



Construction Disputes: A Three-Part Series

Session 2

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Spearin Doctrine

United States v. Spearin, 39 S.Ct. 59 (1918) appeal from a Court of Claims decision that establishes the “doctrine of constructability”

- The government prepared plans and specs provided for reconstructing a sewer that were essentially deficient
- Contractor built sewer as specified
- Unknown dam and drainage condition burst the new sewer dam during a heavy rain
- Contractor declined to proceed with repairs once government paid for the damages
- Central holding: Allows contractor to rely upon owner issued design specifications as accurate and correct

Spearin Doctrine

- United States Supreme Court held: “The contractor is bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications.”
- Court found an implied warranty that was not overcome by usual site visit clause, duty to check plans for their adequacy
- Rationale – Owner in better position to decide accuracy of plans, access to site
- Under the Spearin Doctrine, the contractor does not have to make a showing that the owner was negligent

Spearin Doctrine

Recent cases in New Jersey that rely upon Spearin:

- Ten West Apparel, Inc. v. Mueser Rutledge Consulting Engineers, et al., 2020 WL 969310 decided February 28, 2020. Property damage case commenced by neighboring landowner.
 - This was a private matter in which the court noted that the Spearin Doctrine “has not explicitly been applied outside government contracts.” Here, the Spearin Doctrine was being argued by a sheet piling contractor (Entac) to assert that it was not negligent.
 - Appellate Division looked to Spearin for guidance on subcontractor’s duty of care and standard of proof for breach of that duty. Court ultimately found Plaintiff failed to show sufficient proof.

Spearin Doctrine

- Froin-Colnon Corp. v. Niagara Frontier Transp. Authority, 180 A.D.2d 222 (4th Dept. 1992) contractor “bears no responsibility if the design proves inadequate to achieve the intended result.”
- Spearin Doctrine adopted by most jurisdictions
- Hawaii and Iowa neither endorsed nor rejected the Spearin Doctrine
- Ohio closest to rejecting. In Dugan & Meyers Construction Company v. Ohio Dept. of Administrative Services, 864 N.E.2d 68 (2007) applies to differing soil conditions, but not delay damages. (*Modern Contract Solutions May 2017*).

Design Bid-Build

How can you waive Spearin protections in a DBB contract?

- i. By assuming responsibility for design
- ii. By taking on responsibility for design (e.g., by performing design/design review services even when you aren't contractually bound)
- iii. By agreeing to contract terms that don't entitle you to relief for design errors
- iv. In some circumstances by performing V/E and/or constructability reviews

Design Bid-Build

- vi. Conduct (actually performing design services/performing design review)
- vii. Ensure that your assumption of design liability is bargained-for (who's the designer? Who's responsible for the designer?). Don't take-on an obligation to back-stop the designer for their errors
- viii. Tips for examining Contract Documents to uncover provisions that may make contractors responsible for design [***risk shifting provisions – only assume responsibility for errors/omissions that you discover and fail to report. Don't assume liability for discovering design errors***]

Design Responsibility

“Contractor has carefully reviewed all Contract Documents, including, but not limited to, all Plans incorporated therein, and **agrees that the Contract Documents are adequate and sufficient for the performance and completion of the Work.**”

Design Responsibility

“**Contractor shall participate** in the development and review of the Design Documents being developed by the Design Professionals including, but not limited to architectural, civil engineering, mechanical, electrical, structural and fire protection plans, and any specifications. **Contractor shall make recommendations** with respect to such factors as site conditions, foundations, selection of systems and materials, construction feasibility, costs, suggested economies, availability of labor and materials, time requirements for procurement, installation and construction.”

Design Responsibility

“Except as set forth in the Contract, the Contractor shall not be liable to the Owner or Architect for damage resulting from errors, inconsistencies, or omissions in the Contract Documents, **unless the Contractor recognized or should have recognized such error, inconsistency or omission** and failed to report it to the Architect and Owner. If the Contractor performs, or permits any of its Subcontractors of any tier to perform, any construction activity for which it **knew or should have known would involve an error, inconsistency or omission in the Contract Documents**, the Contractor shall **assume responsibility** for such performance and shall bear **all costs** for correction.”

Design Build Stats

- Five-year period – 2005 to 2010 design build increased from 30% to 40% of the nonresidential construction market.
- Traditional design bid build has decreased from 68% to 52% of the nonresidential construction market. (Analysis by RS Means Business Solutions, a division of Reed Construction data.)
- Since 1985 increase from approximately 5% to 40% of nonresidential construction market.

Design Build Benefits

- Expedite entire construction process.
- Minimize extras and change orders resulted from disagreements with architects.
- Shorter overall design and construction process.
- Create greater cost reliability.
- Reduce risk through enhanced project coordination. See, O'Shea v. New Jersey School Development Authority (2010 WL 1330916 April 7, 2010).

What Happens to the Spearin Protections

Question: What is general contractor's liability to the owner in the context of design build?

- Is the design build delivery method a public owner answer to Spearin?
- Pure design build essentially flip flops the holding of Spearin placing liability for plans and specs on the general contractor.
- Bridging or use of a design criteria consultant increases the risk of responsibility to the owner.

Potential Problems and Liabilities

- Design Defects
 - Cost of fixing
 - Cost of schedule impact
- Schedule impacts from slow design process
 - LD's/Delay damages
 - Cost of acceleration/mitigation
 - Extended GC's
 - Sub claims

Potential Problems and Liabilities

- Confusion surrounding design versus performance specs
- Impossibility
 - What precisely did design build agree to
 - Knowledge of the parties
- Extent of bridging
- Owner active involvement and interference

What to Do if the Designer Is the Problem?

- Beware the record that the designer is making
 - Improve the record
 - Don't inflame the situation
 - If situation is getting worse – get help
- Peer review
- Document the solution clearly and positively
 - Get legal input

How to Document

- Document that Designer of Record has final sign off
- ***Consistently*** document that the architect and its subconsultants ***own their responsibilities***
- ***Consistently*** document that design-assist subcontractors ***own their responsibilities***
- Be conduits and facilitators – but don't take on responsibilities that are not yours contractually

Risk Mitigation Strategies

- Define sub scope broadly
 - Tie to basis of design
 - Don't limit sub's scope by drawings, specs or other potential limiting factors
 - Insurance or surety coverage
- Must define clear processes in the contracts
 - Clear flow-down of design responsibility

CLE Code #1

PA1978

What is a P3?

P3 Defined

- *A Public-Private Partnership (P3) is a contractual agreement between a public agency and a private entity that allows for greater private sector participation in the delivery and financing of a project.*

...but, why?

- Role for the private sector in solving any extraordinary public challenge (innovation, resources, risk)
- Performance-based, outcome-focused
- There should be a business case made for delivery method chosen for all complex projects that eliminate P3 based on full knowledge of cost of ownership

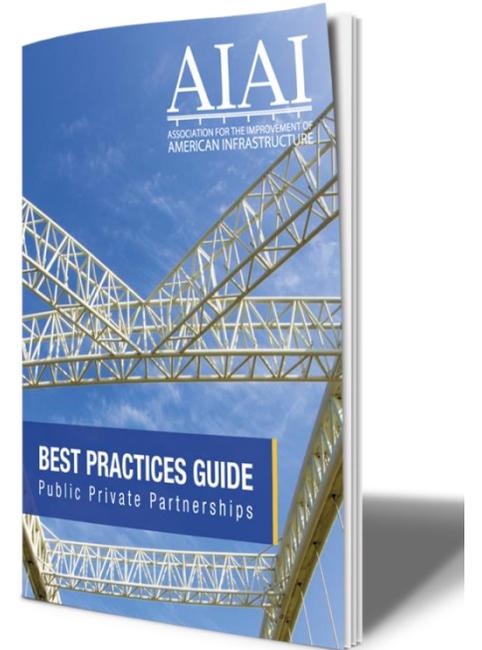
P3 Opportunities



Identifying a P3

A P3 IS:

- **DESIGN AND CONSTRUCTION, FINANCING, OPERATIONS AND MAINTENANCE PARTNERSHIP**
Public Sector enters into a long-term contract with private sector to deliver assets and services for the benefit of the general public
- **A RISK SHARING APPROACH**
Private sector assumes financial, technical and operational risk, public sector sets policy and retains ownership
- **LIFECYCLE PROCUREMENT APPROACH THAT GUARANTEES PERFORMANCE**
By integrating design, construction, and financing, with operations and maintenance, the asset performance is optimized for the long term
- **A TRANSPARENT RELATIONSHIP**
Public stakeholders have full control and can expect to be regularly updated and informed throughout the project



Benefits of P3s

- **Allocation of risk to parties best able to mitigate and manage risk**
- **Innovative delivery resulting in reduced project costs and construction timeline**
- **Guaranteed performance of lifecycle costs, including O&M and replacement**
- **Long term fixed payment terms and schedule**
- **Supplemental source of financing**



Qualifying a P3

A P3 IS NOT:

- **PRIVATIZATION**

Public sector retains ownership and ultimate control of public asset

- **A FUNDING SOLUTION**

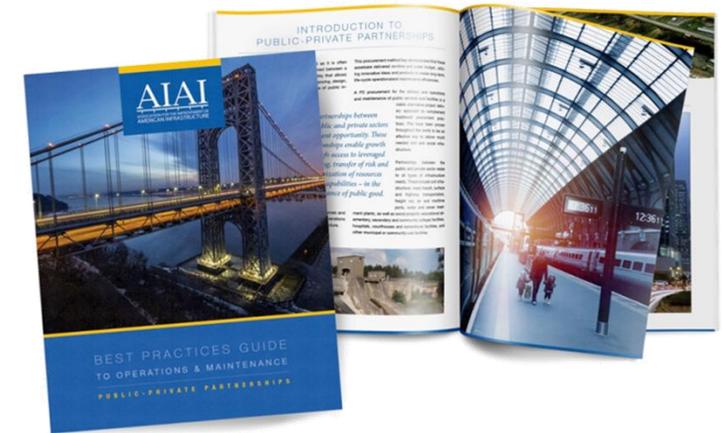
Government agency gains access to private debt and equity financing, which may not be available in regular public procurement, but project must still be creditworthy for debt and equity investors

- **A LOW-QUALITY DELIVERY MODEL**

Private entity enters into a performance-based contract with financial penalties imposed by the public agency if availability and quality standards are not met

- **THE RIGHT SOLUTION FOR EVERY PROJECT**

A Value-for-Money analysis is performed by experienced legal, technical and financial advisors to determine if a P3 is right for your project



NJ Public-Private Partnership Statutes

- Local Public Contracts Law, NJSA 40A:11-1, *et seq.*
 - Public-private partnership agreements. NJSA 40A:11-52
- Public Schools Contracts Law, NJSA 18A:18A-1, *et seq.*
 - Public-private partnership agreements with school districts. NJSA 18A:18A-60
- State Contracts Law, NJSA 52:34-6, *et seq.*
 - Public-private partnership agreements with State government entity.
NJSA 52:34-26
- State College Contracts Law, NJSA 18A:64-52, *et seq.*
 - Authority of college to enter into a public-private partnership agreement for certain building and facilities projects. NJSA 18A:64-85

Lessons Learned

- Limited Pilot P3 Program from 2009-14; it was not renewed
- New legislation developed in 2016; but Governor Christie vetoed the prevailing wage and PLA provisions of the new legislation
- ACCNJ, AIAI and P&A continued to work to create a comprehensive bill in order to address the urgent need for work in NJ
- The result is a truly thoughtful, comprehensive bill that includes all interests and does not limit the scope of P3 project opportunities

Novel Features Ensuring Payment

- The private partner must establish a construction account managed by a third-party financial institution to hold the project funding in trust for benefit of the contractor, CM and the design-build team
- All workers are to be paid not less than the applicable prevailing wage for that craft or trade
- All building projects shall contain a PLA designed to enhance employment opportunities of individuals residing in the county of the project
- The GC, CM, or DB team shall provide payment and performance bonds conforming to NJSA 2A:44-143, et seq.
- A fund will be established at 1% of project value, allowing for the administration of P3s in the State

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PA2000

Owners, Contractors and Lenders: Managing Risk Allocation

Introduction

Historically:

- Contractor documentation was more limited than it is today. Typically only a General Contract which incorporated certain plans and specifications.
- Contractors were asked by lenders to consent to a collateral assignment of the Construction Contract by Owner to the Construction Lender.
- Under some Construction Contracts, Contractors were required to bond the project to assure performance under the Construction Contract.

Introduction

Over the last twenty years, we have seen a progressive shifting of risks associated with performance and completion from Owners and Lenders to Contractors:

- Lenders require Contractors to subordinate lien rights and payment rights
- Lenders require Contractors to guarantee completion and performance – even payment

Assignment of Construction Contract

- Construction Lenders require an Owner to assign the Construction Contract from the Owner as part of the collateral for the construction loan.
- ConsensusDOCS Standard Agreement and General Conditions between Owner and Contractor provides in Section 13.1 that “neither Owner nor Contractor shall assign their interest in this Agreement without the written consent of the Owner...”
- Typically, a Contractor must consent to assignment of the construction contract.

Consent to Assignment

- Basic Elements of Contractor Consent to Assignment:
 - Contractor consents to assignment of Construction Contract.
 - Contractor agrees to give Lender notice of any default by Owner under the Construction Contract and grants lender a right to cure an Owner default.
 - Following Owner default, the Lender may elect to have the Contractor continue work and complete the project in accordance with the Construction Contract.

Subordination of Lien Rights and Rights to Payment

- Over time, Consents to Assignment have evolved to include:
 - Subordination of a Contractor's lien rights to the lien of the Lender's mortgage
 - Subordination of Contractor's right to payment
 - Following a default by Owner, Contractor cannot be paid by Owner on outstanding payments until after the Lender is paid in full

Types of Guaranties

- It has become commonplace for Construction Lenders to require Contractors to deliver a guaranty. Types of guaranties:
 - Completion Guaranties – a guaranty that the project will be completed on time, free of liens and encumbrances, and in accordance with approved plans and specifications
 - Performance Guaranties – a guaranty that the Contractor will perform its duties and functions in the general contract and pursuant to the consent to assignment
 - Payment Guaranties – a guaranty payment of enumerated payment obligations

Liability Under Guaranties

- A guaranty by a Contractor in favor of a Lender creates a direct cause of action by the Lender against the Contractor
- If a construction loan is assigned by the original Lender, then the assignee becomes entitled to enforce claims against the Contractor

Practical Effect of Completion Guaranties

- A Completion Guaranty is not just a substitute for a bond
 - Review and negotiation of the scope of guaranteed obligations is critical
 - The scope of guaranteed obligations under a Completion Guaranty can go well beyond completion of a project and performance under the Construction Contract
- A guaranty can include:
 - Carrying costs of a project/property
 - Hard and soft costs of the project

How to Avoid the Guaranty Trap

- Contractors may be asked to agree to deliver a guaranty at the bidding stage - in general terms. The devil is in the details.
- If a guaranty is to be given, the scope of the guaranty should be clearly defined and limited in the Construction Contract

Default Under a Construction Loan and the Payment Gap

- It can take weeks, if not months, before a Contractor is given formal notice of an Owner default.
- In the meantime, the Contractor may be continuing work on the project while Owner no longer has the ability to pay for work performed and in place.
- Construction loan documents typically provide that following a default by Owner, Owner no longer has the right to requisition loan dollars to pay the Contractor.

Default under a Construction Loan and the Payment Gap

- After Owner defaults, funding of construction loan requisitions is suspended. Contractors who do not stop work are at risk.
- A gap in payment is created - from the time of the last payment for work in place, to the time the Lender elects to assume the Construction Contract. The gap is likely months.
- The Contractor can only pursue the Owner – not the Lender - for the amounts due for work performed during the gap period. This is an empty remedy in most cases.
- A well negotiated Consent to Assignment should include a provision which conditions assumption of the Construction Contract by Lender upon Lender's funding of all amounts due for work in place to the date of assumption, including all costs of remobilization.

Contractor's Remedies Upon Owner Default

- In a properly negotiated Consent to Assignment, upon a default by Owner, the Lender will have the choice of:
 - Assumption of the Construction Contract – Lender assumes the obligations of the Owner and pays Contractor for all work in place. Under this scenario, the Contractor continues work, is paid requisitions and completes the project. The payment gap is covered.
 - Termination of the Construction Contract - Contractor will be left with its remedies against the Owner under the Construction Contract.

Contractor's Remedies Upon Owner Default

Foreclosure - Contractor is left with remedies under the Construction Contract against the Owner, including lien rights, which are subordinate to the construction mortgage.

Additional Considerations

- Construction Contract will set forth dispute resolution procedures, which may include arbitration and/or mediation, choice of law and venue. These provisions may not be consistent with provisions in the construction loan documents.
- Loan documents will also set forth choice of law and venue:
 - Governing law and venue for foreclosure proceedings will be the state in which the real property is located
 - Governing law and venue for the remaining loan documents, including guarantees and consents to assignment, may be different than the state in which the real property is located (i.e.-property located in NJ, foreclosure in NJ, but remaining loan documents governed by NY law)

Additional Considerations

Contractors should be aware that if there is a dispute with the Owner and the Lender, enforcement of the Construction Contract and loan documents:

- may not be resolved in one proceeding
- may result in proceedings in multiple jurisdictions
- may not be governed by the same law

Avoiding Pitfalls

- The more you know...
- Contractors should understand the availability of construction funds, draw schedule, terms and conditions of disbursement prior to signing a Consent to Assignment or any guarantees.

Avoiding Pitfalls

- Contractors should understand any limitations on guarantees in:
 - Their own loan or line of credit documents
 - Their own By-Laws or equivalent organizational documents
 - Their bonding agreements

Avoiding Pitfalls

- Contractors should make sure that any provisions in the Construction Contract requiring guaranties include the scope, details and limitations thereof.
- Contractors should work with the Owner to deal with all of these issues in advance of signing the Construction Contract and loan closing.
- The earlier the better – be clear with the Owners of what is, and what is not, acceptable risk shifting to the Contractor.

CLE Code #3

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QUESTIONS?

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