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Workshop W

***DESIGN-BUILD:
CONTRACTS AND CLAIMS***

Presented by

**Michael C. Loulakis, President
Owen J. Shean, Attorney
Wickwire Gavin, P.C.**

Thursday, November 11, 8:30–11:15 a.m.

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Michael C. Loulakis
President
Wickwire Gavin, P.C.

Mr. Loulakis is a copresenter for Workshop W, "Design-Build: Contracts and Claims," on Thursday. He is president of Wickwire Gavin, P.C., a Vienna, Virginia, law firm that concentrates on representing domestic and international clients on construction-related matters. His legal practice focuses on representing members of the construction industry, including owners/developers, sureties, contractors, and design professionals.

His diverse background includes contract administration advice; review of procurement and contracting documents; contract drafting and negotiations; preparation, negotiation, analysis, and defense of contract claims; resolution of claims through litigation, arbitration, and other ADR methods; and establishing risk management policies and project delivery methods. Mr. Loulakis is a national speaker on these and other issues and holds an IRMI Words of Wisdom (WOW) award. He is the author of numerous publications, including several recent books on design-build titled *Design-Build for the Public Sector* (Aspen Publishers 2003), *Design-Build: Planning Through Development* (McGraw Hill 2001), and *Design-Build Contracting Handbook*, 2nd Edition (Wiley Law & Business 2001). Mr. Loulakis is also the author of *Design-Build Lessons Learned*, which is a series he has published each year since 1995 that examines case law on design-build projects reported upon in a given year, as well as a widely acclaimed interactive CD-ROM program titled *Construction Project Delivery Systems: Evaluating the Owner's Alternatives*, produced and distributed by A/E/C Training Technologies.

Mr. Loulakis is a member of the Board of Directors of the Design-Build Institute of America (DBIA) and served as Chairman of DBIA's Manual of Practice Committee. He had principal responsibility for drafting the DBIA Contracting Guide and DBIA's standard form design-build contracts and subcontracts. Prior to joining Wickwire Gavin in 1979, Mr. Loulakis was a practicing engineer with a Boston, Massachusetts, area geotechnical consulting firm.

He received a bachelor of science degree, *magna cum laude*, in Civil Engineering from Tufts University in 1976 and a Juris Doctor degree from Boston University School of Law in 1979.

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Mr. Shean is a copresenter of Workshop W, "Design-Build: Contracts and Claims," on Thursday. He is a shareholder in the national law firm of Wickwire Gavin, P.C., in its Vienna, Virginia, office. Mr. Shean represents clients in commercial litigation and arbitration. His practice focuses on construction-related matters, insurance, government contracts, and creditors' rights. Mr. Shean has worked with clients in the construction, insurance, semiconductor, software, and chemical processing industries. Mr. Shean received a B.A. *magna cum laude* and J.D. from the University of Virginia. He lectures and writes frequently on insurance and construction law. He is coauthor of *Construction Insurance: Coverages & Disputes*, The Michie Company, 1994, updated 1995, 1999, 2000, and 2001. Mr. Shean has been an adjunct professor of law at Georgetown University Law Center since 1988.

Notes

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DESIGN-BUILD: CONTRACTS AND CLAIMS

**Michael C. Loulakis
Owen J. Shean
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- I. Risk Allocation under Design-Build Contracts
 - A. Reasonable Expectations
 - B. Differing Site Conditions
 - C. Scope of Work
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- II. Responsibility for Bridging Errors
 - A. Purpose of Bridging Documents
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- III. Scope of Work & Design Development
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- IX. Current Context of Design-Build Disputes
 - A. Evolving Case Law
 - B. Application of Prior Precedent to Design-Build Cases
- X. Disputes Regarding Scope of Work
 - A. Role of RFP Requirements

- B. Design-Build Proposal as Element of Scope of Work
- C. Role of Design/Performance Specifications
- XI. Disclaimer of Design
 - A. Vitality of *Spearin*
 - B. Identification and Articulation of Design Standards
 - C. Role of Design Development Procedures
 - D. Notice
- XII. Insurance
 - A. Competing Strategies for Design-Build Risks
 - B. Design-Builder's CGL Coverage for Property Loss Caused by Subcontractor's Subconsultant's Negligence
 - C. Application of "No Action" Clause/ "Cooperation" Clause
 - D. Coverage under "All Risk" Property Policy for Defective Work
- XIII. Limitations of Liability
 - A. Scope and Interpretations of Clauses
 - B. Conditions Precedent to Clauses
 - C. Application of Clauses to Design-Build Risks
- XIV. Liability of Sureties under Design-Build Contracts
 - A. Provisions of Traditional Bond Forms
 - B. Conditions Precedent to Surety Performance
 - C. Defenses of Waiver & Prejudice
- XV. Conclusions

DESIGN-BUILD: CONTRACTS AND CLAIMS

**Michael C. Loulakis
Wickwire Gavin, P.C.**

Contractual Risk Allocation

The ideal contract -- the one that will be most cost effective -- is the one that assigns each risk to the party that is best equipped to manage and minimize that risk, recognizing the unique circumstances of the project.

Construction Industry Institute

Realities of Design-Build Risk Allocation

- **Owners control the project risk profile**
- **Public and private sector owners act similarly**
 - pay lip service to proper risk allocation
 - shift it all to the contractor
- **Design-builders are not in the best position to assume all project risk**
 - pricing inefficiency
 - conflict
 - risk vs. uncertainty

Special Public Sector Problems: Water and Transportation

- **Contracts have unreasonable risk shifted to design-build team**
- **Bid bonds and certifications that contract will be “accepted as written”**
- **Impact:**
 - no bid, lower competition, higher prices
 - shifting of risk within the team
 - insurance and surety backlash
 - conflict
- **Should the “greater fool theory” be the basis for a public agency’s procurement approach?**

What Can One Reasonably Expect from Design-Build?

- **Schedule benefits from the phasing of design, procurement and construction**
- **Technical innovation**
- **Enhanced project relations when designer and contractor are teammates**
- **Shifting risks of gaps in design and construction**

What Risks are Beyond the Bounds of Reasonableness?

- Clairvoyance about site conditions
- Errors in reference data
- Changes in the design assumptions
- Unlimited liability on a risk-loaded contract
- Converting design-builder into a financier and insurance company

Critical Design-Build Contract Problem Areas

- Responsibility for errors in the bridging documents
- Scope of work and design development
- Standard of care for design
- Differing site conditions
- Ownership of design documents
- Schedule delay
- Limitations of liability

Responsibility for Bridging Errors

- Philosophy behind bridging
- Contract language shifts risks to contractor
 - “design provided for information only”
 - “concept designs not to be relied upon”
- Competitive bidding environment
 - right of bidder to rely on adequacy of owner-specified equipment and systems
 - risks with new technology
 - *Spearin* doctrine alive and well

M.A. Mortenson Co. (1993)

- Air Force medical clinic
- Design-builder relied on solicitation design documents
- Corps rejected request for equitable adjustment
- Board agreed that Corps had warranted information

Donahue Electric (2002)

- VA ambulatory care facility in Las Vegas
- Donahue and HCE (Allen) form a team
- Budget problems change nature of the procurement and team
- VA-furnished boiler needed 25HP boiler
- Parker B-3 boiler listed on equipment schedule was a 7HP boiler
- VA claimed that Donahue had “total design responsibility” and denied claim

Quotes from the VABCA Opinion

At a minimum, the drawings were provided as guidance/concepts for the design-build bidders. The ‘Note’ that the drawings are ‘information only’ is not consistent with that approach. VA’s position would require that bidders design the project prior to bid.

Quotes from the VABCA Opinion (cont'd)

The VA could simply have stated, 'install the Steris 3400 GFP sterilizer and a boiler to operate it.' Such a specification would have made Donahue responsible for choosing a boiler that would properly operate the sterilizer. When, as here, the VA specifies [the] boiler, absent actual knowledge to the contrary a bidder may rely on that information.

Mitigating the Risk of Bridging Errors

- **Phased contracting approach**
 - preliminary agreements
 - GMP pricing approaches
- **Design verification periods**
 - period after NTP for design-build team to verify design assumptions and site conditions
 - offer relief for material issues that could not have been reasonably determined pre-bid
 - fix liability on design-builder thereafter

Scope of Work and Design Development

- **Establishing scope of work**
 - public sector (RFP)
 - conflicts between RFP and proposal
- **Design development**
 - owner's rights to review and approve design
 - owner control over design
 - design-builder's right to make minor changes

Developing the Design

DBIA Suggested Language

“Design-Builder shall submit to Owner interim design submissions as the parties may agree upon to support the overall project schedule. On or about the time of the scheduled submissions, Design-Builder and Owner shall meet and confer about the submissions, with Design-Builder identifying during the meeting, among other things, the evolution of the design and any significant changes or deviations that have taken place from previous design submissions.

...”

Developing the Design (cont'd)

DBIA Suggested Language

“ . . . Minutes of the meeting will be maintained by the Design-Builder and provided to all attendees for review. Following the design review meeting, Owner shall review and provide its response to the interim submissions in a time that is consistent with the turnaround times set forth in Design-Builder’s schedule.”

Design Standard of Care

- **Measuring typical standard of care for design professionals**
- **Evaluating unique design-build issues**
 - **single point of responsibility “spin”**
 - **conflicts within the plans and specifications**
 - **performance specifications**
 - **post-completion defects**

Design Standard of Care

- Commercial and marketplace reality
- Problems:
 - fitness for purpose
 - “best” design
 - design warranted to be “free of defects”
 - application of UCC
 - certifications
- Protecting owner who bargains for performance guarantees
- Reasonable performance guarantees with measurable standards

Standard of Care (DBIA)

“The standard of care for all design services performed to execute the Work shall be the care and skill ordinarily used by members of the design professional practicing under similar conditions at the same time and place of the Project. Notwithstanding the preceding sentence, if the parties agree upon specific performance standards for any aspect of the Work, which standards are to be set forth in an exhibit to the Agreement entitled ‘Performance Standard Requirements,’ the design professional services shall be performed to achieve such standards.”

Performance Guarantees and Acceptance Testing

- **Potentially great benefit of design-build**
- **Problems for water and wastewater sector:**
 - subjective standards for water quality
 - broad range of influent parameters
 - effluent standards that are more stringent than applicable law
 - measuring the standards
 - remedy if fail to meet guarantee
 - impact of operations on ability to meet guarantees

The Challenges of Meeting T&O, Color and Noise Guarantees

- **Taste, odor and color are directly related to influent**
 - what is the baseline for raw water?
 - what happens if actual influent changes from the baseline?
 - different ways to treat different influents
- **Attempt to make standards of classification objective**
- **Noise**
 - what is objectionable?
 - how much pre-award money do you spend?

Differing Site Conditions

- **Philosophy behind DSC clause**
- **Tendency of owners to disclaim DSC risk**
 - no ability to rely upon reference information
 - DSC clause with severe limitations
- **Realities of case law**
- **Suggested contracting approaches:**
 - geotechnical baseline reports
 - use of assumptions
 - allowances

Ownership of Design Work Product

- **Non-integrated project delivery systems:**
 - no design ownership challenges
 - designer works for owner
 - owner has right to use design
- **Design-build**
 - designer working with contractor
 - procurement and default issues

Johnson v. Jones

- **Architect to provide design-build services**
- **Owner terminates architect**
- **New architect uses original work product**
- **Owner and follow-on architect liable for copyright infringement**

Ownership of Design Work Product

- **Design-build contracting approach**
 - **define “Design Work Product”**
 - **instruments of service**
 - **provide limited licenses conditioned on:**
 - **payment of monies due under Agreement**
 - **indemnity to design-build team**
 - **other payments**

Ownership of Design Work Product (cont'd)

- **Owner's payment in full**
 - use in connection with occupancy
- **Owner's T for C or Design-Builder's election to terminate**
 - premium if resumes project
- **Design-Builder's default**
 - determination of default & satisfaction of Owner's obligations
 - conversion to T for C

Schedule Delays

- **Problem:**
 - unreasonable time extension clauses
 - narrow definition of uncontrollable circumstances
 - no damages for delay
 - share of cost
 - severe consequences for delay
- **Contracting approach**
 - classic "who can control" risk
 - strong scheduling clauses to protect owner
 - reasonable liquidated damages

Overall Liability

- **Competing philosophies:**
 - “Something goes wrong, you pay all costs.”
 - “You broke it, you fix it.”
- **Liquidated or actual damages?**
 - owner’s consequential damages
 - benefits of actual cost approach
- **Limitations of liability**
 - dollar value
 - carve-outs for liquidated damages
- **Commercial reality**

Teaming Relationships

- **Flow-down obligations**
- **Enforceability of teaming agreement**
- **Allocating liability from owner**
- **Unique role of design subcontractors**

Trident v. Austin (2003)

- NAVFAC project
- Trident was a prospective steel supplier and erector
- Trident's \$5.2 million price used by Austin in bid, but Austin awards to other
- Statute of frauds found applicable
- "Agreement to agree"

Siemens Westinghouse v. Dick Corporation (2003)

- Power plant in New Hampshire for AES
- \$85,000/day in liquidated damages
- \$18 million drawn from an LOC posted by Siemens
- Question: Who bears the risk of "fronting" the payment?

***C.L. Maddox, Inc. v.
Benham Group, Inc. (1996)***

- Electric power plant retrofit
- Design-builder sued A/E for bidding and engineering errors and delays
- Jury award of \$5 million in damages
- Implied warranty of design

**Unique Contract Issues:
Design-Builder and Designer**

- Designing to budget
- Role of contractor during design
- Duties during construction administration
- Financial considerations
 - Contingencies
 - Bonus/penalty
 - E&O coverages

Current U.S. Standard Form Design-Build Contracts

- EJCDC (2002)
- AGC (2000)
- DBIA (1998)
- AIA (1997)

Final Thoughts on Design-Build Contracting

- Owners control the procurement and contracting process
- Owners:
 - think through why design-build is being used
 - prioritize your goals
 - remember that the protection of “price certain” and “claims-proof” contracts can be illusory
- Design-builders – remember that design-build is not “business as usual”

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DESIGN-BUILD: CONTRACTS AND CLAIMS

**Owen J. Shean
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D-B Claims & Disputes

- D-B as Maturing System of Procurement
- Decisions & Case Law Developing Substantial Legal Precedent
- Crystalizing Principles & Precedent Regarding Scope and Risk under Design-Build Contracts

Some Things Old and Some Things New

- Familiar Themes
- Struggle to Reconcile Prior Precedent to New Realities
- Embracing of D-B Principles & Corresponding Risks

Five Familiar Disputes

- **Scope**
- **Design vs. Performance Specifications**
- **Insurance**
- **Limitations of Liability**
- **Surety's Obligations**

Scope

- **D-B Has Not Ended Disputes Regarding Contractual Obligations**
- **Significant Opportunity for Misunderstanding**
 - Varying Experience
 - Divergent Expectations
- **Functional & Substantive Distinctions with D-B Scope**
- **Use of Design vs. Performance Specs. as Elements of D-B Contract**

RFP vs. BAFO

Wade Perrow Construction, Inc., ASBCA 2003

- D-B Contract for Golf Clubhouse & Facilities
- RFP Required Storm Drainage System and Prevention of Ponding of Storm Water
- BFO Employed “Sheet Flow to Ditch”
- 50% Design Submittal Included “Sheet Flow” System, Rejected by Government

RFP Prevails

Wade Perrow Construction, Inc., ASBCA 2003

- Government Properly Rejected Proposed Design
- No Protest by D-B During Design Process that Government Action Was a Change
- No Demonstration that “Sheet Flow” System Would Work

BAFO Prevails

*Sherman R. Smoot Corporation,
ASBCA (2002)*

- Demolition, Renovation and Construction of Buildings at Washington Navy Yard
- RFP Encouraged “Greening Plan”
- Initial Design Showed 128 Fixtures, Inclusive of WCs, Urinals and Lavatories
- BAFO Identified 124 Fixtures

*Sherman R. Smoot Corporation,
ASBCA (2002)*

- BAFO Prevails
- RFP Requested “Greening Plan”
- Navy Stated its Commitment to Consider Modifications Consistent With “Greening Plan”
- Smoot Entitled to Compensation for Difference Between Number of Fixtures in BAFO and Number of Fixtures Installed

Design vs. Performance Specifications

- Both Types of Specifications Employed in D-B Contracts
- D-B Concept Does Not Jettison Role of Design Specifications
- D-B Contract is Not Tantamount to One Large Performance Specification

Disclaimer of Design

White v. Edsall Construction Co., Fed. Ct. 2002

- Fixed Price Contract for Helicopter Hangar
- Design/Specifications Detailed Tilt-Up Canopy Doors Weighing 21,000 lbs. Each
- Drawings Identified Three “Pick Points” for Cable Attachments to Doors
- Notes Required Contractors to Verify Requirements for Canopy Doors

White v. Edsall Construction Co., Fed. Ct. 2002

- After Bidding Contractor Determined “Three Pick-Point” System Inadequate
- “Four Pick-Point” System Required
- Fed. Cir. Held Spearin Applied
- Design Defect Was Not Patent
- Disclaimer Only Required Verification of General Details Rather than Efficacy of Design

Insurance

- Industry Forms Have Not Kept Pace With Changes in Scope of D-B Risk
- Competing Strategies of Modifying CGL vs. E&O Platform
- Substantial Case Law Which Predates D-B Principles
- Potential Anomalies in Application of Case Law to D-B Contracts and Corresponding Insurance

***American Family Mutual Insurance Co. v.
American Girl, Inc., Wis. 2003***

- D-B Contract for Distribution Center Warehouse
- Warranty of Design & Construction
- Subconsultant Furnished Soils Advice Regarding Compaction of Soils
- Completed Structure Sank and Later Demolished
- Subconsultant's Advice Considered Negligent

***American Family Mutual Insurance Co. v.
American Girl, Inc., Wis. 2003***

- D-B Notified CGL Carrier of Claim
- CGL Carrier Initially Determined Coverage Existed and Set Reserves
- CGL Carrier Later Disclaimed Coverage
- Trial Court Held that CGL Policy Provided No Coverage for Claims

American Family Mutual Insurance Co. v. American Girl, Inc., Wis. 2003

Wisconsin Supreme Court Held:

- Claims Constituted “Property Damage”
- Claims Alleged “Occurrence”
- “Contractually Assumed Liability” Exclusion Did Not Apply
- Economic Loss Did Not Bar Insurance Coverage

Insurance

Phillips Way, Inc. v. American Equity Insurance Company, Md. App. Ct. 2002

- D-B Contract for Golf Course Construction
- Design Deficiencies Encountered During Construction
- Design-Builder Proceeded with Correction of Architectural and Structural Design Without Notification of E&O Carrier
- Design-Builder Submitted Claim to Carrier After Completion of Project and Acceptance by Owner

Phillips Way, Inc. v. American Equity Insurance Company, Md. App. Ct. 2002

- **Carrier Asserted “No Action” Clause as Basis to Decline**
 - Failure of adherence to policy
 - Absence of final judgment or agreement fixing loss with consent of insured
- **Design-Builder Asserted That Lack of Notice Created No Prejudice**
- **Design-Builder Asserted Carrier’s Defense Barred by Statutory Requirements Re: Notice**

Phillips Way, Inc. v. American Equity Insurance Company, Md. App. Ct. 2002

- **Maryland Appeals Court Held No Coverage**
- **“No Action” Clause Applied to Insured’s Action for Coverage**
- **“No Action” Clauses Operate to Avoid Collusion**
- **Statutory Provisions Only Apply Where Declination of Coverage is Based Upon Notice**

INSURANCE

City of Burlington v. Indemnity Insurance Co. of North America, 2d. Cir. (2002)

- Construction of Wood-Fired Steam Electric Generating Facility
- Initial Leaks Detected After Successful Hydrostatic Testing & Commercial Operation
- Subsequent Leaks Detected and Traced to Defective Welds in Piping
- Owner Asserted Claims Under “All Risk” Property Policies Maintained When Subsequent Leaks Detected

City of Burlington v. Indemnity Insurance Co. of North America, 2d. Cir. (2002)

- City Sought Costs for Repairing All Welds
- Court Construed “Direct Physical Loss or Damages” as Applying Only to Welds Evidencing Leaks
- Court held that “Latent Defect” and “Inherent Vice” Exclusion in “All Risk” Policy Precluded Coverage for Leaks

Limitations of Liability

Mistry Prabhudas Manji Eng. Pvt. Ltd. v. Raytheon Engineers & Constructors, Inc., et al. (D.Mass. 2002)

- Design-Build Caustic Soda Plant
- 72-HP Performance Test or Deemed Acceptance
- LDs for Shortfall in Performance Guarantees
- Unit Failed to Achieve Start-Up and Never Passed 72-HP Test

Mistry Prabhudas Manji Eng. Pvt. Ltd. v. Raytheon Engineers & Constructors, Inc., et al. (D.Mass. 2002)

- Owner Asserted That Limitation of Liability Applied Only if Performance Test was Run and Failed
- Language of Clause Established “Maximum Limit of Liability Under the Agreement”
- Payment of LDs Subject to Limitation of Liability was Owner’s “Exclusive Remedy” for Failure to Meet Performance Guarantee
- Court Concluded Limitation of Liability was Enforceable

Sureties

*USF&G v. Braspetra Oil Service Company,
S.D.N.Y. 2002*

- D-B project for conversion of oil platform facilities from exploration to production
- Design-Builder furnished A312 Performance Bond
- Substantial Overruns
- Owner Informed Surety of Significant Difference Between Contract Amount and Cost to Complete

Sureties

*USF&G v. Braspetra Oil Service Company,
S.D.N.Y. 2002*

- Attempts by Owner to Lessen Financial Strain on D-B by Making Contract Payments
- Surety Invoked “Investigation” Option under A312
- Owner Informed Surety of Catastrophic Implications of “Protracted Investigation”

Sureties

USF&G v. Braspetra Oil Service Company,
S.D.N.Y. 2002

- Court Concludes Conditions Precedent Satisfied by Actions of Owner
- Surety Unfamiliar With Contracts
- Owner Assistance Did Not “Discharge Surety”
- Contract Modifications Improved Position of Surety
- “Obligee’s act of leniency . . . does not suffice to release surety”

Conclusions

- Tribunals – Specifically CBAs and Federal Courts – Are Developing Substantial Case Law on D-B
- Decisions Reflect a Mixture of Established Precedent and Application of New Principles
- Principles of D-B Substantially Influence Decisions Relating to Assumption of Performance Risks
- Courts Still Constrained by Existing Case Law, Particularly in Areas Reflecting Use of Standard Forms