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Callahan Wilson & Schurter on Constr. Mgmt. as Preferred Project Delivery Method

2010 Emerging Issues 5178

Michael T. Callahan, Jennifer Wilson & Thaddeus J. Schurter on Construction Management: Overtaking Design/Build as the Preferred Project Delivery Method?

By Michael T. Callahan and Thaddeus J. Schurter

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SUMMARY: This LexisNexis Emerging Issues Analysis examines the various roles assumed by construction managers, their duties and obligations, and the willingness of courts to hold construction managers to a fiduciary standard.

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ARTICLE: When it comes to liability, the construction manager (CM) may feel like a traveler lost in uncharted territory. Unlike the traditional participants in a construction project with more clearly defined roles, such as the owner, general contractor, and design professional, the CM's responsibilities are not as established. n1 The practice of construction management has been a shifting terrain, in which the duties of CMs have continued to change since the inception of construction management over 40 years ago. n2 In addition to the evolution of responsibilities over time, the responsibilities of CMs vary widely from project to project at any given time. n3 As construction management law has developed, its advantages as a project delivery method have become more apparent.

Defining Construction Management

In the 1980s, a commentator writing about new construction methods observed that "[t]he one, and probably only, area of agreement regarding construction management is that there is no consensus as to what it is, what it ought to be, and how it should be applied." n4 As long as there remains confusion as to the appropriate function of the CM, n5 arriving at a coherent understanding of construction management and its attendant liabilities seems unlikely. Creating a standardized definition would provide a better understanding of the purpose and benefits of construction management, as well as a systematic framework for legal decision-makers. n6

The CM's duties range from serving as an owner's agent, in a role comparable to that of a design professional, to serving in an at-risk capacity, in a role comparable to that of a general contractor. n7 As an agent, the CM usually performs services such as project administration, coordination, and supervision. n8 While the CM as agent typically does not assume responsibility for completion dates, quality of work, and construction costs, the CM in an at-risk role does undertake those risks. n9 Dividing construction management into agency and at-risk categories, however, has only contributed to confusion about the construction management label. n10

One commentator has suggested that any definition of construction management, whether classified as agency or at-risk, should be understood to involve an agency relationship. n11 Utilizing such a definition, the CM label would include features which have been traditionally associated with the at-risk category, such as using a guaranteed maximum project price and contracting directly with subcontractors, while retaining the benefits of the agency relationship between the owner and CM. n12 Moreover, the CM would plan, coordinate, and manage the project, but would not perform any construction work. n13 Consequently, tort liability would be allocated more appropriately by maintaining a clear distinction between the duties of the CM and general contractor. n14

Construction Manager as Fiduciary

Given the inherent nature of its advisory role, and its relationship with the owner, a bright line rule whereby all CM owner relations would be construed as agency ones bolsters the view of CM as master builder and enhances its reputation as a professional services provider. Although the agency label raises issues of fiduciary responsibility, n15 some commentators have already described the CM's role as a fiduciary one more akin to that of the architect/engineer than a conventional general contractor. n16 Fiduciary relationships are marked by a degree of trust and confidence between two parties where the party possessing superior knowledge, skill or expertise has a duty to represent the interests of the other party. n17 Whether the CM's relationship with the owner is classified as agency or at risk, there is no question but that both are characterized by a disparity in expertise and knowledge and that the owner relies heavily on the CM's construction expertise. As one commentator put it, "[a]lthough the construction manager is not often a design professional, [it] must be THE construction expert." n18 By contrast, design-builders do not share these characteristics because a design-builder is not the owner's agent.

The fiduciary obligations of a CM can arise out of its contract with the owner. In *Jones v. J.H. Hiser Construction Co.*, n19 contract language wherein a contractor promised to use its best skill and judgment to further the interests of the owner was construed as creating a fiduciary relationship. The language at issue n20 was nearly identical to the AIA's 121 CM/c - 2003 and AGC Document 565 "Relationship of Parties" provision. n21 Focusing on the "relationship of trust and confidence" wording and the contractor's assent to furthering the owner's interests by working in an expeditious and economical manner, the court concluded that the owner, who was not an expert in home construction, was entitled to rely on the contractor to protect its financial interests. n22 Although the arm's length relationship between most owners and contractors makes any discussion of fiduciary duty seem inappropriate, n23 the language used in *Jones* was sufficient to create such a duty. n24

Other courts have found, however, that "[t]he existence of a fiduciary duty is not coterminous with contractual obligations, but rather, depends upon an analysis which focuses upon whether one person has reposed trust in another who thereby gains a resulting superiority over the first" n25 In *Rose v. Simms*, n26 a CM who promised better results than a general contractor because it would owe the owner a fiduciary duty was sued after the owner learned that the CM awarded contracts to a specific group of contractors, without competitive bidding, at inflated prices. Finding that the CM owed a duty separate from its contractual ones, the court noted that a fiduciary relationship is "founded upon trust or confidence reposed by one person in the integrity and fidelity of another." n27 The CM's duty did not originate in a contract provision, but rather was the result of the trust the owner had placed in it as a professional services provider.

A 2004 decision from the Third Circuit further demonstrates that some courts are willing to hold CMs to a fiduciary standard. In *IPSCO Steel, Inc. v. Blaine Construction Corp.* n28, a CM was listed as the owner's agent, charged with protecting the owner's interests at all times, and was required to consent to any settlement agreements arising from litigation. After a contractor recommended by the CM abandoned the project, the owner and CM settled with the contractor and agreed to enter a \$26 million stipulated judgment against the contractor if it was found liable. However, because the contractor had empty pockets, the owner and CM agreed to satisfy the \$26 million judgment, if at all, by looking to the contractor's insurer. After settlement discussions, the owner released its claims against the contractor who in turn released its claims against the insurer, owner, and CM. The insurer, in return, agreed to pay the owner \$6 million, which represented a fraction of the total recovery possible against the contractor. The CM refused to

consent to the settlement because it felt it was insufficient in light of the negotiated judgment of \$26 million.

The CM argued that the fact that the owner, contractor, and insurer conditioned the insurer's settlement on its consent demonstrated that those parties viewed the rights subject to dismissal as belonging, at least in part, to the manager in its own right. It also maintained that, although it was assigned primary responsibility for the management and resolution of claims and disputes, its agency role had been exaggerated by the trial court. The Third Circuit disagreed. As the owner's agent, the CM had a duty of loyalty which required it to protect the owner's best interests. Once the owner reached a settlement with the insurer, the CM was obligated to execute the owner's wishes and consent to the settlements. Even though the settlement was adverse to the CM's interests, its duty of loyalty surmounted any conflict of interest.

Construction Management and Tort Liability

An April 2009 decision by the Colorado Court of Appeals, *Hamon Contractors, Inc. v. Carter & Burgess, Inc.*,ⁿ²⁹ contrasts a CM's fiduciary responsibility to the owner to the limited obligations it has to a contractor. *Hamon Contractors* concerns the liability of a CM, Carter & Burgess, acting as an agent not at risk for the City of Louisville, Colorado. The City solicited bids for a public works project involving the installation of a large pipe or culvert below a street. Hamon Contractors was selected as the project's general contractor. After excessive water on the site delayed construction, the contractor submitted a change order for its soil stabilization work. The CM denied the request for additional payment, claiming that the general contractor could have taken measures to prevent the drainage problem.

The contractor alleged that the CM knew the drainage design was inadequate, yet fraudulently concealed that information from the contractor. The contractor further alleged the CM fraudulently misrepresented that weather and improper grading caused the delays. The contractor also alleged that the CM negligently failed to detect the drainage design flaws and that the CM owed it a duty to detect those problems and notify it during the bidding process. The district court granted summary judgment in favor of the CM.

On appeal, the reviewing court concluded that the CM did not create or increase a risk of harm to the contractor by an affirmative act, nor did it prepare or revise the design plans or specifications. In the absence of a special relationship between the contractor and CM, the CM was not obligated to inform the contractor during the bidding process of flaws in the drainage design and thus was not liable for negligence. The appellate court also concluded that the economic loss rule barred the contractor's claims for post-contractual fraud. The application of the economic loss rule was not contrary to public policy since the alleged fraud related to contractual performance. The implied covenant of good faith and fair dealing restricted the CM's discretion in considering change orders and deciding whether to impose delay damages, matters which were clearly within the scope of the CM's contract with the City. Furthermore, the contract between the CM and the City explicitly set forth the CM's duty of care, providing that the CM's professional services would conform to the prevailing standard of practice.

As a signpost along the path from legal confusion to coherence, *Hamon Contractors* has relevance beyond Colorado's borders. The appellate court's willingness to apply the economic loss rule to a CM, thereby protecting it from liability for fraud claims, makes this case particularly compelling. *Hamon Contractors* suggests that a CM with no special relationship with a contractor has no duty to the contractor and thus can be shielded from liability for negligence claims.

A Preferable Project Delivery Method

The tort liability protections offered by *Hamon Contractors*, coupled with the heightened duty owed by the CM in *IPSCO*, demonstrate why construction management has emerged as the preferred project delivery method. ⁿ³⁰ Consider the utility of the construction management method in contrast to the design-build method. In design-build, the owner loses some control over the quality of design and construction. ⁿ³¹ The design-builder is not bound by fiduciary duties to the owner, who lacks a knowledgeable representative to protect its own interests. ⁿ³² The CM could provide

services typically offered by the design-builder. n33 It could hold subcontracts and assemble the guaranteed maximum price from those subcontracts, yet still serve as the owner's agent. n34 It would provide fiduciary responsibility, construction expertise, and economic efficiency to the owner during the design and construction process. n35 Although there are valid concerns whether contracting directly with subcontractors would be consistent with the construction manager's role as the owner's agent and whether the CM would be consistently motivated to act in the owner's best interest, n36 such concerns may be outweighed by the fiduciary obligations that accompany a professional services relationship. But a standardized definition of construction management should emphasize the CM's fiduciary responsibility and construction expertise as an agent for the owner, while delineating the limited boundaries of CM liability.

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n1 *Aladdin Constr. Co. v. John Hancock Life Ins. Co.*, 914 So. 2d 169 (Miss. 2005) ("There is no single, widely accepted definition of construction management."); See also Construction Law § 3.01[4][a] (Steven G.M. Stein ed., Release No. 64, LexisNexis September 2008); Gregory M. Simonsen, *Now You See It, Now You Don't: Road Side Warnings To The Hocus Pocus World of Construction Management*, 6 Utah Bar. J. 15, 16 (1993).

n2 Tymon Berger, *Construction Law: Drawing the Line*, 34 Wm. Mitchell L. Rev. 153, 175 (2007); W. Henry Parkman, *The Economic Loss Rule Applied to Negligence Claims Against Construction Managers - Does One Size Fit All?*, Const. Litigation Reporter 403, 404 (Oct. 2008); see generally John I. Spangler & William M. Hill, *The Evolving Liabilities of Construction Managers*, 19 Constr. Law 30 (Jan. 1999).

n3 *Construction Law*, supra n.1, at § 3.01[4][a].

n4 Milton F. Lunch, *New Construction Methods and New Roles for Engineers*, 46 Law & Contemp. Probs. 83 (1983).

n5 As evidence of this confusion, consider that the American Institute of Architects devotes two distinct Document Families comprised of twenty three different documents to the various interactions between owners and construction managers. See Am. Inst. Of Architects, Contract Documents, available at <http://www.aia.org/contractdocs/AIAS076693>.

n6 Berger, supra n.2, at 161, 171.

n7 Parkman, *supra* n.2, at 404.

n8 Construction Law, *supra* n. 1, at § 5B.03[1][c].

n9 *Id.*

n10 Berger, *supra* n.2, at 154.

n11 *Id.* at 155, 167.

n12 *Id.* at 164-168, 171.

n13 *Id.* at 171, 174.

n14 *Id.* at 160-163.

n15 Restatement (Third) of Agency § 1.01 (2006), "Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

n16 Construction Law, *supra* n.1, at § 5B.03[1][d]; *See also* Robert F. Cushman et al., *Proving and Pricing Construction Claims* § 8.02 (Aspen Law & Bus. 3d ed. 2001) ("The CM's role is typically described as an agency or fiduciary relationship to the owner and can take the form either as an advisor or as a constructor.").

n17 *Tricon Int'l, Ltd. v. United Constr., Inc.*, 2005 Conn. Super. LEXIS 1050 (Conn. Super. Ct. Apr. 1, 2005).

n18 Stanley P. Sklar, § 11.04[D], *Construction Law Handbook Volume I* (Robert F. Cushman and James J. Myers, eds., Aspen Law & Business 1999) (A construction manager "must . . . advise the owner regarding the project cost, time, means, methods, materials, labor, equipment, material costs, project feasibility, and constructability. [It] must possess strong administrative, managerial, and accounting skills in order to provide cost estimating, bid review project scheduling, and budget controls.") (emphasis in original).

n19 *Jones v. J.H. Hiser Constr. Co.*, 60 Md. App. 671, 484 A.2d 302 (1984).

n20 *Jones*, 484 A.2d at 303 ("The Contractor accepts the relationship of trust and confidence established between him and the [Joneses] by this Agreement. He covenants with the [Joneses] to use his best skill and judgment in furthering [their] own interests. He agrees . . . to perform the Work in the best way and in the most expeditious and economical manner consistent with the interests of the [Joneses].").

n21 AIA's 121 CM/c - 2003 and AGC Document 565, Copyright 1991 and 2003, "The Construction Manager accepts the relationship of trust and confidence established with the Owner by this Agreement, and covenants with the Owner to furnish the Construction Manager's reasonable skill and judgment to cooperate with the Architect in furthering the interests of the Owner. The Construction Manager shall furnish construction administration and management services and use the Construction Manager's best efforts to perform the Project in an expeditious and economical manner consistent with the interests of the Owner."

n22 See *Construction Law*, *supra* n.1, at § 5B.01[2][f] (discussing Relationship of Parties provision in AIA A111 - 1997 "The 'relationship of trust and confidence' appears to be general in applicability. However, the promises which appear thereafter following the conjunctive 'and covenants,' vary in nature. Some are more and some are less subject to measurement under the fiduciary standard. The final promise is of a different nature: 'to perform the Work in an expeditious and economical manner consistent with the Owner's interest.' This promise reiterates and identifies the circumstances under which the fiduciary duty arises . . .").

n23 *Construction Law*, *supra* n.1, at § 5B.01[2][f].

n24 But see *Eastover Ridge, L.L.C. v. Metric Constructors, Inc.*, 139 N.C. App. 360, 533 S.E.2d 827 (2000)

(no fiduciary obligations created by similar language where an "architect's constant, close involvement in the project belie[d] any claim that a "relation of trust and confidence" existed between [owner] and [contractor] giving rise to a fiduciary relationship. . .").

n25 *Rose v. Simms*, 1995 U.S. Dist. LEXIS 17686 (S.D.N.Y. Nov. 27, 1995) (citing *Litton Lindus., Inc. v. Lehman Bros. Kuhn Loeb Inc.*, 767 F. Supp. 1220, 1231 (S.D.N.Y. 1991), *rev'd on other grounds*).

n26 *Id.*

n27 *Id.*, citing *Schmidt v. Bishop*, 779 F. Supp. 321, 325 (S.D.N.Y. 1991).

n28 *IPSCO Steel (Ala.), Inc. v. Blaine Constr. Corp.*, 371 F.3d 141 (3d Cir. Pa. 2004), in *Construction Law Digest*, October 2004, Digest No. D003573.

n29 229 P.3d 282 (Colo. Ct. App. 2009).

n30 Spangler & Hill, *supra* n.2.

n31 *Construction Law*, *supra* n.1, at § 3.01[4][c].

n32 Berger, *supra* n.2, at 172.

n33 *Id.*

n34 *Id.* at 173.

n35 *Id.*

n36 Berger, *supra* n.2, at 164-168; Construction Law, *supra* n.1, at § 5B.03[3][d].

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Callahan & Schurter on Expanding CGL Coverage for Construction Defect Claims?

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Michael T. Callahan & Thaddeus J. Schurter on Expanding Commercial General Liability Coverage for Construction Defect Claims?

By Michael T. Callahan and Thaddeus J. Schurter

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SUMMARY: This LexisNexis Emerging Issues Analysis discusses insurance coverage for construction defects or faulty workmanship under Commercial General Liability policies, which has long been a contentious issue between insurers and policyholders. Numerous jurisdictions rejected coverage for such claims in the past, but now disputes over construction defect claims are increasingly resolved in favor of coverage.

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ARTICLE: RECENT DECISIONS

In recent years, the high courts of Texas, Florida, Tennessee, Kansas, Wisconsin, North Dakota, Nebraska, and Minnesota have held that Commercial General Liability (CGL) policies can provide coverage for defect claims or faulty workmanship. By contrast, however, the high courts of Arkansas, Pennsylvania, and South Carolina n1 have reached the opposite conclusion. Even so, recent decisions involving construction defect claims suggests a trend may be emerging favoring policyholders. n2

A 2009 case from the First Circuit, *Essex Insurance Co. v. BloomSouth Flooring Corp.*, n3 held that a complaint alleging air contamination from VOCs which affected an entire building constituted property damage for purposes of CGL coverage. In *Essex*, employees of Boston Financial Data Services noticed a foul odor in their office space following a remodeling project. The employees complained that the offices smelled like sour chemicals or a locker room. At the owner's insistence the offensive carpet tile and adhesive were removed and replaced, but the odor persisted. The general contractor spent nearly \$1.5 million in remediation costs after the subcontractor who installed the carpet refused to resolve the problem. The subcontractor's insurer refused coverage. In the ensuing litigation, the trial court concluded that the concrete floor became the subcontractor's property during the carpet installation process. It viewed the damaged floor as damage to the insured's product and excluded remediation costs under the 'your product' provision.

On appeal, the insurer that asserted odor could not constitute a physical injury and that Suffolk's claim only alleged injured air quality, not damage to tangible property. The insurer further maintained that any expenses to abate the odor, including bead blasting the concrete slab, were replacement costs, not remediation costs. The First Circuit reversed.

Nothing in the policy suggested odor could not constitute physical injury to property. The 'your product' exclusion only barred coverage for damaged goods or products other than real property. As real property, the concrete floor was not subject to the exclusion because it was not the insured's product. Likewise, the 'impaired property' exclusion was only available where the defective work could be restored through repair, replacement, adjustment, or removal of the defective product or work. The defect was only resolved after the concrete slab's top layer was physically removed. In so doing, the general contractor exceeded the scope of the exclusion by going beyond the repair, replacement, or adjustment of the defective work.

In *United National Insurance Co. v. Dexter Honore Construction Co.*,ⁿ⁴ another 2009 decision, allegations of property damage arising from construction defects were sufficient to constitute an occurrence under a CGL policy. In *Dexter*, a developer began preliminary work on an RV resort in Louisiana. After hurricanes Katrina and Rita struck, the developer leased half its property to FEMA for an emergency housing mobile home park. FEMA hired Fluor, a design-builder, to design and construct the facility. Shortly thereafter, FEMA ordered all work to stop. The developer filed suit against the design-builder, subcontractor, and sub-subcontractor for destroying the clay soil base and destroying the property's usefulness for commercial development. The developer claimed the defendants failed to provide adequate drainage and failed to dig drainage ditches or retention ponds prior to employing heavy machinery on the site. Fluor, an additional insured under its subcontractor's CGL policy, demanded its insurer defend it in the underlying suit. Claiming there was no duty to defend or indemnify, the insurer initiated a declaratory judgment action.

The insurer asserted that the design-builder and subcontractor failed to follow engineering plans, retain qualified management, or perform soil testing, which were intentional rather than accidental acts and thus not occurrences under the policy. Fluor and its subcontractor contended that the developer had alleged unexpected property damage, which was covered as an occurrence. The developer's complaint, in addition to alleging defective work by the design-builder and subcontractor, also alleged significant property damage arising from construction defects, including erosion and an unstable surface. The court concluded there was an occurrence under the CGL policy. No coverage exceptions were unambiguously applicable, and the insurer was obligated to defend.

In *Mid-Continent Casualty Co. v. JHP Development, Inc.*,ⁿ⁵ the Fifth Circuit ruled that damage to a contractor's non-defective work was not excluded from coverage even where that damage was caused by its own defective work. In that case JHP Development was hired to construct a five-unit condominium project. The individual units remained partially unfinished so the new owner could choose the finishing details. The contractor's failure to properly seal the exterior finishes and retaining walls caused water damage to the unfinished units. The owner terminated the contractor after it refused to repair the damage. The owner filed suit against the contractor for breach of contract, breach of warranty, and negligence. The contractor's insurer denied coverage, and a default judgment was entered against the contractor. The insurer filed a declaratory judgment action. The trial court found both property damage and an occurrence, and held that the default judgment was binding on the insurer. The insurer appealed.

The insurer's appeal was stayed pending resolution of another defect case in the Texas Supreme Court.ⁿ⁶ However, after the Texas high court held that a CGL insurer was obligated to defend a general contractor against lawsuits alleging damage caused by its own construction defects, the insurer abandoned its occurrence arguments. The insurer maintained that because some units remained unfinished when the damage occurred, construction operations were ongoing and thus excluded from coverage. It further argued that another exclusion applied to all property damage resulting from the contractor's defective work, including any interior damage. The owner countered that the exclusions were not applicable because the work had been suspended until the remaining units were purchased and trimmed out. It further asserted that the 'particular part' language of the 'your work' exclusion demonstrated that it only applied to damage which was itself the subject of the defective work that caused property damage, not to other parts which were damaged as a result of the defective work but were not themselves defective.

The Fifth Circuit in 2009 held that given the plain meaning of the exclusions, they were inapplicable. The exclusion only applied to property damage caused during active physical construction activities, not to damage which occurred during prolonged periods of inactivity. Further, the 'your work' exclusion was not a bar to coverage for damage

to non-defective work damaged as a result of the insured's defective work on other parts of the property. Because neither the allegations of the underlying suit nor the evidence presented fell under the provisions of either of the exclusions, the insurer was obligated to defend and bound by the default judgment.

In 2008, the South Carolina Supreme Court held that continuous damage caused by the insured's work product qualified as an accident and occurrence in *Auto-Owners Insurance Co. v. Newman*.ⁿ⁷ In that case, after construction of a new home was completed, the owner sued the contractor for breach of contract, negligence, and breach of warranty. The complaint alleged defective construction, mostly related to the installation of the stucco siding on the house. An engineer's inspection confirmed that the stucco did not conform to industry standards and noted that the defective construction caused severe damage to the home's framing and sheathing. The owner was awarded damages in arbitration. The contractor's insurer subsequently initiated a declaratory judgment action, insisting that the damages were not covered under its policy. The trial court determined that the CGL policy covered all but four items of the damages provided for in the arbitration award.

On appeal the insurer contended that the defective stucco installation was not an accident constituting an occurrence under the policy. The Supreme Court of South Carolina noted that the arbitrator had determined that the owner suffered damages as a result of the contractor's negligent application of the stucco. The defective stucco allowed water intrusion, which resulted in additional damages to the home. As such, there was property damage beyond that of the negligently applied stucco itself. While the negligent application of the stucco was not by itself sufficient to constitute an occurrence, the continuous water intrusion into the home resulting from the negligence qualified as an accident which triggered coverage under the policy.

ACCIDENT OR INTENTIONAL ACT?

As the previous cases illustrate, whether defective work is covered by CGL insurance is often decided by how the word "accident" is understood. Does the intent to commit an act, even where that act results in unintended consequences, preclude coverage because an intentional act is not an accidental one? Courts have reached different conclusions, sometimes even when applying the same laws. In one such case, the U.S. District Court for the Southern District of Illinois recently concluded in *Western World Insurance Co. v. Penn-Star Insurance Co.*ⁿ⁸ that unintentional damage caused to an adjoining structure during demolition constituted an occurrence. In *Western*, the City of East St. Louis contracted with McCoy Construction to demolish a building at 320 Collinsville Road. During demolition part of a wall that was common to both 320 Collinsville Road and 318 Collinsville Road was damaged. Upon realizing its mistake, the contractor stopped immediately, but the damage was done. Penn Star Insurance, which insured the damaged building, filed a subrogation suit against the city and the contractor for negligence and inverse condemnation. Western World Insurance, the contractor's insurer, refused to defend or indemnify in the suit. After the parties reached a settlement, the contractor's insurer filed a declaratory judgment action.

The contractor's insurer asserted what had become the default insurer position in nearly all construction defect cases,ⁿ⁹ that the damage was not covered because it was not an occurrence. It maintained that because the contractor intended to demolish the common wall, any damage it caused was not accidental. The city contended that while the demolition was intentional, the resulting harm to the neighboring building was not, and thus its actions were covered as an accident. In addressing what types of conduct trigger CGL coverage, the court explained that the important question was not whether the acts which resulted in damage were intentional, but rather whether the injury was expected or intended by the insured.ⁿ¹⁰ Accordingly, intentional acts that produced unintended and unforeseen consequences could qualify as accidents. Because the contractor intended to demolish the common wall but did not intend to damage the second building, the property damage was an accident and an occurrence under the policy.

By contrast the U.S. District Court for the Northern District of Illinois reached an opposite conclusion on a similar case some three years earlier. In *Century Surety Co. v. Demolition & Development Ltd.*,ⁿ¹¹ a contractor's demolition of the wrong building, based on erroneous information from a city employee, was not considered an occurrence. In *Century*, the City of Chicago hired a demolition contractor for an emergency tear down of a building located at 4710-20

South Indiana Avenue. After arriving on site, the contractor's president was uncertain which buildings to demolish, since three buildings with no addresses posted on them were near the demolition location. An employee at the city's buildings department verified that the three buildings were to be demolished. The contractor began its demolition but stopped after the surprised owner of one of the buildings indicated that his building, 4708 South Indiana, was not supposed to be demolished. n12 A city inspector confirmed that the building was not subject to the court order. The contractor's insurer denied coverage and filed a declaratory judgment action.

The contractor's insurer conceded that the property was damaged but argued that because the demolition was intentional, any resulting damage was not accidental, despite the error in identification. The insurer further maintained that as an expected result of demolition, the damage could not be classified as unforeseen. The insurer added that even if an occurrence took place, several exclusions exempted coverage. The contractor contended that its demolition of the wrong building was accidental. The court disagreed. Using the same definition of accident that would be cited in *Western*, n13 the court reasoned that the natural and ordinary consequences of an act could not constitute an accident. Although the contractor's actions were based on erroneous instructions from a city employee, the natural and ordinary consequence of its act of demolition was the destruction of the building. Because the damage was foreseeable, it was not accidental, and thus not an occurrence within the policy's terms. An exclusion barring coverage for property damage that was expected or intended also operated to bar coverage. The court reasoned that once the contractor received verification from the City as to which property was to be destroyed, any resulting damage was expected and thus excluded. Additionally, under the 'work product' exclusion, because the contractor performed as directed by the City, its demolition constituted work product. The court used the same logic to apply the 'your work' exclusion.

The two courts' differing interpretations of the word accident explain the divergent results. In both cases the contractor was instructed to demolish specific property, and in both cases a neighboring structure not slated for demolition was damaged. Each court cited the same Illinois Appellate Court ruling in its decision, n14 but the Northern district concluded that an intent to commit the act of demolition meant that there was no occurrence, while the Southern district looked to whether or not the injury was expected or intended by the contractor and not whether the act of demolition was performed intentionally.

Some courts, like the *Century* court, continue to view construction defects and faulty workmanship as foreseeable events not subject to CGL coverage. In *Cincinnati Insurance Companies v. Collier Landholdings*, n15 another 2009 decision, a contractor hired to build a mixed use facility hired several subcontractors to work on the project. After substantial completion and occupancy by the tenants, water infiltrated the building through its ceilings, walls, and floor causing mold to grow in the interior walls. The owner sued the contractor for breach of contract and alleged it had suffered damages including repair and remediation costs, loss of use, financing costs, loss of business expectancy, and other losses. The insurer denied the contractor's coverage and filed a declaratory judgment action.

The insurer argued that defective construction was not an occurrence under state law. The owner contended that state law interpreting the term 'occurrence' only addressed defective workmanship by general contractors, not by subcontractors. The owner maintained that the damage which resulted from the subcontractor's defective workmanship was clearly an occurrence. The contractor conceded that its subcontractor's defective work was not an occurrence but argued that damage to non-defective portions of the center caused by the water intrusion was an occurrence. Applying Arkansas law, the court concluded that defective workmanship was a foreseeable risk associated with the employment of subcontractors and not an occurrence. A general contractor could not segment its work into that performed by various subcontractors, some of which was defective and some of which was not, in order to create an occurrence.

A Mississippi court reached a similar conclusion in 2008. In *Nationwide Mutual Insurance Co. v. Panther Creek Construction Co.*, n16 an insurer denied coverage to a developer after it was sued by the owners of a newly constructed residence which suffered extensive water damage from allegedly faulty construction. The insurer asserted that the developer's intent to build the home precluded coverage because an intentional act could not constitute an occurrence. The insurer maintained there was no coverage for the consequences of intentional conduct, even where the actual injury suffered was unintended by the developer. The court agreed and held that there was no duty to defend because the

owners' claims were based on the developer's intentional conduct.

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n1 *Essex Ins. Co. v. Holder*, 372 Ark. 535, 261 S.W.3d 456 (2008); *Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 908 A.2d 888 (2006); *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 366 S.C. 117, 621 S.E.2d 33 (2005). *But see Auto Owners Ins. Co. v. Newman*, 2008 S.C. LEXIS 74 (S.C. Mar. 10, 2008).

n2 Owen J. Shean and Douglas L. Patin, *Construction Insurance: Coverages and Disputes* (Cumulative Supp. 2009) (citing *Auto Owners Ins. Co. v. Newman*, 2008 S.C. LEXIS 74 (S.C. Mar. 10, 2008) (continuous damage caused by insured's work product is an accident and occurrence); *Aten v. Scottsdale Ins. Co.*, 511 F.3d 818 (8th Cir. 2008) (insurer liable for work performed by an insured's subcontractor under an exception to the 'your work' exclusion of CGL policy); *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 50 Tex. Sup. Ct. J. 1162 (2007) (insurer obligated to defend general contractor in suit alleging damage caused by its own construction defects); *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 32 Fla. L. Weekly S 811 (2007) (subcontractor's defective work that damaged a contractor's completed project which was neither expected nor intended from the contractor's standpoint can constitute property damage caused by an occurrence as defined in CGL policy); *Travelers Indem. Co. of Am. v. Moore & Assocs.*, 216 S.W.3d 302 (Tenn. 2007) (damage caused by faulty workmanship was property damage and constituted an occurrence under CGL policy); *Columbia Mut. Ins. Co. v. Epstein*, 239 S.W.3d 667 (Mo. Ct. App. 2007) (construction defects, including defective foundation and sub-floor constituted accidents and thus occurrences under the CGL policy); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 281 Kan. 844, 137 P.3d 486 (2006) (leaks caused by defective materials or workmanship, which caused structural damage, constituted an occurrence under the CGL policy); *French v. Assurance Co. of Am.*, 448 F.3d 693 (4th Cir. Va. 2006) (holding that CGL covers damage to a contractor's nondefective work caused by a subcontractor's defective work, but noting that defective construction is not an occurrence for CGL purposes); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 2004 WI 2, 268 Wis. 2d 16, 673 N.W.2d 65 (2004) (subcontractor's faulty soil preparation work was an accident and thus an occurrence under CGL policy); *But see Cincinnati Ins. Cos. v. Collier Landholdings, LLC*, 614 F. Supp. 2d 960 (W.D. Ark. 2009) (subcontractor's defective workmanship was a foreseeable risk and not an occurrence under contractor's CGL policy); *Essex Ins. Co. v. Holder*, 372 Ark. 535, 261 S.W.3d 456 (Ark. 2008) (no occurrence and no obligation to defend insured contractor where defective workmanship damaged only the work product itself); *Auto-Owners Ins. Co. v. Chorak & Sons, Inc.*, 2008 U.S. Dist. LEXIS 60444 (N.D. Ill. 2008) (insurer not obligated to defend or indemnify subcontractor for catastrophic damage caused by the subcontractor's defective performance); *Adair Group, Inc. v. St. Paul Fire & Marine Ins. Co.*, 477 F.3d 1186 (10th Cir. Colo. 2007) (deficient performance of subcontractors does not trigger application of CGL policy); *Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 908 A.2d 888 (2006) (property damage resulting from faulty workmanship does not constitute an occurrence under CGL policy); *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 366 S.C. 117, 621 S.E.2d 33 (2005) (subcontractor's faulty workmanship not an accident, and resulting damage not an occurrence)).

n3 *Essex Ins. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399 (1st Cir. Mass. 2009).

n4 *United Nat'l Ins. Co. v. Dexter Honore Constr. Co., LLC*, 2009 U.S. Dist. LEXIS 38478 (W.D. La. Apr. 30, 2009).

n5 *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207 (5th Cir. Tex. 2009).

n6 *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 50 Tex. Sup. Ct. J. 1162 (2007). See Lee H. Shidlofsky, *Supreme Court of TX Weigh-In on Property Damage and Occurrence in the Real, 2008 Emerging Issues 1315*, available at https://www.lexis.com/research/retrieve?_m=ed59230d88a369e39168fd05ca913ed1&csvc=le&cform=&_fmtstr=FULL&docnum

n7 *Auto Owners Ins. Co. v. Newman*, 2008 S.C. LEXIS 74 (Mar. 10, 2008).

n8 *W. World Ins. Co. v. Penn-Star Ins. Co.*, 2009 U.S. Dist. LEXIS 47921 (S.D. Ill. June 8, 2009).

n9 James Duffy O'Connor, *What Every Construction Lawyer Should Know About CGL Coverage for Defective Construction*, 21 Construction Law 15 (2001).

n10 *W. World*, *supra* n.8, citing *Lyons v. State Farm Fire & Cas. Co.*, 349 Ill. App. 3d 404, 811 N.E.2d 718, 285 Ill. Dec. 231 (Ill. App. Ct. 5th Dist. 2004). See also *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 50 Tex. Sup. Ct. J. 1162 (2007) (citing *Mass. Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396, 300 (1967) ("[A] deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly.")).

n11 *Century Sur. Co. v. Demolition & Dev., Ltd.*, 2006 U.S. Dist. LEXIS 2128 (N.D. Ill. Jan. 18, 2006).

n12 Apparently, inadvertent destruction of neighboring property isn't as uncommon as one might think. *See also Thommes v. Milwaukee Ins. Co.*, 641 N.W.2d 877, 6 No. 16 Minn. Lawyer 6 (2002).

n13 *Century*, *supra* n.11, quoting *Massachusetts Bay Ins. Co. v. Vic Koenig Leasing*, 136 F.3d 1116 (7th Cir. Ill. 1998) ("an unforeseen occurrence, usually of an untoward or disastrous character, or an undesigned sudden or unexpected event of an inflictive or unfortunate character").

n14 *Lyons v. State Farm Fire & Cas. Co.*, 349 Ill. App. 3d 404, 811 N.E.2d 718, 285 Ill. Dec. 231 (Ill. App. Ct. 5th Dist. 2004).

n15 *Cincinnati Ins. Cos. v. Collier Landholdings, LLC*, 614 F. Supp. 2d 960 (W.D. Ark. 2009).

n16 *Nationwide Mut. Ins. Co. v. Panther Creek Constr. Co.*, 2008 U.S. Dist. LEXIS 25746 (S.D. Miss. Mar. 30, 2008).

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THE RISK OF SPOILIATING ELECTRONIC SCHEDULES

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THE RISK OF SPOILIATING ELECTRONIC SCHEDULES

By Michael Callahan and Jason Romero

May 24, 2010

SUMMARY: Schedules are an important part of proving or refuting delay and other impact claims because they provide a detailed medium for comparing and measuring time and intent. The use of a detailed method to present a time claim is important to establish the claimant's entitlement to both the delay and other additional costs related to the delay. Proof of the delay and its impact on performance period is the claimant's burden.

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ARTICLE: Schedules are an important part of proving or refuting delay and other impact claims because they provide a detailed medium for comparing and measuring time and intent. The use of a detailed method to present a time claim is important to establish the claimant's entitlement to both the delay and other additional costs related to the delay. Proof of the delay and its impact on performance period is the claimant's burden. A delay claim will be rejected if there is no evidence of the delaying event's impact.

At a minimum, a successful delay claim requires a hard copy of the schedules used to manage the project and a hard copy of the schedules used to prove the events actually caused delay. However, because the calculations and commands given to the software by the scheduler are not exposed on the default views used to produce paper schedules, a paper schedule does not show the underlying detail necessary to understand the activity relationships and restraints. Without showing such detail, using only a paper schedule to prove a delay may not only be unreliable, but also deceptive. Thus, a meaningful proof or defense may be impossible unless an electronic copy of the schedule is made available.

When scheduling software is used, a claimant that has deleted, destroyed, or overwritten its electronic schedules may have foreclosed the possibility of proving or defending its delay claim. n1 Recreating an electronic schedule from hard copies is expensive and the effort is not always successful. Parties defending against a delay claim have argued that where a claimant has not maintained a copy of all schedules used during the project (or required by the specifications, which is often an entirely separate set of schedules) it has been denied the opportunity to assert a reasonable defense. n2 Moreover, some parties defending a delay claim have argued that a paper copy of a network schedule is insufficient and that if an electronic copy was created during the project, it must be provided. Further, if an electronic copy had not been maintained, the delay claimant had committed spoliation. n3

Although owners, designers, and contractors do not typically anticipate complex delay disputes, the risk of spoliation sanctions is inherent whenever scheduling requirements are not sufficiently addressed. There are, however, several ways to minimize the risk, and at the same time, add value to the project:

- Clearly define scheduling obligations in the contract.
- Determine the amount of detail the schedules need for each project.
- Communicate with a skilled scheduling consultant.
- Follow a record retention plan for scheduling data.

WHAT IS SPOLIATION?

"Spoliation" occurs when one party destroys relevant evidence to a case or future case. The duty to preserve relevant evidence is fundamental to litigation. It arises when the party in possession of evidence knows or should know that the evidence is relevant to pending or future litigation. n4 "Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents." n5

For construction projects, there is no clearly identifiable point at which a contractor "should know" the scheduling data may be relevant to future litigation. Because there are numerous parties performing complex work under multiple contracts, change orders, time extensions, and disputes are inevitable. Thus, one could argue that a party "should know" the scheduling data may be relevant to future litigation from the start date of the project or shortly thereafter. Alternatively, the need for litigation may not become apparent until the last payment application is refused after the project is completed. Such uncertainty demonstrates why spoliation risks are inherent on many construction projects.

In some jurisdictions, spoliation sanctions do not require bad faith or intentional misconduct. Courts will consider the degree of fault of the party who altered or destroyed the evidence; the degree of prejudice suffered by the opposing party; and whether the appropriate sanction minimizes the prejudice to the opposing party and serves to deter such conduct by others in the future. n6 Depending on what the court deems appropriate, there are several possible sanctions including:

- Contempt and monetary sanctions, including legal fees
- Exclusion of witnesses or testimony
- Exclusion of physical evidence
- An adverse inference instructions in favor of the non-spoliating party
- Granting a default judgment or dismissing claims

As an alternative to seeking sanctions, some jurisdictions recognize a tort cause of action for intentional spoliation. Generally, to prevail, the plaintiff must show: (1) a pending or potential civil action; (2) the spoliator's knowledge of the pending or potential civil action; (3) willful destruction of evidence; (4) the spoliated evidence was vital to a party's ability to prevail in the pending or potential civil action; (5) the intent of the spoliator to defeat a party's ability to prevail in the pending or potential civil action; (6) the party's inability to prevail in the civil action; and (7) damages. n7

SCHEDULING PROVISIONS IN THE CONTRACT

The contract is the starting point for the parties' underlying obligations with regards to scheduling. Standard form industry contracts for private projects provide minimal or no guidance on scheduling requirements.

The American Institute of Architects (AIA) standard form agreement between the owner and contractor requires a contractor to promptly prepare and submit a construction schedule for the work. n8 It further requires that the schedule be revised at "appropriate intervals" and that the contractor follow the most recent schedule submitted. n9 Because "time is of the essence," any delay from the most recent schedule can be considered a material breach and provide the owner with grounds to terminate the contract. n10

The AIA does not provide a definition of "appropriate intervals." Unless separate scheduling specifications indicate when the contractor is required to submit a revised schedule, the contractor is only obligated to do so when it is deemed necessary by the parties. Depending on the frequency of approved change orders, the contractor may need to revise the schedule more than once a month. Or, if the most recent schedule remains unchanged for an extended period, the contractor may need to provide written affirmation in place of a revised schedule. The pre-determined number of intervals specified in the contract or scheduling specifications will determine the minimum number of schedule files to be accounted for at the outset of a dispute. Missing or deleted scheduling data can have serious consequences.

Including scheduling provisions in the contract is also important because the updated or revised schedules provide an accurate historical record of the project. Schedule updates show actual dates and rates of progress and can predict new start and finish dates for each activity. With this information, it is possible to create, and potentially recreate, a schedule to measure a disputed extension or delay claim. Without the historical time record it may be impossible to prove or defend a claim for additional time.

SCHEDULING SPECIFICATIONS

Scheduling specifications will vary from project to project. Some specifications require a great amount of detail and obligations. The specifications can define duration units, resource and cost load requirements, review periods for submittals, sequencing logic and organizational sorting methods, milestone activities, update and narrative requirements, and any other relevant scheduling coordination requirements. The schedule specifications may even define the detail and special schedules necessary to support a time extension request. Careful attention must be paid to drafting these provisions rather than copying and pasting from previously used specifications.

Scheduling specifications may also require use of particular scheduling software. Agreeing on specific software will reduce the risk of discovering multiple schedules from different software providers. Reconciling the different software models makes it difficult to draw accurate comparisons if the contractor submits a baseline schedule made in one software and schedule updates made in another. Specifications that are too burdensome or too vague will make measuring time extensions or claims for delay more difficult. In *Morganti National, Inc. v. United States* n11, Morganti was required to prepare a schedule and submit monthly updates using the critical path method. The contract specifications prohibited Morganti from adding time to the contract schedule until the time was approved by the Federal Bureau of Prisons (FBOP) via a bilateral modification agreement. As a result, Morganti was required to schedule and track 7,000 activities. Neither Morganti nor the FBOP were able to compute possible delays because the schedule had become so hopelessly confused. The specification requiring a bilateral modification to add time, combined with the outrageous number of activities to be tracked, rendered the schedule useless as a tool to measure time. If Morganti had disregarded the bilateral modification specification and wrote over the baseline schedule or altered updated schedules to conform to all the change orders, the FBOP might have motioned for spoliation sanctions. Any changes Morganti made to the schedules not in accordance with the specifications could have been viewed as the deletion of relevant, discoverable electronic evidence and subjected Morganti to spoliation sanctions.

Another case, *Turner Construction Co. v. General Services Administration* n12 demonstrates the dangers that claimants must confront if schedule copies are not properly maintained. Although the holding does not distinguish between paper and electronic copies, the message is clear: if a delay claimant does not maintain copies of all its schedules, its claims for delay may be denied.

Turner involved a substantial claim regarding construction of the United States Courthouse and Federal Building in Islip, New York. The contract's scheduling provisions required Turner to use critical path method for planning, scheduling and reporting all performed work. Specifically, Turner was to utilize the most current version of Primavera Project Planner, or a similar scheduling software system which could be transferred over to Primavera. Additionally, where modifications were indicated or delays experienced, Turner was to submit a "written time impact analysis illustrating the influence of each modification, delay or contractor request on the [overall] contract time." The analysis had to "demonstrate the time impact based on the date the modification [was] given . . . or the date the delay occurred."

The event times used in the analysis were to be those included in the most recent schedule update or as adjusted by the parties' mutual agreement. Impact analyses were to be submitted within seven calendar days after receipt of a modification or within seven calendar days from the beginning of a delay as defined in the contract conditions. If Turner failed to timely submit an analysis, the contract provided that the particular modification, delay or request did not merit an extension of the contract time.

The GSA filed a "Motion For Relief from Prejudice Caused by Appellant's Failure to Preserve Evidence." The GSA alleged that Turner failed to preserve electronic scheduling updates past the final updated schedule (G139), which was issued roughly ten months before project completion. It further alleged that Turner failed to preserve data from the electronic resource allocation control system (RACS) from June 1996 through March 1997 and from July 1998 through the end of the project.

Turner responded that the final updated schedule (G139) produced in electronic format was dated October 8, 1999, and that the final paper copy of the schedule (G144) was dated March 8, 2000. Turner maintained that it produced no schedules in any form for the time period between G139 and G144 and none for the final six months of the project. There were no electronic schedule updates beyond update G139 because none were submitted as part of the project record. Subsequent updates during the later portions of the project were completed by hand for specific work areas, reviewed and approved by the owner and its representative during project meetings and incorporated into the approved payment applications. Moreover, no complete electronic updates were prepared after G139 because the project was not managed at that time on the basis of the Primavera schedule, it was not being fully updated and, unlike the official updates that were exchanged with GSA and its Quality Control Manager, no procedure was in place to formally record such drafts electronically.

The GSA's second allegation involved the RACS, a computer-based management tool used to evaluate job progress. RACS reflected the status of resource utilization, work duration, and work in place up to the data date, and the projected value to complete the project. RACS gave information to the specification section level. Turner insisted that no RACS data was created after June or July 1998, because it had concluded that RACS was an inefficient management tool for the Islip project; that earlier electronic versions of RACS data through March 1997 would have been automatically overwritten in the normal course of business by later iterations of the RACS data, and that hard copies of RACS data for early 1996 and 1997 did exist.

The GSA contended that Turner failed to safeguard and preserve evidence that was both discoverable and highly probative of the issues. The GSA sought an order granting it a presumption that the lost or destroyed information would have supported GSA's case and harmed Turner; and an order imposing other adequate sanctions against Turner. The GSA's motion was one for spoliation of evidence during discovery, as the motion explicitly sought sanctions for alleged failure to preserve evidence.

The Board concluded that the allegedly missing items, the schedule updates and the post-June or July 1998 RACS data, were never created and thus were not destroyed. The electronic RACS data for early 1996 through March 1997 were erased in the normal course of business, not negligently or intentionally deleted. If hard copies of the RACS data existed for that time period, however, Turner was to provide the data to the GSA. Moreover, the Board observed that it was Turner who might be prejudiced by the allegedly missing scheduling update data. It was Turner's burden to establish the fundamental facts of causation, liability, and damage. The construction contract placed explicit and detailed scheduling requirements upon the contractor. Contract appeals boards were required to analyze delays in accordance with the express scheduling provisions of the contract, rather than crediting "litigation arguments" of the parties as to the combined effects of delays. n13 When CPM analyses failed to reflect the dynamic nature of CPM scheduling and did not give appropriate credit for all of the delays alleged to have occurred such claims have been rejected by other boards. n14 The GSA's motion for relief was denied.

According to the Board, Turner's statements that it did not use Primavera during the later stages of the project, or provided schedule updates as required by the contract, brought into question whether Turner would be able to prove

delay during the stages of the project for which update data was missing. Turner maintained that it used manual updates for certain work areas, but it was not clear whether the areas covered a significant percentage of the project and would be useful in a delay analysis for the project as a whole, particularly during the later stages of construction. It was also unclear whether the manual updates conformed to the contract's CPM scheduling requirements for use of Primavera by being fully transferable to the Primavera environment, and, if not, what adverse effect that fact had on Turner's proof of delay.

AVOIDING SPOILIATION OF CONSTRUCTION SCHEDULES

Construction scheduling requires a reasonable understanding of all phases of construction and design, various scheduling techniques, and electronic scheduling software. Although contractors usually employ their own schedulers, agreements to retain independent scheduling consultants are not uncommon. ⁿ¹⁵ A skilled independent scheduling consultant will not only bring expert schedule preparation knowledge to the table, but also delay analysis and activity management skills. Perhaps most importantly, a scheduling consultant who is in tune with litigation procedure will know what to do with the project schedules to preserve historical time records in the schedule in the event of a delay claim so as to avoid the risk of spoliation.

The scheduling consultant may also advise the contractor to adopt a records retention policy that particularly addresses schedule retention. Parties to a project might agree in advance to a record retention policy for project files. For instance, the contractor may be required to hold hard copies of the schedules along with multiple electronic back-up files for a specified period and may also need to provide verification that the files have not been altered. Although many contractors already implement retention policies, because these policies may not consider the need to preserve records in the event of litigation, they may be insufficient to avoid the risk of destroying potential evidence. In construction litigation, particularly with delay claims, schedule files are deleted, lost, or overwritten due to carelessness or inattention rather than intentional destruction. Nevertheless, necessary scheduling data is often unavailable. Where the files have been retained, the contractor may wonder how long it should retain old project scheduling data. Because litigation is arguably foreseeable from the moment the contract is entered, the contractor certainly should not delete any schedule files during the course of the project.

Deleting or overwriting prior schedule updates could constitute spoliation even if a delay has yet to occur. It is the individual scheduler that must understand that the convenience of overwriting must be surrendered in order to maintain a historical record. If the contractor wishes to overwrite previous schedule versions in the same file or delete scheduling data and avoid spoliation accusations, notice must be given to the owner. Such notice should be sufficient to discharge the duty to preserve evidence and allow reasonable opportunity to inspect or make copies.

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ⁿ¹ For additional background on construction scheduling and delay claims, see Barry B. Bramble & Michael T. Callahan, *Construction Delay Claims* (3rd ed. 2000) (ISBN 978-0-7355-0548-3) and the 2009 Cumulative Supplement (ISBN 978-0-7355-7443-4).

ⁿ² *Id.*

n3 *Id.*

n4 *Innis Arden Golf Club v. Pitney Bowes*, 257 F.R.D. 334, 2009 U.S. Dist. LEXIS 43588, at *17 (D. Conn. 2009) (citing *Fujitsu Ltd. v. Federal Express Corp.*, 247 F.3d 423 (2d Cir. 2001)).

n5 *Id.* at *19 (quoting *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 218 (S.D.N.Y. 2003)).

n6 *Id.* at *28; In federal litigation, the court's power to impose sanctions is derived from Rule 37 of the Federal Rules of Civil Procedure. Under Rule 37, there must first be a violation of an order compelling discovery before a district court can impose sanctions. Otherwise, the court can rely on its inherent power to manage its own affairs.

n7 *Williams v. Great W. Cas. Co.*, 2009 U.S. Dist. LEXIS 46247 (N.D. W. Va. June 1, 2009).

n8 AIA Document A201-2007 General Conditions of the Contract for Construction, § 3.10.1.

n9 AIA Document A201-2007 General Conditions of the Contract for Construction, §§ 3.10.1 - 3.10.3.

n10 *See* AIA Document A201-2007 General Conditions of the Contract for Construction, § 8.2.1.

n11 *49 Fed. Cl. 110 (2001)*; Michael T. Callahan and H. Murray Hohns, *Construction Schedules* (3d ed. 2004) § 3-1(a)(2).

n12 *GSABCA Nos. 15502, 16055, 16551, 2005-1 B.C.A. (CCH) & 32,895, 2005 GSBCA LEXIS 32* (February 16, 2005).

n13 *Id.* at 9 (citing *P.J. Dick., Inc. v. Principi*, 324 F.3d 1364, 1369 (Fed. Cir. 2003)).

n14 *Id.* (citing *Galaxy Builders, Inc., ASBCA 50018, et al., 00-2 BCA P 31,040*).

n15 The cost of an independent scheduling consultant is typically included in the contractor's bid.

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EXPANDING CGL COVERAGE FOR CONSTRUCTION DEFECT CLAIMS?

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EXPANDING CGL COVERAGE FOR CONSTRUCTION DEFECT CLAIMS?

By Michael T. Callahan and Thad Schurter

February 9, 2010

SUMMARY: Insurance coverage for construction defects or faulty workmanship under a Commercial General Liability policy has long been a contentious issue between insurers and policyholders. In recent years, the high courts of Texas, Florida, Tennessee, Kansas, Wisconsin, North Dakota, Nebraska, and Minnesota have held that CGL policies can provide coverage for defect claims or faulty workmanship.

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ARTICLE: EXPANDING CGL COVERAGE FOR CONSTRUCTION DEFECT CLAIMS?

Insurance coverage for construction defects or faulty workmanship under a Commercial General Liability policy has long been a contentious issue between insurers and policyholders. Numerous jurisdictions rejected coverage for such claims in the past, but now disputes over construction defect claims are increasingly resolved in favor of coverage. In recent years, the high courts of Texas, Florida, Tennessee, Kansas, Wisconsin, North Dakota, Nebraska, and Minnesota have held that CGL policies can provide coverage for defect claims or faulty workmanship. By contrast, however, the high courts of Arkansas, Pennsylvania, and South Carolina, n1 have reached the opposite conclusion. Even so, recent decisions involving construction defect claims suggests a trend may be emerging favoring policyholders. n2

A 2009 case from the First Circuit, *Essex Insurance Company v. BloomSouth Flooring Corporation*, n3 held that a complaint alleging air contamination from VOCs which affected an entire building constituted property damage for purposes of CGL coverage. In *Essex*, employees of Boston Financial Data Services noticed a foul odor in their office space following a remodeling project. The employees complained the offices smelled like sour chemicals or a locker room. At the owner's insistence the offensive carpet tile and adhesive were removed and replaced, but the odor persisted. The general contractor spent nearly \$1.5 million in remediation costs after the subcontractor who installed the carpet refused to resolve the problem. The subcontractor's insurer refused coverage. In the ensuing litigation, the trial court concluded that the concrete floor became the subcontractor's property during the carpet installation process. It viewed the damaged floor as damage to the insured's product and excluded remediation costs under the 'your product' provision.

On appeal, the insurer asserted odor could not constitute a physical injury and that Suffolk's claim only alleged injured air quality, not damage to tangible property. The insurer further maintained any expenses to abate the odor, including bead blasting the concrete slab, were replacement costs, not remediation costs. The First Circuit reversed. Nothing in the policy suggested odor could not constitute physical injury to property. The 'your product' exclusion only barred coverage for damaged goods or products other than real property. As real property, the concrete floor was not subject to the exclusion because it was not the insured's product. Likewise, the 'impaired property' exclusion was only available where the defective work could be restored through repair, replacement, adjustment or removal of the defective product or work. The defect was only resolved after the concrete slab's top layer was physically removed. In so doing, the general contractor exceeded the scope of the exclusion by going beyond the repair, replacement, or adjustment of the defective work.

In *United National Insurance Company v. Dexter Honore Construction Company*, n4 another 2009 decision, allegations of property damage arising from construction defects were sufficient to constitute an occurrence under a CGL policy. In *Dexter*, a developer began preliminary work on an RV resort in Louisiana. After hurricanes Katrina and Rita struck, the developer leased half its property to FEMA for an emergency housing mobile home park. FEMA hired Fluor, a design-builder, to design and construct the facility. Shortly thereafter, FEMA ordered all work to stop. The developer filed suit against the design-builder, subcontractor, and sub-subcontractor for destroying the clay soil base and destroying the property's usefulness for commercial development. The developer claimed the defendants failed to provide adequate drainage and failed to dig drainage ditches or retention ponds prior to employing heavy machinery on the site. Fluor, an additional insured under its subcontractor's CGL policy, demanded its insurer defend it in the underlying suit. Claiming there was no duty to defend or indemnify, the insurer initiated a declaratory judgment action.

The insurer asserted that the design-builder and subcontractor failed to follow engineering plans, retain qualified management, or perform soil testing, which were intentional rather than accidental acts and thus not occurrences under the policy. Fluor and its subcontractor contended the developer had alleged unexpected property damage, which was covered as an occurrence. The developer's complaint, in addition to alleging defective work by the design-builder and subcontractor, also alleged significant property damage arising from construction defects, including erosion and an unstable surface. The court concluded there was an occurrence under the CGL policy. No coverage exceptions were unambiguously applicable, and the insurer was obligated to defend.

In *Mid-Continent Casualty Company v. JHP Development, Inc.*, n5 the Fifth Circuit ruled that damage to a contractor's non-defective work was not excluded from coverage even where that damage was caused by its own defective work. In that case JHP Development was hired to construct a five unit condominium project. The individual units remained partially unfinished so the new owner could choose the finishing details. The contractor's failure to properly seal the exterior finishes and retaining walls caused water damage the unfinished units. The owner terminated the contractor after it refused to repair the damage. The owner filed suit against the contractor for breach of contract, breach of warranty, and negligence. The contractor's insurer denied coverage and a default judgment was entered against the contractor. The insurer filed a declaratory judgment action. The trial court found both property damage and an occurrence and that default judgment was binding on the insurer. The insurer appealed.

The insurer's appeal was stayed pending resolution of another defect case in the Texas Supreme Court. n6 However, after the Texas high court held that a CGL insurer was obligated to defend a general contractor against lawsuits alleging damage caused by its own construction defects, the insurer abandoned its occurrence arguments. The insurer maintained that because some units remained unfinished when the damage occurred, construction operations were ongoing and thus excluded from coverage. It further argued that another exclusion applied to all property damage resulting from the contractor's defective work, including any interior damage. The owner countered that the exclusions were not applicable because the work had been suspended until the remaining units were purchased and trimmed out. It further asserted that the 'particular part' language of the 'your work' exclusion demonstrated that it only applied to damage which was itself the subject of the defective work that caused property damage, not to other parts which were damaged as a result of the defective work but were not themselves defective.

The Fifth Circuit in 2009 held that given the plain meaning of the exclusions, they were inapplicable. The exclusion only applied to property damage caused during active physical construction activities, not to damage which occurred during prolonged periods of inactivity. Further, the 'your work' exclusion was not a bar to coverage for damage to non-defective work damaged as a result of the insured's defective work on other parts of the property. Because neither the allegations of the underlying suit nor the evidence presented fell under the provisions of either of the exclusions, the insurer was obligated to defend and bound by the default judgment.

In 2008, the South Carolina Supreme Court held that continuous damage caused by the insured's work product qualified as an accident and occurrence in *Auto-Owners Insurance Co. v. Newman*.ⁿ⁷ In that case, after construction of a new home was completed, the owner sued the contractor for breach of contract, negligence, and breach of warranty. The complaint alleged defective construction, mostly related to the installation of the stucco siding on the house. An engineer's inspection confirmed that the stucco did not conform to industry standards. It also noted the defective construction caused severe damage to the home's framing and sheathing. The owner was awarded damages in arbitration. The contractor's insurer subsequently initiated a declaratory judgment action. The insurer insisted the damages were not covered under its policy. The trial court determined that the CGL policy covered all but four items of the damages provided for in the arbitration award.

On appeal the insurer contended the defective stucco installation was not an accident constituting an occurrence under the policy. The Supreme Court of South Carolina noted the arbitrator had determined that the owner suffered damages as a result of the contractor's negligent application of the stucco. The defective stucco allowed water intrusion, which resulted in additional damages to the home. As such, there was property damage beyond that of the negligently applied stucco itself. While the negligent application of the stucco was not by itself sufficient to constitute an occurrence, the continuous water intrusion into the home resulting from the negligence qualified as an accident which triggered coverage under the policy.

ACCIDENT OR INTENTIONAL ACT?

As the previous cases illustrate, whether defective work is covered by CGL insurance is often decided by how the word "accident" is understood. Does the intent to commit an act, even where that act results in unintended consequences, preclude coverage because an intentional act is not an accidental one? Courts have reached different conclusions, sometimes even when applying the same laws. In one such case, the U.S. District Court for the Southern District of Illinois recently concluded in *Western World Insurance Company v. Penn-Star Insurance Company*ⁿ⁸ that unintentional damage caused to an adjoining structure during demolition constituted an occurrence. In *Western*, the City of East St. Louis contracted with McCoy Construction to demolish a building at 320 Collinsville Road. During demolition part of a wall that was common to both 320 Collinsville Road and 318 Collinsville Road was damaged. Upon realizing its mistake, the contractor stopped immediately, but the damage was done. Penn Star Insurance, which insured the damaged building, filed a subrogation suit against the city and the contractor for negligence and inverse condemnation. Western World Insurance, the contractor's insurer, refused to defend or indemnify in the suit. After the parties reached a settlement, the contractor's insurer filed a declaratory judgment action.

The contractor's insurer asserted what had become the default insurer position in nearly all construction defect cases,ⁿ⁹ that the damage was not covered because it was not an occurrence. It maintained that because the contractor intended to demolish the common wall, any damage it caused was not accidental. The city contended that while the demolition was intentional, the resulting harm to the neighboring building was not, and thus its actions were covered as an accident. In addressing what types of conduct trigger CGL coverage, the court explained that the important question was not whether the acts which resulted in damage were intentional, but rather whether the injury was expected or intended by the insured.ⁿ¹⁰ Accordingly, intentional acts that produced unintended and unforeseen consequences could qualify as accidents. Because the contractor intended to demolish the common wall but did not intend to damage the second building, the property damage was an accident and an occurrence under the policy.

By contrast the U.S. District Court for the Northern District of Illinois reached an opposite conclusion on a similar case some three years prior. In *Century Surety Company v. Demolition & Development Ltd.*,¹¹ a contractor's demolition of the wrong building, based on erroneous information from a city employee, was not considered an occurrence. In *Century*, the City of Chicago hired a demolition contractor for an emergency tear down of a building located at 4710-20 South Indiana Avenue. After arriving on site, the contractor's president was uncertain which buildings to demolish, since three buildings with no addresses posted on them were near the demolition location. An employee at the city's buildings department verified that the three buildings were to be demolished. The contractor began its demolition, but stopped after the surprised owner of one of the buildings indicated that his building, 4708 South Indiana, was not supposed to be demolished.¹² A city inspector confirmed the building was not subject to the court order. The contractor's insurer denied coverage and filed a declaratory judgment action.

The contractor's insurer conceded that the property was damaged, but argued that because the demolition was intentional, any resulting damage was not accidental, despite the error in identification. The insurer further maintained that as an expected result of demolition, the damage could not be classified as unforeseen. The insurer added that even if an occurrence took place, several exclusions exempted coverage. The contractor contended its demolition of the wrong building was accidental. The court disagreed. Using the same definition of accident that would be cited in *Western*,¹³ the court reasoned that the natural and ordinary consequences of an act could not constitute an accident. Although the contractor's actions were based on erroneous instructions from a city employee, the natural and ordinary consequence of its act of demolition was the destruction of the building. Because the damage was foreseeable, it was not accidental, and thus not an occurrence within the policy's terms. An exclusion barring coverage for property damage that was expected or intended also operated to bar coverage. The court reasoned that once the contractor received verification from the City as to which property was to be destroyed, any resulting damage was expected and thus excluded. Additionally, under the 'work product' exclusion, because the contractor performed as directed by the City, its demolition constituted work product. The court used the same logic to apply the 'your work' exclusion.

The two courts differing interpretations of the word accident explains the divergent results. In both cases the contractor was instructed to demolish specific property and in both cases a neighboring structure not slated for demolition was damaged. Each court cited the same Illinois Appellate Court ruling in its decision,¹⁴ but the Northern district concluded that an intent to commit the act of demolition meant that there was no occurrence, while the Southern district looked to whether or not the injury was expected or intended by the contractor and not whether the act of demolition was performed intentionally.

Some courts, like the *Century* court, continue to view construction defects and faulty workmanship as foreseeable events not subject to CGL coverage. In *Cincinnati Insurance Companies v. Collier Landholdings*,¹⁵ another 2009 decision, a contractor hired to build a mixed use facility hired several subcontractors to work on the project. After substantial completion and occupancy by the tenants, water infiltrated the building through its ceilings, walls, and floor causing mold to grow in the interior walls. The owner sued the contractor for breach of contract and alleged it had suffered damages including repair and remediation costs, loss of use, financing costs, loss of business expectancy, and other losses. The insurer denied the contractor's coverage and filed a declaratory judgment action.

The insurer argued that defective construction was not an occurrence under state law. The owner contended state law interpreting the term occurrence only addressed defective workmanship by general contractors, not by subcontractors. The owner maintained that the damage which resulted from the subcontractor's defective workmanship was clearly an occurrence. The contractor conceded its subcontractor's defective work was not an occurrence, but argued that damage to non-defective portions of the center caused by the water intrusion was an occurrence. Applying Arkansas law, the court concluded defective workmanship was a foreseeable risk associated with the employment of subcontractors and not an occurrence. A general contractor could not segment its work into that performed by various subcontractors, some of which was defective and some of which was not, in order to create an occurrence.

A Mississippi court reached a similar conclusion in 2008. In *Nationwide Mutual Insurance Company v. Panther Creek Construction Company*,¹⁶ an insurer denied coverage to a developer after it was sued by the owners of a newly

constructed residence which suffered extensive water damage from allegedly faulty construction. The insurer asserted that the developer's intent to build the home precluded coverage because an intentional act could not constitute an occurrence. The insurer maintained there was no coverage for the consequences of intentional conduct, even where the actual injury suffered was unintended by the developer. The court agreed and held there was no duty to defend because the owners' claims were based on the developer's intentional conduct.

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n1 *Essex Ins. Co. v. Holder*, 372 Ark. 535, 261 S.W.3d 456, 2008 Ark. LEXIS 138 (Ark. 2008); *Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 908 A.2d 888, 2006 Pa. LEXIS 2064 (2006); *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 366 S.C. 117, 621 S.E.2d 33 (S.C. 2005), *But see Auto Owners Ins. Co. v. Newman*, 2008 S.C. LEXIS 74 (S.C. Mar. 10, 2008).

n2 Owen J. Shean and Douglas L. Patin, construction insurance: coverages and disputes (2009 Cumulative Supplement (citing *Auto Owners Ins. Co. v. Newman*, 2008 S.C. LEXIS 74 (S.C. Mar. 10, 2008) (continuous damage caused by insured's work product is an accident and occurrence); *Aten v. Scottsdale Ins. Co.*, 511 F.3d 818, 2008 U.S. App. LEXIS 251 (8th Cir. 2008) (insurer liable for work performed by an insured's subcontractor under an exception to the 'your work' exclusion of CGL policy); *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 2007 Tex. LEXIS 797, 50 Tex. Sup. Ct. J. 1162 (Tex. 2007) (insurer obligated to defend general contractor in suit alleging damage caused by its own construction defects); *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 2007 Fla. LEXIS 2394, 32 Fla. L. Weekly S 811 (Fla. 2007) (subcontractor's defective work that damaged a contractor's completed project which was neither expected nor intended from the contractor's standpoint can constitute property damage caused by an occurrence as defined in CGL policy); *Travelers Indem. Co. of Am. v. Moore & Assocs.*, 216 S.W.3d 302, 2007 Tenn. LEXIS 234 (Tenn. 2007) (damage caused by faulty workmanship was property damage and constituted an occurrence under CGL policy); *Columbia Mut. Ins. Co. v. Epstein*, 239 S.W.3d 667, 2007 Mo. App. LEXIS 1664 (Mo. Ct. App. 2007) (construction defects, including defective foundation and sub-floor constituted accidents and thus occurrences under the CGL policy); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 281 Kan. 844, 137 P.3d 486, 2006 Kan. LEXIS 358 (2006) (leaks caused by defective materials or workmanship, which caused structural damage constituted an occurrence under the CGL policy); *French v. Assurance Co. of Am.*, 448 F.3d 693, 2006 U.S. App. LEXIS 10470 (4th Cir. Va. 2006) (CGL covers damage to a contractor's nondefective work caused by a subcontractor's defective work, but noting that defective construction is not an occurrence for CGL purposes); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 2004 WI 2, 268 Wis. 2d 16, 673 N.W.2d 65, 2004 Wisc. LEXIS 1 (2004) (subcontractor's faulty soil preparation work was an accident and thus an occurrence under CGL policy); *But see Cincinnati Ins. Cos. v. Collier Landholdings, LLC*, 2009 U.S. Dist. LEXIS 32936 (W.D. Ark. Apr. 16, 2009) (subcontractor's defective workmanship was a foreseeable risk and not an occurrence under contractor's CGL policy); *Essex Ins. Co. v. Holder*, 372 Ark. 535, 261 S.W.3d 456, 2008 Ark. LEXIS 138 (Ark. 2008) (no occurrence and no obligation to defend insured contractor where defective workmanship damaged only the work product itself); *Auto-Owners Ins. Co. v. Chorak & Sons, Inc.*, 2008 U.S. Dist. LEXIS 60444 (N.D. Ill. 2008) (insurer not obligated to defend or indemnify subcontractor for catastrophic damage caused by the subcontractor's defective performance); *Adair Group, Inc. v. St. Paul Fire & Marine Ins. Co.*, 477 F.3d 1186, 2007 U.S. App. LEXIS 4156 (10th Cir. Colo. 2007) (deficient performance of subcontractors does not trigger application of CGL policy); *Kvaerner Metals Div. of Kvaerner United States, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 908 A.2d 888, 2006 Pa. LEXIS 2064 (2006) (property damage resulting from faulty workmanship does not constitute an occurrence under CGL

policy); *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 366 S.C. 117, 621 S.E.2d 33 (S.C. 2005) (subcontractor's faulty workmanship not an accident and resulting damage not an occurrence)).

n3 *Essex Ins. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399, 2009 U.S. App. LEXIS 7896 (1st Cir. Mass. 2009).

n4 *United Nat'l Ins. Co. v. Dexter Honore Constr. Co., LLC*, 2009 U.S. Dist. LEXIS 38478 (W.D. La. Apr. 30, 2009).

n5 *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207, 2009 U.S. App. LEXIS 1889 (5th Cir. Tex. 2009).

n6 *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 2007 Tex. LEXIS 797, 50 Tex. Sup. Ct. J. 1162 (Tex. 2007) See Lee H. Shidlofsky, *Supreme Court of TX Weigh-In on Property Damage and Occurrence in the Real*, 2008 *Emerging Issues* 1315.

n7 *Auto Owners Ins. Co. v. Newman*, 2008 S.C. LEXIS 74 (S.C. Mar. 10, 2008).

n8 *W. World Ins. Co. v. Penn-Star Ins. Co.*, 2009 U.S. Dist. LEXIS 47921 (S.D. Ill. June 8, 2009).

n9 James Duffy O'Connor, *What Every Construction Lawyer Should Know About CGL Coverage for Defective Construction*, 21 *Construction Law* 15, 15 (2001).

n10 *W. World* citing *Lyons v. State Farm Fire & Cas. Co.*, 349 Ill. App. 3d 404, 811 N.E.2d 718, 2004 Ill. App. LEXIS 709, 285 Ill. Dec. 231 (Ill. App. Ct. 5th Dist. 2004) see also *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 2007 Tex. LEXIS 797, 50 Tex. Sup. Ct. J. 1162 (Tex. 2007) (citing *Mass. Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396, 300 "[A] deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly.").

n11 *Century Sur. Co. v. Demolition & Dev., Ltd.*, 2006 U.S. Dist. LEXIS 2128 (N.D. Ill. Jan. 18, 2006).

n12 Apparently, inadvertent destruction of neighboring property isn't as uncommon as one might think. *See also Thommes v. Milwaukee Ins. Co.*, 641 N.W.2d 877, 2002 Minn. LEXIS 244, 6 No. 16 Minn. Lawyer 6 (2002).

n13 *Century* quoting *Massachusetts Bay Ins. Co. v. Vic Koenig Leasing*, 136 F.3d 1116, 1998 U.S. App. LEXIS 1859 (7th Cir. Ill. 1998) ("an unforeseen occurrence, usually of an untoward or disastrous character, or an undesigned sudden or unexpected event of an inflictive or unfortunate character.").

n14 *Lyons v. State Farm Fire & Cas. Co.*, 349 Ill. App. 3d 404, 811 N.E.2d 718, 2004 Ill. App. LEXIS 709, 285 Ill. Dec. 231 (Ill. App. Ct. 5th Dist. 2004).

n15 *Cincinnati Ins. Cos. v. Collier Landholdings, LLC*, 2009 U.S. Dist. LEXIS 32936 (W.D. Ark. Apr. 16, 2009).

n16 *Nationwide Mut. Ins. Co. v. Panther Creek Constr. Co.*, 2008 U.S. Dist. LEXIS 25746 (S.D. Miss. Mar. 30, 2008).

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Callahan on Enron Federal Solutions, Inc. v. United States

2008 Emerging Issues 2552

Michael T. Callahan on Enron Federal Solutions, Inc. v. United States, 80 Fed. Cl. 382, 2008 U.S. Claims LEXIS 27 (Fed. Cl. Feb. 7, 2008)

By Michael T. Callahan

July 16, 2008

SUMMARY: Get expert commentary from Michael T. Callahan on a Federal Claims Court case about whether a privatization contract required the U.S. Army to compensate a contractor for the capital improvements made before materially breaching the contract and being terminated for default.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Cite as: Callahan, Michael T. *Enron Federal Solutions, Inc. v. United States*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

In *Enron Federal Solutions, Inc. v. United States*, the Federal Claims Court ruled that a privatization contract did not require the U.S. Army to compensate a contractor for the capital improvements made before materially breaching the contract and being terminated for default.

Enron Federal Solutions Inc. (EFSI), a subsidiary of Enron Corp, entered into a ten year privatization contract with the United States Army to own, operate and maintain the power, water and waste systems at the United States Army Garrison at Fort Hamilton, Brooklyn, New York. The contract furthered a federal government policy of privatization by the transfer of ownership, responsibilities, investments, upgrade, plant replacement, continued operation and maintenance of the Army-owned utility systems to the private sector.

Over the past two decades the enormous costs of financing infrastructure projects has generated interest among many nations in promoting private investment in some infrastructure projects. The term privatization generally refers to the participation by the private sector in financing, developing, building and operating infrastructure projects that have traditionally been financed and operated by governments. Richard W. Pearse, *International Privatization*, 5 construction law 22-3 (Stein Ed. 2006). A privatization contract with a public entity, can lead down a tortured path to that special crowded ring in Hell reserved for trusting contractors. Although privatization contractors and their lenders do not like the kind of expropriation rights public entities feel they must have in the public interest, these rights have rarely been implemented. Peter Hughes, *Design-Build for Water and Wastewater Projects*, design-build for the public sector, at 456 (Loulakis ed., 2003). The expropriation implementation was initiated in *Enron Federal Solutions, Inc. v. United States*.

The Army anticipated that the natural gas, potable water, and wastewater utility distribution systems at Fort Hamilton needed either major capital repair or complete reconstruction to comply with modern industry standards. EFSI was required to initiate and complete any "substantial initial utility system upgrade or utility system replacement" by the end of the first contract year. The Army took no responsibility for the facility upgrade process and placed on the contractor, "at its expense to furnish, install, operate and maintain all facilities required to furnish the utilities. EFSI's proposal included a "Risks Transferred" chart that indicated that EFSI would be responsible for all financial risk associated with material procurement, capital financing, expense fluctuation, as well as other issues that might arise throughout the contract.

In addition to responsibility for the initial upgrade investments, the contractor also was to be responsible for *any* capital investment required for all system upgrades or enhancements not associated with new or renovated facilities. These capital investments would be the upgrades and enhancements required throughout the course of the Contract annual capital improvement investments. Any capital investments not associated with new or renovated facilities were to be subject to negotiation between the contractor and the Army.

The Army, in return, was to make monthly installment payments for ten years that represented combined charges for the services and capital improvements; and title to the facilities was to transfer to EFSI. The transfer of ownership of the utilities was subject to Congressional notification and a notice-and-wait requirement. The notice-and-wait requirement delayed conveyance until the Secretary of the Army submitted to the Senate and the House of Representatives an economic analysis demonstrating that the long-term economic benefit of the conveyance to the United States exceeded the long-term economic costs.

Upon expiration or termination of the contract, EFSI's unrecovered investment was to be determined as set for in *FAR § 52.241-10 Termination Liability*.

After Enron Corp filed for bankruptcy, Enron terminated all EFSI employees at the Fort Hamilton site and EFSI ceased performance. EFSI later renounced its contract with the Army in its bankruptcy hearing. The Army terminated the contract for default. At that time, EFSI had completed the capital improvements, but had only provided just over two years of utility service to the base. While the contract required EFSI take title to the utility systems at Fort Hamilton, both parties agreed that no transfer of title actually took place during the first two years of the Contract, and title remained with the government.

EFSI later submitted to the government a certified claim requesting payment of \$10,476,801 for the capital improvements and for its services in operating and maintaining the utility systems. The Army's contracting officer (CO) rejected EFSI's claim.

The CO rejected EFSI's claim because *FAR § 52.241-10*, a termination liability clause, set out a formula for calculating termination charges the government owed a contractor in the event the government discontinued utility service before the end of a contract. Within the formula, there were blank sections that needed to be filled in by the contracting parties. These blanks, referred to as "fill-ins" by the CO, were: negotiated facility cost recovery period, negotiated net facility cost, and negotiated monthly facility cost recovery rate. The formula calculated what the government would owe by taking the time left on the contract and multiplying that by a cost recovery rate, which was determined by the "salvage value" of the property divided by the time left on the contract. All these fill-ins, according to the CO, must have been negotiated into the contract in order for the provision to make any sense. Since no fill-ins were ever negotiated, agreed to, or incorporated into the contract, *FAR § 52.241-10* was not applicable and would not provide EFSI with a basis for recovery.

Practice Note. Failure to transfer ownership to the utilities after two years put EFSI in poor position after its bankruptcy and termination to recover anything. When negotiating similar privatization contracts in the future, one may wish to know just when the property will be transferred and price any delayed transfer accordingly. Consider negotiating a shorter transfer period. One may also insure that any privatization contracts have all the blanks filled-in.

Do not ignore complex ownership data; fill in all the blanks.

The CO's second articulated reason for rejecting EFSI's claim was that EFSI was not entitled to recover under the Contract's "Termination for Default" provision, *FAR § 52.249-8(f)*. The Termination for Default provision to which the CO referred provided that in the event of a default termination, the defaulting contractor was entitled to recover the "contract price for completed supplies delivered and accepted." However, the CO maintained that *FAR § 52.249-8* was incorporated into the contract mistakenly, and instead should have been replaced with *FAR § 52.249-10*, Default (Fixed-Price Construction) because of the nature of the capital improvement work; and *FAR § 52.249-10* (in contrast to *FAR § 52.249-8(f)*) contained no provision allowing a defaulting contractor to recover for unfinished construction. The CO stated that the contract provided for payment of a fixed, monthly service fee to EFSI as long as EFSI remained in general compliance with contract performance requirements. As soon as EFSI abandoned the project, it forfeited its right to recover continued payment of the monthly service fee.

EFSI argued to the Federal Claims Court on appeal that the contract required the Army to pay for the capital improvement costs regardless of why the contract was terminated. The Claims Court disagreed. EFSI's failure to continue operating the facility was a material breach of the contract. EFSI's material breach and default excused the Army from performing its obligations under the contract. The Court held that EFSI was not entitled to any portion of the contract amount after it materially breached the Contract.

The Claims Court explained that *FAR § 52.241-10* applied solely to termination for convenience. Furthermore, the parties never negotiated and filled-in the numerical provisions, including the required "salvage value" of the capital improvements. EFSI argued that the fill-in provisions could not be determined until either the end of the contract period or when the contract was terminated for default. Likewise, it argued that the present market value for the utility upgrades should be substituted in place of salvage value. But the two were not synonymous; salvage value was equated not with what the market brought upon sale of a tangible item, but instead with the value of an asset after its "useful life." Salvage value certainly could be determined before the contract was executed. This provision was intended to apply to a situation where it was the Army that discontinued the contract and terminated it for its own convenience.

Because the contract called for monthly installment payments for capital improvements and services, it would have been unfair to require the government to make an accelerated lump sum payment for the capital improvements. The capital improvements were a preparatory activity intended to make the utility services more efficient. The government purchased the utility services, not the capital improvements. The contract was a fixed-price privatization agreement that allocated the risks associated with the capital improvements to the contractor, not the government. The contractor's bankruptcy and subsequent inability to perform constituted a material breach of the contract. The contractor's material breach and default excused the government from performing its contractual obligations, including compensating the contractor for the capital improvements made prior to materially breaching the contract and being terminated for default. As the portion of the installment payments that represented the amortized capital improvements was not severable from the other portions of the contract, the contractor was not entitled to any portion of the contract amount. The government's motion for summary judgment was granted.

EFSI did not get title; it owned nothing at termination. EFSI did not complete the fill-in information in the termination clause, so it collected no termination costs. EFSI stopped providing utility service so it received no further monthly payments. The Army got something it did not want, according to the Claims Court. But EFSI got only 20% of its ten-year monthly payments for 100% of its construction work, something EFSI also did not want. And much of the harsh result related to differences between a privatization contract and a construction contract. What were these differences?

The Claims Court explained many times in its decision that a privatization contract was not a construction contract or a contract for the sale of supplies. What the Army essentially wanted to do through this contract was what the average private utility consumer did use water, power, sewage, and other utilities provided to it by a private utility company, and then pay a bill at the end of each month for what it used. It did not want to have to maintain the

infrastructure itself or directly pay to have the utility systems upgraded. This was the only explanation of why the contract allocated all the risks associated with the capital improvements, including loss of the facilities, to the contractor, not the Army. *Enron Fed. Solutions*, at *39-40.

EFSI's argument that the terms of the contract itself indicated that the parties intended for the Army to pay for the capital upgrades, regardless of why the contract was terminated, was completely contrary to the parties' intended result of the contract as a whole. The Army wanted to receive continued utility service throughout the course of the fixed-price contract. With continued service, EFSI could expect to receive fixed, monthly service fees. However, upon early termination of service, EFSI knew that it would stop receiving the fixed, monthly payments, and the credit for the amortized purchase price for the facility. Under the privatization model, the very essence of the contract was to shift the risk of capital improvements onto the contractor. EFSI therefore bore the risk of the capital improvements, and when it defaulted, could not then shift its burden to the Army. *Enron Fed. Solutions*, at *41.

This case was unique in that the party buying the utility services (Army) now had the new and improved infrastructure that it never wanted in the first place, but this did not mean that party (Army) should have to pay for it. *Enron Fed. Solutions*, at*43.

A privatization contract was not simply a contract for the sale to the Army of certain infrastructure. The overarching purpose is to provide certain utility services at a fixed price for a period of ten years. The contract provided that EFSI would own the utilities and the upgrade and placed the risk of damage and price increases on EFSI. Under these circumstances, it would be absurd to turn around and now place the risk of EFSI's nonperformance of EFSI's material breach on the Army. *Enron Fed. Solutions*, at *75.

The costs of the capital improvements were to be amortized and, along with the utility service charges, paid in monthly installments to the contractor. Additionally, the contractor was not required to pay the Army an up-front lump sum purchase price; instead, the purchase price was also amortized via deduction from the Army's monthly payments. Consequently, the capital improvements could not be divorced from the rest of the contract. These promises were all dependent upon one another. This was a "contract in the entirety." The part of the installment payments that represented the amortized capital improvements was not severable from the contract. The contract provided for both the utility service charges and amortized capital improvements to be paid to EFSI in monthly installments. *Enron Fed. Solutions*, at *76.

EFSI was attempting to re-characterize its contract with the Army as a construction contract, or, alternatively, as part construction and part services contract. However, neither was a valid characterization of the privatization contract between the parties. *Enron Fed. Solutions*, at *78.

EFSI had one overwhelming problem here: the capital improvements portion of the privatization contract did not constitute a contract for supplies and to be sure, EFSI offered no evidence that the parties intended "supply" to mean capital improvements in that provision. *Enron Fed. Solutions*, at *89.

Practice Note. Dispute Resolution in Privatization Contracts. Consider negotiating an arbitration clause into the privatization contract. Although normally arbitration is of little benefit for a sophisticated contractor, in a privatization contract with a public entity client, it can be a lifesaver if structured properly. A properly constituted dispute resolution board will take the contractor's side in most change order disputes, because they have been there. Peter Hughes, *Design-Build for Water and Wastewater Projects*, design-build for the public sector, at 456 (Loulakis ed., 2003).

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Callahan on Dugan & Meyers Constr. Co. v. Ohio Dep't of Admin. Servs.

2008 Emerging Issues 1390

Callahan on Dugan & Meyers Constr. Co. v. Ohio Dep't of Admin. Servs.

By Michael T. Callahan Esq.

December 7, 2007

SUMMARY: Conforming to the contracts procedures for time extensions and change orders are important, as reiterated by the Supreme Court of Ohio in *Dugan & Meyers Constr. Co. v. Ohio Dep't of Admin. Servs.*

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ARTICLE: *Dugan & Meyers Constr. Co. v. Ohio Dep't of Admin. Servs.*, 113 Ohio St. 3d 226, 2007 Ohio 1687, 864 N.E.2d 68, 2007 Ohio LEXIS 977 (2007) involved a contractors claim for breach of an owners implied warranty for design. The issue the *Dugan & Meyers* court faced was whether the owners breach of its implied warranty for design excused the contractors failure to conform to the procedures for administrative relief in the contract: the change order and time extension clauses.

Generally, if acts of the owner cause the delay or additional cost, then the delay is usually both excusable and compensable, and the contractor is entitled to a changer order both extending the contract time and compensating the contractor for its additional costs due to the delay. Barry B. Bramble and Michael T. Callahan, construction delay claims, at p. 2-44 (3rd Ed. 2000) (citing *Electronic & Missile Facilities, Inc. v. United States*, 416 F.2d 1345, 189 Ct. Cl. 237, 1969 U.S. Ct. Cl. LEXIS 79 (1969); John S. Mrowiec and Edward B. Keidan, *Changes That Result From Delays and Interferences*, construction change order claims 227 (Callahan Editor, 2nd Ed. 2005). Most construction contracts, however, include an administrative procedure that demands notice of the delaying event and that the contractor demonstrate that the delaying event extended project completion by performing some sort of schedule evaluation; and of course, prove that any claimed additional costs relate to the event.

For example, a contractor is commonly required to prepare and submit a time-impact analysis using new activities inserted into the approved construction schedule that model the delaying event (a fragnet). This is done to demonstrate the effect of any proposed change on the overall project schedule for each proposed contract modification and concurrent with its submission. Many contractors are inconvenienced by these notice and substantiation requirements. Enter now the *Spearin* doctrine.

The *Spearin* doctrine is a judicially created rule which provides that when an owner provides plans and specifications to a contractor, the owner impliedly warrants the adequacy of those plans and specifications. The owners implied warranty of plans and specifications, and the implied obligation of good faith and fair dealing, include an

obligation to disclose information material to contract performance. The owner may be held liable for delays or additional costs caused by its failure to disclose material information. § 5.02[2][b] construction law at 5-66 (citing *Department of Natural Resources v. Transamerica Premier Ins. Co.*, 856 P.2d 766, 1993 Alas. LEXIS 64 (Alaska 1993)); Nicholas K. Holmes and Christopher D. Hawkins, *Changes Resulting from Breach of Implied Warranties, Misrepresentation, and Nondisclosure of Superior Knowledge*, construction change order claims 170 (Callahan Editor, 2nd Ed. 2005).

In 1918, the United States Supreme Court issued *United States v. Spearin*, the landmark decision addressing allocation of risks of defective plans and specifications between the owner and contractor on federal construction projects. The case formed the foundation for much of the law underlying the relationship between owners and contractors. Holmes & Hawkins, construction change order claims at 172 (citing *Spearin*, 248 U.S. 132 (1918)). An owner that furnishes plans or specifications impliedly warrants their adequacy and accuracy, even if the plans or specifications were prepared by another party, such as an architect or engineer, on the owners behalf. Holmes & Hawkins, construction change order claims at 172 (citing *APAC Carolina, Inc. v. Town of Allendale*, 41 F.3d 157 (4th Cir. 1994)).

In *Spearin*, the United States Supreme Court explained that when a contractor is "bound to build according to plans and specifications prepared by the owner, the contractor will not be responsible for the consequences of defects in the plans and specifications." *Spearin*, 248 U.S. at 136, 39 S.Ct. 59, 63 L.Ed. 166. Thus exited the contractors obligation to conform to any administrative procedure for changes and claims under the contract.

In *J. L. Simmons Co. v. United States*, 412 F. 2d 1360, 188 Ct. Cl. 684, 1969 U.S. Ct. Cl. LEXIS 45 (1969), the court explained that, if faulty specifications prevent or delay completion of the contract, the contractor is entitled to recover damages for the defendants breach of its implied warranty. . . The defendant cannot, by errors in the specifications, cause delay in plaintiffs completion of the work and then compensate plaintiff merely by extending its performance time and by payment of any added direct costs occasioned by changes to correct those errors. As a result, contractors that failed to conform to the notice requirements, the schedule evaluation requirements, or the additional performance cost requirements still collected damages. A high penalty for defective plans or specifications to encourage owners and their agents to be sure the design in fact will work.

Generally, the *Spearin* doctrine has found favor in modern case law involving private contracts as well as public contracts. § 5.03[2][b] construction law 5-65 (Steven G.M. Stein Ed. 2007) (citing *McGovney & McKee, Inc. v. Berea*, 448 F. Supp. 1049, 1056 (E.D. Ky. 1978), *affd*, 627 F.2d 1091 (6th Cir. 1980)). Most states have adopted the federal principle that every construction contract includes an implied warranty by the owner of the accuracy and adequacy of the plans and specifications. Holmes & Hawkins, construction change order claims at 173. For example, in *Gogo v. Los Angeles County Flood Control Dist.*, 45 Cal. App. 2d 334, 114 P.2d 65, 1941 Cal. App. LEXIS 929 (Cal. App. 1941), one California court stated that, where the plans and specifications induce a public contractor reasonably to believe that certain indicated conditions actually exist and may be relied upon in submitting a bid, he is entitled to recover the value of such extra work as was necessitated by the conditions being other than as represented.

In *Dugan & Meyers Construction Co. v. Ohio Department of Administrative Services*, however, the Ohio Supreme Court ruled that the *Spearin* Doctrine did not apply to cases involving delay due to changes in project plans and specifications when the contract includes administrative remedies.

Flashback to Dugan & Meyers project. The Ohio Department of Administrative Services and Ohio State University contracted with Dugan & Meyers Construction Co., Inc. for construction of three buildings in accordance with plans and specifications prepared by the project architect, Karlsberger Companies. The contract stated that time was of the essence and called for completion of the project within 660 days of the Notice to Proceed, unless an extension was granted by the State for delays beyond the control of the contractor. Any claims for an extension had to be submitted by the contractor in writing, and failure to request an extension within 10 days after the occurrence necessitating a delay constituted a waiver of the claim for extension.

Construction progressed virtually on schedule during the first year. By June 1998, however, the project began to fall behind schedule. As the interior work progressed numerous omissions, inaccuracies, and conflicts in the design documents were discovered that required Dugan & Meyers, before proceeding with their work, to seek a determination by the designer as to what was intended or required. By February 1999 it was apparent that the project was unlikely to be completed on time. And guess what, Dugan & Meyers did not make any written requests for extensions of time after January, 1998 or comply with the contracts seven pages of Change Order Procedure and Pricing Guidelines. Nevertheless, Dugan & Meyers sued for \$3.4 million claiming that it had issued in excess of 700 requests for information, many of which produced no timely response; and associate architect Karlsberger had issued over 250 field work orders and 85 architectural supplemental instructions directing Dugan & Meyers to perform work outside the contract. The complaint concluded that the state had breached its duty to provide Dugan & Meyers with plans that were buildable, accurate, and complete, and had unreasonably rejected legitimate time-extension requests.

Practice Note. Conform to the Contracts Administrative Requirements. Attorneys may not be involved sufficiently early to insure contractor compliance with all the terms of the contract, but when they do get involved, they can be sure the contractor catches up. Late notice; late schedule updates; and late requests for additional performance costs are better than none. Substantial compliance may carry the day, especially if the owner is given what is required before the project is over. So, read the schedule clause. Read the change order clause. Read the time extension clause. Investigate the contractors compliance. And make all necessary steps to comply even if outside the contracts time window.

The contractor argued in *Dugan & Meyers* that under the *Spearin* Doctrine, which was recognized in Ohio, a contractor could recover if the owner breached that implied warranty, resulting in delay or increased cost to complete the contract. The Supreme Court held that the *Spearin* Doctrine applied to cases where the government had impliedly warranted the accuracy of information regarding on-site conditions, but would not be extended in Ohio to cases involving delay in completion of a construction project due to plan changes. The Ohio Supreme Court held that the contractor failed to request extensions and waived any claim for extension or for mitigation of liquidated damages as dictated under the contract. The decision was affirmed.

A tremor went through the construction law community when this decision was handed down. Few icons of construction law were thought to be more unassailable as the *Spearin* doctrine. Steven G.M. Stein, 89 construction law digest 12 (August 2007).

In *Dugan & Meyers*, the Supreme Court of Ohio made the contracts administrative remedy the only recourse to obtain change orders if the contract permitted changes orders under such circumstances left for a contractor faced with errors and omissions in the plans and specifications. A contractor claiming additional money or time for an error in the plans or specifications has to provide notice. A contractor claiming additional money or time for an error in the plans or specifications has to provide a schedule evaluation. A contractor claiming additional money or time for an error in the plans or specifications has to provide a schedule evaluation. None of these requirements are new and should need no judicial articulation. Is that such a bad result?

Conclusion. Be sure to dot the i and cross the t, because conforming to the contracts procedures for time extensions and change orders are even more important. Ohio contractors need to prove their time extensions and additional costs from breach of design warranty for any relief.

Compare *PCL Constr. Servs., Inc. v. United States*, 47 Fed. Cl. 745, 2000 U.S. Claims LEXIS 198 (2000) where PCL Construction Services, Inc. (PCL) claimed that the contract documents were severely defective and pointed to all

the Change requests that were necessary. Here PCL called them Change Request Extras (CRXs). The government initiated changes to the contract by requesting cost proposals from PCL, or directed PCL by unilateral modification to proceed with changes. When this happened, PCL would initiate a CRX, which ascended in number throughout the job. PCL itself also requested changes to the contract via CRXs. PCL even used CRXs to track changes between PCL and its subcontractors. PCL maintained a CRX log during the performance of the construction work. The log listed the CRXs by number, a description of the CRX, and the date it was initiated. There were a total of 535 CRXs issued during the course of the project. Of the 535 CRXs, only 335 were considered to have some degree of merit. The other 200 CRXs (almost forty percent of all CRXs) were either canceled by PCL, abandoned by PCL without further action, or, in a small number, disagreement continued and no action was taken. From a financial perspective, the 335 changes were not significant: of the 335 CRXs, sixty (eighteen percent) were for less than \$1,000.00, 122 (thirty-six percent) CRXs were for less than \$2,500.00, and 226 (sixty seven percent) were for less than \$10,000. All told only nine CRXs were over \$100,000.

PCL claimed that there were 167 CRXs issued from the start of the work in October 1991 through the end of December 1992, but PCL's log listed CRX 167 being issued in April 1993 and that only 126 were issued through December 1992. Moreover PCL unilaterally canceled thirty or one of four of these 126 CRXs. Just focusing on the number of CRXs did not prove breach of the owners implied design warranty. For example CRX 1 and 2 were assigned to changes in temporary power and telephone service that were requested by PCL for its own convenience.

The very example that PCL pointed to in order to demonstrate government delay in responding a CRX and subsequent modification, was compounded by PCL actions. Modification 12 directed PCL to construct a revised drag tie. PCL later elected to split the drag tie change into three separate CRXs: CRX 44.0 for PCL Civil's excavation, CRX 44.1 for concrete, and CRX 44.2 for the rebar portion of the work, thereby increasing the work involved in processing CRXs. PCL submitted seven proposals and revisions related to this single CRX. Other examples were CRX 3.1 and 5.0, for which PCL submitted five different cost proposals for each; CRX 161.1, for which PCL submitted six different cost proposals; and CRXs 74.0, 133.0, 152.0, 420.0, and 447.0, for which PCL submitted four different cost proposals for each. Finally, although there were a number of unresolved change orders for which the government owner recognized contractual liability, those costs are offset by provisional payments. The court concluded that mere numbers of CRXs did not automatically lead back to defective plans and delays.

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Callahan on McDonnell Douglas Corp. v. United States

2008 Emerging Issues 756

Callahan on McDonnell Douglas Corp. v. United States

By Michael T. Callahan

October 17, 2007

SUMMARY: Michael T. Callahan on McDonnell Douglas Corp. v. United States addresses the difficult issue of whether a contractor should be terminated before the project completion date. Factors such as the importance of the project schedule and project milestones are examined in addressing this difficult issue, and are addressed by the author.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: *McDonnell Douglas Corp. v. United States*, 76 Fed. Cl. 385, 2007 U.S. Claims LEXIS 140 (2007), involved termination of a government contractor failure to progress. The issue the *McDonnell Douglas* court dealt with was whether a government contractor could be terminated for failure to progress before the contracts completion date had expired. This is an important issue because most owners dont want to wait until a recalcitrant has missed the contract completion date before ending the contract. Most contractors, on the other hand prefer to wait until project completion, believing that somehow, someday they will make up any lost time. The *McDonnell Douglas* case shows the difficulty a court or other dispute resolver faces when asked to decide whether a contractor should be terminated before the project completion date.

Most standard form construction contracts provide that either party can terminate for certain defaults by the other party. *Construction Law*, Chapter 4 (Steven G.M. Stein ed. 1998). For example, *Federal Acquisition Regulation 52.249-9* describes the federal government's authority to terminate a contract for default in federal standard form construction contracts. That section authorizes the Government to terminate a contract if the contractor fails to prosecute the work in a manner that endangers performance of the contract.

Severe difficulties at the outset of the contract caused the joint venture contractors McDonnell Douglas and General Dynamics to fall far behind schedule. When the contractor missed some initial progress milestones in the contract, the Government unilaterally extended them by adopting a revised schedule known as "P00046". That schedule did not adjust the dates for later progress milestones, or completion of the contract, but it was clear that the later dates would have to be extended. The Government continued to extend other progress milestone dates unilaterally, but finally terminated the contract for default the same day a **\$553 million progress payment was due the contractors, but nearly a year before the first progress benchmark date. The contractors sued to convert the default termination to termination for convenience of the Government.**

The *McDonnell Douglas* court first considered whether there was an enforceable completion date at termination because the government could not prevail without one. *McDonnell Douglas Corp. at 388-389* (citing *Divecon Servs., LP v. Dep't of Commerce, 2004 GSBCA LEXIS 105, 2004-2 B.C.A. (CCH) P32656* (Gen. Services Admin. B.C.A. June 22, 2004) ("Without a . . . specific completion date, the Government could not rationally terminate for default for failure to make progress, since there was no objective against which the contractor's progress could be judged.")). However, the Government was not necessarily required to provide a completion date for the entire contract effort. Interim completion dates would do. The FAR default provision did not refer to contract completion, but rather authorized the Government to terminate a contract if the contractor failed to "prosecute the work so as to endanger performance of th[e] contract." *FAR 52.249-9(a)(1)(ii)*.

The Federal Circuit evaluates a contractor's default termination for failure to progress according to the "Lisbon standard." *Lisbon Contractors, Inc. v. United States, 828 F.2d 759 (Fed. Cir. 1987)*. The Lisbon standard permits termination for default if the Government demonstrates a reasonable belief "that there was no reasonable likelihood that the contractor[s] could perform the entire contract effort within the time remaining for contract performance." *Lisbon, 828 F.2d at 765*. The Federal Circuit Court of Appeals emphasized the importance of "decid[ing] the actual performance that the contract requires and the amount of time remaining for performance" before making a determination that a contractor has no reasonable likelihood to complete within the time remaining. *Id. at 1017* (citing *Lisbon, 828 F.2d at 766*).

The *McDonnell Douglas* contractors were required to prepare, and did prepare, a Master Schedule that included all critical activities necessary to complete the work required by the contract and the important Government milestones. Upon approval by the Government, the Master Program Schedule was to be the baseline schedule against which progress would be measured.

Practice Note. Evaluation Of Schedule. *McDonnell Douglas* illustrates that the schedule is traditionally used to demonstrate the contractors failure to make progress and often plays a key role in decisions whether to terminate a contractor for default for failure to progress. Especially in federal contract litigation where specialty courts regularly review contractor claims, the schedule provides much of the detail on which the specialty court relies to make its failure to progress decisions.

Generally, the contractors past ability to meet scheduled performance requirements is a persuasive indication of the contractors future ability to complete the work when required. Past low productivity, slow completion, inadequate crews, interference with other contractors, or inability to progress in order to complete the entire project is a good indication that future work will be no different. Even though some termination clauses require a cure notice before the work is terminated, it is the contractors entire performance, not just its work after the cure notice, that is evaluated. As a result, the entire schedule, the contractors complete performance history, is used in the evaluation whether a contractor has failed to progress.

Be sure a schedule used to evaluate failure to progress whether by the owner or contractor is accurate, complete, and meets the appropriate standard of care or specification requirements. Time invested before the evaluation to improve or repair the project schedule is essential.

According to the court, performance deadlines could be derived either from the Master Program Schedule, or from the contracts assigned milestone dates. For example, project completion was due initially in January 1991, a date in the contract. Derived dates in the schedule included, Initial Design Review, due "[n]ot later than 6 months after contract award;" Preliminary Design Review was due "[n]ot later than 12 months after Contract Award;" and Critical Design Review, would occur "18 Months after Contract Award."

The contractors did not achieve the first milestone. Although the Government took no steps to terminate the contract, the contracting officer at the time sent a letter to the contractors stating that they had not met the first milestone as required by the contract and warned of the consequences of failure. During the months leading to termination, the

contractors' internal schedules showed that the first milestone would not occur until March 1992.

The schedule against which the contractors were attempting to make progress was the P00046 delivery schedule. The P00046 schedule used a period before the ultimate completion date for measuring performance. P00046 comprised a series of milestones, each with its own date due and its own standards of completion. The Federal Circuit concluded the P00046 schedule contained milestones for performance and delivery dates that were enforceable and explicit at termination.

The P00046 schedule showed the contractors were behind schedule at termination according to that schedules series of milestones. However, comparison of the work completed with the time remaining was only one consideration. *McDonnell Douglas Corporation at 425 (citing Universal Fiberglass Corp. v. United States, 537 F.2d 393, 397 (1976))* (Missed milestones "indicate a pattern of nonperformance and delay which should not be ignored. Although not justifications for default in themselves, they provide a context for understanding and evaluating plaintiff's continued problems").

Contractors' statements that they could not meet the contract specifications, the contract delivery schedule, and complete performance at the specified contract price were all relevant to deciding whether the termination for default was justified. The contractors' internal schedules had showed they would not complete the milestones covered by the P00046 schedule. Six months prior to termination, the contractors projected a twelve to fourteen-month delay in first milestone. By termination, the contractors had extended the first milestone 15 months. The contractor would not commit to another schedule without first agreement with the Government to outstanding technical and business issues. The parties were negotiating solutions at termination.

The contractors did not intend to abandon the project, though a showing of abandonment was not necessary to establish failure to make progress. A recent failure to make progress decision explained that "[i]f that was our ultimate goal, the court would simply state that the record evidence establishes that [the contractors] worked very hard on the contract. . . . [Assessing whether the contractor failed to diligently prosecute the work] requires that we look at the results of the contractor's efforts" *McDonnell Douglas Corporation at 426-427 (citing Aptus Co. v. United States, 61 Fed. Cl. 638, 657-58 (2004), aff'd sub nom. Lin v. United States, 159 Fed. Appx. 186 (Fed. Cir. 2005) , cert. denied, 547 U.S. 1113, 126 S. Ct. 1921, 164 L. Ed. 2d 666 (2006))*. Despite delays, the contractors continued operations. They were spending **\$120 to \$150 million of their own money every month. They were committed to performing the contract until the date of termination. Overall evidence of record supported a conclusion that the Government was justified in terminating the contract for default for failure to make progress.**

Conclusion. Failure to meet interim dates in the schedule often persuades a court that a contractor had indeed failed to progress justifying a termination for default.

Practice Note. Schedule Analysis. One of the lessons of *McDonnell Douglas* is that the closer to the contracts end date, the easier to prove failure to progress. The farther from the completion date in the contract, the greater requirement for proof. Greater proof requires a schedule analysis which at least starts with the schedules created and submitted by the contractor during the project. Contractor scheduling effort during the project may require some correction, revision, or expansion until sufficient for use to evaluate failure to progress. To apply this lesson if the terminated party maintained a schedule, the practitioner may need to take necessary steps to assure the contractors schedules are sufficiently detailed and sensitive to measure progress.

A schedule analysis used to prove failure to progress is fact intensive and a time consuming exercise. Just creating and updating a project schedule during the project is a necessary, but burdensome obligation to the contractor. Cases involving termination for failure to progress on federal contracts illustrate the fact-intensive and often tedious proof federal courts have found minimally required to evaluate failure to progress claims; and federal contracting officers demand and study during the project.

Without the existence of a project schedule, the practitioner needs to identify other milestones. These other potential progress milestones may include progress payment requests or progress dates identified in the contract.

Compare In Re Stone & Webster, Inc., 279 B.R. 748 (D. Del. 2002), which used progress payment requests as milestones. Stone & Webster Engineering Corporation (SWEC) failed to develop an adequate project schedule. Early schedules that SWEC submitted did not include all of the licensing and permitting tasks, was not resource-loaded, and included false logic. Although SWEC implemented a series of workshops in hopes of getting an approved schedule, the final SWEC schedule still did not include all work activities, particularly in the area of licensing and permitting, and lacked sufficient details. Maine Yankee Atomic Power Company terminated the Agreement because SWEC had not adequately performed under the contract.

An update of the inadequate schedule reflected that as of just prior to termination, SWEC projected that the physical work would be completed some nine months late. Maine Yankee noted that according to SWEC's April, 2000 monthly report SWEC had earned only **\$20.8 million of the planned \$25.7 million (approximately 80%) during the 2000 calendar year. The April 2000 monthly report also reflects that during the month of April, SWEC started only 48% of the tasks and completed only 53% that were intended to be started and completed that month. Moreover, based on its earned value, SWEC only earned 75-85% of its projected earned value in 1999 and 80% in 2000, which demonstrated that SWEC was behind schedule. Based on the fact that SWEC was behind schedule and was earning far less than the expected earned value at the time of termination, Maine Yankee was within its right to terminate SWEC for failure to progress.**

Compare Intermetal Fabricators, Inc. v. The Losco Group, Inc., 2000 U.S. Dist. LEXIS 11622 (S.D.N.Y. 2000) where long delays to activities identified by the contract justified a contractor's refusal to pay the subcontractor and eventual termination before the project was completed. Intermetal subcontracted to perform the steel fabrication and installation at two properties for the United States Postal Service. The subcontract provided that all steel work was to be completed within 200 days of execution. The subcontract also provided that the shop drawings were to be submitted by the subcontractor within two weeks of the signing of the subcontract. No shop drawings were submitted within the two-week period. One year after the execution of the initial subcontract, the subcontractor had not yet submitted a full set of approved shop drawings, and had not begun fabrication or erection of the steel. The subcontractor delayed ordering the steel. The contractor later terminated the subcontract. The court found that the subcontractor failed to timely deliver the initial structural steel shop drawings; and that the subcontractor also failed to timely order the steel for the project. Once steel fabrication and erection began, the subcontractor's inability to meet its own obligations to pay for labor and material caused additional project delays. The subcontractor substantially delayed the project which justified the termination of the subcontract.

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