Anticipated Hot Topics in Construction Law for the 2020s

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Current and Future Topics Expected to Trend During the Next Ten Years

- Liability of Construction Managers and Project Managers to Workers, Contractors, and Third Parties
- Insurance Coverage Topics including:
  - Applicability of "Construction Management for a Fee" Exclusion dependent on characterization as general contractor and construction manager
  - Deductibles in Policies with Sub-limits for Flood or Windstorms
  - Potential coverage under another party's Commercial General Liability policy pursuant to the "insured contract" provision versus the usual contractual exclusion for such coverage.
  - Liability coverage for damage to third parties and/or their work versus the usual exclusions for damage to "your work" and "your product."
- Arbitration versus Litigation for Construction Disputes

Liability of Construction Managers and Project Managers to Contractors and Third Parties

Liability of Construction Manager to Contractor

- In *Simon v. Granite Bldg. 2, LLC*, 170 A.D.3d 1227; 97 N.Y.S.3d 240 (N.Y. App. Div.2019), a contractor, individually and as administrator of estate of wife who was also a contractor, filed suit against building owner and construction manager to recover damages for personal injuries and wrongful death after their vehicle fell into an excavation pit with the wife inside it, asserting claims for common-law negligence and
- A jury entered a verdict in favor of contractor, and the building owner and construction manager filed separate motions to set aside the verdict and for a new trial.
- The appellate court upheld the findings of liability.

- The court held that sufficient evidence established that the **construction manager functioned as a general contractor** having control over the work site, and the thus construction manager was liable for common law negligence in failing to keep premises safe and for violating workplace safety statute.
- The court found that the jury rationally found that Kulka, **the construction manager functioned as a general contractor having control over the work site**, possessed actual or constructive notice of the dangerous conditions that caused the accident, and was negligent with regard to keeping the premises safe.

- The jury made a credibility determination that, even though the Kulka was designated a “construction manager,” it also acted as a general contractor.
- The testimony demonstrated that there was no general contractor at the site, and that Kulka, as construction manager of the property, took on duties of a general contractor, and was responsible to make sure the job site was safe and to make recommendations regarding safety.
- The evidence also showed Kulka was aware the fence had been opened, and was also aware that at this stage of the construction the drains could be covered.
- Thus, the construction manager was ultimately liable to the contractor.

Liability of Construction Manager to Worker

- In *Savlas v. City of New York*, 167 A.D.3d 546; 91 N.Y.S.3d 33 (N.Y. App. Div.2018), a worker who tripped on an overlapping steel floor plate covering an opening into a lower level of the building while working in a city water treatment plant sued the city of New York, the construction manager, and a subcontractor.
- The worker alleged violations of the workplace safety statute applicable to owners and contractors and the statute requiring owners and contractors to provide reasonable and adequate protection and safety for construction workers in addition to common-law negligence claims.

- The appellate court held the trial court correctly found that **neither the construction manager nor the subcontractor, was a general contractor** or an agent of the City, and correctly dismissed the complaint as against the subcontractor.
- The trial court also correctly dismissed all claims against the subcontractor for contractual indemnification, because there is no evidence that the subcontractor was negligent in the performance of its contract with the construction manager so as to trigger the indemnification clause.
- The appellate court found the trial court should have dismissed the common-law negligence claim against the construction manager.

- The construction manager's contract did not establish authority on its part to control the work site.
- In addition, the plaintiff was not a third-party beneficiary of the contract, and there was no evidence that the construction manager caused or created the alleged dangerous condition of the work site.
- Thus, the construction manager was not liable to the worker in this case.

Liability of Project Manager to Contractor

- In *Lathan Co., Inc. v. State, Dep't of Educ., Recovery School. District,* a public works project contractor (Lathan) was hired by a project owner (La. Department of Education Recovery School Distict) to renovate a school in New Orleans.
- Lathan brought an action against project manager (Jacobs) separately hired by project owner for negligent professional undertaking and violation of the Louisiana Unfair Trade Practices Act (LUPTA).
- The trial court considered on a motion for summary judgment whether a project manager, Jacobs, owed a duty to the plaintiffs to support such a claim.

- Lathan alleged that Jacobs owed a duty to Lathan to conduct constructability reviews and to oversee and administer the project according to the standard of care of similar professionals in the industry, which Jacobs did not do.
- The Louisiana First Circuit Court of Appeal addressed duties owed by parties in the construction business, such as architects and engineers, cited other cases regarding contractors, and adopted a balancing test to determine that a duty could be extended for Jacobs.

- The court adopted a balancing test “that was to be applied on a case-by-case basis in determining whether a cause of action exists” from *Colbert v. B.F. Carvin Construction Co.*, 600 So.2d 719 (La. App. 5th Cir. 1992) as set forth below:

“The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the **foreseeability** of harm to him, the **degree of certainty** that the plaintiff suffered injury, the **closeness of the connection** between the defendant's conduct and the injury suffered, the moral blame attached to defendant's conduct, and the policy of preventing future harm.”

Liability to Subcontractor for its Delay Damages

- In *J. Petrocelli Contracting, Inc. v. Morganti Grp., Inc.*, 137 A.D.3d 1082; 27 N.Y.S.3d 646 (N.Y. App. Div.2016), a subcontractor hired to perform construction work on a renovation project for the City of New York Department of Design and Construction brought a breach of contract action against construction manager.
- The subcontractor sought to recover damages it alleges it incurred when the project was substantially delayed through no fault of its own.
- The trial court granted the construction manager's motion to dismiss the subcontractor's claims against it. The appellate court upheld the ruling and held the construction manager was not liable for delay damages allegedly incurred by plaintiff.

- The contract between the construction manager and the subcontractor contained a clause that expressly provides that the construction manager "shall not be liable to the [plaintiff] for any damages resulting from delays caused by any entity."
- The subcontractor expressly agreed that, "apart from recovery from said entity, [the plaintiff's] exclusive remedy for delay shall be an extension of the time for performance of the [plaintiff's] work."
- Thus, the court found it was proper to dismiss the breach of contract cause of action to recover damages for delays in the completion of the defendant's work

- The court also properly granted dismissal of the second cause of action for alleged gross negligence and willful misconduct.
- The court found that for the claim to be successful, a party's conduct must show intentional wrongdoing or evince a reckless indifference to the rights of others but here, the plaintiff failed to allege any facts constituting willful misconduct or gross negligence on the part of the construction manager.

Liability to Passerby

- In *Tracy v. David Christa Const., Inc*, 125 A.D.3d 1291 (N.Y. App. Div.2015), a plaintiff who slipped and fell in an airport sued the construction manager and general contractor.
- The court dismissed the claims finding the construction manager and defendants ***did not*** owe the plaintiff a duty of care.
- The court concluded that defendants met their initial burden of establishing that they owed no duty of care to plaintiff who, at the time of her accident, was merely a third-party passerby with no relationship of privity with defendants.

Recap Regarding Liability to Others

- Parties will continue to add construction managers as defendants in construction cases in the 2020s, but they may or not be successful depending on the facts and applicable construction agreements.
- Construction managers are not shielded from liability soley due to their title as a construction manager.
  - Even if one's title is a Construction Manager, it could be held liable as a general contractor if it conducts any actions in a general contractor role.
  - There could also be liability should there be willful misconduct or gross negligence.
- Construction managers should attempt to include language stating it will not be liable for damages caused by other entities involved in the construction project.

Insurance Coverage Topics

Explanation of Commercial General Liability Insurance ("CGL")

- CGL policies are insurance policies issued to businesses to protect them against liability claims for bodily injury (BI) and property damage (PD) arising out of premises, operations, products, and completed operations; and advertising and personal injury (PI) liability.
- They are generally designed to provide coverage for tort liability for physical damages to others and *not for contractual liability* of the insured for economic loss because the product or work is not that for which the damaged person bargained.

  § 129:1.Overview of commercial general liability policies, 9A Couch on Ins. § 129:1

CGL Policies

- Commercial general liability insurance policies consist of two primary parts:

  (1) the insuring clauses, which set forth the specific risk or risks covered by the policy; and

  (2) the exclusions, which remove coverage for risks that would otherwise fall within the purview of the insuring clauses.

- Within the second part, there may be exceptions to the exclusions, that add back coverage. One of those exceptions is the "insured" contract exception.

CGL Policies: Defense and Indemnity

- CGL policies provide coverage for indemnity (payment of actual damage or losses of third parties).
- Another valuable aspect of many CGL policies is the insurer's "duty to defend" the contractor against claims.
  - In CGL policies with defense obligations, the insurers must provide attorneys to defend suits against contractor or pay for attorney of the contractor's choosing.
  - Thus, when contractors are sued or claims are otherwise made against the contractors, it's important to notify their insurance carriers immediately and request that they defend the suit.

Applicability of "Construction Management for a Fee" Exclusion

- Some CGL Policies contain "Construction Management for a Fee" exclusions, which exclude coverage if the insured acted as a construction manager rather than a general contractor.

- In *U.S. Specialty Ins. Co. v. SMI Construction Management, Inc.*, 168 A.D.3d 431 1/8/2019, a liability insurer brought an action against SMI Construction Management, Inc. for declaratory judgment that it owed no duty to defend or indemnify SMI in personal injury action based on "Construction Management for a Fee" exclusion.
- The Supreme Court in New York County denied the insurer's summary judgment motion, and the insurer appealed.
- The Supreme Court, Appellate Division affirmed the denial finding that factual issues as to whether the insured/SMI performed the job as a construction manager or a general contractor precluded summary judgment on applicability of the exclusion.

- The court found that “The label of construction manager versus general contractor is not necessarily determinative,” and this determination depends on the duties SMI was assigned and performed.
- The contract described SMI’s duties in relation to the project owner as, inter alia, supplying an adequate supply of workers and materials and performing the work.
- SMI’s owner characterized SMI as both a construction manager and a general contractor, and described its work on the project as “the total supervision of ... the construction,” the provision of some laborers, and supervision of maintenance and carpentry.
- The contract was divided into two phases—preconstruction and construction—and SMI performed services at the inception of the project, such as working with the owner, architect, and engineer, and when the work was ready to proceed, obtained permits, hired and paid the subcontractors, and allegedly acted as a general contractor.

- The court also found that although SMI performed for a fee, the budget attached to the contract suggests that the fee was based in part on profit.
- The fee in the contract refers to the budget attached as Exhibit A to the contract. The budget, in turn, includes an amount of $1,042,918 payable to defendant for “profit and overhead.”
- The court found that evidence raised issues of fact as to whether defendant performed as the functional equivalent of a general contractor and whether it was being compensated on a cost-of-work-plus-profit-basis.
- The court found the facts were distinguishable from *Houston Cas. Co. v. Cavan Corp. of NY, Inc.*, 158 A.D.3d 536, 71 N.Y.S.3d 455 [1st Dept 2018], in which the third-party plaintiff was compensated by a flat fee plus reimbursement for overhead and staffing expenses.

- In *Houston Cas. Co. v. Cavan Corp. of NY, Inc.*, 158 A.D.3d 536 (N.Y. App. Div.2018), a CGL insurer filed a declaratory judgment action against construction manager to seek a determination as to whether the insurer was obligated to defend the manager in an underlying personal injury action filed by sidewalk restoration contractor, who was injured in the course of work on building project, pursuant to insurance policy issued to manager that was in effect at time of contractor's accident.
- The Supreme Court, Appellate Division, held that the insurance policy did not provide the manager coverage in the contractor's underlying personal injury action.

- Cavan Corp. entered into a “Construction Management Agreement” (CMA) with the owners under which Cavan agreed to function as “construction manager” for a building project on Lafayette Street in Manhattan.
- The CMA provides that Cavan is to receive compensation in the form of a fixed fee of $600,000, in addition to a payment of $1,700,000 as reimbursement “for all reasonable and customary staffing and overhead costs incurred by [Cavan] in the performance of its duties hereunder.”
- The principal of the project's sidewalk restoration contractor was injured in the course of the work and sued Cavan, the owners, and another entity.
- The principal alleged that Cavan had been engaged as “the general contractor and/or construction manager” for the project.

- While the policy generally provides coverage for “bodily injury” arising out of Cavan's work, it contains an endorsement entitled “Exclusion—Construction Management for a Fee,” providing that the insurance does not apply to losses “arising out of ‘construction management,’ regardless of whether such operations are conducted by you or on your behalf.”
- The endorsement defined “construction management” to mean “the planning, coordinating, supervising or controlling of construction activities *while being compensated on a fee basis* by an owner or developer.”

- The insurer filed a motion for summary judgment seeking a ruling that no coverage was provided based on the construction management exclusion.
- The court denied summary judgment finding that there were triable issues as to whether Cavan was functioning as a construction manager so as to fall within the exclusions.
- The appellate court found there was no coverage in the underlying action pursuant to the exclusion for construction management. It found that it didn't matter that Cavan may have been acting as general contractor for the project and that that it may ultimately be determined in that action that Cavan was actually functioning as the project's general contractor.

- The court found that the policy, in defining the term “construction management,” excluded from coverage operations for which Cavan was “being compensated on a fee basis.”
- Under the CMA, Cavan was compensated for its work on this project by a flat fee of $600,000, plus reimbursement in a prescribed amount for overhead and staffing expenses, rather than by progress payments covering the cost of the work done by the trade contractors plus an additional increment to provide Cavan with a profit.
- The court found that whether or not Cavan was acting as a general contractor, the CMA established that it was “being compensated on a fee basis,” not a cost-of-work-plus-profit basis, and this suffices to bring its operations within the scope of the exclusion for “Construction Management for a Fee.”
- Thus, there was no coverage for the construction manager’s actions.

Insurance Coverage for Construction Manager under General Contractor's CGL Policy

- In *Gilbane Building Co./TDX Construction Corp. v. St. Paul Fire and Marine Insurance Company*, 31 N.Y.3d 131, 74 N.Y.S.3d 162, 97 N.E.3d 711 (2018), the court found an additional insured endorsement in a CGL policy issued by an insurer to general contractor **did not** obligate insurer to defend and indemnify construction manager.
- The policy unambiguously provided that an additional insured was "any person or organization with whom [insured has] agreed to add as an additional insured by written contract."
- In that case, there was no written contract between the general contractor and construction manager and, thus, no insurance coverage under the contractor's CGL policy for the construction manager.

- In *Scottsdale Ins. Co. v. Columbia Ins. Grp., Inc.*, 403 F.Supp.3d 656 (N.D. Ill.2019), however, a construction manager was an additional insured under a subcontractor's policy.
- Thus, whether construction managers will be additional insureds are dependent on the specific policies.

Calculation of Deductible for Damages Caused by Flood or Other Peril with a Sub-limit

- An issue that arisen recently is how to calculate the deductible for damages caused by flood or another peril that contains a sub-limit.
- There is a suit that was filed by a general contractor against its insurer related to construction at the Jung Hotel in New Orleans. *McDonnel Grp., LLC v. Starr Surplus Lines Ins. Co.*, 19-10462 (E.D. La.). The owner of the Jung Hotel intervened.
- Defendant insurers issued builder's risk insurance policies to the general contractor, McDonel, to cover the renovation of the Jung Hotel in New Orleans. Jung has alleged that it is an additional insured under the Starr and Lexington policies.

- The policies contain a $10 million sub-limit for damages caused by flood.
- The policies also provided for a deductible of 5% "of the total insured values at the time and risk of loss subject to a $500,000 minimum deductible as respects the peril of flood."
- On August 5, 2017, the Jung Hotel sustained damages resulting from flood.
- The Insurers contend that "total insured values at the time and risk of loss" means the value of the **entire** Jung Hotel project. Thus, Defendants argue the flood deductible for the August 5, 2017 flood event is $3,443,475.32, as of August 5, 2017.
- Jung contends that, as of August 5, 2017, "total insured values at the time and risk of loss . . . as respects the peril of flood" was not more than $10 million based on the flood sub-limit. Under Jung's interpretation of the flood deductible provision, the flood deductible cannot exceed 5% of $10 million, or $500,000.

- Jung has argued the interpretations of the term “total insured values at the time and risk of loss . . . as respects the peril of flood” proffered by Jung and the Defendants are reasonable, rendering the flood deductible provisions ambiguous as a matter of law.
- Jung has argued that in light of said ambiguity, the flood deductible should be construed in favor of the insureds, Jung and McDonnel, and against the Defendants and consistent with the insured’s reasonable expectations as to coverage.
- Thus, this Court should hold that the total values at risk for damages caused by flood as of August 5, 2017 at the Jung Hotel cannot exceed $10 million and that the flood deductible will not exceed $500,000.

- Thus, the pending issue is whether the flood deductible provision is clear and that "values on the risk at the time of loss" means either (1) the total value of the insured property or (2) only the actual risk insured against for the peril of flood, $10 million.
- Construing a similarly worded deductible provision with a coverage sublimit, the court in *Terra-Adi International Dadeland, LLC v. Zurich American Insurance Company* found the deductible clause ambiguous and construed the deductible in favor of the insured to hold that the risk at the time of loss could not exceed the coverage sublimit to which the deductible applied. No. 06-22380, 2007 WL 675971 (S.D. Fla. Mar. 1, 2007).

- In *Terra-Adi*, the plaintiffs owned two real estate projects near Miami, Florida that were insured by builder's risk policies issued by the defendant.
- Both policies provided for a coverage sub-limit of $10 million for damages resulting from windstorm.
- Both policies also provided for a deductible of "5% of the total insured values at risk at the time and place of loss subject to a minimum deduction of $250,000, as respects the peril of WINDSTORM."
- The court observed that "[t]he problem is that the policies provide no guidance as to whether the 'total insured values at risk' are those insured against the peril of windstorm or the aggregate insured value of the project of the whole."
- The properties were damaged from winds associated with Hurricanes Wilma and Katrina, and the insured made claims for those damages with the defendant. The insurer argued that the 5% deductible applied to the aggregate value of the entire covered property, or about $31.5 million for one property and $47.8 million for the other property.

- The court determined that the deductible provision was ambiguous and reasonably subject to more than one interpretation based on “the facial reasonableness of the parties’ competing interpretations.”
- The court noted that limiting the deductible to the risk insured against – windstorm – was consistent with the purpose of insurance deductibles.
- The court observed that deductibles are determined by the loss insured against and that the insurer “should not be allowed to increase the applicable deductible on windstorm damage on the basis of the value of Plaintiffs’ property that is not covered against windstorms.”
- Limiting the deductibles only to the amount of covered loss for windstorm would mean that the insurer and insured still shared in that risk, with the risk increasing as the project progresses, up to the sub-limit for damage by windstorm.

- Evaluating the insurer's position, the court observed that "total insured values at risk" could mean the aggregate value of the physical property insured. The court found it reasonable to interpret the deductible as applying to the amount of each claim for insured loss or damage, rather than just the sublimit.
- Faced with what it considered to be two reasonable competing interpretations of the deductible provision, the court found that the provision must be construed in favor of the Plaintiffs.
- In pertinent part, the Court held:

  The term "total insured values", as used in this case, is modified by the term, "as respects the peril of WINDSTORM." Therein lies the ambiguity that compels this Court's holding that section 7(D) of the policies at issue here is reasonably susceptible to differing interpretations and must therefore be resolved in favor of Plaintiffs. Accordingly, Plaintiffs are entitled to summary judgment as to Count II insofar as it relates to the proper calculation of the deductible applicable to property damage resulting from windstorm.

- The windstorm deductible in *Terra-Adi International* is nearly identical to the flood deductible in the insurance policies issued by the Defendants to Jung and McDonnel.
- In both cases, the deductible was based on the "total insured values at risk . . . as respects the peril" of either windstorm or flood. Both the Defendants' policies in the Jung case and the policies at issue in *Terra-Adi International* contained risk-specific sub-limits.
- It remains to be seen what the Court will rule in the Jung case. The submission date for the motion was November 27, 2019, and the court has not yet ruled on the motion.

Contractual Liability Exclusions in CGL Policies

- Most CGL policies contain contractual liability exclusions similar to the below exclusion:

> This insurance does not apply to:
>
> . . .
>
> b. "Bodily injury" or "property damage" for which the insured is obligated to pay damages ***by reason of the assumption of liability in a contract or agreement***.

Exception to the Contractual Liability Exclusion

- Many CGL policies, however, will contain an ***exception*** to the contractual liability exclusion.
- The exception would provide coverage for “bodily injury” or “property damage” for which the insured is “obligated to pay damages by reason of the assumption of liability in a contract or agreement” pursuant to an “**insured contract**” as set forth below:

  This [contractual liability] exclusion does not apply to liability for damages:

  (1) Assumed in a contract or agreement that is an "insured contract," provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement; or

  (2) That the insured would have in the absence of the contract or agreement

What is an “Insured Contract?”

Many policies define “Insured Contract” as the following:

a. A lease of premises;

b. A sidetrack agreement;

c. Any easement or license agreement, except in connection with construction or demolition operations on or within 50 feet of a railroad;

d. An obligation, as required by ordinance, to indemnify a municipality, except in connection with work for a municipality;

e. An elevator maintenance agreement;

f. **That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for "bodily injury" or "property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.**

What is an “Insured Contract?”

- In basic terms, an “insured contract” is a contract in which a third party contractually assumes tort liability of another party.
- An “insured contract” has three elements:
  1. Contract **pertaining to the insured’s business.**
  2. Under which the insured assumed tort liability of another party
  3. To pay “property damage” to third parties.

Scenario Where "Insured Contract" Coverage Could Apply

- An Owner hires a Contractor to construct a hotel.
- The Owner and Contractor enter into a contract in which the Owner agrees to assume tort liability of the Contractor and pay damage for bodily injury or property damage.
- While building the hotel, the Contractor does something wrong, and bystanders are injured.
- Injured parties sue the Contractor.
- The Contractor files a third-party demand against the Owner stating that the Owner is responsible for the Contractor's tort liability.
- Contractor seeks defense and indemnity under the Owner's Policy.
- Owner's insurance policy has an "insured contract" exception to its contractual liability exclusion.
- Although the Contractor is found to be the party at fault for the injuries, the Owner's CGL policy should provide coverage for the Contractor's negligence based on the "insured contract" exception.

“Insured Contract” Must be Executed Prior to Injury or Damage

- Keep in mind that the Exceptions to the Contractual Liability Exclusions typically state that the "bodily injury" or "property damage" must occur **subsequent** to the execution of the contract or agreement:

  This [contractual liability] exclusion does not apply to liability for damages:

  (1) Assumed in a contract or agreement that is an "insured contract," provided the "bodily injury" or "property damage" occurs ***subsequent*** to the execution of the contract or agreement;

When is the contract “executed” for purposes of “insured contract” coverage?

- The issue of timing has arisen where insurers have argued that the insured contract exception does not apply because the contract at issue was not signed prior to the injury or damage and therefore not executed.
- In various cases, courts have held that the contract did not need to be **signed** to be **executed**.

Exception Does Not Apply Where No Tort Claims are at Issue

- *Century Sur. Co. v. Hardscape Const. Specialties Inc.*, 578 F.3d 262, 269 (5th Cir. 2009)- A property owner sued a construction contractor for the alleged defective construction of swimming pool on one of the property owner's properties.
- The contractor's insurer sued the contractor for a declaratory judgment that the insurance policy provided no coverage. The property owner argued that coverage was provided under the "insured contract" exception to the contractual liability exclusion
- The court explained that the exception provides, in part, that the contractual liability exclusion does not apply to damages assumed in "any other contract or agreement pertaining to your business ... under which you assume the tort liability of another party to pay for 'bodily injury' or 'property damage' to a third person or organization," and defines "tort liability" as "a liability that would be imposed by law in the absence of any contract or agreement."

- The court stated that the property owner’s petition triggered the exclusion's exemption only if it properly alleges a tort cause of action against Hardscape under the “eight corners” rule applied by Texas courts.
- The court found that most of the allegations were easily classified as giving rise to contract claims because the damages occurred only to the subject matter of the contract, which was the swimming pool itself and the surrounding deck, and because no liability would arise independently of the contract.
- Thus, although the suit alleged general negligence, the allegations gave rise to contract claims only, and were not tort claims since the suit sought to recover for damage to the subject matter of the contract, Accordingly, the “insured contract” exception did not apply.

“Insured Contract” Exception Applies to Indemnity for Injury or Damage to “Third Parties” Only

- *Concordia General Contracting Co., Inc. v. Preferred Mut. Ins. Co.*, 46 N.Y.S.3d 146, 147–48, (N.Y.A.D. 2 Dept., 2017) - A Subcontractor filed suit against Contractor and others in connection with injuries he allegedly sustained while working as a Subcontractor of the Contractor on a construction project.
- Contractor sued the insurer of the Subcontractor for defense and indemnification after the Subcontractor sued the Contractor.
- Prior to the date of the accident, the Contractor and Subcontractor entered into a hold harmless agreement pursuant to which the subcontractor agreed to indemnify and hold harmless Contractor from any claims for bodily injury resulting from the performance of the subcontractor's work.

- The policy at issue excluded contractual liability except where it was assumed pursuant to the terms of an "insured contract," defined as those portions of a contract pertaining to the business of the named insured "under which [the named insured] assume[s] the tort liability of another party to pay for 'bodily injury' or 'property damage' to a third person or organization."
- The insurer rejected the Contractor's request for defense and indemnification on the ground that the hold harmless agreement was not an "insured contract" as defined in the policy, since the bodily injury occurred to the Subcontractor himself, who was a party to the contract and, therefore, could not be deemed a "third person."
- The court agreed with the insurer of the Subcontractor. It found that the ordinary meaning of "third person," when read in the context of the definition of "insured contract," plainly refers to someone who is not a party to the "insured contract." This would necessarily exclude the Subcontractor.
- Thus, Insurer was not obligated to defend or indemnify contractor in underlying suit filed by a the insured/subcontractor

Example where "insured contract" exception applied to provide coverage

- *United National Insurance Co. v. Dunbar & Sullivan Dredging Co.*, 953 F.2d 334 (7th Cir. 1992) - A Contractor contracted with the United States Army Corps of Engineers to do construction work. Pursuant to the contract, Contractor agreed to be responsible for any damages that would result.
- Several employees of the Contractor were injured and filed tort claims against the United States. The United States, in turn, filed actions for indemnification and contribution against the Contractor.
- Under Illinois law that governed the underlying actions by Contractor's employees, Contractor could be liable to the United States for contribution for Contractor's own negligence.
- United National issued a general liability policy to Contractor. It refused to defend Contractor and then filed a declaratory judgment action seeking a ruling that it owed no coverage. The district court ruled in favor of Contractor, and United National appealed.

- The Seventh Circuit found that United National's insurance policy provided coverage for liabilities assumed in an "incidental contract," which is similar to "insured contracts" in other policies.
- United National insisted that Contractor had not assumed any liabilities of the United States in its contract. The court observed, however, that "the United States seeks indemnity and contribution from [Contractor] only for those damages attributable to [Contractor's] conduct. It is well-settled that the United States cannot seek indemnity for damages attributable to its own negligence."
- The Court then held that it would "refuse to deviate from the common-sense meaning of the phrase 'liability assumed.' The claims of the United States, then, fall within the scope of [Contractor's] insurance contract with [United National]."
- The Seventh Circuit concluded, that Contractor had agreed to indemnify the United States to the extent of Contractor's own negligence in causing the injuries to Contractor's employees. It was of no moment that the United States could not be indemnified for its own negligence. Dunbar agreed to assume the liabilities of the United States, including liability for Dunbar's own negligence.
- The court found that this agreement constituted an assumption of liability under the United National policy, triggering coverage.

Liability coverage for damage to third parties and/or their work versus the usual exclusions for damage to "your work" and "your product."

- CGL policies typically contain "your work" and "your product" exclusions.
- The "your work" exclusion precludes liability coverage for an insureds' own faulty workmanship, whereas the "your product" exclusion precludes coverage for damages arising from the insured's own defective product. *See* 9A Couch on Insurance, § 129.19 (3rd ed. 2006); *see also Stewart Interior Contractors, LLC v. MetalPro Industries, LLC*, 2007-0251 (La. App. 4 Cir. 10/10/2007), 969 So. 2d 653.
- The "your product" and "your work" exclusions are often collectively referred to as the "work-product" exclusions.

“Your Work” and “Your Product” Exclusions

- The exclusions typically state:

  This insurance does not apply to:

  k. “Property damage” to “your product” arising out of it or any part of it.

  l. “Property damage” to “your work” arising out of it or any part of it and included in the “products-completed operations hazard.” This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

Definitions

- The terms “your product” and “your work” are typically defined as follows:

  “Your product” means “any goods or products, other than real property, manufactured, sold, handled, distributed, or disposed of by [y]ou, [o]thers trading under your name; or [a] person or organization whose business or assets that you have acquired.”

  “Your work” means “work or operations performed by you or on your behalf” and “materials, parts or equipment furnished in connection with such work or operations.”

- Both definitions include “warranties or representations made at any time with respect to the fitness, quality, durability or performance” of the product or work.

- "Products Completed Operations Hazard" is typically includes:

  all "bodily injury" and "property damage" occurring away from premises you own or rent and arising out of "your product" or "your work" except:

  1) Products that are still in your physical possession; or

  (2) Work that has not yet been completed or abandoned.

Supreme Services and Specialty Co., Inc. v. Sonny Greer, Inc., 2006-1827, p.8 (La. 5/22/07); 958 So.2d 634, 640.

Legal Precepts of Work-Product Exclusion

- The Louisiana Supreme Court has examined the “work product” exclusion and provided the following legal precepts concerning the basis of the exclusion and how and when the exclusion applies:

  1. The “work product” exclusion reflects the insurance industry's intent to “avoid the possibility that coverage under a CGL policy will be used to repair and replace the insured's defective products and faulty workmanship.”

  2. A CGL policy is not written to guarantee the quality of the insured's work or product.

  3. The “exclusionary language in [the] liability policy makes it clear that damage to the product itself is excluded from coverage.”

4. The CGL policy “excludes coverage for damage to property on which the [insured] ... worked” and further “excludes coverage to property that must be repaired or replaced because the [faulty] work performed by the [insured] was incorrectly performed.”
5. “Louisiana courts have consistently held that a CGL policy containing the “work product” exclusion eliminates coverage for the costs of repairing or replacing the insured's own defective work or defective product.”
5. While “repair and replacement costs for faulty work are excluded ... any damage to other property that may result is included.”

Stewart Interior Contractors, L.L.C. v. Metalpro Industries, L.L.C., 2007-0251, p. 21-23 (La. App. 4 Cir. 10/10/07); 969 So.2d 653, 667–68 (citing *Supreme Services* at 958 So.2d at 641).

- The United States Court of Appeals for the Fifth Circuit has explained that the "your work" exclusion "precludes coverage for damage to an insured's work, whether defective or not defective." *Am. Home. Assurance Co. v. Cat Tech L.L.C.*, 660 F.3d 216, 222 (5th Cir. 2011).
- This exclusion is typically applied to parties such as contractors who build something that is then damaged.
- For example, in *Wilshire Insurance Co. v. RJT Construction, LLC*, the Fifth Circuit held that a faulty foundation put in by a construction company was not covered because of a "your work" exclusion, but damages to other parts of the house called by the faulty foundation were likely not excluded under this provision. 581 F.3d 222, 227 (5th Cir. 2009).

Exception to Work-Product Exclusion for Subcontractors

- The work-production exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor as set forth in the exclusion.

Cases Where Damage to Work or Products were Excluded Under Work-Product Exclusion

- *Western World Ins. Co., Inc. v. Paradise Pools & Spas, Inc.*, 633 So. 2d 790 (La. Ct. App. 5th Cir. 1994) (declaratory judgment granted to CGL insurer upon finding that all allegations were within work, product and completed operations exclusions)
- *Lewis v. Easley*, 614 So. 2d 780 (La. Ct. App. 2d Cir. 1993) (roof repairs necessitated by faulty workmanship were excluded)
- *Swarts v. Woodlawn, Inc.*, 610 So. 2d 888 (La. Ct. App. 1st Cir. 1992) (claim for construction defects, including alleged consequential damages, were not covered)
- *Hallar Enterprises, Inc. v. Hartman*, 583 So. 2d 883 (La. Ct. App. 1st Cir. 1991) (completed operations and work-product exclusions "basically exclude from coverage any property damage to work performed by [contractor] which arises out of operations or a reliance upon representation or warranty made with respect thereto")

WILLIAM SHELBY MCKENZIE & ALSTON JOHNSTON, III, 15 LA. CIV. L. TREATISE, INSURANCE LAW & PRACTICE § 6:21 (4th ed.).

Cases Where Coverage Was ***Not Excluded*** by Work-Product Exclusion Exclusion

- *Barr v. Cool-Vue Aluminum, Inc.*, 439 So. 2d 1161 (La. Ct. App. 4th Cir. 1983) (defects in patio addition constructed by insured caused damage to addition and original structure; exclusion applicable to damage to addition ***but not to original structure***).
- *Bewley Furniture Co., Inc. v. Maryland Cas. Co.*, 271 So. 2d 346 (La. Ct. App. 2d Cir. 1972)(subcontractor's insurer could not be held liable for replacement of defective roof ***but only for damage resulting from defect***);
- *Peltier v. Seabird Industries, Inc.*, 304 So. 2d 695 (La. Ct. App. 3d Cir. 1974) (products exclusion applicable to boat, motor and appurtenances manufactured by insured ***but not to damage to trailer supplied by another***);
- Johnston v. Norcondo, 572 So. 2d 203 (La. Ct. App. 1st Cir. 1990) (work product property damage exclusion is ***not applicable to claim for mental anguish*** resulting from "apprehension associated with knowledge that plaintiffs' homes are of little or no market value").

If CGL Policies do not cover defective work or products, what will?

- Generally, a CGL policy is intended to protect an insured from bearing financial responsibility for unexpected and accidental damage to people or property.
- A performance bond is intended to insure the contractor against claims for the cost of repair or replacement of faulty work.

Town & Country Property, L.L.C. v. Amerisure Ins. Co., 111 So. 3d 699 (Ala. 2011), Overview of commercial general liability policies, 9A *Couch on Ins.* § 129:1.

Performance Bonds/Suretyship

- Suretyship/Performance Bonds are distinguishable from insurance.
- The suretyship relationship is a three-party relationship (principal, obligee and surety).
  - The principal is the primary obligor who performs contractual obligations (e.g. the contractor on a construction project).
  - The obligee is the entity that enters into a contract with the principal and is the recipient of the obligations (e.g. project owner or governmental unit on a construction project).
  - The surety is the secondary obligor which guarantees the principal's obligations will be performed.
- Like insurance, however, performance bonds are not guaranteed as sureties have "surety defenses" that provide a surety with an opportunity to disclaim coverage under the performance bond.

Gary Strong, WHAT TO DO WITH PERFORMANCE BONDS WHEN PROJECTS DEFAULT, Law360.com (1/18/2018)

Liability of Surety

- The liability of a surety under a performance bond is not triggered unless there is a default by the principal.
- After default of a construction project, the surety has four options:
  1. fund the principal to completion;
  2. perform the work itself;
  3. tender a completion contractor;
  4. tender payment to the owner.

  Gary Strong, WHAT TO DO WITH PERFORMANCE BONDS WHEN PROJECTS DEFAULT, Law360.com (1/18/2018)

Performance Bond Surety's Defenses

- Like insurers, sureties may also assert defenses in an attempt to avoid payment.
- The surety can assert the defense of overpayment and/or the related defense of impairment of collateral.
  - After the owner terminates the contractor for default and demands payment under the surety's performance bond, the surety is entitled to utilize the remaining contract balances to complete the contract work or use the contract balances to offset an owner's claim for its own completion costs.
  - Because the surety relies upon the bonded contract funds as collateral security against its corresponding loss and expense, where an owner has prematurely or improperly depleted contract funds prior to involving the surety, the surety can assert the defense of overpayment and/or impairment of collateral.

Gary Strong, WHAT TO DO WITH PERFORMANCE BONDS WHEN PROJECTS DEFAULT, Law360.com (1/18/2018)

Surety's Defense of Overpayment/Impairment

- Overpayment may occur where a project owner releases payments to the bonded contractor in contravention of an express contractual provision, such as provision requiring the owner to retain a certain percentage of the contract funds pending the contractor's satisfaction of certain conditions.
- Overpayment may also occur where the obligee pays for patently defective, noncomplaint and incomplete work, including work that has not actually progressed to the extent that progress payments have been made

  Gary Strong, WHAT TO DO WITH PERFORMANCE BONDS WHEN PROJECTS DEFAULT, Law360.com (1/18/2018)

Surety's Defense of Overpayment/Impairment

- Under the doctrine of impairment, when there is an overpayment, the surety may be discharged from liability completely or in part if it can prove that the obligee has materially modified the bonded contract, which increased the surety's risk.

Gary Strong, WHAT TO DO WITH PERFORMANCE BONDS WHEN PROJECTS DEFAULT, Law360.com (1/18/2018)

Surety's Defense of Material Alteration

- The surety can assert the defense of material alteration to the contract between obligee and contractor.
  - A material alteration is a nonconsensual increase of the surety's risk by some act of the obligee that changes the bonded contract
  - The change must represent a material, substantial departure from the original risk, so that a reasonable person would either have not undertaken the risk at all, or would have charged a greater premium.

Gary Strong, WHAT TO DO WITH PERFORMANCE BONDS WHEN PROJECTS DEFAULT, Law360.com (1/18/2018)

Recap Regarding Insurance Issues

- Construction managers should require owners and contractors to name them as additional insureds that would provide coverage.
- They should read the insurance policies carefully to determine which provisions and exclusions may limit insurance coverage.

Arbitration versus Litigation

Arbitration Clauses

- Many construction-related contracts contain arbitration clauses such as:

  All claims, disputes, and other matters in question between the contractor and the owner arising out of, ... or relating to, the contract documents or the breach thereof, ... except for claims which have been waived by the making or acceptance of final payment ... should be decided by arbitration in accordance with construction industry arbitration rules of the American Arbitration Association.

  Any controversy or claim arising out of or relating to the construction contracts, as amended by this Agreement, or any breach thereof, shall be settled by arbitration in accordance with the rules of the American Arbitration Association (hereinafter referred to as AAA), except to the extent that the rules of the AAA are in conflict with this Agreement."

  This agreement is subject to arbitration under the Commercial Arbitration Rules of the American Arbitration Association.

History of Arbitration

- Arbitration is governed by the Federal Arbitration Act and individual states' arbitration law.
- Courts were initially skeptical of arbitration.
- Federal Arbitration Act (1925) created to overcome courts' hostility. *Allied-Bruce Terminix Companies v. Dobson*, 513 U.S. 265 (1995) (stating that the "basic purpose of the [FAA] is to overcome courts' refusals to enforce agreements to arbitrate.").
- Courts and commentators have identified the U.S. Supreme Court's decision in *Prima Paint Corp. v. Flood & Conklin Mfg, Co.*, 388 U.S. 395 (1967), as declaring the national policy in favor of arbitration.

Federal Arbitration Act ("FAA")

- 9 U.S.C. §2, *et seq*. A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

State Arbitration Acts

- States have similar arbitration acts, and their courts often rely on federal case law, which is more developed than state law
- FAA preempts state arbitration provision if arbitration provision is in a contract evidencing a transaction involving interstate commerce
- “Involving interstate commerce” = “affecting commerce”
- FAA’s reach coincides with Commerce Clause
- FAA likely applies unless a contract unequivocally does not concern interstate commerce

Arbitration

- Marketed as an alternative to litigation where parties agree to arbitrate disputes and accept the ultimate decision as final
- Arbitration promises cost-effective, speedy, and efficient method of dispute resolution as an alternative to the allegedly slower and more expensive litigation process. *See* Statutory Note following FAA § 16 by David Siegel:

[A]rbitration is a form of dispute resolution designed to save the parties time, money, and effort by substituting for the litigation process the advantages of speed, simplicity, and economy associated with arbitration.

Basic Differences between Arbitration and Litigation

- Litigation - a lawsuit is filed with the court and a judge or jury ultimately renders a decision after a trial
  - The parties may appeal the decision, and the appellate courts could overturn it.
- Arbitration – Instead of a judge or jury, a third-party neutral (*i.e.*, the arbitrator or a panel of arbitrators) renders a decision after an evidentiary hearing which is similar to a trial.
  - The parties have limited appeal rights.
  - After arbitration in most states, the winning party must go to a trial court and register the award as a judgment so that it can pursue collection.

Advantages of Arbitration

- **Cost if simple matter**– *Typically* less expensive if amount in dispute is minimal or subject matter is simple due to an expedited procedure, lack of court fees, and lack of a full discovery period
- **Scheduling and Timeliness if simple matter** – *Typically* quicker than litigation because arbitrators are presiding over less cases that judges and can work with parties on scheduling matters, rules are simplified, and generally no appellate process

- **Privacy** –arbitration is a private process and parties can typically resolve the matter while keeping the details confidential.
- **Decision Maker with Expertise and Experience in Subject Matter -** parties may choose arbitrators with construction experience that a judge or jury may not have
- **Finality (also a disadvantage)**– Arbitration decisions are binding and typically cannot be appealed.

Disadvantages of Arbitration

- **Cost if complicated matter**– - arbitration could end up costing more if complicated matter as parties pay: (1) Attorneys' fees; (2) Costs; (3) Arbitrator fees; and (4) AAA (or other arbitral organization such as JAMs (formerly known as Judicial Arbitration and Mediation Services, Inc.) fees
- **Scheduling and Timeliness if complicated matter** –Complicated schedules, protracted discovery, and bifurcated hearings make arbitration rarely quicker than traditional litigation.
  - *Advanced Micro Devices, Inc. v. Intel Corp.*, 36 Cal. Rptr. 2d 581 (Cal. 1994) – Estimated 4-6 weeks for arbitration, entire process took four and a half years, plus two and a half years in appeals.

- **Finality (also a disadvantage)**- Arbitration decisions are binding and typically cannot be appealed.
- **Lack of transparency** – Typically no oversight or transparency in the process
- **No requirement to follow rules of evidence or law** – No traditional safeguards of discovery process. The strict evidentiary rules do not apply which could lead to evidence being presented that may be prejudicial or misleading

- **No precedents** - Varying decisions from arbitrators
- **No meaningful recusal process** to guard against bias
- **Inefficiency for parties** - Summary judgment and dispositive motions rare
- **Subpoenas** – process for forcing a witness to participate in a hearing tends to be much more difficult than in litigation.

Mediation

- Mediation – a settlement conference where a third-party neutral meets with the parties and attempts to facilitate a settlement.
  - The mediator does not render a decision and has no power to compel a settlement.
  - The parties can ultimately decide not to settle.
  - Some contracts may require the party to attempt mediation before pursuing litigation or arbitration.
  - Parties may also decide to mediate while in litigation or arbitration to attempt to resolve the matter before the court in litigation or an arbitrator in arbitration renders a decision.

Recap Regarding Arbitration versus Litigation

- Whether parties should include arbitration clauses in construction contracts has been on ongoing issue that will continue to be an issue in the 2020s.
- Arbitration can be a useful tool in place of litigation under the right circumstances, but it has its disadvantages as well.
- Parties should consider the pros and cons in determination whether to include arbitration clauses in construction contracts

Questions?

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