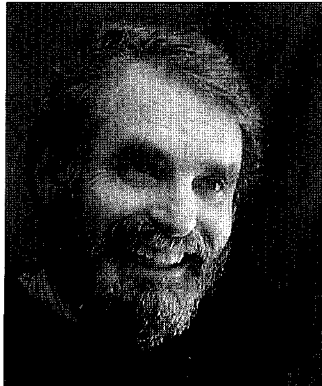
A View from the Tower


Justin Sweet

I feel the winds of legislative intervention into the Construction Contract Law. Those preparing a revised Article Two of the Uniform Commercial Code (UCC) are considering placing some service transactions under their wing. Some ABA groups are investigating the preparation of a Construction Code. In England the Latham Report suggests statutes give impetus to certain standard contracts by making it difficult to modify such contracts and by declaring certain clauses illegal. Finally state legislatures increasingly intervene in the construction payment process, undoubtably one reason for codification interest.

As codification is being talked about in ABA circles, I shall devote this column to that topic. I shall pass by questions that will have to be addressed by anyone considering such a venture, among them being the need for such a Code, the availability of resources to do an adequate job, the drafting theory of such a Code, the coverage of such a Code, the chances such a Code would be enacted and the mechanism by which such a Code would be prepared. These are too complex for the column format.

Let me assume codification will be attempted along the lines of the UCC. I shall put one possible drafting topic through a "dry run." Were I the drafter, how would I deal with what the scholars call payment conditions in subcontracts or, better known in the trade as a "pay when paid" clause (Subcontractor takes the risk only of delay but not nonpayment), as contrasted to a "pay if paid" (Pay if *and only if* would be better) clause (Subcontractor does not get paid for its work if the prime is not paid). Nonpayment results either from owner financial difficulties or failure by another subcontractor to perform properly. This issue also arises between prime design professionals and their consultants. While it has fanned the flames of contention between design professional associations, unlike subcontract clauses it has not generated much litigation.

Contracting parties can, if they express their intent with crystal clarity, create a "pay if paid" clause. If they do, the subcontractor is not paid for work it has done if the prime has not been paid. Contract language varies greatly. This gives courts great latitude when applying this simple rule. Generally subs win because judges: 1) believe subs are at the mercy of primes, 2) think primes are in the best position to assess and avoid the risk of nonpayment, and 3) are hostile to forfeiture.

I could follow the lead of a few legislatures and the Latham Report in England and simply ban the "pay if and only if paid" clause—a favorable outcome for subs. But this frustrates private autonomy. Parties should determine pricing and risk allocation. The prime might pay more to get the sub to assume this risk or less if the prime took this risk.

I could codify the common law rule. I could state the parties can create a "pay if paid" clause if and only if the language is crystal clear. I could supplement this by placing the burden of proof on the party proposing to create a forfeiture. This would favor subs.

I could facilitate autonomy by treating the clause as any other and by including alternative statutory clauses. This would allow the parties (the prime?) to choose what they want and assure them that the outcome they (the prime?) choose will be respected by the courts. This would benefit primes, as they control the language.

How do I decide? I could seek empirical evidence of industry practices and follow them. But it takes professional skill and substantial resources to do empirical research properly, both in short supply these days. Also, U.S. practices often vary from locality to locality.

Can I look to the national standard contracts to show industry practices? The AIA, a neutral, creates a "pay when paid" in A401, its subcontract, and fudged the issue in its A201, its prime contract. In 1994 the national prime and sub associations adopted a "pay when paid" clause. That this would surprise most primes is demonstrated by the California AGC having adopted a "pay if paid" clause. In any event such standard forms may not represent actual practice as primes generally use their own forms. A review of such "standard" contracts may not define industry practices.

If I commission and receive a good empirical questionnaire study, it would show only the the primes favor "pay if paid" and can give you many reasons (prime and sub have a long-term relationship, a *de facto* partnership) for the risk being shared. It would show that subs say they never intend to work for nothing and have no choice in selecting the contract or evaluating the risk. Not much help here. A representative sample of actual subcontracts is likely to reveal attempts to create "pay if paid" clauses. I still must decide whether I should disturb the allocation of bargaining power, much as courts do today.

Should I seek economic efficiency? Who is the cheapest loss avoider? Who can most easily and inexpensively obtain information on likely owner nonpayment? (At least economic analysis is cheap.) With its unproven and often dubious assumptions economic analysis might be interesting but not very useful.

Those who must determine whether to embark on a codification venture must face the questions I noted and others. To help, though, I would suggest they do some "dry runs" as I have done. They will reveal the practical drafting problems codification will present. Their decision will be a difficult one.

HeinOnline -- 15 Constr. Law. 85 1995

Letters to the Editor

Dear Editor:

This fall the Fair Trade Commission of Japan (FTC) moved into its new headquarters. This move consolidated its offices and seems to symbolize a new resolve on the part of the FTC to become tough on violators of the Antimonopoly Act (The Act Concerning Prohibition of Private Monopoly and the Maintenance of Fair Trade—Act No. 54, 1947). The Act, modeled after the Sherman, Clayton and Federal Trade Commission acts, gives the FTC vast powers, but pressures over the years from other regulatory agencies and politicians led to the exemption of many industries and an erosion of the powers of the FTC. However, recent political scandals revealed bid-rigging practices in the very lucrative public works sector and, in an effort to curb these practices, the FTC in July 1994 published "The Antimonopoly Act Guidelines Concerning the Activities of Firms and Trade Associations in Relation to Public Bids." The following is an outline of the guidelines which may be of interest to the readers of *The Construction Lawyer* who advise firms who already do or plan to do business in Japan.

The guidelines are divided into two parts. Part 1 outlines the relevant sections of the act, what action can be taken by the FTC under the act and various penal provisions. Part 2 outlines the interpretation of the FTC of what constitutes actionable activities under the act. Part 2 consists of four subsections: Conduct Related to Selection of Contract Awardee, Conduct Related to Bid Prices, Conduct Related to Contractual Quantity, and Collecting and Offering Information and Management Guidance. In each of the first three subsections, examples of activities are given and classified into "Conduct in principle constituting violation," "Conduct suspected to be in violation," and "Conduct in principle not constituting violation."

In Part 1, "Bid-rigging" is defined as "[f]irms' concerted conduct or a trade association's conduct of substantially restraining competition in a particular field of trade by predetermining an expected winner or a minimum bid price." Such activities violate Article 3 of the act which prohibits unreasonable restraint of trade and the FTC can take "necessary measures" including the issuance of cease and desist orders. Because revelations of bid-rigging usually occur after the fact, in such cases the FTC can order surcharges of up to 6 percent be paid on sales amounts concerned. However, such surcharges can be ordered only within three years of completion of such works. Surcharges are not the only recourse available against violators. The act states violators assume absolute liabilities and may be made to indemnify the aggrieved party penal sanctions of fines as well as penal servitude of a maximum of three years that can also be meted out. The guidelines note that "[t]he FTC has announced the adoption of a policy to actively accuse to seek criminal penalties on" repeat offenders and "vicious and serious cases" which results in "wide-spread influence on people's livings." The message is clear: Offenders beware.

Part 2 covers conduct related to selection of contract awardee. This section explains that not only actual predetermination of the expected bid winner would violate the act, but agreeing on a procedure to predetermine is also considered a violation. This section also discounts the commonly advanced justifications for systematic bid-rigging, "to assure the quality of goods or service supplied, to equalize the opportunities for being awarded contracts, or to take into account the business activities of individual firms, and to respect continuity and established relations with previously contracted work."

Activities tending to establish a procedure to predetermine an expected bid winner and which are considered to be conduct in principle constituting violation include exchange of information concerning interest in being awarded a contract and collating and offering information by firms in a concerted manner regarding the number of times individual firms have been designated for similar bids so that a priority can be established. Needless to say, adjusting bid prices according to such information or other directives amongst the firms and distribution of benefits, through subcontracting portions of the work to firms who participated in the bid-rigging but were not awarded the contract, are considered conduct which violate the act.

Conduct suspected to be in violation include reporting of firms to each other that they had been designated to participate in a forthcoming tender, exchange of information concerning combination of joint venturing partners, and the levying of special membership fees or charges by a trade association in accordance with the number of contracts awarded to such member. It is the opinion of the FTC that all of the foregoing activities tend to lead to bid-rigging practices.

The FTC states merely expressing an interest to the contract-awarding public agency to participate in a forthcoming tender and then declining to participate on its own judgment, after being designated, are conduct which in principle do not constitute violation.

The subsection on Conduct Related to Bid Prices is quite straightforward. Predetermining among firms of a minimum bid price and exchange of information concerning bid prices are considered to be conduct in principle constituting violation. Exchange of information amongst firms concerning price levels of goods or services subject to a bid constitutes conduct suspected to be in violation. Joint studying by firms or trade associations of computation criteria made public by the awarding public agency and formulation of general rules of computation, such as standard expense items, for improving computation capabilities for tenders in general, are considered conduct in principle not constituting violation.

For tenders that require quantities to be submitted as well

HeinOnline -- 15 Constr. Law. 86 1995

as prices (mostly procurement contracts) predetermining such quantities to be submitted or shares of the contract amongst tendering firms is considered conduct in principle constituting violation. Publishing rough aggregate past public procurement of the awarding agency by a trade association would be conduct in principle not constituting violation.

The guidelines state that independent collection of information by firms does not cause concern. However, it is when firms intending to participate in a particular tender collect and offer information to each other that antimonopoly concerns arise. So as to clarify this area the FTC has devoted the last subsection of the guidelines to "Collecting and Offering Information and Management Guidance." This subsection outlines the conduct "suspected of violation" and "in principle not constituting violation" to illustrate its points.

As can be seen by the contents of the guidelines, the FTC is sending a message. It has outlined its opinion as to activities actionable under the act. It is for industry to curb its abuses or face the FTC's announced zeal for criminal prosecution. The FTC has also sounded its concern that other government agencies police themselves by stating that it "strongly hopes that...the contract awarding public agencies will also act to prevent bid-rigging by sufficiently improving the bid procedure and by managing the bid procedure strictly." It is the wish of all of us advising on international transactions involving Japan that the FTC comes through in its promise to vigorously enforce is Antimonopoly Act.

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