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The Perils of Unsigned Subcontracts

By: Robert F. Flinn, Esquire

A Virginia court decision highlights the risks associated with unsigned subcontracts. In the case, *Showcase Woodworking, Ltd. v. Fluor Daniel, Inc.*, 1990 U.S. Dist. LEXIS 19614 (U.S. E.D. 1990), a millwork subcontractor sued a general contractor to recover lost profits although no formal subcontract had ever been signed. The court concluded that no contract existed and dismissed the subcontractor's suit. The facts of the case are typical of what customarily occurs when bidding a job. The general contractor sent a bid package consisting of the plans, specifications, and general conditions to the subcontractor, and the subcontractor submitted a bid. However, the subcontractor substituted plastic laminate for the specified countertop material. Subsequently, the general contractor sent the subcontractor a letter of intent confirming that it would pay the subcontractor the stipulated sum for the millwork "in accordance with the requirements of the plans and specifications." The subcontractor acknowledged the letter and added the phrase "scope of work included per attached quote." As is typical, the general contractor's letter of intent to the subcontractor stated:

> This letter is to express Fluor Daniel's intent to award and enter into a Subcontract with your company...[T]he final subcontract agreement for execution by Showcase Woodworking which will be forwarded at an early date, shall supplant and take precedence over this letter of intent, when the subcontract document is duly executed by Fluor Daniel, Inc. and Showcase

> Woodworking, Ltd.

Before a formal subcontract could be signed, a dispute arose over the extra costs of supplying the specified countertops in lieu of the substituted plastic laminate countertops. As a result, the general contractor awarded the subcontract to another subcontractor. Showcase Woodworking sued, claiming that a valid, enforceable contract was created when the general contractor's letter of intent was accepted.

The court disagreed and dismissed the subcontractor's suit on two grounds. First, the court held that the general contractor's letter of intent was merely a proposal for a future contract. Such proposals are merely expressions of intent, and expressions of intent are not enforceable. Second, the court held that the parties never reached agreement on one of the material terms of the contract-whether plastic laminate countertops could be substituted for the specified tops. When there is not an agreement on all material terms, no binding contract exists.

The court's holding in the *Showcase Woodworking* case contrasts with other Virginia cases which have found a valid enforceable contract to exist under similar, although not identical circumstances. For example, in *Agostini v. Consolvo*, 154 Va. 203, 153 S.E. 676 (Va. 1930), a subcontractor recovered damages from a general contractor for breach of contract even though a formal subcontract was never signed. In this case, a subcontractor submitted a bid to a general contractor to perform certain stone work for a proposed post office building. The general contractor then wrote the subcontractor that its bid was accepted and stated:

> As soon as the contract is awarded to us we will enter into a contract with you in a more detailed form for the prosecution of the work.

When the subcontractor received the general contractor's letter of intent, the subcontractor signed the letter without adding any conditions. However, before a formal subcontract could be signed, a dispute arose over the scope of the work. The general contractor insisted that because of union rules, the subcontractor was required to perform the brick work as well as the stone work. The subcontractor refused and sued the general contractor claiming a valid, enforceable contract for the stone work was created when the general contractor's letter of intent was accepted.

The court agreed and held that a valid, enforceable contract had been created. The court reasoned that the evidence demonstrated that both parties were in full agreement on all material terms, and that both patties intended to be bound at the time the letter of intent was accepted, notwithstanding the fact that a formal contract was to be prepared and signed at a later date. The court acknowledged the fact that both parties had intended a formal

contract to be drawn up at a later date. This implied that they did not intend to be bound until the formal contract was signed. Nonetheless, the court placed greater weight on the letters which were exchanged between the parties at bid time. These letters reflected a present intention to be bound, irrespective of the formal contract which was to follow.

The decisions in the *Showcase Woodworking* and *Agostini* cases offer only limited guidance in determining when a valid, enforceable contract is created. Much depends upon the intention of the parties. And proving intention is a difficult task. Nonetheless, the courts uniformly require that all material terms of a contract be agreed upon in order for an enforceable contract to exist.

The legal risks and uncertainty associated with unsigned subcontracts is further increased by a line of cases allowing a subcontractor to recover from a general contractor under a legal theory known as quantum meruit. Under this theory, if a court finds that no valid, enforceable subcontract exists because the parties never agreed to all material terms, the court may nonetheless require the general contractor to pay the subcontractor the reasonable value of the services provided to prevent the unjust enrichment of the general contractor. Thus, in *Hendrickson v. Meredith*, 161 Va. 193 (1933), the court said:

> It is a general rule of law that he who gains the labor...of another must make reasonable compensation for the same. Hence, when one furnishes labor to another under a contract which, for reasons not prejudicial to the former, is void and of no effect, he may recover the value of his services on a quantum meruit.

Note that under the quantum meruit theory, the measure of recovery is the reasonable value of the services performed, not the competitively bid contract price. Consequently, it has been repeatedly held that a subcontractor may recover more under a quantum meruit theory than it would be entitled to under a written subcontract

The lesson of these cases is that parties take substantial risks when work is performed without a signed subcontract. When disputes arise, the courts will continue to reach varying results based upon the unique facts of each case.

Subcontractors Can No Longer Waive Their Mechanic's Lien or Payment Bond Rights in Virginia in Advance of Doing the Work.

By: Robert F. Flinn, Esquire

The Virginia General Assembly has amended the Virginia mechanic's lien and payment bond statutes, effective July 1, 2015, to provide that a subcontractor, lower-tier subcontractor, or

material supplier may not waive or diminish his lien or payment bond rights in a contract in advance of furnishing any labor or materials and that any such provision in a contract is null and void (Va. Code §§ 43-3 and 11-4.1:1). This change is similar to provisions already in place in the Maryland mechanic's lien statute (Md. Real Property Code § 9-113) and the federal Miller Act governing payment bonds on federal projects (40 U.S.C. § 3133). Provisions in contracts which require partial waivers for work already performed as part of each progress payment remain valid.

Is a Provision in a Contract Enforceable Which Provides That Disputes are Subject to Arbitration Out-Of-State?

By: Robert F. Flinn, Esquire

The answer to this question may not be as simple as it first seems. On the one hand, Virginia Code § 8.01-262.1 provides that if a contract for a project in Virginia requires any arbitration proceedings outside Virginia, such provision is unenforceable and arbitration proceedings shall be in the county or city where the work is to be performed. However, if the project involves "interstate commerce," some federal courts have held that the Federal Arbitration Act, 9 U.S.C. § 1-16, requires that arbitration agreements be enforced in accordance with their terms, even if such agreements would otherwise be unenforceable under state law. The term "interstate commerce" has been broadly defined by some federal courts to apply to construction contracts which involve the provision of labor and materials by out-of-state subcontractors and suppliers.

The Top Ten Pros and Cons of Arbitration

By: Robert F. Flinn, Esquire

Contract provisions which require disputes to be resolved by arbitration are one of the most common provisions found in construction contracts. For example, the American Institute of Architects' standard form AIA A201 General Conditions, the most widely used standard form construction contract in the United States, requires all disputes to be decided by arbitration in accordance with the rules of the American Arbitration Association ("AAA").

Notwithstanding this, owners, general contractors and subcontractors frequently disagree over the merits of arbitration. Here are my top ten pros and cons of mandatory arbitration:

1. **Costs.**

Pro. The costs of pursuing a dispute in arbitration, as distinguished from court litigation, is frequently cited as a reason favoring arbitration. The principal reason for this is that, unlike court litigation, you do not need a lawyer to pursue a claim in arbitration. Also, unlike court litigation, arbitration does not ordinarily involve time-consuming and expensive "discovery," a court procedure by which the attorneys for the parties subpoena each other's documents and interrogate each other's witnesses.

Con. Even though you do not need to be represented by a lawyer in an arbitration, most parties nonetheless elect to be represented by a lawyer. Consequently, the cost-savings opportunity of not using a lawyer is often not realized. Additionally, unlike court filing fees which are relatively nominal, arbitration ordinarily entails substantial filing and arbitrators' fees. For example, the AAA charges an administrative fee based upon the amount of the claim or counterclaim which ranges from $750.00 for claims less than $75,000.00 to $10,000.00 for claims greater than or equal to $10,000,000.00. Additionally, the parties must compensate the arbitrator or arbitrators for their time. A single arbitrator's daily fees can exceed $1,500.00 per day.

2. **Time.**

Pro. The arbitrator sets the date, time and place for the hearing after consulting with the parties. It is common for an arbitration to take three to six months from the initial demand to the issuance of an award. Under the AAA Rules, special "fast track procedures" apply if neither party's claim or counterclaim exceeds $100,000.00. Under these "fast track" procedures, the arbitrator is required to set a date for the hearing within 45 days of confirmation of the arbitrator's appointment.

Con. A lawsuit ordinarily takes nine to twelve months from the initial filing to the trial. However, unlike an arbitration, in a lawsuit there is an opportunity to have the court make legal rulings in advance of the trial which narrow the issues or dismiss all or part of the claims.

3. **The Decision-Maker.**

Pro. In an arbitration, the parties can choose an arbitrator who has experience with construction. Additionally, unlike a judge in a court proceeding whose docket is often dominated by criminal, divorce and personal injury cases, an arbitrator ordinarily has the time needed to evaluate and decide the dispute.

Con. Unlike an arbitration, a judge or jury ordinarily does not have a background as an owner, general contractor, subcontractor or architect. Consequently, a judge or jury ordinarily does not have a bias in favor of one segment of the construction industry. In an arbitration, the appointed arbitrator is sometimes a person who is an architect, a general contractor or a subcontractor and this past experience in one sector of the construction industry

sometimes generates a bias. For this reason, general contractors often object to the selection of a subcontractor as an arbitrator and vice versa.

4. **Evidence.**

Pro. The court rules of evidence do not apply in an arbitration proceeding. It is therefore less time-consuming and less expensive to present a case in an arbitration proceeding than in a court trial.

Con. A party in an arbitration proceeding can be confronted with correspondence and affidavits from third-party witnesses who are not available for cross-examination. Likewise, a party in an arbitration proceeding can be confronted with testimony from witnesses who have no first-hand knowledge of the subject of their testimony. Likewise, in a court proceeding damages must be proven with reasonable certainty, but in an arbitration proceeding proof of damages can be based upon speculation and conjecture.

5. **Discovery.**

Pro. In an arbitration proceeding, unlike a court case, the parties have only limited rights to discover damaging information from the opposing party. Among other things, this means that a party probably will not be able to learn about damaging things in the opposing party's files. Additionally, this means that a party in an arbitration proceeding probably will not incur the significant costs of subpoenaing and reviewing the opposing party's documents and taking depositions of the opposing witnesses. Under the AAA's "fast track" rules (claims under $100,000.00), absent exceptional circumstances there is no discovery, except for an exchange of exhibits and lists of witnesses five days before the hearing. In other cases, the AAA Rules provide that the arbitrator has the discretion to direct the parties to exchange documents and other information and identify witnesses, but absent exceptional circumstances, there is no other discovery, except for an exchange of exhibits seven days before the hearing.

Con. Court rules allow each party to use a variety of methods to discover information known only by the opposing party or a third-party. These methods include interrogatories (written questions) the opposing party must answer under oath, subpoenas for the production of documents, and depositions. These procedures greatly increase the chances that each party will discover the weaknesses and strengths of their respective cases before trial.

6. **Privacy.**

Pro. The parties to an arbitration proceeding can agree to keep the proceedings confidential, and in any event, unlike court cases, an arbitration proceeding is not open to the public.

Con. In a court proceeding, all proceedings are open to the public. This means that confidential or embarrassing matters cannot be concealed.

7. **Joining Third Parties.**

Pro. In an arbitration proceeding, third parties who may ultimately be responsible may not be brought into the arbitration without their consent. The most common example of this is a dispute between an owner and a general contractor over an alleged error in the construction drawings. Under the arbitration rules, an architect who is responsible for the defective drawings may not be brought into an arbitration between the owner and general contractor without the architect's consent. Thus, most arbitration proceedings involve only the two parties to the contract.

Con. Court rules allow a party who has been sued for something for which a third-party is ultimately responsible to bring the third-party into the lawsuit by filing a cross-claim or third-party claim. In this manner, all the parties involved in the dispute are before the court at the same time in the same lawsuit, and the party who is ultimately responsible bears the ultimate liability.

8. **Appeal Rights.**

Pro. Ordinarily an appeal from an arbitration award is permitted only on one of five narrow grounds: (1) the award was procured by corruption, fraud or other undue means; (2) there was evident partiality, corruption or misconduct by the arbitrator; (3) the arbitrator exceeded his powers; (4) the arbitrator refused to postpone the hearing or hear evidence or improperly conducted the hearing; or (5) there was no arbitration agreement. Consequently, an award in an arbitration proceeding is rarely overturned, even if the result is not supported by the evidence.

Con. Unlike an arbitration proceeding, the losing party in a court case has a right to appeal to a higher court. The basis for the appeal can include alleged errors made by the trial judge as well as alleged mistakes made by the jury, including that the result is not supported by the evidence.

9. **Enforcement of the Award.**

Pro. In an arbitration, the prevailing party can file an application with the local court to confirm the arbitration award and enter judgment in conformity with the award. Once a court enters judgment on the arbitration award, the award can be enforced just as any other court judgment, including garnishment of bank accounts and execution and seizure of assets.

Con. Unlike a court judgment which usually allows the party to enforce the judgment within 30 days, an arbitration award cannot be enforced until a lawsuit is filed and a court formally confirms the

arbitration award and enters a court judgment in conformity with the award. This process usually takes ninety days or more.

10. **Legal Errors.**

Pro. In an arbitration proceeding, an arbitrator is not generally bound by legal principles, does not have to explain or justify his decision, and his decision is not reviewed for legal errors. Rather, an arbitrator is generally entitled to make his decision based on what he deems to be just and equitable within the scope of the contract between the parties.

Con. In a court case, the court is required to enforce the terms of the contract between the parties in accordance with the contract's plain terms. Thus, typical provisions in construction contracts such as pay-if-paid clauses, no damages-for-delay clauses, liquidated damages clauses, and clauses requiring timely written notice generally must be enforced in accordance with their terms.

Weighing the Pros and Cons. After weighing these ten pros and cons, the decision about whether to agree to mandatory arbitration frequently turns on whether you view your company as a potential defendant or a potential plaintiff. Those who view their companies as potential defendants frequently strike arbitration provisions from their contracts. Many owners, for example, strike arbitration clauses from their contracts on the simple ground that they think there is no good reason why they should make it easier, less expensive and quicker for a contractor to pursue disputed claims. Using similar logic, many general contractors try to include a mandatory arbitration clause in their contracts with owners, but exclude the clauses from their subcontracts.

Another guiding consideration about whether to agree to mandatory arbitration is how much your company needs to rely upon the written terms and conditions of the contract. Those companies which rely heavily upon risk-shifting clauses such as pay-if-paid clauses and no-damages-for-delay clauses may find that a court is more willing to enforce the clauses as written. In contrast, those companies which view such risk-shifting clauses as an obstacle may find that an arbitrator is more willing to overlook the clauses and make his decision based upon what he deems equitable.

The bottom line is that arbitration may or may not be desirable depending upon how your company evaluates the top ten pros and cons outlined in this article.

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