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Aaron P. Silberman

Disputes and Litigation of Energy Savings Performance Contracts

By Aaron P. Silberman

The federal government incurs billions of dollars in energy and water costs annually. Recent statutory mandates compel government agencies to conserve energy and water and reduce these costs. While there are available measures for the government to do so, many of these measures would be prohibitively expensive using appropriated funds. A way in which agencies increasingly have solved this dilemma is through energy savings performance contracts (ESPCs). State and local governments' and commercial owners' use of ESPCs is growing as well.

ESPCs are authorized by statute and regulation. They enable the government to obtain energy- and water-saving measures through private investment. The government only pays the contractor, or energy savings company (ESCO), to the extent that promised savings are realized. While it does not take ESP to see that the future of ESPCs is quite bright, these contracts also pose many challenges—some unusual or unique—that may lead to disputes between project participants.

What Are ESPCs?

Under an ESPC, the government hires an ESCO to perform a "detailed energy survey" to identify areas in which a government facility can reduce its energy

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Advising Clients in Green-Building Disputes: Four Steps for Defining Roles in LEED Projects

By Jennifer Grippa

Jennifer Grippa

Sustainability has hit the construction market, and sustainable practices and policies are becoming a battleground for owners, architects, contractors, subcontractors, and engineers, among others. Parties attempting to incorporate green-building standards into their construction contracts are having difficulty allocating responsibility, particularly when standards like Leadership in Energy and Environmental Design (LEED) call for an integrated process that requires input from the owner, architect, contractor, mechanical engineer,

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Joshua Shaw is an attorney with Turner Padget Graham & Laney, P.A. in Columbia, South Carolina.

Endnotes

1. Colleton Preparatory Acad. v. Hoover Universal, Inc., 666 S.E.2d 247, 253 n. 8 (S.C. 2008).
2. 403 P.2d 145 (Cal. 1965).
3. 476 U.S. 858, 871 (1986) (quoting *Seely*, 403 P.2d at 151).
4. 63B Am. Jur.2d *Products Liability* § 1912.
5. *See* 6 Bruner & O'Connor Construction Law § 19:10 (listing 11 exceptions).
6. Although *East River* ended the debate over risk-of-harm approaches in many jurisdictions, the debate has remained lively in some. *Compare* KB Home v. Superior Court, 5 Cal.Rptr.3d 587 (Cal. App. 2 Dist. 2003) *and In re* Chi. Flood Litig., 680 N.E.2d 265 (Ill. 1997) *with* Pratt & Whitney Canada, Inc. v. Sheehan, 852 P.2d 1173, 1181 (Alaska 1993) *and* Touchet Valley Grain Growers, Inc. v. Opp & Seibold Gen. Const., Inc., 831 P.2d 724, 733 (Wash. 1992).
7. 412 F. Supp.2d 560 (D.S.C. 2006).
8. 666 S.E.2d 247, 251.
9. ___S.E.2d ___, 2009 WL 4893648 (2009) (not yet released for publication at time article was written).
10. 666 S.E.2d at 253.
11. 667 A.2d 624 (Md. 1994).
12. Maryland's highest appellate court.
13. 667 A.2d at 631 (citing Council of Co-Owners v. Whiting-Turner, 517 A.2d 336 (Md. 1986) and U.S. Gypsum v. Baltimore, 647 A.2d 405 (Md. 1994)).
14. *Council of Co-Owners*, 517 A.2d at 338.
15. *Morris*, 667 A.2d at 629.
16. Heritage Harbour, L.L.C. v. John J. Reynolds, Inc., 795 A.2d 806, 811 (Md. Spec. App. 2002).
17. Potomac Constructors v. EFCO Corp., 530 F.Supp.2d 731, 738 (D. Md. 2008).
18. *Council of Co-Owners*, 517 A.2d at 338.
19. *Morris*, 667 A.2d at 629.
20. Maryland's intermediate appellate court.
21. *Heritage Harbour*, 795 A.2d at 811.
22. *Id.* at 811–812 (quoting *Morris*, 667 A.2d at 631) (emphasis added).
23. *Potomac Constructors*, 530 F. Supp.2d 731, 734.
24. *Morris*, 667 A.2d 624, 633.
25. 916 A.2d 257 (Md. 2007).
26. *Id.* at 270 (quoting *Morris*, 667 A.2d at 632).
27. *Morris*, 667 A.2d at 633.
28. Rebecca Korzec, Lloyd v. General Motors Corporation: *An Unfortunate Detour in Maryland Products Liability Law*, 38 U. Balt. L.F. 127, 141 (2008).
29. *Colleton Prep*, 666 S.E.2d at 258 (Pleicones, J., dissenting) (quoting Carolina Winds Owners' Ass'n v. Joe Harden Bldr., 374 S.E.2d 897, 905–06 (S.C. Ct. App. 1988)).
30. *See* Gary T. Schwartz, *The Economic-loss Doctrine in American Tort Law: Assessing the Recent Experience*, *in* Civil Liability for Pure Economic Loss, 130 (Efstathios K. Banakas ed., 1994).
31. *East River*, 476 U.S. 858, 871 (referring to the "need to keep products liability and contract law in separate spheres and to maintain a realistic limitation on damages").

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Disputes and Litigation

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and/or water usage and cost and, based on that survey, to design, procure, construct, install, and arrange financing for energy/water conservation measures (ECMs). Common examples of ECMs include energy-efficient windows and doors, improved insulation, automated controls (e.g., for lights and thermostats), reduced-flow plumbing fixtures, updated HVAC equipment, and even on-site energy generation (e.g., solar, photovoltaic, and geothermal).

ECMs may be self-funded by the ESCO or financed by a third party under a separate financing agreement (either through separate construction-and-operations loans or through escrow financing). Until recently, a defining characteristic of ESPC projects was that they were never financed by the government,[1] but in the Energy Independence and Security Act of 2007 (EISA), Congress authorized ESPCs in which ESCOs are paid in part with appropriated funds.[2] For the non-appropriated portion of an ESPC, the ESCO provides in its proposal to the government a certified Selection Memorandum and financing offer, describing how it and/or a third party will provide financing for the project.

Under the National Energy Conservation Policy Act of 1978 (NECPA), the ESPC must specify cost savings expected as a result of the ECMs, and the ESCO must guarantee those savings as a term of the ESPC.[3] The NECPA defines "energy savings" as a reduction in the agency's cost of energy as compared to a base cost established through a methodology set forth in the contract.[4] The expectation is that the ECMs implemented by the ESCO will lower the agency's utility bills, so the agency will spend less appropriated funds on utilities after the construction and free up those funds for other uses.[5]

Unless mixed-funded, the ESPC does not obligate the government to commit any appropriated funds or to pay any of the project's capital costs up front. Rather, the ESPC provides

that the contracting agency will pay the ESCO a specified share of the energy-cost savings guaranteed under the ESPC.[6] Usually, the ESPC provides that the government will pay the ESCO an "annual-in-advance" payment at the start of each year in the amount of the ESCO's share of the guaranteed savings for that year. The ESCO in turn uses these payments to pay for the financing (i.e., debt service) and to fund any performance-period services, such as operations and maintenance (O&M), repair and replacement (R&R), measurement and verification (M&V), and training.

ESPCs are long-term contracts, lasting up to a maximum of 25 years.[7] While they may be shorter, agencies may not establish policies to limit ESPC projects to less than the maximum 25-year term.[8] After the contract ends, all subsequent savings accrue to the government.

The NECPA requires that ESPCs provide that, at least once per year, the ESCO will submit an M&V report to the agency, showing whether the guaranteed cost savings for the year have been realized. If not, then the ESCO is required to pay the difference to the government. Moreover, the aggregate annual amount of agency payments to the ESCO and for utilities cannot exceed the amount the agency would have paid for utilities without an ESPC.[9]

Federal government ESPCs are regulated in the Federal Acquisition Regulation (FAR)[10] and Department of Energy (DOE) regulations.[11] DOE regulations trump any inconsistent FAR provisions. The DOE has established the Federal Energy Management Program (FEMP), which has issued qualified-contractors lists, implementation procedures, standard terms and conditions, and conditions of payment.[12]

The DOE and other government agencies, including the Army and Air Force, have awarded indefinite-delivery, indefinite-quantity (IDIQ) ESPCs, dubbed "super-ESPCs."[13] Like other government IDIQ contracts, super-ESPCs allow agencies to award delivery orders without a full-blown contract competition, and they establish general terms and conditions that apply to all orders issued under them.[14] In December 2008, DOE awarded 16 super-ESPCs for up to $80 billion in projects at federal facilities. As with traditional ESPCs, many states have also authorized use of super-ESPCs.

Protesting ESPC Awards

Like other government contract awards, awards of ESPCs and super-ESPCs are subject to agency-level protests and protests at the government Accountability Office (GAO) or Court of Federal Claims (COFC).[15]

Any delay in completion necessarily will shorten the energy-performance period.

Prior to May 2008, almost no delivery orders awarded under super-ESPCs were subject to protests.[16] The 2008 Defense Authorization Act changed that by authorizing the GAO to hear protests of delivery orders in excess of $10 million under IDIQ contracts awarded since May 23, 2008.[17] So, since then, when an agency awards a delivery order of over $10 million under a super-ESPC, any other ESCO with a DOE super-ESPC may challenge that award by filing a GAO protest.

The burden on the protestor in such challenges will be difficult to meet, as government agencies have broad discretion in selecting the firms with which they will negotiate delivery orders.[18]

Contracting Issues

Many critical issues to the success and risk allocation of ESPC projects are left to the parties' discretion in negotiating their particular ESPC or delivery order. The ESCO ultimately will be responsible for the selection, design, installation, and performance of the equipment it installs. But the parties get to decide, and the contract should make clear, whether the ESCO will carry these responsibilities only through construction and government acceptance, for a limited trial performance period, or for the entire contract term.

The parties also may negotiate their respective responsibilities for O&M and R&R. Typically, the agency will operate the equipment with ESCO oversight, and the ESCO will be responsible for R&R. A significant issue is whether the ESCO assumes R&R responsibility under contract-warranty provisions, which typically expire after one year, or extend to the end of the energy-performance period, which may last 20 years or more.

Changes

Because ESPCs cover such long periods, the government often changes its use of subject facilities in ways that affect its energy usage and savings, the equipment it needs, and the ESCO's ongoing service obligations. The most extreme examples are when the government decides to demolish the facility. In those cases, the ESPC should provide that the ESCO will be entitled to continuing payment based on savings achieved before demolition and ideally should provide details on which savings will be used for that calculation (e.g., those achieved in the year before demolition, the most recent three-year average, the average over the energy performance period up to demolition).

More frequently, the government will make significant changes to its facilities during the ESPC term, and those changes will impact ESCO performance obligations and/or achieved energy savings. Again, the ESPC should provide that, to the extent that government changes reduce energy savings, the ESCO still will be entitled to payment based on the savings achieved before the changes. With a traditionally funded,

fixed-price government contract, to the extent that government-imposed changes increase the contractor's cost of performing its obligations, the Changes clause provides for an equitable adjustment to the contract price. This approach usually will not work under ESPCs because of the lack of contract funding. Instead, ESPCs will typically provide that, when the government adds or changes equipment to the facility, it will award a sole-source service contract, called a "companion service contract," to the ESCO for the O&M and R&R of the new or changed equipment.

Scheduling and Delay Issues

The pricing structure of ESPCs places higher schedule risk on ESCOs than traditional contracts do for contractors. An ESCO's recovery under an ESPC depends on the government's realization of guaranteed cost savings during the *post-construction* energy-performance period. Where the term of an ESPC is the statutory maximum 25 years (as is often the case), these savings may be projected out over 20 or more years. Any delay in completion of construction necessarily will shorten the energy-performance period (which the parties are legally precluded from extending) and consequently reduce the government's energy-cost savings and the ESCO's compensation.

All of this puts a premium on scheduling. If the ESCO is too ambitious in its planning and proposal, or if the party responsible for scheduling after contract award gets it wrong, the consequences of delay may be severe. Even a modest delay may quickly put the ESCO in an overall loss position. And, unlike contractors under traditional contracts, which may find extra time to be an adequate remedy for non-disruptive delay, ESCOs under ESPCs will almost always suffer monetary damage because of lost energy-cost savings from any critical-path delay.

One way to lower the ESCO's schedule risk is for the ESPC to allow commissioning of individual ECMs prior to completion of the entire installation. This provides the agency earlier savings and the ESCO earlier cash flow. This method was used, for example, on the delivery order issued by the National Aeronautics and Space Administration under a DOE super-ESPC for the Johnson Space Center.

Termination Issues

Special issues also arise when the government terminates an ESPC for default or convenience.

The standard default-termination clause in fixed-price federal construction contracts provides that, in the event of a contractor default, the government is entitled to take over the work and recover or offset against the contract balance all resulting damages, including its excess reprocurement costs.[19] ESPCs are different because there is no "contract balance." So, does this mean that, in the event the government terminates the ESPC for default, the government has no further obligation to pay the ESCO? Such a rule would often lead to inequitable results because the government's post-termination energy savings in many cases will exceed its excess reprocurement costs for the O&M and R&R services the ESCO would have provided, and, as such, the government would receive a windfall.

ESPCs are well suited to addressing the government's environmental concerns.

In *Enron Federal Solutions, Inc. v. United States*, the COFC denied a default-terminated contractor's claim for its pre-termination expenses under a similar type of contract. In that case, the Army Corps of Engineers terminated a utility-privatization contract. Like an ESPC, that contract required the contractor to pay substantial up-front costs and to provide ongoing O&M services, and it entitled it to payments that would amortize the initial costs over an extended term (10 years). The Corps terminated the contract after less than three years, at which point the contractor had spent about $11.6 million and been paid about $4.2 million. The court denied the contractor's claim for the asserted value of the improvements, which reverted to the Corps. The court found that, because the contract allocated the risk of the capital improvement costs to the contractor, its default entitled the government to enjoy those improvements without paying for them.[20] While it is unclear whether a court would reach the same result in an ESPC default-termination case, this is a risk the parties should take into account.

With regard to convenience terminations, the parties should, and typically do, tailor ESPCs to account for special issues they present. For example, the ESPC should include pre-negotiated terms for retirement of the ESCO's financing debt in the event the government terminates the ESPC for convenience.

When it terminates an ESPC for convenience, the government might argue that, because the contract does not entitle the ESCO to payment unless and until guaranteed energy-cost savings are realized, the ESCO will only be entitled to recover its costs under a termination settlement if and when, and to the extent that, the work performed prior to the termination generates those savings. This argument likely would fail. *Jacobs Engineering Group, Inc. v. United States*[21] is instructive, even though it involved a cost-reimbursement development-and-construction contract with a cost-sharing provision, rather than an ESPC. In *Jacobs Engineering*, the Federal Circuit held that the cost-sharing provisions in Jacobs's contract, which obligated the government to pay Jacobs only 80 percent of its actual costs during performance, did not apply in the context of a termination for convenience. Under

the termination-for-convenience clause, Jacobs was entitled to recover "all costs reimbursable under the contract." In the case below, the COFC granted summary judgment for the government, concluding that the contract's termination-for-convenience and cost-sharing provisions, read together, meant that Jacobs was entitled only to 80 percent of its costs incurred as of the termination. The Federal Circuit reversed, holding that the "all costs reimbursable" language in the termination-for-convenience clause described the type, rather than the amount, of costs Jacobs could recover, such that it was entitled to all, rather than 80 percent, of the types of costs that were specified as reimbursable under the contract.

Bonding Issues

One bonding issue for ESPCs is whether and to what extent the Miller Act applies. The Miller Act requires contractors to obtain performance and payment bonds on all projects for "the construction, alteration, or repair of any public building or public work of the Federal government."[22] Miller Act bonds are not required, however, for service contracts. Because the scope of work on ESPC projects includes both construction and services (i.e., the initial energy audit and post-construction O&M, M&V, and R&R), application of the act to such contracts is unclear.

If a federal agency chooses to treat an ESPC as a service contract, rather than a construction contract, this may deprive subcontractors of Miller Act protections. *Department of Army v. Blue Fox* is instructive. In that case, the army contracted for installation of a telephone switching system at an army depot, including construction of a concrete-block building to house the telephone system and installation of certain safety and support systems. The army treated the contract as a service contract and so did not require that the general contractor obtain a Miller Act bond. The Supreme Court held that the subcontractor was not entitled to an equitable lien on the government property, leaving the subcontractor without an effective remedy.[23] Subcontractors under ESPCs should be aware of the risk that, as in *Blue Fox*, the government might treat an ESPC as a service contract, and, if it does so, the ESCO will not be required to obtain a payment bond for the protection of its subcontractors.

Even if the Miller Act applies, how should the required bond amount be calculated? The act provides that the prime contractor (here, the ESCO) must obtain a bond for 100 percent of "the total amount payable by the terms of the contract" for any project over $100,000.[24] But, under an ESPC, no one will know the contract price until the end of the energy-performance period—up to 25 years after the contract term started. Typically, the agency will require a bond in the amount of the ESCO's share of the total guaranteed cost savings, even though this will include the amount payable for services.

Another issue is how long the ESCO should be required to maintain the bond. It is unclear whether agencies *must* require bonding through the energy-performance period or only through the construction period (i.e., until the agency accepts the installed ECMs). While agencies certainly *may* do so, especially if the ESCO will be subcontracting out any of its M&V, O&M, or R&R work, typically they do not. Miller Act bonds should not be required for that work because it is not predominantly construction, alteration, and repair.

Where ESCOs obtain performance and payment bonds, ESPCs present several other issues. First, ESPC subcontractors and suppliers face a dilemma regarding the statute of limitations for payment-bond claims. The Miller Act provides that a bond claimant may not maintain an action on the bond unless (a) it "has not been paid in full within 90 days after [it] did or performed the last of the labor or furnished or supplied the material for which the claim is made" and (b) the action is filed within one year "after the day on which the last of the labor was performed or material was supplied by [it]."[25] But what triggers the statute if a subcontractor performs services after construction is completed, such as M&V? A subcontractor that performs both construction and post-construction work could end up in a position where it will be unclear whether it should sue before it has completed its post-construction work and risk being premature, or wait until it completes that work and risk being too late.

Second, where the surety has to either take over under the performance bond or pay a subcontractor or supplier under the payment bond, the general indemnity agreement in the bond will entitle the surety to recoup its costs from any remaining balance on the ESPC. But, because the ESPC does not state a firm contract price, how will the surety determine the contract balance? To obtain the protections it would enjoy under bonds for traditional projects, the surety often will require an escrow agreement with the ESCO's financing company that will ensure the surety access to the project funds.

Finally, with the substantial investment that financing companies provide on ESPCs, they typically want to be protected under the ESCO's bonds. While the standard bond only protects the owner (i.e., the government) as an obligee, the financing company will often require that the surety agree to name it as a dual obligee (along with the owner).

Conclusion

The federal budget deficit and the environment are two of the most pressing and difficult issues facing the government today, and that is not going to change any time soon. ESPCs are well suited to addressing the government's environmental concerns, and they work in the fiscal confines of even the most cash-strapped agencies. For these reasons, it is hard to see ESPCs going away in the near future. To the contrary, use of ESPCs is rising and likely will keep on doing so for some time to come, and counsel for participants in ESPC projects need to be aware of the unusual issues and risks these unique contracts present.

Aaron P. Silberman is a shareholder at Rogers Joseph O'Donnell in San Francisco, California. He is the chair of the committee's Design Professional Liability Subcommittee.

Endnotes

1. 42 U.S.C. § 8287(a)(1) 2007.
2. Pub. L. No. 110-140, § 512 (2007).
3. 42 U.S.C. § 8287(a)(2)(B).
4. 42 U.S.C. § 8287c.
5. "Issues related to share-in-savings contract authorities of the [NECPA] and the Clinger-Cohen Act," B-287488, 2001 U.S. Comp. Gen. LEXIS 217 (June 19, 2001) (citing 42 U.S.C. § 8287; Pub. L. No. 104-52, § 625, 109 Stat. 468, 502-503 (1995)).
6. 2001 U.S. Comp. Gen. LEXIS 217; FAR 23.205(b)(1).
7. 42 U.S.C. § 8287(a)(1); FAR 23.205(b)(1).
8. EISA, § 513.
9. 42 U.S.C. § 8287(a)(2)(B).
10. 48 C.F.R. § 23.205.
11. 10 C.F.R. Part 436.
12. 10 C.F.R §§ 436.32, 436.33, 436.35 and 436.36.
13. *See Johnson Controls, Inc.*, B-282326, 99-2 CPD ¶6; *Strategic Resource Solutions Corp.*, B-278732, 98-1 CPD ¶74.
14. FAR 16.505.
15. *See, e.g., Johnson Controls,* 99-2 CPD ¶6.
16. Federal Acquisition Streamlining Act of 1994 (FASA), 41 U.S.C. § 253(j) (prohibiting most delivery-order protests).
17. "Enhanced Competition Requirements for Task and Delivery Order Contracts," Pub. L. No. 110-181, 122 Stat. 3, § 843 (2008).
18. *Strategic Resource Solutions*, 98-1 CPD ¶74 at 4–5; *see also Intellectual Properties, Inc.*, B-280803.2, 99-1 CPD ¶83.
19. FAR 52.249-10(a).
20. 80 Fed. Cl. 382 (2008).
21. 434 F.3d 1378 (Fed. Cir. 2006).
22. 40 U.S.C. § 3131.
23. 525 U.S. 255, 257-58 (1999); *see also* Arvanis v. Noslo Eng'g Consultants, Inc., 739 F.2d 1287, 1289-90 (7th Cir. 1984).
24. 40 U.S.C. § 3131(b).
25. 40 U.S.C. § 3133(b)(1).

Green-Building Disputes

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civil engineer, and/or landscape architect. Because the LEED process involves multiple parties, disputes arise from communication failures and misunderstanding of responsibilities. As LEED construction grows, so too will confusion about the respective roles that each party plays in the process. By advising clients to take the following steps, they can minimize chances the of green-building disputes.

1 Assign and communicate responsibilities before work commences. Call a meeting with the parties as early as possible (*before* contracts are signed and work commences) to discuss and identify the owner's LEED-related goals and expectations. Understand the consequences if a LEED certification is not obtained or if a particular level of certification is not achieved. Identify which LEED credits will be sought and who will be responsible for the work associated with achieving each credit. Within each credit, pinpoint specific actions each party is responsible for, and how and when they will communicate with one another to ensure the work necessary to obtain the credit is accurately and timely performed. Be as specific as possible, and make sure each party comprehends what will be contractually expected from them. The green-building process will run more smoothly if respective roles are assigned and communicated early on.

2 Define roles and responsibilities in the contracts. Once the parties have determined who will be responsible for which LEED roles, document it. All too often the parties do not take the time to memorialize their agreement in writing. This common pitfall is one of the most expensive mistakes a client can make. Regardless of how collegial the parties are at the outset, how professional the other parties seem, or how exceptional their reputation is in the industry, a written contract is critical. It should specify who is responsible for which LEED components. It is also important to identify who will be held accountable if the project fails to achieve the desired level of LEED certification and what each party's rights and remedies are if, for example, someone uses the wrong materials or impairs the owner's ability to obtain a LEED certification. The contract should also address how changes in the scope of work will be handled in light of LEED requirements.

Where subcontractors or suppliers are performing work or providing materials necessary to achieve LEED credits, the subcontract-or-supplier agreement should expressly incorporate the owner's contract, and the subcontractor/supplier should be provided a copy. Contractors frequently fail to supply their subcontractors with a copy of the underlying contract with the owner, making it difficult to hold a subcontractor responsible if the subcontractor does not know the owner's LEED expectations and is not contractually obligated to comply with those known requirements. The contractor should always have a written record of its delivery of the underlying contract to the subcontractor and the subcontractor's willingness to meet the requirements necessary to obtain the desired LEED certification.

The contract is an important means of protecting your client against liability if someone else fails to perform their LEED responsibilities. For instance, if someone else is in charge of LEED online or for determining compliance with intents and requirements, be sure to affirmatively state that it is excluded from your client's scope of work. If your client is not guaranteeing the project will obtain LEED certification at all or even a particular LEED level, be sure to express that in the contract. If your client does not intend to be accountable for lost tax credits or incentives if the project does not obtain LEED certification, note that in the contract. If your client expects final payment before the U.S. Green Building Council (USGBC) makes a decision on LEED certification, the contract should also address this. As green construction becomes

