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Bid Protests on Federal Procurements: Navigating Confusing Waters

Introduction. Everyone in the government contract community is aware that a prospective contractor can protest a defective solicitation before a contract is awarded and can protest the contract award itself. However, many government contractors relegate bid protests to the dustbin

of bad business decisions because they regard them as “unwinnable” and, therefore, simply a waste of money. Our experience, however, has shown that by carefully analyzing the grounds for a protest, making the right strategic decisions, and then filing the protest in the right forum, a bid protest can be successful.

In a statistical sense, the odds against a successful protest are daunting. Historically, only about 15 to 21 percent of protests to the Government Accountability Office (GAO) have been successful. In part to discourage protests, many federal agencies are issuing solicitations that provide for an award decision based upon the “best value” to the government. This is a largely subjective standard that vests broad discretion in the source selection authority (“SSA”). GAO and the courts have generally been reluctant to substitute their judgment for that of the SSA.

Yet the sheer number of protests is increasing. In fiscal year 2004, 1,485 protests were filed with the GAO, almost 30 percent more than the number filed in 2001. Respected commentators in the government contract community have attributed this increase to a decrease in the quality of debriefings and the failure of federal agencies to implement agency-level protest procedures.

The Nash & Cibinic Report, Vol. 19, No. 1 (January 2005). This theory holds that post-award debriefings of unsuccessful offerors have become less informative, and, as a consequence, more disappointed bidders are motivated to protest because they do not understand the rationale for the contract award to a competitor.

Protest procedures do exist at many agencies, but most government contractors are either unaware of the existence of this forum or believe that GAO is more likely than the agency to render an objective decision. Contractors understandably ask: how can the agency that rejected my bid fairly decide my bid protest? Consequently, the prevailing supposition that increasing numbers of disappointed bidders turn to GAO because of a lack of agency-level protest procedures is simply incorrect.

The fact is that most agencies encourage informal communications regarding procurement defects before a formal protest is filed. More broadly, the Federal Acquisition Regulations (FAR), which apply to all federal agencies with the “force and effect of law,” establish a policy favoring the informal resolution of protests. “Prior to submission of an agency protest, all parties shall use their best efforts to resolve concerns raised by an interested



party at the contracting officer level through open and frank discussions.” FAR 33.103(b).

Agencies have great flexibility in establishing protest procedures, including the use of alternative dispute resolution (ADR). FAR 33.103(c) provides: “The agency should provide for inexpensive, informal, procedurally simple and expeditious resolution of protests. Where appropriate, the use of alternative dispute resolution techniques, third-party neutrals and another agency’s personnel are acceptable protest resolution methods.” The DOE has implemented FAR 33.103 by issuing regulations stating that DOE “encourages direct negotiations between the offeror and the contracting officer in an attempt to resolve protests.” DEAR 933.103(j). DOE “favors” ADR and requires a protester to state in the protest whether it is willing to utilize ADR. *Id.*

Our experience has shown that agency-level protests should not be overlooked. One reason is that a protest can be filed at GAO *after* it has been denied by the agency, so the GAO is usually available as a forum, anyway, giving the contractor “another bite of the apple.” More importantly, agencies do not want their procurement decisions to be scrutinized and

solicitation or the manner in which a proposal is being treated by the agency. In one recent case, an information technology (IT) client would have been precluded from bidding on an Indefinite Delivery Indefinite Quantity (IDIQ) contract because the solicitation required contractors to offer a complete range of IT-related services, from data processing to computer hardware and software. Multiple contractors could be eligible for award of the “umbrella” contract, and then the work would be parceled out to the selected contractors in individual Task Orders.

Because of the way the solicitation was structured, only a limited number of contractors could meet all of the solicitation’s requirements. Our client wanted to be eligible only for “commercial item” Task Orders, but could not bid on the umbrella contract because of the breadth of its requirements. P&A assisted in developing a constructive approach that apparently convinced the agency that it could maximize competition (at a lower cost) by revising the solicitation to provide for two tiers of contractors: those contractors who provide the full range of IT services and products, and those contractors who would be eligi-

Finally, in a case decided in August 2005, the Department of Energy sustained an agency level protest of the award of a \$30 million contract for logistics services. The procurement was a “public-private” competition under OMB Circular A-76. The award was to be made to the proposal offering the best value to the government, based upon price, technical quality and other considerations. In this matter, the client was not a contractor, but DOE’s Agency Tender Official — DOE’s designated executive to serve as the offeror on behalf of the agency. In our protest (called a “contest” in the world of A-76), we argued that the DOE’s competitive sourcing office had failed to follow the evaluation criteria set forth in the solicitation. The Senior Procurement Executive agreed and issued a decision suspending the contract award and requiring the competitive sourcing office to reevaluate the proposals in strict accordance with the evaluation criteria in the solicitation or, if necessary, to re-compete the work (See “U.S. Department of Energy Sustains Decision To Outsource on page 5.”)

If GAO had decided those same protests, the results could well have been different. Statistics regarding the rate of success in agency-level protests are not available. However, we do know that the odds weigh heavily against a protest to GAO, and our recent experience with agency-level protests strongly suggests that contractors should give serious consideration to agency protests as an alternative.

Potential Pitfalls and Strategic Considerations. One of the reasons that agency level protests are an underutilized resource is probably that the regulations governing such protests vary from agency to agency, and the regulations themselves are often not models of clarity. Contractors may also be unsure about the relationship between agency-level protests and GAO protests.

Timeliness is always an important consideration. Protests based upon improprieties in a solicitation must be filed “before bid opening or the closing date for receipt of proposals. In all other cases, protests shall be filed no later than 10 days after the basis of

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reversed by GAO. If a disappointed bidder can show the agency that its solicitation is defective or that its source selection procedures were inconsistent with the requirements of the FAR, the agency’s own regulations or the evaluation factors set forth in the solicitation, the odds are reasonably good that the agency will amend its solicitation or sustain a protest. This is illustrated by several recent cases handled by P&A’s Government Contracts Practice Group.

Recent Protests. The relief sought by a prospective contractor can sometimes be obtained by the simple expedient of pointing out to the Contracting Officer the defects in a

ble only for commercial item Task Orders. The agency suspended the solicitation to take corrective action.

In another recent case, it was necessary to file a formal protest with the agency due to time limits on protests (*discussed more fully below*). The client was a manufacturer of military armor, and the agency had rejected the proposal as non-responsive because of the late submission of “first articles” of the armor for testing and approval. The protest pointed out that the agency had previously tested and approved the same armor, and that the proposal included the test data from the previous testing. As a result, the bid was fully responsive, and the agency agreed and accepted the proposal.

protest is known or should have been known, whichever is earlier.” FAR 33.103(e).

These time limits are *strictly enforced*. If filing a protest has been delayed for any reason other than the procuring agency’s fault, the protest will be rejected as untimely. Agencies have the discretion to accept untimely protests, but they rarely do. So, for example, it is not an adequate excuse that a telecommunications network has crashed and a protester could not file the protest by facsimile, or the messenger carrying the protest has been in an automobile accident, or the messenger arrived at the appropriate government facility but went to the wrong entrance and was delayed until several minutes after the deadline. In each of these cases, protests have been rejected as untimely.

It is also important to note that time limits are not tolled because the protester is engaged in an informal dialogue with the Contracting Officer or in some form of ADR. Contractors should not be lulled into a false sense of security simply because their

concerns are sympathetically received by the government. To summarize, *all risk of untimeliness, other than agency fault, is considered to have been assumed by the protester.*

The rules of GAO and the agencies are not always in concert. For example, under the rules that apply to a GAO

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protest, a disappointed bidder can wait to file a protest until five days after a debriefing is conducted. Note, however, that no such grace period specifically applies to agency-level protests. The FAR simply provides that, if a protest is filed with an agency within 10 days of contract award or five days of debriefing, whichever is later, the agency will ordinarily suspend the contract award pending the outcome of the protest. In other words, the protester

cannot wait until after a debriefing to file a protest, but if the protest happens to be filed within those time periods, the contract will normally be suspended. Consequently, a protest to an agency of a contract award should always be filed within 10 days of contract award to ensure that the protest is timely and that the awarded contract will be suspended.

After the protest is filed with an agency, the procedures that the agency follows in reaching a decision are not well defined. For example, the regulations do not give the protester the right to receive relevant documents and information. Instead, “to the extent permitted by law and regulation, the parties may exchange relevant information.” FAR 33.103(g). As contrasted with GAO protests, which authorize the protester and intervenors to receive copies of the agency report” on the protest and to file a response to the report, agencies are not required to provide the agency report to the protester or to allow a response thereto. The regulations simply require that “Agency protest decisions shall



ILLUSTRATIONS: LIAM ROBERTS

be well-reasoned and explain the agency position.” FAR 33.103(h).

Protesters are well-advised to press the agency to follow GAO’s guidance and to allow access to the agency report and the right to respond to the report. Sometimes the agency has to be convinced that, only by allowing the protester access to the agency report and receiving the protester’s input, can the agency provide a “well-reasoned” decision as promised by the FAR.

One of the advantages of an agency-level protest is expeditiousness. The regulations provide that, “Agencies shall make their best efforts to resolve agency protests within 35 days after the protest is filed.” FAR 33.103(g). Although it is not uncommon for agencies to exceed this target, our experience has shown that agencies do decide protests expeditiously. This is particularly so where the

circumstances, a protester should usually elect to have the Procurement Executive decide the protest to ensure a greater level of objectivity. This is a good example of the types of strategic decisions that can only be made with a thorough understanding of the regula-



protester, a *detailed* statement of the factual and legal grounds for the protest, along with supporting documentary exhibits and a “description of the resulting prejudice to the protester.” From a strategic standpoint, it is crucial that a protester state his or her *best case* in the initial protest because, in an agency-level protest, there is no guarantee that the protester will ever see the agency report or be provided another opportunity to state their position.

A protester should also be sure that the protest states the specific relief sought. In most cases, protesters are well-advised to request a “menu” of alternative forms of relief. As a practical matter, a “win” in a bid protest is a decision that the contract will be suspended or terminated and that the procurement will be recompeted or the proposals will be reevaluated. Only in extremely rare cases will an agency or GAO order that the contract be awarded directly to the protester. If the protester can show that it alone would remain eligible for award after the agency implements the corrective action ordered in the agency’s or GAO’s decision, then a request for this form of relief should be considered.

Another form of relief that protesters should seek is award of attorneys’ fees and bid-and-proposal costs. Under GAO’s rules, GAO may order the agency to reimburse the protester if the protest has shown that the solicitation, evaluation of proposals or contract award does not comply with applicable statutes or regulations.

Conclusion. Generalities about bid protests are not particularly useful and often wrong, particularly with regard to the viability of agency-level protests. Whether and where to file a bid protest, as well as the arguments to make and the relief to seek, all depend upon the specific facts and circumstances surrounding the procurement in question. Nevertheless, with careful analysis and sound strategic decisions, bid protests *can* be successful. ■



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In most cases, protestors are well-advised to request a “menu” of alternative forms of relief.

contract award has been suspended. By contrast, the time period for a decision by GAO is normally at least 100 days. One of the reasons for the longer time period at GAO is that GAO will often allow depositions to be taken or will conduct an evidentiary hearing, with witnesses who are examined and cross-examined. No procedure exists for evidentiary hearings in connection with agency-level protests, and, as mentioned above, exchanges of relevant information are encouraged but not specifically required.

Agencies typically designate a senior-level procurement executive to decide protests. The Federal Aviation Administration has established its own quasi-independent dispute resolution group, the Office of Dispute Resolution for Acquisition, which decides bid protests and contract disputes. DOE has an interesting procedure: Protests are decided by the Head of the Contracting Activity (HCA) *unless* the protester requests that the decision be made by the Procurement Executive or certain other conditions apply. Even though the HCA may not be the Contracting Officer (CO) on the procurement in question, he or she may be the superior of the CO. In such

tions and the organizational structure of the procuring agency.

If a protester decides to pursue a collateral protest at GAO, the protester must be wary of a dangerous procedural pitfall. GAO’s rules provide that a protest must be filed within 10 days after the protester learns of “initial adverse agency action” with regard to the protest. 4 C.F.R. § 21.2(a)(3). For example, if the Contracting Officer advises the protester in a telephone conversation that the protest will be denied, this starts the 10 day clock. If the CO. tells the protester nothing, but does proceed with bid opening or the receipt of proposals or an award of the contract during the pendency of a protest, this is also considered an initial adverse agency action that will start the 10-day clock. Therefore, a protester must be vigilant and attentive to the signals received from the government and cannot count on receiving a definitive decision on the protest before the time expires to file with the GAO.

The contents of the protest document (usually in the form of a letter addressed to the Contracting Officer) should include, in addition to an identification of the procurement and the

U.S. Department of Energy Sustains Decision to Outsource Services

Contests Against the Award Under RFQ No: DE-RQ01-04ME90001

What is believed to be the first ever successful challenge to an award decision in favor of a federal agency's bidding organization in an OMB Circular A-76 procurement, the senior procurement executive of the United States Department of Energy (DOE) sustains an agency tender official's contest of the government's decision to outsource logistics services at

Washington, D.C., headquarters facilities.

In June 2004, the DOE issued a Request for Quotations (RFQ) for the performance of logistics and maintenance services at the DOE's headquarters facilities in Washington, D.C. (the Logistics RFQ). The Logistics RFQ was issued pursuant to Office of Management and Budget Circular A-76 (Circular A-76). Circular A-76 procurements are public-private competitions to determine whether functions and services currently performed by government employees should be outsourced to the private sector. In these public-private competitions, the agency establishes an in-house organization for the purpose of preparing the agency's proposal (called the Agency Tender) and designates an official (called the Agency Tender Official, or ATO) to submit the Agency Tender. The Logistics RFQ indicated that the award would be made to the proposal offering the best value to the DOE, based upon price, technical quality and other considerations. The Logistics RFQ further provided that, "the Government will not pay a price premium that it considers disproportionate to the benefits associated with the proposed margin of service superiority."

The DOE received proposals from Logistics Applications, Inc. (LAI) and the ATO. A Technical Evaluation Committee (TEC) evaluated the proposals and prepared a report of its findings for the Source Selection Official (SSO). In making the best value determination, the SSO compared LAI's average hourly labor rate with the ATO's average hourly rate. Although LAI's price was determined to be \$2.6 million higher than the Agency Tender, LAI also offered more

labor hours than the ATO. Accordingly, LAI's average hourly labor rate was lower than the ATO's. Based on the additional labor hours offered and the lower average hourly rate, the SSO concluded that LAI represented the best value to the government. In March 2005, despite the price premium as compared with the Agency Tender, the DOE awarded the contract to LAI in the amount of \$26.7 million.

Pursuant to Circular A-76, the Federal Acquisition Regulations (FAR) and DOE Regulations, the ATO filed a contest with the DOE and requested a decision by the DOE's Senior Procurement Executive. Among other arguments, the ATO contended that the award decision was based upon unstated evaluation criteria and that the DOE failed to conduct a proper best value trade-off because LAI's offer provided no added value in exchange for its significant price premium. According to the ATO, the unstated evaluation criteria improperly utilized by the DOE in making its award decision was the offerors' average hourly labor rates. Also according to the ATO, a proper best value trade-off was not conducted because the DOE made no findings regarding how the additional hours offered by LAI would improve its performance.

In a decision issued in July 2005, the Procurement Executive agreed with both of the ATO's contentions and sustained the contest. First, whereas the Logistics RFQ did contemplate that average hourly labor rates for each offeror would be considered by the SSO, the Logistics RFQ did not give any indication that this information would be used in the best value tradeoff. The Procurement Executive stated, "Nothing in the RFQ would

suggest to a reasonable offeror that this [average hourly rates] was a basis for discrimination among offerors."

Second, whereas LAI did propose more labor hours at a lower average hourly rate than the Agency Tender, the record did not include any analysis of the functions that would be staffed with relatively greater hours or any information to show how performance would be better because of the additional hours. Consequently, the Procurement Executive rejected the DOE's conclusion, stating: "[A] conclusion that LAI, by merely providing more hours to perform, demonstrates better performance is not supported by the TEC analysis."

The Procurement Executive suspended the contract award to LAI and referred the matter back to the Contracting Officer for corrective actions. Specifically, the SSO was directed to make and document a new selection determination based on the disclosed evaluation criteria and the technical merit of each proposal. Further, any technical/cost trade-off made in arriving at the best value determination should be in accordance with the RFQ disclosed evaluation criteria. ■

Editor's Note

>> In reaching his decision, the DOE's Procurement Executive confirmed that the same limitations on the Contracting Officer's discretion in making source selection determinations in traditional federal government procurements also apply in Circular A-76 public-private competitions.

P&A represented the ATO in this matter and has handled other Circular A-76 contests on behalf of the ATO, as well as numerous protests on a wide range of traditional procurements by federal, state and local governments.



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Proposed Amendment to New York Prompt Pay Act is A Boon for General Contractors

A standard provision of most construction contracts is the withholding of a certain percentage from the payment of approved invoices (usually 10 percent), as retainage, to protect that party from the cost of correcting defective work or other contractual defaults prior to final acceptance of the work. However, too often, an owner views such moneys as its own,

instead of the contractor's, despite the fact that the retainage represents money earned by the contractor for approved work that it completed on the project. The New York State Legislature is attempting to alter this misconception by way of a proposed amendment to Article 35-E of the New York General Business Law, §756, et seq., which has come to be known as the Prompt Pay Act.

In 2002, the legislature enacted the Prompt Pay Act essentially to provide

maximum time frames within which owners, contractors, subcontractors, etc., on certain private construction projects, are required to review and pay the invoices and requisitions of those with which they have contracts. Pursuant to the Prompt Pay Act, if a party fails to review an invoice in a timely fashion and fails to timely make payment thereon, the unpaid contractor or subcontractor, etc., has the right to suspend performance and is entitled

to interest on the unpaid, undisputed invoice at the rate of one percent per month until payment is received. GBL § 756-b. With respect to retainage, the statute simply provides that, upon agreement of the parties, the one issuing payment is authorized to withhold a percentage of the contract as retainage, and, if withheld, it must be paid timely or else it too is subject to the 1 percent per month interest penalty. GBL § 756-c.

Now, three years later, the New York Legislature is in the process of making the first amendments to the Prompt Pay Act, dramatically altering the traditional rights between owners and general contractors with respect to retainage. Pursuant to the proposed amendment, retention that is withheld

by owners must be placed in a separate interest-bearing escrow account, with an escrow agent. The proposed amendment further explicitly states that the escrowed retainage is the “sole and separate property of the

While the amendment appears straightforward, its simplicity creates a multitude of legal issues and questions, which in all probability will have to be addressed by the courts. For example, may the parties avoid or alter the stric-

diminish a subcontractor’s or supplier’s lien rights? Typically, a subcontractor has the right to a mechanic’s lien up to the value of the money payable to the contractor at the time that the lien is filed, such that if the contractor has been fully paid on its contract, the subcontractor will have no lien rights. Retention is often a prime source against which subcontractors can establish their lien, but if the retention has been paid into escrow by the owner and is the sole property of the contractor, the subcontractor conceivably will have lost its right to use the retention to establish the value of its lien.

These and other questions remain to be addressed and resolved. ■

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contractor.” There is no corresponding requirement that the general contractor escrow the retention that it withholds from its subcontractors.

Clearly, this amendment presents a tremendous benefit to general contractors. Because the owner is no longer personally holding the retention and the retention money is statutorily mandated as the “sole and separate property of the contractor,” the owner does not have the discretion to use the retainage to pay for the correction of defective work or completion work when the contractor is terminated for default. Presumably, if an owner wants to have corrective or completion work performed, it will have to dip into its own pocket to pay for it, and will then likely have to make an application to a court to request that the retention be paid over to it to cover the cost of such work.

tures of this statute in their contracts? Or can a general contractor lose the protections afforded by this statute if the owner retains a construction manager to enter into the contracts with the general contractor and other contractors? Since only owners are required to escrow retention, and since the construction manager does not have an ownership interest in the project, the retention it withholds can still be used to correct or complete the general contractor’s work. Also, what penalty or consequence is there to an owner who fails to escrow the retention? The statute does not specify any penalty, but since the money is the property of the general contractor, it is conceivable that the owner’s failure to escrow retention could arguably constitute a diversion of construction trust funds under Article 3-A of the New York Lien Law. Finally, could escrowing the retention

Editor’s Note

>> **The proposed amendment was not passed into law prior to the Legislature’s summer recess, but one of the bill’s sponsors has advised P&A that it will be reintroduced when the Legislature reconvenes, and that little opposition is expected. Perhaps, when the bill is reintroduced, amendments will be proposed and adopted to address some of the questions that are posed. Whatever the final outcome, P&A has developed targeted contractual provisions to enable its clients to take advantage of every beneficial aspect of the law and to minimize the impact from the uncertainty of potentially unsettled issues.**

New York Court Allows Contractor to Sue Architect

Travelers Casualty & Surety Co. v. The Dormitory Authority of the State of New York (2005)

A federal court in New York applying New York law held that a contractor’s relationship with the project architect was the “functional equivalent of privity,” meaning a contractual relationship, and, therefore, the contractor had the right to pursue a claim against the architect based on deficient and defective design documents and other acts and omissions during the project. The decision is noteworthy and significant because New York courts have been reluctant

to allow contractor suits to be filed against an owner’s design professionals due to the lack of a contractual rela-

tionship between the parties.

The complaint was filed by Travelers as performance bond surety for Trataros Construction, arising out of two contracts totaling \$74 million that Trataros was awarded for the construction of a project at Baruch College for the Dormitory Authority of the State of New York (DASNY). Trataros asserted claims for itself and its subcontractors against DASNY,

TDX as construction manager for DASNY and the project architect, Kohn Peterson Fox & Associates (KPF), alleging generally that Trataros incurred damages in part because of “faulty and/or incomplete or inaccurate contract documents,” and further that “KPF did not properly perform its responsibility as architect” and that “its actions and/or failures to act . . . constituted negligence” that contributed to the damages incurred by Trataros and its subcontractors. DASNY also asserted a claim against KPF, which alleges that KPF committed various acts, errors and omissions during the design and construction phases of the project leading to significant delays and increased costs.

Contractors can hold owners responsible for damages arising from design errors based on the implied warranty that attaches to the owner’s issuance of the plans and specifica-

The contractor had the right to pursue a claim against the architect based on deficient and defective design documents.

tions. Owners can also be held responsible for the construction phase activities of the architect, based on the architect’s contractual standing as the owner’s representative. However, owners, especially public owners, protect themselves from contractor claims by including various exculpatory clauses and strict notice requirements in the owner-contractor agreements. Under New York law, architects and engineers have been protected from direct contractor claims. As a result, contractors who are often left with no recourse for damages caused by architectural malpractice have attempted to expand the architect’s liability by asserting their knowing reliance on the architect’s work product.

In *Travelers*, the court denied KPF’s motion to dismiss the claims of the contractors, holding that *Travelers* had satisfied the functional equivalent test set forth in the 1989 decision of New York’s highest court, *Ossining Union Free School District v. Anderson LaRocca Anderson*. In *Ossining*, a claim by a school district against the engineering firms hired as sub-consul-

tants by the project architect — the district had no direct contract with the engineering firms — was allowed to proceed. In *Ossining*, the court set out a three-pronged test to establish the functional equivalent of privity:

- (1) awareness by the design professionals that its plans and specifications were to be used for a particular purpose;
- (2) reliance by a known party in furtherance of that purpose; and
- (3) some “conduct” by the design professionals “linking” them to the plaintiff and evincing their understanding of plaintiff’s reliance.

The court in *Travelers* emphasized that KPF had not only prepared the contract documents, but also responded to bid inquiries, analyzed the bids, reviewed and approved contractor submittals and monitored the con-

struction of the project. All bidders were instructed to communicate their requests for information to KPF as final decision maker. KPF’s contractual duties encompassed many of the design and construction phase services commonly performed by the project architect.

The court found that the first prong of the test was easily satisfied since, by its nature, KPF was aware that its plans and specifications would be disseminated by the owner to contractors to build the project. As for the third prong — the linking conduct — the DASNY contract with KPF, as with most owner-architect contracts, contemplated direct interactions between the contractor and the architect, including pre-bid and job meetings and discussions as the owner’s representative, submittal review, responses to Requests For Information (RFIs) and design revisions.

However, the second prong of the functional equivalency test — that there is reliance on the plans and specifications by a *known* party —

had been more difficult to satisfy for claims against the architect, since the architect is usually hired and prepares the design documents before the contractor is selected and becomes a known party. Several appellate courts had held that, while the designer knows that potential bidders will by necessity rely upon its work product to prepare bids, the successful contractor could not be considered a known party merely because it was a potential bidder, and, therefore, was not a member of an “identifiable” class that would satisfy the *Ossining* test. The court in *Travelers* distinguished those cases, holding that KPF cannot maintain that Trataros was an unknown party, stating:

As part of KPF’s relationship with DASNY, KPF was contractually obligated to interact with Trataros pre- and post-bid. Pre-bid, KPF maintained a list of the parties expected to bid on the contract and solicited such bids. During the bidding process pursuant to the terms of the contract between DASNY and KPF, KPF was obligated to examine contract bids.

The court made no distinction between claims based on deficient plans and specifications, which were prepared well before the bidding process, and the architect’s allegedly negligent actions after the award of the contract to Trataros. In essence, the court held that to pursue the architectural negligence claim, it was sufficient for the contractor-plaintiff to show it was initially part of a definable class of potential bidders, followed by post-bidding and post-award direct and indirect interactions with the architect as the owner’s representative. ■

Editor’s Note

>> Since the relationships in *Travelers* are common to most construction projects, the case could be a basis to support similar contractor claims against architects and other design professionals. However, since the matter has been settled, there will be no appellate decision affirming this novel application of New York law, and therefore, no guarantee that a state appellate court will concur with the federal court’s application of the law.

Maryland Court Bars Sureties from Disputing Subcontractors' Claims

National Union Fire Insurance Company of Pittsburgh v. David A. Bramble, Inc.

A general contractor constructing a resort complex on the shores of the Chesapeake Bay in Maryland posted a payment bond that was underwritten by three sureties. The form of bond used was the American Institute of Architects (AIA) Document A312, March 1987 edition. Paragraph 4 required claimants with direct contracts with the general contractor to provide a notice of claim to the surety, with a copy to the owner. Paragraph 6 provided as follows:

When the Claimant has satisfied the conditions of Paragraph 4, the Surety shall promptly, and at the Surety's expense, take the following actions:

6.1 Send an answer to the Claimant, with a copy to the Owner, within 45 days after receipt of the claim, stating the amounts that are undisputed and the basis for challenging any amounts that are undisputed.

6.2 Pay or arrange for payment of any undisputed amounts.

The subcontracts each contained a "pay when paid" clause, Article 4.j., which provided:

At any time all moneys due [general contractor] from the Owner are not paid, [general contractor] shall, in its sole discretion, apportion the nonpayment equitably and reduce the payments due the Subcontractor accordingly. Such reductions shall continue until [general contractor] is paid all moneys due it, provided, however, if the withholdings relate to Subcontractor's work Subcontractor shall be paid in full when [general contractor's] right to recover from the Owner is finally determined or expires. Subcontractor acknowledges that this Article 4.j. establishes a reasonable time for payment.

During the course of construction, the general contractor became embroiled

in litigation with the owner over non-payment, and the general contractor discontinued payments to some of the subcontractors. Two first-tier subcontractors notified the owner and the sureties of claims against the general contractor's bond. In both cases, the claims were forwarded to the lead surety, which acknowledged receipt of the claims and requested that the subcontractors complete and submit proofs of claim; the surety reserved its rights to any defenses the sureties or the principal may have. The two subcontractors each submitted a proof of claim. One claimant received no response at all from the sureties, while the other received only a letter stating that its claim should be reduced to a specified lower amount.

The subcontractors each sued the sureties in state court and filed motions for summary judgment. The sureties filed cross-motions for summary judgment, asserting that (1) pursuant to Article 4.j., the amounts claimed by the subcontractors were not yet payable by the principal (the general contractor) because the owner had not yet paid the principal, and (2) the sureties' obligation to pay under the bonds would arise only when the principal failed to pay amounts due the subcontractors, and no amounts were due. The trial court granted summary judgment in

favor of the subcontractors, ruling that because the sureties did not answer the claims within the 45 days specified in Paragraph 6.1 of the payment bond, the sureties could not thereafter dispute the claims. After Maryland's intermediate appellate court affirmed the judgments, the sureties appealed to the Court of Appeals, Maryland's highest court.

The sureties primarily argued that their failure to answer the subcontractors' claims within 45 days should be deemed an indication that the entire claims were being disputed. The sureties contended that if they were unable to dispute the claims, they might be forced to pay claims not properly covered by the bond. This could result in a windfall to the claimants and to the potential detriment of legitimate claimants against the bond. The sureties suggested a more appropriate remedy would be to award the subcontractors the consequential damages arising from the breach of the 45-day provision (e.g., interest

The sureties contended that... they might be forced to pay claims not properly covered by the bond.

on delayed payments eventually determined to be due).

The Court of Appeals disagreed. Reviewing the legal history of suretyship, the court noted that a compensated surety is, in effect, an insurer, and an insurance contract should be construed most strongly in favor of the party protected by the contract (i.e., the claimants). The court also recognized the rule of contract interpretation that

all clauses of a contract must be given meaning if reasonably possible.

The court found that Paragraph 6.1 of the bond required the sureties to (1) answer the claims, (2) state the disputed

A compensated surety is, in effect, an insurer.

amounts, and (3) list the bases for challenging the disputed amounts. The sureties failed to perform any of these steps, but argued that the function of Paragraph 6.1 in such a case is to render the entirety of the claims in dispute. The court, however, noted that because Paragraph 6.1 requires the sureties to state the bases for challeng-

ing any disputed amounts, the sureties have a higher burden to meet than simply stating an amount in dispute. Therefore, the court held, it would be inconsistent with the plain meaning of Paragraph 6.1 to allow the sureties to dispute the claims in their entirety simply by doing nothing. To hold otherwise would be to render the 45-day requirement meaningless. In addition, allowing sureties, through inaction, to

Editor's Note

>> **This ruling forces sureties using the AIA bond form to promptly investigate and respond substantively to subcontractors' claims. Subcontractors, on the other hand, may be able to use this ruling to force payments from inattentive sureties. This ruling would not necessarily apply to non-AIA bonds that do not require a surety**

dispute claims indefinitely would undermine the bond's purpose to safeguarding suppliers and subcontractors.

Therefore, the court held that the effect of the sureties' failure to answer (and dispute) the subcontractors' claims within the 45-day period required by Paragraph 6.1 is that the entirety of the claims are undisputed and the sureties are required to promptly pay the claims. ■

response within a specific time, although recent decisions in other state courts are forcing sureties to respond promptly and in good faith to bond claims. An interesting follow-up issue to this case is whether a surety would be able to obtain indemnity from the general contractor for payouts under these circumstances.

California Contractors' License Law:

You Did the Work, But Will You Get Paid?

While most people in the California construction industry

know that they need a contractor's license in order to engage in the construction business in California, many do not realize the full implications of performing work without the proper license or, for that matter, the implications of allowing a license to lapse during the course of the construction

of a project. Those implications range from criminal sanctions to disastrous financial consequences.

For instance, apart from possible criminal liability, the California Registrar of Contractors can impose civil fines of up to \$15,000 for a violation of the Contractors' License Law. Similarly, the Labor Commission may impose penalties of \$200 per worker per day on contractors engaging in unlicensed operations. The most severe penalties of all, however, may be incurred when an unlicensed contractor has to sue to collect for work performed on a project.

As in many states, there is a long-standing rule in California requiring contractors performing construction work to be licensed. Since its enactment in 1939, Section 7031 of the Business

and Professions Code has been the teeth of California's public policy mandating that all contractors be properly licensed in order to recover on unpaid invoices. Subsection (a), the core of which has remained essentially unchanged, denies to contractors access to the courts "for the collection of compensation for the performance of any act or contract for which a license is required . . . without alleging that he or she was a duly licensed contractor at all times during performance of that act or contract." The licensing law became even more severe when Business and Professions Code Section 7031(b) was added in 2001, sounding the death knell for unlicensed contractors. This section provides that a person who utilizes the services of an unlicensed contractor

may take legal action to recover all compensation that was previously paid to the unlicensed contractor.

The rule of preclusion is especially harsh when applied to a contractor whose license lapses due to mere inadvertence, as opposed to contractors who either have never obtained a license or who do business under a suspended or revoked license. Therefore, the courts fashioned an exception to avoid a complete bar to recovery in cases of innocent administrative neglect. The California Supreme Court, in *Lati-pac, Inc. v. Superior Court* (1966), created what came to be known as the "doctrine of substantial compliance." Under this doctrine, a contractor who had not been in technical compliance with the licensing requirements could still maintain an action to recover damages if it had a licensed person overseeing the project. Over time, as the courts seemed largely driven by an understandable desire to spare contractors from a forfeiture of their claims, the substantial compliance exception began to swallow the rule.

The California legislature, not wishing to see judges dilute the severe sanctions of the statute, amended Section 7031 in 1989 to add Subsection (d), stating: "The judicial doctrine of substantial compliance shall not apply under this section." With that amendment the substantial compliance doctrine was virtually

wiped off the books with the stroke of a legislative pen. The first judicial test of this amendment came in the Supreme Court decision of *Hydrotech Systems Ltd. v. Oasis Waterpark* (1991). The court upheld the amendment and succinctly set forth the public policy in support of Section 7031 as follows: “to protect the public

the suspension; and (5) had anyone inquired about the status of the license during the time of suspension, the Board would have affirmed that the contractor was properly licensed. Given these extreme facts, the *ICF Kaiser* court found that the contractor had substantially complied with the licensing statutes.

not have knowledge or notice of the loss before the start of the job.”

Most recently, in *MW Erectors, Inc. v. Niederhauser Ornamental & Metal Works Co., Inc.* (2004), the Court of Appeal concluded that, under certain circumstances, a contractor might be able to recover compensation for discrete portions of work that it performed while licensed, even if the contractor did not hold a proper license throughout the entire course of its performance on the project. However, just this summer, on July 14, 2005, the California Supreme Court reversed the Court of Appeal insofar as it had allowed such recovery. (See, *MW Erectors, Inc. v. Niederhauser Ornamental & Metal Works Co., Inc.* (2005).) The true import of the Supreme Court’s decision becomes clear when one considers the facts upon which it was based.

At the time MW Erectors executed a structural steel subcontract with Niederhauser it did not hold the proper C-51 contractor’s license. While MW Erectors began work under the contract on December 3, 1999, it did not obtain the requisite contractor’s license until

The amendment . . . allows recovery if the court determines that the contractor has substantially complied with the licensure requirements . . .

from incompetence and dishonesty in those who provide building and construction services . . .” In fact, the court extended the statutory prohibition to even allow a person who knowingly hires an unlicensed contractor to legally refuse to pay for the contractor’s work. In other words, it was the Court’s view that adherence to the statute was an absolute requirement, even if the result was clearly unfairly draconian.

In 1991 and again in 1993, the legislature took the occasion to reconsider Section 7031 and, to a slight degree at least, soften the impact of the 1989 amendment. In its present form, the statute restores a limited substantial compliance exception. The amendment, codified at Section 7031(e), allows recovery if the court determines that the contractor has substantially complied with the licensure requirements as measured by three factors: the contractor (1) had been duly licensed as a contractor prior to the performance of the work or contract, (2) acted reasonably and in good faith to maintain proper licensure, and (3) did not know or reasonably should not have known of the lack of a license.

An example of a case interpreting Section 7031(e) is *ICF Kaiser Engineers, Inc. v. Superior Court* (1999). The facts were as follows: (1) no one at Kaiser had “a clue” that its contractor’s license had been suspended; (2) the document sent by the Board to Kaiser suggested that there was nothing further to be done by Kaiser; (3) the required bond was at all times in full force and effect so that there would have been coverage for any claim; (4) the Board itself was unaware of

In another case allowing recovery, *Slatkin v. White* (2002), the contractor received notification of a suspension only after entering into the contract and commencing work. Faced with those facts, the *Slatkin* court reasoned that “the contractor does not necessarily lose the right to be compensated simply because he or she performs additional work after discovering the loss of licensure, so long as the individual did



December 21, 1999. The Supreme Court denied MW Erectors any recovery, ruling that contractors must be in compliance with the licensing laws at all times that they are working on a construction project in order to be paid for any of their work. The court further found that in order to invoke the substantial

... a contractor whose license lapses during the course of a project will have a very difficult time recovering ...

compliance doctrine, the contractor must have been licensed at some time before the performance began.

Finally, the Supreme Court was not persuaded by the fact that Niederhauser had successfully sued the project owner and general contractor for recovery based on MW Erectors' work. The court rejected a judicial estoppel argument and expressly reaffirmed the rule codified in Section 7031(a) that "regardless of the merits," one may not maintain any action to "recover in law or in equity."

Given the Supreme Court's decision in MW Erectors, a contractor whose license lapses during the course of a project will have a very difficult time recovering unless it can meet the substantial compliance criteria set forth in Business

and Professions Code Section 7031(e). There is, however, a slight reprieve given for contractors. The *MW Erectors* decision allows recovery on private works of improvement if the contractor was not properly licensed when it executed the contract to perform work, so long as it became properly licensed before beginning the work. Contractors must keep in mind, however, that this permissiveness does not extend to public works. As the supreme court noted in *MW Erectors*, Business and Professions Code Section 7028.15(e) expressly provides that any contract awarded by a public entity to an unlicensed contractor is void and unenforceable.

Despite vacillations by the courts and legislature in the licensing area, one thing remains constant: it is imperative that contractors and subcontractors make sure that they are properly licensed for the specific work that they undertake and make sure to remain vigilant to stay in compliance at all times. Conversely, anyone who is defending a claim made by a contractor has more incentive than ever to make it a first priority to verify that the contractor was properly licensed throughout its performance. ■

Editor's Note

>> A preliminary verification of a contractor's license status can be conducted by visiting the California Contractors State License

Board's website at www.cslb.ca.gov. To receive the most accurate and detailed information concerning a contractor's license status, the best course of action is to request a verified certificate of the contractor's license history from the Board. This can be accomplished by submitting the form entitled "Request for Certified License History" (available on the Board's website), along with a fee, to the California Contractors State License Board at P.O. Box 26000, Sacramento, CA 95826-0026.



>> Mary A. Salamone is a new Partner in the Los Angeles office.

BULLETIN

Peckar & Abramson

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