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Cut Sheets

Volume I, Issue 2

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Differing Site Conditions: An Ounce of Prevention . . .

By Lowell H. Patterson, III

Contractors performing public sector site work or highway construction potentially face special challenges because above ground and subsurface site conditions present significant risk. Perceived site conditions as opposed to actual site conditions may bear no resemblance to each other. The extent of the difference, in practical terms, will be measured in inefficiencies including lost time, higher costs and financial damages. Who ultimately bears that risk is often decided based upon the enforcement of the Differing Site Conditions contract clause.

As a preliminary matter, contractors are subject to a rule articulated in *United States v. Spearin* which provides that where "one agrees to do, for a fixed sum, a thing possible to be performed, he will not be excused or become entitled to additional compensation, because unforeseen difficulties are encountered." The *Spearin* Rule resulted in contractors placing specific exclusions within their proposals concerning rock, unsuitable material and handling excessively

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"Pass-Through Claims" Against Federal and State Governments — Lessons for Prime Contractors, Subcontractors, Material Suppliers and Sureties

By J. Brian Morrow

"Pass-through claims" are particularly important in government contracting. The rules regarding pass-through claims vary between federal, state and local government jurisdictions. Prime contractors, subcontractors, material suppliers and sureties should understand the differences and distinctions regarding "pass-through claims" in different jurisdictions in order to preserve and assert their rights should a pass-through claim arise, as is often the case.

What are pass-through claims?

A pass-through claim is a claim by a party who has suffered damages (typically a subcontractor), against a responsible party with whom it has no contract (typically a governmental entity, *i.e.*, the Owner/Government), presented by an intervening party (typically the prime contractor) who has a contractual relationship with both. In this example, the claim from the subcontractor "passes-through" the prime contractor to the Owner/Government.

Generally, absent "privity of contract," a subcontractor may not make a claim against or sue the Government directly. "Privity of contract" simply means that parties are in a direct contractual relationship. For example, on a typical government project, the prime contractor is in privity of contract with the Government and at the same time its subcontractors; however, the subcontractors are ***not*** in privity of contract with the

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wet materials and the like. Prescribing specific exclusions and insisting that the exclusions are incorporated in a final contract remains prudent in order to avoid differing site condition risk. This remedy is generally unavailable to contractors bidding on public work.

Contractors bidding for public work projects may not typically modify bid forms. Faced with this barrier to differing site condition risk management, contractors tended to include a financial cushion to protect themselves from the possibility of having to address unforeseen site conditions. This protected the successful bidder who encountered unforeseen site conditions. In addition, since most contractors tried to protect themselves, the successful bidder who completed a project without encountering differing site conditions reaped a windfall. In the end, the financial contingency in bids for differing site conditions added cost to project owners. As a consequence, owners began assuming these risks using Differing Site Conditions Clauses.

Assuming the risk of unforeseen site conditions inured to the benefit of owners by encouraging more rational bids from contractors. Specifically, a low bid from the contractor is less likely to be exposed to the risk of problematic subsurface conditions. This also alleviated the possibility that the additional costs arising from unforeseen conditions might wreak financial havoc on a contractor, thus impeding or perhaps even preventing completion of the work.

Differing Site Condition Clauses typically operate such that encountering either one of two distinct types of differing site conditions may entitle a contractor to additional compensation. These are commonly referred to as Type I and Type II Differing Site Conditions.

In a nutshell, Type I involves a subsurface or latent physical condition which differs materially from that indicated in the contract documents. For Type I to be implicated, the owner must have made some sort of representation about the project conditions. To recover, the contractor must demonstrate: (i) that the owner made a representation of the sited conditions in the contract documents; (ii) the representation was material to the means and methods to perform the work and/or the cost of performing the work; (iii) the difference between the conditions represented and the actual conditions was material; and (iv) the contractor incurred increased costs as a direct result.

Type II Differing Site Condition involves an unknown physical condition that is unusual and materially differing from that ordinarily encountered and recognized as inherent in the work of the contract. Type II is not implicated by a representation of an owner; rather, the critical issue is whether or not the condition should have been anticipated under the circumstances. A fact finder will determine whether or not the condition is unusual based upon what an experienced local contractor would expect. A contractor unfamiliar with local subsurface conditions will generally not prevail on a Type II claim.

A Type II claim will likely be defeated: (i) if a reasonable inspection or survey would have revealed the condition; (ii) if other projects in the area have experienced similar problems; or (iii) for failing to heed the owner's suggestion that conditions should be inspected through a pre-bid investigation.

Once a contractor discovers an unforeseen condition, timely notice to the owner must follow to preserve a claim. Notice allows the owner to inspect the unforeseen condition, mitigate costs or at least consider options available and to witness the contractor's extra efforts first hand. Failing to give proper

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"Once a contractor discovers an unforeseen condition, timely notice to the owner must follow to preserve a claim."

Limitations Upon the Owner's Ability to Delete Work Under the "Changes Clause"

By Larry W. Caudle, Jr.

Nearly all contracts in both the private and public sector contain provisions reserving to the owner a right to make changes in the work. Indeed, without such a provision, an owner who orders any alteration in the scope of work agreed to under the contract will be in material breach. The typical Changes Clause states as follows:

> *The Engineer reserves the right to make, in writing, at any time during the work, such changes in quantities and such alterations in the work as are necessary to satisfactorily complete the project. Such changes in quantities and alterations shall not invalidate the contract nor release the surety, and the Contractor agrees to perform the work as altered.*

The remaining language in the Changes Clause sets forth the means the parties will use to adjust the contract sum to account for such damages.

The intent of the Changes Clause is to provide flexibility to the owner in the event alterations in the work are necessary to ensure the finished project functions as the owner originally intended. But, does the Changes Clause provide to the owner unfettered authority to add or delete work as it sees fit? A recent case decided by the Georgia Court of Appeals demonstrates that the plain language of the typical Changes Clause prevents an owner from deleting work when its motivation to do so is improper or is motivated by a desire to take economic advantage of the contractor.

In *Savannah Airport Commission v. Higgerson-Buchanan, Inc.*, the prime contractor entered into a unit price contract with the owner for expansion of the Savannah Airport. The prime, in turn, hired a subcontractor, Caffrey Construction Co., to perform clearing and grubbing, which involved over 500 acres. When it bid the project, the prime simply took Caffrey's unit price per acre and marked it up an unspecified amount to cover its overhead and profit.

Caffrey's bid price per acre was actually based upon the weighted average of several individually-estimated prices because approximately 28% of the clearing area was heavily wooded; 41% was lightly wooded; 13% involved swamp land; and 18% was grassy area. The problem occurred when Caffrey was nearly complete with all clearing and grubbing except the grassy areas, which constituted the easiest and, therefore, least costly clearing work.

The owner apparently did not realize that the grassy areas of the project had been included by its engineer in the quantity of acres applicable to the "clearing and grubbing" bid item. Accordingly, when viewed in isolation, it appeared that the price the owner was paying for grubbing the grassy areas was excessive. What the owner failed to realize was that the inclusion of the grassy areas in the total area to be cleared actually lowered the unit price for clearing and grubbing overall. Nevertheless, in an effort to avoid paying the clearing and grubbing unit price for the grassy areas, the owner relied upon the Changes Clause to delete the remaining work from the contract. That clause provided that the owner "reserves and shall have the right to make such alterations in the work as may be necessary or desirable to complete the work originally contemplated in an acceptable manner."

The court disagreed with the owner's position and determined that the Changes Clause applies only to those changes within the general scope of the original plans and specifications and necessary to complete the work originally contemplated by the contract.

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"Nearly all contracts in both the private and public sector contain provisions reserving to the owner a right to make changes in the work."

Limitations Upon the Owner's Ability to Delete Work Under the "Changes Clause"

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The Changes Clause cannot be used to delete work that is still necessary in order to complete the project. In this case, the court determined that the owner's motivation was improper and was for the purpose of simply securing an economic advantage. Indeed, the grassy area had been subsequently stripped of grass and topsoil and improvements were being made upon that portion of the project by other trades. Hence, the owner never intended to delete the grassy area from the scope of the project – it merely was trying to avoid application of the clearing and grubbing unit price to the grassy area. By doing so, it was denying Caffrey the opportunity to realize the profit it had built into the overall unit price for clearing and grubbing.

The court's decision in *Higgerson-Buchanan* is consistent with court cases interpreting local government, federal and private construction contract cases and was dictated by the plain language of the Changes Clause. Like the typical clause at the beginning of this article and the clause in *Higgerson-Buchanan*, most Changes Clauses apply only to changes necessary to complete the work. An owner cannot rely upon the Changes Clause to delete work from a contract if such work is required in order to provide a complete project.

When confronted with an attempt by an owner to delete work from a contract a contractor should:

- Read carefully the applicable Changes Clause to confirm that changes under the clause must be "necessary" or "to satisfactorily complete the project."
- Attempt to determine the owner's reason for seeking to delete the work.

If the purpose of the change falls outside the scope of the Changes Clause or is otherwise suspect, the contractor should consult legal counsel immediately so that a determination can be made over whether to challenge the owner's order.

"An owner cannot rely upon the Changes Clause to delete work from a contract if such work is required in order to provide a complete project."

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Pass-Through Claims: What Every Claimant Should Know

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Government (because the subcontractors do not have a contract with the Government but only with the prime contractor). Absent legal authority to the contrary, pass-through claims are not allowed due to subcontractors' lack of privity of contract with the Government. However, a body of law has developed in the federal contracting arena, and many states, allowing pass-through claims against the Government if certain requirements are met.

The *Severin* Doctrine and Liquidating Agreements

In the federal contracting arena, the so-called *Severin* doctrine, which developed from the case *Severin v. United States*, 99 Ct. Cl. 435 (1943), provides for pass-through claims against the Federal Government. In the *Severin* case, the court held a subcontractor could not recover against the Government in a representative lawsuit if the prime contractor was not also liable to the subcontractor on the same claim. This means that the prime contractor must be obligated to pay the subcontractor regardless of whether the subcontractor claim is ultimately paid by the Government.

However, Over the past several decades, federal court decisions have modified the *Severin* doctrine to limit the

potential harsh effects from its strict application. For example, the *Severin* doctrine does not bar a legal action against the Government if the prime contractor and subcontractor enter into a liquidating agreement. A "liquidating agreement" is an agreement between the prime contractor and subcontractor which typically provides that the subcontractor will release all claims it may have against the prime contractor in exchange for the prime contractor's promise to pursue the subcontractor's claims against the Government. *When properly drafted*, liquidating agreements are enforceable. Liquidating agreements do not violate the *Severin* doctrine unless they completely and expressly release the prime contractor from liability to its subcontractor.

Federal Pass-Through Claim Examples

In *J.L. Simmons v. United States*, 304 F.2d 886 (Ct. Cl. 1962), the Court defined the basic requirements of a liquidating agreement. The court held that where a prime contractor agreed to reimburse its subcontractor for damages suffered at the hands of the Government, but only as and when the prime received payment for the subcontractor from the Government, the prime may maintain its action against the United States on behalf of the subcontractor. The *J.L. Simmons* court further held, under the specific facts of that case, that a "waiver of lien and release" did not negate an action by the prime contractor on behalf of its subcontractors where the subcontracts did not expressly negate the prime's liability, even though the waivers provided that if the prime was unsuccessful in prosecuting the subcontractor claims the prime's liability would be extinguished.

As it now stands, the *Severin* doctrine has evolved to the point that contractors can now pass-through a subcontractor's claim for unabsorbed home office overhead costs incurred due to government-caused delay, despite the fact the overall project is not delayed. In the recent case of *E.R. Mitchell Construction Co. v. Danzig*, 175 F.3d 1369 (Fed. Cir. 1999), a federal court rejected the Government's argument that the timely completion of the prime contract bars an otherwise satisfactory pass-through delay claim of a subcontractor where the Government caused the subcontractor's delay.

Pass-Through Claims on Non-federal Government Projects

On non-federal government projects, a prime contractor's right to sponsor a pass-through claim against the Government is not as certain or uniform as in the federal arena. The emerging trend among the states permits pass-through claims against the Government, similar to the federal contracting arena. However, some important exceptions exist, creating a potential minefield for unknowing contractors, material suppliers and sureties.

***Interstate Contracting* Case (Texas)**

In the recent case of *Interstate Contracting Corp. v. City of Dallas*, 135 S.W.3d 605 (Tex. 2004), the Texas Supreme Court held that Texas recognizes pass-through claims. The Court further held that, similar to the *Severin* doctrine, in order to assert a pass-through claim, the prime contractor must remain liable to the subcontractor for damages sustained by the subcontractor.

In *Interstate Contracting*, the prime contractor, Interstate Contracting Corp. ("ICC"), contracted with the City of Dallas to construct levees around a water treatment plant, in addition to the excavation of two areas to create storm water detention lakes.

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Legal action against the Government is not barred if the prime contractor and subcontractor enter into a liquidating agreement.

Pass Through Claims: What Every Claimant Should Know

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The material excavated for the lakes was to be used to construct the levees. ICC entered into two subcontracts with Mine Services, Inc. ("MSI") for the levee construction and excavation. Shortly after work began, MSI discovered the excavated materials were unsuitable for the levee construction due to a high clay content. Consequently, MSI was forced to manufacture suitable fill material by mixing sand with the clay. ICC informed the City of MSI's increased work and submitted a claim which the City denied. ICC then filed suit on behalf of MSI against the City. Prior to the lawsuit, ICC and MSI entered into a liquidating agreement.

Other States' Laws regarding Pass-Through Claims

In reaching its decision recognizing pass-through claims in Texas, the *Interstate Contracting* Court reviewed the law regarding pass-through claims in federal courts and other states. The Court concluded that the federal government (through the *Severin* doctrine) and 18 of the 19 states that have considered pass-through claims allow them. The 18 states the *Interstate Contracting* Court found treat pass-through claims favorably include the following: Alaska; California; Florida; Georgia; Kansas; Louisiana; Maryland; Massachusetts; Michigan; Minnesota; Missouri; Nevada; New Jersey; New York; North Carolina; Oregon; Rhode Island and Virginia (regarding claims against the Virginia Department of Transportation ("VDOT") only).

Of the 19 states that have considered pass-through claims, the only state the *Interstate Contracting* Court found that explicitly rejects pass-through claims is Connecticut. In addition, although Virginia allows pass-through claims against VDOT, pass-through claims are not permitted against other Virginia governmental entities, *i.e.*, they are not allowed against Virginia counties, cities and other non-VDOT state agencies pursuant to the Virginia Public Procurement Act. The law regarding pass-through claims in the remaining 30 states is unsettled and subject to change, though the emerging national trend appears to clearly favor pass-through claims.

In addition to the potential minefield created by selected states that do not recognize or have not yet ruled on pass-through claims, contractors, material suppliers and sureties must be aware of the time and procedural requirements for bringing pass-through claims. The failure to follow a state's time and/or procedural requirements is typically fatal to a pass-through claim (prior to the claim ever being considered on the merits).

Summary

Pass-through claims are an important aspect of government contracting at the federal, state and local level. The *Severin* doctrine, which is applicable in federal contracting and some states, allows for subcontractor pass-through claims. However, some states do not allow pass-through claims; while courts in other states have not yet ruled on the issue. In addition, there are often time and procedural requirements — unique to each jurisdiction — which must be satisfied in order to bring a pass-through claim.

In summary, contractors, material suppliers and sureties are well advised to become familiar with the law in whatever jurisdictions they transact business in order to understand, preserve and assert their rights regarding pass-through claims.

"...contractors, material suppliers and sureties are well advised to become familiar with the law in whatever jurisdictions they transact business in order to understand, preserve and assert their rights regarding pass-through claims if the need arises."

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notice will, at a minimum, needlessly complicate recovery. In some instances constructive notice—where no notice is given but the owner knows of the conditions could be, but usually is not, enough. Relying on verbal notice is risky because some jurisdictions strictly enforce written notice requirements in contracts. In addition, time fades memories and witnesses may have very different recollections of what was said to whom and when.

We have many clients, who because they truly seek to please their customers, feel reluctant to serve written notice of differing site conditions. Some contractors worry they may be perceived by the owner as claim happy. These are understandable concerns. However, failing to provide timely written notice could result in a forfeiture of rights or a very costly court battle just to keep a claim alive.

Minimizing Potential Problems

At Bid Time

- The contractor must take steps to ensure that its estimators thoroughly review all contract documents to discern who has the risk for differing site conditions.
- If the owner is assuming the risk using a Differing Site Condition Clause, the Contractor must include in its bid provisions covering only those conditions represented by the owner in the contract documents or those normally expected to be inherent in the work. Normally, this will protect the contractor and pave the way for a work order or modification of the contract if unforeseen conditions emerge.

If the contract documents do not include a Differing Site Conditions provision, the contractor may include in its bid a list of exclusions for the scope of work that specifically address differing site conditions, exercising special care that any list be all-inclusive. Alternatively, if the contractor has no flexibility to alter the Owner's bid firm, it must include a contingency in its pricing to cover the unknown.

Minimizing Potential Problems

In the Field

- The contractor should alert project managers and other field personnel of the notice requirements in the contract.
- A notice letter should politely but clearly advise an owner that the contractor considers the conditions encountered beyond the scope of the contract, thus seeking additional compensation.

To minimize the possibility of an adverse reaction, the notice letter should refer to the notice provision in the contract.

Occasionally, a contractor will delay giving notice if the conditions appear minor at first. The better course is to immediately give notice and advise the owner that the extent of the conditions is unknown and that the contractor seeks to give the owner every opportunity to cooperatively assist with formulating an acceptable solution. If presented with the possibility that a diplomatically worded notice will poison relations with an owner, the wise contractor should assume that an owner with a short fuse will likely attempt to defeat a claim if no notice is provided.

"Failing to provide timely written notice could result in a forfeiture of rights or a very costly court battle just to keep a claim alive."

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