

Application of the UCC to Construction Projects: Suppliers Beware

BY FRED R. KOZAK

Imagine a material supplier who provides a defective or nonconforming product for a construction project. The product could be shoddy cabinets for a military base, or ready mix concrete that does not meet the compressive strength requirements of the project. Under the UCC, the material supplier may be liable not only for direct damages to replace or repair the defective product, but also may face a claim for delay or impact costs, lost profits, liquidated damages, or other consequential damages.

The Uniform Commercial Code (UCC), adopted by Virginia and most other states, seeks to codify the law applicable to the sale of goods between merchants. Where applicable, the UCC may differ from traditional contract law, particularly in the areas of contract formation and remedies for breach.

Construction projects may involve contracts to provide services alone, materials (or “goods”) alone, or a mixed combination of services and materials, in varying proportions. The UCC only applies if the particular contract in question is considered a sale of “goods,”¹ defined as “. . . all things (including specially manufactured goods) which are movable at the time of identification to the contract of sale. . . .”² Contracts which are solely for either goods or services alone are easily categorized.

If a contract involves both goods and services, the majority of courts apply the “predominant factor” test to determine if the UCC applies.³ If the transaction is predominantly a sale of goods, with labor only incidentally involved (e.g., purchase of a water heater with installation), the UCC will apply.⁴ If the primary purpose of a contract is to provide a service, with goods incidentally involved (e.g., a contract for the construction of a house),

the contract is considered one for services, governed by contract law and not the UCC. Most courts find construction contracts to be primarily for services and therefore not covered under the UCC.⁵

Based on the above principles, most contracts between owners, contractors, subcontractors, and architects will be governed by contract law. Most contracts (or purchase orders) between contractors or subcontractors and material suppliers, however, will be considered sales of goods covered by the UCC.

Application of the UCC may have unexpected consequences for both the unwary contractor and material supplier. The supplier probably expects that if it supplies defective or nonconforming goods, it may be liable to replace the materials, refund the purchase price, pay the difference of replacement materials, or even bear the cost of repairs. These types of general or direct damages are among buyer’s remedies under the UCC.⁶

In proper cases, however, the UCC also allows the buyer to recover “incidental and consequential damages” under Va. Code § 8.2 - 715. Consequential damages can be particularly significant where the buyer accepts non-conforming goods and later sues for breach of contract or warranty under Va. Code § 8.2 - 714.⁷

Incidental and consequential damages are described in Va. Code § 8.2 - 715 as follows:

§ 8.2-715. Buyer’s incidental and consequential damages.

(1) Incidental damages resulting from the seller’s breach include expenses reasonably incurred in inspection, receipt, transportation and care and

custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.

(2) Consequential damages resulting from the seller’s breach include (a) **any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise**; and (b) injury to person or property approximately resulting from any breach of warranty. (Emphasis added).

Consequential damages may include lost profits, loss of good will, losses resulting from interruption of buyer’s production process, lost interest, and much else. To recover consequential damages, the buyer must establish: (1) causation; (2) foreseeability; (3) reasonable certainty as to amount; and (4) that he is not barred by mitigation doctrines.⁸

By use of the “reason to know” language in § 8.2 - 715(2)(a), the UCC adopts the objective test of reasonable foreseeability as the standard to recover consequential damages. The foreseeability required to recover consequential damages is established where the parties, at the time of contracting, knew or had reason to know facts that would make the loss a foreseeable result of the breach.⁹

As stated by Professor Corbin:

All that is necessary, in order to charge the defendant with a particular loss, is that it is one that ordinarily follows the breach of such a contract in the usual course of events, or that reasonable men in the position of the parties would have foreseen as the probable result of breach.¹⁰

In a construction materials contract or purchase order, it is common for the contractor to have provided the supplier with product specifications or requirements for the project. Those

specifications may be stated or referred to in the contract or purchase order - for example, a purchase order issued by a concrete supplier to provide "4,000 p.s.i. concrete." Accordingly, the specifications or requirements create a contractual obligation and an express warranty that the product supplied will conform to the requirements.¹¹ In addition, there may be implied warranties of merchantability and/or fitness for a particular purpose.

Unless properly excluded or waived, providing a nonconforming or defective product may subject the supplier to consequential damages. Such damages are not limited to the contract price of the product.¹²

For example, in one case a buyer purchased cement blocks to be used as components in the production of structural planks.¹³ The buyer instructed the block supplier on its requirements for the blocks, including the dimensions, strength, and material. Some of the blocks delivered were defective, causing problems with the buyer's production. The buyer sued for both direct and consequential damages. The court ruled that the block supplier had reason to know - in fact had actual knowledge - of the buyer's general and particular requirements, and that the buyer's losses resulted directly from the failure of the blocks to meet those requirements. The court held the block supplier liable for the claimed consequential damages, including loss of plant time, hauling costs for defective blocks, and additional labor costs to handle broken and defective block units.

In another case, a subcontractor successfully sued its concrete supplier for breach of contract and breach of warranty for delivery of concrete which did not meet the 3000 p.s.i. strength required in construction of an apartment building. When the defect was discovered, work on the project halted pending correction. Eventually, remedial steps including reconstruction were taken to correct the structural inadequacies. The court found that the need to replace defective concrete was reasonably foreseeable, and that the supplier was liable for consequential damages, including delay damages.¹⁴

The supplier may limit its exposure to consequential damages by properly worded limitations that are made a part of the supply contract or purchase order. In *Flintkote Company v. W.W. Wilkinson, Inc.*,¹⁵ the contractor sued the floor tile manufacturer for breach of the implied warranty of merchantability. As a result of defective tile, the owner required the contractor to overlay the rejected tile, leading to substantial remedial costs and liquidated damages for delay. The tile manufacturer's product literature did not exclude the implied warranty of merchantability, although it did conspicuously exclude any implied warranty of fitness for a particular purpose. The product literature also stated - in regular language - that the warranty was limited to replacement of defective products, or at the manufacturer's option, refund of the purchase price. The Court ruled that as opposed to exclusion of warranties, conspicuous language was not required to create a valid limitation of remedy. Accordingly, the Court reversed the judgment against the manufacturer, and remanded the case for a trial on the issue of whether the limitation of remedy was made a part of the parties' contract.

Whether or not an exclusion of warranties or limitation of remedies is made a part of the contract is an important issue. In *J.B. Moore Electrical Contractor, Inc. v. Westinghouse Electric Supply Co.*,¹⁶ the contractor reviewed the project specifications with the electrical supplier, including the requirement for completion within a certain time, and the possibility of liquidated damages. The supplier then submitted to the contractor a purchase order which contained a disclaimer of consequential damages, including delay or liquidated damages. The contractor signed the purchase order without making its acceptance conditional on the supplier's elimination of its disclaimer of liability for consequential damages. During the course of the project, late shipments by the supplier subjected the subcontractor to liquidated damages. The contractor attempted to hold the supplier liable for the liquidated damages, based on letters it had written to the supplier stressing the importance of timely performance.

The Court ruled, however, that the disclaimer language in the supplier's purchase order had become part of the contract, and accordingly the supplier was not liable for consequential damages.¹⁷

Conclusion

A defective or nonconforming product can cause big problems on a construction project, particularly if the defect is not discovered until after the product is incorporated into the structure. In such cases, the cost of the defective product may be the least expensive item of damage. Remedial costs or costs to remove and replace the defective product, with resulting time impacts and delay damages, may be significant. Delays in shipment may also be costly to the owner or contractor. Product suppliers will seek to minimize exposure to such liabilities, while contractors and other buyers will seek to preserve their remedies. To protect themselves, all parties to the transaction need to know (1) what remedies and what limitations are afforded by the UCC, and (2) how those remedies are preserved or liabilities limited in the formation of the contract for sale.

NOTES

1. Va. Code § 8.2 - 106 (1); § 8.2 - 109 (this title applies to transactions in goods).

2. Va. Code § 8.2 - 105 (1).

3. *Bonebrake v. Cox*, 499 F.2d 951 (8th Cir. 1974); *Lane Construction Corp. v. Trading Merchandising Co., Inc.*, 34 Va. Cir. 383 (1994) (whether implied warranties applied to a contract for paving a parking lot depended on a factual determination of whether materials or services predominated in the contract).

4. See, e.g., *Princess Cruises Inc. v. General Electric Co.*, 143 F.3d 828 (4th Cir. 1998).

5. White & Summers, Uniform Commercial Code § 9-12, at 482 (4th Ed. 1995) ("White & Summers").

6. See Va. Code §§ 8.2 - 711, -712, -713, and -714 (buyer's remedies); White & Summers, § 6-3, at 186-87; § 6-5, at 208.

7. § 8.2-714. Buyer's damages for breach in regard to accepted goods.

(1) Where the buyer has accepted goods and given notification (subsection (3) of section 2-607), he may recover his damages for any non-conformity of tender, the loss resulting in the ordinary course of events from the seller's breach as determined in any manner which is reasonable.

(2) The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of

the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount.

(3) In a proper case, any incidental and consequential damages under the next section may also be recovered.

The Official Comment to § 8.2-714, Comment 2 states:

The "non-conformity" referred to in subsection (1) includes not only breaches of warranties but also any failure of the seller to perform according to his obligations under the contract. In the case of such non-conformity, the buyer is permitted to recover for his loss "in any manner which is reasonable."

8. *White & Summers*, Uniform Commercial Code § 6-5, at 210-11 (4th Ed. 1995).

9. *White & Summers*, § 10-4, at 376-77. The majority of courts considering the subject have held that the UCC rejects the "tacit agreement" or "special circumstances" requirement for recovery of consequential damages. See, e.g., *R.I. Lampus Co. v. Neville Cement*, 378 A.2d 288 (Pa. S. Ct. 1997)

10. Corbin, Contracts, Section 1010, at 79 (1964). Damages which a seller "has reason to know of" are those which flow from the breach in the ordinary course of business. *White & Summers*, § 10-4, at 374.

11. See *Fournier Furniture, Inc. v. Waltz-Holst Blowpipe Co.*, 980 F. Supp. 187 (W.D.Va. 1997) (specifications for furnace contained in proposal constituted express warranty).

12. *Id.* Buyer's damages are not limited to the contract price. Under the UCC, the buyer is entitled to incidental and consequential damages that can exceed the purchase price. The buyer is entitled to be put in the same position as if the contract was fulfilled.

13. *R.I. Lampus Co. v. Neville Cement*, 378 A.2d 288 (Pa. S. Ct. 1997)

14. *District Concrete Co. v. Bernstein Concrete Corp.*, 418 A.2d 1030 (Ct.App.D.C. 1980). In another case, *S.M. Wilson & Co. v. Reeves Red-E-Mix Concrete, Inc.*, 350 N.E.2d 321 (Ill.App. 1976), the plaintiff contracted with the defendant to supply concrete for a hospital in accordance with certain specifications provided to the supplier. When the concrete turned out to be defective, the court stated that the only relevant specification was the compressive strength requirement. The court further stated that if the slab had to be removed, the defendant would be liable for the cost of removal and replacement "and for any loss incurred through the delay necessarily involved." 350 N.E.2d at 325. In *Whitaker's Inc. v. C.B.C. Enterprises*, 820 F.Supp. 242 (E.D.Va. 1993), a cabinet manufacturer supplied cabinets and vanities which were defective and rejected by the owner. The contractor sought damages to obtain replacement cabinets, home and field office overhead, and other consequential damages. The court denied recovery of the claimed consequential damages, because it found that

both parties had contributed to the project delays.

15. 220 Va. 564, 260 S.E.2d 229 (1979).

16. 221 Va. 745, 273 S.E.2d 553 (1981).

17. If a contract contains an exclusion of damages which are arguably consequential, the plaintiff in a proper case may attempt to recover under 8.2-714(1) if the damages can be shown to be direct. *White & Summers*, §

10-2, at 364-65. For example, delay damages may be consequential or direct, depending on the contract. If the project time requirements and consequences of delay or liquidated damages are stated or incorporated into the material supply contract or purchase order, delay damages may be direct damages for the breach of that particular contract. *White & Summers*, § 10-4(d), at 379.

The Subcontractor's Dilemma: Recovery of Damages Caused by the Owner Under Virginia Law

BY WILLIAM E. FRANCKEK AND JOHN R. LOCKARD

Many subcontractor claims on construction projects, if not the majority, result from causes that may be the responsibility of the project owner. Such problems include unanticipated subsurface conditions, changes, delays, and acceleration. The general contractor and the subcontractor may agree to jointly pursue such claims against the owner, sometimes called "pass through" claims. Often, the general contractor and subcontractor agree to share *pro rata* the costs of pursuing the claims and the recovery in proportion to the individual amounts of the claims.

A common misconception is that such owner responsible claims are compensable. Virginia law, however, creates several obstacles to the subcontractor that wants to recover for owner caused damages. Virginia law generally prohibits actions by subcontractors against owners for lack of privity of contract. At the same time, the Virginia courts have held that a subcontractor may not recover from the general contractor for delay damages that were not caused by some circumstance under the general contractor's control, unless the general contractor has contractually agreed to be responsible for such damages. The ultimate implications of these decisions, however, are not clear.

The Causation Problem: *Doyle & Russell v. Welch Pile Driving Corporation*

In 1973, the Supreme Court of

Virginia decided *Doyle & Russell v. Welch Pile Driving Corporation*. In *Welch*, the pile driving subcontractor sought damages from the general contractor for delays caused by unexpected subsurface conditions. The parties stipulated that the delays were not caused by the general contractor or by any person over which the general contractor had control.

The Supreme Court of Virginia held that

Absent a contractual commitment *contra*, a general contractor is not liable to its subcontractor for damages flowing from delays incurred by the subcontractor unless the delays were caused by the general contractor or some agency or circumstance under his direction or control.

The Supreme Court of Virginia found that at least part of the subcontractor's claim was for delays that were not caused by the general contractor. Therefore, the general contractor could only be responsible for such amounts if it contractually agreed to be responsible. The Court found that the subcontract was ambiguous with regard to this issue and remanded the case to the trial court so that the jury could consider evidence of the parties' intent.

The *Welch* holding has some limitations. On its face, the case only applies to delay claims by the subcontractor. The case does not address other claims such as, claims for increases in direct costs. Also, the general

contractor may still remain liable for delays that originate with other parties. For example, the general contractor should be responsible for delays caused by one of its other subcontractors, because the general contractor has the ability to control the other subcontractors. Likewise, a delay caused by the owner may not impact the subcontractor but for schedule decisions made by the general contractor in response to the delay. Presumably, this delay would be caused by the general contractor and not excluded by *Welch*.

The Virginia Supreme Court in *Welch* did recognize that the subcontract could expressly provide that the general contractor would be responsible for owner caused delays or that the general contractor could agree to be responsible for the extra costs in a change order. Few, if any, subcontracts, however, contain such language. In fact, many subcontracts expressly provide that the subcontractor is only entitled to an extension of time for any delays and the general contractor is not responsible for any damages resulting from the delay. These are known as “no damage for delay” clauses and are generally enforceable in Virginia. Other subcontract clauses limit the general contractor’s liability to amounts recovered from the owner. As discussed below, however, these latter clauses create different problems.

The Lack of Privity Problem: APAC-Virginia, Inc. v. Virginia Department of Highways & Transportation

Seventeen years after *Welch*, the Court of Appeals of Virginia decided *APAC-Virginia, Inc. v. Virginia Department of Highways & Transportation*. In *APAC-Virginia*, the general contractor sought to recover delay damages from the Virginia Department of Highways & Transportation (“VDOT”) for additional costs incurred by a subcontractor. The general contractor did not seek any of its own damages and the style of the case indicated that the suit was filed on behalf of its subcontractor. The Court of Appeals noted that “[a]n action on a contract must be brought in the name of the party in whom the legal interest is

vested.” Applying that rule of law, the court held that the action was barred because of the lack of privity of contract between the subcontractor and VDOT.

Although *APAC-Virginia* is a Court of Appeals decision and is not binding authority, the case has had wide impact. First, unlike *Welch*, *APAC-Virginia* addresses to all subcontractor claims, not just delay claims. Second, at least some circuit courts have interpreted *APAC-Virginia* to mean that a general contractor cannot recover damages incurred by its subcontractor unless the general contractor can prove that it has more than “potential” or “contingent” liability to the subcontractor. For example, in *Marriott Corp. v. Thomas P. Harkins, Inc.*, the Circuit Court of Fairfax County held that a general contractor must prove that it is actually liable for a subcontractor’s claim before it can include the claim in a suit against the owner. While the court held that the general contractor did not have to actually pay the subcontractor before filing suit against the owner, it concluded the general contractor did have to demonstrate that it was liable to its subcontractor pursuant to its subcontract or settlement agreement.

The interpretation of *APAC-Virginia* as expressed in the *Harkins* decision makes it difficult for the general contractor and subcontractor to resolve their disputes prior to bringing suit against the owner. In *Harkins*, the general contractor reached a settlement agreement with several of its subcontractors that provided that the general contractor would only be liable to the subcontractor to the extent the general contractor recovered against the owner. Such settlements are often called “pass through agreements” or “liquidation agreements.” The court, however, found in that case that the general contractor could not pursue these claims against the owner. The court reasoned that the general contractor had no real liability because if the general recovered nothing from the owner, it would not be liable to the subcontractors.

Harkins has two important ramifications. First, many subcontracts contain language similar to the “pass through agreement” in *Harkins* that limits

the general contractor’s liability for owner caused damages to only amounts actually recovered from the owner. In *Harkins*, the subcontractors recovered nothing on their claims because any potential recovery was contingent upon the general contractor’s recovery from the owner. By the same reasoning, a subcontractor that signs a subcontract that limits the general contractor’s liability to amounts recovered from the owner may, in effect, be waiving all its claims in advance for any owner caused damages.

Second, under *Harkins*, the general contractor must essentially admit liability to its subcontractors before the issue of the owner’s responsibility has been decided. Obviously, this is not an attractive option for the general contractor. It is also not an efficient way to resolve construction disputes.

The Subcontractor’s Dilemma

The combined impact of *Welch* and *APAC-Virginia* creates significant problems for subcontractors. Under some circuit court interpretations of *APAC-Virginia*, the general contractor cannot sue the owner to recover damages on behalf of a subcontractor unless the general contractor can show that it is actually liable for the subcontractor’s claim. In many cases, therefore, the subcontractor would have to file an action directly against the general contractor for its damages. Under the *Welch* decision, however, the subcontractor cannot sue the general contractor for delay damages caused by the owner. The subcontractor appears to be left without a remedy for recovery of delay damages caused by the owner, absent a contractual agreement to the contrary.

This result is demonstrated in *Harkins, supra*, where all but one of the subcontractor claims was denied because the court found that the general contractor had no liability pursuant to the “pass through agreements.” This holding was based on *APAC-Virginia*. The last subcontractor claim involved delay damages that had been reduced to a settlement agreement that was not contingent on the owner’s liability. The court also dismissed this claim, however,

because the general contractor and subcontractor had stipulated in the settlement agreement that the general contractor did not cause the delays. As such, the court found that the general contractor could have no liability to the subcontractor pursuant to *Welch*. *Harkins* is a case where all the subcontractors lost their claims because they had reached settlements with the general contractor.

The Subcontractor Options after *Welch* and *APAC-Virginia*

Welch and *APAC-Virginia* are not problems for all construction projects. The Code of Virginia has abolished the privity requirement for claims against the Virginia Department of Transportation. Likewise, federal law allows the recovery of subcontractor costs on federal construction projects. On other Virginia construction projects, unfortunately, *Welch* and *APAC-Virginia* have created a situation that does not reflect the realities of construction practices. The holdings also do not allow for efficient resolution of construction disputes.

The subcontractor does have some options. The subcontractor can insist that the general contractor assume liability for owner delays pursuant to the terms of the subcontract or change orders. The subcontractor can also file suit against the general contractor directly alleging that the general contractor caused the delay. This is not a particularly desirable option, but the general contractor then should be able to bring the owner into the suit pursuant to third party practice rules. Neither of these options, however, resolves the underlying problem of making the owner directly responsible

for damages caused by its actions.

APAC-Virginia is not binding authority. In an appropriate case, the Supreme Court of Virginia may overrule or clarify this decision. By comparison, there are New York decisions similar to *Welch* and *APAC-Virginia*. Very recently, however, the New York Supreme Court, Appellate Division, recognized that a general contractor may pursue a subcontractor's claim against the owner pursuant to a liquidation agreement.

Several contractor groups have also lobbied in the last few years for legislation to expressly allow general contractors to pursue subcontractor claims against the owner in Virginia. Until such time as the law is changed, however, subcontractors will need to carefully review their subcontracts, settlement agreements, and lien waivers to ensure that they preserve their rights to recover damages for which the owner may be responsible. ♦

NOTES

1. 213 Va. 698, 194 S.E.2d 719 (1973).
2. *Id.* at 699-700.
3. *Id.* at 699.
4. *Id.* at 700-01 (citing *Norcross v. Wills*, 198 N.Y. 336, 91 N.E. 803 (1910); *McGrath v. Electrical Construction Company*, 230 Or. 295, 364 P.2d 604 (1961).
5. *Id.* at 702.
6. *Id.*
7. *Id.* at 703. The results of the case on remand were not reported.
8. *Id.* at 702.
9. The Virginia Public Procurement Act provides some limitation on "no damage for delay" clauses for state government contracts. Va. Code Ann. § 2.2-4335 (Michie 2001).
10. 9 Va. App. 450
11. *Id.* at 451.
12. *Id.* at 452.
13. *Id.* Since *APAC-Virginia*, the Code of Virginia has been amended to allow pass through claims on VDOT projects. Va. Code Ann.
14. 30 Va. Cir. 515, 518-19 (Circuit Court of Fairfax County, 1990).
15. *Id.* at 519-20.
16. *Id.* at 518.
17. *Id.*
18. *Id.*
19. *Id.* at 518-19.
20. Va. Code Ann. § 33.1-386 (Michie Supp. 2001).
21. Rule 3:10 of the Rules of the Supreme Court of Virginia. See also *Valley Landscape Company, Inc. v. Rolland*, 218 Va. 257, 262, 237 S.E.2d 120 (1977) ("Under Rule 3:10 a defendant can bring in a third-party defendant only for the purpose of passing through to the third-party defendant all or part of the liability which might be imposed on the defendant by the plaintiff as the result of the conduct of the third-party defendant.").
22. See *Triangle Sheet Metal Works, Inc. v. James H. Merritt and Co.*, 588 N.E. 2d. 69 (N.Y. 1991) (general contractor not responsible for delays caused by owner, citing *Welch*); *Alvord & Swift v. Muller Constr. Co.*, 385 N.E.2d 1238 (N.Y. 1978) (subcontractor cannot sue owner directly due to lack of privity of contract).
23. *Bovis Lend Lease LMB, Inc. v. GCT Venture, Inc.*, 728 N.Y.S.2d 25 (N.Y. App.Div. 2001). Of note in *Bovis*, the subcontract contained a "no damage for delay" clause that should have prevented the subcontractor from recovering any delay damages from the general contractor. After the delays occurred, and in spite of the "no damage for delay" clause, the general contractor and subcontractor entered into a liquidation agreement addressing the subcontractor's delay claim. The New York court upheld this agree-