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Public-Private Partnerships: Design-Build Contractors Take Heed! – Part One

by Robert G. Barbour and Timothy E. Heffernan, Senior Partners

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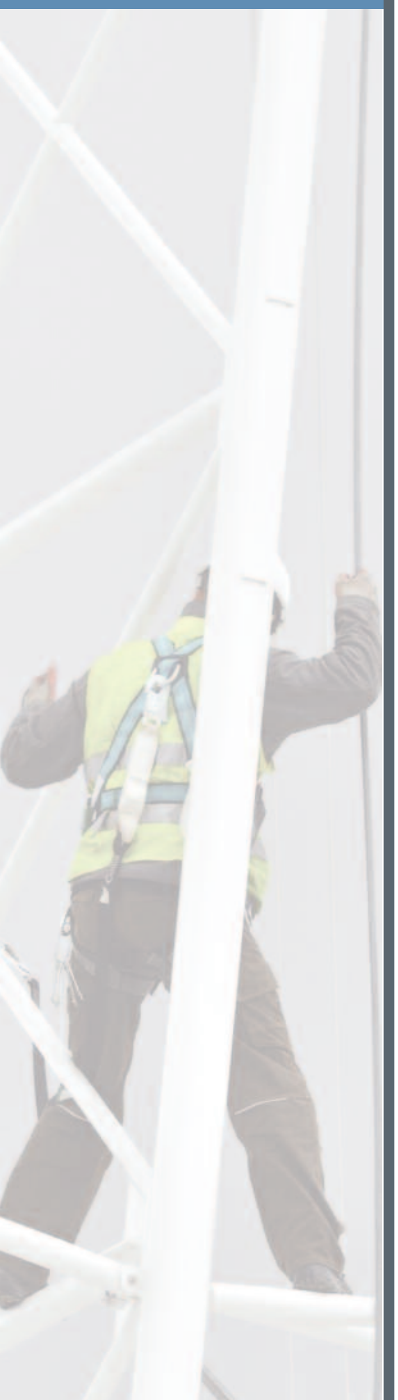

It is difficult to imagine a project delivery method that offers more excitement and causes more trepidation to contractors than public-private partnerships (PPP). PPPs are rapidly growing in popularity because they enable the public sector to harness the expertise and efficiencies that the private sector can bring to a project and because PPPs are structured so that public sector bodies can make capital investments without borrowing. In the PPP model, the borrowing is incurred by the private sector partners implementing the project. Given the contract values and durations of most PPP projects being undertaken in North America, the rewards to the private sector Design-Build Contractor are obvious and long-lasting. With construction costs typically in the hundreds of millions of dollars and with lengthy operations and maintenance periods, PPPs offer great opportunities for contractors to generate substantial revenue and profit.

Why then are so few qualified Design-Build Contractors bidding and competing for PPP projects? Put simply, the risks that the PPP delivery model "drops down" on Design-Build Contractors are daunting and, if not properly controlled, can outweigh the rewards of being involved in a major project. In addition to the usual construction risks associated with any design-build project, the Design-Build Contractor bears risks that arise out of the unique nature of the PPP arrangement. For instance, the Design-Build Contractor involved in a PPP project will often be asked to take on risk related to site conditions, resource availability, equipment procurement and installation, permits and approvals, labor markets, changes in law, and force majeure events, among others. Under a more traditional project delivery method, all or a part of these risks would be allocated to the project Owner. Moreover, since the private sector's participation in a PPP project often lasts much longer than in a more traditional construction project, due to its involvement in operations, maintenance and the concession period, the Design-Build Contractor's risks relating to construction warranties and latent defects often extend beyond the normal one and six-year periods, respectively.

For those Design-Build Contractors prepared to confront these increased risks in order to compete for the rewards associated with successful PPP projects, this two-part article is intended to assist in developing a well-organized plan, with attention to detail, to understand, mitigate and manage the construction risks associated with the PPP project delivery method. This first part will address up front considerations regarding project participants and the basic contract agreements typically used in connection with PPP projects. The second part of the article will address risks associated with the performance of work on a PPP project and ways to mitigate those risks.

Pick The Right Project

Not all PPP projects are created equal, and not all projects are suited to the PPP model. Public owners usually undertake a thorough analysis that compares the outcomes for delivery under the PPP model to the outcomes under a standard design-build approach. As a general rule, public owners choose the PPP model only where the size and scope of the project justify the significant associated costs. From the Design-Build Contractor's perspective, the viability of a PPP project often turns on whether there are clear performance criteria articulated up front at the time of the bid/proposal, as changes in performance criteria midstream create the potential for increased costs and raise the likelihood of disputes. Similarly, Design-Build Contractors should consider whether a prospective PPP project has clearly stated expectations regarding post-construction operation and management. The more autonomy the Design-Build Contractor has (*i.e.*, control to devise the means and methods for the overall design and construction of the project to meet straightforward performance criteria), the higher the likelihood of a PPP project's success.

In addition, new construction, as opposed to renovation or upgrade of existing facilities, is often best suited for the PPP model. New construction gives the private sector participants the greatest latitude to choose a design that meets the stated performance criteria while controlling risk. Projects involving the renovation or upgrading of existing facilities, on the other hand, often present fewer options for design and have a greater potential for open-ended or undefined costs, such as costs attributable to unforeseen conditions or design issues.

Choose Your Partners Wisely

The earnest pursuit of a PPP project typically begins with the negotiation of a teaming agreement among the primary participants, which includes the Proposal Sponsor, one or more contractors who will deliver the Design-Build Contract work elements, and one or more contractors who will be responsible for the operation and maintenance obligations during the term of the concession. Depending upon the nature of the project and the level of design development at the time of proposal submission, a significant burden is often placed on the Design-Build Contractor during the proposal phase. As the scope of PPP projects are often quite large, with construction costs typically in the hundreds of millions of dollars, there is an increased risk on the designer and contractor to accurately price the scope of work to be performed. Any mistake in pricing could prove disastrous and could have a serious impact on even the largest of contractors. Picking the right team members, who have substantial, relevant experience and expertise in the specific type of design and construction to be undertaken, is imperative.

Given the size of most PPP projects, the costs that will be incurred during just the proposal stage can be substantial. As such, the teaming agreement should unambiguously spell out the responsibilities of the various team members for the preparation of the proposal, as well as address how the costs associated with the proposal will be reimbursed at financial close or split among the team members if the bid is not accepted. It is imperative that the teaming agreement reflect a firm commitment by the Project Sponsor to award a design-build contract to the Design-Build Contractor if the team bid is accepted. The teaming agreement should also address whether members of the team may participate in another team or have the intent to form an exclusive venture. Further, it is highly recommended that the Design-Build Contractor seek to include language in the teaming agreement that provides the Design-Build Contractor the greatest possible involvement in all aspects of the project, including an opportunity to participate in all meetings between the Concessionaire and the project Owner. As discussed below, the risks the Design-Build Contractor will face on the project are driven, in large part, by the terms of the concession agreement, and ensuring that the Design-Build Contractor has the right to participate in the negotiation of that agreement is critical to the Design-Build Contractor's success.

Often, the Proposal Sponsor is a large international construction firm, a financial institution, or an infrastructure investment fund that operates toll roads or other revenue-generating infrastructure facilities, or may be a combination of any of these. The teaming agreement and any proposal that is submitted to the project Owner customarily provide that the Project Sponsor, upon acceptance of the proposal, will form a Special Purpose Entity ("SPE") to manage the project. An SPE is organized to shield the Project Sponsor and equity investors from liability and to provide "clean" collateral for Lenders to the project. The SPE typically will be responsible for obtaining limited recourse financing for the project's design and construction and for managing the project's performance as the Concessionaire. In connection with securing financing, the SPE Concessionaire is typically required to pledge all of its assets to the Lenders on the project, supported by a pledge of the Project Sponsors' respective equity interests in the SPE. The SPE Concessionaire also must negotiate a contract with the Design-Build Contractor and with any specialty contractors on the project. Although not always the case, in most instances the concession agreement and the Design-Build Contract are negotiated concurrently, and the Design-Build Contractor has an opportunity to (and should if at all possible) participate in the negotiations between the Owner and the SPE Concessionaire related to the allocation of risk under the concession agreement.

Finally, one of the most overlooked aspects of a successful teaming relationship is an open discussion of how disputes will be resolved. It is highly recommended that any PPP teaming agreement include a robust dispute provision that defines the procedures to be followed in the event of a dispute (*e.g.*, use of a dispute review board, binding or non-binding arbitration, or court proceeding), identifies potential causes of action, and sets forth the available remedies

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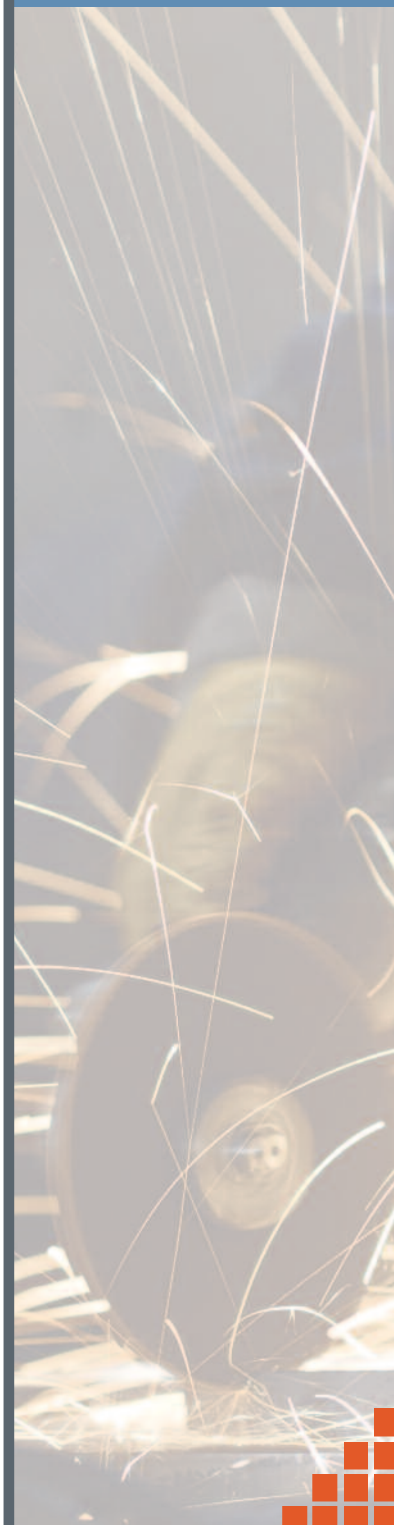

(*e.g.*, indemnity, specific performance, injunctions, liquidated damages, or limitations on damages). Provisions that provide clear guidance and prompt resolution of disputes should be a priority for all other PPP agreements as well.

Understand The Inherent Risk In The Concession Agreement

Risk allocation in the PPP project delivery model follows a natural, flow-down progression. In short, most of the risk inherent on a PPP project is shifted from the Owner to the SPE Concessionaire and flows down contractually to the Design-Build Contractor. The Design-Build Contractor may be able to mitigate its exposure under this flow-down paradigm by similarly pushing some of the risk down to lower level subcontractors and suppliers. Mitigation of the Design-Build Contractor's risk can also be accomplished through insurance, bonds and other contractual agreements.

As a starting point, Design-Build Contractors must first appreciate that, although an SPE Concessionaire will usually accept responsibility for its own acts or omissions, the SPE Concessionaire will generally only grant relief to the Design-Build Contractor for risks that the public sector Owner accepts under the concession agreement. For this reason alone, it is critical that the Design-Build Contractor negotiate the contractual right to a seat at the table when the Concession Agreement is being negotiated between the Owner and Concessionaire.

Absent contractual rights against the Owner or public sector authority, the SPE Concessionaire will be reluctant to agree to any adjustment of the Design-Build Contract price or schedule, for fear of a potential "mismatch" with its Concession Agreement. In this regard, the Concessionaire's own cash flow constraints would likely encumber its ability to make a payment to the Design-Build Contractor in advance of receiving funds from the Owner. For this reason, Design-Build Contracts in the PPP project delivery model typically include "Equivalent Project Relief" provisions, which are structured to provide the Design-Build Contractor a right to require the Concessionaire to pursue a claim against the Owner. Because any such claim must be brought in the name of the Concessionaire, the Equivalent Project Relief provision typically allows the Design-Build Contractor to control the management of the claim in a pass-through manner. Notably, the enforceability of "Equivalent Project Relief" provisions needs to be considered on a jurisdiction-by-jurisdiction basis, as certain jurisdictions do not permit the assertion of pass-through claims.

With the Owner's acceptance of a team's proposal and after the Concession Agreement and the Design-Build Contract have been negotiated, the Design-Build Contractor's risk is anything but set in stone. The second part of this article will address additional ways in which the Design-Build Contractor can mitigate its risk during performance and through other vehicles, such as insurance.

A Contractor Cannot Sue The Project Designers For Negligence In The Pacific Northwest... Or Can It? The Changing Landscape Of The Economic Loss Rule In The Pacific Northwest

by Diane C. Utz, Associate

It is not an uncommon scenario related to a construction project: a general contractor on a public construction project that is almost complete is analyzing the project financial information and trying to understand why its profit margin has eroded so severely. The onsite personnel point fingers at the slow responses to a multitude of Requests for Information ("RFI") and claim that the designers are the reason for the issues. They relate countless stories of interruptions in the flow of work while waiting on answers to technical design questions affecting several construction activities and related trades. Over the course of the project, the cumulative effects of the RFIs have seemingly caused a severe deterioration of the general contractor's bottom line. That is the time when the contractor may call its attorneys with the question "can we sue the designers?" Unfortunately, the only response we can give at this time, particularly in the Pacific Northwest, is "it depends."

Economic Loss Rule Generally

First, a little bit of background. On a typical construction project, an owner contracts directly with the designers and then separately with the contractor. As a result, the contractor has no contractual relationship with the designers and therefore cannot sue a designer for breach of a contractual obligation. Under this typical scenario, the contractor would have to sue the owner for the breach of a contractual requirement and then the owner would have to either seek indemnification from the designers or cross-claim against the designers for any liability it owed to the contractor. A more logical approach would be to allow the contractor to sue the designer directly for a cause of action arising in tort, such as negligence. The law that commonly applies to this scenario is known as the Economic Loss Rule and generally bars a negligence claim by one party against another for purely economic losses that arise out of a contractual relationship. In the states that have adopted the Economic Loss Rule, parties are restricted to contract claims. The contractual relationship does not need to be direct; the party just needs to be in a line of contractual relationships that allows indirect access to the offending party, such as the scenario described above with the contractor suing the owner and the owner suing the designer.

The Economic Loss Rule is a judicially developed rule that was first articulated in California in 1965. If the Economic Loss Rule applies, a party will be strictly held to contract remedies, regardless of how a plaintiff characterizes them. This means that the party will be confined to a breach of contract claim (that may be passed down the contractual chain) and will not be able to sustain a negligence claim for purely economic losses. "Economic losses" include costs of repair and replacement of defective property that was the subject of the transaction. On the other hand, if the alleged costs are related to damage of personal property or personal injury, then the Economic Loss Rule does not apply. Courts faced with this issue often find it necessary to distinguish between economic loss and physical harm or property damage. This distinction is typically drawn depending on the nature of the defect and manner in which the damage occurred.

In the past, the answer to the contractor's question of whether it could sue the designer in the Pacific Northwest was not so complicated. For many years, based on Washington and Idaho law, the answer was simply "no." If the contractor was in the line of contractual relationships with the designers, either directly or indirectly, the contractor could not sue the designers for economic damages resulting from alleged negligence. That is, any claims for economic damages against the designers were restricted to contract claims. Because of several recent court decisions in both of these states relating to the Economic Loss Rule, however, the answer to the question now is much more complicated.

The Economic Loss Rule In Washington

The Economic Loss Rule was thoroughly addressed by the Washington Supreme Court when it analyzed a negligence claim brought by a contractor against a designer in 1994. In *Berschauer/Phillips Const. Co. v. Seattle School Dist. No. 1, et al.*, 881 P.2d 986 (Wash. 1994), the court cited the Economic Loss Rule as its reason for dismissing the contractor's negligence claims against the designers. The court stated that the Economic Loss Rule results in the maintenance of the "fundamental boundaries of tort and contract law by limiting the recovery of economic loss due to construction delays to the remedies provided in the contract." The court further stated, in part:

> We so hold to ensure that the allocation of risk and the determination of potential future liability is based on what the parties bargained for in the contract. We hold parties to their contracts. If tort and contract remedies were allowed to overlap, certainty and predictability in allocating risk would decrease and impede future business activity. The construction industry in particular will suffer, for it is in this industry that we see most clearly the importance of the precise allocation of risk as secured by contract.

In other words, the Economic Loss Rule prevents a party from doing an "end run" around the contract in order to pursue a result it otherwise did not bargain for at the time of contracting. For years, the analysis has been as simple as: Is there a contract? If yes, then negligence claims will not be permitted for purely economic damages.

But in recent years, Washington courts have made a move away from the Economic Loss Rule as a bar to negligence claims that arise out of a contractual relationship. In 2010, the Washington Supreme Court released two opinions that adopt an approach that is more

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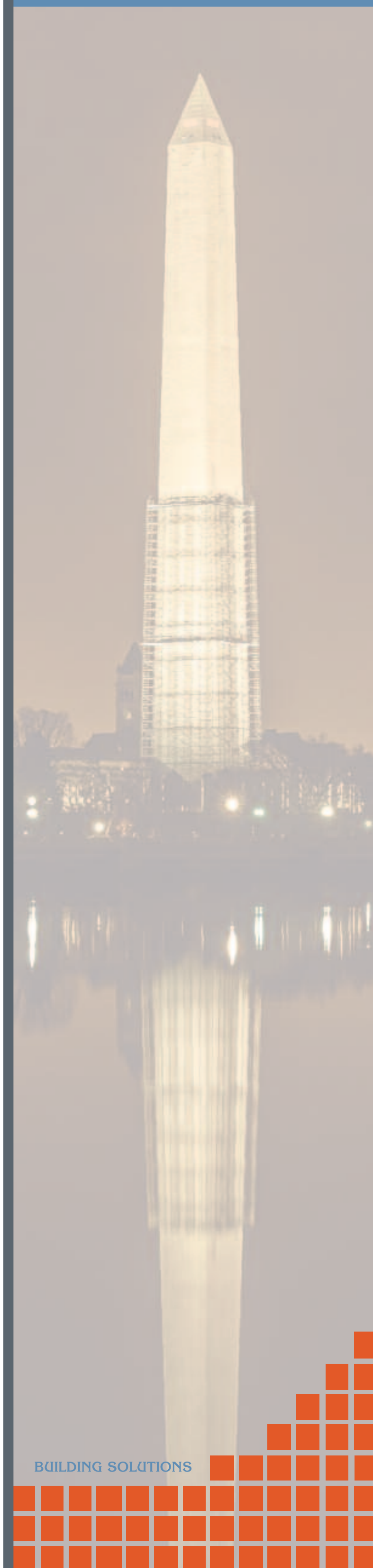

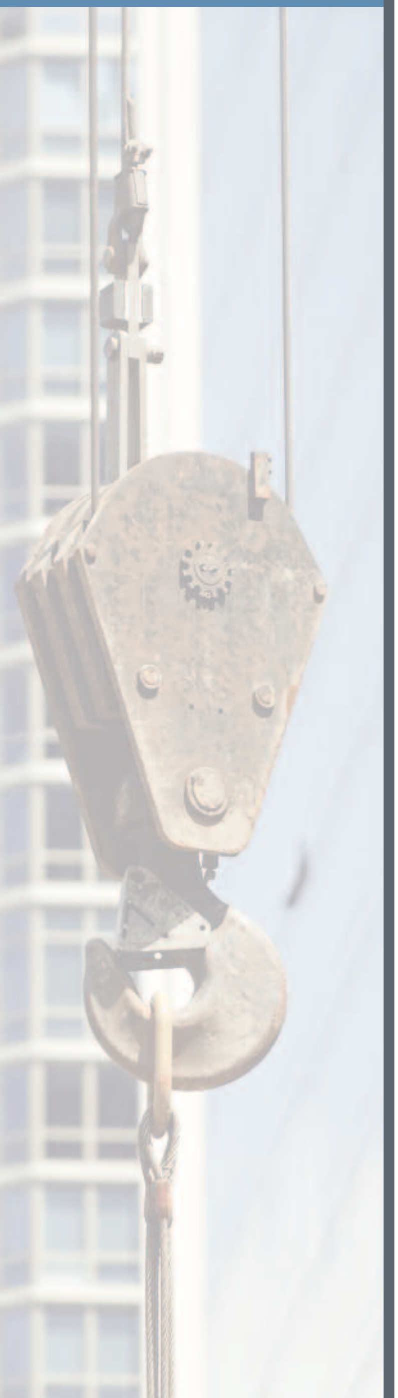

reasoned than the yes/no analysis that has been associated with the Economic Loss Rule. In *Eastwood v. Horse Harbor Found., Inc.*, 241 P.3d 1256 (Wash. 2010), the court insisted that the proper analysis should not focus on the type of damage that was suffered (*e.g.*, economic damages versus non-economic damages), but rather on whether some separate duty of care exists outside the parties' contractual relationship. The *Eastwood* court went so far as to erase the term "Economic Loss Rule" from the state's legal lexicon in favor of what is now called the "Independent Duty Doctrine." Through its adoption of this Doctrine, the court acknowledged that "[i]n some circumstances, a plaintiff's alleged harm is nothing more than a contractual breach or a difference in the profits, revenue or costs that the plaintiff had expected from a business enterprise." Yet, the court further stated that "[i]n other circumstances, however, the harm is simultaneously the result of the defendant breaching an independent and concurrent tort duty. Thus, while the harm can be described as an economic loss, it is more than that: it is an injury remediable in tort."

The *Eastwood* decision was issued around the same time that the Washington Supreme Court published a similar opinion on a case in which the plaintiffs were seeking tort damages in addition to contractual remedies. In *Affiliated FM Ins. Co. v. LTK Consulting Services, Inc.*, 243 P.3d 521 (Wash. 2010), the court addressed whether an engineering company under a monorail maintenance agreement with the city of Seattle could be liable in negligence to the company that operates the daily monorail service for a fire that caused millions of dollars in losses. In applying the Independent Duty Doctrine, the *Affiliated FM* court held that since monorail trains carry thousands of people every year in Seattle, the engineering firm assumes a tort law duty of reasonable care that is independent of its contractual obligations because of the safety concerns involved. This duty was in addition to any contractual relationship the engineering company had with the city of Seattle, and therefore, the monorail concessionaire could maintain its tort claim against the engineer.

The rise of the Independent Duty Doctrine and its role of replacing the Economic Loss Rule in Washington were further bolstered in late 2013 when the Washington Supreme Court ruled that an engineer had duties independent of its contract with certain landowners. In *Donatelli v. D.R. Strong Consulting Engineers, Inc.*, 312 P.3d 620 (Wash. 2013), the court determined that: 1) design professionals owe duties to their clients and the public to act with reasonable care, which can sometimes give rise to a tort duty independent of the contract; and 2) a duty to avoid negligent misrepresentation might arise independently of a contract where one party, through misrepresentations, induces another party to enter into a contractual relationship. This second duty is necessarily independent of the contract because it occurs before the parties execute a contract. A Justice who had concurred in the *Berschauer Phillips* opinion (discussed above) dissented in the *Donatelli* decision. In so doing, he noted that although the majority states that its opinion does not overturn the *Berschauer Phillips* holding, the facts are virtually the same, while the outcome is strikingly different. Consequently, the question becomes very factually intensive for future courts that must address similar issues and the outcome may be impossible to predict given the current state of the law in Washington.

The Economic Loss Rule In Idaho

Similarly, Idaho's Supreme Court, a long-time subscriber to the Economic Loss Rule, published an opinion in 2010 in which it allowed a party to maintain a tort action despite an underlying contractual relationship. In *Brian and Christie, Inc. v. Leishman Elec., Inc.*, 244 P.3d 166 (Idaho 2010), the plaintiff alleged a cause of action for the negligent performance of electrical work. The faulty electrical work caused a costly fire in the restaurant in which the defendant had installed an electric sign. In holding that the Economic Loss Rule did not bar recovery of the type of damages the plaintiff was seeking, the court stated that in circumstances involving the rendition of personal services, the actor has a duty to perform the services in a workman-like manner. This statement may have opened a door for the courts to assess whether there is an independent duty that arises outside a parties' contract that would render the Economic Loss Rule inapplicable to bar recovery for damages under a tort theory.

Conclusion

As a result of the recent decisions in both Washington and Idaho, it is currently very difficult to predict how courts will handle a negligence claim brought by a contractor against a design professional. The court will be required to perform a factually intensive analysis to determine if the designer breached a contractual duty or a duty that arose outside the contract. The issue of whether there is a direct or indirect contractual relationship is one distinguishing factor between *Berschauer Phillips* and *Donatelli* in that the contractor in *Berschauer Phillips* was not in contractual privity with the designer, but the plaintiff in *Donatelli* was in direct contractual privity.

Why is the issue of whether the designer can be sued in contract or in tort important? There may be strategic reasons, such as avoiding contractual notice provisions or contractual liability limits. For example, if the contractor arguably did not adhere to a contract's strict notification provisions, it may be able to seek damages in tort to avoid the contractual notice provisions in their entirety. Similarly, if the contract has a limitation on the amount of daily field office overhead or other damages a contractor may receive for excusable delays (such as the architect taking an unreasonable amount of time to respond to RFIs or return submittals), then the contractor may be able to bring a negligence claim based on the architect's independent duty to not engage in conduct that is in "wanton disregard of the rights of others," pursuant to Washington Administrative Code § 308-12-330(5)(c).

While these theories have not been thoroughly tested yet, by all appearances courts in Washington and Idaho are clearing the way for negligence claims to be brought against design professionals. Contractors and design professionals need to be aware of the developments in these jurisdictions as the courts wrestle with these issues in the future.

Be Safe, Not Sorry – Protect Against Employee Data Theft

by Mark Rosencrantz, Of Counsel

Introduction

It is becoming more and more common to see news headlines announcing data breaches that result in confidential business and consumer information being stolen. Companies from Home Depot to Target to JP Morgan, as well as millions of customers have been affected, and hundreds of millions of dollars will be spent on investigations, revamping security protocols, and compensating and retaining customers.

Less commonly reported, but equally problematic, is the all too common situation of employees stealing confidential data and business information. With the proliferation of email, portable electronic storage devices such as USB drives, and wireless networks, coupled with the emergence of the cloud, protecting against internal data theft is as important for companies today as protecting against hackers.

The risks are real. A 2009 study conducted by the Ponemon Institute revealed that 59% of employees who resign or are asked to leave take confidential or sensitive business information with them. The costs of such thefts are significant. The National White Collar Crime Center reported that: "It is estimated that losses due to employee theft can range from $20 to $90 billion annually to upwards of $240 billion a year when accounting for losses due to intellectual property theft." In addition, employee theft "accounts for approximately 30 to 50 percent of all business failures."

No industry is exempt from these dangers. In fact, the construction industry is particularly susceptible to the dangers of employee data theft. Most construction companies now rely on computers and related software for the entire lifespan of projects, including estimating, bidding, scheduling, claim and change order preparation, billing, and a variety of other tasks. A variety of proprietary information such as profit margins, labor rates, target jobs, and client lists are contained in such materials. Moreover, construction companies are inherently decentralized with employees at the home office and on job sites, which means email and remote access to computer networks is often required, and monitoring is more difficult.

The vulnerability of construction companies to theft of confidential information is underscored by the fact that there are published opinions dealing with such issues from state and federal courts across the country, including in Washington, Texas, New York, California, Georgia, Michigan, Pennsylvania, and Oregon. The multitude of reported cases is all the more significant due to the fact that the vast majority of lawsuits do not generate published opinions.

A Case Study

Given the level of employee turnover in the construction industry, and the ease at which

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such information can be taken, construction companies need to be particularly mindful of putting protections in place. Consider the following scenario, based on an actual case: A project manager asks his employer to renegotiate his compensation package, but makes demands the company feels to be unreasonable, and is told "no." The project manager responds by getting a new job with a key competitor. Before resigning, the project manager stays late one night and downloads not only information regarding historical information regarding prior jobs, but also all available information on key projects on which the company plans to bid (including partially prepared bids), as well as current jobs. The information fits on a portable drive no larger than a pack of playing cards, and no one is aware that the information has been copied.

The employee also disrupts current projects by contacting equipment and material suppliers directly and cancelling orders, and informing subcontractors that a project has been terminated for convenience. While the company is scrambling to fix those problems, the employee organizes an exodus of other employees who join him at his new employer. The departed employees then begin submitting bids on projects with enough knowledge to slightly undercut their former employer.

The former employer eventually realizes what is happening and files a lawsuit against the employee. However, by then, the key competitor has been awarded and started work on a large project both companies bid on, and an existing project is behind schedule due to critical materials not being delivered on time due to the now former employee cancelling an order. Similarly, a long-standing customer cancels a job as work is about to begin, to avoid being dragged into the dispute.

Although the lawsuit filed by the former employer settles on favorable terms before trial, a large job was lost, key executives are forced to devote weeks of time to the case instead of on profit-generating activities, a relationship with an existing customer has been harmed, tens of thousands of dollars in attorneys' fees were spent, and the company will never know for sure whether its competitor retained a copy of confidential information.

Plan Ahead

In all likelihood most or all of these problems could have been prevented with advance planning. However, many construction companies lack sufficient safeguards to protect themselves from the damage a disgruntled employee can cause. To avoid situations like the one described above, companies should consider implementing or upgrading a number of important and overlapping safeguards.

First, all companies with employees should have an employee handbook in place that is provided to all employees and updated on a regular basis. The handbook should contain at least the following:

- An acknowledgement that all confidential information the employee learns of during his employment, regardless of whether it raises to the level of a trade secret, belongs to the company and cannot be disclosed during the employee's employment or following the end of the employee's employment, regardless of the reason the employee leaves.
- A policy describing exactly how employees are entitled to use and disseminate company confidential information. Included in this should be limits on when employees are entitled to copy, download, and email documents and other electronically stored materials.
- A policy with strict limits on how employer issued computers, cell phones, and other electronic devices can be used.
- A policy allowing employers to monitor employee email.
- A policy that governs steps departing employees must take with regard to returning electronic devices upon resigning or being terminated.
- A policy that strictly limits the copying of company information and data.
- A clause in which the employee affirms his or her understanding that they owe the company a duty of loyalty.
- A provision that in cases where the employee releases such information or is about to release such information the company is entitled to have a court issue an injunction preventing the employee from using or releasing the information.
- A clause providing that in the event the employer gets an injunction, it is entitled to recover its attorneys' fees from the former employee.

Further, unless the company is in a state like California that generally prohibits non-compete agreements, companies should strongly consider requiring all new employees to sign non-compete agreements upon being hired. Such agreements should restrict employees from working for competitors in certain geographic areas for a specified amount of time following the end of employment. They should also contain clauses providing for the issuance of injunctions to stop violations as well as the award of attorneys' fees.

Also critical are electronic safeguards. Companies should consider restricting employees' ability to install software on company issued computers and other electronic devices, and limit (by written policy and in practice) employees' ability to download information and documents. Consideration should be given to banning employees from downloading information to USB drives, portable hard drives, and CDs, or at least restricting the ability to do so to a limited group of employees. Restrictions and safeguards should also be considered on whether employees are permitted to access company email accounts and computer systems with their own electronic devices. Certain information should also be password protected and accessible by need to know employees only.

Additionally, companies should have policies and procedures in place for what happens when an employee resigns or is terminated. To that end, the company should create and retain a ghost copy of all computers and other electronic devices the employee used. Email accounts should be maintained for easy access and, to the extent possible, a review should be undertaken of what the employee had been accessing, downloading, and copying in the weeks and months prior to his resignation or firing.

Conclusion

Although there is no perfect way to protect against a determined and disgruntled employee, having the proper safeguards in place ahead of time can significantly reduce both the risks and the damage that can occur due to employee theft.

CONTRACTS

Are You Playing For The Right Team? A Guide To Drafting Small Business Teaming Agreements

by Heather L. Stangle, Associate

When properly structured, teaming agreements allow both large and small businesses to expand their federal government procurement opportunities, complement one another's capabilities, and offer the government the best combination of performance, cost, and delivery. Yet, when parties to a teaming agreement fail to pay close attention to applicable rules and regulations, including the Federal Acquisition Regulation ("FAR") and U.S. Small Business Administration ("SBA") regulations, they risk penalties ranging from disqualification to civil or criminal prosecution. In light of robust suspension and debarment activities by the federal government in recent years, changes to applicable regulations, and the increased risk of size protests, contractors must carefully structure teams for small business set-aside contracts.

This article focuses on avoiding the potential risks that arise when a small business teams with a large business with the intent of subcontracting part of the work on a set-aside contract to the large business. Although such arrangements are common and generally permissible, contractors must ensure that they do not run afoul of the so-called "ostensible subcontractor rule," which would render the team ineligible for award. Contractors may avoid affiliation under the ostensible subcontractor rule through careful attention to the FAR and SBA rules and regulations. This article provides a summary of key tips to keep in mind when developing a teaming relationship or drafting a teaming agreement for a small business set-aside.

What Is The Difference Between A Teaming Agreement And A Joint Venture, And Which One Is Right For My Company?

A teaming agreement is an agreement between two independent business entities to work together for the specific purpose of obtaining and performing a contract. The government generally recognizes the integrity and validity of

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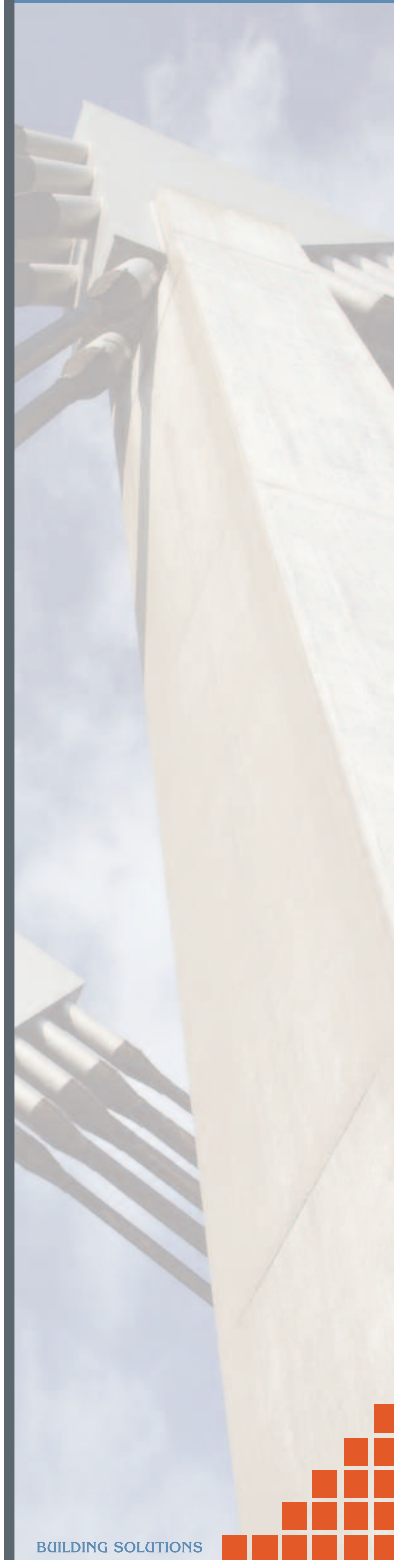

such arrangements. Pursuant to a teaming agreement, a potential prime contractor may agree with one or more other companies to have the company or companies act as subcontractor(s) under a specified government contract or acquisition program.

A joint venture, on the other hand, is an association of two or more individuals or companies that form a partnership for the purpose of engaging in a single defined project. The members of the joint venture generally share profits and losses.

With limited exceptions, parties to a joint venture are deemed affiliated by the SBA for the purpose of determining size status for a particular procurement. Teaming agreements, on the other hand, may provide an avenue for companies to work together to compete for government contracts without being deemed affiliated and in violation of the SBA's size standards.

How Can My Company Best Minimize The Risk Of Affiliation And Comply With Limitations On Subcontracting?

Generally, under existing regulations, a small business must perform at least 50% of the cost of contract performance incurred for personnel of a set-aside contract with its own employees. Pursuant to the National Defense Authorization Act of 2013 (NDAA), small business prime contractors generally are limited to subcontracting no more than 50% of the amount paid to the small business prime under the contract; however, neither the SBA regulations nor FAR have been updated to reflect the changes implemented by the NDAA. As application of the subcontracting limits is often complex, particularly given the changes implemented by the NDAA, contractors may wish to consult with an experienced attorney to ensure compliance.

Even if a small business meets the applicable subcontracting limits, the government may find parties to a teaming agreement to be "affiliated" for purposes of size standards if the proposed prime contractor is unduly, or unusually, reliant on its teaming partner(s), or if the teaming partner(s) will perform primary and vital requirements of the contract. This rule, referred to as the ostensible subcontractor rule, seeks to prevent large firms from forming relationships with small firms for the purpose of evading the SBA's size requirements.

What Are The Risks Of Non-Compliance?

Where affiliation exists, the SBA adds the size of the teaming partners together for eligibility purposes. As such, affiliation may render a team ineligible for award or subject to protest.

Other potential sanctions where ineligible parties willfully seek and certify eligibility to receive work that is set aside, reserved, or otherwise classified as intended for award to small businesses, include fines up to the amount paid by the government under the contract itself, suspension and debarment, liability under the False Claims Act, and civil and criminal prosecution. The federal government increasingly is investigating and prosecuting ineligible businesses that obtain small business set-aside contracts.

Given such risks, contractors must be proactive in evaluating compliance with applicable rules and regulations. Contractors must be familiar with such rules and must actively watch for and avoid red flags that may signal a risk of affiliation.

How Can My Company Best Minimize The Risk Of Affiliation And Comply With Limitations On Subcontracting?

In determining whether affiliation exists, SBA considers the "totality of the circumstances," including, but not limited to, the following factors:

- Division of Work: The small business must perform primary and vital requirements of the contract with its own employees. The "primary and vital" requirements of a particular contract are determined by all aspects of the solicitation, proposal, contract, and relationship between the parties.
- Skills and Experience: The small business must have skills and experience applicable to the primary and vital requirements of the contract.
- Proposal Support: The small business must lead proposal efforts.
- Use of Resources and Personnel: The small business and its subcontractor must not commingle resources, personnel, equipment, and/or office space.
- Teaming Agreement and Proposal Terms: The teaming agreement and proposal must designate the small business as the lead contractor. The teaming agreement should also make clear that the scope of the subcontractor's work complies with the applicable limitations on subcon-tracting.
- Contract Management: Although per-forming the contract management function, in and of itself, is not enough

- to avoid affiliation, in addition to performing the primary and vital work required by the contract, the small business must take primary responsibility for contract management.
- Incumbency: A subcontractor's incumbency may indicate unusual reliance, particularly when coupled with other risk factors. As such, contractors should treat a subcontractor's incumbency as a potential risk factor for affiliation.

Conclusion

Of course, whenever possible, contractors should avoid any potential for affiliation. When ostensible subcontractor risk factors do exist, however, structuring the relationship carefully may help contractors avoid a successful size protest. Both large and small businesses alike should keep the factors highlighted above in mind when forming teaming relationships.

LITIGATION

Personal Jurisdiction Through The Lens Of Chinese Drywall Litigation

by Stephanie M. Rochel, Associate

Introduction

It may have started with a runny nose or a recurrent headache. Perhaps the children's noses began to bleed or their coughs would not disappear. Maybe someone noticed the house smelled like rotten eggs or that black and corroded air conditioning parts needed replacement too soon. Others worried when their eyes and skin would not stop feeling itchy or their breathing became unusually difficult.

These are examples of recurring symptoms that consumers described in 4,051 reports to the U.S. Consumer Products and Safety Commission that have been linked to homes constructed between 2006 and 2007, during a dramatic increase in new construction. Many of the newly constructed homes contained drywall imported from China because the domestic supply of drywall could not keep up with the demand. In 2005, foreign manufacturers imported fewer than two million pounds of drywall from China. A year later, however, foreign manufacturers dramatically increased drywall imports to 550 million pounds. Tim Padgett, "*Is Drywall the Next Chinese Import Scandal?*," Time (March 23, 2009).

Manufacturers make drywall using natural gypsum ore, an important mineral building material, or synthetic gypsum. Problematic drywall was marked by elevated rates of silver and copper corrosion, a distinctive malodor, and sulfur gas emissions. The Safety Commission's investigations showed that "the top ten reactive sulfur-emitting drywall samples were all produced in China [and that] [s]ome of the Chinese drywall had emission rates of hydrogen sulfide 100 times greater than non-Chinese drywall samples." Press Release, Consumer Product Safety Commission, C*PSC Identifies Manufacturers of Problem Drywall Made in China* (May 25, 2010). Consequently, lawsuits implicating foreign manufacturers ensued.

Foreign Entity Lawsuits

When a suit involves a foreign entity like the Chinese drywall manufacturers, laws from other jurisdictions can add complexity to domestic laws. Parties generally encounter four procedural hurdles in legal actions against foreign manufacturers: (1) identifying the manufacturer; (2) serving process on the manufacturer; (3) obtaining jurisdiction over the manufacturer; and (4) collecting a judgment from the manufacturer. For example, serving formal notice of a complaint under applicable international treaties may require significant time and expense. This article outlines the personal jurisdiction hurdle.

To establish personal jurisdiction over nonresident defendants, such as foreign

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manufacturers, federal courts utilize a two-part sequential analysis to satisfy the requirements of the Fourteenth Amendment Due Process Clause. The first part of the constitutional analysis is whether a defendant had purposefully established minimum contacts in the forum state. The second part considers whether exercising personal jurisdiction comports with traditional notions of fair play and substantial justice.

Products made by foreign manufacturers can reach the United States even when foreign manufacturers lack the minimum contacts constitutionally necessary for establishing personal jurisdiction. In *Asahi Metal Industry Co. v. Superior Court of California, Solano Cnty.*, 480 U.S. 102 (1987), the United States Supreme Court held that merely placing the product into the stream of commerce fails to satisfy the minimum contacts test. Instead of simply entering the stream of commerce, *Asahi* established that a nonresident defendant must perform an additional purposeful act in the jurisdiction.

Proposed and Enacted Legislative Solutions

Due to *Asahi* and similar cases, experts have argued that U.S. courts are unsure about personal jurisdiction over foreign manufacturers who produce goods that harm U.S. consumers. The complexity and breadth of the Chinese drywall litigation spotlighted this procedural hurdle. In response, federal legislators proposed the Foreign Manufacturer's Legal Accountability Act of 2010 (the "2010 Act") to establish "a level playing field on which to compete with foreign corporations." Press Release, U.S. Rep. Braley (Jun. 28, 2010). The 2010 Act focused on simplifying service of process and jurisdictional issues involving foreign manufacturers by requiring them to consent to personal jurisdiction. Specifically, the 2010 Act would have required foreign manufacturers to register an agent and to consent to personal jurisdiction in the state and federal courts of the state where the agent is located.

Supporters generally viewed the 2010 Act as a means of closing loopholes unavailable to domestic manufacturers, who were financially undercut by foreign manufacturers. Detractors generally opposed the 2010 Act because they believed it overlapped with existing regulations and unlawfully targeted international trade partners. This debate resulted in Congress passing and President Obama signing the Drywall Safety Act of 2012 (the "2012 Act"), instead of the proposed 2010 Act.

The 2012 Act does not require foreign manufacturers to register an agent for service of process or to consent to personal jurisdiction. Instead, it expresses Congress's sense that China should "direct the companies that manufactured and exported problematic drywall to submit to jurisdiction in United States Federal Courts and comply with any decisions issued by the Courts for homeowners with problematic drywall." Drywall Safety Act of 2012, Pub. L. No. 112-266, 126 Stat. 2437 (2013). The 2012 Act also sets forth a mix of mandatory and voluntary standards for limiting sulfur content and for labeling, identifying, and removing problematic drywall. The mandatory labeling standards use ASTM International's gypsum board labeling provisions.

The 2010 Act, however, has not completely disappeared. Legislators recently introduced a similar bill named the Foreign Manufacturers Legal Accountability Act of 2013 (H.R. 1910). These legislative efforts illustrate the gravity of procedural issues lurking in every civil lawsuit – even if not disputed in your particular case.

Watt Tieder newsletters are posted on our website, www.watttieder.com, under the Resources Tab. If you would like to receive an electronic copy of our newsletter, please contact Peggy Groscup at: **pgroscup@watttieder.com**

BUILDING SOLUTIONS

Got An Emergency? Skip The Wait And Arbitrate!

by Daniel Rodriguez, Associate

Emergency arbitration is a relatively new option in the pantheon of alternative dispute resolution. While many jurisdictions allow for interim or preliminary relief to be awarded by an arbitral tribunal, it may take weeks or months for such a tribunal to be fully convened and even then enforceability of such relief remains dubious in some international jurisdictions. Until relatively recently, the only option for immediate emergency relief was to seek a preliminary injunction in a court. However, such relief may run counter to the entire spirit of arbitration desired by the parties.

This is where emergency arbitration provisions step in, allowing a chance for immediate relief granted by an appointed arbitrator. With the adoption of an emergency arbitrator provision by the London Court of International Arbitration (LCIA) on October 1, 2014, the three most widely utilized arbitration institutions (ICC, AAA and ICDR) all provide for emergency arbitration in their default rules. Further confirming this trend, two of the fastest growing arbitration institutions (SIAC and HKIAC) include such emergency arbitration provisions as well.

This article will: 1) explore generally the powers of an arbitrator (or arbitrators) to issue preliminary or interim relief; 2) discuss whether you should opt-out of or utilize emergency arbitration; and 3) discuss the mechanics of opting-out from the default emergency arbitration provisions (should you wish to do so).

Power Of Arbitrators To Grant Interim Or Preliminary Relief Generally

If a speedy assembly of an arbitral tribunal is possible, then parties may simply seek interim relief from the panel so assembled. This power has been expressly granted by statute in 17 states and the District of Columbia (and introduced as legislation in 3 more), all of which have adopted the 2000 revision of the Uniform Arbitration Act. In addition, courts widely enforce arbitral interim relief throughout the United States. Some courts have even upheld "interim" awards as "final" with regard to the issue of the status of the parties during the pendency of arbitration.

In fact, under the 2000 Uniform Arbitration Act, once the arbitral tribunal has been appointed, parties may seek provisional relief in the courts "only if the matter is urgent and the arbitrator is not able to act timely or the arbitrator cannot provide an adequate remedy." While interim relief issued by an arbitrator is generally enforced in the United States, different countries may not necessarily follow suit. An arbitral award of any kind without court enforcement is essentially useless, so verifying enforcement in your particular jurisdiction is critical.

Should You Opt-Out Of Emergency Arbitration Provisions?

Prior to October 2013, the only way to have the option of emergency arbitration under the AAA rules was to opt-in to those optional provisions. Now, all of the major arbitration institutions have included those provisions in their default rules. As a result, the analysis of risk in *opting-in* to an emergency arbitration agreement has now shifted to the risk of failing to *opt-out*.

The risk of failing to opt-out of an emergency arbitration provision is similar to the general risk of arbitration. That is, a lone arbitrator may be empowered to issue a ruling that is not reviewable on the merits. It may be that the effect of that "interim" ruling is in effect a final ruling on the merits. A recent decision from the Southern District of New York addressed a similar issue. *Yahoo!, Inc. v. Microsoft Corp.*, 983 F. Supp. 2d 310 (S.D.N.Y. 2013).

In *Yahoo!*, the parties affirmatively opted-in to the optional rules for emergency relief, since they signed their contract before the AAA had integrated the provisions into its standard rules. When Yahoo! stated that it would be pausing

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performance on the contract for several months, Microsoft sought and received an emergency award enjoining Yahoo! from withholding its performance. Yahoo! objected to the award on the grounds that it amounted to a final award rather than an interim order, but the court reasoned that the rules allowed for "interim, injunctive, or emergency relief." In the end, Microsoft got everything it wanted from the emergency arbitration without a further need for the parties to continue with a full arbitration proceeding under the AAA rules.

The benefits of the emergency arbitration were apparent, at least from Microsoft's position: in less than one month—26 days to be precise—an arbitrator was appointed, conducted a hearing, issued an order, and a court confirmed the order.

The risk for the parties agreeing to retain emergency arbitration is less apparent from Yahoo!'s perspective. In this case, Microsoft may have sought a preliminary injunction in court, which may have proven to be more expensive, complicated, and time consuming. While a delay would have benefited Yahoo! in the short-term, a decision issued by a judge would have been just as final given that an interlocutory appeal is unlikely to succeed. Further, at least in the United States, there are no published orders denying an emergency award/order. For domestic disputes, the pros and cons of emergency arbitration will obviously vary upon the particular circumstances and, as noted above, can differ sharply between the parties.

The real advantage of emergency arbitration lies in its potential to avoid a situation where you need emergency relief and the only court capable of granting it is in a foreign country where you are either unfamiliar with the procedures or customs of seeking such relief or where the courts are notoriously corrupt or inefficient. Also unclear is the international status of emergency awards and whether foreign countries would be required to view interim measures as enforceable under the New York Convention on the Recognition and Enforcement of Arbitral Awards (some jurisdictions draw distinctions between arbitral orders and awards under this Convention).

Ultimately you will need to ask yourself three questions before choosing emergency arbitration:

- In which court do I ultimately need to enforce my emergency relief and is the jurisdiction favorable to emergency arbitration (*e.g.*, Florida, Hong Kong, or Singapore)?
- How quickly do I need this relief – can it wait for a national court to make a decision or for my arbitral tribunal to convene and issue an order?
- Are the costs of appointing and paying for an emergency arbitrator prohibitive?

The Mechanics Of Opting-Out Of Emergency Arbitration (A Minor Wrinkle)

As previously mentioned, the ICC, AAA/ICDR, and LCIA rules provide for emergency arbitration as their default, but expressly allow for parties to opt-out of this expedited proceeding through their arbitration agreement. If, after reading this article and advising your client or consulting with counsel, you decide that you want the court system to be the exclusive realm for emergency relief, then you should expressly opt-out of the emergency arbitration rules in your agreement.

There is, however, one wrinkle to be aware of if you desire the ICC rules to govern your dispute and you do not want to opt-out of the emergency arbitrator provisions. Under the ICC Rules, emergency arbitration will be denied if "the parties have agreed to another pre-arbitral procedure that provides for the granting of conservatory, interim or similar measures." There is no case law addressing this potential "inadvertent opt-out" – a fact that is hardly surprising inasmuch as the emergency arbitration option has only been available since 2012 and, according to the ICC, there have only been eight requests for emergency measures during that timeframe. The important take-away at this juncture is that by expressly providing a provision for some alternative interim relief in the event of a dispute, you may have inadvertently opted-out from the opportunity to pursue emergency relief. Accordingly, it is essential to be as clear as possible when drafting your arbitration agreement, regardless of the governing rules.

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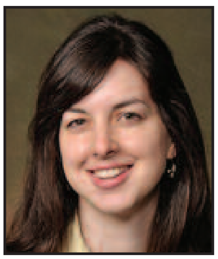
FIRM NEWS

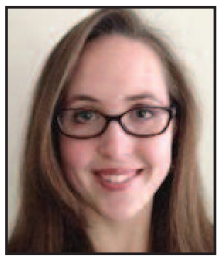
Watt Tieder Launches Two New Websites

Watt Tieder is proud to introduce a fresh new firm website and brand to showcase our decades of extensive experience in domestic and international construction litigation, government contracts, surety law and bankruptcy law. The site has an exciting new look and is more accessible, informative, interactive and easy to navigate than ever before. Our firm website also provides a link to the new interactive website version of our 50 State Analysis of Key Issues Related to Construction and Engineering Contracts which has proven to be a highly regarded resource. The 50 State Analysis is now available at your desktop as well as on all mobile devices. Visit us at www.watttieder.com.

Watt Tieder Welcomes Two New Associates



Carolyn R. Cody joins the McLean, Virginia office. Carolyn's practice will focus on construction litigation, government contracts, and suretyship. Carolyn received her J.D. from the William and Mary Law School, Williamsburg, Virginia in 2014 and her B.A. from the College of the Holy Cross, Worcester, Massachusetts in 2008. Carolyn is a member of the Virginia Bar.



Robyn N. Burrows joins the McLean, Virginia office. Robyn's practice will focus on construction litigation, government contracts, and suretyship. Robyn received her J.D. from George Mason University School of Law, Arlington, Virginia in 2012 and her B.A. from Houghton College, Houghton, New York in 2008. Robyn is a member of the Bars of Virginia and the District of Columbia.

Upcoming And Recent Events

GcilA Oktoberfest Celebration, September 21-22, 2014; Munich, Germany; Watt Tieder was pleased to once again participate in this annual Oktoberfest celebration. Events included: a Folk Parade Viewing and Bavarian Breakfast; and a seminar entitled "Proving Delay in International Construction Arbitration – What Works Best?" presented by **John B. Tieder, Jr. and Shelly L. Ewald**, in conjunction with Secretariat and Delta Consulting.

35th Annual Construction and Public Contract Law Seminar, November 7, 2014; Charlottesville, Virginia; Watt Tieder partner **Hanna Lee Blake** spoke on "How to Prosecute and Defend Payment Bond Claims." Hanna sits on the Board of Governors for the Construction and Public Contract Section of the Virginia State Bar.

Construction SuperConference 2014, December 1-3, 2014; Las Vegas, Nevada; **R. Miles Stanislaw** and **Christopher Wright** (moderator) will join a panel of speakers from Hensel Phelps Construction Co., Marsh USA and Zurich North America to discuss the role of insurance from project commencement to completion on complex commercial and public projects.

ABA TIPS Fidelity & Surety Law Committee Mid-Winter Meeting, January 21-23, 2015; New York, New York; **John E. Sebastian** to speak.

AGC National Convention, March 18-20, 2015; San Juan, Puerto Rico; **R. Miles Stanislaw** to speak.

Inter-Pacific Bar Association Annual Conference, May 8, 2015; Hong Kong, China; **Keith C. Philips** to speak.

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The Watt, Tieder, Hoffar & Fitzgerald newsletter is published quarterly and is designed to provide information on general legal issues that are of interest to our friends and clients. For specific questions and concerns, the advice of legal counsel should be obtained. Any opinions expressed herein are solely those of the individual author.

Special Thanks to Editors, **Robert G. Barbour, Keith C. Phillips, William Groscup** and **Heather Stangle**.

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