

Construction Defect Claims: Legal and Strategic Considerations

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Contract Clauses to Be Aware of in Construction Litigation

Construction contracts are the foundation for most construction lawsuits. A few important (and oftentimes controversial) contract terms are present in most construction contracts and are reviewed initially in this paper because they can influence the case’s result, whether the dispute is between (a) an owner and a prime contractor, (b) a prime contractor and its subcontractors, or (c) somehow involves the architect/engineer (“A/E”).

“Incorporation by Reference” Provisions

Do you know what are the terms of your contract? In every dispute, an initial task is to determine which documents and clauses are included in a contract for an owner, contractor, subcontractor, supplier, or architect. “Incorporation by reference” clauses can dramatically increase the terms/provisions that are incorporated into a particular contract, thereby affecting a party’s contractual obligations. An example of an “incorporation by reference” clause is:

The Instructions to Bidders, the Proposed Description of Assembly Units, Material and Construction Specifications, Construction Sheets, Special Drawings, and Plans are hereby by reference incorporated herein and together with the Construction Agreement constitute the Contract.

Subcontractors should be particularly careful of the incorporation by reference clause Many standard subcontract forms say that the subcontractor acknowledges receipt of the General Contract, the General Conditions, plans and specifications, and the terms of those documents are to be incorporated into the subcontract to the extent they apply to the subcontractor's work. There are many risk shifting clauses typically found in the General Conditions between the owner and the prime contractor and the subcontractor should insist upon receiving and carefully reviewing these documents before incorporating those terms into a subcontract.

“Flow Down” Clauses

Owners usually seek to avoid any hint of a contractual relationship with subcontractors, but often times exert influence by including a provision in a general contract that binds subcontractors to the contractor by the terms of the general contract with the owner. A typical “flow down” provision is found in ALA Form A201, 15.3.1:

By an appropriate agreement, written where legally required for validity, the contractor shall require each subcontractor, to the extent of the work to be performed by the subcontractor, to be bound to the contractor by the terms of the contract documents, and to assume toward the contractor all the obligations and responsibilities which the contractor, by these documents, assumes toward the owner and the architect. Said agreement shall preserve and protect the rights of the owner and the architect under the contract documents with respect to the work to be performed by the subcontractor so that the subcontracting thereof will not prejudice such rights, and shall allow to the subcontractor, unless specifically provided otherwise in the contractor-subcontractor agreement, the benefit of all rights, remedies and redress against the contractor that the contractor by these documents, has against the owner. Where appropriate, the contractor shall require each subcontractor to enter into similar agreements with his sub-subcontractor.

The effect of this clause is an attempt to bind the subcontractors to the terms of the general contract. These clauses are important for two reasons. First, contractors must obtain agreements with their subcontractors that actually incorporate the terms of the general contract into the subcontract. Otherwise, the general contractor may be bound to the owner for the failure of subcontractors to perform, but without a corresponding remedy against the subcontractors. Second, subcontractors must be aware of such a provision and determine that the terms of the general contract are acceptable.

Differing Site Conditions and Site Investigation Clauses

Most construction contracts attempt to allocate responsibility for extra costs resulting from unexpected site conditions to the contractor, the owner, or both. A typical Changed Conditions Clause is provided in AIA Document A201, General Conditions of the Contract for Construction and provides:

Should concealed conditions encountered in the performance of the work below the surface of the ground or should concealed or unknown conditions in an existing structure be at variance with the conditions indicated by the contract documents, or should unknown physical conditions below the surface of the ground or should concealed or unknown conditions in an existing structure of an unusual nature, differing materially from those ordinarily encountered and generally recognized as inherent in work of the character

provided for in this contract, be encountered, the contract sum shall be equitably adjusted by change order upon claim by either party made within 20 days after the first observance of the conditions.

Another means to allocate the risk of unforeseen or unexpected site conditions is a contract clause obligating the contractor to conduct a site investigation. AIA Form A201, Art. 1.2.2 provides that:

By executing the contract, the contractor represents that he has visited the site, familiarized himself with the local conditions under which the work is to be performed, and correlated his observations with the requirements of the contract documents.

Notwithstanding this type of language, a contractor is only required to make an investigation that is reasonable under the totality of the circumstances. *North Scope Technical Ltd. v. United States*, 14 Cl. Ct. 242, 245 (1988); *Moorehead Constr. Co. v. City of Grand Forks*, 508 F.2d 1008, 1012 (8th Cir. 1975). The general test to determine whether an investigation is “reasonable” is what an experienced and reasonable contractor should have discovered from a site investigation, not what an expert might have discovered in conducting the same investigation. The differing site conditions clause and site investigations clause often are at the center of construction disputes because the owner attempts to shift contractual risk to the prime contractor.

Indemnification Clauses

The owner usually attempts to require the contractor to indemnify the owner for all losses incurred. A typical Indemnification Clause is:

The Contractor shall hold the Owner harmless from any and all claims for injuries to persons or for damage to property happening by reason of any negligence on the part of the Contractor or any of the Contractor’s agents or employees during the control by the Contractor of the Project or any part thereof

The effectiveness of indemnification provisions is limited by many statutes which render indemnification agreements unenforceable to the extent that they attempt to shift liability from a negligent party to a non-negligent party to a construction contract. See. e.g., Minn. Stat. 337.02.

Insurance Provisions

Most construction contracts require that the contractor purchase insurance for the protection of the contractor and the owner (and, perhaps, various mortgagees). The contracts usually specify what coverage is required, who is to be named as additional insureds, and what limits are to be purchased by the contractor. Always check and see whether you have insurance coverage as an “additional insured.”

The Owner’s Right to Stop or Take Over the Work

An owner will usually include contract provisions allowing it to stop the work or take over the work being performed by the contractor and will specify that it retains other remedies if work stoppage is ordered. Typical provisions are:

3.3.1 If the Contractor fails to correct defective Work. . . or persistently fails to carry out the Work in accordance with the Contract Documents, the Owner, by a written order signed personally or by an agent

specifically empowered by the Owner in writing, may order the Contractor to stop the Work, or any portion thereof, until the cause for such order has been eliminated.

3.4.1 If the Contractor defaults or neglects to carry out the Work in accordance with the Contract Documents and fails within seven days after receipt of written notice from the Owner to commence and continue correction of such default or neglect with diligence and promptness, the Owner may, after seven days following receipt by the Contractor of an additional written notice and without prejudice to any other remedy he may have, make good such deficiencies. In such case, an appropriate change order shall be issued deducting from the payments then or thereafter due the Contractor, the cost of correcting such deficiencies, including compensation for the Architect's additional services made necessary by such default, neglect or failure.

In this example (and many others), note that the Owner's right to take over the work usually is conditioned on written notice, although the right to stop the work does not require written notice.

Liquidated Damages Clauses

Most standard form construction contracts do not provide for liquidated damages. These clauses often are added by the owner (and sometimes the contractor) in an attempt to better define the liability of the contractor (or subcontractors) for failure to complete the work on time. A sample liquidated damages clause is as follows:

The time of the Completion of the Construction of the Project is of the essence of this Contract. Should the Contractor neglect, refuse or fail to complete the construction within the time herein agreed upon, after giving effect to extensions of time, if any, herein provided, then in that event and in view of the difficulty of estimating with exactness damages caused by such delay, the Owner shall have the right to deduct from and retain out of such monies which may be then due, or which may become due and payable to the Contractor, the sum of \$ _____ per day for each and every day that such construction is delay in its completion beyond the specified time, as liquidated damages and not as a penalty; if the amount due and to become due from the Owner to the Contractor is insufficient to pay in full any such liquidated damages, the Contractor shall pay to the Owner the amount necessary to effect such payment in full: Provided, however, that the Owner shall promptly notify the Contractor in writing of the manner in which the amount retained, deducted, or claimed as liquidated damages was computed.

Liquidated damages provisions may be enforced if the amount of the liquidated damages are not unreasonable and to the extent that they are not considered a penalty. These clauses can work both ways. The owner may recover liquidated damages for each day the project is late. But the owner may be limited to recovering only the amount of liquidated damages specified in the contract if the contractor fails to complete the project on time.

“Pay-When-Paid” Clauses

The general rule is that, as between the contractor and the subcontractor, the contractor bears the risk of an owner's insolvency or an architect's refusal to certify an application for payment. This rule flows from the parties' relationship. Courts frequently state that the contractor is in privity of contract with the owner and thus is in a (better) position to protect itself from the risk of late payment or insolvency through the use of contract clauses, guarantees, and similar devices. A subcontractor, in contrast, is not in privity with the owner and therefore is not in as good a position to protect itself from the owner's late payment or insolvency.

Contractors have attempted to shift the risk of the owner's late payment or insolvency to subcontractors through the use of “pay-when-paid” or “pay if paid” clauses. In Minnesota, as in

most jurisdictions, these clauses are narrowly construed. See *Mrozik Constr., Inc. v. Lovering Assoc., Inc.*, 461 N.W.2d 49 (Minn. Ct. App. 1990). According to the Minnesota Court of Appeals' opinion in Mrozik, a pay-when-paid clause will be effective only if written in unequivocal, unambiguous language.

Termination Clauses

Termination clauses also vary considerably from contract to contract. Typical termination provisions are found in AIA Form A201, Arts. 14.1.1 and 14.2.1.

Termination clauses are important because of the significance of their impact and the finality of their effect. They are usually a last resort and, even if they are invoked, termination does not occur because the contractor or the owner usually cures its default. Contractors must be aware of the notice provisions in termination clauses when developing their agreements with subcontractors. The contractor should allow itself ample time to cure a subcontractor's default before the owner is permitted to terminate the general contract.

Payment & Performance Bonds

Introduction

Payment and performance bonds are an important remedy in construction litigation because they provide a remedy for owners and subcontractors/suppliers. Prime contractors have the "privilege" to pay for them, but have no remedy under them. Payment bonds originated as a substitute for the protection offered by mechanic's liens after courts decided that public property was not lienable. See *United States v. Ansonia Brass and Copper Co.*, 218 U.S. 452 (1910). A payment bond requires the surety to pay third-party subcontractors and materialmen if the bonded contractor (the "principal") fails to do so, assuming the statutory or contract requirements to perfect the bond claim are satisfied.

In contrast, a performance bond requires the surety to complete the contractual work upon the default of the contractor. Thus, the performance bond can be an effective remedy for the owner whose project is not completed. A payment bond protects both the owner and third-party laborers, suppliers, and subcontractors, but a performance bond generally protects only the owner.

When Are Payment and Performance Bonds Required

Since the late 1800's, public bodies have enacted public contractor's bond laws requiring public bodies, as a condition of any contract award, to obtain from the contractor bonds assuring performance of the contract and payment for all labor and materials.

Public Projects

Federal

The Miller Act, 40 U.S.C. § 270a-d, requires almost all contracts for the construction, alteration, or repair of a federal building or project to specify that the contractor provide performance and payment bonds.

State and Local Projects

Each state has particular laws governing the requirements for payment and performance bonds on state or municipal projects. Generally, most states follow the federal Miller Act and require such bonds on public construction projects for both state and municipal projects and, as a result, are called “Little Miller Acts.” See, e.g., Minn. Stat. § 574.26.31.[1]

Private Projects

Private owners, especially on larger projects, increasingly require performance and payment bonds. And general contractors, on both public and private jobs, frequently require bonds from their subcontractors.

Rule of Interpretation

Another thing to remember in construction litigation: there is ample authority construing bonds in favor of claimants, rather than in favor of sureties.

Compensated sureties are not favored by the law. They are abundantly able to take care of themselves. They select the persons for whom they will act as surety and they select the language of their bonds. They are experts in the business of appraising risks. The courts will see to it that they give the protection which they hold themselves out to give and for which they are paid.

18 Dunnell’s Minnesota Digest § 9107a (3rd ed.).

Performance Bonds Are Not Payment Bonds or Insurance

In Minnesota, the only person entitled to the performance bond’s protection is the named obligee. *Cretex Companies v. Construction Leaders*, 342 N.W.2d 135, 140 (Minn. 1984). Because of hardship cases when performance bonds were first used, some courts held that a performance bond protected the named obligee (owner) *and* unpaid laborers, subcontractors, and suppliers even though they were not named as obligees in the bond. Likewise, in other jurisdictions, recovery has sometimes been allowed to parties other than the owner under a third-party beneficiary theory or a finding that the contract terms required that such persons be paid as a condition of contract performance. See Hayes, Performance Bonds-The Third Party Beneficiary Dilemma, 11 Forum 966 (1976); *Bristol Steel and Iron Works v. Plank*, 163 Va. 819, 178 S.E. 58 (1935).

In order to avoid any dispute about the bond’s intended coverage, many public bond statutes require a single “combined performance and payment bond.” Also, a performance bond is not a substitute for other forms of insurance, and the surety generally is not liable for third party claims for damage caused by the contractor’s negligence. See *DeBries v. City of Austin*, 110

N.W.2d 529, 538 (Minn. 1961); *Long v. City of Midway*, 169 Ga. App. 72, 311 S.E.2d 508 (1983). See generally Reynolds, Liability of Surety for Tort Claims Against Principal, 31 Ins. Counsel J. 447 (1964).

Damage Claims By the Contractor

Introduction

A construction claim is comprised of two primary parts, entitlement (i.e., contractor encounters a differing site condition) and damages (i.e., increased labor and material costs the contractor sustains because of differing site condition). These two components are equally important because if entitlement is not substantiated, damages cannot be recovered; and, without proof of damage, even the best liability claim is of little consequence.

Entitlement: Does The Contractor Have A Claim?

Theories of Recovery

Generally, there are four theories upon which a claim for damages may be based: (1) contract, (2) tort, (3) equitable restitution, and (4) statutory remedies (i.e. mechanic's liens and payment bonds). Each theory will be briefly discussed.

Contract Actions

When a contract exists, a party's failure to perform constitutes a breach of contract. Hence, when a contractor seeks to recover "on the contract", it seeks judicial enforcement of its rights under the contract. See, e.g., Cushman and Myers, *Construction Law Handbook*, §30.01[A], pp. 1120 (1999 ed.)

In addition to seeking the enforcement of express terms of the contract, a contractor may seek to enforce the implied warranties and duties that exist in every contract. Implied warranties are not expressly defined in the contract documents; rather, they are defined by common law. For example, an owner furnishing contract documents to prospective bidders impliedly warrants the accuracy of any factual representations in those documents, and the suitability of the specific design, materials, and methods. Therefore, in addition to analyzing what express contract provisions an owner may have breached, a contractor should be aware of the implied obligations that may exist as well.

Tort Actions

When a construction project devolves into a total disaster, the parties are likely to raise tort and contract claims. Typical tort claims include negligence, misrepresentation, fraud, and tortious interference with contractual relations. The relationship between owner and contractor, however, is fundamentally based on contract and, therefore, contractual provisions often exist that bar the assertion of tort claims. See *Otis Elevator v. Don Stodola's Well Drilling Co.*, 372 N.W.2d 77 (Minn. Ct. App. 1985). Such provisions, however, do not prevent a contractor from asserting a tort claim against parties not in privity to the contractual relationship, such as a design professional.

