



RECENT COURT DECISIONS OF RELEVANCE TO CONTRACT DOCUMENTS

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1. **Issue:** Implied right of termination found where . *Hillhouse v. Chris Cook Construction, Inc.* Supreme Court of Mississippi (2021).

Summary: The 2013 contract for a residential design/construction project stipulated that all claims and disputes would be submitted to the Southern Arbitration and Mediation Association for binding resolution. The SAMA had ceased to exist in 1996.

In 2019 the project owners (the Hillhouses) filed a complaint in a local court against the contractor, Chris Cook Construction (CCC), asserting various claims involving flood damage to the house. CCC requested that the court require that the dispute be resolved by arbitration, as contemplated by the design/construction contract. The trial court concluded that the contract contained a valid and enforceable arbitration clause, and ordered that the dispute be arbitrated. The homeowners appealed.

Decision: The Supreme Court of Mississippi reversed the lower court's order to compel arbitration, holding that precedent and fundamental rules of contract formation prevented the courts from enforcing an arbitration clause that was dependent on an arbitration forum—the SAMA—that had not existed when the contract was signed.

The contractor, CCC, had pointed out that the Mississippi statutes governing construction arbitrations include the following provision:

If an agreement or provision for arbitration provides a method for the appointment of arbitrators this method shall be followed. In the absence thereof, or if the agreed method fails or for any reason cannot be followed, or if an arbitrator who has been appointed fails or is unable to act and his successor has not been duly appointed, the court, on application of a party to such agreement or provision, shall appoint one or more arbitrators.

The stipulation that the parties submit disputes to the defunct SAMA was arguably a “method for appointing arbitrators” that had failed, thus allowing the court to step in and appoint the arbitrators. Also supporting the contractor's demand for arbitration was what the Mississippi Supreme Court acknowledged was strong state and federal favor for the use of arbitration to resolve disputes. However, the high court pointed out that a 2009 Mississippi Supreme Court case, *Moulds*, had warned that “a court should not become a party to redrafting or reforming agreements” and had declared that “arbitration is about choice of forum—period.” In *Moulds*, the court had held that “when a contract required that arbitration be administered by a certain organization, and when such organization was not available to administer arbitration, this court would not enforce the arbitration agreement.”

Citing precedent from South Carolina, the Mississippi court drew a distinction between arbitration provisions that merely require arbitration in accordance with a named forum's rules and arbitration provisions that require that the named forum administer the arbitration proceedings:

In the case of proceedings "administered by" a named forum, most courts view the forum selected as an integral term of the agreement because it is an express statement of the parties' intent to arbitrate exclusively before that forum; therefore, if the forum is unavailable, a material term of the agreement has failed, rendering the entire arbitration agreement invalid.

The arbitration clause in the *Hillhouse* case had required that all claims "shall be submitted to arbitration before the Southern Arbitration and Mediation Association." Because this was a commitment to a specific arbitration forum, under the logic cited above the use of the SAMA was an "integral term" of the clause, and because SAMA was not available, the arbitration agreement was deemed invalid.

The court concluded:

However, when the situs [arbitration forum] or arbitrator is a contract requirement, courts should not rewrite an agreement due to forum availability in favor of the drafter to select a forum unanticipated by either party. *** Instead of drafting a contract that provided for an entity actually in existence to administer arbitration or providing backup methods of arbitration in its contract, CCC now asks the courts to remedy its failures in contract drafting. This Court declines to do so and consequently reverses the order compelling arbitration and appointing an arbitrator.

Comment: The arbitration clause that is included as a dispute resolution option in EJCDC® C-800, Supplementary Conditions of the Construction Contract, states that disputes "will be settled by arbitration administered by the American Arbitration Association." This wording reasonably assumes that the AAA will continue to be available as a forum for arbitrations—we note that AAA has been an institution in American law and commerce for nearly a century. However, in Mississippi and other states that are reluctant to allow the courts to revise arbitration clauses if the named forum is not available, some users may elect to supplement the standard clause with a second or third choice of arbitration forum.

The *Hillhouse* case has been described in construction law blogs as an example of the dangers of using outdated construction contracts. The contract used by the contractor in the *Hillhouse* case was clearly outdated, but perhaps could have been functional if carefully revised. EJCDC strongly supports the use of current editions of its documents, because the current editions generally reflect advancements in risk allocation, administrative practices, and ease of use.

2. **Issue:** Statutory requirements for rejection of a payment application. *Tocci Building Corp. v. IRIV Partners, LLC*. Massachusetts Supreme Judicial Court (2022).

Summary: The Massachusetts Prompt Payment Act that applies to private construction projects in excess of \$3 million contains several specific requirements:

- Applications for payment must be in writing, and must be submitted within 30 days
- An application must be approved or rejected, in whole or in part, within 15 days
- An approved application must be paid within 45 days
- A rejection must include (1) an explanation of the factual and contractual basis for the rejection, and (2) a certification that the rejection is made in good faith. Failure to satisfy these requirements results in approval of the application, by operation of law.
- The contractor submitting an application that is rejected must have recourse to dispute resolution within no more than 60 days.

On a project at 645 Summer Street in Boston, Tocci Building Corporation submitted seven applications for progress payments that were not paid. The construction contract contained payment clauses that at were approximately consistent with the controlling statute. The project owner, IRIV, did not expressly reject the payment applications, provide a contractual or factual basis for rejection, or certify that rejection (or non-payment) had been made in good faith. Tocci eventually filed a lawsuit seeking payment and other damages, based in part on the owner's failure to comply with the statutory payment requirements.

The trial court directed separate and final judgment with respect to the failure to pay the seven applications for payment. The owner appealed.

Decision: The Massachusetts Supreme Judicial Court affirmed the lower court's decision. The reviewing court was not persuaded that various actions that the owner had taken during the project satisfied the statutory requirements. For example, the owner had sent a letter declaring Tocci in default for failure to supply enough qualified workers to maintain progress. As another example, the owner had sent Tocci an e-mail stating that "the General Conditions and General Requirements line item was held back." Neither of these actions were sufficiently on point to satisfy the contractual and factual explanation requirement of the statute.

The owner also challenged the requirement that a rejection be accompanied by a certification of good faith, asserting that the requirement was merely "ministerial" and thus not essential. The court disagreed, holding that the certification was an essential component of the Prompt Payment statute:

The certification requirement ensures not only that the owner be deliberate about rejecting applications for periodic progress payments, and that it takes care to reject them only in good faith, [the certification's] presence on a communication also provides a clear indication to the contractor that an application has been rejected, so that the contractor can know both that some response is needed and that time periods have been triggered for invoking what remedies are available.

Comment: The decision points out that although the owner was required to pay the contractor because of the failure to follow the requirements of the statute, such failure did not constitute a waiver of the owner's right to recover damages from the contractor, for example damages for breach of contract or delay in completion.

The EJDC standard documents do not expressly require "contractual and factual" explanations justifying rejection of an application for payment; they do require that the Engineer (which is responsible for reviewing the payment applications) indicate "in writing Engineer's reasons for refusing to recommend payment." EJDC also does not expressly require a formal certification of good faith in support of a recommendation. Contracts governed by Massachusetts law should be reviewed, during the drafting stage, for compliance with the statutory requirements, including time frames for submittal and response, and commitment to formal certification.

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- 3. Issue:** Bond claimant's entitlement to attorneys' fees under private payment bond. *Owners Insurance Company v. Fidelity and Deposit Company of Maryland*. United States Court of Appeals for the Eighth Circuit (2022).

Summary: A luxury apartment construction project went wrong. An arbitrator awarded two subcontractors damages for the labor and materials that they had provided to the general contractor, plus attorneys' fees. The attorneys' fees incurred (\$375,000) to obtain the arbitration award exceeded the damages awarded to the two subcontractors (\$152,000). The general contractor declared bankruptcy and the subcontractors turned to the payment bond surety for payment of the damages and attorneys' fees. The surety agreed to pay the damages, but balked at paying the attorneys' fees. A lawsuit ensued in federal court.

The payment bond allowed for recovery of those sums "as may be justly due." The bond did not specify that a claimant could recover attorneys' fees, and the federal district court held that the surety was not obligated to pay the subcontractors for the fees they had incurred. The subcontractors appealed.

Decision: The U.S. Court of Appeals reversed the district court, holding in favor of the subcontractors recovering their attorneys' fees. The court concluded that the phrase "justly due" was a term with a long history in the law of payment bonds, having originated in early versions of the federal Miller Act. Many federal cases had concluded that if the underlying contract between general contractor and subcontractor had entitled the subcontractor to attorneys' fees, then the bond would be interpreted as allowing such recovery as well. The Court of Appeals therefore sent the case back to the district court to confirm whether the subcontracts contained attorneys' fees clauses—the arbitrators' award of attorneys' fees suggested that such was indeed the case.

Comment: The industry-standard payment bond (EJCDC® C-615; AIA A312) calls for payment of attorneys' fees under specified, limited circumstances; and the standard bond does not contain the phrase "justly due." Thus no broad conclusions should be drawn from the *Owners Insurance* case as to attorneys' fees under the standard bond.

The circumstance of the *Owners Insurance* case is somewhat unusual, because the subcontractors' claim had already been adjudicated (in arbitration, at great expense), so the surety did not have the option of making a quick settlement to avoid the accumulation of attorneys' fees.

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4. **Issue:** Was termination an essential prerequisite to recovery on a performance bond? *Arch Insurance Co. v. The Graphic Builders LLC*. United States Court of Appeals for the First Circuit (2022).

Summary: We reported on this same case in the November 2021 edition of Recent Court Decisions of Relevance. At that time, the U.S. District Court (Massachusetts) had rejected the attempted claim by a contractor against a subcontractor’s performance bond, because although the contractor/claimant had declared the subcontractor to be in default, the contractor/claimant had failed to terminate the subcontract.

To provide some background and refresh memories, the following is an excerpt from the summary we published a year ago:

The Graphic Builders (aka TGB) was the general contractor on an apartment building construction project in Boston. TGB retained a subcontractor, RCM Modular, to fabricate, deliver, and assemble modular components of the apartment building. TGB required RCM to furnish a subcontractor’s performance bond covering RCM’s work. Arch Insurance issued the required bond. Based on excerpts, the bond was based on the standard bond published by AIA (AIA A312) and EJCDC (EJCDC® C-610, Performance Bond), adapted for use at the subcontractor level.

The subcontractor, RCM, delivered and began installing the modular units. TGB contended that the modules were defective, citing leaking windows and misalignment issues. TGB did not terminate the RCM subcontract, however....

The [district] court found that it was undisputed that although TGB declared a Contractor Default, TGB never terminated the RCM subcontract. Accordingly, the court held that Arch was discharged from “any and all liability relating to [the Arch Subcontractor’s Performance Bond].”

The contractor, Graphic, appealed the adverse decision to the Court of Appeals. In the appeal, the various issues in the dispute had boiled down to a single point: the surety’s responsibility for the subcontractor’s failure to meet an express subcontract commitment to deliver a window warranty. This was not a trivial commitment: the window warranty was valued at \$2 million. The window manufacturer had refused to provide the warranty to the subcontractor because of concerns about the quality of the installation of the manufacturer’s specialized products.

In the appeal, the contractor/claimant argued that the warranty was a post-completion obligation, which would make the termination requirement in the bond moot—it would make no sense to terminate a contract that had been completed.

Decision: Court of Appeals affirmed the District Court’s decision in favor of the surety.

In rejecting the contractor/claimant’s argument, the Court of Appeals stated:

Graphic’s argument depends on distinguishing the provision of the window warranty from the physical work that RCM [the subcontractor] was obligated to perform under the subcontract. Its [Graphic’s] principal contention is that a “post completion” warranty obligation is not reasonably subject to [the bond’s] termination requirement. Graphic, however, is not making a post-completion warranty claim in the sense that such a claim ordinarily would be understood—i.e. a demand under an operative warranty for remediation of construction work that is revealed, post-completion, to be defective. ***Rather, Graphic asserts that RCM failed to produce a promised warranty. ***

The obligation to provide a manufacturer’s window warranty is a distinct element of the Graphic-RCM subcontract. The mere fact that the warranty obligation does not involve hands-on construction does not reveal why it would be excluded from the conditions in the bond that apply to other performance elements of the subcontract. Nor does timing provide the explanation. While the benefits of a warranty ordinarily may be realized after a construction project is completed (or substantially completed)...procuring the warranty from the window manufacturer was an obligation that needed to be fulfilled before RCM’s performance under the contract would be complete.

Comment: The Court of Appeals decisively held that obtaining and submitting a major specified warranty was an essential part of the performance phase of the subcontract, and hence the contractor should have terminated the subcontract when the subcontractor was unable to procure the warranty. However, the decision does bring to mind the more difficult analysis that would need to be made with respect to failures late in a project, such as failing to deliver instruction manuals, or failing to address all punch list items. Rarely are such lapses worthy of termination, let alone litigation, and usually the power of withholding final payment will cure the problems, but at least in theory there may be a gray area where the procedures to be followed by performance bond obligees are uncertain.

The Court of Appeals decision was helpful in explaining why there is a termination requirement in a performance bond. Among the points that the court made:

- “With respect to securing the warranty, Graphic’s decision to eschew termination and continue working with RCM despite Graphic’s ongoing dissatisfaction with RCM’s performance was no different, under the terms of the bond, from a unilateral decision to replace RCM with a third-party subcontractor. Both decisions sidestepped the requirements of [the bond] and ‘extinguish the options available to the surety under the performance bond.’”
- “The performance options available to Arch [the surety] under section 5 of the bond are no less suitable for the warranty obligation than for the physical work of fixing the windows.”
- Given the opportunity, “Arch might have attempted to secure the warranty by using its own agents or a new subcontractor to remedy the window problems, as contemplated by Section 5.”
- “Or Arch might have attempted to secure the warranty through negotiations with the window manufacturer based on the remedial work that RCM had already performed.”
- “Graphic should have terminated RCM and asked Arch to take over the task of properly completing the window installation work to the satisfaction of the manufacturer.”

5. **Issue:** Contractor’s capacity to enter into contracts or pursue an appeal. *Hudson General Contractor, Inc. v. Department of the Interior*. United States Civilian Board of Contract Appeals (2021).

Summary: In September 2019 an entity that called itself Hudson General Contractor, Inc. signed a contract with the National Park Service (Department of the Interior), for construction work at a park in Ohio. A few months later the Park Service terminated the contract for cause. Hudson appealed its termination to the Civilian Board of Contract Appeals.

The government moved for summary judgment of the appeal, because it had learned that “Hudson General Contractor, Inc.” was no longer a viable corporate entity under the laws of Virginia, by reason of an administrative termination of corporate status for failure to file an annual report and pay registration fees, followed by five years of inaction—Hudson had made no attempt to be reinstated.

Decision: The Board ended the appeal by granting summary judgment in the government’s favor. The contractor failed to bring forward any facts establishing that it was a viable corporate entity under Virginia law or otherwise. According to the Board,

A necessary element of a contract is that the parties entering into it both possessed capacity to do so [citing Restatement (Second) of Contracts]. Thus where there is no capacity to contract, there is no contract.

Meanwhile, under federal law, the capacity of a corporation to maintain an action before the board is determined by the law of the state under which that entity was organized. Under the governing Virginia statute, “it shall be unlawful for any person to transact business in the Commonwealth as a corporation...unless the alleged corporation is either a domestic corporation or a foreign corporation authorized to transact business.” Hudson lacked any such status or authorization.

Comment: This was a straightforward issue that the Board handled with ease.

In most such situations the problem would have been identified during the contractor selection or bidding process, or as a result of a performance/payment bond requirement, and the owner would not have entered into the contract in the first instance.

The EJCDC standard documents contain various pertinent requirements intended to screen unqualified contractor candidates (such as the Contractor qualifications requirements in EJCDC®C--200, Instructions to Bidders for Construction Contract, Article 3), but ultimately a lapse could occur if the contract/bidding administration is not adequate.

6. **Issue:** Negligent Negotiations

Summary: This may be a developing trend in federal contract claims. The Federal Acquisition Regulations (FAR) contain a regulation that requires federal agencies to engage in “meaningful negotiations” during contract formation of negotiated procurements. The government’s contracting officer must discuss significant weaknesses and deficiencies in the prospective contractor’s proposal, with the intent that the contractor not be set up to fail from the outset. Failure to conduct a “meaningful negotiation” can lead to subsequent claims for additional compensation.

Comment: This subject is discussed in an interesting article entitled *Cutting Edge Federal Contract Claims: Contractor Prevails on “Negligent Negotiations” Theory*, by Nick Solosky and published in the ABA Forum’s UnderConstruction newsletter (Spring 2021). Although the theory arises directly out of specific wording in the FAR, it has parallels in common law principles such as the duty of good faith and fair dealing.

An issue for consideration: Should procurements outside the federal orbit contain similar “meaningful negotiations” requirements? Or should procurement processes be conducted under disclaimers that shield the owner from potential liability for not saving proposers from themselves?
