

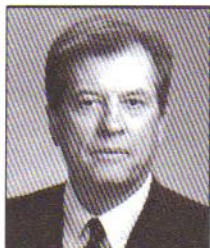


Construct!

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David M. Hayes

Since Benjamin Cardozo's memorable formulation in the famous Reading Pipe Case, *Jacob & Youngs, Inc. v. Kent*,¹ parties have often litigated the proper measure of damages in construction defect cases. In that case, a homeowner complained that the wrought iron pipe a builder installed in his finished home, and that was encased in the walls, was of a manufacturer other than that named in the specifications. Cardozo, writing for the majority, denied the homeowner damages for the wasteful removal and replacement of pipes, on the grounds that the contractor's accidental placement of the wrong brand of otherwise-conforming pipe did not diminish the value of the home.

Since that time, other courts have more fully developed and applied the ideas expressed in *Jacob & Youngs*.

A Defect by Any Other Measure: Damages for Defects and Related Issues

By David M. Hayes and Matthew R. Rechtien, P.E.



Matthew R. Rechtien, P.E.

This article summarizes current law regarding the proper measure of nonconsequential damages in construction defect cases and then explores related, practical implications.²

Majority Rule for Measuring Defect Damages

Because most defect claims are contractual, and because contract damages tend to protect the expectation interest³ (i.e., the "loss in the value to [the injured party] of the other party's performance caused by its . . . deficiency"⁴) the majority rule is that, for a substantially completed building,⁵ the measure of the owner's direct, nonliquidated damages is the cost of correcting the defects.⁶ However, this preference for the cost-of-correction measure is subject to universal

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Ellis I. Medoway

Allegations of defective workmanship on construction projects lead to eventual claims of property damage and consequential loss. Counsel who represent owners, general contractors, and subcontractors faced with such liability claims need to analyze whether the claims are covered by insurance, in terms of defense and indemnification. Several states' supreme courts have recently addressed the question of whether coverage is available for construction defect

State Courts Trend: Coverage for Faulty Workmanship

By Ellis I. Medoway, William L. Ryan, and Benjamin D. Morgan

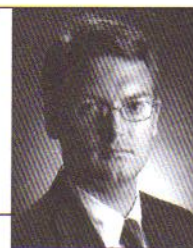


William L. Ryan

claims and the majority trend is to find coverage.

Before 1976, a widely held consensus existed that commercial general liability (CGL) policies covered only "tort liability for physical damages to others and not for contractual liability of the insured for economic loss."¹ However, after the 1976 Broad Form Property Damage Endorsement and the 1986 revisions to the standard CGL policy, consensus

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Benjamin D. Morgan



New ADR Processes Revolutionize Project Disputes

By Peter G. Merrill

Peter G. Merrill

Large construction projects generally have two main objectives: to be completed (1) on time and (2) within budget. Secondary goals are for the general contractor and all other parties involved in the construction to make a profit and for the owner to end up with a properly constructed building, road, bridge, and so on, that will accomplish what it was designed to do.

It is virtually impossible to complete a large construction project without a dispute developing between or among parties. Such disputes are likely to affect less adversely those who plan ahead. Although dispute review boards (DRBs) have been around for many years, they traditionally offer only recommendations or advisory opinions upon which the parties should be able to resolve their dispute through discussions based on those recommendations or advisory opinions. If the parties cannot resolve their dispute after considering a DRB's recommendations or opinions, they will need to proceed on to outside arbitration or to litigation, whichever the construction contract specifies, to reach a final and binding resolution to the dispute.

In general, it is accepted that the average large construction litigation case takes approximately two and a half years to complete, including appeals. During that time, the parties often continue working on the project but may perform differently because of the pending dispute. If the dispute is between two major parties in the construction project, a project may have to shut down until the dispute is settled. The comfort level of the parties with respect to working together will diminish, and the project will begin to witness a different level of cooperation between disputing parties. Regardless of the nature of the dispute, the effects of the dispute will most

likely adversely affect the project and cause it to run behind schedule and possibly over budget.

Most large construction disputes provide a mechanism for the parties involved in the construction project to write change orders or to file claims related to unforeseen issues that develop during the construction project. Those change orders and/or claims are usually held to the end of the project before the parties address them. This process often requires the contractor to foot the bill or pay for the issues in the change orders or claims until the end of the construction project. If there were a process available to the contractor and project owner whereby they could have the change order or claim reviewed as it developed, with current available knowledge of the issues, the parties could reach a proper resolution or agreement to the terms and conditions of the change order, which would be more meaningful, fair, and equitable to the parties involved.

At major sports events, a medical emergency crew, trained to handle medical emergencies, usually stands by just in case someone is injured. Response time can mean life or death in some instances. A construction project can use the same planning ideas. If you have construction-knowledgeable specialists available in the event of a construction dispute, those experts can render the same emergency treatment to minimize injuries to the construction project. Better yet would be a team of construction experts that meets on a regular basis not only to handle any disputes but also to help prevent any disputes. That team of construction experts is known as either a DRB, if it meets on a regular basis, or a construction settlement panel (CSP), if the construction specialists work on an on-call basis as their services are requested.

A DRB usually comprises three construction-knowledgeable individuals whom the project owner (hereafter, the owner) and the general contractor (GC) have selected mutually. The construction industry across the world has used DRBs for many years. A DRB usually meets on a regular basis: every month, two months, quarterly, or as the DRB agreement specifies. The DRB reviews the progress of the project and tries to anticipate any possible future disputes or handles any disputes that have developed since its last meeting. All DRBs issue recommendations or advisory opinions specifying how the DRB believes that the parties should handle the issue to prevent or settle the dispute. Each party to the dispute has an opportunity to present its case to the DRB for consideration. Because the DRB has the success of the project in mind and acts neutrally without representing any of the parties, it renders its recommendations or advisory opinions as to how the dispute should be handled for the betterment of the project to keep the project on time and within budget.

As mentioned earlier, if the parties can come to an agreement through discussions based on a recommendation or an advisory opinion, the dispute will come to an end. If the parties do not come to an agreement, the dispute will need to be referred to outside arbitration or litigation. Arbitration and especially litigation can take several months to reach a final and binding decision from the arbitrator, judge, and/or jury. It can easily take years for a dispute to come to a final settlement. Many parties, especially small subcontractors and similar small companies, go out of business waiting for a dispute to settle.

It would certainly be in the interest of the success of the project to have the dispute handled as quickly

as possible. It would be even better if all disputes could be handled quickly and inexpensively by construction-knowledgeable neutrals. A traditional DRB that only offers recommendations and advisory opinions can accomplish this only if the parties ultimately agree on how to handle the dispute as a result of the DRB recommendation or advisory opinion.

In contrast to a traditional DRB, an extended dispute review board (EDRB; see diagram on page 9) can provide full alternative dispute resolution (ADR), including mediation and binding arbitration, which would ensure that all disputes are handled and settled entirely in-house. In addition, an EDRB can provide its services to all parties involved in the construction project, including not only the owner and GC but also all subcontractors, sub-subcontractors, material suppliers, service providers, and so on. Traditional DRBs usually are very effective in helping prevent or settle disputes between the owner and the GC; however, any disputes between any other two parties fall outside of the DRB's responsibilities and must go on to outside arbitration or litigation. All major parties to the construction project under an EDRB can be required to agree to use the three-step dispute resolution process, which includes recommendations and advisory opinions, mediation, and, if necessary, binding arbitration to settle all disputes. All disputes will be handled in-house, that is, without the use of the court system. Depending on the complexity of the dispute and the preparation time that a party might need to make a proper presentation to the EDRB, a typical dispute can be completely settled in between 30 and 90 days. If a dispute is of a critical nature, the parties may mutually choose to skip the advisory opinion and/or mediation processes and proceed directly to binding arbitration to reach an expeditious final settlement. A major benefit of an EDRB is its flexibility, which allows parties to select the best process to settle their dispute. Construction Dispute Resolution Services, LLC (CDRS), which conceived of and developed the EDRB process, generally does not recom-

mend that the DRB issue binding arbitration awards, as it is important that the DRB remain totally neutral and continue to have the respect and confidence of the parties. DRBs should only be involved in final and binding decisions if the disputed issues are minor in nature and if the parties mutually agree that the DRB issue a final and binding arbitration award. Arbitrators are usually called up from the construction settlement panel to arbitrate any disputes.

A typical dispute can be completely settled in between 30 and 90 days.

Construction Dispute Resolution Services also recently conceived of and developed the CSP to assist a DRB or an EDRB and to reduce the fixed costs associated with them. On major construction projects, it is not unusual that several DRBs participate, each with its own specialization (e.g., electrical, structural, underground, mechanical, HVAC). On Boston's Big Dig artery project, there were 47 different participating DRBs throughout the construction project. These DRBs each met on a regular basis to review the progress of the project and to render recommendations or advisory opinions as necessary to prevent or settle a dispute specifically related to the DRB's area of expertise. The 47 DRBs had fixed costs, though some of them sometimes met as scheduled without having any important issues to handle. In an effort to provide the same exper-

tise supplied by the many DRBs, without the fixed costs related to having multiple DRBs, the CSP was developed. The CSP comprises several construction-knowledgeable individuals, each with his or her own expertise; however, the CSP is available only on request and does not meet on a regular basis, as DRBs do. For example, an HVAC DRB may have met on a regular basis whether or not there were HVAC issues to handle. If those same individuals were on the CSP rather than the DRB, a general DRB that required their expertise would call on them if an HVAC-related dispute was submitted to the general DRB. The expense of those HVAC CSP members would be incurred only when there was an HVAC-related dispute rather than as incurred through the regular DRB meetings. Members of the CSP, then, serve as a panel of readily available construction specialists at the request of a general DRB. It is not unusual that both construction-knowledgeable specialists and construction mediators or arbitrators (ADR specialists) participate on a CSP.

The owner and GC individually select all CSP members and execute all required paperwork, including a CSP member agreement, that specifies the expertise of the CSP member and his or her required fees and related expenses. Keep in mind that all parties participating in the construction project would also have executed the EDRB agreements, including an agreement to mediate, an agreement to arbitrate, and related agreements, addendums, and other required documents.

The flexibility of the CSP-supported EDRB program allows for any number of possible combinations of EDRBs with CSP support. The most popular scenario is to set up one, two, or three general EDRBs, depending on the size and complexity of the construction project. If those EDRBs find that they are constantly calling on the same CSP members, it might be advisable that a new EDRB be established comprising those members who were called upon regularly. The CSP members must rearrange their schedules to accommodate the requests of the EDRB. If they had

been scheduled to meet as a DRB or an EDRB regularly, scheduling should not be a problem, because they can plan far in advance for meetings rather than try to juggle schedules to accommodate the requests of the EDRB.

On more complex construction projects, it might be necessary to set up several specialized EDRBs with members not experienced in ADR but who could call on CSP members with ADR experience to mediate or arbitrate a dispute if the parties do not accept the DRB-rendered recommendation or advisory opinion.

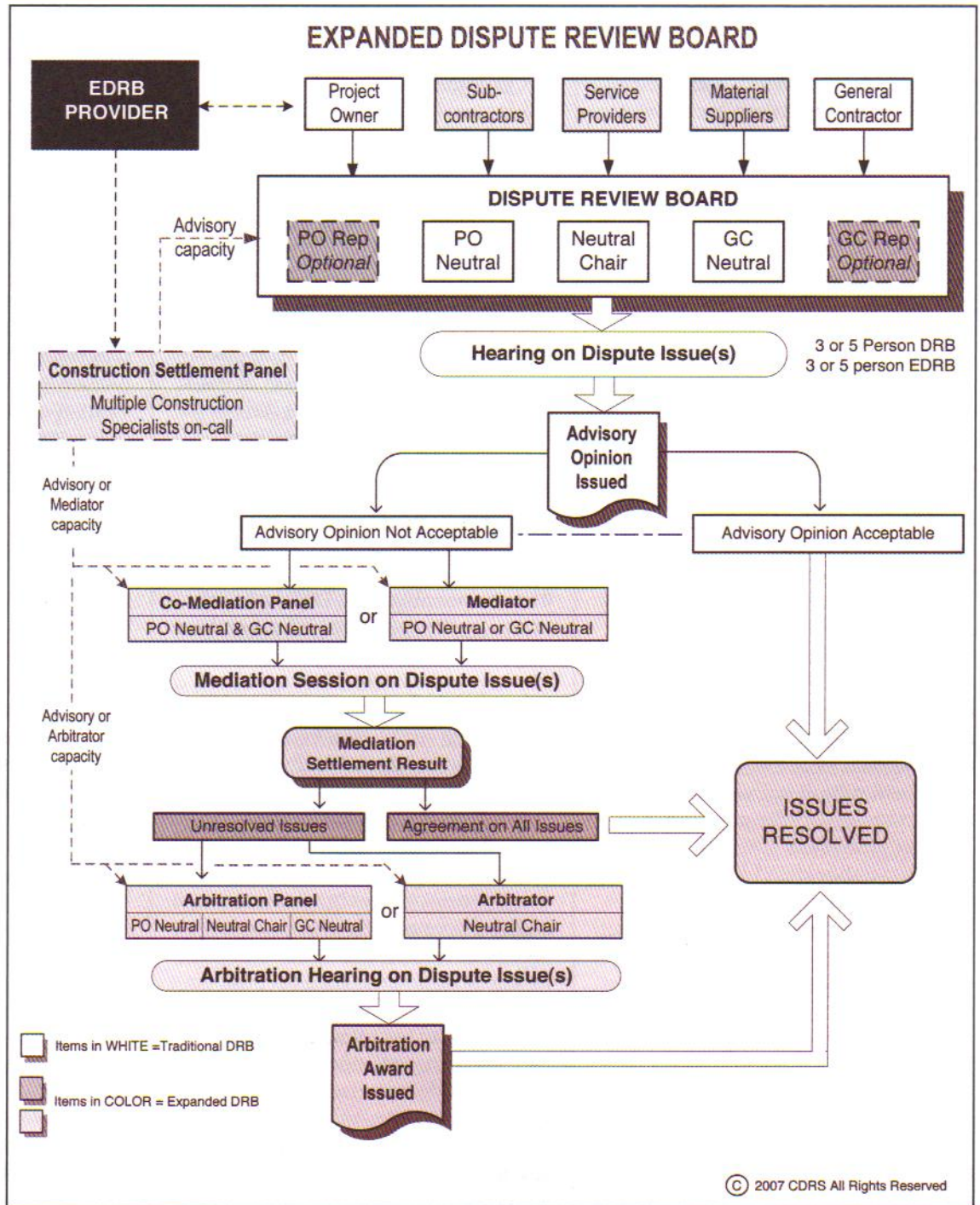
In another scenario, there could be several specialized DRBs and one or two ADR DRBs established to handle the mediation or arbitration requirements of the project. As you can see, the possibilities of DRBs or EDRBs are limitless, and each construction project must consider which combination is appropriate for its needs. Keep in mind that each project requires only one CSP, which can support as many general DRBs or EDRBs as the project requires. Also keep in mind that new DRBs can be formed at any time, and additional members can be added to the CSP if there is a special expertise required of a CSP member who is not currently on the CSP (however, it will take a few extra days to complete the paperwork to have the member join the CSP).

A common misconception is that all DRBs or EDRBs comprise only construction-knowledgeable individuals. However, it is not unusual that

a financial oversight EDRB participates, comprising a forensic accountant and two other individuals with construction estimating or accounting backgrounds with responsibilities to analyze all invoices, change orders, claims, addendums, and so on, that might be in dispute. The likelihood of overcharges, kickbacks, under-the-table payments, graft, and corruption would be minimal if there were a DRB with the responsibility of reviewing any questionable financial

matters of the project. As mentioned earlier, the EDRB possibilities are limited only to the imaginations of the major parties, especially the owner, who formulates and specifies the initial DRB or EDRB program.

On major projects where the owner and the GC have worked well together before or on other projects where few if any disputes were encountered or are expected, parties may set up only a CSP, whose members would be called on only as parties requested. There is



a small administrative charge to set up the CSP, but there are no fixed recurring expenses as there would be with one or more DRBs or EDRBs operating on the construction project. By presigning the members to the CSP and presigning other related documents, such as agreements to mediate or arbitrate, a CSP member could conceivably be on the job site the next day to render his or her services for a neutral advisory opinion or recommendation, or to serve as a mediator or an arbitrator. Time is money. How quickly disputes are settled may very well determine whether the project will come in on time and within budget.

Because most owners are not experienced in formulating a DRB or an EDRB program, it is recommended that owners work with a national and/or international DRB provider firm, such as CDRS. A provider should be able to analyze the complexity and requirements of the construction project and to recommend several possibilities for combinations of DRBs, EDRBs, and a CSP to address properly the potential disputes of the construction project.

A DRB provider can also coordinate all administrative aspects of the DRB or EDRB program. Typically, an owner, such as a municipality, forms a DRB by putting out a request for proposal (RFP) for individuals who would like to serve on the DRB program. The owner reviews RFPs, selects members along with the GC, and individually contracts for services with each DRB member. The DRB members then make all their own travel arrangements and submit individual expenses to the proper party for payment. A DRB provider, such as CDRS, can provide a national and/or an international panel of DRB members who are properly trained in the DRB and EDRB processes and possess a special expertise that might be required for construction projects. In addition, the provider can handle the execution of all required documents, including the DRB member agreements, party participation agreements, agreements to mediate, agreements to arbitrate, all CSP member agreements, and other required documents and forms. At

the end of each month, the provider also can bill the appropriate parties for all the DRB, EDRB members, and all fees and expenses of CSP members, rather than having each DRB, EDRB, or CSP member submit his or her own individual expenses. There is always a good amount of additional administrative functions that the DRB could handle with respect to the EDRB meetings. The hiring of an ADR provider to design and administer the DRB, EDRB, or CSP program to prevent and settle disputes is no different from hiring an architect to design a building and oversee its construction.

On large construction projects, bidders usually build a litigation contingency into their administrative costs to cover the costs of any potential future disputes, which are purely speculative. If the EDRB is established before the project goes out to bid, which is usually the case, the estimated costs of the EDRB would be available through the EDRB provider, as would the bid estimates for other aspects of the project. If the established DRBs or EDRBs did not need to hold any special meetings, other than the regularly scheduled ones, the costs related to an EDRB program would be available at the time of the bid. Contractors would not need to allow for a litigation contingency other than for possible extra DRB or EDRB meetings. The parties involved in the dispute usually share the expense for any required special EDRB meetings.

Let's take a quick look at some other major considerations involved in construction disputes. If you were injured or became sick, you would go to a doctor or a hospital for the best treatment, not to a judge or a jury for them to decide how to administer to you. A doctor knows how you are built, how your parts fit and work together, and so a doctor should know how to remedy your medical problem. If the doctor does not have the depth of knowledge to treat your medical problem, he or she will most likely refer you to a more knowledgeable specialist. Likewise, a construction specialist knows how the project should be built and the best ways to correct or remedy a problem or dispute. If you bring a

construction dispute before an arbitrator, a judge, or a jury unfamiliar with construction, the parties, usually with the assistance of their lawyers, make a presentation to convince the fact finders of which party is correct. The best and most convincing presentation usually is the prevailing party (winner) and does not necessarily recognize which party was right or wrong. As a result, CDRS highly recommends that all parties to a construction project work with construction-knowledgeable individuals to decide how to prevent or settle a construction dispute. Where appropriate, CDRS also recommends that lawyers participate in the DRB. A lawyer with construction litigation or construction ADR experience can be a very effective DRB or EDRB chair and will be able to conduct the affairs of the DRB in a professional and organized manner.

Although there are both fixed and variable costs related to the implementation of the DRB, EDRB, and CSP programs, the direct costs of just one outside arbitration or litigation can be many thousands of dollars, and the indirect costs of a project delay or similar occurrence are impossible to estimate. If there were several major disputes that went on to outside settlement through arbitration or litigation, the project would most likely experience unnecessary delays and additional unbudgeted expenses. An EDRB program can also give the parties peace of mind as to the success of the project, in terms of the proper handling of construction disputes. The EDRBs offer a type of insurance that virtually guarantees the parties that they will not be involved in lengthy, costly litigation that can fester for many months or even years before settling.

Additional information, including many of the required agreements, forms, and documents concerning the DRB, EDRB, and CSP programs is available at the CDRS website: www.constructiondisputes-cdrs.com, or you can call CDRS at 888-930-0011.

Peter G. Merrill is the president and CEO of Construction Dispute Resolution Services, LLC, a national and international construction alternative dispute resolution provider.