CONSTRUCTION LAW REPORT

Summer 2003

Board permits government contractor to collect reasonable contract administration costs despite failed negotiations

In the *Appeal of American Mechanical, Inc.*, ASBCA No. 52033 (December 20, 2002), the Armed Services Board of Contract Appeals revisited the issue of under what circumstances a government contractor may recover contract administration costs.

The U.S. Army Corps of Engineers selected American Mechanical, Inc. (AMI), the contractor, to provide a new computer control system for a water treatment plant at Fort Richardson, Alaska. In turn, AMI subcontracted a portion of the work to Phoenix Control Systems, Inc. (PCSI). AMI, on behalf of PCSI, presented several requests for equitable adjustment for price adjustments concerning alleged additional work. Although the parties successfully negotiated 15 contract modifications authorizing price increases and extensions of time, AMI sponsored a PCSI claim with respect to unresolved issues, including that of whether PCSI would be able to recover out-of-scope claim preparation costs incurred in documenting and pricing the claim. Such out-of-scope costs included PCSI's use of a unique cost code for recording time spent on the preparation of the claims and assembling supporting documentation.

While AMI argued that such costs are recoverable as they were incurred as part of contract administration and in furtherance of negotiations, the Government argued that such costs were claims preparation and prosecution costs for which recovery is expressly not permitted under FAR 31.205-47(f).

In distinguishing the two types of costs, the Board confirmed that:

> Costs incurred in connection with the performance or administration of a contract are allowable, if allocable and reasonable. There is a strong legal presumption that costs incurred before a CDA claim arose were not incurred in connection with the prosecution of such a claim against the Government...On the other hand, if the contractor's underlying purpose for incurring the cost is to promote prosecution of the CDA against the Government, then such costs are unallowable.

The Board further stated that the rule requires the application of an objective test in determining under what circumstances the costs were incurred, and that, where the costs were incurred "for the genuine purpose of materially furthering the negotiation process, such cost should normally be contract administration cost *even if negotiations fail and a CDA claim is later submitted.*

In light of (1) the applicable presumption, and (2) facts indicative of PCSI's attempts to amicably settle the claims outside of litigation (*e.g.* active exchange of correspondence on claims issues and active negotiations of contract modification while costs were incurred), the Board concluded that PCSI's intent was to further negotiation and that as such, these were allowable contract administration costs.

A New York project owner's misrepresentations regarding available financing do not rise to the level of fraud

In the case of *Frontier-Kemper Constructors, Inc. v. American Rock Salt Company*, 224 F.Supp.2d 520 (W.D.N.Y. 2002), the court addressed the issue of whether a project owner has a duty to accurately represent the amount of financing it has available for purposes of negotiating a contract with the contractor.

SEYFARTH SHAW ATTORNEYS

This newsletter is one of a number of publications produced by the firm. For a wide selection of other such publications, please visit us online at www.seyfarth.com.

Copyright © 2003 Seyfarth Shaw

All rights reserved.

The contractor, Frontier-Kemper Constructors, Inc. (Frontier) sued the owner, American Rock Salt Company ("ARS") under a contract for the construction of a mine in Mt. Morris, New York. Frontier sought rescission of the contract, compensation in quantum meruit, punitive damages and declaratory judgment in claiming that the owner's alleged fraudulent statements during negotiations induced ARS to enter into the contract at a reduced price.

After Frontier quoted a price of $75.5 million, ARS replied that its available financing was $66 million. Following Frontier's reduction in quotation to $72.5 million, ARS represented that it would be unable to obtain financing in excess of $69 million, and that Frontier would have to lower its quotation to allow ARS to obtain the necessary amount of financing. The parties eventually agreed upon a price of approximately $70.6 million. Frontier alleged that ARS had actually obtained financing of $85 million, and that ARS fraudulently induced Frontier into signing the contract at the lower price due to these misrepresentations.

The court held that although New York law provides that a misrepresentation of a present fact can lead to a fraudulent inducement action, such a duty not to misrepresent does not necessarily arise while two parties are negotiating the contract. Therefore, the court found that although ARS's representations regarding the amount of available financing may have constituted hard bargaining, such statements do not constitute fraud as a result of which Frontier would have been induced into a lower price contract. In its opinion, the court further noted that Frontier failed to cite to precedent of any jurisdiction, in which a party was held liable for fraud because it misrepresented the amount it was willing to pay at the negotiating table.

Contractor's failure to make reasonable efforts to obtain materials precludes excuse for nonperformance

In the *Appeal of Southeast Technical Services*, ASBCA 52319, 02-1 BCA 31727, the Board addressed the issue of whether a contractor may rightly walk off the job where the Government fails to provide the promised necessary equipment to complete the job.

The case involved a government contract for the construction of a playground on a Naval base in Millington, Tennessee. Part of the contract required the Government to provide a sufficient amount of filter cloth (used to cover pea gravel), which in turn would be installed by the contractor, Southeast Technical Services (Southeast). After the project fell behind schedule, the contractor walked off the job; the Government defaulted Southeast; and Southeast brought this appeal alleging in part that it was not possible to perform the job because the Government failed to provide a sufficient quantity of filter cloth.

The Board concluded that although the Government indeed only provided enough filter cloth for approximately half of the playground, such failure does not excuse the contractor's performance on the overall contract. The Board went on to state that "[Southeast] must do more than prove the existence of an excuse. It must also show it took all reasonable action to perform in spite of the excuse." Since it was established through testimony that it would have taken 10 days to receive additional filter cloth, and there was evidence that Southeast would have been unable to complete the overall project for reasons independent of the lack of filter cloth (such that Southeast would have been in default anyway), the Board denied the appeal.

Arbitrator's failure to fully disclose his relationship with a party to the arbitration results in the award being vacated

In *Houston Village Builders, Inc. v. William Craig Falbaum*, 105 S.W.3d 28 (Tex. App. 2003), the appellate court reviewed the trial court's decision to vacate an arbitration award whereby the sole arbitrator in a contract dispute failed to identify an indirect relationship he held with one of the parties.

In this case, the owners of a new home (the Falbaums) brought suit against the seller, Houston Village Builders, Inc. (HVB) alleging significant foundation problems. Pursuant to the contract, the parties entered into binding arbitration subject to the Construction Industry Arbitration Rules of the American Arbitration Association (AAA).

The AAA allowed each party to eliminate 3 arbitrators from a list of ten, whereupon the AAA designated the sole arbitrator from the remaining names. The arbitrator's CV indicated that he was a member of the Greater Houston Builders Association (GHBA) which is an organization of approximately 1,350 resident builders. In a disclosure letter to the AAA, the arbitrator indicated that HVB and its parent company were both members of the GHBA, that he had met an individual from the parent company, but that he has not represented HVB or its parent, such that no conflict existed.

After the arbitrator issued an award that the Falbaums take nothing and must pay $235 in administrative fees and expenses, the Falbaums' attorney learned that the arbitrator had had an attorney-client relationship with the GHBA, on the basis of which the Falbaums filed a motion to vacate the award under the Texas Arbitration Act on grounds of "evident partiality" of the arbitrator.

The court confirmed the applicability of the rule set forth in *Burlington Northern Railroad Co. v. TUCO Inc.*, 960 S.W. 2d 629 (Tex. 1997) in which the court held that:

> a prospective neutral arbitrator selected by the parties or their representatives exhibits evident partiality if he or she does not disclose facts which might, to an objective observ-

er, create a reasonable impression of the arbitrator's partiality. We emphasize that this evident partiality is established from the nondisclosure itself, regardless of whether the nondisclosed information necessarily establishes partiality or bias.

The court concluded that even though the arbitrator did not have a direct attorney-client relationship with HVB or its parent company, the arbitrator should have disclosed the attorney-client relationship with GHBA (which was on-going at the time of the arbitration) because "it is not unreasonable to suggest that someone in the Arbitrator's position might be influenced into ruling in favor of a trade-association member to protect his status as the association's counsel." The court also noted that a footnote reference in an 8-year old article written by the arbitrator (identified in his CV) identifying that the arbitrator held a counsel position with the GHBA was insufficient to satisfy the arbitrator's affirmative duty to disclose. Therefore, the appellate court affirmed the trial court's decision to vacate the award as the arbitrator failed his affirmative duty to disclose as required under TUCO.

A New California bidder's option to explore the seldom-used tort of 'interference with a prospective economic advantage'

In the case of *Korea Supply Company v. Lockheed Martin*, 131 Cal.Rptr.2d 29 (Cal. 2003), the court addressed (1)under what circumstances a disgorgement of profits claim is appropriate under the California's Unfair Competition Law, and (2)to what extent the plaintiff must allege that the defendant intentionally interfered with the plaintiff's economic advantage under the tort of interference with a prospective economic advantage.

MacDonald Dettwiller and Associates, Ltd. (MacDonald) and Loral Corporation (Loral) submitted bids on a procurement contract solicited by the Republic of Korea (Korea). Both parties were represented during negotiations in Korea: Loral by Ms. Linda Kim and MacDonald by Korea Supply Company (KSC), the latter of which was to receive a $30 million commission if MacDonald was awarded the contract. After Loral was awarded the contract despite having bid $50 million higher than MacDonald, it was discovered that Loral received the bid because Ms. Kim had paid bribes and provided sexual favors to Korean public officials. Consequently, MacDonald brought suit seeking relief under the California Unfair Competition Law (UCL) and the tort of interference with a prospective economic advantage.

Under MacDonald's cause of action for disgorgement of profits (*i.e.* profits Loral realized under the contract), the Court explored Section 17302 of the UCL which provides for injunctive relief on the bases of restitution to "restore to any person … any money which may have been acquired ... by means of [certain instances of] unfair competition." However, the Court dismissed this cause of action because the remedy sought by KSC was non-restitutionary in nature (*i.e.* KSC never had an ownership interest in the money), and that therefore KSC had not pled facts sufficient to qualify under the UCL.

With respect to MacDonald's cause of action for interference with prospective economic advantage, the Court wrestled with the issue of the applicable standard of the intent element (the third of five elements necessary to be proved under the tort) which a plaintiff must plead in such an action. In drawing from the commentary in the Restatement Second of Torts which addresses the analogous tort of intentional interference with a contractual relationship, the Court concluded that a plaintiff need not plead a specific intent to harm or interfere. Rather, the Court found that it is sufficient to plead that "the defendant knew that the interference was certain or substantially certain to occur as a result of its action," thereby effectively opting to require a lower standard of intent to bring an action. In applying the facts of the case to the five elements of the tort, the court upheld the Appellate court's decision that the plaintiff had properly pled the tort action.

Calendar of Events

Zoning and Land Use in Massachusetts

Peter S. Brooks will speak at a seminar on August 27, 2003, at the Holiday Inn Worcester, 500 Lincoln Street, Worcester, Massachusetts, concerning the constitutional aspects of zoning and land use decisions (*i.e.* when do permit denials or conditions violate the Constitution).

"Tools for Identifying, Evaluating and Mitigating Design-Build Contract Risks."

Design Build Institute of America

Bennett Greenberg will be speaking on October 9, 2003, at the 2003 DBIA Professional Design Build Conference in Orlando, Florida.

"Your Next Job is Where?"

Associated Builders and Contractors of Georgia

Kamy Molavi and Clay Haden will be speaking at a seminar sponsored by the Associated Builders and Contractors of Georgia on August 22, 2003, in Atlanta, concerning some differences in legal requirements of various states as they relate to the construction industry. Allen Groves and Jeff Cunningham will also be participating.

Publications

Government Contract Litigation Reporter

Greg Correnti and Don Featherstun co-authored an article entitled "California Supreme Court Decision Refines Remedies for Disappointed Bidders and Public Agencies in the Procurement Process." published in the July 17, 2003 edition (Vol. 16, Issue 6).

Contact Information for Members of the Construction Group

John H. Anderson, Chicago
janderson@seyfarth.com
312-269-8848

John Bergin, Washington, DC
berginj@dc.seyfarth.com
202-463-2400

David A. Blake, Washington, DC
dblake@dc.seyfarth.com
202-828-3523

Peter Brooks, Boston
brookspr@seyfarth.com
617-946-4991

Jerome F. Buch, Chicago
jbuch@seyfarth.com
312-269-8927

Robert B. Carpenter, Boston
carpero@seyfarth.com
877-202-9001

Philip L. Comella, Chicago
312-269-8501
pcomella@seyfarth.com

J. Gregory Correnti, Los Angeles
gcorrenti@la.seyfarth.com
310-201-5233

Marcus Eyth, Washington, DC
meyth@dc.seyfarth.com
202-828-3574

Sara Beiro Farabow, Washington, DC
sfarabow@dc.seyfarth.com
202-828-3591

Donald G. Featherstun, San Francisco
dfeatherstun@sf.seyfarth.com
415-544-1088

Martin J. Golub, Brussels
golubma@dc.seyfarth.com

Bennett D. Greenberg, Washington, DC
bgreenberg@dc.seyfarth.com
202-828-5336

Thomas P. Guerard, Atlanta
tguerard@seyfarth.com
404-885-6767

C. Clay Haden, Atlanta
chaden@seyfarth.com
404-885-6737

Richard Holderness, San Francisco
rholderness@sf.seyfarth.com
415-544-1084

Jeffrey M. Hummel, Washington, DC
jhummel@dc.seyfarth.com
202-828-5342

C. Walker (Chip) Ingraham, Atlanta
cingraham@seyfarth.com
404-885-6717

Jeffrey Jahns, Chicago
jjahns@seyfarth.com
312-269-8819

Deanna Johnston, San Francisco
djohnston@sf.seyfarth.com
415-544-1061

Steven J. Kmieciak, Washington, DC
skmieciak@dc.seyfarth.com
202-828-5381

William H. Lancaster, Los Angeles
wlancanster@la.seyfarth.com
310-201-5286

Kari Erickson Levine, San Francisco
klevine@sf.seyfarth.com
415-544-1078

Mark A Lies II, Chicago
mlies@seyfarth.com
312-739-8877

Todd Maiden, San Francisco
tmaiden@sf.seyfarth.com
415-544-1014

Michael T. McKeeman, San Francisco
mmckeeman@sf.seyfarth.com
415-544-1038

Kamyar Molavi, Atlanta
kmolavi@seyfarth.com
404-885-6739

Allan S. Ono, Los Angeles
aono@la.seyfarth.com
310-201-5291

Anna R. Palmer, Atlanta
apalmer@seyfarth.com
404-888-1039

Lowell H. Patterson III, Washington, DC
lpatterson@dc.seyfarth.com
202-828-3559

Robert F. Pezzimenti, Washington, DC
rpezzimenti@dc.seyfarth.com
202-828-3563

Richard M. (Kim) Preston, Washington, DC
rpreston@dc.seyfarth.com
202-828-5370

David W. Waddell, Houston
dwaddell@seyfarth.com
713-225-0283

Thomas Larry Watts, Los Angeles
lwatts@la.seyfarth.com
310-201-5287

William Karl Wilburn, Washington DC
wwilburn@dc.seyfarth.com
202-828-3540

This newsletter is a periodical publication of Seyfarth Shaw and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents, please contact the firm's Construction Law Practice Group.

ATLANTA
One Peachtree Pointe
1545 Peachtree Street , N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON
Two Seaport Lane, Suite 300
Boston, MA 02210
617-737-1900
617-737-6139 fax

CHICAGO
55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON
700 Louisiana Street, Suite 3850
Houston, Texas 77002-2731
713-225-2300
713-225-2340 fax

LOS ANGELES
One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK
1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO
400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO
101 California Street, Suite 2900
San Francisco, California 94111-5858
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.
815 Connecticut Avenue, N.W, Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS
Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax