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DBE Contractors And Those Working With DBEs Travel A Treacherous Road On Federally-Funded Highway Projects

by Hanna Lee Blake, Partner

The Federal Government spends billions of dollars annually on infrastructure projects, including highway construction and reconstruction, approximately $40 billion of which goes to state departments of transportation. As part of the U.S. Department of Transportation's ("DOT") Disadvantaged Business Enterprise ("DBE") program, each recipient of federal financial assistance, *e.g.*, state DOTs, is required to set goals for participation of disadvantaged entrepreneurs and certify the eligibility of DBE firms to participate in DOT-assisted contracts. The Federal Government's generosity to the states is increasingly accompanied by significant oversight and scrutiny of the DBE participation on federally-assisted projects. Importantly, that attention is focused on the contractors, subcontractors and manufacturers performing the work and less so on the state agencies setting the DBE participation goals and implementing the contracts.

The Federal Government has embarked on a journey to eradicate the "DBE Fraud" that it has found prevalent and engrained in the construction industry. As evidenced by recent federal investigations, and the resulting convictions and/or settlements, even well-established and experienced contractors have found that the climate has changed and if they do not change course they may find themselves headed for significant tolls (*e.g.*, hefty fines, penalties and legal fees) or a dead end (*i.e.*, suspension, debarment or jail).

This article will provide an overview of the common types of DBE fraud, pertinent regulations, and the serious risks – including civil and criminal penalties – facing contractors who fail to adhere to the rules of DBE contracting. In addition, this article will explore certain recent government investigations uncovering rampant DBE fraud within the industry. Contractors seeking to take advantage of the lucrative opportunities provided by the federal-assisted projects should institute stringent internal controls and compliance measures to avoid violations of the regulations and contract requirements applicable to DBE participation on federally-funded projects.

Overview Of The U.S. DOT DBE Program And Regulations

Since 1983, the Federal Government has earmarked certain funds authorized for highway and transit federal financial assistance programs for DBEs. Through its DBE program, the U.S. DOT has endeavored, among other objectives, to: (1) level the playing field so that DBEs can fairly compete for U.S. DOT-assisted projects; (2) ensure that only eligible firms become certified as DBEs; and (3) assist in the development of DBE firms so that they can compete outside of the U.S. DOT DBE program. The government's primary method of achieving these objectives is the mandate to recipients of federal funds to set DBE goals in each of their federally-assisted construction contracts.

The numerous directives and mandates upon recipients of federal highway and transit funds are set out in the Code of Federal Regulations, Title 49, Part 26. The regulations can be boiled down to a few of main components: (i) good faith efforts must be made to meet and maintain the stated DBE goal during the construction project; and (ii) credit toward the goal may be taken only when DBE firms perform a commercially useful function. Many contractors have found themselves on a bumpy road because they either failed to perform a *commercially useful function* themselves or they failed to ensure that the entity with which they contracted actually performed a commercially useful function. Failures by both groups have resulted in severe penalties, as noted below.

Contractors often ask "what is a commercially useful function in the context of DBE contracting?" This can be difficult to answer in the abstract, but the starting point has to be the DBE regulations. In that regard, 26 CFR 26.55(c)(1) advises that "[a] DBE performs a commercially useful function when it is responsible for execution of the work of the contract and is carrying out its responsibilities by actually performing, managing, and supervising the work involved." The regulations also provide guidance for recognizing when a DBE is *not* performing a commercially useful function. 26 CFR 26.55(c)(2) instructs that "[a] DBE does not perform a commercially useful function if its role is limited to that of an extra participant in a transaction, contract, or project through which funds are passed in order to obtain the appearance of DBE participation." Contractors should be aware that the specific tasks to be performed by a DBE and the associated credit that may be taken toward meeting the DBE goal vary depending on whether the DBE is acting as a subcontractor, manufacturer, trucker or supplier. As such, it is imperative for contractors performing on federally-assisted projects to be well-studied in the applicable regulations to avoid the potential for making false claims when submitting, for instance, applications for payment and related certifications.

DBE Fraud

The most common types of schemes addressed in highly publicized DBE fraud cases and investigations are the "front scheme" and the "pass-through scheme." In both cases, a DBE does not perform a commercially useful function as required by the government in exchange for its financial assistance.

The primary characteristic of the "front scheme" is typically the false representation of the ownership and/or control of a DBE firm. Under the regulations, to qualify as a DBE, the entity must be majority owned and independently controlled by a disadvantaged owner, *e.g.*, a woman or racial minority, it must be "small" by the SBA's size standards for the type of work to be performed, and must not have exceeded the limit on gross receipts set forth in the regulations. A classic front scheme occurs when, for example, a "women-owned business" is actually run and operated by a large company owned by the "woman's" husband or brother. In such a case, both the woman owner of the "DBE" and the owner of the non-DBE company using the DBE as a front may be subject to prosecution.

In a "pass-through" scheme, the ownership is often not the issue, but rather the failure to perform a commercially useful function is at the fore. In this case, the pass-through or conduit company usually does little more than process paperwork, such as invoices for payment, while the work is actually performed by a non-DBE. As with the front scheme, both companies and all participants involved in a pass-through scheme may find themselves in hot water.

Contractors involved in fraudulent DBE-related schemes on U.S. DOT-assisted projects are at risk for severe consequences, including: (1) invasive, disruptive and costly investigations by numerous federal and state agencies (*e.g.*, U.S. DOT, State DOTs, FHWA, FBI, IRS, DOL); (2) criminal prosecution (typical charges include mail and/or wire fraud, conspiracy, obstruction, false claims, and false statements); (3) civil action (*e.g.*, civil false claims); and (4) administrative actions that could result in suspension or debarment. Significant fines and penalties, forfeiture of contract proceeds and jail time are also real risks for contractors found in violation of the DBE regulations.

Lessons Learned From Recent DBE Fraud Case Studies

DBE fraud investigations are on the rise as DBE Fraud has become a top priority for prosecutors and government agencies. One need look no further than the myriad press releases issued by the U.S. DOT's Office of Inspector General and/or the Department of Justice over the last three or four months to recognize the caution signs and to extrapolate several lessons for avoiding a similar fate.

- **Lesson 1: Don't Say You Paid A DBE When You Did Not**
  According to a government investigation, a Washington-based contractor, Tri-State Construction ("Tri-State"), bought and used a storm water treatment system on the federally-funded I-5 High Occupancy Vehicle lane project in Tacoma, Washington. Despite owning the system, the government's investigation found that Tri-State submitted invoices to the state DOT representing that it was renting the treatment system from a DBE and that Tri-State certified that the rental costs were eligible for DBE credit on the project. Without admitting any misconduct, on June 30, 2015, Tri-State agreed to pay $142,440 to the government to settle the false claims allegations.

- **Lesson 2: Don't Say You Performed Work When You Did Not**
  After an investigation, the government alleged that a South Carolina based highway contractor, Premier Constructors ("Premier"), falsely certified that it had completed work as a DBE on a federally-funded road project in Greenville, South Carolina. The government further alleged that a non-DBE contractor actually performed

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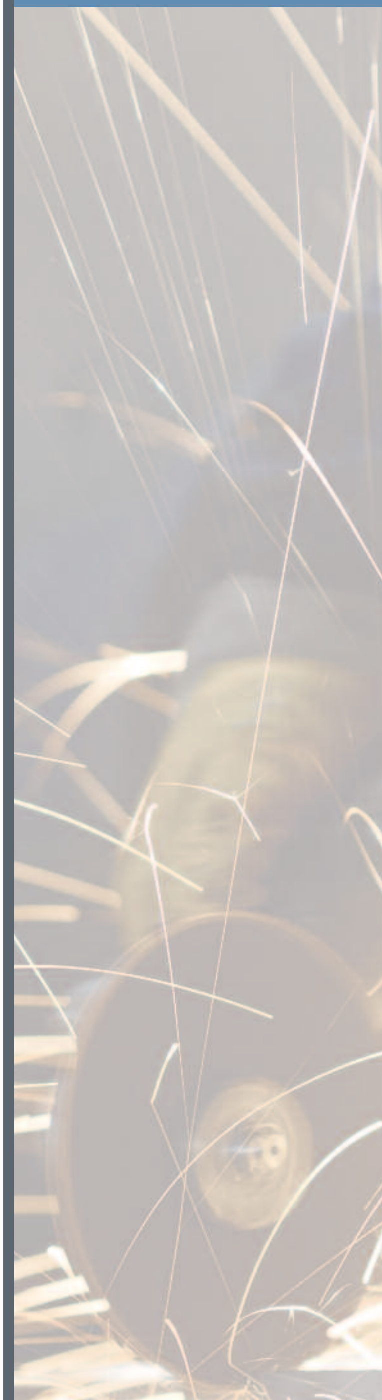


the work and that, despite its certifications, Premier did not perform a commercially useful function. On March 25, 2015, the Federal Highway Administration ("FHWA") suspended Premier and its President from conducting business with the Federal Government. In May 2015, Premier and its President entered into a three-year administrative settlement agreement with FHWA accepting responsibility for the alleged misconduct and agreeing to implement a corporate compliance program, among other internal controls. Thereafter, on July 7, 2015, Premier and its President entered into a civil settlement agreement with the government and agreed to repay the government $77,335 to settle the civil false claims act allegations.

- **Lesson 3: You Could Be Permanently Debarred If You Engage In DBE Fraud**
  In November 2014, Watson Maloy ("Maloy"), the owner of WMCC, Incorporated ("WMCC"), a Pennsylvania certified DBE steel erection and precast concrete erection subcontractor, pleaded guilty to conspiracy charges and admitted that in 2012 and 2013, he and co-conspirators employed by Century Steel Erectors Co., LP ("CSE"), agreed to use WMCC as a front company to obtain profits from DBE contracts. CSE staff actually found, negotiated, coordinated, performed, managed and supervised the DBE subcontracts awarded to WMCC. Thus, WMCC failed to perform a commercially useful function. In an attempt to conceal the scheme, CSE officials used WMCC letterhead and email accounts when communicating with general contractors and PennDOT officials. Also, CSE personnel obtained WMCC business cards, t-shirts and hard hats, among other items. Maloy, WMCC's owner, reportedly received approximately $1.8 million in illicit proceeds as a fee for his participation in the scheme. On December 12, 2014, FHWA suspended Maloy and WMCC for their roles in the DBE fraud. On June 30, 2015, PennDOT *permanently debarred* WMCC from state-funded contracts. Sentencing on Maloy's criminal conviction for conspiracy to defraud the U.S. has been continued until December 2015.

- **Lesson 4: Government Investigations May Not Be Limited To A Single Project**
  On June 16, 2015, the owners of Carl M. Weber Steel Service, Inc. ("Weber Steel"), a Pennsylvania bridge and highway contractor, and Judy Noll ("Noll") were charged with conspiracy to commit wire fraud related to a DBE fraud scheme that allegedly ran for *over 16 years* and totaled almost $19 million. The government alleged that since Weber Steel was not a certified DBE, its owners set up Karen Construction, Inc. ("Karen"), a sham DBE owned by Noll to obtain DBE subcontracts throughout Pennsylvania. According to the government's investigation, Weber Steel's owners were in control of Karen's sales, marketing, project selection, price estimating, purchasing, project supervision and hiring. In addition, Karen and Weber Steel shared a computer network, office space, equipment, fuel, materials, an office manager and a labor pool of construction employees – all classic "red flags." This case is ongoing.

- **Lesson 5: You Could Be Guilty of Fraud If You "Knew Or Should Have Known…"**
  Between 2006 and 2007, C.W. Matthews, a Georgia-based construction firm, was awarded several construction contracts on federally-funded highway projects that required them to subcontract a certain percentage of the work to a qualifying DBE. In its bids and contracts, C.W. Matthews promised to subcontract with a DBE firm called Longoria Trucking ("Longoria") to satisfy the contracts' DBE goals. According to the government's investigation, a non-DBE trucking firm called G.E. Robinson – not Longoria – performed most of the work and received most of the payments. The government's investigation revealed that G.E. Robinson used Longoria as a "front" to obtain and receive payment under the federally-funded contracts. The government concluded that C.W. Matthews *either knew, or should have known*, of the scheme between its subcontractor Longoria, and third-party G.E. Robinson. More specifically, the government contended that in certifying that Longoria was performing work under the contracts, despite clear signs that the work was actually being performed by G.E. Robinson, C.W. Matthews, *at a minimum, was either*

reckless or deliberately indifferent. In April 2015, C.W. Matthews agreed to pay $1 million to settle the false claim allegations against it and also agreed to adopt an ethics code and corporate compliance program, appoint a compliance officer and retain an independent monitor to assess C.W. Matthews' performance.

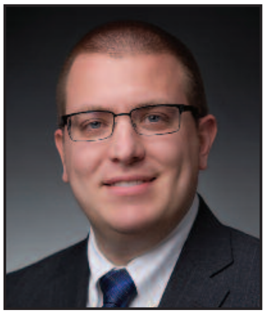
Conclusion

As discussed above, the Federal Government has begun zealously investigating and prosecuting DBE fraud in the construction industry. Contractors involved in such a scheme, or those that knew or should have known of such a scheme, may become targets of the government's attention and may, ultimately, face charges, jail time, and/or significant fines and other penalties. In light of the severe consequences of non-compliance, DBE and non-DBE contractors on federally-assisted road and highway projects must be familiar and ensure compliance with the DBE regulations from the beginning to the end of their projects. The following are some helpful tips and suggestions for ensuring compliance with the regulations and avoiding the consequences faced by the contractors mentioned above.

- Contractors should carefully study the DBE program requirements and regulations;
- Contractors should require DBE subcontractors to certify that they will perform a commercially useful function as required by the DBE regulations;
- Contractors should ensure that all staff are able to recognize "red flags" and report them to management or a compliance officer;
- DBE contractors should avoid accepting too much assistance from non-DBE entities in performing work on federally-funded projects;
- Contractors should implement a compliance program;
- Contractors should document the performance and provision of a commercially useful function by DBEs;
- Contractors should conduct internal audits to ensure continuing compliance with DBE program requirements;
- Contractors should implement in-house training for employees, including estimating and project management staff, to ensure compliance with DBE program requirements.

The best way to avoid an investigation or a finding of involvement in a DBE-related fraud scheme is to be educated, vigilant and proactive, much like a highway sign I drove past a few years ago that read: *"Stop Accidents Before They Stop You."*

GOVERNMENT CONTRACTS



Fair Pay And Safe Workplaces: Proposed Rule Updates Federal Labor Laws And Creates Self-Disclosure Requirements Of Violations

by Mitchell A. Bashur, Associate

Introduction

The Federal Acquisition Regulatory Council and the Department of Labor ("DOL") recently published proposed regulations that update federal labor laws and create new self-disclosure requirements for violations. The regulations also create significant traps for unwary contractors. In response to a report that a small number of contractors with significant labor law violations were receiving a large amount of taxpayer-funded contracts, the White House issued the Fair Pay and Safe Workplaces executive order on July 31, 2014. The executive order aimed to ensure that federal agencies contract only with "responsible" contractors that comply with labor laws.

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On May 28, 2015, proposed regulations and guidance were issued. The proposed regulations will: (1) require self-reporting of labor violations for the past three years when submitting an offer for a contract and thereafter on a semiannual basis; (2) require prime contractors to collect information on labor violations of subcontractors and determine whether they are responsible sources; (3) require certain paycheck transparency measures; and (4) generally prevent federal contractors from requiring employees to arbitrate sexual assault or harassment claims. The government estimates that the proposed regulations will cost the public over $106 million for the first year and over $91 million per year thereafter.

Contractors Must Self-Report Labor Violations

The proposed rules apply to procurement contracts for goods and services exceeding $500,000. For these contracts, prospective contractors must self-certify whether there has been any labor law administrative merits determination, civil judgment, or arbitral award or decision rendered against it within the preceding three-year period. The labor laws covered include the Davis-Bacon Act and the Fair Labor Standards Act. The reporting obligation is limited to procurement contracts and does not include grants and cooperative agreements. The contracting officer for the solicitation must consider the information as part of the responsibility determination prior to making an award.

The DOL has provided guidance on what types of decisions must be disclosed. The DOL has defined "administrative merits determination" to mean notices or findings, whether final or subject to appeal or further review, issued by an enforcement agency following an investigation that indicates that the contractor violated any provision of the labor laws. If an appeal is pending, then the contractor may explain this as a mitigating circumstance. "Civil judgments" include decisions granting partial summary judgment if a court finds that there was a violation but reserves judgment on damages. "Arbitral award or decision" means any award or order by an arbitrator or panel that determines that the contractor or subcontractor violated any provision of the labor laws or enjoined the contractor from violating any provision of the labor laws. This applies whether or not the arbitral proceeding is private or confidential.

If the contractor is awarded the contract, it is subject to additional reporting obligations. Semi-annually during the performance of the contract, contractors must update the information provided about their own labor law violations. This includes any affirmation of a previously disclosed decision. The contracting officer then must consider any new information and determine whether any action is necessary including remedial measures, declining to exercise an option, contract termination, or referral to the agency suspension and debarment official.

The Prime Contractor Must Collect Information On Subcontracts Over $500,000

Similar self-reporting requirements apply to subcontractors where the estimated value of the subcontract exceeds $500,000 and the subcontract is not for commercially available off-the-shelf items. For the prime contractor, this means that at the time of contract execution, the prime contractor must require covered subcontractors to disclose any administrative merits determination, civil judgment, or arbitral award or decision rendered against it for the preceding three years. The prime contractor will then be required to consider, before awarding the subcontract, whether this information affects the finding that the subcontractor is a responsible source with a satisfactory record of integrity and business ethics.

If the subcontract is awarded, then similar reporting obligations are required. Semi-annually during the performance of the contract, contractors must obtain the required updated information for covered subcontracts. If new information about violations is obtained from the subcontractor, then the prime contractor is required to consider whether any action is necessary.

Examples Of Serious, Willful, And Repeated Violations Of Davis-Bacon Act

Under the proposed regulations, violations that are most concerning and will be addressed by contracting officers are those that are serious, willful, and repeated, or pervasive. The DOL provided the following specific examples in its guidance as to serious, willful, and repeated violations of the Davis Bacon Act ("DBA"):

- *Serious Violation* – DOL issued a letter indicating that a contractor violated the DBA, and that back wages were due in the amount of $12,000. The contractor had previously been investigated by DOL and, to resolve that investigation, had entered into a written agreement to pay the affected workers prevailing wages as required by the DBA.

    - This is a serious violation for two reasons. First, a violation of ***any*** of the labor laws is serious if back wages of at least $10,000 were due. Second, a violation of ***any*** of the labor laws is serious if the contractor or subcontractor breached the material terms of any settlement entered into with an enforcement agency.

- *Willful Violation* – An Administrative Law Judge's ("ALJ") order affirming a violation of the DBA included a finding that the contractor manipulated payroll documents to make it appear as if it had paid workers the required prevailing wages.

    - This is a willful violation because the findings of the ALJ support a conclusion that the contractor knew that its conduct was prohibited by the DBA. The ALJ's finding that documents were falsified indicates that the contractor knew that it was required to pay the workers prevailing wages, yet paid them less anyway.

- *Repeated Violation* – A federal district court granted a preliminary injunction enjoining a contractor from further violations of the overtime provisions of the Fair Labor Standards Act. Subsequently, DOL sent the contractor a letter finding that the contractor violated the DBA by failing to pay workers at a different worksite their prevailing wages.

    - The second violation is a repeated violation because it is substantially similar to a prior violation reflected in a civil judgment. Even though the contractor violated two different statutes, the violations are substantially similar because both involve the practice of failing to pay wages required by law.

Contractors Will Have Certain Paycheck Transparency Obligations

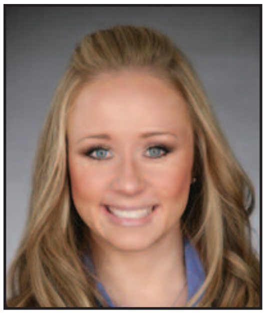
The proposed rules also contain two paycheck transparency requirements. First, they require contractors to provide all individuals working under a covered contract with a document showing the individual's hours worked, overtime hours, pay, and any additions made to or deducted from pay (*i.e.*, wage statement). This same requirement must be incorporated by prime contractors into covered subcontracts. Second, the proposed rules and guidance require that the contractor inform independent contractors of their status as such.

Contractors Generally Will Be Prevented From Requiring Employees To Arbitrate Title VII And Sexual Assault Or Harassment Claims

The proposed rules require that for contracts in excess of $1 million, contractors must agree that the decision to arbitrate claims arising under Title VII or any other tort related to or arising out of sexual assault or harassment, may only be made with the voluntary consent of employees or independent contractors *after* such disputes arise. One major exception to the rule is where employees are covered by a collective bargaining agreement. Prime contractors are also required to incorporate the same requirement into subcontracts valued at over $1 million.

Conclusion

For larger federal contractors, the proposed rules pose unique problems. Not only do the rules impose a number of additional administrative tasks, but they require coordination between the persons involved in defending labor violation claims, the persons bidding on solicitations, and the persons managing subcontracts. Without a robust ethics and compliance program, this coordination could break down and the contractor may fail in its reporting obligations. Because the proposed regulations require a certification for each covered contract, providing a false certification by failing to disclose a violation creates the risk of contract termination, suspension and debarment, and False Claims Act liability.



No More Extensions: Clarity On The "Deemed Denial" Of A Federal Claim

by Kaysie D. Garcia, Associate

A Familiar Dilemma

A contractor working on a federal government project submits a properly certified claim to the Contracting Officer. Within the required 60-day response period, the Contracting Officer notifies the contractor that additional time is required to properly review and evaluate the claim and that a decision on the claim will be issued by a certain date many months in the future. Under protest and considerable objection, the contractor waits patiently. Just shy of the newly established deadline, the contractor is informed by the Contracting Officer that additional time is necessary to evaluate the claim and that a decision on the claim will not be reached by the extended deadline. Instead, the contractor is advised that a final decision on the claim will be issued by a new date months in the future.

What options does the contractor have? Pursuant to the Contract Disputes Act of 1978 ("CDA"), the contractor's claim is not ripe for litigation until: (1) a proper claim is submitted to the relevant Contracting Officer; and (2) the contractor *receives a final decision on the claim*. What rights does the contractor have when the Contracting Officer fails to issue a "final decision?"

The foregoing facts are drawn directly from the United States Court of Federal Claims' decision in *Rudolph & Sletten, Inc. v. United States*, 120 Fed. Cl. 137 (2015), which was issued earlier this year. In *Rudolph & Sletten*, the contractor submitted a certified claim to the government seeking $26,809,003 for, among other damages, costs attributable to alleged government-caused delay and disruption, additional consultant costs, and the cost of extra work undertaken by the contractor. Under the CDA, the Contracting Officer was required to, "within 60 days of receipt of a submitted certified claim over $100,000 - (A) issue a decision; or (B) notify the contractor of the time within which a decision will be issued." 41 U.S.C. § 7103(f)(2).

The government's Contracting Officer advised the contractor within the initial 60-day period that due to the complexity and extensive nature of the claim, a final decision would not be issued for nine months. Although the contractor disputed whether the nine-month response period was reasonable, the contractor refrained from further action. Days before the government's self-imposed nine-month response period was set to expire, the contractor was notified that eight additional months were needed. Rightfully frustrated with the persistent delay, the contractor filed a lawsuit on the claim. The government responded to the lawsuit by moving to dismiss the case on grounds that the contractor failed to obtain a "final decision." In the alternative, the government requested that the lawsuit be stayed pending the imminent issuance of a final decision on the claim by the Contracting Officer.

In connection with the pending motions, the Court of Federal Claims was tasked with determining whether the Contracting Officer's failure to issue a "final decision" within the original time frame identified during the initial 60-day period operated as a "deemed denial" of the contractor's claim that would operate as a "final decision" for purposes of establishing the court's jurisdiction.

Does The Failure To Issue A Response Within The Original Time Identified Operate As A "Final Decision" Under The CDA?

As a backdrop to the Court of Federal Claims decision, two important points must be made: (1) the CDA expressly provides that a claim is deemed denied when a Contracting Officer fails to issue a decision within the required time period; and (2) the CDA provides that a deemed denial operates as a final decision. See 41 U.S.C. § 7103(f)(5). The question before the Court of Federal Claims, however, was whether a Contracting Officer's failure to issue a decision before expiration of its own unilaterally established deadline similarly operates as a deemed denial, despite the Contracting Officer's effort to unilaterally establish a second extension to the response deadline? In *Rudolph & Sletten*, the Court of Federal Claims answered this question with an unwavering "YES."

The Court of Federal Claim's decision focused on the express language in section 7103(f)(2), set forth above. In looking at the plain language of the statute, the court concluded that the statute explicitly requires the Contracting Officer either to issue a decision within 60 days, or to set a firm and reasonable deadline for issuing a final decision during this initial 60-day period. Importantly, the court noted that no authority provides the government with the right to a second unilateral extension outside the original 60-day period. Thus, the court held that passage of the government's self-imposed deadline to respond to the claim constituted a "deemed denial" of the claim and operated as a final decision for purposes of allowing the contractor to pursue other options. Despite this ruling, the Court of Federal Claims stayed the contractors' lawsuit for 30 days pending issuance of a decision by the Contracting Officer because by the time the court heard the motion to dismiss, the additional eight-month period identified by the Contracting Officer was nearly complete.

Will This Clarity Result In Less Claim Response Delay?

While the Court of Federal Claims' decision in *Rudolph & Sletten* appears to be a victory for government contractors, there are at least three likely consequences of the ruling that contractors should anticipate:

1. Given the government no longer has the ability to obtain an extension to its response time outside of the initial 60-day period, contractors will likely encounter more unnecessarily prolonged initial response dates;

2. The government's likely effort to unnecessarily prolong the initial response period will result in more contractors having to seek court intervention to direct the Contracting Officer to issue a decision within a more reasonable (and significantly shorter) period of time, an option that is available to contractors under the CDA (41 U.S.C. § 7103(f)(4)); and

3. Even if a claim is deemed denied as a result of the Contracting Officer's failure to issue a final decision within the initially established response period, the Court of Federal Claims can still stay properly initiated proceedings if a decision by the Contracting Officer appears imminent.

Further, as noted in the *Rudolph & Sletten* decision, there appears to be some contrary authority in several Board of Contract Appeals cases that state that a Contracting Officer need only provide a "good faith estimate" during the initial 60-day period for when a decision will be rendered and that the "good faith estimate" can be extended if doing so is reasonable. Thus, it is not clear whether a Board of Contract Appeals would necessarily reach the same result reached by the Court of Federal Claims in *Rudolph & Sletten*.

Conclusion

Although *Rudolph & Sletten* may eliminate some uncertainty regarding the government's ability to continually extend claim response deadlines, it is unlikely to significantly minimize the response delay with which many contractors are all too familiar. To ensure minimal delay, contractors must be vigilant and informed of their rights and options under the CDA, and not hesitate to seek counsel and involve the court early in the claim process.

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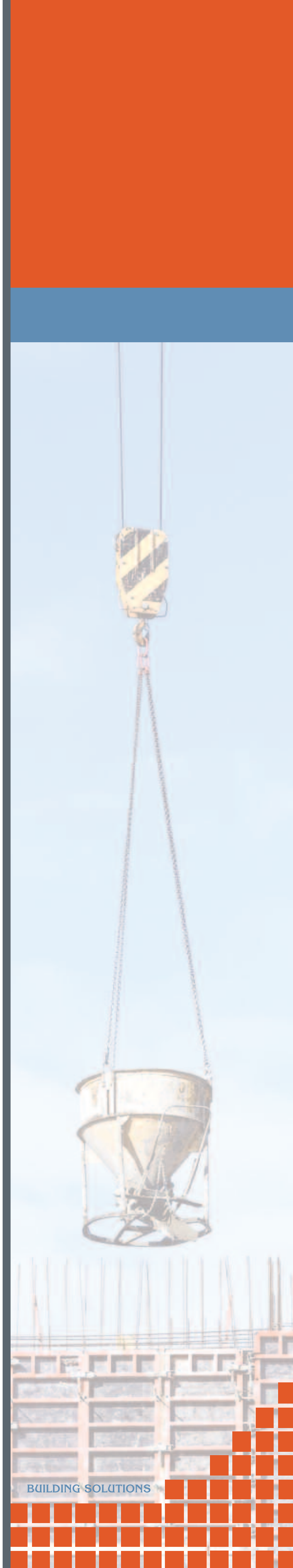

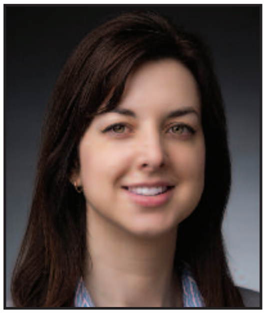

Virginia Joins The Herd: The General Assembly Enacts A Bar On Pre-Work Waivers Of Lien, Bond, And Additional Cost Claims

by Carolyn Cody Jones, Associate

Introduction

Virginia recently enacted and signed into law Senate Bill 891, effective on July 1, 2015, which renders null and void construction contract clauses containing pre-work waivers or limitations on the ability of subcontractors, lower-tier subcontractors, and material suppliers to file or enforce mechanic's liens, bond claim rights, and claims for demonstrated additional costs. With this new law, Virginia joins the majority of states that have similar laws in place barring prospective lien waivers in construction contracts. The effects of the new law promise to impact financial risk shifting between owners (and their financiers), general contractors, subcontractors, and suppliers. Notably, general contractors are currently excluded from the new law's protections. Consequently, the new law as written may have the potential to transfer significantly more financial risk onto general contractors.

New Statutory Language

The new law amends Titles 11 and 43 of the Virginia Code, which address Contracts and Mechanic's Liens, respectively. Section 43-3 adds new language to subsection (C) as presented below (italicized):

> C. Any right to file or enforce any mechanic's lien granted hereunder may be waived in whole or in part at any time by any person entitled to such lien, *except that a subcontractor, lower-tier subcontractor, or material supplier may not waive or diminish his lien rights in a contract in advance of furnishing any labor, service, or materials. A provision that waives or diminishes a subcontractor's, lower-tier subcontractor's, or material supplier's lien rights in a contract executed prior to providing any labor, services, or materials is null and void. . . .*

Similarly, almost identical language appears in the new Virginia Code section 11-4.1:1, which applies to payment bond claims and "the right to assert claims for demonstrated additional costs." The statutes expressly mandate that subcontractors and suppliers cannot contractually waive or diminish these rights, and arguably also apply to any third-party waiving such rights on their behalf, which has been barred in other states.

Owners and general contractors should consider the possibility that the language of the new law may be applied beyond provisions expressly addressing liens and bond claim waivers. Key to an understanding of how broadly the new statutes will be applied in the future is the interpretation of the phrase "waive or *diminish*" in both statutes and what falls into the category of "claims for demonstrated additional costs" under § 11-4.1:1. A broad interpretation could potentially result in limitations on other sometimes controversial clauses between general contractors and their subcontractors and suppliers.

Financial Risk Shifting Considerations

A sizeable shift in how general contractors and subcontractors in Virginia bear the financial risk on construction projects could occur in subcontracts and change orders, or other subcontract amendments, dated on or after the effective date of July 1, 2015 (Virginia has generally disfavored retroactive interpretation of new laws absent express legislative intent). Of significant concern for general contractors is that the new law creates a situation where owners on Virginia construction projects can contractually require general contractors to waive their mechanic's lien rights and claims for additional costs, but general contractors are proscribed from passing similar provisions onto subcontractors and suppliers to mitigate the risk of owner non-payment.

An early question might be the continued validity of changes clauses setting out procedures for making additional cost claims, such as requiring a subcontractor to receive express, written authorization from the general contractor or limiting the number of days a subcontractor has to submit a change order request after costs are incurred. Such procedures help avert disputes and litigation over subsequent disagreements for allegedly extra work; however, they could possibly now run afoul of the "waive or diminish" language in the new law.

Subordination clauses altering the priority of liens also could potentially be challenged, more so in Virginia where mechanic's liens are inchoate. A comparison with Virginia's new statutory language might be drawn with California's anti-lien waiver statute, which similarly states that lien rights may not be "waive[d], affect[ed], or impair[ed]." A recent appellate decision in California suggests the possibility that its anti-lien waiver law could support an interpretation that subordination of lien rights violates its policy. See *Moorefield Constr., Inc. v. Intervest-Mortgage Inv. Co.*, 178 Cal. Rptr. 3d 709, 715-20 (Cal. Ct. App. 2014) (interpreting a prior version of the statute to protect general contractors). The use of "diminish" in Virginia's new law could be interpreted by its courts to encompass subordination of liens to other legal interests in the project property, such as deeds of trust and construction lender advances. This would remove another negotiating pawn for general contractors in crafting both their prime and subcontracts. That said, there is no clear, current trend among other states labeling subordination clauses akin to lien waivers. This is an area that construction professionals will have to review for future development in Virginia and elsewhere. A declination by Virginia courts to extend the new law to subordination clauses could alternatively result in a muted effect for the application of "diminish."

"Pay-if-paid" clauses (conditioning subcontractor payment on the general contractor's receipt of payment) could become another casualty of the new law, which would mark a shift in prior Virginia policy of accepting the validity of such clauses. Again, such provisions could be challenged based on the "diminish" language in the new law, based on an argument that conditional payment affects the ability to file a valid lien or make a valid bond claim. Such arguments have been successful in California and New York, and several states ban such clauses. Yet, if such an interpretation were adopted by Virginia courts due to the new law, general contractors might delay (but not avoid) the financial consequences of nonpayment from the owner through the substitution of "pay-when-paid" clauses (pertaining to timing of payment rather than condition), which some states have found do not violate anti-lien waiver laws.

The implication for pay-if-paid clauses could be significant for general contractors and owners (and their lenders) on Virginia construction projects. The latter will likely become subject to greater lien exposure, with such inchoate liens difficult to invalidate through foreclosure, the sale of the property, or bankruptcy. The owner could, however, contractually require the general contractor to bond off such a lien while also possibly enforcing the general contractor's agreement to waive its own lien rights. Still too, owners may assert a defense of payment under Virginia's mechanic's lien law, leaving the subcontractor only with remedies against the general contractor. Va. Code. § 43.7.

Moreover, a Virginia subcontractor or supplier is under no obligation to file and enforce a mechanic's lien against the owner over a bond claim against the general contractor. If a defense of payment may be raised by the owner or the mechanic's lien would have unfavorable priority against the owner's property, the unpaid subcontractor or supplier may prefer to make a claim on the general contractor's payment bond. In such a case, the general contractor would likely become liable to indemnify the surety for the subcontractor's claim on the payment bond with limited recourse against the owner if it has not been paid and has no lien rights. One way general contractors might consider offsetting the risk of bond claim losses from lower-tier subcontractors and suppliers is by more frequently requiring subcontractors to furnish their own bonds. Additionally, general contractors might consider including anti-assignment provisions of lien rights in their subcontracts to reduce chances of such claims being enforced by third-parties.

Despite its express focus on pre-work waivers, Virginia's new law may also limit the ability of general contractors to include progress payment waiver templates as part of the subcontract. If such forms waive retainage for the progress payment period this arguably might violate the new law's command not to prospectively "diminish" rights. On the other hand, separate lien waivers agreed to after the execution of the subcontract and partial performance of some work are presumably not addressed by the new law. Developing waiver forms during the project performance might

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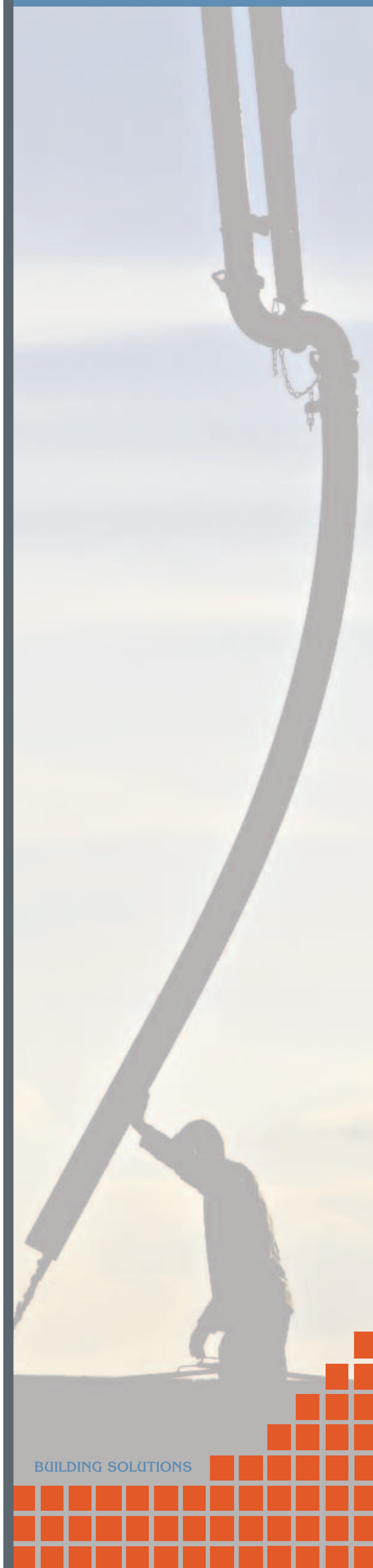
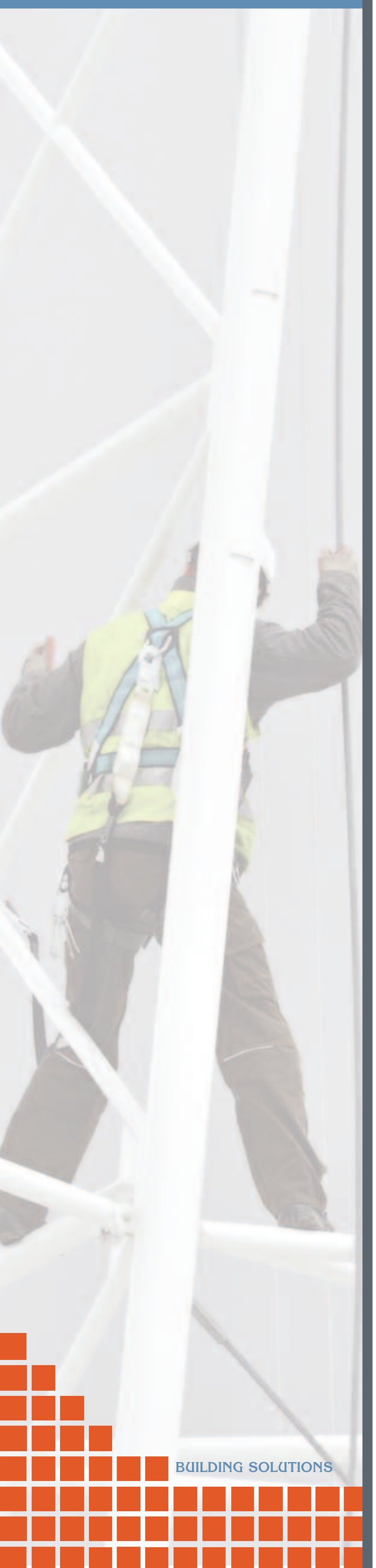


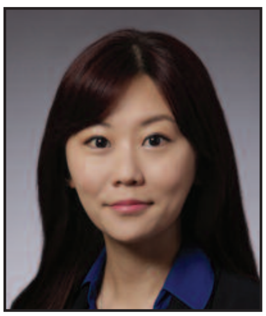


require additional negotiation and uncertainty about whether the owner and general contractor will receive a conditional or unconditional waiver. Furthermore, a lien waiver form created after the subcontract execution and during the project performance might still potentially violate the new law's prohibition if it waives the subcontractor's ability to file any subsequent liens for any remaining portion of the work in exchange for a progress payment. Despite these possibilities, it is worth noting that the language of lien waivers in general remains unregulated in Virginia. As such, some room remains for general contractors in negotiating these forms to share ongoing financial risks on a project.

Conclusion

The new statutory language addressing pre-work waivers of mechanic's liens, payment bond claim rights, and claims for additional costs for subcontractors, lower-tier subcontractors, and suppliers must be kept in mind for owners and general contractors entering new contracts. The new statutory language has potential implications for financial risk shifting provisions in Virginia construction contracts. Owners, general contractors, subcontractors, and suppliers should work closely with legal counsel to evaluate the breadth of their financial risk when entering into new construction projects and to determine whether any new developments in the law could affect their contract rights.

CONTRACTS



Back To Back, From Top To Bottom: Important Considerations For Drafting And Reviewing "Back-To-Back" Agreements

by Christine J. Lee, Associate

Large construction projects, including international construction projects, are commonly structured such that an owner hires a prime contractor who assumes responsibility for the execution of the overall project and, in turn, that main contractor transfers performance of the various components comprising the project to one or more subcontractors and/or suppliers. In entering into such subcontracts, the contractor will typically seek to pass its contractual obligations and liabilities towards the owner down to its subcontractor(s) through what is called a "back-to-back" or "flow down" contracting arrangement, thereby leaving the contractor with as few obligations or responsibilities relating to the project as possible. In a nutshell, the back-to-back principle is a method where the terms of the prime contract become a part of the agreement with another party down the subcontract chain.

Although such back-to-back agreements appear simple and straightforward conceptually, they require comprehensive knowledge of the terms and conditions of all of the referenced or mirrored agreements and highly rigorous drafting. As poorly drafted back-to-back agreements or flow-down clauses can lead to complex and time consuming disputes, it is imperative when drafting or reviewing such agreements to meticulously consider all provisions contained in the relevant contracts and also to remain cognizant of external factors that may affect the validity or enforceability of back-to-back agreements. This article briefly addresses certain key areas that parties may wish to consider in drafting back-to-back agreements, and also discusses particular concerns that may arise on international construction projects.

Introduction To Back-To-Back Agreements

The predominant approaches to structuring back-to-back subcontracts are the incorporation by reference approach and the stand-alone agreement approach. An additional approach is the use of a standard form subcontract. Each of these approaches is addressed briefly below.

Incorporation by reference of the prime contract involves incorporating applicable terms by reference in a subcontract agreement and expressly excluding or varying in the subcontract those provisions that are clearly not applicable (such as clauses relating to contract price or other similar terms clearly specific to the prime contractor only). Although this method may seem to be the quickest and most efficient structure for a back-to-back agreement, incorporation by reference is sometimes more complicated than drafting a stand-alone agreement. For example, meticulous attention must be given to ensuring that all of the back-to-back provisions are appropriate and are in fact incorporated into the subcontract properly. The parties must also ensure that the terms and conditions remain consistent between the two agreements. Furthermore, the necessity to constantly cross-reference the prime contract can also be inconvenient for the subcontractor(s).

A stand-alone agreement contains all of the terms and conditions of the prime contract that are specific to the subcontract. Although a stand-alone agreement eliminates any need for cross-referencing between the contracts and eases concerns regarding accuracy and consistency, drafting such an agreement from scratch can also be time consuming and expensive because the parties must analyze and determine which provisions will be incorporated into the subcontract and which provisions will require modifications and adjustments.

Finally, another approach is the use of a *standard form subcontract*, which includes back-to-back provisions from the main contract. An example of such a standard form contract in the international arena is the FIDIC Subcontract for Construction for Building and Engineering Works Designed by the Employer, a standard form subcontract intended to be back-to-back with the FIDIC Red Book 1999 edition and FIDIC Pink Book. The efficacy of the standard form contract approach varies, however, because parties typically amend standard form contracts to their respective preferences, thereby running the risk of inadvertently creating inconsistencies between the prime contract and subcontract.

Examples Of Areas To Be Aware Of When Drafting Back-To-Back Agreements

When drafting or reviewing back-to-back agreements, it is imperative to closely examine all contract provisions. Certain areas that may be of particular concern, include, but are not limited to the following:

- Extension of time and additional payment;
- Changes/variation procedures;
- Claims procedures;
- Completion requirements and deadlines;
- Defects liability requirements and deadlines;
- Limitations on liability;
- Indemnification;
- General or liquidated damages;
- Suspension and termination;
- Cooperation and coordination of parties;
- Force majeure;
- Governing language and law;
- Dispute resolution;
- Payment requirements and procedures;
- Key deadlines and notice requirements; and
- Confirmation of subcontractor's cognizance and thorough knowledge on the terms and conditions of the prime contract.

The approach to these issues may vary depending on a number of considerations, including whether the party in question is the prime contractor or subcontractor.

For example, expanding upon a few of the issues above, the prime contractor may wish to focus on imposing obligations—equally as stringent as the prime contract—on the subcontractor relating to deadlines and notice requirements, so as to preserve the ability of the prime contractor to pass on any subcontractor claims to the owner. Additionally, the prime contractor may seek to insert language providing that the subcontractor's recovery will be limited to the compensation that the prime contractor is able to recover under the prime contract (provided, of course, that any such compensation is actually applicable to the subcontract). The prime contractor may seek to insert language in the subcontract requiring that the subcontractor perform all of the prime contractor's obligations under the prime contract as applicable to the scope of work under the subcontract. Among other issues, the prime contractor may also want to ensure that termination clauses in the subcontract mirror termination provisions in the prime contract, as applicable.

On the other hand, the subcontractor may try to include an obligation on the prime contractor to adopt and adhere to an established pass-through claims procedure in order to avoid undermining the subcontractor's position under the subcontract and increase the subcontractor's ability to recover from the owner. The

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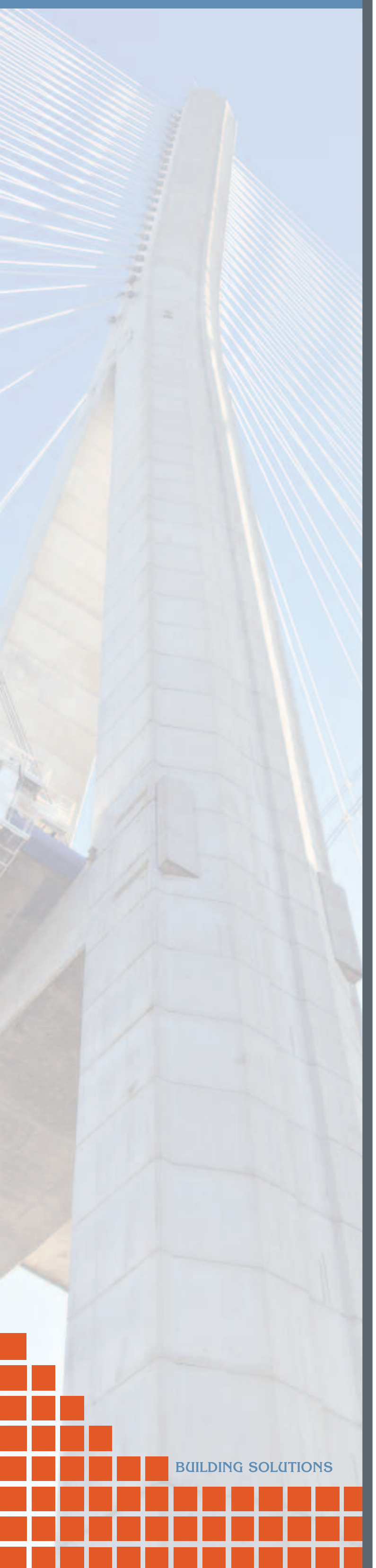


subcontractor may also wish to insert language stating that the subcontractor, in the event the prime contractor breaches the subcontract, may be entitled to recovery from the prime contractor that is not limited to the amount of compensation that the prime contractor is able to recover under the prime contract.

The foregoing represents only a small sampling of the issues that parties may wish to consider when drafting and negotiating back-to-back agreements. Given the number of considerations that come into play when drafting back-to-back agreements and the varying approaches taken by prime contractors and subcontractors, as highlighted above, negotiating back-to-back agreements that are both equitable and enforceable often requires the assistance of experienced counsel, and parties are advised to consult with counsel when negotiating such agreements.

A Cautionary Tale Of Incorporation By Reference

With regard to international construction projects, parties should exercise particular caution to ensure that back-to-back agreements are enforceable and consistent with the requirements of applicable law. For instance, the laws of certain countries may limit the extent that certain obligations or liabilities can be passed down to subcontractors.

As one cautionary example, a limitation was addressed this past April by the English courts in *Imtech Inviron Ltd. v. Loppingdale Plant Ltd.* ("LPL"). This case involved a back-to-back agreement between the prime contractor LPL and the subcontractor Imtech that incorporated by reference the prime contract. The prime contract required the parties to refer a dispute to adjudication as a condition precedent to litigation and to follow certain other specific rules relating to adjudication. Imtech referred a dispute to adjudication against LPL for failure to pay pursuant to an interim payment application. In response, LPL claimed that the adjudicator lacked jurisdiction to hear the dispute, as he had not been properly appointed under the terms of the prime contract.

Imtech distinguished between primary obligations, such as those relating to the work to be carried out and the manner in which it was to be executed, and secondary obligations, such as those which related to matters including indemnification or insurance. Imtech argued that the extent to which obligations arising out of the main contract were incorporated into the subcontract depended on whether such obligations were primary or secondary. Because adjudication provisions were secondary obligations, there needed to be clear and specific indication that the parties intended to incorporate the adjudication clause into the subcontract. The court found that it was not clear whether the parties had intended to incorporate the adjudication provisions into the subcontract and thus, Imtech was not bound by the adjudication provisions of the prime contract.

Accordingly, under English law, a general incorporation by reference may not actually incorporate certain types of provisions from the prime contract to the subcontract: it may be necessary to draft express language into the subcontract that mirrors the desired provisions from the prime contract, rather than relying on a blanket incorporation by reference clause. Similar restrictions may arise under other local and international laws, and parties are advised to seek the advice of experienced legal counsel when entering into back-to-back agreements on international construction projects.

Conclusion

In short, it is of paramount importance that the parties carefully and comprehensively review the terms and conditions of the prime contract to ensure that all desired provisions are effectively flowed down to the subcontract and are consistent. Although potentially time consuming and tedious, each party should adopt a "walkthrough" or "step by step" approach for tackling each provision and confirming whether incorporation of that provision into the subcontract will be consistent with commercial and legal sense and will truly have the desired effect—regardless of whether the subcontract ultimately incorporates the prime contract by reference or is specifically drafted as a stand-alone agreement.

FIRM NEWS

Honors

Chambers USA Guide To America's Leading Lawyers For Business

Watt, Tieder, Hoffar & Fitzgerald, L.L.P. is recognized in the 2015 edition of Chambers USA Guide to America's Leading Lawyers For Business as a Band One Construction Law Firm in the United States. Chambers and Partners has consistently named **Watt Tieder** and its attorneys among the top construction firms and attorneys both nationally and regionally since 2004.

Chambers also recognized the McLean, Virginia and Irvine, California offices as top Band One construction law practices in Virginia and California. The following **Watt Tieder** attorneys are recognized as "leaders in their field for Construction Law:" **John B. Tieder, Jr., Robert M. Fitzgerald, Lewis J. Baker, Carter B. Reid, Vivian Katsantonis, Robert C. Niesley**, and **Gregory J. Dukellis**.

Super Lawyers

2015 Virginia Super Lawyers recognized **John B. Tieder, Jr., Robert M. Fitzgerald, Lewis J. Baker**, and **Vivian Katsantonis**. **Kevin J. McKeon, Hanna L. Blake** and **Sarah Simmons Wronsky** were recognized as Rising Stars. **2015 Southern California Super Lawyers** recognized **Robert C. Niesley** and **Gregory J. Dukellis**. **Brent Mackay** was selected as a Rising Star. **2015 Washington Super Lawyers** recognized **Christopher A. Wright** and **R. Miles Stanislaw**. **Mark Rosencrantz** and **Diane C. Utz** were recognized as Rising Stars. **2015 Illinois Super Lawyers** recognized **John E. Sebastian**. **2015 Mountain States Super Lawyers** recognized **Jared M. Sechrist** as a Rising Star.

Legal 500

Legal 500 United States recognized **Watt, Tieder, Hoffar & Fitzgerald, L.L.P.** as a top tier construction law firm for 2015. **Lewis J. Baker** of the McLean, Virginia office was recognized as a Legal 500 Leading Lawyer.

Upcoming And Recent Events

ABA Section on Public Contract Law Small Business Committee Meeting, July 15, 2015; Washington, D.C.; **Mitchell A. Bashur** spoke on the Mentor Protégé Program And Subcontracting Responsibilities.

Transportation Research Board 54th Annual Workshop on Transportation Law, July 21, 2015; Chicago, Illinois; **Hanna L. Blake** spoke on Current Trends in P3 Project Delivery.

University of Stuttgart International Construction Law and Practice Master's Program, September 3-5, 2015; Stuttgart, Germany; **John B. Tieder, Jr.** to lecture on Legal Systems and Contract Law.

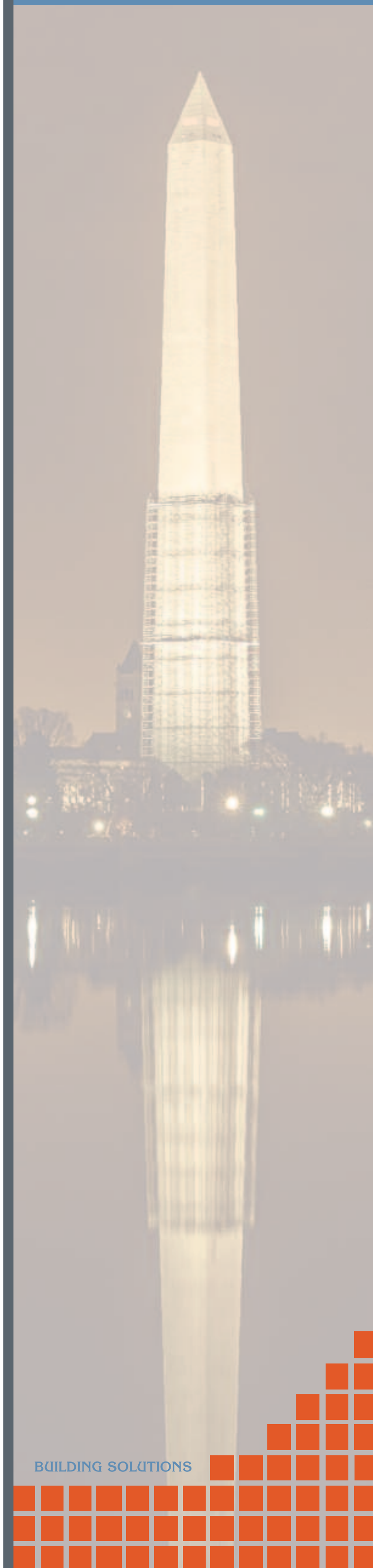
2015 Pearlman Association Conference, September 10-11, 2015; Seattle, Washington; Robert C. Niesley to co-chair the program, "Delivering the Promise of Surety – Exceptional Claims Handling."

Canadian Construction Association Industry Summit, September 29, 2015; Toronto, Canada; Christopher Wright to speak on Prompt Payment in the U.S. Construction Industry.

Dispute Resolution Board Foundation Annual Conference, October 2, 2015; San Francisco, California; **Hanna L. Blake** to speak on the Use of Dispute Boards on Alternative Project Delivery Projects.

Construction Management Association of America National Conference and Trade Show, October 11 - 13, 2015; Orlando, Florida; **Christopher J. Brasco** and **Kathleen O. Barnes** to speak on Risk Management for e-Collaboration and Cyber-Security, and Adopting Innovative Contracting Formats and Construction Trends.

Emmanuel Kant Baltic University, October 19-30, 2015; Kaliningrad, Russia; **John B. Tieder, Jr.** to teach a program on International Commercial Arbitration.



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WATT TIEDER

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

Attorneys at Law

WATT TIEDER

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

8405 Greensboro Drive, Suite 100
McLean, Virginia 22102

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

**Independent Law Firm*

Global Construction &
Infrastructure Legal Alliance
91, rue du Faubourg Saint-Honoré
75008 Paris, France
Phone 33 (0)1 44 71 35 97

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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