

Court Decision Finds NYSDOT's Standard Settlement Agreement Unenforceable

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Is New York State Department of Transportations' Standard Settlement Agreement An Illusory Promise? Recent Federal Court Decision Finds NYSDOT's Standard Settlement Agreement Unenforceable Because Of A Lack Of Consideration [1]

Construction contractors that negotiate the terms of a claim with the New York State Department of Transportation ("NYSDOT" or "State") are often frustrated by: (i) the NYSDOT's snail-like pace for conducting supplemental due diligence reviews of the claim documentation; or (ii) the NYSDOT's reduction of the claim amount, notwithstanding the parties' agreement to the claim amount in a prior executed settlement agreement. Furthermore, a delay claim means that a contractor has already incurred significant unanticipated costs on a large public construction project. The contractor will most likely have to tap its working capital to satisfy its additional labor and other costs caused by the delay claim. If it does not, it runs the risk of numerous subcontractors making claims against the contractor's performance and payment bonds with the contractor's surety.

In turn, multiple claims against the contractors' surety bonds can lead to a variety of problems with its surety—the provider of the contractor's bonding facility. Problems with the contractors' surety or bonding facility can severely impact a contractor's operations due to the lack of additional bonding capacity to continue its operations and to complete its open, bonded projects. Those problems can also adversely impact the contractor's ability to bid on new work. Accordingly, most contractors cannot afford to finance long and costly disputes with the NYSDOT over delay and other claims arising out of a project.

A recent decision by the United States Bankruptcy Court for the Eastern District of New York held that the NYSDOT standard letter settlement agreement (the "Agreement") arising out of a delay claim on a public construction contract was unenforceable against a heavy construction company, Grace Industries, Inc. ("Grace"), because the Agreement lacked consideration, one of the fundamental elements necessary to the formation of a contract.[2] The Court's decision has the potential to significantly strengthen a contractors' bargaining position with the NYSDOT regarding the terms of any settlement of a claim arising out of public construction contracts. Among other things, a contractor can now seek (i) to include language in the NYSDOT's standard agreement that limits the amount of time for the NYSDOT to perform any supplemental due diligence review of a contractor's claim to a date certain, commonly referred to as a sunset clause, and (ii) also to include a provision that requires the NYSDOT to submit any change orders or final agreements seeking payment for the claim to the Office

of the State Comptroller by a date certain.[3] Given the court’s recent decision in Grace, the NYSDOT should be more amenable to altering the language of their form settlement agreements in order to demonstrate to the courts that adequate consideration exists to create an enforceable contract between the parties.

Grace’s History

Grace was founded in 1952 and operated a heavy construction business in the New York metropolitan area for approximately fifty-four years.[4] During its existence, Grace had been involved in major highway, bridge and airport construction projects including, but not limited to, the rehabilitation of Segment 6 of the West Side Highway. Grace primarily worked for the Port Authority of New York and New Jersey and agencies of the City and State of New York. The company employed approximately 330 people during the height of its paving season.

Historically, Grace had operated profitably. In the late 1990s and early 2000s, however, it began to experience significant cash flow problems due to losses on certain public construction projects, including its project to for the reconstruction of a portion of the West Side Highway. The costs and disruptions to Grace’s cash flow emanating from its projects, along with certain disputes with Grace’s surety and secured lender, caused the company to seek protection pursuant to Title 11 of Chapter 11 of the Bankruptcy Code in December of 2004.

The Project

On May 12, 1998, the NYSDOT awarded Contract D257543 (the “Contract”) for the reconstruction of Route 9A (a/k/a the West Side Highway) from West 25th Street to West 40th Street in New York, New York (the “Project”) to Grace. The Project was essentially set up for three different roadways, the southbound detour road, the southbound roadway, and the northbound roadway. Pursuant to the Project guidelines, these three roadways were to be rebuilt in a sequential manner to allow a continuous and unimpeded traffic flow for tens of thousands of daily commuters. The Project was, to begin with, the construction of new tide gates next to the Hudson River to allow traffic to be shifted onto the southbound detour road prior to completing southbound and northbound roadways and shifting the traffic as each roadway was completed.

The Contract was divided into two parts: the “A” portion and the “B” portion. The “A” portion described the work that Grace needed to complete the Project and set forth the amounts Grace would be paid for each item. The “B” portion set the Project’s completion date and provided Grace with either a bonus or a penalty depending on Grace’s ability to successfully meet the Contract’s deadline for completion. Grace submitted a bid of \$53,644,312 for the Project consisting of an “A” portion of \$43,744,312 and a “B” portion of \$9,900,000 for a 660-day term at a penalty or bonus of \$15,000 per day.[5] Eventually, the State paid Grace a time bonus of \$1.65 million because Grace had successfully completed the Project earlier than the time specified in the “B” portion of the Contract.

Grace Discovers An Undisclosed Differing Site Condition — The Elliptical Pipe

On November 10, 1998, when excavating in connection with the construction of a tide gate, Grace discovered an elliptical pipe (which measured 68 inches wide by 43 inches tall) that did not appear on the drawings or site

information the State provided to Grace and the other prospective bidders. The State acknowledged that the undisclosed elliptical pipe was a “differing site condition” (“DSC”) as that term is defined in Section 109-16 of the NYSDOT’s Standard Specifications (the “Specifications”). Shortly after it discovered the pipe, on November 11, 1998, Grace gave proper written notice to the State of the pipe’s existence.

The State Restages the Project

On December 4, 1998, the NYSDOT responded to Grace’s letters by directing Grace to begin work on a modified stage 2 of the Project. That letter represented the beginning of the Project’s restaging at the direction of the State. Grace alleged that the restaging fundamentally changed the Project’s CPM or “critical path method,” an NYSDOT-mandated project management tool used to schedule the key or critical project activities necessary to complete a project in a safe, efficient and effective manner. Grace also asserted that the Project’s restaging led to a significant increase in Grace’s labor costs on the Project because Grace could no longer use its labor in a sequential manner that it had planned to use to complete the different stages of the Project and upon which Grace had based its bid for the Project.

As a result of the delay and changes to the Project caused by the DSC, Grace also incurred additional overhead costs. To provide funds to begin paying Grace for its additional overhead costs, the State added \$3 million to the Contract pursuant to order on a contract which was issued in July 2000. Eventually, the NYSDOT paid Grace \$2.7 million dollars for its additional overhead costs on the Project, which payment the NYSDOT later contended constituted consideration under the settlement agreement. The State agreed that the delay claim was a time-related dispute subject to Sections 109-16, 105-14 and 109-05(D) of the Specifications. The State also agreed to entertain a claim by Grace for delay compensation because, among other reasons, Grace had given the State proper notice of a claim for time-related damages pursuant to Section 105-14 of the Specifications.

The Failed Settlement Agreement

By 2003, Grace was in a poor financial condition due in part to its significant losses on the Project which the State had accepted as complete on January 23, 2003. Against that backdrop, Grace and the NYSDOT entered into settlement negotiations regarding Grace’s delay claim. After the parties had come to a general agreement as to the final sums due and owing Grace on the Project, the State prepared its standard or form letter agreement to memorialize the terms of the parties’ settlement.

In a March 3, 2003 standard settlement letter to Grace, which is the Agreement referred to in his article, the NYSDOT stated that it was willing to pay actual, reasonable and verifiable costs of approximately \$7.1 million in connection with the items set forth in the letter to settle Grace’s delay claim against the State. Although the final settlement number was well below Grace’s alleged losses on the Project, it authorized its attorney to countersign the Agreement because (i) it urgently needed an infusion of funds and (ii) Grace believed that it would receive the funds promptly. The State issued an order on a contract or an amendment to the contract in the amount of \$4.45 million which, in conjunction with an earlier order on contract in the amount of \$3 million, were to provide the necessary funds required under the Agreement. The State, however, notified Grace that it was reducing the amounts set forth in the Agreement as a result of an audit by the Office of the State Comptroller (“OSC”). Grace

disputed the results of that audit.

The Decision

On August 15, 2007, Grace initiated a lawsuit against the NYSDOT for a breach of contract seeking approximately \$7,870,619 in damages and a declaratory judgment with respect to the parties' rights and obligations under the Agreement. Among other things, Grace asserted that the State breached the Agreement because of its failure to pay all sums due and owing to Grace. On January 28, 2008, after the NYSDOT answered Grace's initial complaint and asserted a counterclaim based on the OSC audit results, Grace filed an amended complaint seeking \$10,680,503 in damages for the NYSDOT's alleged breach of the contract. Subsequently, the NYSDOT answered Grace's amended complaint.

At trial, Grace argued that the Agreement was unenforceable because the NYSDOT did not furnish adequate consideration for the Agreement. The NYSDOT disagreed and asserted that the Agreement was supported by consideration because (i) the Contract did not require the NYSDOT to pay Grace for its alleged losses related to the delay claim; and (ii) the NYSDOT had merely agreed to pay the actual, reasonable and verifiable costs attributed to the delay claim in the Agreement. The court eventually rejected the NYSDOT's argument and ruled in favor of Grace.[6]

After a four -day trial, Grace moved pursuant to Rule 52(c) of the Federal Rules of Civil Procedure for a judgment on partial findings asserting that the NYSDOT had not provided sufficient evidence for the court to find that the Agreement was enforceable against Grace. On September 23, 2009, the court issued its decision granting Grace's motion for partial summary judgment against the NYSDOT and finding the Agreement to be unenforceable because it lacked consideration.[7]

The court based its decision on the plain language of the terms of the Specifications that were incorporated into and governed the terms of the Contract and the testimony of two of the State's own witnesses.[8] Section 109-05(D) of the Specifications provides that a contractor may recover its actual and reasonable expenses, including labor and material expenses, caused by a time-related dispute.[9] Two of the State's witnesses also testified that Grace was entitled to some compensation because of the delay claim caused by the DSC and restaging of the Project.[10] The court found that the State's witnesses' testimony and the plain terms of the Specifications established that Grace was entitled to recover its actual, reasonable and verifiable costs incurred as a result of the DSC and related restaging.[11] As such, the court reasoned that the NYSDOT's promise to pay Grace for its actual costs incurred because of the DSC did not constitute fair consideration because the NYSDOT was already obligated under the terms of the Contract to compensate Grace for its actual costs related to the delay claim.[12]

In support of its decision, the court also focused upon the Agreement's lack of a legal detriment to the NYSDOT.[13] The terms of the Agreement capped Grace's costs which provided a benefit to the NYSDOT if Grace's costs were higher than the settlement amount. The Agreement; however, did not require the NYSDOT to pay Grace a minimum amount or make a payment to Grace by a date certain.[14] Accordingly, the court found that the Agreement provided the NYSDOT with the benefit of a cap on Grace's damages on the Project but did not obligate the NYSDOT to do anything that the NYSDOT was not already obligated to do under the plain terms of the

Contract.[15] The court also rejected the State's argument that the payment of millions of dollars to Grace after the Agreement's execution constituted consideration that rendered the Contract enforceable.[16] The court disagreed stating that the State was already obligated under the Contract to make those payments to Grace pursuant to Specifications and the Contract.[17] Therefore, the court found that the Agreement was not an enforceable contract under applicable New York State law.[18]

Conclusion

The court's decision is an important one for contractors performing on public construction contracts with the NYSDOT because it gives contractors the ability to include additional payment and timing terms in a settlement that are not contained in the NYSDOT's standard settlement agreement. For example, a contractor may now seek to include terms that accelerate the due diligence or payment process for settlements with the State by inserting sunset clauses or other deadlines into the NYSDOT standard settlement agreements. Sunset clauses or other negotiated deadlines will require the NYSDOT to complete its due diligence review on a contractor's claim and submit the claim documentation to the OSC by a date certain. In the past, contractors would often negotiate a claim settlement with the NYSDOT only to find after the contractors and the State had reached an agreement that the NYSDOT required additional due diligence regarding the claim, even though a particular contractor and the NYSDOT already reached an agreement with respect to the settlement of the claim. The State could take months, if not years, to complete such due diligence. As a contractor asserts a claim against the State because of financial losses suffered on a particular project, any additional delays in the payment process caused by open-ended due diligence periods and the State's relatively slow payment process would only cause additional financial harm to the contractor. Accordingly, contractors should use all available tools at their disposal, including the *Grace* decision, to ensure that their claims are resolved in a timely, fair and just manner as is required by the terms of the dispute resolution section of the Specifications.

1. The opinions and positions set forth in this article are of the author only, and not of Cullen and Dykman, LLP.
2. All references and citations to the Court's decision in this article relate to an unpublished opinion by the Honorable Carla E. Craig, Chief Bankruptcy Judge for the United States Bankruptcy Court for the Eastern District of New York in the action titled *Gil Industries, Inc. f/k/a Grace Industries, Inc. v. New York State Department of Transportation, See Gil Industries, Inc. f/k/a Grace Industries, Inc. v. New York State Department of Transportation, Adv. Pro. No. 07-01464* (CEC), Decision [Dkt. No. 70] (Bankr. E.D.N.Y, September 23, 2009).
3. Pursuant NY CLS High § 38 (8) (2008), NY CLS St. Fin § 112 (2) (2009) and Article V, §1, of the New York State Constitution, the NYSDOT cannot bind the Office of the State Comptroller to the amount and/or timing of the payment of any sums in a settlement agreement on a public construction contract. Accordingly, contractors may use the reasoning set forth in the *Grace* decision to limit the amount of time the NYSDOT can use to conduct any additional due diligence of a potential claim and to process any related paperwork in order to accelerate the NYSDOT's performance of its obligations within the State's payment process.
4. The factual background for this article is based upon certain pleadings filed in Grace's bankruptcy case and related trial testimony, including the undisputed facts of that certain joint pre-trial statement dated January 15, 2009, that was filed in Grace's adversary proceeding against the State.
5. This means Grace would receive a \$15,000 bonus for every day it completed its work earlier than the Project's contemplated completion date. On the other hand, Grace would have been penalized the sum of \$15,000 for every day it was late in completing the Project.

6. See *In Re GII Industries, Inc.*, Adv. Pro. No. 07-01464 (CEC), Decision [Dkt. No. 70] (Bankr. E.D.N.Y, September 23, 2009).
7. See *In Re GII Industries, Inc.*, Adv. Pro. No. 07-01464 (CEC), Decision [Dkt. No. 70] (Bankr. E.D.N.Y, September 23, 2009).
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. See *In Re GII Industries, Inc.*, Adv. Pro. No. 07-01464 (CEC), Decision [Dkt. No. 70] (Bankr. E.D.N.Y, September 23, 2009).
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*

Practices

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Industries

- Business Reorganization and Financial Restructuring
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Attorneys

- Matthew G. Roseman