



RECENT COURT DECISIONS OF RELEVANCE TO CONTRACT DOCUMENTS

June 2013

**Hugh Anderson
EJCDC Legal Counsel
608-798-0698**

hugh.anderson@aecddocuments.com

The following case summaries and comments are general in nature and should not be taken as legal advice or counsel. The summaries and comments are solely the views of the author based on a preliminary review of the cited cases. The contents of this document do not represent the official position of EJCDC, its sponsoring organizations, or its members, on any topic.

© 2013 American Council of Engineering Companies, National Society of Professional Engineers, and American Society of Civil Engineers. All rights reserved.

1. **Issue:** Application of “completed and accepted” doctrine in favor of architect, arising from owner’s acceptance of work with obvious safety defect. *Neiman v. Leo A. Daly Company*, Court of Appeal of California (2012).

Summary: Theater patron brought a personal injury action against Santa Monica Community College for a fall on stairs at the Main Stage Theater. Architectural firm Leo A. Daly (LAD) had designed the theater, and was added to the lawsuit as a defendant.

LAD’s design had called for contrasting marking stripes on the theater stairs, to make the stairs more visible to users. The California Building Code probably required such stripes, though an exception may have applied. The parties conceded that the design was adequate and not in dispute. However, LAD had failed to notify the owner during the construction phase of the project that the contractor, Turner, had neglected to install the marking stripes. The injured patron contended that LAD was partly responsible for the injuries because of this failure to notify.

LAD brought a motion for summary judgment, contending that the lack of marking stripes was obvious. LAD argued that under the “completed and accepted” defense, an owner’s failure to remedy construction defects that are “patent”—apparent by reasonable inspection—is an intervening cause that relieves the contractor and the architect of responsibility for any failures during construction. The injured patron raised various defenses, most notably that the lack of marking stripes was not patent. In support of her argument the patron pointed out that various inspections of the completed work had failed to detect the lack of stripes, suggesting that their absence was a latent defect.

The trial court granted summary judgment to LAD, holding that the defect was patent and that under the “completed and accepted” doctrine, once the owner had accepted the patent defect, the architect no longer had any liability for the failure to notify the owner.

Decision: The Court of Appeals upheld the summary judgment. In previous applications in California the “completed and accepted” doctrine had always been a defense protecting a contractor. The Court of Appeals found no reason the doctrine should not also apply to the benefit of design professionals.

Comment: The “completed and accepted” doctrine has been rejected in approximately 39 states. The underlying idea that an intervening cause can relieve a wrongdoer of tort liability has also been abandoned or diluted in many jurisdictions, in favor of a more flexible approach involving the comparative fault of all the various involved parties.

In a 2007 Supreme Court of Washington decision rejecting the “completed and accepted” doctrine, the court commented as follows:

The doctrine is also harmful because it weakens the deterrent effect of tort law on negligent builders. By insulating contractors from liability, the completion and acceptance doctrine increases the public's exposure to injuries caused by negligent design and construction of improvements to real property and undermines the deterrent effect of tort law.

The doctrine also has the result of shifting a great deal of risk to the owner.

It is not clear from the *Leo A. Daly* case whether the project's construction or design contracts contained clauses that might have had a bearing on the decision. Under EJCDC's General Conditions, the Contractor's warranty commitment should apply despite the inspection and acceptance of the work, and the indemnification clause should also prevent the contractor from escaping responsibility for errors. Specific provisions govern the separate case of a mutually acknowledged acceptance of a defect.

As a matter of policy, should EJCDC's professional services agreements attempt to relieve the Engineer of liability if obviously defective construction work has been completed and accepted?

2. **Issue:** Commercial General Liability coverage for contractor, when damage to the work was caused by a subcontractor. *K & L Homes, Inc., v. American Family Mutual Insurance Co.*, Supreme Court of North Dakota (2013).

Summary: House owners brought a lawsuit against the general contractor because the house was plagued by cracks, unevenness, and shifting. The general contractor sought coverage under its Commercial General Liability (CGL) insurance. The insurer contested coverage under various terms and exclusions of the policy.

The facts of the case indicated that the cause of the problems was substantial shifting caused by improper footings, and inadequately compacted soil under the footings and foundation. The footing and foundation work had been done by a subcontractor.

The trial court granted summary judgment to the insurance company, concluding that the deficient work was not an “occurrence” as required by the policy, and stating that the entire house was the general contractor’s work product, thus bringing into play the exclusion for “damage to your [the insured’s] work.”

Decision: The North Dakota Supreme Court reversed the trial court. The high court held that faulty workmanship may constitute an “occurrence” under a CGL policy if it was unexpected and not intended by the insured; that cracks and unevenness are a physical injury to tangible property, one of the fundamental bases for coverage; and that the policy’s subcontractor exception preserves coverage that the “your work” exclusion would otherwise negate.

The case is in line with many other decisions favoring coverage under similar circumstances, though there are also cases to the contrary. It is notable for an exceptionally thorough summary of relevant insurance decisions from courts around the country, including an examination of the history of the standard CGL policy forms that is set out in a leading Florida case. Documents obtained from the insurance industry showed that the industry had elected and intended to provide such coverage based on a survey of customer preferences and the anticipation of higher sales. Also, as one analyst viewed the public policy implications, “there may be a ‘moral hazard’ in insuring contractors who cut corners in their own work, but that hazard does not exist with regard to their subcontractors, whom they do not control.”

Comment: CGL coverage claims for defective construction work spawn a great deal of litigation. This is in contrast to professional liability insurance, where there is seldom any doubt that the policy covers the A/E for defects in its services. Should CGL insurers draft a CGL policy that openly insures against defective workmanship, including by the contractor; or perhaps a policy that eliminates the many exclusions and exceptions that are grist for coverage disputes and policy payouts?

3. **Issue:** Interpretation of indemnification clause in case of negligence/breach by A/E and contractor. *LeBlanc v. Logan Hilton Joint Venture*, Supreme Court of Massachusetts (2012).

Summary: We discussed a Massachusetts court of appeals decision in this same case in 2011. As summarized then: “Maintenance electrician was electrocuted while working on switchgear at airport hotel. Electrical engineer (subconsultant to hotel’s architect) had designed system to include two live feeds, and had specified that the switchgear should include a warning and diagram that would alert users to danger. The electrical subcontractor did not include these warnings. This omission was detected and noted in punch list, with a request for a shop drawing of the warning wording and placement. No follow up by anyone. Estate of maintenance electrician sued hotel, contractor, electrical subcontractor, architect, electrical engineer, and others. Electrical sub cross-claimed against design professionals, essentially claiming that the architect and engineer should have protected sub against its own oversight. Appellate court held as a matter of law that the sub’s causal negligence barred its cross-claim. Court then took a “comprehensive view” of design contract and concluded that although certain clauses relieved architect of duty to ensure compliance or compel contractor performance, the failure to monitor and report dangerous deficiency to owner (hotel) was a contract breach, and created a “field of risk” for third parties. Finally the court concluded that no expert testimony was needed, since hazards were comprehensible to laypersons.”

“Core A/E error was failure to keep owner informed. Court noted that although A/Es were correct that they lacked power or duty to force electrical sub to perform, if they had informed owner of sub’s failure to comply, owner could have withheld payment or exercised other contractual powers. Court cited provisions requiring architect to visit the site, provide weekly reports to owner regarding progress and deficiencies, make payment recommendations, and arrange and observe tests, as indicators of intention to create duty to inform.”

Decision: The case was appealed to the Supreme Court for further review. The high court looked at two issues of interest. One was whether the hotel and the contractor could seek common-law contribution from the design team. The court held that the hotel and contractor could both do so, finding a genuine issue of fact as to whether the A/Es could have prevented the accident altogether by reporting deficiencies to the owner and refusing to declare the project complete.

The state Supreme Court also analyzed a contractual indemnification clause. Under Hilton’s contract with the A/E, the right of indemnification “shall not apply” where the losses “result from the negligent acts or omissions...of other parties for which [A/E] is not responsible.” The court held that there was no indemnity duty, because any losses from the A/E’s negligence in not reporting the deficiency would also result from the contractor’s negligence, a party for which A/E was not responsible.

Comment: The ultimate result for A/E is the need to participate in the trial, and exposure to liability for its own share of the negligence—possibly substantial.

4. **Issue:** Economic Loss Doctrine. *Tiara Condominium Association v. Marsh and McLennan Companies*, Supreme Court of Florida (2013).

Summary: Condo association retained insurance broker to secure casualty coverage for the condominium complex. After hurricane damage, and \$100 million in repair work, the association learned that the broker had erred in reporting available insurance proceeds to the association. A lawsuit followed in federal court.

The trial court dismissed breach of contract claims against the broker, and the federal appeals court confirmed. However, the federal courts asked the Florida Supreme Court for guidance on whether the two remaining claims, negligence and breach of fiduciary duty, should also be dismissed based on the economic loss doctrine, or whether the Florida professional services exclusion to the doctrine applied, which would allow the association to proceed with its tort claims.

The economic loss rule (doctrine; defense) is a judicially created doctrine that prohibits or limits tort claims if the only damages are economic (as opposed to property damage or physical injury claims).

Decision: The Florida Supreme Court reviewed the origin and purpose of the economic loss doctrine, and what it labeled as the “unprincipled extension of the rule,” and announced that it was “receding” from prior rulings:

“We now take this final step and hold that the economic loss rule applies only in the products liability context...The Court will depart from precedent as it does here ‘when such departure is necessary to vindicate other principles of law or to remedy continued injustice.’ ”

Because the court essentially abolished the economic loss rule (except for product liability cases), there was no need to rule on whether the professional services exception should apply to insurance brokers.

Comment: In the past several meetings we have discussed economic loss decisions that expanded or confirmed the rule’s application to claims against design professionals. The Florida decision is contrary to that trend, and an unusual rejection of the precedent set by the court itself in past decisions.

According to various reports, trade associations and others are seeking to persuade the Florida legislature to enact a statute that would establish the economic loss rule as binding law for all tort claims, including those against design professionals.

5. **Issue:** Amount of interest owed to contractor, as prevailing party in claim for additional compensation. *Redondo Construction Corporation v. Puerto Rico Highway and Transportation Authority*, United States Court of Appeals for the First Circuit (2012).

Summary: Redondo completed five highway projects for the Puerto Rico Highway and Transportation Authority before filing for Chapter 11 bankruptcy protection. While in bankruptcy, Redondo pursued claims for extra compensation based on unforeseen site conditions and flawed designs. Following a lengthy trial, Redondo was awarded \$10 million in damages, as well as interest at 6% from the “payment due” dates of the respective projects. The Highway Authority appealed the award on the merits, but was unsuccessful. A further appeal was taken as to the interest.

Three different categories of interest were potentially involved. First, if the Highway Authority had delayed in making payments that were due and owing, such delay would give rise to prejudgment “contractual delay” interest under a Puerto Rico statute. Second, it was possible that the lower court had intended that prejudgment interest be imposed based on the Authority’s alleged “obstinacy in the course of litigation” under a court rule. Third, postjudgment interest would be owed at a low rate (0.11%) under a federal statute.

Decision: The federal appellate court determined that the lower court’s decision was opaque as to the award of interest. The court held that if it was justified at all, the 6% interest rate ceased to apply as of the date of award of judgment; at that point the lower federal statutory interest rate would begin to apply. The record of proceedings below did not contain any clear indication that lower court had imposed the “obstinacy” penalty interest. And in the appellate court’s view, the record did not include the dates Redondo made demands for the extra payments, which would be logical triggers for a 6% interest rate for “contractual delay” in payment. Because of the uncertainty, the appellate court sent the parties back to the lower court for resolution of the interest questions: entitlement to prejudgment interest; basis for such entitlement; rate of interest; periods of accrual.

Comment: Contractual provisions regarding interest on late payments, such as those in the EJCDC Owner-Contractor Agreement forms, are useful, but would not have resolved the uncertainties encountered in this appeal.

Perhaps the contractor should have argued that the logical interpretation of the lower court’s interest award was an implicit conclusion that the 6% interest should apply starting no later than the completion dates of the contracts. If claims had been filed (and denied) earlier, or the payments were due and owing earlier, the contractor would miss out on some interest, but the dispute would be over.

6. **Issues:** Risk allocation in design/build contract. *Fluor Intercontinental v. Department of State*, United States Civilian Board of Contract Appeals (2012).

Summary: After an RFP process, the Department of State awarded the contract for the design and construction of an embassy complex in Kazakhstan's new capital city, Astana, to Fluor, for the fixed price of \$63 million. Fluor encountered many problems in carrying out its obligations, and sought additional time and compensation for lack of expected infrastructure at the site; geotechnical problems and foundation pile issues; perimeter wall foundations; and acceleration to meet schedule.

The appeals board decision gives considerable detail about the content of the RFP documents and the contract documents. The Government had gone to great lengths to openly, transparently shift risk to the design/builder. The documents were laced with disclaimers and warnings to contractors about not relying on the limited Government-furnished information. The design/builder was given substantial responsibility for data gathering. For example, the standard clause under which the Government was to disclose physical data regarding the site (similar to EJCDC clauses in Article 5 of the Supplementary Conditions) was amended "N/A— Design/Build Contractor shall gather the required data during the site visit and design phase." Also, the RFP expressly required the proposers to retain their own geotechnical engineers to evaluate the site prior to submitting price proposals. Fluor did not do so.

The Government did provide standard embassy design documents to the proposers. However, these were accompanied by specific warnings that they were only for the purpose of illustrating the design intent, not as the basis for design.

Decision: The Board of Contract Appeals denied all claims, based on the clear terms of the contract:

The contract places all of the responsibility for design and construction (and as a consequence all of the risk) on Fluor. While the Government provided Fluor with standard design documents and basic technical specifications developed for use on all embassy construction, the contract made plain that Fluor would be responsible for adapting the design to the specific location...Bidders were expressly told in many different sections of the RFP not to rely on the drawings....

One of Fluor's most expensive mistakes involved the pile foundations. It designed piles that could not be built using local materials, and that were too large for local subcontractors to drive into the soil. The board summarized its rejection of Fluor's related claim:

In this design/build contract, the risk of developing a design, and the consequences of miscalculating the resources available for constructing to the design, fell solely upon the contractor. Fluor assumed that its plan for construction would work. The fact that Fluor had to change its plan based upon conditions at the project site is Fluor's own problem.

Comments: In developing its standard contract documents, EJDCDC has attempted to include fair risk allocations that in the long run, over the course of multiple projects, should result in successful projects at reasonable prices. For that matter, the Federal government has much the same philosophy and has been a leader with respect to use of various progressive standard clauses. However, on individual projects, for specific reasons, an owner may choose to shift more risk to contractors. If the contract is well crafted, and in the absence of any misrepresentations or illegal provisions, such a contract is enforceable, as Fluor learned on the Kazakhstan embassy project.

It is also important to consider the range of approaches to design/build. Under one common model, the design/build contractor is given an initial design and asked to finish it and construct the facilities. That was clearly not the case on the embassy project. Even when such an initial design is provided, to what extent must the design/builder verify that design, adopt it, and take responsibility for its content?

Finally, consider the challenge that Fluor and the other proposers faced in committing to a hard-dollar price on construction that is not yet designed. Many design/build projects use a process under which the construction component is not priced until the design is substantially advanced, or allow for some type of re-pricing at that point. Other design/build projects use a cost-based approach to pricing the construction.

The EJDCDC design/build documents are about to be revised and modified, and many of these issues will be discussed and resolved in the new edition.

7. **Issue:** Differing site condition claims. *Appeal of NDG Constructors*, Armed Service Board of Contract Appeals (2013).

Summary: Corps of Engineers contract to construct a 16-inch waterline under Interstate 90 near Rapid City, South Dakota, by boring and jacking a 54-inch diameter steel casing roughly 560 linear feet. Two geotechnical reports were available, because the exact location for the pipeline changed during the planning stage and the Corps chose to have a second report prepared for the new route's precise location. The geotechnical information in the two reports was consistent.

During construction the contractor made several differing site condition claims. The Government granted a few of these, resulting in a modest increase in contract price and in time allowed for completion. The Government rejected claims based on the location where a critical soil transition would take place, and on encountering substantially wetter soils than anticipated. Both these conditions were alleged to result in higher costs and slower progress—approximately \$146,000 and 9 days.

The Corps's Contracting Officer denied the two remaining claims, and the contractor appealed.

Decision: According to the contractor, it encountered a transition to Carlile Shale approximately 100 feet sooner than expected. However, evidence from the bidding process showed that the contractor did not expect to transition at any specific point but only at "some point" between two of the test borings—and such was the case. More important than contractor's expectation, however, was the fundamental question of whether the actual conditions differed from those stated in the contract. The Board concluded that the geotechnical reports did not indicate precisely where the transition would occur, and hence the actual location could not differ from any contract data.

The contractor's contention that the clay soils were wetter than anticipated was based on tests during construction showing moisture content as high as 40%, whereas the tests that were the basis of the geotechnical report showed values around 20%. However, the sampling process during construction was unconventional, and there was evidence that wet bentonite slurry had contaminated the sample. Moreover, the Board found the geotechnical report's discussion of conditions compelling: the geotechnical engineer had seen indications that actual conditions would likely be substantially wetter than those in the boring tests, and had added several explicit warnings to bidders that they should anticipate "moist to very moist" soil and "soft wet soils, along with groundwater."

Comment: The conventional DSC process (including EJCDC's and the Federal government's) places most of the risk of conditions between borings on the

contractor. If a geotechnical baseline report is used, the “blank spaces” between borings are assigned characteristics on which bidders (and contractor) can rely. This may result in more uniform bidding, ease administrative challenges with differing site conditions, and reduce claims, but it does not assure lower costs in any given situation.

One very interesting feature of the *NDG* decision is that the Government’s position on the wet soils DSC claim was greatly aided by the astute comments and extrapolations made by the geotechnical engineer in preparing the reports that were provided to bidders. EJCDC’s philosophy has been that only technical data is reliable and of relevance in determining DSC claims. In this case the geotech’s interpretation of conditions and warning of what conditions bidders should anticipate was more important than the data.