

I. INTRODUCTION

A. The Problem.

Poor, deluded Eleanor. She might better have dreamt that it was Prime Contractors and Subcontractors who “*joined together*” and attacked, where appropriate, the third parties responsible for job site delays and other problems. Typical construction projects involve numerous parties - a private or public Owner or multiple Owners, a Prime Contractor or possibly multiple Primes, a Lender or two, a Surety or two, numerous Subcontractors, Sub-Subcontractors, Distributors, Suppliers, Manufacturers, Fabricators, Insurance carriers and agents, Sureties and agents, Blue Collars on site, White Collars off site, Architects, Engineers and other Consultants retained by one or more of the other parties, and batteries of Lawyers too often retained only after the fact to treat the wounded.

Some participants are linked by contract; others are not. Some participants impact other participants; others do not. A Manufacturer’s error may injure an Owner. Erroneous plans may impact a Prime Contractor. A Sub-Subcontractor may damage a Prime Contractor or an Owner may injure Subcontractors, but injured parties may find recompense difficult, if not impossible, due to the lack of a contractual relationship with the party responsible. A breach of contract claim may exist against the one with whom it has a contract but, in an age of risk transference, terms of that contract may prevent or greatly limit recovery.

If the injured party seeks redress pursuant to its contract and the other party agrees to pass the claim, and any attendant liability, through to a responsible third party, they must then consider the means and methods of doing so. The problems are multi-faceted, complex and diverse and led one Court, a master of understatement, to comment:

*“This is indeed a troubling area of the law.”*¹

B. Scope of Paper

The theme of the Forum’s 1998 annual meeting is “*Learning from the Past - Building for the Future.*” Liquidation Agreements have been around for years and are

¹ Kensington Corp. v. State of Michigan, 74 Mich. App. 417, 253 N. W. 2d 781, 784 (1977).

responsive to many of the trends that will carry construction law into the future. As the industry moves toward alliances, teaming, partnering and consolidation, a greater need arises for pre-planning for dispute avoidance and management. Good faith cooperation can keep the construction team and project moving forward instead of deteriorating under factional in-fighting. Valuable relationships can be preserved. Recognition of the logic and advisability of placing responsibility on the party which caused a problem can lead to settlements that bypass the intermediary by the vehicle of a Liquidation Agreement.

Whether reached by direct negotiation or with the assistance of a Mediator, these Agreements require a thoughtful and fair analysis of fault and risk. If counsel try to cover every base, every possibility, regardless of client cost and regardless of a fair analysis of fault, and if parties cannot trust, or think they cannot trust, another party to act in good faith when pursuing a claim, Liquidation Agreements will be under-utilized and ineffective.

The primary purpose of this paper is to discuss the handling of “*pass through claims*” by negotiated “*liquidation agreements*” that cope with problems posed by the lack of contractual privity and with Court-imposed restrictions on the ability to present such claims. It is not our intent to present a comprehensive discussion of privity per se. Treatment of Court-imposed restrictions and liquidation agreements is central to our purpose. An exhaustive review of Court treatment of pass through claims not involving liquidation agreements is not.

We hope to provide the construction lawyer with a strong understanding of the advantages and disadvantages of liquidation agreements, a checklist with comments on issues that should be considered for inclusion in liquidation agreements, and a few samples from which the reader may borrow what seems most valuable.

C. Definitions

01. Pass Through Claims are claims by an allegedly damaged party against an allegedly responsible party with whom it has no contractual relationship and which are presented by or through an intervening party in privity with both.

02. Liquidation Agreements (also known as “*Liquidating Agreements*”, “*Pass Through Agreements*”, “*Prosecution Agreements*”, “*Joint Prosecution Agreements*”, “*Litigation Agreements*”, “*Pre-litigation Agreements*”, “*Sponsoring*”

Agreements” and probably a few others we’ve missed) are a form of or portion of a settlement agreement in which a dispute between two parties with contractual privity is liquidated (“*settled*”) on terms delineating the rights, responsibilities and procedures for presenting a Pass Through Claim to a third party and allocating the costs expended and benefits received when doing so. They are an attempt by the parties to avoid an extra layer of litigation (i.e. litigation between themselves) with its attendant costs and risks by focusing on the party allegedly responsible.

a. While Liquidation Agreements are, and should be, written, an oral Liquidation Agreement may be enforceable. See Hubble Elec., Inc. v. State, 583 N.Y.S. 2d 112 (Ct. Cl. 1992).

II. THE PRIVITY PROBLEM

A. Privity.

Privity is “*a connection, or bond or union, between parties, as to some particular transaction*”. Webster’s New Collegiate Dictionary (G. & C. Merriam Co., 6th ed.).

Privity of contract “*is that connection or relationship which exists between two or more contracting parties. It is essential to the maintenance of an action on any contract that there should subsist a privity between the plaintiff and defendant in respect of the matter sued on.*” Black’s Law Dictionary (West Publishing Co., revised 4th ed., 1968).

B. Privity Required.

Subcontractors may generally not make contractual claims against a governmental Owner without establishing privity of contract, but may make such claims if a contractual relationship can be shown. See W. R. Cooper General Contractor, Inc. v. United States, 843 F.2d 1362 (1988), remanding a Subcontractor’s action where the possibility of an express or implied contract existed between the Subcontractor and Government or between a City and Government of which the Subcontractor was a beneficiary, and United States v. Johnson Controls, Inc., 713 F.2d 1541 (Fed. Cir. 1983), holding a Subcontractor had no privity of contract with the Government and the Armed Services Board of Contract Appeals erred when it assumed jurisdiction. (The latter case includes a good discussion of the privity issue as it relates to the Contract Disputes Act of 1978, 41 U.S.C. §601 et seq., of the definition of “*contractor*” under that Act, and of various contract provisions.)

If Subcontractors try to make contractual claims directly against the governmental Owner without contractual privity, the claims are routinely rejected. Petition of Arcon, Inc., ASBCA No. 44572-664, 93-1 B.C.A. (CCH) ¶25,557 (1992); Appeal of Technic Services, Inc., ASBCA No. 38411, 89-3 B.C.A. (CCH) ¶22,193 (1989); Riley Creek Lumber Co., AGBCA No. 84-312-1, 85-2 B.C.A. (CCH) ¶17,958.

C. The Contract Bypass.

Where Courts have been able to find a contractual nexus between the Owner and a Subcontractor, a direct claim will be allowed. For example:

1. Joint Checks. When a Subcontractor refused to extend credit unless the Prime Contractor and Government consented to a joint check arrangement, the Government agreed. When the Government then paid the Prime directly and the Prime became insolvent, the Court held the purpose of the joint check agreement was to benefit the Subcontractor as a third party beneficiary. D & H Distributing Company v. United States, 102 F.3d 542 (Fed. Cir. 1996).

2. Assignment. When a Prime Contractor assigned its right to receive Government payments to its bank, the Government's contracting officer agreed to name the bank as payee. When the Government then paid the Prime directly and the Prime filed bankruptcy, the bank filed suit. The Court, citing D&H, supra, held the bank was the intended beneficiary of the assignment and a third party beneficiary entitled to recover from the Government and the Government was therefore obligated to pay the Bank "*under the contract*". Norwest Bank Arizona, NA. v. United States, 37 Fed. Cl. 605, 610 (1997).

a. Similarly, in Topco, Inc. v. Montana Department of Highways, 912 P. 2d 805 (Mont. 1996), a Prime assigned its rights regarding a portion of a highway contract to the Subcontractor that performed that portion of the work and the Sub sued the Department directly. The Court held the assignment valid and ordered recovery for the Sub at the Prime's price, a price that included more than a 50% mark-up on the Sub's quote to the Prime.

3. Agency. A contractual relationship may be found and privity established where the Prime Contractor was a "*mere government agent*". Kern-Limerick v. Scurlock, 347 U.S. 110, 74 S.Ct 403, 98 L.Ed. 546 (1954); Western Union Telegraph

Co. v. United States, 66 Ct. Cl. 38 (1928). Agency parameters, however, are narrow. United States v. Johnson Controls, Inc., supra at 1551.

4. Implied Contract. In Seger v. United States, 469 F. 2d 292 (Court of Claims, November 10, 1972), a Sub attempted to avoid Severin, infra, by arguing an excessive number of changes by the Owner resulted in abandonment of the original Contract and creation of new implied contracts. The Court did not adopt or reject the theory but, on the facts, found the Owner's direct dealings with the Sub were for convenience only and created no privity. The changes were not excessive and did not result in a product essentially different from that originally contemplated.

5. Subrogee. While no cases have been found in which an Owner filed a pass through claim against a Subcontractor, National Cash Register Co. v. Unarco Indus., Inc., 490 F.2d 285 (7th Cir. 1974), did permit an Owner to sue a Subcontractor as an "*equitable subrogee*" of the Prime's breach of contract claim.

6. Third Party Beneficiary. D & H Distributing, supra, viewed the Subcontractor as a third party beneficiary of a joint check arrangement. Similarly, an Owner may be viewed as a third party beneficiary of the Prime Contractor - Subcontractor agreement. See Jardel Enterprises, Inc., v. Triconsultants, Inc., 770 P.2d 1301 (Colorado 1988), and Aetna Casualty & Sur. Co. v. L.K. Comstock & Co., 488 F.Supp. 732 (Nevada 1980).

D. The Tort Bypass. Tort theories offer hope, a potential detour to avoid the privity problem, but are not without limitations.

1. Theories. A Subcontractor might, for example, try to establish a direct action against an Owner for negligence by showing a duty of care owed by the Owner and a breach of that duty that was the proximate cause of the injuries suffered. Similarly, a Claimant may find a basis for alleging negligence per se, strict liability or peculiar risk. See, for example, Smith v. ACandS, Inc., 31 Cal. App. 4th 77 (1994), involving asbestos installation. Especially in personal injury cases liability may be imposed despite a lack of privity if the circumstances constituted a "*peculiar*" or "*special*" risk as in Jiminez v. Pacific, 185 Cal. App. 3d 102 (1986) (Prime liable for death of Employee of Sub), but see Privette v. Superior Court, 5 Cal. 4th 689 (1993) limiting the scope of peculiar risk in

California. A Subcontractor may also try to prove reliance on a negligent or intentional misrepresentation by an Owner or an Owner's agent. See, for example, Moorman Manufacturing Co. v. National Tank Co., 91 Ill.2d 69, 435 N.E.2d 443 (1982) and Murphy v. City of Springfield, 738 S.W.2d 521 (Mo. Ct. App. 1987).

2. Limitations. Other than factual difficulties affecting the burden of proof, the most significant limitation on negligence claims is the Economic Loss Rule. Economic losses include damages incurred for “*inadequate value, costs of repair and replacement of defective product, or consequent loss of profits - without any claim of personal injury or damage to other property*”. Note, Economic Loss in Products Liability Jurisprudence, 66 Colum. L. Rev. 917, 918 (1966). In the construction context, the Rule, when strictly applied, prohibits tort recovery when a product causes “*economic loss*” by damaging itself but doesn't cause personal injury or damage to property other than itself.

a. A full discussion of the ELR is beyond the scope of this paper but several contributors to The Construction Lawyer, the publication of the ABA's Forum on the Construction Industry, have kept members well-informed. See House & Bell, “*The Economic Loss Rule: A Fair Balancing of Interests*” (April 1991); Cheezem, “*Economic Loss in the Construction Setting: Toward an Appropriate Definition of 'Other Property'*” (April 1992); Lesser, “*Economic Loss Doctrine and Its Impact Upon Construction Claims*” (August 1994); Feinman, “*Economic Negligence in Construction Litigation*” (August 1995). Also see Ewell, “*Damages: California's Economic Loss Rule Revisited*”, California Construction Law Reporter (Shepard's McGraw-Hill, October 1991), discussing J'Aire Corp. v. Gregory, 24 Cal. 3d 799, 598 P. 2d 60 (1979) (holding a demurrer to a Complaint by a Lessee against a Prime who had contracted with the Lessor should not have been sustained).

b. The ELR may not be strictly applied. See “*Economic Loss Rule Weakened in Delaware*”, Construction Law Adviser (Callaghan & Company, May 1991), discussing Guardian Const. Co. v. Tetra Tech Richardson, Inc., 583 A.2d 1378 (Del. Super 1990) where a Prime and Sub were not barred by a lack of privity from seeking to recover damages allegedly caused by a design engineer's negligence. The Court reasoned, based on the Restatement (Second) of Torts §552, that when the engineer

prepared project specifications and conveyed the information to bidders, it knew and intended that the information be supplied to others and relied upon. Another Court has indicated the ELR exception based on §552 must be “*rigidly applied and narrowly construed*” and limited to one “*in the business*” of selling information on which its customers rely when “*taking additional information*” and, even if a design professional is “*in the business*” (which this Court held it was not), the Sub must have relied on the representations. Palco Linings, Inc. v. Pavex, Inc., 755 F. Supp. 1269, 1274 (M.D. Pa. 1990).

III. SEVERIN DOCTRINE

A. Severin. So who was Nils Severin and why does he have a Doctrine? A partnership of Nils and Alfred Severin, as Prime Contractor, entered into a contract with the United States government, as Owner, for construction of a post office and hired a Sub pursuant to a Subcontract providing:

The Contractor ... shall not ... be held responsible for any loss ... or delay caused by the Owner ... or any other cause beyond the control of Contractor ... or in any event for consequential damages.

When completion was delayed by the Owner, the Prime filed a claim for its damages and those of its Sub. The Sub’s damages were \$737.10 and the Prime’s a 10% mark-up of \$73.71. The Prime’s mark-up was allowed but the Sub’s damages were not. According to the Court, the Sub could not sue the Owner directly since there was no “*privity*” and the Owner had not otherwise consented to be sued. The Prime could recover its own damages but could not recover the Sub’s damages since, by virtue of the explicit language of the Subcontract, it had no obligation to the Sub. Severin v. United States, 99 Ct. Cl. 435 (May 3, 1943); cert. denied, 322 U.S. 733.

B. Severin Progeny. It is sometimes said that exceptions to Severin have overcome the rule.

1. Total Release and Non-Reimbursement. For Severin to bar recovery, the injured party must not have already been reimbursed for its losses and it must not have totally released all claims against the party with whom it contracted. A total release

through a subcontract exculpatory clause is “intended to insulate the general contractor from the possibility of being (1) liable to the subcontractor for delay caused by the Government, yet (2) unable to recover from the Government.” Blount Brothers Construction v. United States, 348 F.2d 471, 474 (1965); Schiavone Constr. Co. v. Triborough Bridge & Tunnel Auth., 619 N.Y.S. 2d 117 (App. Div. 1994). As stated by Blount, a Prime Contractor “may sue the Government for damages incurred by one of its subcontractors through the fault of the Government . . . only when the prime contractor has reimbursed its subcontractor for the latter’s damages or remains liable for such reimbursement in the future. These are the only ways in which the damages of the subcontractor can become, in turn, the damages of the prime contractor, for which recovery may be had against the Government.”

a. In Blount, the exculpatory clause, although not necessary for the Court’s decision, was less than total since it relieved the Prime of liability to its Sub provided the Prime “cooperate with Sub-Contractor to enforce any just claim against the Owner or Architect for delay”.

b. In the Appeal of Castagna & Son, Inc., General Services Administration Board of Contract Appeals No. 6906 (July 20, 1984), the Government thought a Subcontract provision that the Prime “shall not be liable to the Subcontractor for any delay caused by . . . the Owner” was pretty clear but the Board agreed with the Prime that another provision obligated it to “present” Subcontractor claims to the Government and, read together, they were less than a total release. What is “passed through”, said the Board, is not simply a claim but the Prime’s liability to the Subcontractor on that claim and it recognized the numerous restrictions on Severin.

c. In Cable Belt Conveyers, Inc. v. Alumina Partners, 717 F. Supp. 1021 (S.D.N.Y. 1989), the Prime and Sub agreed to cooperate and jointly litigate claims against the Owner and their agreement was held to merely liquidate the Prime’s liability to the Sub based on the result of their consolidated action against the Owner.

d. A similar joint litigation agreement was attacked differently (but with the same result) in Affholder, Inc. v. Preston Carroll Co., Inc., 866 F.2d 881 (6th Cir. 1989). A Prime Contractor and Subcontractor on a public project in Kentucky entered into an Agreement that neither would seek recovery from the other with respect

to claims relating to changed conditions and/or design errors, but would cooperate with each other, the Subcontractor would file suit and the Prime would appear “*to facilitate the joining therein of all parties who are, or might be, appropriate*”. [The full text of their Agreement appears in the Appendix.] The Sub sued the Prime and the Prime filed a third-party Complaint for indemnity and delay damages against the public owner and other parties including those who provided management, soil testing and other services. The third parties claimed the Agreement eliminated any “*case or controversy*” under the U.S. Constitution, Article III, and the District Court agreed and dismissed the claims of both the Sub and Prime, but the Court of Appeals disagreed. Settlement of a claim before final adjudication deprives the Court of jurisdiction, but this Agreement was not a “*settlement*”. The Sub and Prime had resolved neither liability nor the issue of damages but merely placed a limit on the amount they might recover (i.e. the amount recovered from third parties).

e. In a unique twist, a Prime and Sub entered into a Liquidation Agreement, the Prime sued the Owner and they settled the suit. The welching Prime later argued it owed none of the settlement to the Sub. “*Au contraire*”, said a pragmatic Court. A deal’s a deal and the Sub had surrendered its right to proceed against the Prime in reliance on the Prime’s agreement to present the claims to the Owner. Nolfi Masonry Corp. v. Lasker-Goldman Corp., 553 N.Y.S. 2d 156 (App. Div. 1990).

2. Equitable adjustments. Where a claim seeks recovery of money damages or time extensions “*pursuant to*” the Prime Contract rather than for “*breach of*” the Prime Contract, Severin does not apply and an “*equitable adjustment*” may be allowed. “*The Severin rule where it is applicable produces harsh results. Where the provisions of the prime contract provide a mechanism that in a proper case can mitigate injury to the subcontractor, and such provisions are incorporated by reference in the subcontract, abstract legal doctrines of privity and exculpatory clauses in the subcontract do not control*”. Seger v. United States, *supra* at 300. Also see Blount, *supra*, and Owens-Corning Fiberglas Corporation v. United States, 419 F. 2d 439 (Court of Claims, December 12, 1969).

a. In Blount the Owner directed its Prime to stop work on a portion of a project. The Prime notified the Owner that its Sub “*agreed to accept a hold order on*

this equipment at no additional cost to the Government, subject to the condition that this work shall not be reentered at a later date” and the Owner replied that the “*condition*” was “*adequately covered by the change order provisions of the contract*”. When the Owner later instructed the Prime to proceed with the work, the Prime requested a Change Order to compensate it and its Sub. The Owner argued the request was barred by Severin, but the Court ruled it was not since the claim was being made pursuant to the change order provisions of the contract and was within “*the supplemental agreement*” of the parties.

b. In Owens-Corning a Subcontractor and Sub-Subcontractor brought a claim “*by and through*” the Prime for an equitable contract adjustment for faulty specifications on a public project. While the more frequently used “*for and on behalf of*” would have pleased the Court, it swallowed hard and on the “*proper plaintiffs*” or “*standing to sue*” issue decided Primes typically have been allowed to sue for the use and benefit of Subs. Severin was not applicable “*since the claim presented here has been repeatedly and expressly reserved and excepted*” in the format approved by this same Court in Donovan v. United States, 149 F. Supp. 898 (Ct. Cl. 1957), cert. denied, 355 U.S. 826, and “*its language and substance parallel that in Barnard-Curtiss*”. Severin was also distinguished on the ground that “*this is not a suit for damages for breach of contract*” but “*a claim for an equitable adjustment by a prime contractor pursuing a remedy redressable under the [prime] contract terms*”. In similar circumstances, Blount held the exculpatory language did not affect the Prime’s liability to its Sub “*insofar as claims under the prime contract were concerned. Therefore, if the present claims are encompassed by the terms of plaintiff’s contract with the Navy, then the Severin rule is not a bar*” since “*the Government warrants the sufficiency of its specifications*” and should respond “*in damages or equitable adjustment*” if they’re defective. See U.S. v. Spearin, 248 U.S. 132 (1918) and Leaderman, “*The Spearin Doctrine: It Isn’t What It Used to Be*”, The Construction Lawyer (October 1996).

c. In Seger it was reiterated that Severin does not apply if a Sub’s delay claims may be included as an “*equitable adjustment*” within the terms of the prime contract but does apply if the Prime is asserting a “*breach of contract*” claim. “*The Severin rule where it is applicable produces harsh results. Where the provisions of the*

prime contract provide a mechanism that in a proper case can mitigate injury to the subcontractor, and such provisions are incorporated by reference in the subcontract, abstract legal doctrines of privity and exculpatory clauses in the subcontract do not control.” The Sub attempted to avoid Severin by arguing an excessive number of changes by the Owner resulted in abandonment of the original Contract and creation of new implied contracts. The Court did not adopt or reject the theory but, on the facts, found the Owner’s direct dealings with the Sub were for convenience only and created no privity. The changes were not excessive and did not result in a product essentially different from that originally contemplated.

i. Where the Prime Contract does not allow equitable adjustments and the Prime’s only remedy is a breach of contract action against the Owner, the Prime will usually want exculpatory clauses in its Subcontract to prevent it from being liable to its Sub for Owner-caused delays. The need for such exculpatory Subcontract clauses does not exist if the Prime Contract provides the Owner will pay the Prime for unreasonable delays.

3. Equitable Lien. In Blue Fox, Inc. v. SBA, 121 F.3d 1357 (9th Cir. 1997), the Army failed to require the Prime to post a Miller Act bond. When a Subcontractor was unpaid it told the Army and the Army fired the Prime, hired a Replacement Prime and paid the contract balance to the Replacement. The Sub then filed a claim against the Army claiming an equitable lien on the contract balance on hand when the Prime was terminated. The Army felt it was protected by sovereign immunity but the Court concluded an action for an equitable lien is not a contract action for damages and immunity was waived. Even though the Army had paid the funds to the Replacement, it ran the risk and would have to pay twice.

4. Liquidation Agreements. In J. L. Simmons Company, Inc. v. United States, 304 F. 2d 886 (Ct. Cl. 1962), a Prime sued on its behalf and on behalf of Subs for damages caused by the Government’s alleged breach of contract in failing to provide a workable design for foundation work. Subsequent to completion, the Prime and each of the involved Subs signed a “*Subcontractor’s Waiver of Lien and Release*” providing that in any claim prosecuted by the Prime, the claims of the Subs would be included. Most expenses would be borne by the Prime but the Subs would pay for attendance of their

witnesses and preparation of their documents. The Prime (except in one instance) would pick the attorneys, contingent attorney fees would be allocated and:

Either the disallowance of the undersigned's claim by the court or the payment to the undersigned" Subs by the Prime 'of the amount, if any, that may be recovered" (less specified expenses and fees) 'shall completely extinguish all further obligation of" the Prime to the Subs 'and shall operate as a full and complete release of any and all liability"' of the Prime to the Subs.

This, said the Government, was a clear Severin situation since the Prime owed the Subs if and only if and to the extent it recovered from the Government. The Court reiterated that a Prime may sue on behalf of its Subs "*only when the prime contractor has reimbursed its subcontractor for its damages or remains liable*" and, even though the subject provisions were "*somewhat inartistic*" neither they nor their related subcontracts expressly negated the Prime's liability to its Subs. Instead, they recognized a liability and established the manner in which it was "*to be*" extinguished by requiring the Prime to prosecute the claims.

a. If the subcontract is silent as to ultimate liability of the Prime to the Sub, suit is usually permitted (e.g. Warren Brothers Roads Co. v. United States, 105 F.Supp. 826 (Ct. Cl. 1952), and J. W. Bateson Co., Inc. v. United States, 163 F.Supp. 871 (Ct.Cl. 1958)) and the same is true where the Prime has agreed to reimburse its Sub "*only as and when the former receives payment for them from the Government*" (Donovan, supra; Barnard-Curtiss, infra).

b. In Barnard-Curtiss v. United States, 301 F.2d 909 (Court of Claims, April 4, 1962), a Prime subcontracted a portion of its New Mexico earthen dam project to a Subcontractor. The project was damaged by "*an unprecedented and unforeseeable amount of rain*" and the Prime sued for earth it replaced and for dewatering work by the Sub pursuant to a "*Mutual Release*" including a pass through agreement providing the Prime "*is prosecuting in behalf of*" the Sub "*a claim for work done by*" the Sub. "*Any amount which*" the Prime "*receives from the government with respect to*" the Sub's "*claim is excepted from this release, and*" the Prime "*agrees to forward such sums it may collect when received.*" The Court agreed with the Government that the Prime could not recover the Sub's money without first showing "*it*

is liable to the subcontractor for the amount” but rejected the Government’s argument that the above language precluded such a showing. “*This language is substantially the same as the ‘as and when’ clause sustained by this court against a similar attack*” in Donovan. “*Consequently, we hold that Plaintiff may recover*” the Sub’s damages.

5. Burden of proof. The Owner generally has the burden of proving the Prime has no liability to its Sub. The Prime does not have to prove it does have liability. Kensington Corporation v. State of Michigan, 253 N.W. 2d 781, 784 (1977); Morrisson-Knudson Co. v. United States, 397 F.2d 826 (1968).

6. State laws vary. Practitioners will have to examine the treatment given by their specific states, but a few examples might indicate some of the variations.

a. **Connecticut.** In Federal Deposit Insurance Corporation v. Peabody, N.E., Inc., 239 Conn. 93, 680 A. 2d 1321, 1327 (1996), a state Supreme Court indicated Connecticut takes its sovereign immunity seriously. The State hired a Prime who hired a Sub. The Sub made claims the Prime blamed on the State. The FDIC (as successor in interest to the Sub) sued the Prime who interpleaded the State who moved to dismiss. The motion was denied and the State appealed and won. According to the majority, “*a contractor cannot implead the state in an action against the contractor by a subcontractor unless the contractor admits liability to the subcontractor and incorporates the subcontractor’s claim into its own, so that the contractor then has a disputed claim under its own direct contract with the state*”. An admission of liability to the extent of recovery from the State, said the Court, is “*actually not an admission at all.*” The more enjoyable portion of the opinion is the dissent in which Associate Justice Berdon, a lone voice of reason, chided the majority for its “*archaic legalism*”, narrow definition of “*disputed claim*” and opinion “*not in the best interest of the state*”.

i. The majority’s analysis was based on sovereign immunity and the Court recognized a different result might have been reached in the “*private sector*”. Supra, page 1326.

b. **Louisiana.** Farrell Construction Co. v. Jefferson Parish, Louisiana, 896 F.2d 136 (5th Cir. 1990) considered the status of a Subcontractor to a liquidation agreement as a real party in interest for such matters as diversity.

c. **New York.** Does your state require the Sub to make a formal claim against the Prime? New York allows Primes to prosecute actions for Subs if there is an agreement between them, either in the Subcontract or Liquidating Agreement, that the Prime will pay over any sums recovered. The Owner argued (1) the Sub must assert an actual claim against the Prime and had not and (2) the Prime was contractually responsible for any Owner-caused delays its Sub might incur. The Trial Court dismissed the pass-through claims but was reversed on appeal. New York law does not require assertion of an actual claim by a Sub as a condition precedent to the Prime's action against the Owner on pass-through claims. The Court distinguished between an agreement (a) to be responsible for Owner-caused delay and (b) only to be liable to the Sub for damages proved and recovered from the Owner on the Sub's behalf. Schiavone Construction Co. v. Triborough Bridge & Tunnel Authority, 619 N.Y.S. 2d 117 (1994). Also see American Standard v. N.Y.C. Transit Auth., 519 N.Y.S.2d 701 (1987), and Lambert Houses Redevelopment Co. v. HRH Equity Corp., 502 N.Y.S.2d 433 (1986).

i. But see Mars Assocs. v. New York City Educ. Constr. Fund, 513 N.Y.S.2d 125 (1987), where a Prime's claim seeking indemnification from the Owner for amounts claimed by its Subcontractors was held not appropriate since the Prime had not admitted liability to its Subs in liquidation agreements

d. **New York.** John B. Pike and Son, Inc. v. New York, 647 N.Y.S.2d 654 (Ct. Cl. 1996). The Prime made a claim against the State for losses incurred by its Sub, but the Prime had no liquidation agreement with its Sub to pass through the damages. The Court held the Prime could not pursue the unliquidated damages of its Sub. The Sub and Prime had settled a lawsuit for \$75,000 and the Prime was assigned all claims, claims that exceeded the settlement amount. The Court noted that absent a liquidation agreement, the Sub had no claims against the State which it could assign. Thus the Prime was limited in recovering against the State to the amount of the settlement.

IV. PROVIDING FOR PASS THROUGH CLAIMS IN THE SUBCONTRACT.

In many cases in which the Severin doctrine has been successfully invoked it is the exculpatory language of the subcontract that has been relied upon to demonstrate

there was no liability of the Prime Contractor to the Subcontractor and, therefore, no liability of the Owner to the Prime. For example, in Severin at page 440, the Court determined there was no liability based upon the following clause:

21st. The Contractor or Subcontractor shall not in any event be held responsible for any loss, damate [sic], detention, or delay caused by the Owner or any other Subcontractor upon the building; or delays in transportation, fire, strikes, lockouts, civil or military authority, or by insurrection or riot, or by any other cause beyond the control of Contractor or Subcontractor, or in any event for consequential damages.

In Donovan Construction v. United States, supra, the Court considered the following contract language favorable to dismissing the pass through claim:

The Subcontractor shall hold and save the Contractor harmless from any liability for damage to the said work, or for injury or damage to persons or property occurring on or in connection therewith.

However, the contract also provided, in connection with the handling and transportation of steel, a provision that the Prime Contractor would pay the Subcontractor for extra work “as and when it is paid therefor by the Principal.” This together with other clauses led the court to decide that the Prime Contractor was obligated to proceed on the Subcontractor’s claim.

In Castagna & Sons, supra, the Board considered and denied the government’s motion to dismiss the Prime Contractor’s claims on behalf of Subcontractors. Relying on Severin the government pointed to the exculpatory provision:

B. Any provision in this Agreement to the contrary notwithstanding, the Contractor shall not be liable to the Subcontractor for any delay caused by the Contractor, or by the Owner, or by any of the Contractor’s other sub-contractors, or for any other cause whatsoever.

On the other hand the Prime Contractor pointed to the subcontract provisions for “pass through” claims:

In the event that the Sub-Contractor shall claim to have sustained any damage by reason of delays or for the performance of additional or different work, or for any other cause whatsoever, which claimed damage is or may be due to any act, omission, direction or order of the Owner, the Sub-Contractor shall not have or assert any claim or prosecute any suit, action or proceeding therefor against the Contractor, but, provided that such claim is prepared by the Sub-Contractor and delivered to the Contractor in proper form for presentation to the Owner, so that the said

claim may be presented to the Owner in the manner and within the time specified in the Construction Contract, the Contractor agrees to present such claim to the Owner, either in its own name or in the name of the Sub-Contractor. The Sub-Contractor shall pay all costs and disbursements including legal fees incurred by the Contractor in the presentation of such claim or claims, including interest on all payments to the Contractor that may be delayed because of the presentation of such claim or claims.

The Board denied the government's motion. It noted that Severin has not been held to apply when the subcontract provides that the Prime Contractor will sue on behalf of the Subcontractor. Castagna & Sons, supra, page 6. In those situations the failure of the Prime Contractor to pursue the claims of its Subcontractors would constitute a breach of contract, exposing the Prime Contractor to liability for the claim.

These three cases illustrate that the language of the subcontract can affect whether a pass through claim can be brought and whether there is an obligation to pursue Subcontractor claims. As with most matters having a contractual basis, the parties can shape the results by what they say in the contract. If a Prime Contractor wishes to avoid an obligation to pursue Subcontractor claims, then the subcontract can be written to shift the risk of damages and losses resulting from Owner or architect errors to the Subcontractor and to prevent the Subcontractor from making any claim against the contractor for damages or losses caused by the Owner or other third parties. This is what was done in Severin. However, this exculpatory approach may be strengthened by specifically providing that there is no duty of the Prime Contractor to present a claim on behalf of the Subcontractor (See Appendix 1, Part B, Clause 2).

This exculpatory approach, while protecting one party from liability and burden, does not place the liability and burden on the right party. There are reasons, in addition to a sense of fairness, why the Prime Contractor should consider an approach other than the exculpatory one. Most construction disputes are not so simple that they can be characterized as a Subcontractor claim for damages caused by the Owner without active contractor involvement. Even if there were such a claim, under the circumstances of an exculpatory approach the Subcontractor is likely to make every effort to prove that the contractor was itself responsible or contributed to the loss or harm. Simply put, the Prime Contractor may be left alone as a defendant to the claim and avoid the loss, if it

does, after a judge, jury or arbitrator issues a decision. As is seen in the cases that apply the Severin doctrine, the Prime Contractor may not be able to pursue a pass through claim should it decide to do so contrary to its subcontract. Providing for pass through claims in conjunction with liquidating the damages as the obtained result may, therefore, actually add protection. If you are going to be sued anyway, it may be wiser to provide a mechanism for deflecting the suit to the real culprit. Providing for pass through claims is like practicing jujitsu -- instead of simply resisting the Subcontractor, the Prime Contractor deflects the claim through to the Owner.

In deciding to use fully exculpatory contract provisions or releases, the Prime Contractor and Subcontractor should recognize that once such provisions or releases are in effect, the consequences may be irreversible. Consider George Hyman Const. Co. v. United States, 30 Fed. Cl. 170 (1993). Hyman's Subcontractor made a claim for multiple replacements of a sidewalk at a government project. Inadvertently, the Subcontractor endorsed a check containing a full release. Hyman and the Subcontractor did not intend to release the claim, but to pursue it with Hyman being liable "as and when" it recovered from the government. Consequently, they attempted to "revive" the claim by a liquidation agreement. The government moved for summary judgment on Severin grounds. Hyman argued (1) there was no intent to release and, accordingly, the release could be reformed, and (2) the liquidation agreement was sufficient to revive the claim. The Court granted summary judgment. The Court decided that it lacked jurisdiction to reform a release between a Prime Contractor and a Subcontractor and, "[t]herefore, the general release remains effective and brings this case within the Severin doctrine." George Hyman Const. Co. at 175. With respect to the effort to revive the claim by a liquidation agreement, the Court concluded that once Severin bars the claim, an agreement made after a general release cannot revive the claim. The Court noted that the Court of Claims in Pearson, Dickerson, Inc. v. United States, 115 Ct. Cl. 236 (1950) had held that a subsequent stipulation of liability by the Prime Contractor for the amount to be recovered in a pass through case was ineffective. In addition, the Court noted that J. L. Simmons Co., 304 F.2d at 888-889, stated that once the Subcontractor exonerated the Prime Contractor from liability, suit could not be maintained. To permit the parties to

revive liability “would essentially nullify the Severin doctrine in every action....” George Hyman Const. Co. at 177.

It is possible for the contract to promote pass through claims and liquidation agreements by directly setting forth the way in which pass through claims will be handled. Indeed, one court has noted that the subcontract could actually serve as the liquidation agreement. Schiavone Construction Co. v. Triborough Bridge & Tunnel Auth., supra. Part A of Appendix 1 illustrates several efforts by Prime contractors to limit their liability while still providing for pass through claims. Clause 1 of Part A is a disputes clause that contains the principal terms of a liquidation agreement, limiting the damages recoverable from the Prime Contractor to what may be recovered from the Owner and dictating the methods under which the claim will be presented. While there is little question that the subcontract can contain a liquidation agreement, the authors believe the factual and legal context in which construction disputes arise are complex enough and that a liquidation agreement should be attempted only after the specifics of the dispute are known.

In drafting a subcontract to allow pass through claims while limiting the extent of the recovery, the level of detail can vary enormously. The drafter should directly address the matter rather than relying on incorporation of the Prime Contract by reference or a flow down clause to create the sort of relationship necessary for a liquidation agreement. In Barry, Bette & Led Duke, Inc. v. New York, 645 N.Y.S.2d 713 (Cl. Ct. 1996) the Court considered an Owner’s challenge to the right of a Prime Contractor to bring a pass through claim. The Owner argued there were no contractual provisions stating that the Prime Contractor was liable to the Subcontractor. The Court reviewed various contractual provisions. It held that a flow down clause which obligated the Prime Contractor to the Subcontractor for “all the obligations that the Owner assumes to the Contractor” simply meant that whereas Owner was responsible for the Owner’s delay to the Prime Contractor, so the Prime Contractor was responsible for the Prime Contractor’s delay (not the Owner’s) to the Subcontractor. The Court also regarded subcontract provisions which allowed the Subcontractor to be present to submit evidence and even to name the Arbitrator to be insufficient to create adequate liability in the Prime Contractor to support a claim against the Owner. There was no subcontract provision obligating the

Prime Contractor to pursue claims or making the Prime Contractor liable for the claims. The Court in Barry went on to find a liquidation agreement in the course of conduct of the Subcontractor and Prime Contractor during the eight years of litigation.

Of course, in drafting a subcontract that requires the Prime Contractor to present a pass through claim, the Prime Contractor must recognize that it is providing a basis for its own liability if it fails to make the presentation. *See, e.g., J. L. Simmons Co. v. United States*, supra (agreement imposed certain obligations on contractor to present the Subcontractors' claims which it must fulfill before its liability is extinguished); Castagna & Sons, supra (failure to pursue the subcontractors' claims would constitute a breach of contract).

V. DRAFTING LIQUIDATION AGREEMENTS

No fixed form is required for the agreement between the Prime Contractor and Subcontractor with respect to presentation of a pass through claim. It may be memorialized in the subcontract or in a separate written agreement, or it may be verbal or implied from conduct. *See Barry, Bette & Led Duke, Inc. v. New York*, 645 N.Y.S.2d 713 (Ct. Cl. 1996). Given the diverse levels of acceptance of liquidation agreements by the courts and the complexity and diversity of the context in which claims arise and may be frustrated, a writing seems wise. For example, consider the problems confronting the Subcontractor in Riley Creek Lumber Co., AGBCA No. 84-312-1, 85-2 B.C.A. (CCH) ¶17,958. In that case the Agriculture Board of Contract Appeals had before it a claim of a Subcontractor to Riley Creek Lumber Co. and a challenge by the government claiming that the Riley Creek Lumber Co. was not sponsoring the claim. The Subcontractor presented evidence that it had the sponsorship of Riley Creek Lumber Co. as shown by contract documents, correspondence and an unsigned stipulation, but it could not produce a liquidation agreement or even a signed agreement allowing the use of the Prime Contractor's name. The Board was not satisfied that Riley Creek Lumber Co. was sponsoring the claim and dismissed.

In this section of the paper, therefore, we examine a wide variety of items that should be considered in drafting liquidation agreements. Courts and boards have discussed many liquidation agreements, but other than provisions regarding liability and

limitation on damages, most provisions have been mentioned or illustrated without any comment. Only one case was found where the terms of the liquidation agreement were being litigated between the parties to the agreement. HOH Co. v. The Travelers Indem. Co., 903 F.2d 8 (D.C. Cir. 1990). Consequently, much of what follows will provide counsel with issues and ideas instead of conclusions and court holdings. Appendix 2 provides four sample liquidation agreements. Appendix 3 contains the authors' "Liquidation Agreement Checklist." The topic order in this section follows that of the "Liquidation Agreement Checklist."

A. Identification of parties and persons to be bound.

It goes without saying that the liquidation agreement should be between the party with the claim and the party passing through the claim, and that it should cover the usual successors in interest and assignees. However, counsel should consider whether to include other persons such as sureties, sub-subcontractors, and suppliers.

A review of United States Fidelity & Guar. Co. v. Ernest Const. Co., 854 F. Supp. 1545 (M. D. Fla. 1994) demonstrates the need to consider binding the Prime Contractor's surety to the liquidation agreement. In that case, a Subcontractor encountered differing site conditions and notified the Prime Contractor, who notified the government and the Prime Contractor submitted the Subcontractor's claim. The Prime Contractor submitted the Subcontractor's claim. The Prime Contractor fell behind on the project and the government had a right to impose liquidated damages, but agreed not to do so until the claim had been reviewed. The Prime Contractor and its Subcontractor entered into a liquidation agreement with the Prime Contractor admitting liability for the equitable adjustment, but only in the amount to be granted. The surety was not a party to that agreement. There was an attempt to add the surety, but the surety insisted that liability be extinguished when the claim was "collected or recovered" while the Subcontractor insisted that liability be extinguished when the claim was "collected." The contracting officer denied the claim and imposed liquidated damages. The Prime Contractor's surety, who would end up paying the liquidated damages, appealed both the liquidated damage assessment and the denial of the Subcontractor's claim. The Board granted the claim but allowed only a small extension of time which made only a small reduction in

the liquidated damages. Subcontractor negotiated the claim amount and agreed with the government on \$425,000 with interest. The surety insisted that the government offset the claim against the liquidated damages and, accordingly, the surety paid the government only the difference and refused to pay the Subcontractor any amount. The Subcontractor sued the surety.

At this point in the story of Ernest Const. Co., it should be clear that binding the Prime Contractor's surety to the liquidation agreement should be considered. While the point is made, we should complete the story. The surety claimed it was not liable to the Subcontractor on its bond since the suit was untimely and it was not otherwise liable because its claim, based upon payment of the liquidated damages, would have priority to the Subcontractor's pass through claim. The Court agreed that the surety was not liable on the bond due to untimely filing, but the Court did not agree the surety had the right to use the government's right to offset against the Subcontractor. After a lengthy analysis, the Court held that the Subcontractor had priority to the funds in this case. Ultimately, the Court granted the Subcontractor summary judgment against the surety on a breach of constructive trust theory.

There is a second case that illustrates why one should consider adding sureties as parties to the liquidation agreement, but this case involves the Subcontractor's sureties. In HOH, supra, the Prime Contractor filed suit to require Travelers, the surety for one of its Subcontractors, to reimburse the Prime Contractor for legal fees incurred in pursuing the Subcontractor's claim via a liquidation agreement. Again the fact that the surety was not an express party to the liquidation agreement was the reason there was the resulting litigation. The surety claimed that the liquidation agreement was not a subcontract modification binding on it. The Court disagreed, the Prime Contractor was entitled to enforce it and the surety was bound to the modification by the terms of the bond. The express agreement of the surety was not necessary, but its advance agreement to the liquidation agreement should have been considered.

While we have found no cases in which sub-subcontractors or suppliers were involved in liquidation agreements between Subcontractors and contractors, consideration should be given to joining them in the liquidation agreement. Sub-subcontractors and suppliers may have lien or bond claims directly against or directly

affecting the Prime Contractor which are not avoided by exculpatory or pass through language of the subcontract. While the Subcontractor may be forced to wait on the results of a pass through claim, these others may be entitled to much quicker payment. In any case, review all the companies that may have a stake in the claim and consider whether it would be beneficial to include them. Many of the reasons noted in the discussion of negotiation (Section VI) apply to sub-subcontractors and suppliers.

B. Identification of the dispute.

It is necessary to clearly, frankly and fairly identify the claim or claims that will be the subject of the pass through. Only by doing so will many of the other terms of the liquidation agreement be clear. For example, without a clear identification of the claim, a provision with regard to allocation of attorney's fees may be difficult to apply. A clear identification of the claim will be sufficient for the written liquidation agreement. In considering and evaluating the liquidation agreement, we have noted that the claim must be "frankly and fairly" identified; that is, the facts concerning the claim need to be brought out. Only by doing so can the parties fully assess what defenses or counterclaims they will encounter. At the start of the negotiation of a liquidation agreement the parties should recognize that their discussions are settlement discussions and subject to the evidentiary privileges of settlement discussions. The fact that negotiation of a liquidation agreement is a settlement discussion, however, does not provide any confidentiality between the parties concerning facts that are otherwise discoverable. The joint defense doctrine or common interest privilege discussed below does not apply until there is an agreement to pursue and defend. The parties should expect that neither side will reveal all of its weaknesses, but an effort to identify the expected weaknesses and, therefore, the possible defenses and counterclaims will allow the parties to write a more comprehensive agreement.

Frequently, there will not be a single pass through claim. The liquidation agreement in Appendix 2, Agreement No. 4, illustrates just how complex the claims can be -- a series of Subcontractor claims, a series of Owner backcharges and a Prime Contractor with direct and pass through claims against the Subcontractor and with direct and pass through claims against the Owner. If the individual claims are identified and

itemized, then each can be treated as a distinct claim. When the claims multiply, the possibility of successfully negotiating a liquidation agreement are reduced.

C. The liability of the Prime Contractor to the Subcontractor.

From the perspective of the Prime Contractor and the above discussion of Severin, it is clear that the complete total release of the Prime Contractor of liability is the end of the pass through claim. A key provision in the liquidation agreement will be the recognition of some liability on the part of the Prime Contractor passing through the claim.

In John B. Pike and Son, Inc. v. New York, supra, the Subcontractor and Prime Contractor settled their dispute. The Prime Contractor paid the Subcontractor \$75,000 on the claim and took an assignment for the full claim and sued the government. All liability of the Prime Contractor to the Subcontractor above the amount paid had been released. The Court held that the Prime Contractor was limited to recovery of \$75,000. Since the Subcontractor had released the rest of its claim, it had nothing to assign. This result might have been avoided if the Prime Contractor had remained liable to the Subcontractor for the remaining damages, but had limited that liability to the amount received on the claim. The Prime Contractor and Subcontractor would still have had to prepare their agreement so that the Prime Contractor kept the excess. The case illustrates the need to retain a liability context.

Perhaps it is well to point out again that there are states in which an admission of liability limited to the amount recovered may be an insufficient basis for a pass through claim. F.D.I.C. v. Peabody, N.E., Inc., 680 A.2d 1321 (Conn. 1996) (leaving open the possibility in private actions.)

D. Liquidation of Damages.

Of course, the provision for liquidation of damages is the major reason for the liquidation agreement, so it is unlikely that this provision will be overlooked. In most cases the Prime Contractor will want to liquidate the damages on its liability to the amount to be recovered. However, consideration should be given to possible modifications. The parties might agree for the Prime Contractor to make a specific payment in addition to the payment of what is recovered. This situation might arise when the general contractor has some direct exposure on the claim. The parties might agree to

an advance (refundable or not) from the Prime Contractor to the Subcontractor. This situation might arise when the Subcontractor will not agree to the liquidation agreement otherwise or when the Subcontractor's solvency may adversely impact the project. It is possible to liquidate the damages to a sum certain to be paid by Prime Contractor with the liquidation agreement being only a method of litigating the claim and delaying payment. This situation can arise, for example, when the Subcontractor has a direct action against the Prime Contractor and its payment bond and the Prime Contractor wants to be allowed time to recover the amount before it must pay. The parties should not allow their thinking on these matters to be limited to the more common liquidation terms.

For those companies and attorneys dealing with claims in states in which there are no decisions on liquidation agreements, we recommend a review of the cases on liquidated damages generally. There should be precedent for liquidated damages using language that is applicable at least by analogy to cases where the amount is to be decided by set future events.

E. Stipulations.

What are the commonly accepted facts about the claim? The use of stipulations in recitals is commonly used to provide a context for interpretation of the document. Stipulations reached between two parties with potentially adverse interests, while not binding on third parties or courts, however, are persuasive. Some of the legal hurdles can be aided by stipulations or admissions. A stipulation that "Contractor is liable to Subcontractor for twenty-five days' delay due to delay in processing of the submittals" will assist in arguing liability on a specific rather than abstract basis. Of course, any stipulation should be assessed to determine whether it is of assistance to the opposition. Generally, the liquidation agreement will be discoverable and the parties will be bound by stipulations unless a very good case of mistake can be made out.

Stipulations can also be used simply to identify various items that the parties have successfully negotiated. Stipulations can be reached on a variety of factual matters, e.g. who is withholding how much, how many cubic yards of base course was laid. Stipulations can also be reached on a variety of legal areas, e.g. contractual method of presentation of claim. These types of stipulations assist in avoiding future disputes between the parties to the liquidation agreement.

F. Payment Trigger.

In the typical liquidation agreement, the liability of the Prime Contractor has been determined and damages set at the amount to be recovered. Given the expected facts and potential ranges of outcome on various claims and defenses, thought must be given to whether money will actually pass once there is a decision on the claim. Assume that the claim process is over and the final decision has been given by an award in the Prime Contractor's favor on the Subcontractor's claim. The "payment trigger" is the event which converts the Prime Contractor's future liability into a present obligation to pay money. The Subcontractor may want the Prime Contractor obligated to pay the claim at the time the claim has been determined. The general contractor will not want the obligation to pay to commence at that time but only when the amount of the claim has been actually paid by the Owner. Thus, the first liquidation agreement in Appendix 2 has the following payment trigger: "obligation of Contractor to Subcontractor to pay said claims of Subcontractor as set forth in Schedule 'A' is conditioned upon, payable only from and out of, and limited to, collection or recovery by Contractor from The State of New York in the Court of Claims of The State of New York or as the result of appeal. . . ." In the second liquidation agreement the payment trigger is: "The liability and obligation of Contractor to Subcontractor for payment on the loads exceeding legal load limits is conditioned upon, payable from and only out of and limited to such amounts as may be collected on behalf of Subcontractor by way of any settlement or any recovery from the City in any action or proceeding less any costs or liabilities incurred by Contractor and not previously paid by Subcontractor."

The Subcontractor should make some effort to have the payment trigger account for credits to the Prime Contractor in addition to payments to the Prime Contractor, for example, "actually paid to contractor or credited to the contractor in the case payment is not made due to an offset not the responsibility of the subcontractor." This problem is illustrated in United States Fidelity & Guar. Co. v. Ernest Const. Co. The facts are set forth in Section V (A) above. There the Subcontractor's claim was favorably determined, thereby increasing the amount owed the Prime Contractor on the prime contract. However, the government had an offset claim for liquidated damages for delay that was greater than the Subcontractor's pass-through claim. The issue was whether the

liquidation agreement under which the claim had been submitted required actual payment of claim or whether the recovery of the claim was sufficient even though not paid due to offset. It said “collected or recovered.” Unfortunately the Prime Contractor had no way of paying and its surety was refusing to pay except to the extent moneys were collected. If the payment trigger had been “payable from and only out of and limited to such amounts as contractor is paid by owner”, the Prime Contractor might have escaped liability. Whereas if the payment trigger said “actually paid to contractor or credited to the contractor in the case payment is not made due to an offset not the responsibility of the subcontractor”, the entitlement to payment would have been more secure.

G. Indemnity and response to counterclaims, crossclaims, offsets, retaliation, defenses.

Counterclaims, crossclaims, offsets, retaliation, and defenses by the Owner present an unlimited variety of problems. Prime Contractors may resist liquidation agreements because of the fear they will lead the Owner to withhold payment or to press offsetting claims that would otherwise be informally offset. Subcontractors may resist liquidation agreements for the fear that their claim may be compromised or “sold out” to offset unrelated claims. There are a variety of ways to handle the counterattack, but it is important to be able to identify what counterattack is likely in order to pick a fair approach. If the pass through claim is a very well defined claim that is otherwise part of a smooth project, the fear of other counterclaims may be small. In those cases the Prime Contractor may want some agreement from the Subcontractor to protect the Prime Contractor from some of the retaliatory defenses of the Owner, e.g. withholding all project payment, increasing inspections, increasing quality required for approval. We all know it can happen. Thus, a simple indemnity for losses incurred as a result the claim may be sufficient. In Appendix 2, Agreement 2 the Subcontractor agreed: “to indemnify and hold Contractor harmless for all risks and consequences of the loads exceeding the legal load limits and of pursuing the dispute.” In Castagna & Sons, 84-3 BCA (CCH) ¶17,612 (1984) the parties agreed that the Subcontractor would indemnify the Prime Contractor for “interest on all payments to the Contractor that may be delayed because of the presentation of such claim or claims.” With careful consideration the parties should be able to craft an indemnity agreement.

When the pass through claim is not so simple and there are expected counterclaims or offsets as well the fear of retaliation, an indemnity/hold harmless provision may not be sufficient. The parties may want to identify exactly how any defense will be conducted or how any award in favor of the Owner will be handled. For example, in Farrell Construction Co. v. Jefferson Parish, 896 F.2d 136 (5th Cir. 1990) the parties accounted for offsetting recovery by the Owner by the clause “any recovery against either party by the Parish would reduce that party’s percentage share by the amount of the recovery.” There may have been no expectation of an award in favor of the Owner larger than the recovery. Hopefully, that possibility was considered and a decision made to leave it unmentioned.

If the counterattack can be identified at least roughly, the parties should be able to work out who should pay the cost and bear the burden of any loss. This part of the liquidation agreement should be integrated with the attorneys’ fees allocation, the provisions for settlement authority and handling settlements.

H. Cooperation, best efforts, time and attention, good faith.

One of the major reasons raised in opposition to liquidation agreements is distrust - the fear of the Subcontractor that the Prime Contractor will not really press the claim or will sell it out for some other Owner concession. Well, it does happen. An open discussion and affirmative requirements in the liquidation agreement can go a long way to resolving the distrust. The parties should consider expressly stating a good faith requirement. This concedes very little since the law of most states will find a good faith performance obligation implied in every contract. Moreover, an obligation to use their best efforts should be imposed on both parties. Sometimes, this cannot be achieved as a “best efforts” clause, but a provision agreeing that neither party will interfere in the claim presentation may be acceptable.

In addition to good faith performance of the agreement, the parties need to consider whether the claim can be presented in good faith and whether there will be certification requirements for the Prime Contractor. See additional discussion at IV. A. 1.

More particularly, we recommend that the parties consider a requirement on both sides to disclose all relevant information on the claims or defenses. Another provision

that is often overlooked is a requirement to proceed expeditiously. Distrust will result from the perception that the Prime Contractor is dragging its feet.

I. Who prepares and presents the dispute.

The liquidation agreement should identify who will prepare and present the dispute at two levels: first, overall control and direction or final authority; second, control of specific evidence, witnesses and records. We think of the former in the same manner we think of “lead” counsel in multiple party litigation in which there is common interest. Since the suit is brought only in one company’s name, there may be a desire of the Prime Contractor to retain overall control. This is generally effective when there are claims by more than one Subcontractor or by the Prime Contractor as well. When the claim is purely a pass through Subcontractor claim, it may be appropriate to give the Subcontractor overall control perhaps while carving out some exceptions for events like settlements or appeals.

At the level of developing and presenting disputes, it is usually best to place the burden on the party with the most to gain and the best control of the witnesses and documents, i.e. each party is responsible for preparing its own claim. See ¶05 of Agreement 2 and ¶05 of Agreement 3 on Appendix 2.

In Erickson Air Crane Co. v. United States, 731 F.2d 810 (Fed. Cir. 1984) the parties went so far as to establish how briefing space or oral argument would be allocated. This seems to stretch the ability of the parties to foresee the future. If the decisions are not reached at the time of the liquidation agreement, the agreement should nevertheless establish who has the power to make the decision.

J. Who pays what legal fees.

All persons, counsel and contractors alike, recognize that legal fees can be a significant part of any contract dispute. Consequently, all parties to the liquidation agreement will push for favorable treatment on fees. It is common for subcontracts providing for pass through claims to provide for the Subcontractor to pay all fees for the claim. With the exception of very simple pass through claims, the Subcontractor is not likely to agree to that in a liquidation agreement. Agreement No. 2 of Appendix 2 is a sample liquidation agreement in which the Subcontractor agreed to pay its fees and those

of the Prime Contractor in making the claim. In the reported cases the most common attorney's fees clause provides that each party will pay its own fees. *See, e.g. Farrell Constr. Co. v. Jefferson Parish*, 896 F.2d 136 (5th Cir. 1990); *Affholder, Inc. v. Preston Carroll Co.*, 866 F.2d 881 (6th Cir. 1989).

There are other allocation methods that may be appropriate:

- a. Pro-rata based upon the amount of the claim;
- b. Pro-rata based upon the complexity of the claim;
- c. Allocated based upon time spent by either attorney on a specific claim;
- d. Contingency percentage fee.

When there are multiple claims or contractor mark-ups or possible counterclaims or offsets the parties need to identify how fees will be handled on those matters. In *HOH Co. v. Travelers Indem. Co.* (discussed above with respect to including the Subcontractor's surety in the liquidation agreement) after holding that the surety was responsible, the court remanded for a consideration of what legal fees could be recovered. The agreement limited the Subcontractor's exposure to fees "incurred by you in prosecuting the suit." Here there were fees for the Subcontractor base claim, for the mark-up and for defense of counterclaims. The Subcontractor had no responsibility for the counterclaims and the court had decided that the mark-up claim was not proper. This case also points out the need for counsel to keep excellent records on which aspect of the case it is working. On a large case one might have one attorney handle the pass through and another handle the non-pass through portions.

Morse/Diesel, Inc. v. Trinity Industries, Inc., 875 F. Supp. 165 (S.D.N.Y., 1994) raised a different aspect of the attorneys' fee issue, namely the recovery of attorneys' fees in the pass through action. The Subcontractor argued that it should not be required to pay the Prime Contractor's attorneys' fees because they had been paid by the Owner. By the way *Morse/Diesel* has the Prime Contractor passing through an Owner's claim against a Subcontractor. The Court examined the contract which called for attorneys' fees which were "incurred" by the Prime Contractor and did not provide that they need to be "paid" by the Prime Contractor and allowed recovery of the fees. In determining who will pay attorneys' fees it will pay to check any language about ultimate recovery of the attorneys' fees.

K. Who pays costs.

This issue in many ways mirrors the attorneys' fees issue but it need not be decided the same way. In Affholder, Inc. v. Preston Carroll Co., 866 F.2d 881 (6th Cir. 1989) each party agreed to pay its own attorney, but they used a pro-rata agreement based on value of claims for experts and other costs. Costs are frequently identifiable with specific claims, e.g. an expert is hired to quantify inefficiencies resulting from excessive testing or stacking of trades. Perhaps these relate only to the Subcontractor's claim. Each type of cost, filing, deposition, expert, arbitrator fees, should be individually considered. The provision at ¶11 of Agreement 4 in Appendix 2 illustrates one mechanism.

L. Settlement rights or obligations.

Settlements can be problematical, all the more so when the litigation concerns more than one pass through claim. If the Subcontractor cannot approve the settlement, it may not agree to the liquidation agreement. If the sub does not like the settlement, it may lead to further litigation. There are a variety of ways to handle settlements.

First, consider inserting a mechanism for considering the settlement proposals. The provision at ¶12 of Agreement 4 in Appendix 2 is a good starting place for ideas. Ultimately, the agreement should provide what will happen when the Subcontractor does not like the settlement. Perhaps the Prime Contractor can convince the Subcontractor to accept the result absent bad faith, or to accept the result and take to the dispute mechanism only the allocation among the parties of the recovery. Finally, the Prime Contractor should consider allowing the Subcontractor to retain the right to sue the Prime Contractor should the settlement be less than the Subcontractor believes appropriate. While this seems to defeat the purpose of the liquidation agreement, it avoids litigating in both directions from the very start by postponing the Subcontractor/contractor litigation until an event that may not occur occurs.

Consideration should be given to allowing the Subcontractor to veto settlements and continue litigation. This can be appropriate when the litigation concerns only Subcontractor claims or when the Subcontractor is paying all the fees and costs. If the Subcontractor is not paying all the fees and costs, perhaps the veto and continuation of

the suit can be made conditional upon the Subcontractor's paying all of the fees and costs thereafter.

M. Appeal rights or obligations.

When to quit? How far to go? These questions are as difficult for the parties negotiating liquidation agreements as for teenagers. Each step in the process should be identified and evaluated. It may be easy to accept the obligation to present the claim to the contracting officer. It is more costly and more time consuming to appeal the decision to a Board of Contract Appeals. Will you undertake to pursue or to pay for an appeal? How about a Writ of Certiorari to the United States Supreme Court? We recommend that these issues not be left to a more general provision on control. The parties should also consider simply deciding that an appeal will not be taken at some stage. Alternatively, the parties should consider a recovery cut off, i.e. if the result is greater than \$75,000 there will be no appeal. A strong attempt should be made to keep any such decision from becoming discoverable, since such agreements have a way of limiting a higher recovery. A separate confidential memorandum protected by the common interest rule should be used rather than incorporation in the liquidation agreement. The parties should also consider whether other terms of the agreement should shift at each stage of the process. For example, if each of the parties initially agree to pay their own costs and attorneys' fees, they might agree that the Subcontractor can decide to appeal provided it pays all legal costs and fees.

N. Privilege issues.

In any presentation of a pass through claim there is a need to discuss and reveal to another party or its counsel matters that would be confidential and privileged if revealed to one's own counsel. There will be a need for counsel to discuss among themselves how best to present the claim. Some protection for these communications can be obtained by recognizing the joint defense doctrine or common interest agreements. These are more extensively discussed in Section VII of this paper.

In addition to a common interest agreement the parties should consider whether there is a likelihood of disclosure of proprietary data or trade secrets. If there is such a

possibility, the parties should either incorporate an agreement in the liquidation agreement or prepare a separate agreement.

O. Disputes arising from or related to liquidation agreement.

We have noted above that our research revealed only one case in which the interpretation of the liquidation agreement itself was being disputed, HOH Co. v. Travelers Indem. Co. Nevertheless, the parties should reconsider what has been set forth in the subcontract with respect to dispute resolution and consider whether it should be changed. For example, when the liquidation agreement allows for a dispute when a Subcontractor does not like a settlement agreement or when the Prime Contractor refuses to take the matter to an appellate court, will the subcontract dispute provisions be satisfactory? These disputes do not arise in the same way other disputes may arise. By the time a settlement is obtained from the Owner, the Subcontractor and Prime Contractor will be quite familiar with the dispute. Perhaps there has been substantial discovery already conducted. Certainly a certain amount of time will already have passed. In these circumstances, litigation with its formal evidence and massive discovery may not be warranted. The dispute is unlikely to involve other parties where problems with joinder in arbitration will be substantial. To the authors, disputes between the parties to liquidation agreements are quite well handled by arbitration. The parties entered into a liquidation agreement in the first place to avoid multiple litigation. The authors suggest the inclusion of an arbitration clause for these disputes. In addition, the parties should consider agreement to mediate prior to the arbitration. See the brief discussion of the use of mediation below at VI.B.

P. Boilerplate.

1. What will be the relationship of the liquidation agreement to the subcontract?

In HOH Co. v. Travelers Indem. Co., the court noted “The Pass-Through Agreement, entered into after the Subcontract and Change Orders, supersedes those contracts.” As one might expect, a specific agreement on a specific matter executed after a more general agreement will take precedence over the more general. Disputes can arise when one of the parties wishes to rely on the language of a prior agreement. Parties can

avoid recourse to court decisions by expressly stating the specific relationship that they wish to preserve. It is our recommendation that the liquidation agreement override the contract documents only when such documents contradict the liquidation agreement. If done in that manner, it may not be necessary to reassert many of the subcontract provisions, e.g. that the Subcontractor will continue to perform its work during the dispute or that payment will be made within seven days of receipt of the funds from the Owner. Of course if done in this manner, it will be wise in composing the liquidation agreement to review the terms of the subcontract to determine where you want to express expressly override its provisions.

2. Choice of Law.

While a choice of law agreement inserted in a liquidation agreement will not necessarily determine the law applied in the litigation with a third party on the pass through claim, it can be a significant matter between the parties to the liquidation agreement. If the liability of the Prime Contractor under a liquidation agreement has been agreed to be determined under federal common law, some of the very adverse state cases might be avoided. As noted, however, the third party will argue when it is to that party's benefit that the choice of law provision is not binding on it. At a minimum the Prime Contractor will have two benefits: first, a court will usually look at the federal law in making a decision; and, second, the law chosen by the Prime Contractor and Subcontractor to determine the Prime Contractor's liability to the Subcontractor will be decisive on that point even though not conclusive on whether liability of that type, e.g. contingent on recovery, is sufficient under the law chosen by the court for the pass through claim. Michael Lowe and Carl Hahn, Pass-Through Claims, Flow-Down Clauses, and Subcontractor Choice of Law Issues, 1994 Wiley Construction Law Update, (1994), offers a good discussion of choice of law in subcontracts.

3. Other boilerplate.

The parties should consider their usual contract checklist to determine what other clauses to include, for example, notice clause, joint preparation, captions, non-waiver clauses, and parole evidence.

VI. NEGOTIATING THE LIQUIDATION AGREEMENT:

ADVANTAGES AND DISADVANTAGES

A. Factors in deciding to use a liquidation agreement.

In this part of the materials, we consider the problems encountered in negotiation of liquidation agreements, not from the standpoint of individual provisions, e.g. how attorneys' fees will be handled, but from the broader perspective of whether to agree to use a liquidation agreement at all. The advantages and disadvantages of a liquidation agreement arise from the factual situations of the parties when a claim arises and from the existing contract terms. We have commented previously on the manner in which contract provisions prohibit, impede or enhance the use of liquidation agreements. While now focusing on advantages and disadvantages from the perspective of post-dispute negotiations, most of the advantages or disadvantages also are usefully considered in deciding whether to incorporate provisions promoting liquidation agreements in the subcontract.

Initially, consider a simple fact pattern in which the Owner has specified a brand name cooling unit "or equal", but no sooner has the job been awarded than the manufacturer of the brand name units files bankruptcy and ceases operations. The HVAC Subcontractor proposes cooling units by another manufacturer that are the same price and claims these units are equal to those specified. The Owner, after consulting with its mechanical engineer, rejects those units and requires much more expensive units. The Owner insists Subcontractor and Prime Contractor are not entitled to an adjustment in the contract sum. Experience teaches that the easiest claims to handle through liquidation agreements are those involving one or only a few items and passing through a party innocent of wrong. Thus our example should provide as easy a case as can be expected.

Given this situation, what are the Prime Contractor's advantages or disadvantages in agreeing to a liquidation agreement?

1. Good faith and certification.

Hopefully, the Prime Contractor will first decide whether the claim can be presented to the Owner in good faith. In some circumstances, the Prime Contractor may be able to make the initial presentation of a claim that it could not otherwise present in

good faith by presenting it with no opinion or with a neutral or adverse opinion on the claim's merits. When there is a certification requirement and the Prime Contractor cannot make the required certification, the possibility of a liquidation agreement is eliminated. When the claim can be made in the contractual administrative process without a certification, then the issue of whether the claim can be presented in good faith may again arise with the initial pleading. If a liquidation agreement would involve presentation of a claim that cannot be made in good faith, the possibility of a liquidation agreement should be eliminated. It is not our purpose to deal with the certification process or the various limitations on pleading. We shall assume that the Prime Contractor has reviewed the basis of the claim and that it may be presented in good faith.

2. Fairness.

While many companies in the construction industry have made an effort to shift the risks of construction away from those who may best control and insure the risks and away from those who are responsible or at fault, most companies understand who is actually responsible or at fault. Most will recognize that fairness requires the person responsible for a loss to bear the loss instead of a person who is not responsible. Most of us will say that we want to be fair. When fair placement of the loss requires that the Owner be responsible for the loss, that is one of the most powerful arguments to either party favoring a liquidation agreement. The Prime Contractor can argue to the Subcontractor that the Subcontractor should not sue the Prime Contractor but should agree to a method of bringing the claim to the responsible party. The Subcontractor can argue to the Prime Contractor that fairness requires the Prime Contractor to present the Subcontractor's claim. Everyone will recognize that judge, jury or arbitrator will be greatly influenced by their sense of where the loss should be fairly placed. If fairness is not unduly threatening, i.e. if the liability of the Prime Contractor is limited to the amount recovered, there will be additional likelihood that a liquidation agreement can be negotiated.

At the same time if either the Subcontractor or Prime Contractor does not believe that the party responsible is the Owner, that will be an impediment to negotiating a liquidation agreement. In our example, if the Subcontractor believes the Prime

Contractor knew the equipment specified was not available before the Subcontractor's bid or that it proposed to the Owner to use the higher cost equipment (perhaps from some decreased cost to the Prime Contractor on another part of the project), the Subcontractor is very unlikely to agree to limit its recovery to that obtained from the Owner. Both parties should carefully consider the fair placement of the loss. Even if there is shared fault, the parties may be able to settle their part of the dispute and still present the claim through a liquidation agreement.

3. Contract documents.

Both parties should carefully consider the provisions of the subcontract and other contract documents. If the subcontract has been drafted so that the Prime Contractor will present the claims and the Subcontractor will be limited to the results, negotiation of a written liquidation agreement will be facilitated. If the subcontract has been drafted to avoid liability for pass through claims, there will be additional hurdles and perhaps a brick wall. First, the fact that the subcontract agreement contains a provision excusing the Prime Contractor from liability for the Owner's actions may eliminate the ability of the parties to amend the agreement or make a superseding agreement adding a liquidation agreement. The parties should be aware that once there is a complete, total release of the Prime Contractor, a situation in which Severin would apply, they may not be allowed to create liability in order to avoid Severin. See the discussion at the end of Section IV above. Some analysis should be made whether a modification can be made to the subcontract. For example, when the possibility of a claim first arises, the Subcontractor might refuse to go forward unless the Prime Contractor agreed to sponsor the claim. If an amendment or superseding agreement is needed to bring the claim, careful analysis will be needed. However, it is difficult to believe that the parties to a subcontract cannot amend the subcontract at any time during the project provided there are the normal contract requirements, e.g. consideration.

If the Prime Contractor has agreed to present a claim having merit, then the failure of the Prime Contractor to present a claim to the Owner, when properly asked by the Subcontractor, will simply expose the Prime Contractor itself to the possibility of being liable for the claim. See, e.g., *J. L. Simmons Co. v. United States*, 158 Ct. Cl. 393,

304 F.2d 886 (1962); *Castagna & Sons*, 1984 GSBCA Lexis 255; 84-3 BCA (CCH) ¶17,612 (1984). In these cases the Prime Contractor has a strong reason for pinning down the details of the claim presentation in a liquidation agreement. If the Subcontractor has agreed in the subcontract to be bound by the results obtained from presenting the claim to the Owner, then it will have strong reasons for pinning down the details of the presentation to insure it is properly presented. To simply sue the Prime Contractor rather than allowing it to present the claim as a pass through claim will give the Prime Contractor an additional contractual defense to the claim.

4. Avoidance of inconsistent results.

A major reason for the Prime Contractor to consider allowing a pass through claim and for using a liquidation agreement is the danger of inconsistent results if multiple suits result. The injured company may need to sue a company with whom it does have privity even though that company, while contractually responsible, may not be the cause of the damage. The intermediary company must then defend while at the same time determining to what extent it can pursue the claim against the company causing the problem. In our example, the Subcontractor may simply sue the Prime Contractor for failure to pay on a constructive change to the subcontract. The Prime Contractor may be able to bring in the Owner on a third party action for indemnity claim or it may be required to await the results and then bring an independent action to recover its loss. Regardless of how the third party action happens, there is a risk that the results of the two actions will be inconsistent so that the Prime Contractor loses to the Subcontractor but also fails to recover from the Owner. In any case the Prime Contractor should carefully assess the applicable law on contract indemnity before deciding to be sued and then add the Owner by a third party action.

A related problem arises when the Prime Contractor is attempting to defend against the Subcontractor's claim while seeking to recover from the Owner on that claim. As counsel who have been in the situation know, there are great practical difficulties in forcefully presenting a defense, e.g. the Subcontractor should have known that the supplier intended to stop manufacturing the equipment, while avoiding having the Owner successfully use the same defense. The Subcontractor on the other hand should carefully

consider whether the decision maker might decide that the Prime Contractor was not responsible and it will have lost the opportunity to have the claim presented against the culpable party.

5. Limitation of liability.

This one is easy for the Prime Contractor. Why pass up the opportunity to limit your liability to the amount that you can recover from someone else? However, the Subcontractor and more particularly its lawyer may have difficulty avoiding the proverbial shotgun approach of looking to every conceivable source for recovery. These decisions require a strong analysis of the case before the decision is made.

6. Continued working relationship on the project.

Most construction contracts require that work must continue regardless of the existence of a dispute. This leads to parties continuing to deal with each other while at the same time engaged in litigation. Cooperation in that case can deteriorate and friction increase. Thus, the need to continue to work together to complete the project provides an incentive to both the Prime Contractor and the Subcontractor to avoid fighting among themselves. The Prime Contractor cannot simply rely on the contractual provision to continue work. The requirement to continue work may be ignored by a Subcontractor for a variety of reasons, e.g. lack of economic power to stay the course, or perhaps an opinion from counsel, whether wise or not, that the breach by non-payment of the claim is sufficient to excuse continued performance. Replacement of a Subcontractor can be expensive and pose difficulties for warranties, scheduling, etc. The Prime Contractor may be able to avoid such a result by negotiating satisfactory terms, perhaps including a partial or advanced payment, of a liquidation agreement. The Subcontractor may be able to use the threat of termination to bring about a satisfactory liquidation agreement.

7. Continued future working relationship.

While a continued working relationship on the project may be of immediate concern, an assessment should be made of the value and importance of future working relations on other projects. A Prime Contractor that has or wishes to establish a long term relationship with an Owner may not want to sponsor a claim for fear of damaging the relationship. On the other hand, when a Prime Contractor routinely works with a

Subcontractor they may want to preserve that relationship. In an era when partnering and teaming arrangements are growing in use, when there is a recognition that litigation is not the best way to conduct business or the best way to resolve disputes, liquidation agreements deserve a serious examination.

8. Avoidance of Prime Contractor Insolvency.

It will not be a surprise to many in the construction industry to observe that construction companies occasionally become insolvent and either disappear or proceed into bankruptcy. When this is a possibility for the Prime Contractor, a Subcontractor should consider whether a liquidation agreement in which it is entitled to pursue a claim against the Owner in the Prime Contractor's name is better than a claim against an insolvent or bankrupt Prime Contractor. When there is a possibility of the Subcontractor becoming insolvent or filing bankruptcy, the Prime Contractor might assess the loss should that occur with the cost of some arrangement to assist the Subcontractor in recovering on a claim.

B. Use of mediation.

The authors recommend that the parties and their counsel consider the use of mediation to assist the parties in settling upon a liquidation agreement. A liquidation agreement is a settlement agreement in many ways. Often the failure of the parties to agree upon the terms of a liquidation agreement stem from concerns that a neutral mediator can overcome. Arguments from opposing counsel may be regarded with suspicion, while the same point made by a mediator may be persuasive.

Mediators should also keep in mind the use of liquidation agreements to resolve disputes. Often it is not possible to come to a dollar settlement when one of the parties then has to pursue recovery of the claim against a third. As we have seen, a settlement agreement may limit the recovery on the claim to the amount settled, thereby giving the responsible party the benefit of a settlement while the settling party does not have the benefits of settlement, e.g. no further litigation. It is possible that the intermediary party who has the double exposure may be willing to make some interim payments or concessions contingent upon agreement upon a liquidation agreement. Such payments may alleviate the distress of the injured party and avoid having that party believe it has

only one recourse, namely to fight with the only party close enough to hit. Hopefully, by this stage readers who serve as mediators will have a repertory of ideas that will assist in using liquidation agreements when full settlements are not achievable.

VII. JOINT DEFENSE PRIVILEGE AND COMMON INTEREST AGREEMENTS

Persons considering entering into a liquidation agreement should consider the joint defense doctrine and agree on the extent to which it will apply. The joint defense doctrine is an extension of the attorney-client privilege when more than one party is involved in a legal matter in which they share common interests. In ordinary circumstances the disclosure to another party or that party's attorney of otherwise privileged material will eliminate the privilege, i.e. the attorney-client privilege will not apply. Similarly, if counsel for one party discloses such matters as strategies and estimates of success, those matters will no longer be privileged, i.e. the attorney work product privilege will not apply. The "joint defense doctrine" allows parties who are jointly defending an action to preserve the attorney-client and attorney work product privilege for communications and preparations in the joint defense. However, the joint defense doctrine is not limited to communications regarding defensive matters, but also covers communications regarding joint offensive matters. Hunydee v. United States, 355 F.2d 183 (9th Cir. 1965); Eisenberg v. Gagnon, 766 F.2d 770 (3rd Cir. 1985). "Communications to an attorney to establish a common defense strategy are privileged even though the attorney represents another client with some adverse interests." Eisenberg, at 787-789. "Only those communications made in the course of an ongoing common enterprise and intended to further the enterprise are protected." United States v. Schwimmer, 892 F.2d 237, 243-244 (2nd Cir. 1989). The scope of the privilege varies between the courts with the Ninth Circuit in Hunydee taking the most expansive approach.

Persons considering entering into a liquidation should establish their joint defense agreement in writing. Such agreements are commonly called "common interest agreements." The burden of establishing the privilege rests on the party asserting the privilege. "This placement of the burden reflects the policy that the privilege be used

sparingly, “only when well identified and established.” United States v. Weissman, 1996 WL 737042, at 6 (S.D.N.Y. 1996). The Weissman case contains a valuable summary of the law on joint defense privilege. Weissman, at 7 to 10. It stresses the need for the party asserting the privilege to demonstrate a joint defense agreement. Weissman, at 13 and 15. The use of a written agreement identifying the fact of a common interest and the intent to claim and not waive the privilege can materially assist in carrying the burden of establishing the privilege. In a jurisdiction that requires evidence of an ongoing common enterprise or an agreement to a common defense strategy, a written common interest agreement can be very useful. The lesson of Weissman is “put the common interest agreement in writing.” It is our recommendation that a simple common interest agreement be included in the liquidation agreement, but that it also be separately written and signed so that it can be introduced as proof of the common enterprise or common defense without having to provide the liquidation agreement.

Once established, “[a] joint defense privilege cannot be waived without the consent of all parties to the privilege.” Weissman, at 26 (citing In re Grand Jury Subpoenas 89-3 and 89-4, 905 F.2d 244, 248 (4th Cir. 1990)). There is no reason to rely on the other party’s familiarity with the law on this subject. The better practice is to set forth in the common interest agreement the agreement that neither party has the right to unilaterally waive the privilege.

The common interest agreement should include agreement that:

1. the parties have agreed to pursue a common purpose related to pursuit of the claim,
2. the communications between the parties and counsel are for the purpose of pursuing this common purpose,
3. such communications are intended to be privileged and protected,
4. neither party will disclose such information without the express written consent of the other party, and
5. the party receiving the information shall not have the right nor the power to waive the privilege for the other party.

While the parties may choose to elaborate upon the following provision, this provision should be sufficient to establish the joint defense privilege within a liquidation agreement.

The parties agree that they have a common interest and purpose in the prosecution of the claim identified in this Liquidation Agreement and the defense to claims, counterclaims or offsets raised by the Owner. Communications between Subcontractor and Subcontractor's counsel, their agents and representatives, and Contractor and Contractor's counsel, their agents and representatives, with respect to the claim are for the purpose of pursuing this common interest. It is the intention of the parties that information, opinions, and communications revealed by them concerning the prosecution of the claim be privileged and not disclosed -- that such information, opinions, and communications shall be entitled to the attorney-client and work product privileges. Each party agrees that it will not release or disclose such privileged communications without the express consent of the other party and further agrees that it shall not have the power or the authority to waive the privileges.

VIII. CONCLUSION

Liquidation agreements can be a useful tool in the often encountered situation in which a company on a construction project has suffered damage as a result of actions by another company involved in the project but with whom the injured company has no contract privity. In such circumstances the injured company may need to sue a company with whom it does have privity even though that company, while contractually responsible, may not be the cause of the damage. That company must then defend while at the same time determining to what extent it can pursue the claim against the company causally responsible directly or by an indemnity claim. We have reviewed many reasons to avoid handling pass through claims in that manner, while recognizing that the complexity of circumstances may force such multiple adverse actions.

We have advocated the use of liquidation agreements as a means to simplify the pursuit of pass through claims while preserving working relationships and reducing costs. However, it is our thought that the major reason for negotiating liquidation agreements is to bring the claim against the causally responsible party. Hopefully, the reader has gained insight into the legal problems that must be considered in negotiating liquidation agreements and the potential variety of methods and terms that can be used for

liquidation agreements. Readers are welcome to make use of what they deem valuable from the sample agreements or the checklist. If readers find errors or have additional samples or items, the authors will appreciate receiving such comments.

APPENDIX

Appendix 1: Sample contract provisions.

Appendix 2: Sample liquidating agreements.

Appendix 3: Liquidation agreement checklist

Appendix 1
Sample Contract Provisions Promoting
Liquidation Agreements

Clause No. 1

(a) Should Owner file a claim, counterclaim or crossclaim against Contractor relating to, or arising out of, in whole or part, performance of Subcontractor's Work, Subcontractor and its surety agree to be bound to Contractor to the same extent that Contractor is bound to Owner by the terms of the Contract and shall likewise be bound by all rulings, decisions or determinations made pursuant to the Contract including but not limited to the final decision of an appeal board, arbitration or court of competent jurisdiction, whether or not Subcontractor or its surety is a party to such proceeding. If called for by Contractor, Subcontractor shall defend at no cost to Contractor all claims, or that portion thereof, relating to or arising out of the performance of Subcontractor's Work, and shall become a party to such proceeding or determination.

(b) As to any claim by Subcontractor on account of acts or omissions of Owner, or its representatives, Contractor agrees to present to Owner, in Contractor's name, all of Subcontractor's claims for extras and equitable adjustments and to further invoke on behalf of Subcontractor those provisions of the Contract for determining disputes. Subcontractor shall have full responsibility for preparation and presentation of such claims and shall bear all expenses thereof, including attorney's fees. Subcontractor agrees to be bound by the procedure and final determination as specified in the Contract and agrees that it will not take any other action with respect to any such claims and will pursue no independent litigation or any disputes resolution procedures with respect thereto. Subcontractor shall not be entitled to receive any greater amount from Contractor than Contractor is entitled to and actually does receive from Owner on account of Subcontractor's claims less any markups entitled to or costs incurred by Contractor. Subcontractor shall accept such amount, if any, as full discharge of all such claims. With respect to such claims, Subcontractor shall give written notice to Contractor within sufficient time to permit Contractor to give notice to Owner within the time allowed by the Contract. Failure to give such notice shall constitute a waiver of such claim.

(c) Notwithstanding paragraph (b) of this Section, Contractor shall have the right, at any time, to settle or otherwise dispose of any claim by Subcontractor on account of acts or omissions of owner or its representatives. Should Contractor exercise this right, Contractor shall determine the amount, if any, to be paid to Subcontractor on account of such claim. Such decision shall be final and binding unless Contractor's decision is submitted to arbitration in accordance with paragraph (d) of this Section.

(d) Should a dispute arise which is not controlled or determined by the above paragraphs of this Section or other provisions of the Subcontract, then said dispute shall

be settled by Contractor's written decision with respect to such dispute. Such written decision shall be conclusive and shall be final and binding on Subcontractor and its surety unless Subcontractor within thirty (30) days following the receipt of such written decision, shall file a demand for arbitration in accordance with the then current rules of the Construction Industry Arbitration Rules of the American Arbitration Association, unless the parties mutually agree otherwise. If such demand is filed, then the dispute shall be decided by arbitration in accordance with such Rules, before three (3) neutral arbitrators. This agreement to arbitration shall be specifically enforceable and the arbitration decision shall be final and binding as between Contractor and Subcontractor and its surety. If arbitration is conducted involving Owner, Contractor or any other party concerning or in any way relating to responsibility under this Subcontract; any dispute relating to the Work required or alleged to be required herein; this Subcontract; or Subcontractor; then in any of these events, Subcontractor expressly agrees to a consolidated or joint arbitration, if and as called for by Contractor.

(e) Subcontractor shall proceed diligently with the Work pending final determination of any dispute or claim.

(f) The provisions of this Section shall survive the completion or termination of this Subcontract.

(g) Subcontractor covenants and expressly agrees that if for any reason the Subcontract is not completed as contemplated herein or if any dispute shall arise over the entitlement or the rights of Subcontractor, Subcontractor's sole recourse shall be an action as provided herein to enforce the several terms and provisions of this Subcontract, and no action shall lie in favor of Subcontractor in the nature of quantum meruit, quantum valebant, quasi-contract, or any other theory of law or equity.

Clause No 2.

(a) If the Subcontractor makes a claim, in whole or in part, in connection with changes ordered by the Owner or any dispute arising out of the Owner's or its authorized representative's conduct or their interpretation of the Contract Documents or any dispute arising out of inaccuracies, deficiencies, discrepancies or ambiguities in the plans and specifications, the Subcontractor shall proceed in accordance with the remedies provided for in the Contract Documents and shall exhaust its administrative remedies thereunder prior to commencing any legal action in connection therewith. Subcontractor shall be bound by all procedural provisions, administrative determinations and final judgments which are binding on the Contractor as to such claims. The Subcontractor shall bear the expenses and the burden of prosecuting and proving any such claim against the Owner and shall give the Contractor adequate and timely notification in writing of any action it desires the Contractor to make on its behalf against the Owner. The Subcontractor will not be entitled to receive any greater amount of money or time or other consideration from the Contractor with respect to a dispute than the Contractor is entitled to and actually does receive from the Owner on account of the Subcontractor's Work, less any markups or costs to which the Contractor is entitled and the Subcontractor agrees that it

will accept such amount, if any, received by the Subcontractor in full satisfaction and discharge of all disputes.

(b) If at any time a controversy should arise between Contractor and Subcontractor with respect to any matter in this Subcontract, and which Contractor determines is not a claim, dispute or controversy which should involve or be asserted against the Owner, the decision of Contractor relating to the subject of the controversy shall be followed by Subcontractor. If Subcontractor is not satisfied with such decision, and if the controversy cannot be settled amicably between Contractor and Subcontractor, the matter in dispute shall be settled by arbitration pursuant to the Construction Industry Arbitration Rules (the "Rules") of the American Arbitration Association (the "AAA") then in effect. The venue of such action shall be in New Mexico.

(c) No such controversy or dispute shall interfere with the progress of construction, and Subcontractor shall proceed with the Work pending resolution of the dispute.

Clause No 3.

If the Subcontractor makes a claim, in whole or in part, in connection with changes ordered by the Owner or any dispute arising out of the Owner's or its authorized representative's conduct or their interpretation of the Contract Documents or any dispute arising out of inaccuracies, deficiencies, discrepancies or ambiguities in the plans and specifications, the Subcontractor's right to recovery shall be limited to the results obtained using the claims procedures of the Contract Documents. Contractor shall have no obligation to present any claim to the Owner which upon review Contractor believes lacks merit. Contractor shall have no obligation to appeal any decision on the claim should it be denied at any stage of the claims procedure.

Clause No 4.

¶23. It is agreed that the Subcontractor shall be bound by the rulings and decisions of the Contracting Authority of the Prime Contract to the same extent and degree that the Contractor is bound by said rulings and decisions insofar as they may pertain to the work included within this Subcontract.

B. Contract Provisions Impeding or Preventing Liquidation Agreements:

Clause No. 1¹

21st. The Contractor or Subcontractor shall not in any event be held responsible for any loss, damage [sic], detention, or delay caused by the Owner or any other Subcontractor upon the building; or delays in transportation, fire,

¹ Severin v. United States, 99 Ct. Cl. 435, 440 (1943), cert. denied 322 U.S. 733.

strikes, lockouts, civil or military authority, or by insurrection or riot, or by any other cause beyond the control of Contractor or Subcontractor, or in any event for consequential damages.

Clause No. 2

Subcontractor agrees to hold the Contractor harmless from any loss, damage or claim caused, in whole or in part, by the Owner, the Architect or their employees, agents, or consultants. Subcontractor further agrees that it shall be a condition precedent to Subcontractor's right to recover for any such loss, damage or claim that the Owner actually makes payment therefor and that the amount of any such recovery shall be limited to the amount received by Contractor from the Owner for the loss, damage or claim. Contractor shall have no obligation to pursue a claim against the Owner for any such loss or damage.

Appendix 2

SAMPLE LIQUIDATING AGREEMENTS

AGREEMENT NO. 1²

Contractor shall present to the State of New York in the form and the manner required by the contract and specifications and by claim to the Court of Claims of the State of New York, Subcontractor's claims as set forth in Schedule 'A' [of Liquidating Agreement], arising out of, under, or in connection with the subcontract performed as part of the work under the contract, liability and obligation for which is, as aforesaid hereby acknowledged by Contractor, said obligation being expressly conditioned as hereinafter provided in this agreement, together with other and further claims which Contractor may have and the claims of other subcontractors, if any.

The liability and obligation of Contractor to Subcontractor to pay said claims of Subcontractor as set forth in Schedule 'A' is conditioned upon, payable only from and out of, and limited to, collection or recovery by Contractor from The State of New York in the Court of Claims of The State of New York or as the result of appeal

Contractor agrees that promptly following the making of the Final Estimate under the contract, it will institute in its own name a claim, in accordance with the laws of the State of New York in the Court of Claims of that State to recover, with interest, the amounts due to Contractor for unpaid balance of amounts earned by Contractor in its performance of the contract and any supplemental agreements in connection therewith and for retained percentages, and also for the amount of the claims as set forth in Schedule 'A', for which Contractor has and does acknowledge liability, which may include any other and further claims of Contractor or Subcontractor as promptly as may be possible.

It is agreed by and between the parties hereto that the claim of Subcontractor as set forth in Schedule 'A', for which Contractor's liability to Subcontractor has been and is acknowledged, shall be prepared by counsel designated by Subcontractor for presentation as a part of the claim to be made in the Court of Claims by Contractor against the State of New York. . . .

In the claim which shall be brought against The State of New York in accordance with the provisions hereof, the parties hereto shall use their best efforts to have the decision or award in such form that will provide what amount has been allowed for the claims of Subcontractor as specified in Schedule 'A'.

² Tully & DiNapoli v State, 272 N.Y.S. 2d 667 (1966).

AGREEMENT NO. 2

This Agreement is entered into between Contractor and Subcontractor effective _____.

RECITALS

- A. Contractor is the prime contractor on a project for the City and Subcontractor is a subcontractor of Contractor on the project.
- B. During the course of the project the City decided to reduce payment to Contractor and, consequently, to Subcontractor for tonnage hauled to the landfill on loads that exceeded legal load limits. Subcontractor disputes the right of the City to reduce payment in the manner proposed.
- C. Contractor and Subcontractor desire to enter into this Liquidating Agreement to organize and state their agreement with respect to prosecution of the claim against the City consistent with the terms of their Subcontract.

AGREEMENT

In consideration of the recitals and the mutual rights and duties stated in this Agreement, the parties agree as follows:

- 01. Contractor is the prime contractor for the City project and Subcontractor is a subcontractor to Contractor on the project.
- 02. Under Subcontract between Contractor and Subcontractor, it is a condition precedent of the obligation of Contractor to make payments to Subcontractor that Contractor actually receive funds for that purpose from the City. Additionally, in a claim involving the City, Subcontractor is bound by all procedural provisions, administrative determinations and final judgments which are binding on Contractor as to any claims to be presented to the City.
- 03. The City has asserted against Contractor as a consequence of subcontract performance by Subcontractor a right to a deductive Change Order in the amount of \$41,394.00. Subcontractor agrees to be subject to a deductive Change Order for \$5.50 per ton after March 24, 1995 for an amount of \$1,925.00 and for a deductive Change Order for \$2.08 per ton for the weight in excess of the legal load limit for materials hauled prior to March 24, 1995 and disputes the remainder.

04. The parties to this agreement recognize that the dispute must be pursued with the City in the name of Contractor. Contractor agrees with Subcontractor to present the dispute in the name of Contractor. Subcontractor agrees with Contractor to pay all expenses incurred in pursuing the dispute and to accept all risk resulting from the pursuit of the dispute including any risk that the City will increase the amount of the claimed deductive change if there is a dispute. Subcontractor agrees that it will be bound by the results of the arbitration of the dispute without taking any further legal action on this dispute with respect to either Contractor or the City. Subcontractor further agrees to pay all reasonable expenses, including attorney's fees, incurred by Contractor in this matter and to indemnify and hold Contractor harmless for all risks and consequences of the loads exceeding the legal load limits and of pursuing the dispute.
05. Subcontractor will have the right and obligation to prepare and present its dispute in the arbitration. Contractor shall have the right to review in advance all actions to be taken by Subcontractor in preparing and presenting its dispute. Contractor shall have the right to refuse any action to be undertaken in its name which it believes to be contrary to the best interests of Contractor.
06. Subcontractor agrees to prepare, pay all filing fees and file the arbitration demand within ten days of this agreement. Thereafter Subcontractor will proceed as expeditiously as possible under the applicable dispute rules to bring the matter to arbitration and award. Subcontractor will submit all pleadings, documents and correspondence written in the name of Contractor to Contractor prior to filing. Contractor agrees to promptly review and comment on all such pleadings, documents and correspondence and, if there are no objections in accordance with the rights of ¶5 of this Agreement, Contractor agrees to present such pleadings, documents and correspondence in its name.
07. The liability and obligation of Contractor to Subcontractor for payment on the loads exceeding legal load limits is conditioned upon, payable from and only out of and limited to such amounts as may be collected on behalf of Subcontractor by way of any settlement or any recovery from the City in any action or proceeding less any costs or liabilities incurred by Contractor and not previously paid by Subcontractor.
08. Any dispute concerning this Agreement, or the performance, interpretation or breach thereof shall be resolved by arbitration pursuant to the Construction Industry Arbitration Rules of the American Arbitration Association then in effect. Notice of demand for arbitration must be filed in writing with the other party to this Agreement and with AAA. The

demand must be made within thirty days after the claim, dispute or other matter in question has arisen.

09. This Agreement shall not be deemed to be, nor construed as, nor is it the intent of the parties that it constitutes, a waiver of any of the terms, conditions or provisions of the Subcontract between the parties, but merely provides for a method of presentation of the claims, the liquidation of the same, method of payment of same and provision for full satisfaction, payment and discharge of each and every liability with respect to the overweight loads.

AGREEMENT NO. 3

(Excerpts)

02. Except as set forth in Schedule "A", Contractor and Subcontractor hereby settle and discharge all claims which each may have against the other. With respect to Schedule "A", Subcontractor agrees to accept in full satisfaction and discharge of its claims set forth in Schedule "A" the amounts, if any, that may be collected for said claims from the Owner and paid to Subcontractor in liquidation, satisfaction and discharge thereof as hereinafter provided.

04. The liability and obligation of Contractor to Subcontractor to pay the claims of Subcontractor as set forth in Schedule "A" is conditioned upon, payable from and only out of and limited to such amounts as may be collected for Subcontractor's claims as set forth in Schedule "A" by way of any settlement by Contractor with Owner whether before or after the commencement of any action or proceeding or from any recovery from Owner in any action or proceeding, after trial thereof or as the result of any appeal or appeals, and upon such collection being made by Contractor for said claims, payment of any sums collected for said claims as set forth in Schedule "A" to be made by Contractor to Subcontractor as provided in ¶¶6 and ¶8 hereof and accepted by Subcontractor in full payment, settlement and discharge of said claims.

05. Any such evidence as shall be required to substantiate and prove the claims of either party shall be presented and provided at the expense of the party submitting such evidence. Subcontractor shall be given adequate notice of all hearings and/or settlement conferences so as to arrange for attendance by Subcontractor's representatives and its attorneys. Subcontractor has the right to choose its attorneys, consultants, experts or other counsel, advisors or witnesses in the prosecution of this claim.

07. Subcontractor's share of any collection by way of any settlement or judgment on account of the claims of Subcontractor as set forth in Schedule "A" and the claims of Contractor or the claims of any other subcontractors, if any, against the Owner shall be determined as follows:
 - a. That portion of Subcontractor's said claims as may be filed in any decision or compromise wherein the amount allowed on account of Subcontractor's said claims is fixed and determined, separate and distinct, apart from the amounts allowed on account of all other claims.

- b. Concerning the acceleration claim, where a decision or compromise is had in such form that the method set forth in ¶7(a) cannot be determined, then Subcontractor's portion of the acceleration shall be 12.0% of the total amount received by the Contractor specifically for acceleration not to exceed \$116,067.00 plus interest, if any is allowed by the Owner. This allocation shall be binding on Subcontractor.
 - c. It is the intent of the parties hereto that Contractor is, and it expressly acknowledges that it is, responsible for the presentation of Subcontractor's claims as set forth in Schedule "A" against the Owner for the benefit of Subcontractor, that Contractor shall be liable for the payment to Subcontractor of the monies recovered on behalf of Subcontractor, if any, as provided herein, and that Subcontractor has accepted and does hereby accept the above provisos and agreements by Contractor and payment by Contractor of such amount, if any, as may be collected by Contractor from Owner for the claims of Subcontractor as determined in accordance with ¶6 and ¶8 hereof in full satisfaction, payment and discharge of the liability of Contractor to Subcontractor for Subcontractor's said claims. It is understood that if no amount is allowed and paid by Owner, then no amount shall be due Subcontractor. Contractor shall make any payment for Subcontractor's claims if any amount is due in accord with the Prompt Payment Act.
08. This Agreement shall not be deemed to be, nor construed as, nor is it the intent of the parties that it constitutes a waiver of any terms, conditions or provisions of the Subcontract between the parties, but merely provides for a method of presentation of the claims of Subcontractor as set forth in Schedule "A", the liquidation of the same, method of payment of same and provision for full satisfaction, payment and discharge of each and every liability of Contractor to Subcontractor. Without in any way limiting the generality of the foregoing, it is agreed that Subcontractor shall continue to be liable under any maintenance and/or guaranty obligations of the Subcontract and for the doing and performing of the various things specified to be done and performed by Subcontractor in its Subcontract to the extent that such matters or things remain to be done or performed by Subcontractor thereunder.

AGREEMENT NO. 4

(Simplified to Maintain Confidentiality)

This Agreement is between Contractor and Subcontractor effective _____.

Recitals

- A. Contractor is the prime contractor on two public projects and Subcontractor is a supplier and subcontractor to Contractor on both of the projects.
- B. During the course of the two projects Subcontractor has developed claims against Contractor and Owner and Contractor has developed claims against Subcontractor and Owner.
- C. The parties desire to enter into this Liquidating Agreement to organize and state their agreement with respect to the prosecution of the claims against Owner in terms consistent with the terms of their previous agreements.

Agreement

In consideration of the Recitals and the mutual rights and duties stated in this Agreement, the parties agree as follows:

- 01. Contractor is the prime contractor for two projects for Owner described as Project 1993 and Project 1996.
 - a. On Project 1993, Subcontractor has Purchase Order No. 1 and Subcontract No. 1.
 - b. On Project 1996, Subcontractor has Purchase Order No. 2 and Subcontract No. 2.
- 02. Under the Purchase Orders and Subcontracts identified above, it is a condition precedent of the obligation of Contractor to make payments to Subcontractor that Contractor actually receive funds for that purpose from Owner. Contractor and Subcontractor are both subject to terms and conditions of the [prime] Contract. Subcontractor is bound by all procedural provisions, administrative determinations and final judgments which are binding on Contractor as to any claims to be presented to Owner. Subcontractor is not entitled to receive any greater amount of money or time or other consideration from Contractor with respect to a dispute than Contractor is entitled to and actually does receive from Owner on account of Subcontractor's performance, less any markups or

costs to which Contractor is entitled and Subcontractor agrees it will accept such amount, if any, received by it in full satisfaction and discharge of all claims.

03. The balance unpaid for work performed or materials supplied by Subcontractor based upon final quantities as of the date of this Agreement, without any claims and withholdings, is:

a.	Project 1993	Purchase Order	\$160,170.23
b.	Project 1993	Subcontract	\$111,989.55
c.	Project 1996	Purchase Order	\$ 59,968.80
d.	Project 1996	Subcontract	<u>\$ 90,185.34</u>
	Total		\$422,313.92

04. Contractor has asserted against Subcontractor the following claims and exercised its right to withhold funds with respect to said claims:

a.	Project 1993	pass through liquidated damages	\$ 25,200.00
b.	Project 1996	pass through liquidated damages	\$ 11,760.00
c.	Contractor extended overhead		\$161,069.58
d.	Cost to damaged culvert		\$ 3,757.64
e.	Administrative charge on foregoing		<u>\$ 10,089.36</u>
	Total		\$211,876.58

05. With respect to Contractor claims in ¶4(a) and ¶4(b), the parties agree the liquidated damages will be disputed with Owner and that Contractor will impose and Subcontractor will accept only the amount of liquidated damages, if any, that remain at the conclusion of the legal dispute with Owner. With respect to Contractor claims in ¶4(c), the parties agree that it is a part of the claim of Contractor against Owner and to the extent that it is recovered from Owner, Contractor will not pursue it against Subcontractor. To the extent it is not recovered against Owner, Contractor will assert it against Subcontractor and Subcontractor reserves the right to dispute the validity of the claim. With respect to Contractor claims in ¶4(d), Subcontractor agrees to accept this claim. With respect to Contractor claims in ¶4(e), Subcontractor agrees to accept the 5% administrative charge assessed on the final amount of the backcharges as determined in accordance with this Agreement.

06. With respect to undisputed balances on Subcontractor's Subcontracts and Purchase Orders, if and only if and when and only when received from Owner, Contractor shall pay to Subcontractor pursuant to ¶7:

- a. From the first funds received, by joint check to Subcontractor and Materials Company until Materials Company is paid in full and has signed releases for Contractor and its Surety;
- b. From the next funds received, by joint check to Subcontractor and its Suppliers until its Suppliers are paid in full and have signed releases for Contractor and its Surety;
- c. Thereafter by check directly to Subcontractor.

Subcontractor will provide Contractor at the same time as signing this Agreement, a sworn list of all Suppliers and subcontractors of Subcontractor that have supplied material or provided labor and the amount presently due to each of said Suppliers and subcontractors. For any Supplier or subcontractor listed as being paid in full, Subcontractor shall provide Contractor a full and final Release signed by the Supplier or subcontractor.

07. Of the balance unpaid to Subcontractor described in ¶3, Contractor at this time has received for the work of Subcontractor, \$270,437.65 from Owner. After deduction of the amount withheld by Contractor for the reasons stated in ¶4, there is an undisputed balance payable, subject to normal Subcontract and Purchase Order provisions on payment, on the Subcontractor Subcontracts and Purchase Orders as of the time of this Agreement of \$58,561.07. This amount shall be paid by joint check to Subcontractor and Materials Company. Thereafter, as undisputed funds are received, Contractor will disburse in accordance with ¶6.
08. Subcontractor has a pass through claim against Owner in the amount of \$2,032,319.48 as originally submitted directly to Owner, which claim is attached hereto as Appendix 1 and Contractor has a claim against Owner for \$1,192,527.52, which claim is attached hereto as Appendix 2, a joint total of \$3,224,847.00. These are collectively referred to as the "Owner Claims". Contractor agrees to promptly revise its claim to reflect final quantities and charges and endeavor to do so within ten days of the date of this Agreement. Subcontractor agrees to promptly bring its claim current for final quantities and charges and endeavor to do so within ten days of the date of this Agreement. Subcontractor warrants to Contractor that its claim is being presented in good faith and is legally and factually supportable. The parties anticipate Owner will raise issues and defenses concerning contractual precedents such as notice and releases. Neither party to this Agreement warrants or covenants that it has succeeded in meeting all contractual precedents for a determination of the validity of all or any portion of the claims.

09. Claims shall be presented (as further elaborated herein) to Owner in accordance with the general conditions of the contracts with Owner which shall include:
 - a. Administrative claim procedure specified in Supplemental Specification §105.20;
 - b. State Public Works Mediation Act;
 - c. Litigation in a court of competent jurisdiction or arbitration if the amount in controversy has been reduced to bring the controversy within the limits of the Owner agreement to arbitrate.
10. Each party shall be directly in charge of and responsible for development of and presentation of its portion of the Owner Claims. Each party shall fully cooperate with the other party in the presentation of such other party's portion of the Owner Claims including, without limitation, promptly providing information and documentation needed for the presentation, and making witnesses available for consultation and preparation of the presentation. Both parties shall confer with regard to the proposed presentation and give due regard to the needs of the other party's proof. If the presentation of the proof or part of the proof of one party's claim directly interferes with the proof of the other party's claim, Contractor, as the named party, will make the decision as to what action to take.
11. Each party will bear its own attorney's fees, expert fees and costs. To the extent that common costs are incurred (e.g. common filing fees, deposition costs, mediation fees), they shall be borne pro rata on the initial claim ratio. To the extent possible, a party that intends to incur a cost that should be treated as a common cost shall give advance notice to the other party. If the cost is agreed to be a common cost and it is paid in full by one of the parties, the other party's share will be reimbursed within ten days of notice of the payment. If it becomes necessary for Contractor, as the party in privity with Owner, to incur legal fees in the actual presentation of proof of Subcontractor's claim, Contractor will provide advance notice and Subcontractor will repay such fees within ten days of notice by Contractor of payment.
12. At any stage of the administrative, mediation, arbitration or litigation process in which a decision must be made concerning resolution of the Owner Claims, including presentation of a settlement offer from Owner or the receipt of a decision from which there is a subsequent step, the parties agree:

- a. The parties shall promptly confer and if there is agreement on the proper response, that shall be the response taken;
 - b. To the extent it is possible for each party to separately decide, with respect to its portion of the Owner Claims without adversely affecting the other party's rights, each party may make the response it deems appropriate;
 - i. If the settlement or decision is acceptable to Subcontractor but rejected by Contractor, then Contractor shall be entitled to continue pursuit of its portion of the Owner Claims;
 - ii. If the settlement or decision is acceptable to Contractor but rejected by Subcontractor, then Subcontractor shall be entitled to continue pursuit of its portion of the Owner Claims in the name of Contractor at the sole expense and risk of Subcontractor provided, however, that if continued pursuit of such portion poses any risk for Contractor which is unacceptable to Contractor in the exercise of its sole discretion, then ¶12(c) applies.
 - c. To the extent it is not possible for each party to separately decide with respect to its portion of the Owner Claims without adversely affecting the other party's rights, then Contractor, as the party in privity and in whose name the claims must be brought, shall have authority to accept or reject the decision or settlement offer. So long as the decision is made in good faith, the decision shall be final and binding on Subcontractor without further right of appeal or dispute other than provided in ¶12(d).
 - d. If there is no agreement by the parties as to the proper allocation of costs or settlement or recovery, then the issue of allocation shall be decided by Contractor. If Subcontractor disagrees with the allocation, Subcontractor may present the issue of the proper allocation of the cost, settlement or decision, but not the issue of whether the cost, settlement or decision was acceptable or should have been accepted, to arbitration in accordance with this Agreement.
13. The liability and obligation of Contractor to Subcontractor to pay the Owner Claims of Subcontractor is conditioned upon, payable from and only out of and limited to such amounts as may be collected on behalf of Subcontractor by way of any settlement by Contractor with Owner whether before or after the commencement of any action or proceeding or from any recovery from Owner in any action or proceeding, after trial thereof or as the result of any appeal or appeals, and upon such collection

being made by Contractor for said claims, payment of any sums collected for said claims to be made by Contractor to Subcontractor as provided in ¶6 and accepted by Subcontractor in full payment, settlement and discharge of said Owner Claims.

14. Any dispute concerning this Agreement, or the performance, interpretation, or breach thereof shall be resolved by arbitration pursuant to the Construction Industry Arbitration Rules of the American Arbitration Association then in effect. Notice of demand for arbitration must be filed in writing with the other party to this Agreement and with AAA. The demand must be made within thirty days after the claim, dispute or other matter in question has arisen.

In any arbitration the Arbitrator shall have no power to render an Award which has the effect of altering or amending or changing in any way any provisions of this Agreement or the parties' Purchase Orders and Subcontracts. The Award of the Arbitrator shall be final and binding. In any such arbitration, the Arbitrator shall have the powers of a court having jurisdiction as well as all of the powers pursuant to the Rules. Without limiting the generality of the foregoing, the Arbitrator shall have the power to award attorney fees and other costs, in the discretion of the Arbitrator, and shall have the power to issue orders for injunctive relief. The parties agree to exchange all relevant documentation that would be discoverable in a court of law. Depositions shall be allowed to the extent the parties can both agree or which the Arbitrator may order for the purpose of discovery as well as for preserving evidence.

15. Subcontractor has commenced litigation. Subcontractor will stay that litigation during the course of the parties' action taken in accordance with this Agreement. If the claims of the parties are resolved as provided for in this Agreement at the administrative stage, then Subcontractor will dismiss the action with prejudice. If the claims of the parties are not resolved at the administrative stage and Contractor is required to file litigation against Owner, Subcontractor will continue the stay in effect pending resolution of the litigation between Contractor and the Owner. If the claims or the parties are resolved in accordance with this Agreement as a result of litigation between Contractor and Owner, then Subcontractor will dismiss the action with prejudice. Only if Contractor refuses and fails to pay to Subcontractor those amounts which would be required to be paid under this Agreement as the result of the administrative or litigation proceeding involving the Owner and after resolution of any disputes by arbitration as required by this Agreement will Subcontractor have a right to continue the action and then only with respect to the collection of any amounts that would be due in accordance with any arbitration award taken pursuant to the terms of this Agreement.

16. The parties agree that they have a common interest and purpose in the prosecution of the claim and the defense to claims raised by the Owner. Communications between Subcontractor and Subcontractor's counsel and Contractor and Contractor's counsel with respect to the claim are for the purpose of pursuing this common interest. It is the intention of the parties that information, opinions, etc. revealed by them concerning the prosecution of the claim be privileged and not disclosed -- that they shall be entitled to the attorney-client and work product privileges. Each party agrees that it will not release or disclose such privileged communications without the express consent of the other party and agrees that it shall not have the power or the authority to waive the privileges.
17. Any notice, consent, waiver or demand pursuant to or in connection with this Agreement must be in writing and either personally delivered to the authorized representative of the party or placed in the U.S. mail postage prepaid, certified or registered, return receipt requested, addressed to the party or parties hereto at the addresses stated in this Agreement to the attention of the signatories of this Agreement (or at such other addresses or to the attention of such other persons as the parties may designate by written notice to the other party).
18. This Agreement shall not be deemed to be, nor construed as, nor is it the intent of the parties that it constitute a waiver of any of the terms, conditions or provisions of the Subcontracts and Purchase Orders between the parties, but merely provides for a method of presentation of the claims, the liquidation of the same, method of payment of same, and provision for full satisfaction, payment and discharge of each and every liability of Contractor to Subcontractor. Without in any way limiting the generality of the foregoing, it is understood and agreed that Subcontractor shall continue to be liable under any maintenance and guaranty obligations under the Subcontracts and Purchase Orders and for the doing and performing of the various things specified to be done and performed to the extent that such matters or things remain to be done or performed by Subcontractor thereunder.
19. Nothing in this Agreement will be construed as a waiver or release of Contractor's Surety under its Payment Bonds.
20. This Agreement shall be deemed to have been jointly prepared and no ambiguity herein shall be construed against any party hereto based upon the identity of the author of this Agreement, or any portion thereof.

CONTRACTOR

SUBCONTRACTOR

By: _____

By:

AGREEMENT NO. 5³

01. Contractor and Subcontractor shall use their reasonable best efforts to separate their claims arising from Government action or inaction. To the extent practicable, Contractor shall seek separate government evaluation of these claims, request that the government make separate settlement offers, and negotiate individual settlements. If the government makes a total settlement offer including both Contractor and Subcontractor claims and the offer is acceptable to Contractor, Contractor shall make a good faith allocation of an equitable portion of the proceeds payable to Subcontractor from the Government's total settlement offer. Contractor's allocation shall consider the Government's evaluation of the claims of each party during audit, fact-finding, negotiations and legal analyses; defenses and offsets by the Government; indications of merit or lack of merit of claims; quality of supporting data and documentation; and the elements of the Government's lump-sum offer and how it was evaluated and presented.

02. Contractor may, in its sole discretion, invite Subcontractor to settlement negotiations with the Government if it appears to Contractor that a lump-sum settlement may be offered or one has been offered by the Government and if a lump-sum settlement may be accepted by Contractor. The sum allocated by Contractor to Subcontractor shall be paid when received from the Government, less outstanding claims or reasonable offsets of the government or the Contractor. Acceptance by Subcontractor of payment of the allocated sum shall be a full accord and satisfaction of all Subcontractor claims against Contractor relating to Government action or inaction.

³ Huffcut, Basic Techniques of Public Contracts Practice §20.19 (California Continuing Education of the Bar, 1977).

Appendix 3

LIQUIDATION AGREEMENT CHECKLIST

1. Identification of parties and persons to be bound
 - 1.1. contractual parties
 - 1.2. sureties
 - 1.3. assignees
 - 1.4. lower tier subcontractors - suppliers
2. Identification of the dispute
3. Liability of GC to subcontractor
 - 3.1. Concession of liability with limitation to results obtained.
4. Liquidation of Damages
5. Payment Trigger: What event must occur for subcontractor to actually receive funds?
6. Stipulations?:
 - 6.1. factual (e.g. who is withholding how much)
 - 6.2. legal (e.g. contractual method of presentation of claim)
7. Indemnity and responses to counterclaims, crossclaims, offsets, retaliation, defenses
8. Cooperation, best efforts, time and attention, good faith
 - 8.1. positive standards - disclosures
 - 8.2. negative standards - shall not interfere in the progress of the work
 - 8.3. Time - proceed expeditiously
9. Who prepares and presents the dispute
 - 9.1. Overall control -- over-ride or veto
 - 9.2. Specific evidence control - witnesses, records, etc.
 - 9.3. Certification requirements

10. Liability of Sub to GC
 - 10.1. Indemnity
11. Who pays what legal fees
 - 11.1. Each party bears own
 - 11.2. Sub pays its own plus those of GC
 - 11.3. pro-rata with amount or complexity of claim
12. Who pays costs
 - 12.1. Filing fees
 - 12.2. Arbitrator fees
 - 12.3. Expert fees
13. Settlement rights or obligations
14. Appeal rights or obligations
15. Privilege issues
 - 15.1. Joint defense or common interest agreement
 - 15.2. Non-disclosure and proprietary data agreements
16. Disputes arising from or related to liquidation agreement
 - 16.1. mediation
 - 16.2. arbitration
 - 16.3. litigation
17. Boilerplate
 - 17.1. Priority of liquidation agreement and subcontract.
 - 17.2. Choice of Law and Jurisdiction
 - 17.3. Notice
 - 17.4. Others (non-waiver, integration, etc.)

