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## Construction Defects—Breach of Contract & Negligence: Same Facts, Alternative Claims

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As it relates to construction defects and delays, contractors typically face two types of claims: breach of contract and negligence. On their face, these claims do not differ substantially. They both deal with: the contractor's duties and responsibilities; some failure to meet those duties and responsibilities; and, usually monetary damages caused as a result. If these claims are so similar, why are contractors sometimes sued for both? Does it make a difference which claims are asserted if the underlying facts are the same? This article will discuss the subtle differences between these claims and what impact those differences may have on contractors facing such claims.

### Basic Differences

Typically, the main difference between a breach of contract claim and a negligence claim is whether a contractual relationship exists between the parties. As the name implies, a claim for breach of contract must be based on a valid and enforceable contract, the terms of which have been breached. Negligence does not require a pre-existing contractual relationship. However, it does require some sort of connection or obligation between the parties – this is commonly described as one party owing a "duty" to another party.

Another difference between these claims is the nature of the damages that can be asserted. The contract dictates what types of damages are applicable in most circumstances (i.e., liquidated damages, attorneys' fees, etc.). Because negligence is not based on the contract, there is no express guidance on the types of damages which can be claimed. Most courts only allow compensatory damages for basic tort claims, so under negligence a plaintiff would be limited to collecting the costs it incurred in correcting the defective conditions. Additionally, attorneys' and consultants' fees will not be recoverable under a typical negligence claim. As for delay damages, a plaintiff cannot rely on the liquidated damages provision for a negligence claim. Instead, the delayed party must prove the actual damages incurred as a result of the delay. In short, where there is typically a level of certainty and control over the types of damages and exposure a contractor faces when it breaches its contract, there is no such certainty in a negligence claim.

**Contract Terms v. Duty**

Contractors and owners (or contractors and subcontractors / suppliers) define their relationship and obligations to one another through contracts. Sometimes these contracts are formed through lengthy and thorough negotiations. Other times, most of the terms other than price and timing are based on form contracts neither party customizes project to project (think standard ConsensusDocs or AIA form contracts). In any event, there is often a clear memorialization of the parties' respective obligations to each other. A breach of contract, therefore, is when a party fails to meet the contract terms.

If we ignore the contract terms for a moment, there are other obligations or duties that may exist. Generally speaking, a contractor has the duty to perform its work with the same standard of care as other, similarly-situated contractors would. (Granted, this obligation is often stated in construction contracts, but it likely would exist even if it were not expressly part of the contract). So, even if there were not clear, written contract terms to rely upon, a contractor owes some duties to the project owner.

Here now is the challenge a contractor faces when confronted with a negligence claim – what exactly is the standard of care for that contractor and for that particular project? In short, it is highly subjective. In order to succeed on a negligence claim, the owner would have to rely on an expert who can determine what other, similarly-situated contractors would typically undertake such work. The temptation for such experts is to refer to contract terms—whether the contract actually used for that project, or contracts used on other, similar projects. Under this theory, a contractor could be "negligent" by failing to perform some obligation under the contract. In other words, a contractor may be negligent by breaching the contract. Interestingly, the reverse may also be true. Many construction contracts identify a contractor's or owner's negligence as a basis of a breach of the contract. So, an owner may claim that a contractor breached the contract by being negligent in performing its work.

**Alternative, Similar Claims**

Alright, so if a contractor can be negligent by breaching the contract and/or a contractor can breach the contract by being negligent, what is the point of all of this? This is where the legal subtleties become important. First, a note on legal procedure—in most jurisdictions, plaintiffs are allowed to file alternative claims that are not entirely consistent with the other claims. Essentially, the plaintiff can say to the court or arbitrator, if you determine there is a contract, then the defendant breached the contract and I am entitled to damages. But, if you determine there is not a contract, I am still entitled to damages under a different legal theory that does not require the existence of a contract, such as negligence. As long as the plaintiff sufficiently details the factual bases for its claims, courts and arbitrators will usually allow a plaintiff to assert potentially inconsistent claims to act as belt and suspenders for their legal rights to recover damages it incurred.

Another reason a plaintiff may assert inconsistent claims is because of applicable statutes of limitations. Certain aspects of non-contractual claims, also referred to as torts, such as negligence, are prescribed and limited by statutes that differ by jurisdiction. Most notably, some states may require a plaintiff to bring a negligence claim within three years of the acts leading to the plaintiff's damages, while some may require claims to be filed within one year or as many as five or ten years later. Further, sometimes the clock on these claims do not start running until the defect is actually discovered, while other jurisdictions may start the clock from the last date the contractor performed some work, regardless of whether a defect is known. Contract claims are usually similarly limited by statute, but quite often are not limited for the same period of time even in the same state.

But, we need to be careful because there is a critical difference between negligence and breach of contract that may be the death knell for any negligence claim right out of the gate—the "economic loss rule." Briefly, the economic loss rule states that only contract claims may be asserted where the damages are limited to "economic" damages. Essentially, if an owner has only been harmed monetarily by a construction defect, it cannot maintain a negligence claim instead of or even in addition to a breach of contract claim. Of course, there is no guarantee that a court will immediately dismiss a negligence claim on the basis of the economic loss rule. And, there are exceptions that may allow the claim to survive until judgment. Nevertheless, it is a difficult claim to maintain where breach of contract is more appropriate.

**The Big Difference – Who Pays for It?**

Contractors who have faced claims for defective construction or related delays know that the CGL insurance policy they maintain will neither defend nor pay out for a breach of contract claim. This is because almost all CGL policies exclude from coverage "contractual liability." Many go so far as to specifically exclude from coverage any action "arising out of a breach of contract." However, these exclusions rarely apply to negligence claims.

As a result, even though the underlying facts are very similar, if an owner sues a contractor for negligence, it is likely that the contractor is entitled to a full legal defense provided by its insurance company as well as payment of any judgment or settlement, or to the limits of the policy. Of course, other exclusions may apply, but in general terms, coverage potentially exists for negligence claims. Not so much for breach of contract claims.

In fact, this is where many contractors—and the attorneys who regularly represent contractors—can become complacent and miss opportunities. There is an assumption with typical construction defect cases that insurance will not apply and therefore contractors will hire their attorneys and move for a quick settlement to resolve the matters since it is all coming out of their own pockets. This is often true even when negligence is asserted as an alternative cause of action—construction professionals are simply accustomed to assuming insurance is meant to cover things like fires or bodily injury or pure accidents like a crane collapse, not a simple mistake in construction that results in a defective building component or overall structure. Potential insurance proceeds are thus left on the table every day because of a faulty assumption.

Because of the economic loss rule discussed above, it is not incredibly common for negligence to be asserted in construction defect cases when there is a perfectly valid basis for breach of contract. Even when it is asserted initially, it often times is thrown out fairly early on. Nevertheless, best practice is not only for plaintiffs to assert as many potentially valid claims as they can, which would include negligence. Also, while unusual, it is not impossible for a negligence claim to survive long enough to drag out the litigation and increase defense costs. Therefore, it is also best practice for a contractor defendant to recognize that a potential negligence claim could mean someone else (insurance company) may be on the hook for the costly legal fees and potential settlement or judgment of such claims. It is incumbent upon contractors to immediately notify their insurance carriers of potential and asserted claims in order to preserve any possible right to coverage under the policies. Frequently, by the time the claim has gone from being threatened to actually filed, enough time may have passed that coverage could be precluded under the applicable insurance policy. Contractors should always protect their interests and, when in doubt, inform their insurance carrier. Contractors are also well suited to engage their attorneys earlier in the potential claim process to make sure they have their bases covered.

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## AGC'S Commentary on the AIA A201 Gen. Cond. Doc.

Once every 10 years, the AIA contract document program publishes a new AIA A201 General Conditions document; for the past 30 years, AGC has put out a commentary on the A201 to alert our members. This AGC-member-only commentary document can be accessed on **AGC.org**. We also encourage all those interested to register for a **two-part webinar series** taking place on Aug 15th and 16th about the new AIA documents.

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## Overhead—You Can't Do Business Without It

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Despite sometimes being referred to as an indirect or hidden cost, overhead costs are real and can be substantial. Most overhead costs are time-related, meaning that these costs are incurred throughout the planned duration of a project and continue to be incurred if a project is delayed. As a result, project delays often result in contractor claims for extended and unabsorbed overhead. Overhead can also increase if change orders cause a substantial increase or decrease in the volume of contract work.

Although recovery of overhead costs is arguably required if that contractor is to be made whole, carefully worded contract provisions, case law, and a contractor's chosen accounting method can all dictate actual recovery. This article provides an overview of such considerations with a particular focus on the terms of ConsensusDocs 200 and how those terms affect overhead recovery.

### Field and Home Office Overhead

Construction company overhead includes both field overhead and home office overhead. Field overhead includes the costs of employees, facilities and equipment that support the project but are not directly involved in building the project; for example, upper-level project supervision, on-site engineering, accounting, human resources, clerical personnel, and safety and medical facilities and personnel. Most field overhead costs such as salaries, utilities, and trailer rental are time related. But some, such as permits, mobilization and demolition, are not. When change orders extend the project time, field overhead can be calculated as a daily rate or estimated as a percentage of direct costs.

Home office overhead, as the name implies, includes the contractor's home office and other costs, such as insurance, taxes, and depreciation that are necessary to support the contractor's operation as a whole. Sound business practice requires a contractor to include a portion of its home office overhead cost in its bid or proposal for individual projects. If a project is delayed, the delay may prevent the contractor from taking on new work needed to cover or absorb its home office costs. When this occurs, the contractor will experience unabsorbed home office overhead. For purposes of pricing changes, home office overhead can also be calculated as a daily rate or charged as a percentage of direct cost.

**Contract Limitations**

Despite the essential nature of overhead costs, contract terms can severely limit a contractor's recovery of field or home office overhead, or both. This may create an unfair allocation of risk. While ConsensusDocs 200 does not expressly limit recovery of field or home office overhead, contractors and owners will need to negotiate the extent to which extended field overhead and unabsorbed home office overhead are recoverable. This can be done at the time of contract formation or as claims for equitable adjustments arise during the course of a project.
An initial step in assessing recoverability is to determine whether an applicable contract term specifically addresses field versus home office overhead or even differentiates between the two. For example, a change order clause may provide for a stated percentage markup, usually between 5% and 10%, on direct costs. Deceptively simple, such a provision can be interpreted to encompass both field and home office overhead as well as profit. A contractor may waive recovery of field office and home office overhead by executing such a change order. The contractor's situation is worsened if direct costs of the change order are low—meaning a low multiplier for the stated percentage—but the change causes a long delay resulting in both extended field overhead and unabsorbed home office overhead. In such a case, the contractor may try to price field and home office overhead separately before adding the percentage markup, but the owner may object to paying a markup on overhead. Or the contractor may include a reservation of rights to recover overhead when the actual delay impact of the change is determined.

ConsensusDocs 200 Article 8 Changes avoids confusion as to what is covered by its markup on change orders. Section 8.3.4 provides for a percentage markup on change orders to cover Overhead, which is limited by definition (§ 2.4.18) to home office overhead. Section 8.3.4 also provides a detailed listing of field overhead costs that are recoverable if directly related to the changed work. Article 8 does not expressly provide for recovery of extended field overhead costs incurred as a result of delays caused by a change order. This is covered under Article 6 Time. Section 6.3.1(b) provides that a contractor is entitled to an extension of time for "changes in the Work or the sequencing of the Work ordered by Owner, or arising from decisions of Owner that impact the time of performance of the Work." Section 6.3.2 further provides the contractor is entitled to an equitable adjustment for additional costs resulting from change order caused delays as well as other delays for which the owner is responsible. Article 6 does not, however, specify how this equitable adjustment is to be calculated. That is left for negotiation.

**Cost Accounting Methods**

Absent an express contract prohibition, contractors can legitimately use either a percentage-based or daily rate-based overhead amount to price changes and claims. More aggressive contractors may seek to vary the method used based on the situation. As is discussed above, a percentage markup is unfavorable if the change amount is small and the delay long, but favorable if the change is large and the delay negligible. This strategy will not work for federal contractors. Case law, FAR 31.105(d)(3), and DCAA's audit direction severely limit a contractor's recovery if the contractor seeks to use both methods or assert one method over another when advantageous to the contractor. Outside of the federal contracts arena, a sophisticated owner may incorporate related concepts into applicable contract provisions, to limit a contractor's recovery based on the circumstances of an individual change.
Between extended field overhead and unabsorbed home office overhead, the latter is generally more difficult to prove. This is inherent in the indirect nature of home office overhead. For this reason, formulas are often used to quantify home office overhead.

### ***Eichleay*** **and Other Formulas**

The *Eichleay* formula stems from a 1960s federal government contracts decision and is mandatory for use on federal contract claims. In brief, the *Eichleay* formula allocates home office overhead to a project based on the ratio of the contract amount to the contractor's total home office overhead. The allocable amount is divided by total days of performance to obtain a daily rate which is then multiplied by the number of delay days to arrive at the recoverable amount. Since 1960, the additional requirements of standby and lack of replacement work have been imposed on contractors seeking recovery. The *Eichleay* formula has been adopted by some courts and entirely rejected by other courts.

Beyond *Eichleay*, there are at least seven other formulas used in the U.S. and Canada, carrying names such as Allegheny, Canadian, Carteret, Emden, Ernstrom, Hudson, and Manshul. The intricacies of each of these formulas, and their acceptance in specific jurisdictions, is beyond the scope of this article. They are mentioned to show that home office overhead can be quantified in different ways that often result in significantly different amounts. It should not be surprising then to a sophisticated contractor, that a contractually required method of calculating home office overhead for changes may drastically impact a contractor's recovery.

If parties using ConsensusDocs 200 agree to use Eichleay or a similar formula as part of the calculation of an Article 6 equitable adjustment for delay caused by a change order, consideration should be given to whether a credit is due the owner for the percentage Overhead markup.

### **Practical Pointer**

Using ConsensusDocs 200 can eliminate time-consuming and expensive arguments about recovery of field and home office overhead. Different methods of cost accounting are unnecessary since ConsensusDocs 200 provides for recovery of home office overhead on change orders and an additional equitable adjustment for delays caused by change orders. Additional certainty can be achieved by agreeing during contract formation how equitable adjustments for owner caused delays will be calculated.

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## International Arbitration Considerations

**Frank T. Cara** & **Emily D. Anderson**, **Pepper Hamilton LLP**

Over the past decade, the growing number of mergers and acquisitions of engineering and construction (E&C) firms has consolidated the construction industry, creating an increasingly global market with more multinational mega-firms involved in construction projects. The changing face of E&C firm ownership is causing a shift in construction contract negotiations as well, particularly with respect to dispute resolution, as international parties can be reluctant to bring disputes before a foreign court system. Adding a contract provision to require arbitration before an international arbitral institution is a common solution to this dilemma. Many contractors are unaware that the arbitration process, and the time and cost of the arbitration, can be greatly impacted by their choice of arbitral institution. Additionally, international arbitrations may deviate substantially from the traditional and expected process employed in arbitrations involving only domestic parties, depending on the parties' choice of arbitral institution.

We have encountered contractors who were surprised by these differences when they did not consult with counsel before agreeing to a specific arbitral institution. This article will familiarize contractors with the distinctions between the traditional arbitration process employed in the United States and a more international process employed by other arbitral institutions.

### Arbitral Institutions

When requiring arbitration in a construction contract to resolve disputes, the parties can choose from a number of institutions, such as the American Arbitration Association (AAA), JAMS, the International Chamber of Commerce (ICC), the London Court of International Arbitration (LCIA), the International Institution for Conflict Prevention and Resolution (CPR) and the International Commercial Arbitration Court (ICAC). However, as a point of reference for this article, the AAA and the ICC are used to highlight the variations in international arbitrations.

The AAA provides administrative services for dispute resolution throughout the United States, as well as abroad through its International Centre for Dispute Resolution (ICDR). The AAA rules and procedures are a good representation of the processes followed during typical domestic arbitration.

The ICC, which is one of the leading international arbitral institutions, is based in France and has members in more than 120 countries. The International Court of Arbitration (ICC Court) is the administrative body attached to the ICC that organizes and supervises arbitrations. We have recently seen an insistence by many multinational E&C firms for the inclusion of an ICC arbitration dispute resolution provision in construction contracts.

### Process

The arbitration processes set forth in the AAA's Commercial Arbitration Rules (the AAA Rules) are, in general, typical for arbitration in the United States. Under the AAA Rules, once a case is initiated and the parties have selected an arbitrator (which in and of itself is a key strategic step), a preliminary hearing is held among the parties and the arbitrator to establish a schedule for the exchange of information, witness lists, exhibits and, depending on the complexity of the matter, pre-hearing briefs. The parties then exchange information in accordance with the schedule and proceed to a hearing — which is similar to, but less formal than, a trial — to present evidence and testimony. The parties will present closing arguments in the nature of oral argument or post-hearing briefs. The arbitrator then has 30 days to issue his or her award.

While the AAA Rules set forth this basic framework for the arbitration process, the AAA Rules contain few mandates and give both the parties and the arbitrators the flexibility and discretion to alter the arbitration procedure either by contract or other informal agreement. For example, if the parties wish to amend their claims, they can generally do so freely, and the rules of evidence are far more relaxed than in court.

In contrast, under the ICC, the process is much more rigid. The ICC Court retains a large oversight role during the arbitration by way of a case management team known as the "Court Secretariat," which is responsible for handling communications between the parties and the arbitrator, preparing the documentation required by the ICC Court, and providing information about ICC arbitration practice.

In terms of the procedure under the ICC, an arbitrator is first selected to sit on a tribunal to adjudicate the claim. The tribunal then conducts a case management conference and drafts a key document, known as the "Terms of Reference." The Terms of Reference set forth a summary of the parties' respective claims and the relief sought by each party, including the amount of each claim, a list of issues to be determined, and the procedural timetable for the parties to follow for the conduct of the arbitration. Once the Terms of Reference have been drafted, the parties cannot add additional claims, unless authorized by the tribunal, and it is unclear whether an increase in the amount of existing claims is considered a new claim. While the arbitration schedule under AAA tends to have more flexibility, the tribunal takes measures to comply strictly with the schedule set forth in the Terms of Reference, though the schedule can be amended in the tribunal's discretion.

The ICC arbitration proceeding consists of extensive briefings, the submission of additional documentary evidence and expert witness statements setting forth the expert's opinions and the grounds therefore. Unlike AAA arbitration, the hearing is not the focus of the arbitration. In fact, the tribunal may and often will decide the case on documents alone. When there is a hearing, there is no direct testimony, only cross-examination based on the briefs, evidence and expert witness statements. Expert witness testimony in an ICC arbitration is extremely truncated, and the same expert that would testify in an AAA arbitration for several days may only testify for 10 minutes in an ICC arbitration.

**The Award**

The process of issuing an arbitration award by the ICC also differs significantly from the AAA. Awards under the AAA Rules in complex construction matters are usually issued in the form of a reasoned opinion and generally consist of a brief direction to the parties from the arbitrator with a determination of the fees, expenses and compensation for the arbitration. The AAA does little to adjust the award.

Arbitration awards under the ICC must be approved by the ICC Court before the award is issued.

**Pricing**

The cost of an ICC arbitration also differs from an AAA arbitration. In an AAA arbitration, the price is based on a daily or hourly rate proposed by the arbitrators in addition to the AAA administrative fees.

In an ICC arbitration, the price of each arbitrator is fixed by the ICC using a prescribed cost scale. Each level of the cost scale has a maximum and minimum fee for an arbitrator, but the ICC Court may fix the fees at a higher or lower level than that indicated on the scale in exceptional circumstances. The ICC administrative fees, which are also fixed on the basis of a prescribed cost scale, are separate from the arbitrator fees.

### Conclusion

As the construction industry continues to evolve into a more global marketplace, construction contracts are evolving as well, including with respect to dispute resolution clauses, to reflect the international influence. When international arbitration is mandated by the contract, contractors should give careful consideration to the arbitral institution that is selected to ensure that it is a proper fit for the project and also to ensure that the contractors' expectations and understanding of the arbitration process reflect the true intent of the parties to the contract.

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