Update on Differing Site Conditions Claims In California: Can Public Entities Disclaim Subsurface Conditions In Light Of Public Contract Code § 7104?

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It is a common scenario – a contractor bids on a construction project with the expectation that certain subsurface conditions exist. During construction the contractor encounters unexpected subsurface conditions which dramatically increase the project cost. Who pays for this additional cost, the owner or the contractor? Typically, the answer depends on who bears the risk under the contract. Now, however, with the variety of risk shifting provisions owners use, and the increasing number of federal and state laws governing construction contracts, analyzing the contract alone is not enough. One such law is California Public Contract Code § 7104, which requires California local public entities to include a differing site conditions clause in all construction contracts involving excavation deeper than four feet.

Traditional Risk Allocation

In the past, the risk of unexpected subsurface conditions typically fell on the contractor. A prudent contractor would therefore include a “contingency” in its bid to cover the risk of encountering adverse subsurface conditions. As a result, owners received higher bid prices and paid for the worst-case scenario regardless of the actual subsurface conditions encountered. In addition to increasing bid prices, this method of risk allocation had another inherent flaw. Because a contractor could not accurately estimate the cost impact of unknown conditions, its contingency would rarely match the conditions actually encountered. The contingency would either be too much or too little. Clearly, the traditional approach to allocating the risk of subsurface conditions was an imperfect approach for both parties. To address this problem, owners have incorporated various risk allocation provisions in their contracts. The most common of these provisions is the differing site conditions (“DSC”) clause, also sometimes called a “changed conditions” clause.

Some Background on DSC Clauses

Today, DSC clauses are found in virtually all public works construction contracts. The federal government first used a DSC in 1927, and such a clause is now required in all federal government construction contracts. Following the federal government’s lead, most state and municipal public agencies now include a DSC clause in their construction contracts. A typical DSC clause provides two methods by which the contractor can obtain an increase in the contract price due to subsurface conditions. Under a “Type I” DSC, the contractor is entitled to a price increase if it encounters conditions different from those represented in the contract documents. Under a “Type II” DSC, the contractor is entitled to a price increase if the conditions are unanticipated and of an unusual nature.
not inherent in the type of work being performed. The distinction between the two methods is that a Type I claim is based on the owner’s representation of subsurface conditions, whereas a Type II claim requires only that the condition be unexpected and unusual - no representation of subsurface conditions is required. Because most construction contracts contain at least some subsurface information, Type I DSC claims are far more common.

**Purpose of the DSC Clause**

The purpose of the DSC clause is to shift the risk of unexpected site conditions to the owner. If the contractor encounters unexpected subsurface conditions that increase the project’s cost, the owner is to grant the contractor a price increase. In theory, the DSC clause eliminates the need for contractors to include contingencies in their bids. The owner receives lower bid prices and pays for unexpected subsurface conditions only if the contractor encounters such conditions. The U.S. Court of Claims explained the rationale well in *Foster Construction C.A. & Williams Bros. Co. v. United States*, 435 F.2d 873, 887 (Ct.Cl. 1970):

> The purpose of the changed conditions clause is thus to take at least some of the gamble on subsurface conditions out of bidding. Bidders need not weigh the cost and ease of making their own borings against the risk of encountering an adverse subsurface condition, and they need not consider how large a contingency should be added to the bid to cover the risk. There will be no windfalls and no disasters. The Government benefits from more accurate bidding, without inflation for risks which may not eventuate. It pays for difficult subsurface work only when it is encountered and was not indicated in the logs.

**Owner’s Disclaimer of Differing Site Conditions**

While the DSC clause clearly shifts the risk of subsurface conditions to the owner, confusion often arises when the contract contains other risk allocation provisions that conflict with the DSC clause. One clause that owners frequently use is the disclaimer clause. A typical disclaimer states that the owner does not guarantee the accuracy of the subsurface information provided by the owner, and that the contractor will be responsible for the actual subsurface conditions encountered. So, while a DSC clause places the risk of subsurface conditions on the owner, a disclaimer clause would appear to shift the risk back to the contractor. As a result, many courts have had to resolve the juxtaposition between the DSC clause and conflicting disclaimer language.

**Can DSC Clauses and Disclaimers Coexist?**

While there are some cases to the contrary, most federal and state courts, and boards of contract appeals, have held that an owner’s broad disclaimer language will not defeat a DSC clause. While the body of DSC case law is too extensive to address in this article, the following cases are representative of the current weight of authority in most jurisdictions. In *Woodcrest Construction Co. v. United States*, 408 F.2d 406 (Ct. Cl. 1969), the United States Court of Claims granted relief to a contractor under a changed
conditions clause, despite the contract’s extremely broad exculpatory clauses. The court stated as follows:

The effect of an actual representation is to make the statements of the Government binding upon it, despite exculpatory clauses which do not guarantee the accuracy of a description…[N]or does the exculpatory clause in the instant case absolve the Government, since broad exculpatory clauses…cannot be given their full literal reach, and, do not relieve the defendant of liability for changed conditions as the broad language thereof would seem to indicate.

In Metropolitan Sewerage Commission v. R.W. Construction, Inc., 72 Wis.2d 365, 241 N.W.2d 371 (1976), the contractor claimed that it had encountered subsurface conditions different from those indicated in the contract documents. The court held that the public agency could not rely on contractual disclaimer language to defeat the DSC clause:

It is well settled that such broad admonitory and exculpatory clauses do not restrict the application of the changed-conditions clause…To allow such provisions to cancel out the changed-conditions clauses would destroy the whole equitable adjustment procedure which the [owner] has agreed to when materially different conditions are encountered.

California Law

The leading California cases analyzing the competing interests between DSC clauses and disclaimers are Wunderlich v. State of California, 65 Cal.2d 777 (1967) and E.H. Morrill Co. v. State of California, 65 Cal.2d 787 (1967). Wunderlich and Morrill stand for the general proposition that: (1) a contractor may recover under a DSC clause, despite the owner’s disclaimer language, if the information provided by the owner constitutes a positive assertion of expected conditions; and (2) a contractor may not recover if the provided information is only a representation of the results of an investigation and not a positive statement of expected conditions. Wunderlich and Morrill are consistent with the weight of authority in other jurisdictions. However, both cases were decided before Public Contract Code § 7104 was enacted in 1989. Thus, it was not necessary for the court to address the question of whether a public entity can use contract language to disclaim responsibility for subsurface conditions when it is required by law to include a DSC clause in the contract. Section 7104 creates another level of analysis for the California courts to consider.

California Public Contract Code § 7104

Public Contract Code § 7104 requires all local public entities to include a DSC clause in construction contracts involving excavation deeper than four feet, and appears to add a new dimension to the Wunderlich and Morrill analysis. Previously, the court’s analysis was limited to a traditional “battle of the forms” contract analysis to determine which of two apparently conflicting contract provisions prevailed. Because neither clause was required by law, the court naturally gave equal weight to each, and looked to the contract terms to resolve any conflict. However, applying § 7104, the court must decide the question of whether a public entity can disclaim subsurface conditions when its contract...
contains a DSC clause required by § 7104. In other words, can a public entity use contract language to negate another contract clause which is required by law? Surprisingly, although § 7104 has been around since 1989, no California reported case has addressed this situation. The lack of California precedent notwithstanding, a 2005 Sacramento Superior Court case may provide an indication of how the California courts are likely to apply § 7104.

**Condon-Johnson & Associates v. Sacramento Municipal Utility District; Sacramento Superior Court Case No. 03AS03269, July 14, 2005**

Condon-Johnson & Associates (“CJA”) was the low bidder on a Sacramento Municipal Utility District (“SMUD”) project to construct an earth retention system designed to relieve pressure on the back wall of an existing SMUD powerhouse. CJA’s work consisted of installing thirteen two-meter diameter drilled shafts through rock to depths of eighty-two feet. The contract documents included boring logs and compression tests, which revealed that the compressive strength of the rock was between 3,600 and 7,300 pounds per square inch (“psi”). Specifically, the contract stated:

> It is the intention of the District to provide the soil boring information for the purpose of determining what type rock may be encountered and not for determining the profile of backfill to rock.

> The District has completed compression testing on two samples...[T]hese tests were completed to give additional information as to what may be expected in the pier drilling. These samples were selected, by the District, on the basis of visually appearing to be the most competent core samples...[T]he compression test results are [7300 psi and 3600 psi].

SMUD’s contract contained a DSC clause as required by § 7104. However, the contract also contained the following disclaimer language:

> The District makes no guarantee for the soil reports accuracy, findings or recommendations. The District will make no additional compensation or payments, nor will it accept any claims if the subsurface soil conditions are different from that assumed by the contractor.

Shortly after beginning its work, CJA encountered rock with an average strength of 13,070 psi, and some rock as strong as 19,190 psi. CJA submitted a claim for a price increase pursuant to the contract’s DSC clause. SMUD denied CJA’s claim on the basis that the contract’s disclaimer language placed the risk of unexpected subsurface conditions on CJA, and CJA filed a breach of contract action in Sacramento Superior Court.

During pretrial motions, CJA argued that any evidence of the disclaimer language should be excluded from trial because it negated the effect of the contract’s DSC clause, which SMUD was legally required to include in the contract pursuant to § 7104. Because there were no cases analyzing § 7104, CJA relied on an analogous case holding that a contract clause that conflicts with a state statute is void as against public policy. *Howard*
Contracting, Inc. v. G.A. MacDonald Construction Co., Inc., 71 Cal.App.4th 38 (1999). CJA also relied on numerous federal cases holding that disclaimer clauses cannot be used to negate the effect of a DSC clause. The Court agreed with CJA and found that the disclaimer language had the effect of negating the DSC clause required by California law. Accordingly, the court struck the disclaimer language from the contract and prohibited SMUD from presenting any evidence of the disclaimer at trial.

After a three-week jury trial, CJA was awarded substantially of its claimed damages, as well as prejudgment interest, expert fees and trial costs. Although no binding precedent is created by the trial court’s decision, it may be an indication of how the state’s higher courts will apply § 7104. SMUD has appealed the trial court’s decision to the California Court of Appeal, Third District, in what appears to be a case of first impression in California. The appeal is likely to be decided in early 2007.

Conclusion

It remains to be seen how the court of appeal will decide the CJA case and until then there will be some uncertainty regarding whether Public Contract Code § 7104 prohibits local public entities from disclaiming responsibility for differing site conditions. However, in the meantime, contractors should be aware that § 7104 exists, and that it may provide a better argument in differing site conditions cases than the traditional “battle of the forms” contract analysis. Likewise, when drafting their construction contracts, public entities should be aware that their disclaimers might not be enforceable.

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