, suppliers, surety companies and lenders on projects, the choice of law and dispute resolution procedures need to be well thought out and planned to address the nuances of a particular project if problems arise. Not surprisingly, the choice of law and dispute resolution provisions are frequently the least discussed or negotiated provisions in the contract documents. We believe this is true across the board for most construction projects, whether inside or outside the U.S.

2. What is currently the most popular contract procurement route in the U.S.?

The most popular procurement contract form for industrial projects is the so-called EPC ("engineering, procurement and construction") contract. Under this contract form, the owner selects a contractor to both design and construct the project in accordance with the owner's initial set of criteria. Typically, these projects are contracted on a cost-plus basis with a guaranteed maximum price to be established at a pre-determined stage of completion of the project design and major equipment procurement. The owner (through its construction manager agent) retains certain design and construction oversight rights. The feasibility of industrial projects hinges on their economics, which are improved by the shortened delivery time resulting from the contractor's ability to stage the design, procurement and construction in the most advantageous manner and by the contractor's ability to perform value engineering and "constructability reviews" during design and procurement (with cost and time savings benefits accruing to both the owner and the contractor). Due to the overheated U.S. industrial construction market of the last few years, there has been a steady further evolution from the traditional EPC contract to the EPCM ("engineering, procurement and construction management") contract whereby there is only "target pricing" with no real top-side cost risk for the contractor, other than a potential reduction of its fee percentage if it misses the target.

In non-industrial construction (office towers, hospitals, etc.), the traditional fixed-price construction contract and three-party arrangement consisting of the owner (including its construction manager agent), the architect/engineer, and the contractor, has been gradually overtaken over the last three decades by "design-build" construction. In "design-build" construction, the contractor designs the project in accordance with general parameters established by the owner at the outset and builds the project on a cost-plus basis with a guaranteed maximum price, as with EPC contracts. Now that the novelty of "design-build" has worn off, there is a partial swinging back of the pendulum to the traditional three-party arrangement, some say as a result of

sophisticated owners becoming leery of contractors later hitting them with change orders because the scope of work was not fully developed when the "design-build" contract was signed.

The traditional fixed-price three party arrangement remains dominant in public construction projects due largely to procurement laws requiring competitive bidding, which in turn requires completed plans and specifications. These public procurement laws often date back, in spirit if not in wording, to the late 19th century when legislatures dealt with widespread procurement abuses. However, even in the public sector, the federal government and many states have enacted "fast-track construction" legislation which allows "design-build" delivery of certain types of projects, particularly those needed quickly, e.g., prisons, military installations, toll roads.

It is generally acknowledged that the primary advantage of the traditional arrangement (owner retaining the architect/engineer) is greater owner control over the final design since the owner, rather than the contractor with its possibly divergent interests, engages the designer directly. It is also generally acknowledged that the traditional arrangement has disadvantages, which include increased time from commencement to completion (due to the necessity to complete the design prior to selection of a contractor), reduced "constructability" and value-engineering input into the design (due to the absence of the contractor during the design phase), and the possibility of diffusion of responsibility with regard to defects (due to the contractor and designer each separately contracting with the owner). As expected, "design-build" and EPC contracts are generally acknowledged to experience the converse of the advantages and disadvantages of the traditional arrangement.

In contractual forms involving fixed prices or guaranteed maximum prices, payment and performance bonds should be considered to secure the contractor's obligation to pay its subcontractors and suppliers and to complete the project for the contract amount.

3. Are standard forms of construction and engineering contract used in the States? If so, which are the most popular and who produces them?

By far the most common construction industry forms are those promulgated by the American Institute of Architects ("AIA"). The AIA forms come in three families, the A Series which includes owner-contractor, owner-construction manager (contractor) and owner-design builder forms, the B Series which includes owner-architect and owner-construction manager (agency) forms, and the C Series which includes owner-engineer and owner-consultant forms. The AIA also publishes many other very useful and widely used documents such as forms for performance bonds, payment bonds, change orders, construction change directives, applications and certificates for payment, certificates of substantial completion, affidavits of payment, releases of liens and claims, consent of surety to final payment, etc. In addition, many "manuscript" construction contracts are based largely on the AIA forms with modifications introduced by one or both parties. The AIA forms are so ubiquitously used in the U.S. that there is at least one published treatise that provides advice to owners and contractors as to suggested modifications to the applicable AIA forms. There is also a regularly published citator service that reports appellate decisions interpreting the various AIA contract sections. AIA forms can be found at www.aia.org.

In addition, the Design-Build Institute of America ("DBIA"), the National Society of Professional Engineers ("NSPE"), and the Associated General Contractors of America ("AGCA") publish standard forms as well. The DBIA forms are limited to the "design-build" process; the NSPE forms are generally considered to be better suited for projects with heavy engineering content; and the AGCA forms are considered to be more contractor-friendly than the AIA forms. The DBIA forms can be found at www.dbia.org, the NSPE forms at www.nspe.org, and the AGCA forms at www.agc.org.

Given the bias that each of the above organizations brings to its standard form contracts in favor of its institutional members (e.g., the AIA's favorable treatment of architects), owner's counsel are well advised to heavily modify and amend these standard forms in their initial drafting of proposed project contracts.

4. What is currently the most popular dispute resolution route in the U.S.?

The most popular standard construction contract forms, the AIA forms, contain provisions requiring arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association currently in effect. Many "manuscript" construction contracts also include arbitration clauses. Some states (e.g., Texas) have enacted legislation requiring arbitration in the case of residential construction contracts. As a result of the foregoing, most construction industry disputes in the U.S. are arbitrated, although a good number are still litigated in the court system as evidenced by the number of construction case decisions reported annually. Arbitration is much less common for public construction projects (i.e., contracts with public entities), due both to the perception of public entities that they will fare better in the court system as well as statutory restrictions governing many state and local projects.

As a growing counter trend, more and more construction contracts are including jury waiver clauses as a means of avoiding protracted arbitration, providing for discovery and rights of appeal, and avoiding unpredictable jury verdicts.

5. Is there, in the U.S., any equivalent to the UK construction and engineering dispute resolution process (DRP) of adjudication?

There is no U.S. equivalent of the U.K.'s DRP process for construction and engineering disputes. However, some states (e.g., Texas) have legislated certain preliminary requirements that must be met before filing certain professional liability suits. In Texas, the Certificate of Merit statute requires that in order to file a claim for professional malpractice against architects, engineers or land surveyors, the plaintiff must file, along with the original petition filed to initiate the case, an affidavit signed by a licensed professional in the same professional specialty area attesting to the defendant's failure to follow the applicable standard of care (i.e., negligence). While the stated purpose of the Certificate of Merit legislation is to prevent frivolous lawsuits, many practitioners believe that such requirements mainly serve to make it more difficult and expensive to maintain meritorious claims.

6. ***Under English law, purchasers, tenants, operators and funders of developments expect to be given contractually binding warranties by the designers and main contractor with whom, otherwise, they have no contract (and therefore no contractual remedy) if defects are subsequently found in the building. This arrangement compensates for the lack of an appropriate remedy in the tort of negligence. Do U.S. construction and engineering projects deal with this issue in the same way?***

This practice is not yet prevalent in the United States. However, with the continued expansion over the last several years of the so-called "economic loss doctrine" into the realm of construction law, whereby a person is generally prohibited from recovering damages in tort for purely economic loss (i.e., prohibited from recovering damages in tort except for personal injury or damage to property other than the property being sold, constructed or designed by the defendant), such warranties may well be forthcoming. As a means of overcoming the "economic loss doctrine" and allowing the owner to have direct claims against subcontractors and suppliers, some practitioners draft general (or prime) contracts requiring that the contractor expressly designate the owner a third-party beneficiary in all subcontracts, including design subcontracts, and major supply contracts.

7. ***Is retention of a percentage from interim payments until final completion common practice in U.S. construction and engineering contracts?***

Yes, although the percentage retained by the owner varies by contract, often with the larger the contract the smaller the retention, and to some extent by state, due to the nuances of local lien law.

Traditionally, retention has been ten percent of each of the contractor's periodic payments until, typically, ninety days after completion of the project. In addition to the practical effect of allowing the owner a financial reserve in the event problems arise with the contractor, many states' lien laws effectively encourage retention by affording the owner additional statutory protection from claims and liens of unpaid subcontractors and suppliers if prescribed percentages (again, typically ten percent) are retained from contractor payments for the prescribed period, thereby creating a fund available to pay any unpaid subcontractors and suppliers. That being said, due to bargaining power, market conditions, and the use of payment and performance bonds, letters of credit or other security, the parties often negotiate different retention percentages, from five percent to even fifteen percent, and different retention milestones, from reduction from ten percent to five percent at 50% completion of the project all the way to full retention until the completion of the warranty period.

A contractor normally withholds the same percentage retainage from its subcontractors as the owner withholds from the contractor, although a subcontractor in a strong bargaining position may negotiate a better payment arrangement, particularly if the subcontractor has put up payment and performance bonds, or other security, in favor of the contractor. Some states have passed legislation stemming what is perceived as "retainage abuse". For example, Oregon has legislated a 5% cap on subcontractor retention, and other states require accrual of interest on retained funds. In a related matter, many states have passed "trust fund statutes" whereby funds received from the owner are deemed to be held in trust by the contractor and must be first applied to amounts due to laborers, subcontractors and suppliers, before the contractor may

use any portion of the funds for other purposes. Some trust fund statutes are even enforceable by criminal penalties.

On the related subject of payment, most states will enforce a carefully worded "pay if paid" subcontract clause, whereby the contractor is not required to pay the subcontractor for its work until the contractor is itself paid by the owner for the subcontractor's work. However, in order to be truly effective, the provision must clearly indicate that it operates as a condition precedent rather than merely as a "timing mechanism" covenant. Otherwise, a "pay when paid" provision will be found to have resulted, for which payment to the subcontractor will be required after a reasonable time has elapsed, without regard to whether or not the contractor has been paid.

8. ***In recent years there has been a move in the UK to promote a collaborative approach between employers and contractors under the banner of "partnering". Prior to this the relationship between contractors and employers was seen as more adversarial. What is the position in the U.S. – adversarial, collaborative or something else?***

A movement began in the U.S. several years ago to introduce the non-legal, collegial notion of "partnering" to denote teamwork, dialogue and co-operation between the owner, the contractor and the designer. One of the goals of this concept was the avoidance of legal disputes. This trend has largely ceased due, most likely, to the confusion created by the aspirational, versus the legal, meaning of the term "partnering". In a practical sense, however, partnering between contractors and designers, at least, does take place to some extent through the mechanisms of design-build and EPC contracts. In addition, contractors and designers may (subject to state licensing law restrictions) enter into joint ventures to share project profits and losses, which in turn may reduce the likelihood of a legal dispute between those two parties.

Although the term "partnering" is not much used in the U.S. anymore, more or less contemporaneously with the use of that term came the introduction of contract provisions requiring non-binding mediation of disputes as a condition precedent to commencement of arbitration or court filings. Some construction contracts provide for ad hoc mediation before a joint management representative group or specified expert, or mediation before one of several nationally recognized mediation associations. Two nationally recognized mediation associations often referenced in construction contracts include JAMS (www.jamsadr.com) and The Dispute Resolution Board Foundation (www.drb.org).

9. ***Do construction and engineering claims generally go to the state courts or to arbitration?***

Unless there is a clause in the construction or engineering contract calling for mandatory arbitration of disputes, any unresolved claims go to state court for resolution, or by way of a "diversity action" to federal court if the adverse parties are "citizens" of different states (based on their principal places of business or states of incorporation) or of a foreign country and a state, and the matter in controversy exceeds US $75,000.

However, even if a contract does not have an arbitration clause, the parties may agree after a dispute has arisen to take it to arbitration rather than court, but this occurs only rarely.

10. In England and Wales there is a specialist Technology and Construction Court. Do any U.S. states have specialist construction courts?

There are no specialist construction courts in the United States. However, persons with supply and service contracts, including construction contracts, with the United States Government or its agencies must take their claims against the government through administrative agencies and then specialized courts, e.g., the federal Armed Services Board of Contract Appeals and the Civilian Board of Contract Appeals. Many states have enacted their own administrative procedures and judicial procedures to handle claims by their contractors on public projects.

11. If a construction and engineering claimant is successful in its claim before a U.S. state court will it generally be unable to recover its legal costs? If that is correct is there a way round this?

Most construction contracts include provisions which award legal fees and costs to the prevailing party in any dispute to enforce the contract's provisions, and courts routinely enforce these provisions. In addition, indemnity provisions in construction and design contracts often include the recovery of reasonable legal fees and costs by one party (normally the owner) or both parties.

Otherwise, in the absence of a contractual provision, legal fees and costs incurred in prosecuting or defending lawsuits are not recoverable under the common law of the various states, except where provided by specific statute. For example, Texas has a statute that provides for recovery of reasonable attorney's fees by the prevailing claimant in a breach of contract action. An entire body of case law has developed with regard to the nuances of the application of this statutory provision.

12. Is the costs position the same in arbitration?

Under the rules of the American Arbitration Association, unless the parties have otherwise agreed in the underlying contract or as part of the arbitration process, the arbitrator may in his discretion award attorney's fees and arbitral costs as part of the final award. Such decision is presumably based on the arbitrator's perception of the relative merits and equities of the parties. Often the arbitrator will require each party to pay its own legal fees and to split the arbitral cost on the rationale that the claimant did not fully prevail on its claim (i.e., was not awarded 100% of its claimed amount).

13. Is there federal or state legislation (or both) on health and safety on construction and engineering projects?

The health and safety regulation of construction projects is under the jurisdiction of the federal Occupational Safety and Health Administration (OSHA). OSHA has jurisdiction over all but the smallest construction projects because of the presumption of interstate commerce in such activities. As an exercise of police power by the federal government, OSHA regulations preclude any conflicting state regulations (under the doctrine of federal "preemption"). States are not, however, prevented from imposing more rigorous standards, an example being California's CALOSHA regulations.

14. What are the current headline issues in construction and engineering law in the U.S.?

The most important trend in U.S. construction and engineering law is the overall fallout from the leverage presently enjoyed by contractors as a result of the current protracted building boom in the U.S. Contractors now wield much more bargaining power during contract negotiations resulting in more favorable contract terms in general, and in

the dearth of fixed price EPC contracts in many industry segments, including power, refining and petrochemical projects, in particular.

However, the building boom with its associated rise in building materials costs has on occasion cut both ways. Contractors attempting to pass on rising costs of building materials to owners in the absence of contractual cost escalation provisions have generally been unsuccessful, the courts viewing the present marked, but not yet disruptive, price hikes as being within the reasonable contemplation of the parties and, as compared to the entire project cost, not yet rising to the level of "commercial impracticability or impossibility" required in order for relief to be granted.

From a litigator's perspective, one of the most important issues in construction and engineering law, albeit not of a widely recognized "headline" nature because of its relatively slow acceptance and development by each state, is the continued expansion over the last thirty-odd years of the so-called "economic loss doctrine" into the realm of construction law. While subject to significant variation even among the adopting states, this doctrine generally precludes the recovery of tort damages for purely "economic loss" (i.e., precludes tort recovery except for personal injury or damage to property other than the property being constructed, sold or designed by the defendant). Needless to say, this restrictive doctrine results in the even more heightened importance of carefully drafted contract language in construction and design contracts. Perhaps the biggest beneficiaries of this doctrine are the design professionals, as their exposure to tort claims by non-privity parties (e.g., contractors in the traditional arrangement) is significantly limited.

Finally, perhaps one of the most dramatic recent legal developments is the body of decisions interpreting the fraud provisions of the federal Contract Disputes Act, which provides that if a contractor's inability to support his claim is attributable to misrepresentation of fact or fraud on the part of the contractor, he shall be liable to the (U.S.) government for an amount equal to such unsupported part of the claim in addition to all costs to the government attributable to the cost of reviewing said part of claim. In recent cases, the U.S. Court of Federal Claims has found that a claim of US $50 million in projected future damages (beyond the US$13.4 million in claimed presently incurred damages) were made as a "negotiating ploy". As a result, the court granted the government's counterclaim for fraud and awarded US$50 million to the government plus costs and attorney's fees. (*Daweoo Engineering and Construction Co., Ltd v. U.S.*, 73 Fed. Cl. 547 (2006), currently under appeal.) Another example is the case of *Morse Diesel International Inc. v. U.S*, 2007 WL 25918 (Fed. Cl. Jan. 26, 2007) in which the court held that the contractor's claim for reimbursement of bond premiums, the costs of which had not yet been incurred, was a violation of the Act, resulting in the contractor's legal forfeiture of its larger claim of US $53 million.

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