"From the Tower" Redux: Lessons a Construction Practitioner Must Learn from Federal Procurement Law

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The Construction Lawyer published my "From the Tower" column for five years. Another five years have passed, and I have prepared a "Tower Redux." The main point of this Redux is to recount how federal procurement concepts are folding into construction law and caution lawyers on some of the risks associated with this mix.

Although federal procurement law and construction law form two separate legal bodies, federal procurement has influenced profoundly several recent developments in construction law. Construction lawyers can derive valuable lessons from federal procurement law. We should not adopt concepts from federal procurement, however, without understanding the very different contexts or consequences parties can face outside the federal paradigm. I will identify the solutions and problems generated by this influence.

Construction law is the formation, interpretation, and performance of contracts for design and construction, as well as remedies for their breach. I see it as a special branch of contract law. With a few exceptions for legislation regulating delayed claims (statutes of repose) and indemnification, construction law is common law. Though much of it is governed by the laws of fifty states, its general uniformity arises from frequent use of standard documents such as those drafted by the American Institute of Architects (AIA). Construction law thus mainly emphasizes cases, while federal procurement is governed by statutes and regulations.

Early in my academic career, I attended annual conferences on federal procurement sponsored by the Federal Bar Association. These meetings and my occasional participation in them opened my eyes to their specialized contracts. A tight focused bar deals with federal procurement. Similarly, a group of lawyers, much larger than the federal procurement bar, such as those who are members of the ABA Forum and read this journal, specialize in construction law. They handle the private construction disputes, especially the big ones. Unfortunately, the tight compartments of the legal profession often serve as a barrier to infusing concepts from one into the other and limit research that could benefit both.

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Federal Procurement Enters Construction Law

My early exposure to federal contracts convinced me that those who deal with construction law should be aware of what is happening in federal procurement. They should consider the transactional practices and legal rules that may, should, or will find their way into construction law. The following topics illustrate the entrance of novel approaches from federal procurement into the construction world. As you will see, some of these changes are beneficial, while others have unintended consequences when separated from the framework of federal contracting. I conclude with an example of a recent case that blurs the distinctions between the two fields of law.

Advantages

Federal agencies ordinarily are staffed by experts who have more experience than staff members of other public and private owners. Federal contract offices have both repeated work and a need to protect public funds that generate skill at preparing specifications. Further, federal procurement disputes often are resolved by specialized courts and boards of appeal populated with judges who know and understand construction law. Contrary to judges in ordinary courts, these judges are able to analyze unique construction issues in detail, understand possible unintended consequences unique to the industry, and tailor results appropriate for construction cases. As a result, federal procurement regulations and federal procurement cases provide a valuable resource to construction lawyers. This section explains some positive developments in construction law that have been affected directly by federal procurement law.

Contract Types: Fixed Price and Cost

Because of the resources and expertise available to federal agencies, federal procurement transactions are rife with carefully researched methods to avoid the worst parts of fixed-price contracts (lack of an incentive to reduce costs) and cost-type contracts (lack of control over costs), as well as a failure of the contractor to participate in design (value engineering). For construction practitioners, general exposure to federal practices serves a useful purpose, even though the bedrock of the federal formulas is a carefully prepared set of regulations and contract clauses, overseen by the general administrative presence of well-trained professionals, rather than the common law.

Specification Types

Expertise at the federal level breeds a greater variety of specification types, including the following: design, materi-

als and methods, purchase description, and performance specifications. In addition, federal procurement contracts and decisions generally contain better explanations as to their objectives.

Because interpretation disputes arise frequently, the Federal Acquisition Regulations (FAR) deal with specifications that conflict or are inconsistent. Without these guides, the courts or boards of contract appeal would be forced to rely on somewhat imprecise common law principles such as the intention of the parties, elemental notions of fairness, or the canons of interpretation. Instead, federal regulations provide a useful road map that helps solve disputes. Private parties can learn from the order that these regulations provide and modify their contracts and adjust litigation strategies to better handle disputes that the federal regulations have sought to remedy.

Patent Ambiguity Rule

Federal procurement rules can stem from FAR principles of interpretation. An illustration is the rule of patent ambiguity. In disputes governed by the common law, unclear contracts are construed against the party that caused the ambiguity, the drafter. Federal law follows the patent ambiguity rule that requires the bidders to report any clear discrepancy that they see when they prepare their bids. This principle gives the contractor a role in the design process and protects public money—objectives less central than those seen in private construction. Although private parties cannot avail themselves of federal regulations, they can adopt language requiring bidders and contractors to abide by the rule of patent ambiguity.

Changes

Changes breed construction contract problems. The changes process generated a great deal of creativity in federal procurement law because of its contract dispute resolution rules. Although the innovative ways of handling changes no longer are necessary because of statutory improvements, the concepts pioneered in procurement law have influenced private contracts.

Cardinal Change

This concept developed in the pre-1978 federal procurement system when the contractor-claimant sought to avoid the contractual disputes process and go to court. The normal methodology involved a decision by a contracting officer, a right to appeal to the agency's board of contract appeals, and a limited review by the old Court of Claims (now the U.S. Court of Federal Claims). Usually, the agency wanted to keep the dispute within its contractual dispute process. A contractor, however, might seek to bypass these procedures and go straight to court by claiming a cardinal change, an extraordinary breach of contract that allowed it to circumvent the disputes process.

In 1978, federal legislation allowed the contractor to choose the contract resolution mechanism or to go to court. As a result, the cardinal change technique lost its jurisdictional significance. It began, however, to be used in private contracting. Suppose a private owner directs a change or series of changes that the contractor claims exceeded that owner's power under the changes clause. If the owner has ordered too many alterations or ones that were too drastic, the contractor can refuse to comply with the order. More commonly, the contractor performs, claims a material breach, avoids the contractual disputes process, and seeks an expansive common law breach of contract remedy.

Though cardinal change no longer has a procedural effect, it still appears in both federal and some private contracts. Now, the doctrine turns the concept into a basis to refuse to perform or, more commonly, the basis to pursue a better remedy for breach.

Constructive Change

Constructive change involved a claim that a direction to perform certain work not required by the agreement was a change, although not contained in a formal change order. (The agency, of course, would claim the work fell within the contract.) Claiming a constructive change avoided the requirement of a formal change order to receive money beyond the contract price. It also started as a pre-1978 device to keep the dispute within the contract dispute mechanism.

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Once the term "constructive" was accepted in private contracts, more contractors could avoid the defense by the owner that the contract price could not increase because no change order had been issued. Again, what started out as a fiction to keep the dispute in the federal contract disputes process served another function—to avoid the need for a written change order in both public and private projects.

Retainage

Retainage, or the power of the owner to hold back money, has generated both considerable heat and some light. Increasingly, statutes minimize the owner's power to retain funds.

The federal procurement system (dealing as it must with many contracts and possessing extensive research capabilities, both in manpower and record retention) developed a thoughtful analysis of this issue. The federal approach required that retainage not be a substitute for good contract management. Rather, the agency must take into account the contractor's ability to perform, must have good cause for retaining funds for work completed, and

must limit the amount of retainage.

The federal government provided a reasoned study and introduced techniques to avoid abuse. Although similar efforts are less likely to arise in private construction, such studied approaches can be useful in private contract planning and disputes.

Mistaken Bids

Federal procurement law also affected construction law surrounding the competitive bidding process. One example is the law regarding the attempt by a low bidder to withdraw its bid, usually for mistake. At early common law, such bids could not be withdrawn if the mistake was the unilateral mistake of the bidder. Unless the mistake was mutual, the bid could not be revoked. Later, the common law shifted gears. It allowed a bidder to withdraw its bid for unilateral mistake, as long as the owner knew or should have known that the bid was made in error. If the error was clerical and not an error of judgment, the common law began to afford the bidder relief.

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By regulation, the federal government allowed mistake to revoke or to correct the bid, subject to detailed criteria. FAR employ a formula of determining factors, such as whether the mistake is apparent on its face and whether clear and convincing evidence shows the mistake and the bid intended. This comparison shows the advantages of specific rules versus vague, discretionary techniques.

Completed Project: Damages

Among the most difficult claims in construction are those made after the project has been completed and the balance of the contract price has been paid. If the contractor has lost money or not earned as much as it thought it should have, it looks to justify a claim for damages. Often such claims are based upon delays in completion or performance disruptions caused by inefficient practices of the owner. Inefficiency claims arise when the owner prevents the contractor from performing the work in the most efficient way.[1] Proving the amount of such claims can be difficult.

Federal procurement developed formulas that have been used with some success by federal contractors, state public contractors, and, increasingly, private builders in delay and inefficiency claims. It is in this area that imaginative lawyers and clients in federal claims have paved a path, for better or worse, to expansive recoveries in both federal and private disputes.

Expanded Home Office Overhead:* Eichleay *Formula

When a project continues past its original completion date, the contractor continues to accrue overhead costs for which it should be compensated. However, the original indirect overhead (administrative expenses not connected to a particular project, sometimes called home office overhead) has been used up. The delayed work has not borne its proper share of the home office overhead. Compensation for the lost time should include an amount for the extended administrative burden the contractor bore.

Federal procurement developed a mathematical computation called the *Eichleay* formula.[2] It creates a per diem rate for overhead for the project and multiplies that rate by the number of days of delay.[3] Sometimes this formula seems to overcompensate. Sometimes it may appear to undercompensate. Formulas do that. Good ones do the right things *most of the time.*

In computing delay damages, courts in both private and public contract disputes have grappled with unabsorbed home office overhead. Most refer to the *Eichleay* rule. Some have followed it. Some rejected it. Some modified it. This formula derived from federal procurement law became absorbed into state public contract law and ordinary construction contracts. It has become so well known that it cannot be ignored when extended home office overhead is an issue in delay and inefficiency claims.

Why did it develop in federal procurement law rather than construction law? Civil courts only rarely face difficult computation issues in ordinary construction disputes. This lack of experience is also true of state public contracts, unless a specialized state court has jurisdiction. As a result, most judges do not possess the skill to understand the issues or create formulas that could be used to find an answer to this problem.

Federal courts handling construction cases and agency boards of appeal face these issues often. Some of their judges have extensive construction experience. These specialized boards and courts routinely handling these claims were more likely to create formulas to save time than ordinary courts.

Measuring Lost Productivity in Inefficiency Claims: Total Cost; Jury Verdict; Measured Mile; and Industry Productivity Studies

Inefficiency claims present other measurement problems. The contractor may need to shut its work down because the owner cannot make up its mind as to the sequence of performance. Down time is costly, and resulting damages are hard to measure. Frequently, an owner directs a contractor by change order to alter the sequence of its planned performance. The contractor cannot perform the work in the most efficient manner. Finally, poor owner administration may generate many change orders or such drastic orders that the project simply does not look like the contract that the contractor signed.

The owner has breached the contract. How does the contractor compute its losses? Under the certainty rules of contract damages, the contractor must show that each breach

caused a designated amount of damages. Such proof is extraordinarily difficult or even impossible to establish. Strict adherence to certainty requirements, like the English approach, requires the contractor to keep records with such detail that contractors may not even attempt the task.

In the federal procurement system, the boards and courts developed the global formulas known as *total cost*[4] and its variations, well known to most contractor lawyers. These compare the contractor's predicted expense with its actual costs on the entire contract. Owners may claim, however, that the planned costs were not accurate or that the actual expenses increased because of poor work by the contractor. Refinements, such as modified total costs, were made to deal with these problems.

Just as in extended home office overhead, these global damages formulas, including the even more guesswork-oriented *jury verdict* (the guesswork of a mythical jury), have found their way into disputes before ordinary courts hearing state public contract disputes or private contract disputes. These formulas have become ingrained into the thinking of construction lawyers.

The federal system also created (and exported to construction law generally) other basic formulas to calculate inefficiency damages, such as *the measured mile* (compare the cost of work done before the disruptive event occurred to the cost of work after the event) and the *industry productivity standards* (data provided by industry empirical studies).

Disadvantages

Though construction lawyers and judges can learn valuable lessons and techniques from federal procurement law, they need to be wary of relying upon or applying federal procurement law principles in private cases, unless they understand the possible consequences. Inherent in the federal procurement law system is a substructure of experts, regulations, and law that differ from the common law. Also, risk allocation provisions of federal procurement law have been adjusted to consider that the government enters into a large number of contracts. As a result, a private owner entering into a small number of construction contracts should approach the following issues with care.

Duty to Disclose

The common law "duty to disclose" has seen a pronounced change. It has evolved from a "take care of yourself" approach, much prized by the common law, to the "have a heart" theme arising from public law cases, both federal and state. These decisions brought a new method of examining the contracting process, looking at the balance of the expertise, which often fell heavily on the side of the public agency. Placing a duty to disclose on the part of the entity soliciting competitive bids injected morality into the often hard-hearted common law.

Much of this development we owe to federal procurement. The bedrock of the federal agency with its wealth of technical staff supports this new risk allocation. Yet, we cannot blind ourselves to the fact that it is often inappropriate to fasten a duty to disclose on less-endowed public entities, let alone inexperienced private owners. Though the government with its staff of experts is in a position to discover and disclose conditions, many private owners do not possess this same ability.

Spearin *Doctrine*

Specifications contain a host of information central to the construction project. In addition to informing the contractor what it must do, they often allocate responsibility for defects and describe conditions under which the work will be performed.

The work conditions aspect of specifications gave rise to the most-famous and most-cited construction-related opinion of the Supreme Court of the United States, *United States v. Spearin*.[5] The case was decided in 1918 and created the *Spearin* doctrine. The Court held that, as a rule, the performing contractor bears the risk of unforeseen conditions. However, if the builder is ordered to follow the plans and specifications, it is not responsible if the work fails to comply because of defective design. The Court held that the government impliedly warrants the accuracy of the information furnished to the contractor. This implied warranty is not overcome by general clauses requiring the contractor to check the plans, examine the site, and take responsibility for the work.

To my knowledge, no one contends that this is a special rule of federal procurement law. Justice Brandeis did not emphasize this was a federal contract, nor did he cite cases from federal procurement law.[6] Yet, I cannot help wondering whether being a federal contract affected the holding, especially the portion that rejected the binding effect of the boilerplate requiring the contractor to check the plans and the site. Justice Brandeis may have concluded as he did because he recognized the power of the federal agency to dictate the contract rules. Giving complete and literal effect to governmental disclaimers could endow the agency with too much power and negate the implied warranty as to the suitability of the specifications.

Down time is costly, and resulting damages are hard to measure.

Subsurface Risks

Often the information furnished to the contractor does not accurately reflect the conditions below the surface. This happens not only in public contracts, but in private projects as well. The issue is who bears the risk of unexpected subsurface conditions. As we saw in *Spearin*, the performing party

bears the risk of unexpected events that increase the cost of the work. This is a well-accepted, common law doctrine, with only a few exceptions.

Many state agencies seek to place the risk of subsurface problems on the contractor by disclaiming the accuracy of the information the agency furnishes and requiring the contractor to gather its own data and to draw its own inferences. This risk allocation usually is stated in clear contract language; it frequently works.

Yet, the federal government inserts its Differing Site Conditions Clause (DSC) in its contracts. The DSC allocates this risk to the owner. Without DSC protection, we would expect the contractor to include a pricing contingency in its bid for unforeseen conditions. This precaution should generate a higher bid price. The federal policy makers conclude it is cheaper (lower bids) to assure the contractor that it will not bear this risk by shifting it to the federal agency.

A state agency or a private owner is free to take either approach. Most state agencies place subsurface risks on the contractor. The AIA, however, chose to follow the federal DSC approach. We must be careful, however, when allocating this risk. The federal agencies are professional owners. They make many contracts. In the long run (many contracts), it may be better to take the risk themselves if it induces lower bid prices. These agencies have experts who can study the subsurface. They can plan better than the one-shot private owner, who may face disaster if it assumes risks of subsurface conditions.

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One can argue that the average owner who uses an AIA contract would be wiser to put this risk on the contractor to protect the contract price. Sometimes borrowing risk allocation decisions from a different legal system is dangerous because the entire framework surrounding the decision does not exist in the other system.

Modifications of Contract

Federal procurement has been unwilling to follow basic contract law governing contract modification. The common law required a party to provide consideration to make or modify a valid contract. Scholars attacked the consideration requirement, especially when it took the form of the preexisting duty rule. As a result, the common law developed exceptions, such as unforeseen circumstances. Yet, federal procurement clung to the common law approach of consideration long after it more or less fell by the wayside and was abolished in goods transactions.[7] For a modification to be effective under federal procurement, the public agency must receive consideration in return.

Why this reluctance to permit contractual freedom? I suspect federal procurement felt a powerful need to protect public money, not a dominant feature of common-law contracts.

Termination or Suspension for Convenience

Most lawyers are familiar with termination—and now suspension—for convenience clauses. These were pioneered in federal procurement to give the federal agencies flexibility to respond to new conditions. Although the clauses seem to give the agency power to terminate for any reason, federal procurement law provides some limits to the power.

Under the federal termination clause, invoking such a provision denies the contractor its expectation interest: profit on unperformed work. It is paid only for work it has performed, plus an allowance for overhead and profit on performed work. Its inclusion has another protective function under federal procurement rules: an unjustified default termination is converted into a convenience termination.

Termination for convenience clauses now appear in some private contracts, such as standard documents published by the AIA. I question whether private parties should borrow this clause. Attempts to parrot the federal clause can lead a private owner to believe that it possesses absolute power to terminate—a power does not exist in the federal system. Reflective of the first problem, will the federal procurement jurisprudence be relevant if such a clause comes before an ordinary civil court? Such a clause reflects the need for flexibility that is more necessary in federal procurement than in ordinary contracts.

Attempts by private parties to parrot the federal clauses can lead to language, such as that of the AIA, that seems to be like the federal system but differs in significant ways and is subject to other aspects of the common law. The AIA contract allows the contractor to recover profit on unperformed work, something not permitted in federal procurement. Moreover, this clause can be the basis of a claim that such one-sided power vested in the owner destroys the validity of the contract because it destroys consideration.

These points show the danger of borrowing from federal procurement. You should look carefully at the side effects of such a transfer to make sure you are not blind-sided by unintended consequences after a dispute arises.

Mixing the Lines—The *Tecom* Case

I turn now to a recent decision embodying both construction law and federal procurement concepts, *Tecom v. United States*.[8] The *Tecom* claims most relevant to this Redux were based on breach of an implied duty to cooperate and not to hinder the contractor's performance, and they involved the way the claim of a violation of good faith and fair dealing was treated.[9]

The common law originally recognized no duty of good faith and fair dealing. Acceptance was spurred on by the Uniform Commercial Code (UCC) section 1-203, dealing with many commercial transactions, and culminating by inclusion in section 2-205 of the *Restatement (Second) of Contracts*,

reflecting a belief that it had become a common law rule.

In an ordinary private law dispute, the party asserting a breach would have the burden to establish the breach by a preponderance of the evidence. Suddenly, and for thirteen history-laced pages, the court went off in a direction not found in an ordinary private construction law case. It examined the conduct of public officials.[10]

The court began with an analysis of the law of evidence dating back to 1816.[11] It cited the eminent authority of Justice Joseph Story, who is quoted as stating that under the rules of evidence, it is presumed that a private person and even a public official has done his duty "unless the contrary is proved."[12] The case spends pages describing this presumption. The cases cited are not limited to construction cases like the one before the court.[13]

The court held that if the government official is accused of fraud or quasi-criminal wrongdoing in the exercise of his public duties, a strong presumption of good faith conduct exists and must be rebutted by clear and convincing evidence. If the official acts under a discretion conferred in him by law or regulation and a lack of good faith is alleged, clear and convincing proof is not needed to rebut the presumption. Misconduct may be inferred by a lack of substantial evidence, gross error, or the like. Where a party's decisions are not formal decisions, but are actions that can be taken by any party to the contract, the presumption of good faith has no application.

After this long and tortured journey, the court discusses the case as if it were an ordinary contract dispute, not one involving federal contracts and special rules. The court indeed recognized that its holding deprives the government of some litigation protection. The *Tecom* court stated that some decisions of the Claims Court have come to different conclusions. The court stated that those decisions require clear and convincing evidence in the context of "alleged breaches of the implied covenant of good faith and fair dealing. . . . But for the reasons stated in the text, the Court respectfully disagrees with those conclusions."[14]

So where are we now? This court seems to treat this federal procurement dispute as it would any other construction case. Still, it recognizes that other Claims Court decisions have granted protection to the federal agency by requiring a higher standard of proof in disputes involving the implied covenant of good faith and fair dealing. Those courts would handle such a dispute as this one as a federal procurement decision with its special rules. Therefore, within the federal system, it is not clear whether this issue will be treated under the special rules of federal procurement or be handled in a way no different than would any court deciding a bad faith claim. This case shows that fitting a common law doctrine into federal procurement creates difficulties. Rules may not transplant easily from one system to another.

Conclusion

Construction law and federal procurement have grown closer together. While this relationship gives construction law the advantage of applying specialized expertise often only available in federal procurement law, sometimes principles of federal law have unintended consequences when severed from their federal framework. The *Tecom* case shows that the reverse is also possible. Construction practitioners need to have a basic understanding of federal procurement law and its utility in private construction law.

The AIA contract allows the contractor to recover profit on unperformed work, something not permitted in federal procurement.

Endnotes

1. Justin Sweet, *Contract Regulation of Delay and Disruption Claims in America*, 19 INT. CONST. L.J. 284 (2002).
2. Eichleay Corp., A.S.B.C.A. No. 5183, 60-2 C.B.A. ¶ 2688.
3. The formula is illustrated in *Complete Gen. Constr. Co. v. Ohio Dep't of Transp.*, 760 N.E.2d 364 (2002).
4. WRB Corp. v. United States, 183 Ct. Cl. 409, 426 (1968).
5. 248 U.S. 132 (1918).
6. For his statement that if the contractor does what the plans and specifications require, it is relieved, he cited some state public contract decisions. For his statement that this warranty is not overcome by general clauses, he cited no precedent. That it is an opinion of the Supreme Court of the United States makes it easy to accept it as a basic principle of contract law, better, construction law. It is not one tied to its origin as a dispute under a federal contract.
7. U.C.C. § 2209.
8. 66 Fed. Cl. 726 (2005).
9. *Id.* at 757.
10. *Id.* at 761.
11. *Id.* at 757.
12. *Ibid.*
13. *Id.* at 760–61.
14. *Ibid.*