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Spring 2014

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Delaware Court Loses Final Appeal To Conduct Secret Arbitrations

by Kathleen O. Barnes, Senior Partner

Court ordered arbitration programs and other forms of mandatory alternative dispute resolution are being instituted across the United States. In nearly every state, these arbitration programs offer hearings, most often for smaller dollar value claims, conducted before local lawyers and judges. In 2009, however, the Delaware State Legislature enacted a unique program, which provided for the arbitration of commercial disputes by sitting judges. The program was intended to "preserve Delaware's pre-eminence in offering cost-effective options for resolving disputes, particularly those involving commercial, corporate and technology matters," and to permit Delaware's courts to compete with increasingly popular private arbitrations for the business of multinational and international corporations.

Delaware's program permits parties to request a judge in the Court of Chancery to arbitrate their dispute. The arbitration program requires that both parties consent to arbitrate at the time the action is filed with the Court. The parties and their action must meet certain eligibility criteria in order to participate: 1) at least one party must be a "business entity" and at least one party must be organized under the laws of the state of Delaware, or have its principal place of business in Delaware – one party may meet both criteria; 2) neither party can be a "consumer;" and 3) in an action seeking only monetary damages, the amount-in-controversy must be at least $1 million dollars; if an equitable remedy is also sought, there is no minimum amount-in-controversy. 10 Del. C. §§349(a); 347(a), (b). An award issued by the judge/arbitrator may be appealed by either party to the Delaware Supreme Court. The Supreme Court may only overturn an award, however, in conformity with the Federal Arbitration Act: by a showing of fraud, corruption, that the arbitrator exceeded his/her power or undue means in procuring the award, *i.e.*, partiality, or certain misconduct on the part of the arbitrator. 10 Del. C. § 349(c).

The Delaware Court of Chancery adopted Rules 96, 97 and 98 to administer the arbitration program. In order to initiate a proceeding, the parties file a petition that states the nature of the dispute, the claims made and the remedies sought, and pay a $12,000 filing fee and $6,000 per day of service by the judge/arbitrator. The judge appointed to hear the arbitration holds a preliminary conference and preliminary hearing and, along with the parties, will determine the amount of discovery necessary to permit the parties to prepare for the arbitration and to enable the judge to understand and decide the dispute. The judge/arbitrator has the power to issue a final award in the arbitration and to issue any necessary interim rulings during the course of the action. Upon the issuance of a final award in the arbitration, a final judgment in conformity with the award is entered by the court.

As originally conceived, the entire arbitration proceeding in the Delaware Court of Chancery was to be held outside of public view. All proceedings were to be confidential and not of public record, from the time of filing of the original petition, to the issuance of the award by the judge/arbitrator. The original petition for arbitration and any submissions by the parties are confidential and are not to be filed in the public docketing system. All hearings before the judge/arbitrator are to be attended only by the parties and are not open to the public. Even the award issued by the arbitrator is not made public unless it is appealed to the Supreme Court. Del. Ch. Ct. R. 97(a)(4).

And so Delaware had its state-sponsored arbitration program – a vehicle to serve its corporate citizens whether they chose litigation or arbitration to resolve their dispute – but not for long. In 2010, the Delaware Coalition for Open Government, a non-profit organization, challenged the Delaware Business Arbitration Program by means of a suit against the judges of the Delaware Court of Chancery. *Del. Coal. for Open Gov't, Inc. v. Strine*, 894 F.Supp.2d 493 (D. Del. 2012). In short, the Coalition contended that the arbitrations provided for under Delaware's new program were civil trials under another name, except that the trials were conducted behind closed doors instead of in open court. As such, the Coalition contended, the arbitrations conducted by the State Court of Chancery constituted an unlawful violation of the First Amendment to the Constitution, which granted the public a right of access to trials.

The Federal District Court agreed, holding that, "the Delaware proceeding functions essentially as a non-jury trial before a Chancery Court judge. The court concluded that, "[b]ecause it

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is a civil trial, there is a qualified right of access and this proceeding must be open to the public." *Id.* at 494. Citing case law granting the public a right of access to state civil trials, the District Court considered whether Delaware had created a procedure "sufficiently like a trial" that the public must be allowed access. *Id.* at 500. The District Court stressed the differences between arbitration and litigation, finding that the "essence of arbitration" is the parties' voluntary agreement to resolve their dispute through a decision-maker of their choosing, in a process that they can craft to their specific needs. *Id.* By contrast, litigation follows court procedures and guidelines. The judge reaches a decision with precedential value that is subject to review by a higher court, while the arbitrator's decision is *ad hoc* only, and generally is not subject to review for errors of fact or law. While many of the procedures in arbitration and litigation are similar, the District Court concluded that the critical distinction is that the arbitrator's role is to carry out the aims of the parties' agreement; that role defines the scope of the arbitrator's authority. The trial judge, on the other hand, "bears a special responsibility in the public interest . . . to vindicate the policies of the [law] not merely to afford private relief." *Id.* at 501-02.

The District Court went on to identify the elements of the Delaware arbitration program that are sufficiently like a trial to require that the public be granted access to the proceedings: 1) a sitting judge presides over the arbitration – this distinguishes the Delaware proceeding from court-ordered arbitrations where local lawyers serve as arbitrators; 2) the judge conducts the proceeding in the Chancery courthouse, assisted by the court staff; 3) the judges are not compensated privately for their work as arbitrators; judges and staff are paid their regular salaries by the state; 4) the judge, acting as an arbitrator, hears evidence, finds facts, applies the relevant law and issues a final award with the force of law. The District Court concluded that the Delaware arbitration procedure is sufficiently like a trial, and that the, "public role of [a judge] is undermined when a judge acts as an arbitrator bound only by the parties agreement." *Id.* at 502. Therefore, the court determined that the confidentiality provisions of the statute and the Chancery Court Rules were unconstitutional.

The Chancery Court judges immediately appealed the District Court ruling to the United States Court of Appeals for the Third Circuit, supported by *amici curia* ("friends of the court") briefs from the Chamber of Commerce of the United States of America, the Business Roundtable and the Corporation Law Section of the Delaware State Bar Association. The Appellate Court reached the same conclusion as the lower court, however by taking a different path. *Del. Coal. for Open Gov't, Inc. v. Strine*, 733 F.3d 510 (2013).

The Court of Appeals held that the proper test to be applied in determining the constitutionality of the confidentiality provisions of the Delaware arbitration program is the "experience and logic" test. Under that test, a proceeding qualifies for the First Amendment right of public access when "there has been a tradition of accessibility" to that type of proceeding and when "access plays a significant positive role in the functioning" of the process. *Id.* at 514.

Under the "experience" prong of the test, the Court of Appeals held that, for the type of proceeding that Delaware has instituted – "a binding arbitration before a judge that takes place in a courtroom" – the history of openness is comparable to the history of access to the civil trial because, "both the place and process of Delaware's proceeding have historically been open to the press and general public." *Id.* at 518. Under the logic prong of the test, the Court of Appeals addressed the positive role that public access to the Delaware arbitrations would play including: 1) allowing the public and shareholders to understand how Delaware resolves major business disputes; 2) allaying public concern about a process only accessible to litigants in business disputes who are able to afford the fees; and 3) exposing the behavior of the litigants, lawyers and the Chancery Court judge to the scrutiny of their peers and the press. *Id.* at 520. The Court of Appeals rejected claims by the Chancery Court judges that confidentiality is necessary to prevent the "loss of prestige and goodwill" that corporate parties might suffer in open proceedings, finding that exposure of litigants to public scrutiny discourages perjury and misrepresentation. *Id.* Finally, the Court of Appeals confirmed the lower court decision that there is a First Amendment right of access to Delaware's government-sponsored arbitrations. In the concurring opinion, the court clarified that the Court of Appeals did not intend to declare Delaware's entire arbitration program unconstitutional. Rather, sitting judges of the Chancery Court are permitted to engage in arbitrations, but with the same public access as any other Delaware court proceedings.

The Chancery Court judges sought review by the United States Supreme Court, warning in its petition that the Appellate decision risked the 40% of Delaware's revenue that comes from "corporate citizens" attracted by the state's efficient, expert courts. The Supreme Court was unmoved, denying *certiorari* in March 2014, effectively upholding the decision that the Delaware Business Arbitration Program is unconstitutional insofar as it fails to make arbitration proceedings open to the public.

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In conclusion, the Chancery Court argued before the Court of Appeals that striking down the confidentiality provisions would "effectively end" the Delaware Business Arbitration Program. The Program, however, also boasts other benefits that remain: 1) access to judges experienced in corporate and business litigation; 2) efficient case management for moderate fees; 3) timely hearings; and 4) enforceable awards. Whether the Delaware legislature and courts will determine that a state-sponsored alternative to private arbitration is viable, without the privacy provisions, remains to be seen.

Arbitrators Reign Supreme

by Keith C. Phillips, Senior Partner

The United States Supreme Court ruling on its first case involving international arbitration under a bilateral investment treaty, interpreted the treaty provisions as it would under a contact between two parties and determined that the arbitrators, not the courts, should decide procedural arbitrability questions. In doing so, the court affirmed the deference afforded by U.S. courts to decisions of arbitrators, even in the context of an international treaty. The case again highlights the critical need for precision in drafting dispute resolution clauses in contracts (and treaties).

Bilateral Investment Treaties

A bilateral investment treaty ("BIT") is an agreement establishing the terms and conditions for private investment by nationals and companies of one state in another state. BITs typically require that investors and their investments be treated as favorably as the host party treats its own investors and their investments, or investors and investments from any third country. The BIT generally affords this treatment for the full life-cycle of investment – from establishment or acquisition, through management, operation, and expansion, to disposition. Key features of BITs often include:

- Establishment of limits on the expropriation of investments and provide for payment of prompt, adequate, and effective compensation when expropriation takes place.
- Provision for the transferability of investment-related funds into and out of a host country without delay and using a market rate of exchange.
- Restrictions on the imposition of performance requirements, such as local content targets or export quotas, as a condition for the investment.
- The right to engage the top managerial personnel of their choice, regardless of nationality.

A key provision in many BITs give investors the right to submit an investment dispute with the government of the other party to international arbitration, thus avoiding possible litigation in that country's domestic courts. Investors, as with contractors and others doing business abroad, are sometimes reluctant to submit claims to the local court systems. The BITs often allay these concerns by referring disputes to international arbitration under either United National Commission on International Trade Law (UNCITRAL) or International Center for Settlement of Investment Disputes (ICSID) arbitration rules. It is the BIT arbitration provision that provides the backdrop for the Supreme Court's decision.

- <u>*BG Group, PLC v. Republic of Argentina*</u>

The case arose out of a dispute between BG Group, a United Kingdom company, and Argentina, under a 1990 BIT between the two countries. The treaty provides the general protections for investors noted above. With respect to dispute resolution, the treaty authorizes either party to submit a dispute "to the decision of the competent tribunal of the Contracting Party in whose territory the investment was made" – *i.e.*, the local courts. It provides for arbitration "(i) where, after a period of eighteen months has elapsed from the moment when the dispute was submitted to the competent tribunal . . ., the said tribunal has not given its final disposition; [or] (ii) where the final decision of the aforementioned tribunal has been made but the Parties are still in dispute."

BG Group acquired a majority stake in an Argentine gas distribution company in the early 1990s resulting from the government's privatization of its state-owned gas utility. The Argentine company was awarded a 35 year exclusive license to distribute gas in Buenos Aires. Argentina also enacted statutes that required its regulators to calculate gas tariffs in U.S. dollars and to set levels to ensure reasonable returns on investment.

In the early 2000s, Argentina faced economic crisis and enacted new laws changing the basis for the gas tariffs from dollars to pesos, the local currency, and set an unreasonable exchange rate. The result was that BG Group lost much of its investment. In 2002, the President of Argentina issued a decree staying for 180 days the execution of its courts' final judgments in suits claiming harm as a result of the new economic measures. In addition, Argentina established a "renegotiation process" for public service contracts (including the license for the distribution of gas in Buenos Aires), but barred from participation in the process firms that were litigating against Argentina in court or arbitration.

In 2003, BG Group, under the BIT, sought arbitration claiming that Argentina's new laws and regulations violated the treaty's provisions against expropriation of its investment and requiring "fair and equitable" treatment of investors. The parties appointed an arbitration tribunal and agreed to Washington, DC as the site of the arbitration. Argentina denied the claims and asserted that the tribunal lacked jurisdiction to hear the dispute because, among other reasons, BG Group initiated arbitration without first litigating the claims in Argentina's courts.

The arbitration tribunal issued a decision in December 2007 finding that it had jurisdiction and awarding BG Group US $185 million. With respect to BG Group's failure to initiate litigation first, the arbitrators found that Argentina's own conduct had waived or excused the litigation requirement through its decrees and regulations relating to the courts and the renegotiation process. While these measures did not make litigation in the Argentine courts literally impossible, the arbitrators found that requiring compliance under these circumstances would lead to "absurd and unreasonable result[s]."

Both sides filed petitions for review in Federal District Court in the District of Columbia – BG Group sought to confirm the award under The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (The New York Convention) and the Federal Arbitration Act. Argentina sought to vacate the award in part on the ground that the arbitrators lacked jurisdiction because of BG Group's failure to first initiate litigation in the Argentine courts (under Section 10(a)(4) of the Federal Arbitration Act, a federal court may vacate an award "where the arbitrators exceeded their powers.").

The District Court affirmed the award and denied Argentina's petition to vacate. The Court of Appeals for the District of Columbia Circuit reversed, finding that the interpretation of the treaty provision for local litigation was a matter for the courts to decide *de novo, i.e.*, without deference to the views of the arbitrators. The Court of Appeals went on to decide that the circumstances did not excuse BG Group's failure to comply with the treaty requirement. Because of BG Group's failure to initiate litigation and wait 18 months, the arbitrators lacked jurisdiction and the appeals court vacated the award. The U.S. Supreme Court granted BG Group's petition for certiorari, "[g]iven the importance of the matter for international commercial arbitration."

- <u>Supreme Court Decision</u>

The question before the Court was simply who – as between the courts or the arbitrators – bears responsibility for interpreting and applying the arbitration provision and the local litigation requirement. The Court conducted its analysis of the question in two stages. First, the Court treated the arbitration provision before it as if it were an ordinary contract between two private parties. The Court then analyzed whether the fact that the arbitration provision at issue was included in a treaty as opposed to a contract made a substantive difference.

With respect to the question of private contracts for arbitration, the Court noted that it is up to the parties to determine whether a particular matter is for the arbitrators or the courts to decide, as the parties are free to structure their contractual affairs as they see fit. Where the arbitration agreement is silent, the courts generally presume that substantive matters of arbitrability are left to the courts, including such matters as "whether the parties are bound by a given arbitration clause" or "whether an arbitration clause . . . applies to a particular type of controversy." On the other hand, the Court noted that courts will presume that the parties intended the arbitrators, not the courts, "to decide disputes about the meaning and application of particular procedural preconditions for the use of arbitration", including claims of waiver or delay and the satisfaction of prerequisites "such as time limits, notice, laches, estoppel and other conditions precedent" to arbitrate.

Utilizing those guidelines and presumptions, the Court found that the litigation provision in the arbitration clause before it was "a purely procedural requirement – a claim-processing rule that governs when the arbitration may begin, but not whether it may occur or what its substantive outcome will be on the issues in dispute." Thus, the Court determined, the local litigation requirement, if this were an ordinary contract, would be interpreted and applied by the arbitrators.

With respect to the second part of the analysis – whether it makes a difference that the arbitration provision at issue is contained in a

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treaty as opposed to a contract – the Court answered in the negative. A treaty is simply a contract between nations and, like a contract, its interpretation is a matter of determining the parties' intent. The treaty did not evidence any contrary intent to the normal presumptions about who should decide threshold arbitrability issues and thus the arbitrators hold that power, with a very deferential court review. The Court then conducted a very brief review of the arbitration tribunal's decision regarding the litigation requirement and found that the arbitrators "did not 'stra[y] from interpretation and application of the agreement' or otherwise 'effectively dispens[e]' their 'own brand of . . . justice.'" The Supreme Court thus reversed the Court of Appeals and reinstated the award in favor of BG Group.

Conclusion

The Supreme Court's decision underscores the special place arbitration occupies in the United States' legal structure. Courts have and will continue to generally defer to the decisions of arbitrators absent a specific contractual limitation on the arbitrators' authority. Even in the area of investor-state arbitrations, the courts will apply standard contracting principles to the interpretation of arbitration clauses. The decision also highlights the critical importance of drafting and negotiating arbitration provisions. Whether courts or arbitration tribunals will hear and decide questions of arbitrability and preconditions to arbitration needs to be planned and addressed during the contract negotiation – when the parties are free to bargain for the system that works best for their circumstances.

CONTRACTS

Guidelines For Government Contractors' Recovery Of Costs Related To Negotiated Prices Of Changed Work

by Edward ("Ned") J. Parrott, Senior Partner, and Steven L. Lunsford, Associate

Edward ("Ned") J. Parrott

Steven L. Lunsford

Introduction

When negotiating the price of changed work, federal government contractors are keenly aware of the bottom line. They know the benefits associated with a successful negotiation, as well as the risks of heading down the path of a protracted dispute. Contractors are also mindful of potential legal and consultant costs that may be incurred throughout the price negotiation process. The United States Court of Appeals for the Federal Circuit recently provided additional clarity to contractors regarding the allowability of these costs, holding that contractors may be compensated for costs related to pricing and negotiating changed work, as long as the costs were not incurred in an effort to prosecute a claim against the government.

The Case

In *Tip Top Construction, Inc. v. Donahoe*, the Federal Circuit set forth the applicable test to determine whether legal and consultant costs incurred by a contractor due to negotiations over the price of changed work were recoverable as increased costs of contract administration. 695 F.3d 1276 (Fed. Cir. 2012). According to Court, the outcome of such a determination turns on "the distinction between costs incurred in connection with the administration of a contract and costs incurred in connection with the prosecution of a [Contract Disputes Act ("CDA")] claim, the former being recoverable, but the latter not." *Id.* at 1283. Put simply, legal and consultant costs are recoverable as long as they were incurred "for the genuine purpose of materially furthering the negotiation process." *Id.* at 1284.

Tip Top had entered into a contract with the Postal Service for the renovation and alteration of postal facilities in the United States Virgin Islands. The contract established the procedure for the issuance of new work orders, and, upon the issuance of such an order, the parties engaged in a series of price negotiations. To help determine the cost of the out-of-scope work, Tip Top employed an outside consultant to review the new requirements and estimate the total cost to perform the work.

When negotiations between the parties proved unsuccessful, Tip Top submitted a claim to the Postal Service for the price of the change, its claim preparation costs, and its legal costs. After considering Tip Top's claim, the contracting officer issued a final decision granting the majority of direct costs related to the new work, but rejecting a substantial portion of Tip Top's costs stemming from the price negotiations, including the majority of Tip Top's legal and consultant costs.

Tip Top appealed the contracting officer's final decision to the Postal Service Board of Contract Appeals ("Board"). There, the Board similarly ruled that the vast majority of Tip Top's consultant costs and related overhead were not recoverable because the estimated costs developed by the consultant to price Tip Top's claim "had nothing to do with performance of the changed work or genuine contract administration and were solely directed at trying to convince the contracting officer to accept [Tip Top's] figure for the change and maximizing [Tip Top's] monetary recovery." *Id.* at 1280 (citation to Board decision omitted). The Board also found that Tip Top had not adequately documented its consultant's hours.

Before the Federal Circuit, Tip Top argued that, based on that Court's decision in *Bill Strong Enterprises, Inc. v. Shannon*, 49 F.3d 1541 (Fed.Cir.1995), the Board below committed legal error by holding that Tip Top's consultant and attorney costs associated with the negotiations were not recoverable. In *Bill Strong*, the Federal Circuit held that, under the Federal Acquisition Regulation ("FAR"), "consultant costs incurred by a contractor in connection with negotiations relating to the additional compensation to which the contractor was entitled by reason of government-caused delay *were allowable* as contract administration costs, *even though the negotiation's eventually failed.*" *Id.* at 1281 (emphasis added); *see also* FAR 31.205-33 (establishing the allowability of certain professional and consultant services).

Relying on the holding in *Bill Strong*, Tip Top contended that the legal and consultant fees it incurred in negotiating the price of the change order were recoverable as contract administration costs – even though its contract was not governed by the FAR – because its contract contained a change order provision substantially similar to the FAR's changes clause. In response, the government countered that attorney fees are not recoverable because costs to prepare and document a claim for equitable adjustment are not recoverable, and argued that Tip Top failed to support its claim for all of its consultant costs.

The Federal Circuit agreed with Tip Top, and remanded the case back to the Board with an instruction to award Tip Top its entire claim. The Court reasoned that, "if a change order requires a contractor to incur contract administration costs, those costs are recoverable to the extent they are reasonable. Thus, the dispute depends on whether the costs are classified as general contract administration costs or claim preparation costs." 695 F.3d at 1282-83.

To determine whether claimed costs are related to contract administration costs or claim preparation costs, the Federal Circuit leaned on its prior holding in *Bill Strong*. Quoting that decision, the Court observed that:

> In the practical environment of government contracts, the contractor and the [Contracting Officer ("CO")] usually enter a negotiation stage after the parties recognize a problem regarding the contract. The contractor and the CO labor to settle the problem and avoid litigation. Although there is sometimes an air of adversity in the relationship between the CO and the contractor, their efforts to resolve their differences amicably reflect a mutual desire to achieve a result acceptable to both. This negotiation process often involves requests for information by the CO or Government auditors or both, and, inevitably, this exchange of information involves costs for the contractor. These costs are contract administration costs, which should be allowable since this negotiation process benefits the Government, regardless of whether a settlement is finally reached or whether litigation eventually occurs because the availability of the process increases the likelihood of settlement without litigation. Additionally, contractors would have a greater incentive to negotiate rather than litigate if these costs of contract administration were recoverable.

Id. at 1283 (citations and quotation omitted).

In order to classify a particular cost as either a contract administration cost or a cost incidental to the prosecution of a claim, the Court instructed "contracting officers, the Board, and courts [to] examine the objective reason why the contractor incurred the cost." *Id.* Then, if it is determined that a "contractor incurred the cost for the genuine purpose of materially furthering the negotiation process, such cost should normally be a contract administration

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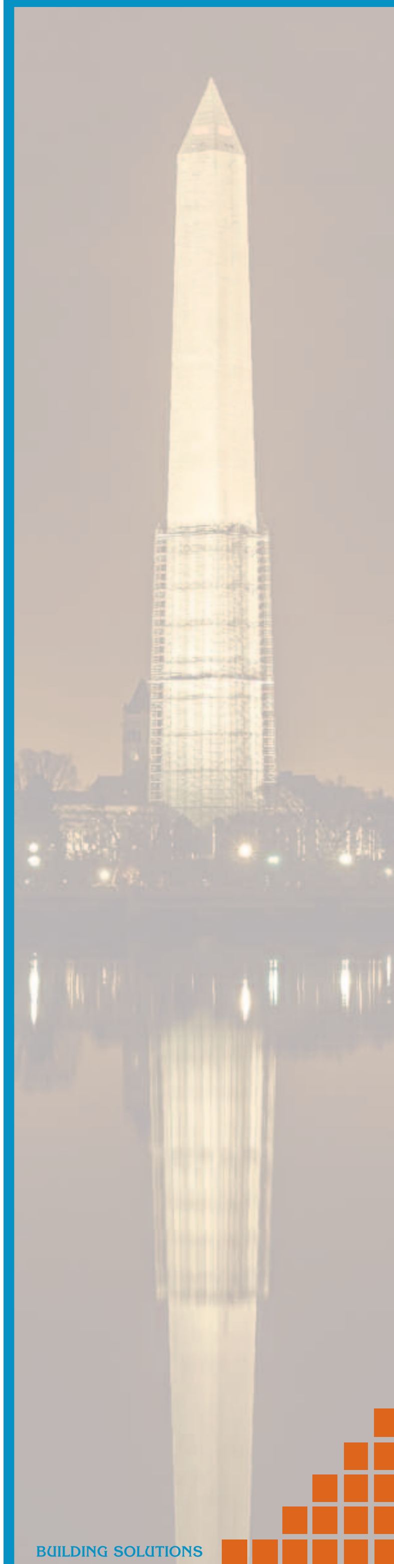

cost allowable under FAR 31.205–33, even if negotiation eventually fails and a CDA claim is later submitted." *Id.* at 1283-84. In contrast, "if a contractor's underlying purpose for incurring a cost is to promote the prosecution of a CDA claim against the Government, then such cost is unallowable under FAR 31.205–33." *Id.* at 1284.

The Lesson

The *Tip Top Construction* decision reinforces the framework for recovering legal and consultant costs related to pricing, negotiating, and administering changed work. In response to this guidance, contractors should take necessary steps to properly account for their negotiation-related costs and present the costs in an acceptable format to the contracting officer. Contractors should track and clearly describe its legal and consultant costs, and ensure that the costs are incurred to further the negotiations – and not to develop or prosecute a claim. Taking such actions can increase the likelihood that contractors will be able to recover these costs and protect the bottom line.

CASE UPDATE

Providing Clarity For Differing Site Conditions Claims On Federal Design-Build Projects

by Albert L. Chollet III, Partner

The U.S. Court of Appeals for the Federal Circuit recently reversed a U.S. Court of Federal Claims opinion relating to a dispute between the federal government and a design-build entity. In the Fall 2013 Newsletter, I joined the public criticism of the Court of Claims' ruling in *Metcalf Construction Company, Inc. v. United States* as it related to its treatment of a differing site conditions ("DSC") claim arising out of a federal design-build contract. While my Fall 2013 article focused solely on the Court of Claims' treatment of the DSC claim, the public criticism of *Metcalf* has not been limited to this issue. In fact, many commentators directly criticized the Court of Claims' reasoning relating to the duty of good faith and fair dealing.

With respect to the DSC claim, a popular critique of the Court of Claims' ruling is that it dramatically reallocated risk among the contracting parties by turning the design-builder's independent review of site conditions into a warranty of conditions, diminishing the reliability of reports and indications included in contract documents. In this way, the Court of Claims' ruling arguably invited more uncertainty in project pricing and greater risk for design-builders.

On February 11, 2014, the Federal Circuit reversed the Court of Claims, vacating the holding and remanding the case back to the trial court for further proceedings. In the process, the Federal Circuit provided needed clarification on the DSC issue.

Metcalf's DSC Claim And The Court Of Claims' Ruling

Metcalf Construction involved a Navy project for demolition of existing housing and design and construction of new family housing units. Metcalf was the design-builder. The Navy's original and revised request for proposal ("RFP") included a soil investigation report. The soil report detailed characteristics of the soil as having "slight expansion potential." Additionally, the RFP stated that the human carcinogen chlordane was present in the soils but at acceptable levels such that remediation was not required. The RFP stated that the soil investigation report was for preliminary information only and advised contractors to perform post-award site design and engineering work, including soil investigation.

After receiving its notice to proceed, Metcalf undertook performance of the project and hired an independent entity to conduct a soil investigation. Metcalf discovered moderate to high expansive near-surface soil that differed materially from the soil described in the Navy's report included in the RFP. Metcalf submitted its DSC claim to the Navy, and the Navy rejected the claim. The Navy contended that the claim was late and that the Navy's soil report was for "preliminary information only" such that Metcalf could not have reasonably relied upon it.

Additionally, Metcalf tested the soil conditions on multiple occasions for contamination. During

testing, Metcalf found no detectable amounts of chlordane. During excavation, however, the Navy required Metcalf to conduct further tests before relocating soil stockpiles. These subsequent tests found detectable levels of chlordane. Metcalf submitted notice of the DSC to the Navy, and the Navy partially rejected Metcalf's claim.

When Metcalf pursued its claim in the Court of Claims, the Court ruled in favor of the Navy. The Court of Claims noted the disclaimers in the RFP that detailed soil investigation reports were for informational purposes only and held that those reports could not reasonably be relied upon. Essentially, the Court distinguished between bid documents (upon which it concluded a contractor cannot rely) and other contract documents (upon which it concluded that a contractor may rely). The Court of Claims also focused on Metcalf's contractual duty to perform an independent investigation of the conditions in denying Metcalf's DSC claim. Metcalf appealed this ruling to the Federal Circuit.

The Federal Circuit's Reversal Of The Court Of Claims

On appeal, the Federal Circuit reversed the Court of Claims, ruling that the Court of Claims applied the wrong legal standard and misinterpreted certain contract provisions in ruling on the implied duty of good faith and fair dealing and the DSC claim. Consequently, the Federal Circuit vacated the Court of Claims' holding and remanded the matter for further proceedings.

The Federal Circuit's opinion squarely addressed Metcalf's claim of breach of the implied duty of good faith and fair dealing, concluding that the Court of Claims' standard of review was "improperly narrow." The Federal Circuit therefore reversed and remanded the case to the lower court on this issue. The Federal Circuit acknowledged that the thrust of Metcalf's claim was the good-faith-and-fair-dealing claim; however, the Court noted that "any breach of that duty has to be connected, though it is not limited, to the bargain struck in the contract." Accordingly, the Federal Circuit examined Metcalf's DSC claim.

Initially, the Federal Circuit observed that the RFP and pre-bid documents established how the DSC clause would apply to soil conditions. While the contract anticipated that Metcalf would test and investigate the soil during performance, the RFP made direct representations about the expansive soils and the absence of any need for remediation of chlordane because those levels were deemed "acceptable."

The Federal Circuit took issue with the Court of Claims' interpretation of the RFP and pre-bid documents, noting that the Court of Claims thus "treated the contract as placing on Metcalf the risk and costs of dealing with newly discovered conditions different from those stated by the government before the contract became binding." The Federal Circuit did not agree that the contract required Metcalf to bear the risk for errors in the government's affirmative representations about soil conditions. Thus, although Metcalf was required to investigate conditions once work began, it did not bear the sole risk of significant errors in the pre-contract assertions by the government of soil conditions.

The Federal Circuit considered it instructive that Metcalf's contract with the Navy incorporated the DSC clause in FAR 52.236-2. The Federal Circuit specifically noted that the FAR provision "exists precisely in order to 'take at least some of the gamble on subsurface conditions out of bidding': instead of requiring high prices that must insure against the risks inherent in unavoidably limited pre-bid knowledge, the provision allows the parties to deal with actual subsurface conditions once, when work begins, 'more accurate' information about them can reasonably be uncovered." For this reason, even pre-bid inspection requirements for contractors are viewed cautiously so that a duty to inspect the site will not negate a DSC clause by putting a contractor in the difficult position of discovering hidden conditions beyond the limits of an inspection appropriate to the time available to perform that inspection.

Finally, the Federal Circuit considered the reference to the soils report being "for preliminary information only" to be inconsequential. In the opinion of the Court, that provision existed solely to signal that the information may change; it did not require Metcalf to bear all risk if preliminary information provided by the government was ultimately determined to be inaccurate. For the foregoing reasons, the Federal Circuit reversed and remanded the matter to the Court of Claims for further proceedings consistent with the Federal Circuit's opinion.

Conclusion

A long line of federal authority has embraced and advanced the public policies furthered by DSC clauses in federal contracts of enhancing the procurement process and minimizing the risk to bidders of unforeseen subsurface conditions. The DSC clause lessens the risk of unknown contingencies and simultaneously provides a direct benefit to the government by allowing for more accurate bids without inflation for unforeseen risks.

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In ruling that the Court of Claims misinterpreted the contract and imposed a too-heavy burden on the design-builder, the Federal Circuit provided clarity to the issue and reached a conclusion more in line with existing precedent. For design-builders, the Federal Circuit's opinion should provide some reassurance that an obligation to perform an independent review of the site is not automatically transformed into a general warranty of conditions. Moreover, the federal government will not be able to utilize broad disclaimers to allocate all risk of unknown site conditions on the design-builder.

For *Metcalf Construction*, it remains to be seen how the Court of Claims will rule on remand on issues of liability and damages. The Federal Circuit's reversal, however, provides much needed clarification, and may also provide some peace of mind to design-builders that long-standing federal authority on the DSC clause's fair allocation of risk between the parties to a construction contract is not in immediate jeopardy.

CISG

Avoiding Uncertainty: The Risks Of Ignoring The CISG When Drafting A Choice-of-Law Clause

by Daniel Rodriguez, Associate

Introduction

An American company enters into a contract with a Chinese contractor to deliver and install certain modules necessary for the upgrade of a power plant, and the date for completed installation is set in the contract. The parties agree that the contract will be governed by New York law. No other mention of governing law is made in the contract.

As the delivery date approaches, the Chinese contractor realizes that, due to some labor issues, it will not be possible for it to comply with the exact date for delivery. The representative of the Chinese company telephones the American company and explains the situation to them, hoping that the American company may be willing to extend the delivery date.

The Chinese representative communicates that they will need seven more days in order to comply with the contract. The American representative replies simply with, "alright, we need those modules as soon as you can deliver them." The parties never memorialize this in writing, nor do they clarify anything further, but the American representative reports to his boss that it looks like the contractor will be late and that he should start looking into how to enforce liquidated damages against the Chinese contractor if it cannot perform on time.

The Chinese company works hard to meet the original delivery date and actually delivers the modules only four days after the original delivery date, instead of their projected seven days. They Chinese contractor works hard to complete installation faster and make up two more days, resulting in completion only two days later than the original date in the contract. Soon after that, the American company sends a letter to the Chinese company expecting payment of liquidated damages for the two days of delay to the installation.

The Chinese company replies that, under the United Nations Convention for the International Sale of Goods, the delivery date was modified by the conversation between the parties' representatives.

To the American company's surprise, their own lawyers inform them that the Chinese company may have a good case against them and that the cost of litigation would not be warranted in their attempt to collect the liquidated damages.

How did this happen? New York law doesn't allow for oral modification of contracts, and even if it did, there clearly wasn't a meeting of the minds on modification. Also, this wasn't a contract for goods; this was really just a contract for installation. So how did this odd convention on sales of goods that the American company never heard of end up being the governing law of their contract?

A Brief History Of The CISG

In the late 1980's globalization was transforming the world, and there was a push to create a uniform commercial law for international sales of goods to alleviate some of the confusion and litigation caused by overlapping foreign legal systems. Out of this push came the United Nations Convention on the International Sale of Goods ("The CISG"). The United States was among the first countries to sign onto the Convention, adopting it as law on January 1, 1988.

The push to create a uniform international commercial law hit a snag, however, due to language in the CISG that allowed parties to abrogate any part of CISG, with certain limitations, or to disregard it altogether, with no limitations.

How To Exclude The CISG

The CISG is the default law for contract formation if no other mention is made in contracts for sales of goods between two parties who each have their primary place of business in different contracting countries. In its infancy, one accepted way to exclude the CISG was simply to choose the national law of a particular country to govern one's contract, even if that country was a signatory to the CISG. The other way was to state explicitly that the CISG was excluded from the contract.

Over the past two and a half decades, increased familiarity with the CISG has resulted in the majority view that simply choosing the law of a signatory country is insufficient to exclude the CISG, because the CISG is part of that law. The accepted way to exclude the convention is to do so explicitly or to do so implicitly by choosing the law of a non-signatory state.

In 1988, the choice of law clause in the above hypothetical may have been sufficient to apply domestic New York law to the contract to the exclusion of the CISG. In 2014, however, that language would likely include the CISG as part of the law of New York, unless the parties specified a particular body of laws to govern the contract.

What Does The CISG Govern?

The fact that the CISG is not excluded from a contract, however, does not automatically result in its application. The CISG only applies to sales of goods. Article 3 of the CISG states, however, that the convention does not apply if the preponderant part of the contractor's obligations is to provide labor or services under the contract. This clause clearly contemplates certain types of mixed contracts, and many courts and arbitral tribunals have used an economic value test to determine preponderance.

Thus, contractors that deal solely in construction and turn-key contracts probably don't have to worry about the CISG as it does not apply to contracts in which the preponderant part of the contractor's obligations consists of services or labor. Contractors may face uncertainty when that "preponderant" line is not so cut and dry. For example, the CISG may apply to contracts for the sale and delivery of modules or contracts to provide construction supplies and equipment coupled with obligations for the provision of labor and services. Simply put, if the value of the services under the contract does not comprise a majority of the total value of the contract, then those services are not likely to comprise a preponderant part of the contract and the CISG will therefore apply.

Even if the economic value of those services provided, for example, installation, were to exceed the value of the goods, some courts and tribunals have looked at the essential purpose of the contract and found that those services may simply be incidental to the sale of goods, and therefore still within the scope of the CISG.

In the case above, it is quite possible that the sale and delivery of the modules would be sufficient to trigger the application of the non-excluded CISG, unless the fact-finder were to determine that the installation was truly the focus of the contract and/or constituted the majority of the value of the contract.

Effects Of The Application Of The CISG

One key difference that might surprise an American company familiar with American contract law, is the CISG's rules, or lack thereof, regarding the statute of frauds. The CISG also differs from American contract law on key issues of parol evidence, perfect tender, and battle of the forms, to name a few.

Under the CISG, the default rule is that no writing is required either for the formation or modification of a contract. Some countries have adopted the CISG with a reservation that would in fact require a writing for formation and modification, but the United States has not.

In the example above, the conversation between the two companies' representatives might rise to the level of contract modification, even though the domestic law of New York would not recognize such a modification. The main issue would be for the fact-finder to determine if the Chinese company's statement was a valid offer and the American response was an acceptance.

The CISG also offers guidance in Article 8 as to how to interpret statements made by one party to another, but this can lead to uncertainty and

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expensive litigation regarding that modification. Such litigation can be avoided if the parties are more precise in their communications – and being conscious of the CISG's rules and application may lead to that level of precision in all communications between international contracting parties so that nothing gets lost in translation.

What Can You Do?

The ultimate lesson here is that the best practice is to be fully aware of the effect of choice-of-law clauses. If you are a seller who deals in the international sale of goods, it is especially important to determine whether the CISG is beneficial to you. The CISG can provide a common ground for business between companies based in foreign countries. There are pros and cons to choosing any particular law to govern your contract, so ensure you do so deliberately.

If your business operates in that gray area between manufacturing and construction, you can still elect to have the CISG govern your contract. Whatever you choose, it is important to explicitly include or exclude the CISG in your contract to avoid potential litigation regarding whether goods or services constitutes the preponderant subject matter of the contract. Such uncertainty can unnecessarily delay ultimate relief under your contract should a dispute arise.

NEVADA UPDATES

David R. Johnson

Las Vegas Is Coming Back! Some Recent Construction-Related Opinions From The Nevada Supreme Court

by David R. Johnson, Partner, and Jared M. Sechrist, Partner

Jared M. Sechrist

Las Vegas Construction Is Coming Back

In the decade before the Great Recession hit Las Vegas in 2008, Sin City's economy was on a roll unlike anything ever before seen. Contractors feasted on the construction of opulent new megaresorts like Bellagio (opened in 1998—$1.6 billion total construction cost), Venetian (1999 - $1.5 billion), Wynn (2005 –$2.7 billion), and Palazzo (January 17, 2008 - $1.8 billion), just to name a few. The new construction projects brought incredible prosperity to the city and in October of 2007 Las Vegas set a new record for gaming revenues. Las Vegas had the hottest economy in the country, resulting in a booming real estate market. Developers, seizing on soaring residential real estate prices, planned and built numerous residential communities and luxury high-rise condominium complexes. Vegas, it seemed, could not lose. Then, in 2008, everything changed.

As the credit crisis swept across America, projects in Las Vegas that had seemed like "sure things" were now viewed as too risky to continue. Boyd Gaming suspended construction of Echelon, which had been estimated to cost $4 billion, on August 1, 2008. Financiers of Fontainebleau, a $1.6 billion Las Vegas Strip resort, stopped lending and construction ground to a halt. Even MGM Resorts International, Las Vegas's largest gaming entity, was forced to obtain new financing and restructure the ownership in order to continue progress on its historically audacious project, CityCenter (ultimately built for $9.2 billion). As a result, the same scaffolding and cranes that once symbolized Las Vegas's vitality and growth were now idle images of economic stagnation.

The outlook was bleak. Industry insiders suggested that the Strip might not see a resumption of substantial building activity for a decade. Fortunately, they were wrong.

Slowly, America is beginning to climb out of the Great Recession and so is Las Vegas, its favorite adult playground. The Genting Group acquired the 87-acre Echelon site from Boyd Gaming and recently commenced work on Resorts World Las Vegas, a resort estimated to cost between $2 and $7 billion, at the site. Caesars

Entertainment Corporation recently completed construction of The High Roller, the world's tallest observation wheel, on the Strip at a price of $550 million. Two older Strip properties have been rebranded and undergone complete makeovers—the Sahara is now SLS after a $415 million overhaul, and, after spending $200 million, Caesars Entertainment is transforming Bill's Gambling Hall into The Cromwell, a trendy boutique property. Additionally, major off-Strip commercial projects have begun moving forward. The Shops at Summerlin, an upscale outdoor mall on the West side of Las Vegas that had been dormant since 2009, is scheduled to open in late 2014. ManhattanWest, another substantial West side project that stopped abruptly as a result of financing problems, has finally been sold and work is again underway. Perhaps most significantly, gaming revenues topped $11 billion in 2013 for the first time since 2008, a strong indicator that Las Vegas's economy is strengthening.

The Nevada Supreme Court Issued Several Opinions During The Recession Affecting Construction

The Great Recession has been incredibly difficult for Nevada contractors, subcontractors and design professionals, causing some to look for work out of the state, to find alternative means to generate revenue, or otherwise not follow changes in the law as closely as perhaps they once did. With the rejuvenation of Las Vegas's construction industry, however, it is important for all construction professionals doing business in Nevada to be aware of several important decisions issued by the Nevada Supreme Court during the Great Recession.

- <u>Liability For Economic Loss: *Halcrow, Inc. v. The Eighth Judicial District Court*, 129 Nev. Adv. Op. 42, 302 P.3d 1148 (2013)</u>

In this case, the Nevada Supreme Court held that purely economic damages sustained in the context of a commercial construction project are only recoverable under a breach of contract theory; therefore, negligent misrepresentation claims against an engineer/designer are barred by the economic loss doctrine.

The general contractor sued the developer of a commercial, non-residential development. The developer counterclaimed and filed indemnity-based third-party actions against two of its subcontractors, which, in turn, filed third-party indemnity claims against an engineer/designer, Halcrow, Inc. ("Halcrow") and others. The subcontractors did not have a contract with Halcrow and sought indemnity on a negligent misrepresentation theory. In response, Halcrow moved to dismiss the subcontractors' claims, arguing that the Nevada Supreme Court's ruling in *Terracon Consultants Western, Inc. v. Mandalay Resort Group*, 125 Nev. 66, 206 P.3d 81 (2009), barred unintentional tort claims against design professionals for purely economic losses in commercial construction projects. The trial court granted Halcrow's motion to dismiss, but permitted the subcontractors to amend their pleadings to conform to the Court's ruling. The Court also stayed the proceedings pending the Nevada Supreme Court's resolution of the issue.

The Nevada Supreme Court ruled in Halcrow's favor. The Court noted that its decision in *Terracon* left open the existence of exceptions to the economic loss doctrine for negligent misrepresentation claims; however, the Court did not believe that such an exception is applicable in the construction project context, concluding:

> [I]n commercial construction defect litigation, the economic loss doctrine applies to bar claims against design professionals for negligent misrepresentation where the damages alleged are purely economic.

Halcrow, 302 P.3d at 1154.

- <u>Design Professional Liability: *In re CityCenter Construction and Lien Master Litigation / The Converse Professional Group, dba Converse Consultants v. The Eighth Judicial District Court*, 129 Nev. Adv. Op. 70, 310 P.3d 574 (2013)</u>

In this case, the Nevada Supreme Court clarified the attorney affidavit and expert report requirements (often referred to as certificates of merit) of NRS 11.256, et seq. in actions against design professionals.

Numerous parties were involved in this commercial dispute. Certain defendant subcontractors brought cross-actions against The Converse Professional Group, dba Converse Consultants ("Converse") claiming that any damages Converse caused were due to Converse's negligent performance of inspection services. Converse moved to dismiss the subcontractors' cross-actions on the grounds that it (Converse) was a design professional and that, due to the subcontractors' failure to file an attorney affidavit and expert report, their actions against Converse were barred by NRS 11.259 and subject to dismissal pursuant to *Otak Nevada, LLC v. Eighth Judicial District Court*, 127 Nev. Adv. Op. 53, 260 P.3d 408 (2011). After expressing concern that NRS 11.259, by its express terms, may require the dismissal of the entire litigation, the trial court

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denied Converse's motions to dismiss the subcontractors' cross-actions. Converse sought review from the Nevada Supreme Court.

The Nevada Supreme Court concluded that Converse was acting as a design professional when it performed testing/inspection services related to the subcontractors' work, and that the subcontractors should have filed an affidavit and expert report at the same time they filed the cross-actions against Converse. *In re CityCenter*, 310 P.3d at 579-80. Due to their failure to file the affidavit and expert report, the subcontractors' claims were void *ab initio* and of no legal effect. However, the Court determined that NRS 11.259 required only the dismissal of the subcontractors' cross-actions, and not the entire litigation. *Id.* at 580-81.

- Mechanic's Lien Rights: *J.E. Dunn Northwest, Inc. v. Corus Const. Venture, LLC*, 127 Nev. Adv. Op. 5, 249 P.3d 501 (2011)

In this case, the Nevada Supreme Court clarified the work for which a contractor can obtain recovery under a mechanic's lien when a construction lender is involved with the project.

Midbar Condo Development ("Midbar") hired J.E. Dunn Northwest, Inc. ("Dunn") to perform a feasibility analysis, serve as construction manager, and be the general contractor for a condominium project ("Project"). After Dunn had performed more than $1 million of preconstruction services, Midbar obtained a construction loan from Corus Bank ("Corus"). Corus recorded a deed of trust on the property, thereby asserting priority of its deed of trust over Dunn's mechanic's lien rights. Dunn subsequently recorded liens on the property and filed suit, seeking a declaratory judgment establishing that its lien rights had priority over Corus's deed of trust. The trial court ruled in Corus's favor, finding that Dunn's preconstruction work did not establish the accrual date for its lien because it was not visible work. Dunn appealed.

The Nevada Supreme Court upheld the district court's ruling, reasoning that, although off-site work such as architectural services may constitute a lienable amount pursuant to NRS Chapter 108, the performance of off-site work does not establish the accrual date for the commencement of construction activities for the purpose of establishing lien priority. Additionally, preconstruction work, such as clearing or grading may require an on-site presence but does not constitute construction and does not start the clock either. Instead, the Court held, "the commencement of construction requires 'actual on-site construction,'" further clarifying that "visibility alone determines priority." *J.E. Dunn*, 249 P.3d at 505-507.

- Contractual Defense And Indemnity Obligations: *Reyburn Lawn & Landscape Designers, Inc.* v. Plaster Dev. Co., Inc., 127 Nev. Adv. Op. 26, 255 P.3d 268 (2011)

In this case, the Nevada Supreme Court clarified the defense and indemnity obligations under a contractual indemnity provision.

A group of homeowners filed a construction defect action against the subdivision developer, Plaster Development Company ("Plaster"), alleging construction defects with respect to a retaining wall. Plaster filed a third-party complaint against, among others, Reyburn Lawn & Landscape Design ("Reyburn"), one of Plaster's subcontractors, seeking indemnity pursuant to an indemnity provision contained within the Plaster/Reyburn subcontract. Plaster argued that the broadly worded indemnity provision obligated Reyburn to indemnify Plaster against Plaster's negligence. The Supreme Court rejected Plaster's argument, ruling that an indemnitor, such as Reyburn, has no obligation to indemnify an indemnitee, such as Plaster, for the indemnitee's (Plaster's) negligence unless it is "expressly or explicitly" stated in the indemnity provision:

> …we conclude that because the indemnity clause does not expressly or explicitly state that Reyburn would indemnify Plaster for Plaster's contributory negligence, Reyburn is required to indemnify Plaster only for liability or damages that can be attributable to Reyburn's negligence.

Reyburn, 255 P.3d at 275. Further, the Court limited the defense obligations imposed by contractual provisions:

> … we now hold that unless specifically stated in the indemnity clause, an indemnitor's duty to defend an indemnitee is limited to those claims directly attributed to the indemnitor's scope of work and does not include defending against claims arising from the negligence of other subcontractors or the indemnitee's own negligence.

Reyburn, 255 P.3d at 278.

Conclusion

It is an exciting time in Las Vegas for construction. Major projects are underway and more are planned, but the recession has left its mark on the industry and the way the law helps to assure fairness and predictability. These opinions and many others demonstrate how the law adapts to changes in the economy and the relative power of contracting parties. As we

move forward into a new era of prosperity here in Las Vegas, owners, contractors, subcontractors, and design professionals can avoid problems, delays, headaches, and costs by staying aware of the impacts, subtle or profound, that recent decisions from the Nevada Supreme Court may have on the way they conduct business.

FIRM NEWS

WTHF Elects Six New Partners

Albert L. Chollet, III of the Chicago, Illinois office focuses his practice on construction and surety law, providing the full range of transactional and litigation services. Bert's clients include owners, contractors, design professionals, sureties, banks and lending institutions, land developers, and other corporate entities. Bert's practice includes contract negotiations and formation, contract litigation and alternative dispute resolution.

Scott P. Fitzsimmons of the McLean, Virginia focuses his practice on government contracts, construction, and suretyship. Scott has represented contractors, owners, and subcontractors in numerous trials and hearings in both state and federal court including the US Court of Federal Claims and the US Boards of Contract Appeals. Scott has also represented contractors in bid protest matters before the GAO.

Brent N. Mackay of the Irvine, California office is an experienced litigator whose practice focuses on construction and surety law matters. Brent has represented contractors and sureties throughout the United States in connection with a diverse range of public and private construction projects, including: residential subdivisions, elementary schools and universities, libraries, student housing, research facilities, materials recovery facilities, sewer pipelines, and power plants.

Jason M. Muncey of the McLean, Virginia office focuses his practice on construction litigation and government contracts. Jason's experience includes handling all aspects of complex commercial litigation, arbitration and mediation. Jason has represented owners, contractors and subcontractors in a variety of construction law matters in state and federal courts, as well as various forms of alternative dispute resolution.

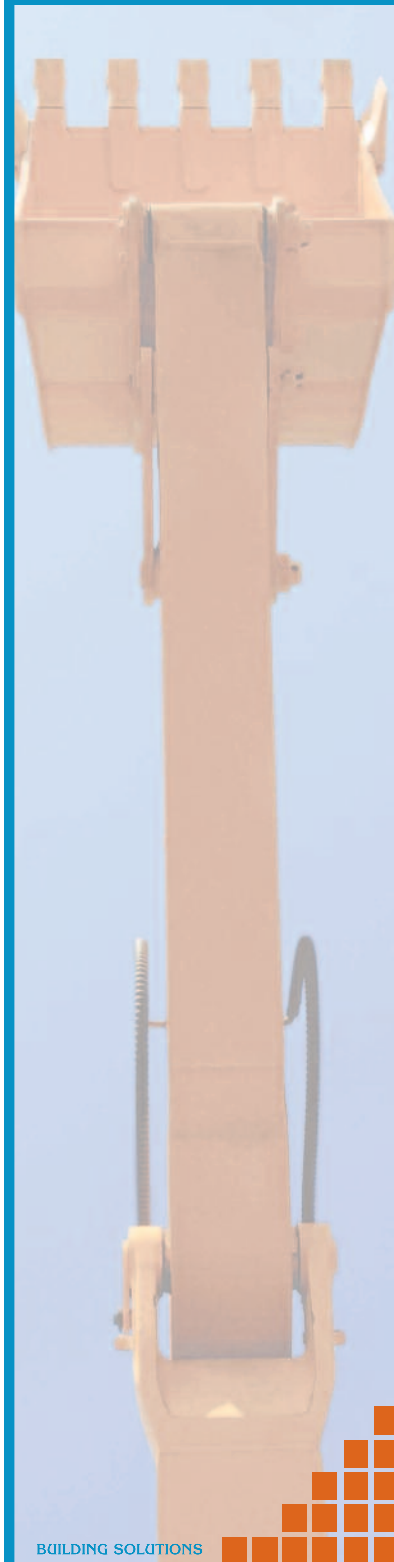
Jared M. Sechrist of the Las Vegas, Nevada office dedicates his practice to representing the many business entities involved in large-scale construction projects, including contractors, sureties, insurers, lenders, and major hotels and casinos on the Las Vegas Strip. In addition to his litigation experience, Jared often assists clients in negotiating contracts, preparing agreements, and advising national companies on Nevada business matters.

Robert C. Shaia of the Irvine, California office is an experienced business litigator. Robert handles all types of business disputes and his practice focuses primarily on construction and real estate matters. Robert has litigated multi-million dollar construction defect cases, and has significant experience with other construction litigation matters, including mechanic's lien claims, and performance and payment bond claims.

Upcoming Programs

Fundamentals of Construction Contracts in Illinois; June 18, 2014; Lorman Educational Services; Naperville, Illinois. **Albert L. Chollet, III** to speak.

Construction Lien Law in Washington; July 31, 2014; Lorman Educational Services; Seattle, Washington. **Christopher Wright** to speak.



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WATT, TIEDER, HOFFAR & FITZGERALD, L.L.P.®

8405 Greensboro Drive, Suite 100
McLean, Virginia 22102

PRSRT STD
US POSTAGE
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DULLES, VA

8405 Greensboro Drive
Suite 100
McLean, Virginia 22102
(703) 749-1000

2040 Main Street
Suite 300
Irvine, California 92614
(949) 852-6700

10 South Wacker Drive
Suite 2935
Chicago, Illinois 60606
(312) 219-6900

6325 S. Rainbow Boulevard
Suite 110
Las Vegas, Nevada 89118
(702) 789-3100

1200 Brickell Avenue
Suite 1800
Miami, Florida 33131
(305) 777-3572

1215 Fourth Avenue
Suite 2210
Seattle, Washington 98161
(206) 204-5800

HFK Rechtsanwälte*
Maximilianstrasse 29
D-80539 Munich, Germany
Phone 011 49 89 291 93 00

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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** and **William Groscup**.

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