Construction Toolbox: Construction Laws, Cases, Notes and Alerts

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Welcome to our last issue of 2016. We present some interesting and educational cases on construction bidding controversies and always useful Miller Act cases. We also present two contrasting and divergent cases from California and New Jersey on the question of insurance coverage for construction defects under CGL insurance policies. The Harmonie Group Construction Committee will discuss and update this and other topics during our upcoming 2017 presentations.

Happy New Year, and best wishes for 2017.

- The Editor

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MILLER ACT PROVISIONS SUPERSEDE

U.S. f/u/b/o Tusco, Inc. v. Clark Construction Group LLC, 2016 U.S. Dist. LEXIS 107571 (D. Md. August 15, 2016).

Subcontractor sued the general contractor and Miller Act payment bond surety to recover for alleged extra work. General contractor moved to dismiss the claim by pointing to a paid-if-paid clause in the subcontract. The contractor contended that this condition had not been satisfied because the government had not paid the contractor for alleged "extra work" performed by the subcontractor.

The subcontractor's right of recovery on the Miller Act Bond accrued 90 days after work completion, and not when and if the contractor was paid by the government. The requirements of the Miller Act superseded or were read into the terms of the bond and took precedence over the alleged contractual pay-if-paid clause.

NATIONAL FOCUS

BIDS – RELIANCE ON SUBCONTRACTOR'S BID

C.G. Schmidt Inc. v. Permasteelisa North America, 2016 U.S. App. LEXIS 10920 (7th Circuit, June 16, 2016).

This case involved a large construction project to construct an 18 story office building in Milwaukee, WI. Schmidt chose PNA as a glass curtainwall contractor, but the parties never came to a formal subcontract for the work. PNA eventually withdrew from the project, and the replacement contractor charged Schmidt a greater price. Schmidt sued PNA seeking damages alleging breach of contract and promissory estoppel.

The Federal Court attempted to apply Wisconsin law which does recognize that a general contractor may have a cause of action to assert "promissory estoppel" to prevent a sub-contractor from reneging on a bid commitment. However, this doctrine requires the general contractor to make a decision: the general contractor can either keep the subcontractor's bid open for a reasonable amount of time, or seek a better deal, but not both. In this case, Schmidt did not initially accept PNA's bid, and the parties had not settled on the terms of any future subcontract agreement. In fact, they attempted (and failed) to negotiate such an agreement over more than a year.

The Court noted that the parties clearly expected further negotiations to follow the bidding, therefore any promise made was very conditional. The Court also ruled that applying promissory estoppel in this situation would essentially give Schmidt an "option contract" over PNA's bid that it did not bargain for. Therefore, the Trial Court's judgment that the contractor's claims against PNA failed as a matter of law was affirmed.

NATIONAL FOCUS

F.A.R. BID RECEIPT

Matter of : Athena Construction Group, Inc., 2016 U.S. Comp. Gen., B-413406 (October 21, 2016).

Athena Construction protested a bid award arguing that the Veterans' Administration should have rejected an opposition bid as late. The bid deadline was on a certain date at a certain room at the V.A. Washington D.C. Office. Athena hand delivered its bid to the contracting officer in the bid opening room shortly before the time. However, at two minutes after the appointed time, three more bids arrived to the bid-opening room which were lower priced, one of which was eventually accepted. Athena protested that the V.A. should have rejected the three late bids because the bid solicitation stated that bids received after 2:00 p.m. would not be accepted, and argued that this express language would override more liberal FAR provisions allowing a bid to be considered if it is received at the "government installation" designated for receipt of the bids and was under "government control" prior to the time set for receipt of bids.

In this case, the contracting officer confirmed with the mailroom that all three "late" bids, although delivered to the bid opening room late, were under the agency control and delivered before the 2:00 p.m. deadline. The Comptroller General upheld the contracting officer, and found no reason to question the decision that accepting the "late" bid would not delay the acquisition process.

ALABAMA

RELEASE OF CLAIMS

Roberson Excavation Inc. v Dale County Water Authority, 2016 U.S. Dist. LEXIS 123512 (M.D. Ala., September 9, 2016)

Roberson was the contractor on a construction project for the Dale County Water Authority who eventually suspended the project. The parties entered into an agreement that Roberson would complete its contractual requirements, but the County did not pay for additional work. Roberson sought almost $200,000.00 in damages for non-payment for completed work as well as held retainage. The County argued that the interim agreement barred the breach of contract claim because it covered any claims arising or occurring prior to the date of the agreement. Roberson countered that, for example, it expressly reserved its retainage rights.

After reviewing the documents, the Court concluded that there was language indicating that Roberson had maintained and not released its contractual rights to payment of retainage withheld by the County.

CALIFORNIA

CGL COVERAGE DENIED FOR CONSTRUCTION DEFECT

Swiss Re International SE v. Comac Investments, Inc., 2016 WL 5394087 (N.D. Cal., September 27, 2016.)

Cases keep coming down from courts in various states on whether and when there is CGL coverage for claims of defective construction. In this case, Swiss Re brought a declaratory judgment action concerning its duty to defend and indemnify Comac Investments under four CGL policies issued from 1998 – 2002. In the underlying action, a Homeowners' Association sought several million dollars in damages for alleged construction defects at a development of 23 housing units and 7 townhouses. Swiss Re represented Comac in the underlying action subject to a complete reservation of rights, and then the subsequently filed the declaratory judgment action. The insurance company made a motion for summary judgment for a declaration of no coverage, and the Court granted that motion.

The Court first ruled that, under California law, the allegations of defective construction did not constitute a covered "accident". This is because, although the construction was allegedly defective, the act of so doing was a deliberate, intentional act and not "unexpected" or "unforeseen". For example, the Court cited to cases holding that the term "accident" does not apply where an intentional act results in unintended harm.

There was also an exclusion in the policy denying coverage for damages "expected or intended from the standpoint of the insured" which paralleled a California state statute prohibiting insurance and indemnification for "willful acts"' of an insured. The Court held that, again, the allegations of construction defect fell within the "intentional acts" exclusion as well as the California statutory prohibition, and that allegations of construction defect were within the exclusion.

This case represents a fairly standard analysis, but one on which courts have differed over the past several years as to whether and when a construction defect can be deemed an "accident" or a covered "occurrence". Several courts have essentially adhered to the reasoning of this case that, even if unintended harm and consequences result, installing defective construction is not an "accident" because it is a deliberate albeit "misguided" act.

Likewise, construction defects may not be covered under a CGL policy based on several common policy exclusions, such as the one in this case for intentional or deliberate acts. Other common policy "exclusions" that may come into play in these cases are those dealing with work in place, completed operations, and claims incurred by reason of a contractual agreement.

Although not covered in this case specifically, another common issue in these cases is whether damages claimed fall within the policy definition of damages or a covered loss. For example, some courts have parsed the issue and held that loss or damage to the actual construction is not covered, but if there is residual or secondary damage to existing or pre-existing building elements that might be within the scope of covered damages.

Overall, this issue has raised numerous and conflicting cases across the country, and even within states. Sometimes it is difficult for a Federal court such as this one to actually determine and correctly apply what

the given law is in a given state at a given time. Some states have had to address this issue by statute and/or insurance regulation in order to bring some clarity and finality.

Courts which have resisted allowing coverage for construction defects under a CGL policy have, ultimately, approached the issue from a perspective that a CGL policy is intended to be a liability insurance policy, and not a "performance bond" or a warranty of construction.

- The Editor

CALIFORNIA

CONTRACTUAL PRIVITY

U.S. f/u/b/o Penn Air Control, Inc. v. Bilbro Construction Co., Inc. , 2016 U.S. Dist. LEXIS 115809 (S.D. Cal., August 26, 2016).

Bilbro was the general contractor on a U.S. Navy renovation project who contracted with an architect and design-build mechanical subcontractor. After construction, the Navy discovered that 23 of the rooms exceeded noise-level requirements. The Navy refused to accept the project, Billbro terminated the mechanical subcontractor, and withheld funds.

The subcontractor initiated a negligence claim against the architect and the architect's acoustical consultant. The subcontractor sought approximately $1.1 Million in damages for extra work. The legal issue was that Alpha had no contract privity with either the architect or the acoustical consultant, and therefore had to establish the existence of a "special relationship" under which those parties owed a legal duty of care, as to which the subcontractor was successful, but only against the architect.

In California, such a non-contractual "special relationship" depends on six factors as follows: (1) the extent to which the architects' work was intended to affect the subcontractor; (2) foreseeability of harm to the subcontractor; (3) certainty that the subcontractor suffered injuries; (4) certainty that defendant's conduct caused the injury; (5) supposed "moral" blame; and (6) the policy of preventing future harm which suggests that sophisticated contracting parties be held responsible for protecting themselves. Based upon all these factors, the Court held that there was a special relationship between the subcontractor and architect and denied the architect's motion to dismiss. However, given that the facts were very different with respect to the acoustical consulting firm, the Court granted the consultant's motion to dismiss.

KENTUCKY

CONTRACT MISTAKE – PAROL EVIDENCE

Hall Waterproofing Technology, LLC v. Volatile Free, Inc. 2016 WL 3597639 (E.D. Kentucky, June 27, 2016).

Hall Waterproofing was the general contractor on a roof replacement project at Kentucky Speedway in Sparta, KY. It hired Volatile Free to apply a roof coating product to seal the roof, but after three years the

roof began to leak. At issue was a 15 year "material and labor warranty" the parties had signed. Volatile Free claimed the document required it to provide only material, while Hall Waterproofing was required to provide labor for warranty repairs. Hall replied that during negotiations Volatile Free promised to cover both labor and material for warranty repairs.

The Court noted that ordinarily parol evidence of Volatile Free's alleged oral promise would not be admissible. Instead, the Court applied an exception to the parol evidence rule since the dispute could be regarded as potential fraud or mutual mistake. In certain cases, including fraud and mistake, evidence of agreements and negotiations outside of the writing may become admissible. The Court concluded that there was evidence that, notwithstanding the written documentation, the parties had negotiated a warranty under which Volatile Free would bear the cost of both material and labor to perform warranty repairs. The Court ruled that the case could go forward and Hall could try to establish a case of either "fraud" or "mutual mistake" regarding the extent and coverage of the warranty.

MICHIGAN

ARBITRATION-SCOPE OF DEMAND

W.J. O'Neil Co. v. Shepley, Bulfinch, Richardson & Abbot, Inc., 2016 U.S. Dist. LEXIS 103097 (E.D. Mich., August 5, 2016)

O'Neil was a mechanical contractor on a hospital construction project at the University of Michigan, and claimed nearly $20 Million in damages due to "design errors" caused by the project architect, (Shepley), and the designer of the building's mechanical, electrical, and plumbing systems. The designers alleged that O'Neil's claims were barred by collateral estoppel because the questions had already been litigated and determined in an earlier arbitration. In that earlier arbitration, O'Neil had sued the construction manager, with whom it was in contractual privity, for breach of contract, and the arbitrator ruled that O'Neil was entitled to $2.4 Million in damages out of the $19 Million total claim.

The District Court agreed that O'Neil's damages had been litigated and determined in the prior arbitration. O'Neil had sought the totality of its damages in the arbitration, and the arbitrator had also rejected claims for consequential damages, lost profit, etc. O'Neil argued that contract damages were not the same as the alleged tort damages, but collateral estoppel bars the re-litigation of issues regardless of the legal claims to which they may be attached. Significantly, the designers were also parties in the arbitration and, presumably, also bound by the decision.

The Court ruled that O'Neil failed to distinguish how the damages it sought in court differed significantly than those previously submitted and determined by the arbitrator. It held that O'Neil had a full and fair opportunity to litigate its damages in the arbitration.

MINNESOTA

CHANGE ORDER REDUCTION

Storms, Inc. v. Mathy Construction Co., 2016 Minn. LEXIS 517 (August 17, 2016).

The Minnesota Department of Transportation hired Mathy as general contractor for highway repair. The estimated quantities of excavation and fill were overstated, DOT issued a change order deduction to Mathy, and Mathy applied that same reduction to its excavation subcontrator's project price. The lower courts held that Mathy's actions were in breach of the subcontract, but the Supreme Court of Minnesota overruled them.

The subcontract incorporated the prime contract which gave the project engineer the authority to adjust material quantities in the event that estimates, such as for excavation and fill in this case, were incorrect (presumably either plus or in this case minus). In addition, the actual work scope was not altered, the change order just conformed estimated quantities to the actual scope of work. Mathy did not breach the subcontract by passing on DOT's change order deduction to the excavating subcontractor, and the decisions of the lower courts were reversed.

NEW JERSEY

CGL COVERAGE GRANTED FOR CONSTRUCTION DEFECT

Cypress Point Condominium Association, Inc. v. Adria Towers, LLC, 226 N.J. 403 (Supreme Court of New Jersey, August 4, 2016).

In this case, the Condominium Association brought an action against the General Contractor, the contractor's insurers, and various subcontractors, seeking coverage under CGL policies for consequential damages caused by the subcontractors' defective work. The Trial Court granted summary judgment in favor of the insurance companies, however a first Appellate Court reversed. The case then went on to the Supreme Court of New Jersey, which affirmed the decision of the Appellate Court. One of the essential arguments in the case was whether rainwater damage caused by faulty workmanship constituted "property damage" and an "occurrence" covered under CGL policies. The Trial Court granted summary judgment to the insurance companies on the essential basis that there was no property damage or "occurrence", as defined by the policies, to trigger coverage. The Appellate Courts held that the damages caused by the faulty workmanship did constitute "property damage" which was an "occurrence" within the covering language of the CGL policies.

The essential claims of construction defect were roof leaks and water infiltration at interior window jambs and sills of the residential units. The insurers made cogent arguments that such construction defects are not a covered accident or occurrence, and also cited cases and arguments that, at most, CGL policies might only provide coverage for damage to other property not part of the construction itself. The insurance companies further argued that the Appellate Courts failed to apply a correct definition of "accident" as it relates to a covered "occurrence" under the policies.

The New Jersey Supreme Court held that the alleged water infiltration caused by faulty workmanship constituted property damage caused by an occurrence where the policy defined an occurrence as an "accident", and there was no allegation that the subcontractor "intentionally" performed faulty work.

A second issue in the case was whether an exclusion in the CGL policies eliminating coverage for the cost of repairing damage to the contractor's own work (commonly known as a "your work" exclusion) precluded coverage. However, this argument was rejected as well because the exclusion expressly stated it did not apply if the damages arose out of work performed by a subcontractor.

The Appellate Courts accepted the argument that consequential harm caused by defective construction work is an "accident", essentially ruling that CGL policies provide coverage for "faulty workmanship" and construction defects that cause "accidental" harm or "unintended" damage.

It should first be noted that the analysis of the terms "accident" and "occurrence" in this case is different from that undertaken by other courts confronted with this issue. The New Jersey courts seemed to focus upon the outcome of allegedly defective work, and if a poor outcome was not expected or intended, i.e. an accident, it would be covered under the CGL policies. Other courts have emphasized the actual acts involved, and held that, regardless of the consequences, defective construction is not an accident since the construction itself is an intentional, directed act, albeit misguided, resulting in unfortunate consequences. These other courts essentially review the argument under a traditional analysis that unintended consequences of intentional acts are not a covered accident or occurrence. This case focuses on the outcome and damages; i.e., unintended consequences, in defining an "accidental occurrence".

This case, although from a major commercial jurisdiction, may be a minority view. Many other courts have held that there is no coverage for construction defects under CGL policies, or have limited any such recovery to damages caused to pre-existing or other construction not part of the actual construction project. Courts have essentially taken the position that a CGL policy is not intended to be a performance bond or warranty of work.

Another issue in these cases is whether the property damage involved is covered, and again, the New Jersey case may be somewhat a minority view. Many courts have held that CGL coverage does not apply to damage caused to the actual construction work itself. At most, there may arguably be coverage for damage to other or pre-existing property separate and apart from construction work itself. This case is at odds with such holdings since the water infiltration was in the new construction work itself. Here, no such distinction was made or apparently seriously argued.

It is important to note that there were several parties who filed amicus curiae briefs with the New Jersey Supreme Court given the importance of this issue. Almost all of them were on behalf of groups supporting policyholders, builders, and general contractors who would normally be seeking to cram down CGL coverage onto their subcontractors' CGL insurance coverage. It is worth noting, and perhaps unfortunate, that there was no similar effort by insurance companies or associations to brief this issue to the New Jersey Supreme Court to push back on these points.

This debate is also complicated by various other exclusions that commonly appear in CGL policies, as in this case the "your work" exclusion was held not to apply because it specifically did not apply to alleged damage caused by subcontractors. However, other exclusions such as the "your work" exclusion, "completed operations" exclusions or limitations, and exclusions for liability assumed under a contract have also been applied in these cases as part of the analysis potentially denying CGL liability coverage for construction defects. The "your work" exclusion was the only one apparently pursued by the insurance companies in this case.

- The Editor

WASHINGTON

DAMAGES – NEED FOR EXPERT TESTIMONY

U.S. f/u/b/o Salinas Construction, Inc. The Western Surety Co., 2016 U.S. App. LEXIS 88267 (W.D. Wash. July 7, 2016).

General Contractor CJW hired sub-contractor Salinas Construction on an army base project in Washington State. Salinas claimed that CJW interfered with project performance causing damages of some $425,000.00. The specific allegations were that CJW failed to provide concrete on time, failed to properly prepare the subgrade, and delayed the project resulting in weather delays. A jury ruled in favor of Salinas, but the District Court granted a post-trial motion and vacated the jury verdict. The primary basis for the decision was that Salinas offered no expert testimony for its "lost productivity claim."

The Salinas witness used a variation of the "measured mile analysis", although he had never used the method before, did not consult with any experts, and was not skilled in the topic. The witness subjectively decided which costs were considered impacted, and measured the course of the project to an unreal scenario in which Salinas' work was unimpacted vs. the impact scenario. In addition, the witness did not account for problems that arose that were not related to CJW, and did not acknowledge any reductions or issues caused by Salinas. Thus the testimony overstated Salinas' inefficiency damages, and as a result was not admissible evidence on damages to support the jury's award.