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Should Subcontractors Bear Scheduling Risks They Can't Control?

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The project schedule and a project's financial success or failure are inextricably linked. A delayed project can expose prime contractors and their subcontractors to damages suffered by the owner, liquidated and actual, in addition to cost increases from field and home office overhead. Even if the schedule is "recovered," the effort to right the ship may require so much overtime, crew augmentation, and inefficiency that a potentially profitable job turns into a puddle of red ink. Given these financial risks, some prime contractors draft their subcontracts to push the risk of scheduling problems and resulting delays

downstream. Sometimes these scheduling clauses require subcontractors to bear the cost of risks the subcontractor cannot control. Is this a good idea?

This article compares risk allocation in the scheduling provisions of the ConsensusDocs 750 standard form subcontract (2016 revision) with those of two subcontracts written by prime contractors. The three provisions discussed are set out in full at the end of this article. These latter two examples, on balance, shift much more of the risk of project delays to the subcontractor, while at the same time limiting the subcontractor's participation in the scheduling process. We will then examine what a subcontractor can do when faced with unfavorable risk-shifting provisions. Finally, we will consider whether there are benefits to a more balanced allocation of risk.

Key Schedule Provisions of ConsensusDocs 750

The ConsensusDocs subcontract, paragraph 5.2, couches the duty to complete in accordance with the project schedule as a mutual obligation between subcontractor and the prime contractor. As the schedule changes, the prime has a duty to the subcontractor to communicate any schedule changes to the subcontractor reasonably before the subcontractor is to perform. If the Prime's schedule changes increase performance time and/or costs, the subcontractor receives additional compensation and time if warranted.

Paragraph 5.3.1 provides that, if the start or progress of the work is delayed without the subcontractor's fault, the subcontractor's completion date will be extended, the schedule will be adjusted, and the subcontractor will receive any increased compensation obtained by the prime contractor. Paragraph 5.3.2 requires the subcontractor to pursue claims for which the owner may be liable in accordance with the owner-prime agreement and allows the subcontractor to pursue a pass-through claim in the prime contractor's name at the subcontractor's expense. Most significantly for comparison purposes, per paragraph 5.3.3, nothing in Paragraph 5 precludes the subcontractor from recovering delay damages caused by the prime contractor.

The ConsensusDocs subcontractor accepts two types of delay risk: (1) liquidated damages assessed by the owner against the prime to the extent the subcontractor is responsible; and (2) actual (but not consequential) damages suffered by the prime as a result of any failure by the subcontractor to meet the schedule, paragraph 5.5.

This ConsensusDocs approach attempts to balance risk to the parties who can most readily control it. The prime and subcontractor have mutual obligations to meet the schedule; the subcontractor has input into its schedule; the prime controls the ultimate project schedule; and the subcontractor assumes financial risk based on its level of responsibility for schedule performance failure. If delays are not its fault, the subcontractor may recover from the prime, subject to provisions governing owner-caused delay.

Comparison with Prime Contractor Drafted Scheduling Provisions

Many subcontracts allocate these risks quite differently. Example 1, set out below, imposes on the subcontractor full financial risk for project schedule failure when the subcontractor bears any responsibility for delay, paragraph 1.1. The subcontractor's "cooperation" with the schedule is subject to a definition which gives the prime contractor almost full control over the effort, paragraph 1.2. Finally, the scheduling provision allows the prime contractor very broad discretion to direct the means and methods of the subcontractor's work almost entirely at the subcontractor's cost and expense. Although not contained in the scheduling clause itself, this particular subcontract also contains a no-damages-for-delay clause (except to the extent the prime contractor recovers from the owner or third party) and requires that the delay be solely the responsibility of the contractor or other of the prime's subcontractors. In short, Example 1 severely limits the subcontractor's ability to recover damages if it is delayed by the prime, and exposes the subcontractor to financial responsibility for harm that it did not even cause in a process it does not control.

Example 2 also prevents the subcontractor from recovering money for delays caused by the prime and limits time extensions to extensions obtained from the owner, article 2(b). The clause also assumes that the cost of providing any scheduling information requested by the prime is included in the subcontract amount. Much of this information traditionally is the province of the prime contractor, paragraph 2(c). Virtually all financial risk of falling behind schedule belongs to the subcontractor. There is no limitation on the types of damages the contractor may recover from the subcontractor in the event of a subcontractor-caused delay, paragraph 2(a).

What's a Subcontractor to Do?

When faced with more one one-sided provisions such as Provisions 1 and 2 in the Appendix, a subcontractor's options include:

- Negotiate to achieve a more balanced allocation of risk.
- Include a larger contingency for the schedule risk that is assumed.
- Take the risk.
- Turn down the work.

If the subcontractor elects to assume the risk of a one-sided scheduling provision, it can mitigate its risk to a certain extent through attentive contract administration. First and foremost, it may be in the subcontractor's best interest to banish the term "delay" from its vocabulary and to view all project issues in terms of changes. Most events that result in delay can be characterized as a change to the original scope of work. In such circumstances, a request for a change order equitably adjusting the contract price, if appropriate, and the project completion date may work better than a simple request for an extension of time. Secondly it is important for the subcontractor to comply strictly with all notice and other requirements and insist that the prime contractor do so as well, particularly with regard to providing formal direction for dealing with problems, including issues causing delay. Such formal direction may also give the subcontractor an opportunity to request relief under the subcontract's changes provision.

Does the Prime Contractor Truly Benefit?

One-sided provisions can be advantageous, particularly in the short term when faced with a claim or change order request. But these provisions are not necessarily in the prime contractor's best interest in all cases. Some issues to consider:

- One-sided scheduling provisions may limit the quantity and quality of potential subcontracts (those who can afford to avoid the risk will pass in favor of less risky jobs).
- Fewer potential subcontractors mean less competition, which can result in higher prices.
- Onerous provisions invite contingencies, which raise prices.
- Subcontractors may fail financially under onerous scheduling requirements, which results in defaults, uncertainty, and, potentially, more delay.
- Exercising control over a subcontractor's planning, manpower, and execution of work may open the prime to claims under other legal theories.
- One-sided scheduling provisions may be difficult to enforce. Judges and arbitrators may find provisions that require a subcontractor to bear risk it cannot control to be fundamentally unfair.

Conclusion

Reasonable risk allocation can increase competition, lower costs, improve team work, and enhance quality. Although sometimes desirable in the short term, one-sided risk allocation often creates a more expensive and troubled project.

Article 5 Progress Schedule

5.1 TIME IS OF THE ESSENCE Time is of the essence with regard to the obligations of the Subcontract Documents.

5.2 SCHEDULE Subcontractor shall provide Constructor with any scheduling information proposed by Subcontractor for the Subcontract Work. In consultation with Subcontractor, Constructor shall prepare the schedule for performance of the Work ("Progress Schedule") and shall revise and update such schedule, as necessary, as the Work progresses. The Progress Schedule binds each Party and all subsequent changes and additional details shall be submitted to Subcontractor promptly and reasonably in advance of the required performance. Constructor shall have the right to determine and, if necessary, make reasonable changes to the time, order, and priority in which the various portions of the Work shall be performed and all other matters relative to the Subcontract Work. To the extent such changes increase Subcontractor's time and costs, Subcontractor may seek equitable adjustment in the Subcontract Amount or Subcontract Time in accordance with the Subcontract Documents.

5.3 DELAYS AND EXTENSIONS OF TIME

5.3.1 OWNER CAUSED DELAY Subject to § 5.3.2, if the commencement or progress of the Subcontract Work is delayed without the fault or responsibility of Subcontractor, the Subcontract Time shall be extended by Subcontract Change Order and the Subcontract Amount equitably adjusted to the extent obtained by Constructor under the Subcontract Documents, and the Progress Schedule shall be revised accordingly.

5.3.2 CLAIMS RELATING TO OWNER Subcontractor agrees to initiate all claims for which Owner is or may be liable in the manner and within the time limits provided in the Subcontract Documents for like claims by Constructor upon Owner and in sufficient time for Constructor to initiate such claims against Owner in accordance with the Subcontract Documents. At Subcontractor's request and expense to the extent agreed upon in writing, Constructor agrees to permit Subcontractor to prosecute a claim in the name of Constructor for the use and benefit of Subcontractor in the manner provided in the Subcontract Documents for like claims by Constructor upon Owner.

5.3.3 CONSTRUCTOR CAUSED DELAY Nothing in this article precludes Subcontractor's recovery of delay damages caused by Constructor.

5.3.4 CLAIMS RELATING TO CONSTRUCTOR Subcontractor shall give Constructor written notice of all claims not included in § 5.3.2 within fourteen (14) Days of Subcontractor's knowledge of the facts giving rise to the claim. Thereafter, Subcontractor shall submit written documentation of its claim, including appropriate supporting documentation, within twenty-one (21) Days after giving notice, unless the Parties agree upon a longer period of time. Constructor shall respond in writing denying or approving, in whole or in part, Subcontractor's claim no later than fourteen (14) Days after receipt of Subcontractor's documentation of claim. Constructor's failure to respond shall be deemed a denial of Subcontractor's claim. All unresolved claims, disputes, and other matters in question between the Parties not relating to claims included in § 5.3.2 shall be resolved as provided for in Article 11.

5.4 LIMITED MUTUAL WAIVER OF CONSEQUENTIAL DAMAGES

5.4.1 Except for any (a) liquidated, consequential, or other damages that Owner is entitled to recover against Constructor under the prime agreement, and (b) losses covered by insurance required by the Subcontract Documents, the Parties mutually waive all claims against each other for consequential damages, including but not limited to, damages for loss of business, loss of financing, loss of profits not related to this Project, loss of bonding capacity, loss of reputation, or insolvency. Similarly, Subcontractor shall obtain in contracts with its subcontractors mutual waivers of consequential damages that correspond

to Subcontractor's waiver of consequential damages. The provisions of this subsection shall also apply to and survive this Agreement.

5.5 LIQUIDATED DAMAGES

5.5.1 If the Subcontract Documents provide for liquidated damages or other damages for delay beyond the completion date set forth in the Subcontract Documents that are not specifically addressed as a liquidated damage item in this Agreement, and such damages are assessed, Constructor may assess a share of the damages against Subcontractor in proportion to Subcontractor's share of the responsibility for the damages. However, the amount of such assessment shall not exceed the amount assessed against Constructor. This section shall not limit Subcontractor's liability to Constructor for Constructor's actual damages caused by Subcontractor.

Prime Contractor Drafted Scheduling Provisions

Example 1

1.1 Time is of the essence in the performance of this Subcontract. Subcontractor is aware of the Contract Time (as defined in the Contract Documents) and agrees to take any and all steps necessary to insure that the Work is performed in such time as to permit Contractor to meet its obligations to Owner in accordance with the schedule for the Project to be prepared by Contractor ("the Schedule"). If Subcontractor fails to maintain the progress required by the Schedule and such failure is Subcontractor's fault, in whole or in part as reasonably determined by Contractor, Subcontractor agrees that the Contractor may direct the Subcontractor, at its sole cost and expense, to take whatever actions are necessary to get the Work back on schedule.

1.2 The Schedule will be developed in a cooperative effort between the Contractor and the Subcontractor as follows: The Project may use the services of a professional scheduling organization or may manage scheduling with Contractor's management personnel. Subcontractor accepts this concept and agrees to attend and participate in all scheduling activities. These activities are at a minimum: One day of data gathering of Subcontractors' activities and manpower and one day of logic planning for the Schedule preparation at the beginning of the Project. Subcontractor further agrees to attend half a day work sessions every other week for near term schedule update and commitment. This activity requires preparation as well as attendance.

1.3 Subcontractor agrees at its sole cost and expense: (a) to begin the Work upon Contractor's order to do so; (b) to cooperate with Contractor and its other subcontractors and the other contractors, if any; (c) to perform the Work in such sequence as Contractor may from time to time direct; (d) when requested, to provide all information required to prepare updates or revisions to the Schedule; (e) to allow other work to proceed in preference to Subcontractor's Work; and (f) to furnish at all times sufficient and qualified forces and supervision, adequate and conforming materials, equipment, tools and all other things necessary to achieve the progress required by the Schedule. Subcontractor agrees that Contractor has full discretion with regard to preparation of the Schedule and updates or revisions thereto during the course of the Project, and that Subcontractor shall perform, at its own cost and expense, the Work in accordance with the requirements of the Schedule and all revisions or updates thereto. The Contractor shall have the right to approve all manpower levels employed by Subcontractor and to direct that manpower be increased as deemed necessary by Contractor. If the Subcontractor fails to adhere to the manpower levels as determined by Contractor, then Contractor may, at its discretion, supplement the manpower of Subcontractor. The costs related thereto shall be deducted from the Contract Price. If Contractor supplements Subcontractor's labor, Subcontractor will nevertheless be fully responsible, including all warranty and guarantee requirements, for all Work included in the Subcontract scope.

Example 2

ARTICLE 2.

(a) Subcontractor agrees to commence, pursue diligently and complete the work in such sequence and order and according to such schedules as Contractor shall establish from time to time during the course of the work, and shall perform the work so as not to delay any other trades or contractors, time being of the essence of this Subcontract. Any written dates furnished by the Subcontractor and approved by Contractor and Owner for delivery of materials, samples, shop drawings, etc., shall become a part of this Subcontract. Subcontractor shall furnish information requested by the Contractor in connection with monitoring and updating the Project schedule and shall immediately notify Contractor in writing of any interruption of the work or late delivery which causes or may cause a delay in Subcontractor's performance. No extension of completion date shall be permitted unless approved in writing by the Contractor and Owner, and Subcontractor shall be responsible for any losses or penalties incurred by Contractor as a result of delays in completing Subcontractor's work. If Contractor determines that the Subcontractor is behind schedule or will not be able to maintain the schedule, Subcontractor shall submit a remedial plan to recover, shall work overtime, shift work, or work in an altered sequence, if deemed necessary, in the judgment of the Contractor to maintain the progress of the work. Any such overtime, acceleration, shift or altered sequence work required to maintain progress or to complete the work on a timely basis shall be at Subcontractor's expense and shall not entitle Subcontractor to an extension of time or additional compensation. Contractor may supplement Subcontractor's forces, at Subcontractor's expense, if deemed necessary by the Contractor to maintain the Project schedule. Subcontractor shall be liable to the Contractor for any delay or damages, including consequential or liquidated damages, threatened or assessed against the Contractor to the extent caused by the Subcontractor.

(b) To the fullest extent permitted by applicable law, Contractor shall have the right at any time to delay or suspend the work or any part thereof without incurring liability therefor. An extension of time shall be the sole and exclusive remedy of Subcontractor for any delays or suspensions suffered by Subcontractor, but only to the extent that a time extension is obtained from the Owner, and Subcontractor shall have no right to seek or recover from Contractor any damages or losses, whether direct or indirect, arising from or related to any delay or acceleration to overcome delay, and/or any impact or effect of such delays on the Work.

(c) Subcontractor shall cooperate fully with Contractor in providing promptly any information requested by Contractor in connection with preparation of schedules for the Project, including, but not limited to, detailed information concerning the sequence, beginning and ending dates of activities, cost breakdowns related to such activities, and any information requested for Critical Path Method scheduling if used for the Project. The costs of all such activities on the part of Subcontractor are included in the Subcontract Amount.

(d) In the event of any dispute under this Subcontract or as to the work to be performed, Subcontractor shall continue to diligently perform the work as directed by Contractor without interruption, deficiency or delay.

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What Every Contractor Needs To Know About Arbitration: Dispelling Myths and Finding the Hidden Advantages and Disadvantages

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Proponents of arbitration often will tell you that arbitration is faster and less formal and has decision-makers who are more familiar with the subject matter of the dispute. Detractors of arbitration often say arbitrators tend to “split the baby” and avoid taking on the merits of the case, and they complain about arbitrations dragging on for an extended period of time. Contractors who have had good results at arbitration tend to be proponents, while those disappointed in their arbitration results are likely detractors.

Arbitration Can Be Faster and Less Expensive

There are several factors common to most significant arbitrations that may extend the procedures and foster inefficiencies, sometimes in the extreme. It is important to identify these factors so parties can implement the necessary measures to control time and expenses.

First, arbitrators are not required to adhere to the rules of evidence. Courts routinely point out that one of the prime virtues of arbitration is its informality, and therefore courts do not impose rigid compliance with procedural rules. *See, e.g.,* See AAA Construction Industry Rules, R-3(a) (“The parties may offer such evidence as is relevant and material to the dispute and shall produce such evidence as the arbitrator may deem necessary to an understanding and determination of the dispute. Conformity to legal rules of evidence shall not be necessary.”). However, some arbitrations drag on unnecessarily long because arbitrators fear that their decisions could be reversed due to an alleged refusal to hear relevant evidence.

Another issue is that arbitration hearings are often only scheduled for several days or a week at a time, particularly in disputes involving millions or hundreds of millions of dollars. With significant breaks between hearings, lawyers tend to over-prepare and sometimes use the breaks to dig up new evidence or over-prepare for cross-examination. In addition, every new phase of the hearings involves a certain amount of catching up with where the proceedings left off. This combination of factors has a huge potential for extending the hearings and driving up costs.

There are steps that parties can take to minimize unnecessary delay, however.

First, pick an arbitrator(s) with the experience and predisposition to control the proceedings. Through experience, such an arbitrator will know what evidence should be heard and what evidence is merely cumulative or simply irrelevant. And if you are involved in an AAA proceeding, you may be able to determine the arbitrator’s approach and philosophy from the AAA arbitrator self-profiles.

Second, agree on time limits to arbitrate. Either in the contract providing for arbitration or before the hearings commence, the parties should agree on a time duration for each side’s case, with the time strictly monitored throughout the proceeding. So, for example, if each side has 50 hours for their case, then they have 50 hours for the opening statement, the direct presentation of the case, the cross-examination of opposing witnesses and final argument.

Third, consider submitting the direct testimony by written affidavit, subject to oral cross-examination. This saves time and expense. For decades, most international arbitration proceedings have required the presentation of one’s direct case by affidavit.

Fourth, impose strict page limits on the legal briefings that follow the hearings. Absent such limits, the costs and time associated with oversized briefings drive up expenses and often provide little utility to the arbitrators.

The key to an efficient and economical arbitration is an arbitrator or arbitrators who will take control of the arbitration and strongly encourage the parties to adopt those procedures that will shorten the proceedings consistent with the fair presentation of all relevant information.

Hidden Advantages

Contractors, among other things, are business people. And two aspects of arbitration make it a superior venue for the resolution of business disputes: confidentiality and predictability.

Confidentiality

Except in unusual circumstances, court proceedings are public. The public may attend proceedings and has access to the record of the case. For contractors who have litigated in court, they can depend on other potential clients or competitors becoming well aware of that litigation history.

By contrast, arbitration proceedings are confidential. Indeed, the Rules of the American Arbitration Association provide specifically:

The arbitrator and the AAA shall maintain the privacy of the hearings unless the law provides to the contrary. Any person having a direct interest in the arbitration is entitled to attend hearings. The arbitrator shall otherwise have the power to require the exclusion of any witness, other than a party or other essential person, during the testimony of any other witness. It shall be discretionary with the arbitrator to determine the propriety of the attendance of a person other than a party and its representative.

AAA Construction Industry Rules, R-26.

Third parties may not attend proceedings except by agreement or as a witness. Any award, whether interim or final, is not subject to public scrutiny. Restricted access to proprietary information, like estimates or employment records, typically is readily enforced by experienced arbitrators.

All this works quite well to restrict any public “airing of dirty laundry,” with one major exception. What happens when one party who has full access to the information developed as part of the arbitration wants to publish what he learned about his opponent?

Enforcing confidentiality after an arbitration has concluded is not so easy. An arbitrator’s jurisdiction (the power to issue enforceable orders) lapses once a final award is issued.

If continuing confidentiality is important, the arbitrators must make that part of their final award. If they do that, the award can be enforced in court, even after the arbitrators’ jurisdiction has lapsed, typically pursuant to a Motion to Confirm the Award of Arbitrators. Once judgment is entered on the Award of Arbitrators, confidentiality can be enforced by the courts.

Predictability

Almost nothing is more important to a business person than predictability. Without predictability and a level of continuity that accompanies predictability, business planning becomes a risky venture. But litigation is inherently unpredictable and litigations are dynamic, with one’s fortunes ebbing and flowing as facts are developed or as judges or arbitrators issue decisions and directions that may impact the probable outcome of a dispute.

During trial, particularly in the case of a jury trial where jurors may not communicate with counsel, there is little that reveals what jurors or judges are thinking. Courts and juries typically give little indication of how they will decide.

My experience in literally scores of arbitrations is exactly the opposite. At arbitration, typically there is a running dialogue between the arbitrators and counsel. By their questions and comments, arbitrators often let the parties know exactly what they are thinking. A party should embrace these not-so-subtle messages, even if sometimes they are unpleasant. These signals from arbitrators can impact one's approach to trial, and often signal a probable result or an opportunity where the case can be settled at a particular stage of the litigation.

Hidden Disadvantage: Multiple Party Disputes

One of the biggest risks in using arbitration clauses in your contracts with owners or subcontractors arises in disputes involving multiple parties.

For example, in a dispute over a construction failure, it is typical for the dispute to involve the owner, the contractor, the architect, the engineer and various subcontractors. These parties may be bound together by a series of individual contracts, but there will be no overall agreement to arbitration that binds all the parties to participate in one consolidated arbitration.

In these multiparty disputes, judicial economy and the desire for an overall consistent outcome suggest that any dispute resolution procedure should involve all the parties. But unless all parties agree to a consolidated arbitration after the dispute arises, that is not possible at arbitration.

Moreover, if only two parties to the dispute have agreed to arbitrate by contract, they can opt out of any consolidated court proceeding by asserting those arbitration rights. Thus, in multiparty disputes, there is a high risk that those who use arbitration clauses in their contracts will be faced with litigating the same dispute in multiple forums, with the real possibility of inconsistent results.

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Construction Liability Without A Contract – The Erosion Of The Economic Loss Rule

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California courts continue to expand liability with respect to holding third parties liable in construction contracts even though those third parties have no contractual relationship in the dispute. Is this a national trend?

The California trend started in 2014, with the Supreme Court of California deciding in *Beacon Residential Community Association v. Skidmore, Owings & Merrill, LLP* 59 Cal.4th 568 (2014) that architects and engineers have a duty of care, and therefore can be held liable, to residential homeowners for negligently prepared plans, specifications or design modifications, even though the design professional had no contractual relationship with the homeowner. In doing so, the California Supreme Court enlarged the scope of duty owed by design professionals to third party purchasers.

The *Beacon* court concluded its analysis by applying the so-called *Biakanja* factors¹ in reaching its ultimate determination that a duty of care was owed, noting that: (1) the designer's work was intended to benefit the homeowners; (2) it was foreseeable that these homeowners would be harmed by a negligent design; (3) homeowners suffered injury due to design defects; (4) there is a close connection between the designer's conduct and the injury; (5) significant moral blame attached to the defendants' conduct; and (6) public policy supports preventing future harm to homeowners by establishing a duty of care.

The issue following the holding in *Beacon* was whether the holding would be subsequently expanded to allow liability against other third parties (in addition to architects) such as other design professionals, consultants, subcontractors, suppliers and even general contractors who are not in privity of contract with the plaintiff, all of which is in tension with the Economic Loss Doctrine ("ELD").

The ELD doctrine holds that a plaintiff cannot sue in tort for a defective product that causes pure economic loss (inadequate value, costs of repair and replacement of the defective product, or loss of profits, etc.) and that the plaintiff can only assert claims under a breach of contract theory (and not in tort for negligence). In addition, and importantly, a third party not in privity of contract with a negligent party cannot sue that party for economic loss damages absent the existence of a duty of care. In the majority of state jurisdictions, property owners, contractors or subcontractors are prevented by the ELD from suing a design professional in tort for defective design.

Fast forward to mid-2015 and a California court, in *Apex Directional Drilling, LLC v. SHN Consulting Engineers & Geologists, Inc.*, 119 F.Supp.3d 1117 (N.D. Cal. Aug. 11, 2015), expanded the holding of *Beacon*.

In *Apex*, the court held, for the first time, that the *lead engineer/project manager ("SHN") on a municipal construction project potentially owed the contractor a duty of care* such that it may be held liable for professional negligence. The facts were that an engineering firm contracted with the city of Eureka, California to serve as lead engineer and project manager on a construction project for a new wastewater pipeline. The engineer was responsible for conducting geological studies and the preparation of plans, reports and specifications provided to potential bidders. The successful bidder/contractor relied upon the engineer's Geotechnical Baseline Report ("GBR") which indicated the project was composed of stable soils suitable for the drilling specified. In fact, the contractor incurred unforeseen expenses and lost valuable equipment by drilling in flowing sands as opposed to the competent soils described in the GBR. Per the contractor, the engineer continued to provide illogical instructions and unreasonably continued to maintain that the project was proceeding in competent soils described in the GBR. Based on the engineer's recommendations, the city rejected the contractor's change orders and thereafter terminated the contractor from the project. The dispute between the City and the contractor was resolved via mandatory arbitration, but the contractor sued SHN in court for negligence based causes of action.

Recognizing the absence of privity, the court applied the *Biakanja* factors to determine whether a duty of care could be asserted. Significantly, the court determined the engineer's negligent acts were clearly intended to affect the contractor. In the GBR, the engineer undertook the role of identifying the soil conditions for the project site, which affected the cost and scope of the project and ultimately provided a baseline upon which the potential bids would be based. Moreover, the engineer repeatedly provided the contractor directives based upon the soil conditions in the GBR. The court found that by the time the contractor was dropped from the project, the engineer had knowledge that its actions were directly responsible for considerable losses to the contractor. Specifically, the engineer ordered the contractor to take unreasonable actions that caused the contractor to lose equipment and sustain unexpected costs, and recommended the city deny the contractor's requests for change orders. The court noted that California courts have repeatedly found construction design professionals potentially liable to third party consumers with whom they had no direct relationship, and thus, the court rejected arguments that the contractor's only cause of action was against the city. The court opined that although negligence actions

¹ *Biakanja v. Irving*, 49 Cal.2d 647 (1958).

between commercial entities have the potential to undermine contract law, the court found this critique purely hypothetical.

In a similar but more recent case, *United States of America for the Use and Benefit of Penn Air Control Inc. v. Bilbro Construction Company, Inc.*, No. 16cv0003-WQH-NLS, 2017 WL 733415 (S.D. Cal. Feb. 24, 2017), a California district court denied a consultant's motion to dismiss where the subcontractor alleged facts that a consultant owed a legal duty of care to the subcontractor. Bilbro Construction Company, Inc. ("Bilbro") was the prime contractor on a project awarded by the Department of the Navy ("Navy") for the renovation of a building. Bilbro contracted with Ferguson Pape Baldwin Architects ("FPBA") to provide architectural design services for the Project. FPBA contracted with Sparling and Shadpour Consulting Engineers ("Sparling"), an acoustical consultant, to provide noise prediction and vibration control measures. Bilbro also entered into a written contract with Alpha Mechanical, Inc. ("Alpha") designating it as a subcontractor on the project.

Sparling identified eight specific units which would require enclosures to meet the noise level requirements for the building and upon Alpha's request, reviewed and approved the sketch of the enclosures and the materials for Alpha to proceed. Upon completion of Alpha's work, 23 of the rooms exceeded the Navy's noise level requirements. To resolve the noise issues, Bilbro entered into a written agreement with Sparling to assess the noise associated with the equipment and to prepare a document presenting findings and recommendations. Sparling visited the project site and prepared a memorandum of findings and recommendations to decrease the noise, which Alpha implemented. To implement the findings, Alpha had to purchase new equipment, remove prior installations, purchase additional supplies, and remobilize its crew on four separate occasions. Nevertheless, Sparling's proposed solutions for Alpha did not sufficiently reduce the noise level and the Navy refused to accept the project. Bilbro then terminated Alpha's subcontract and withheld payment to Alpha.

In finding that Alpha could assert a negligence claim against Sparling, the court used the *Biakanja* factors and found that Sparling's recommendations were intended to be acted upon by Alpha pursuant to the agreement between Bilbro and Sparling. The recommendations effectively eliminated the legal separation between Sparling and Alpha, and thus weighed in favor of imposing a duty of care. As the sound consultant and acoustical expert on the project, the court determined it was foreseeable that Alpha would suffer harm based on any negligent representations offered by Sparling. Additional factors also considered by the court were that Sparling was aware that its initial recommendations had failed to adequately reduce noise levels and thereafter provided inadequate recommendations (to Alpha's detriment) to resolve the noise issues. Notably, the court also relied upon the inference that there was a special relationship between Alpha and Sparling, such that Alpha was an intended beneficiary of the contract between Sparling and Bilbro.

Therefore, California courts have now held that designers and consultants, absent a contractual relationship, can be held liable for negligence to third parties such as owners, contractors and subcontractors. There is no case yet in California that an owner's Construction Manager ("CM") can be similarly held liable, but the logic would be similar if not identical.

In other major markets, some courts have followed California, while others have not.

New York courts have allowed negligence and misrepresentation claims in the absence of privity if the relationship creates the "functional equivalent of contractual privity." The New York Court of Appeals held an engineering consultant can be held liable to someone that is not in privity of contract if: (1) a defendant knows that its plans or specifications will be used for a particular purpose by a known plaintiff; (2) the known plaintiff relies upon the services for that particular purpose; and (3) the conduct between the parties evidences an understanding of reliance. *Ossining Union Free School Dist. v. Anderson LaRocca Anderson*, 73 N.Y.2d 417, 425 (1989).

In *A.R. Moyer, Inc. v. Graham*, 285 So.2d 397 (1973), the Florida Supreme Court created a narrow exception to the economic loss rule and determined a third-party general contractor had a cause of action for the alleged negligent supervision by an architect. The contractor was neither a party to the contract with the architect (who contracted with the City), nor an intended third party beneficiary of the architect's contract. Citing to the reasoning in *Biakanja* (the California case discussed above), the court held that "considerations of reason and policy impel the conclusion that the position and authority of a supervising architect are such that he ought to labor under a duty to the prime contractor to supervise the project with due care under the circumstances, even though his sole contractual relationship is with the owner, here the United States." The *Moyer* court reasoned a third party general contractor who may be injured or sustained an economic loss caused by the negligent performance of the contractual duty of an architect has a cause of action against the alleged negligent architect, notwithstanding the absence of privity. However, in a subsequent case, the Florida Court of Appeal refused to extend this concept of liability and dismissed a complaint brought by subcontractors on a construction project against architects hired by the city by distinguishing *Moyer*, refusing to extend *Moyer* to a nonsupervising architect sued by a subcontractor. *McElvy, Jennewein, Stefany, Howard, Inc. v. Arlington Elec., Inc.*, 582 So.2d 47 (1991).

Texas courts are more conservative as to finding such liability and more strictly apply the economic loss rule to preclude imposing a duty of care in the absence of privity. In *LAN/STV v. Martin K. Eby Const. Co., Inc.*, 435 S.W.3d 234 (2014), the Texas Supreme Court held the economic loss rule precluded a contractor from recovering delay damages from a project architect in tort.

In *Eby*, the Dallas Area Rapid Transportation Authority ("DART") contracted with LAN/STV to prepare plans, drawings, and specifications for construction of a light rail transit line. DART incorporated LAN/STV's plans into a solicitation for competitive bids to construct the project. Eby Construction ("Eby") submitted the lowest bid and was awarded the contract. There was no contractual obligation between Eby and LAN/STV.

The court declined to impose a general tort duty on architects and engineers and reasoned that "courts should use contract principles, not tort principles, to determine whether the architect has 'contractual obligations' to the contractors and subcontractors." The court determined the contractor's principal reliance must be on the presentation of the plans by the owner, not the architect, a contractual stranger. Based on this reasoning, the general contractor was precluded from recovering delay damages from the owner's architect. Similarly, in *A&H Properties Partnership v. GPM Engineering*, No. 03-13-00850-CV, 2015 WL 9435974 (Tex. App. Dec. 23, 2015) the Texas Court of Appeals affirmed a summary judgment motion dismissing the contractor's negligence claim against a design professional. A&H Properties ("A&H") contracted with Bell Industry, Inc. ("Bell") to design and install energy-efficient improvements, including a geothermal loop, for A&H's warehouse and office project. In turn, Bell contracted with GPM to design the geothermal loop. On appeal, A&H argued that the trial court erred in applying the economic-loss rule to bar its negligence claim because GPM, as a design professional, had an independent duty to exercise skill and care commensurate with the requirements of the profession. Citing to *Eby*, the court found application of the economic-loss rule particularly appropriate because permitting A&H to sue GPM for economic loss would disrupt the risk allocations that A&H negotiated with Bell, and that Bell, in turn, negotiated with GPM. Accordingly, the court held imposing liability on GPM through a separate tort action would "judicially renegotiate the private risk allocations to which the parties contractually bound themselves."

In conclusion, the takeaway for design professionals, consultants, and construction managers is to be mindful of an individual state's proclivity to allow such third-party tort actions. This is especially true in states like California where the courts, as noted above, are expanding tort liability to various third parties. For contractors and subcontractors, this is a double edged sword. As noted above, courts have found that a consultant can owe a duty of care to a contractor despite the lack of a contractual relationship. On the other hand, such a duty, and hence potential liability, could be asserted by a third party against a contractor or subcontractor if, as is the case more and more in recent years, the contractor or subcontractor also provides design services. It remains to be seen if other states follow the lead of California regarding this erosion of the long established and recognized economic loss rule.

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Project Case Study

HomeFront New Family Campus, Ewing Township, NJ



Contract Used:

- ConsensusDocs 410 - Owner and Design-Builder Agreement (Cost of Work Plus Fee with GMP)
- ConsensusDocs 410.1 - GMP & Completion Dates Amendment

Owner's Counsel: Saul Ewing LLP – contract drafting and review

Project Description: HomeFront plans to convert an 8.5-acre decommissioned U.S. Navy base in Ewing Township, N.J. into a one-stop social service campus for homeless mothers and their children. A 42,000-square-foot building...[Read More](#)

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