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Articles contained in this issue of the CLE:

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Subguard Insurance – A General Contractor's Risk Management Option for Defaults by Subcontractors

Subcontractor defaults often cause major problems for construction projects which, in turn, cause problems for the General Contractor vis-à-vis the Owner. A potential solution comes in the form of Subguard Insurance. It provides the General Contractor a way to cover a subcontractor default without the need for the General Contractor to finance the default from the contractor's own funds, which is normally the situation in a project involving a performance bond. And so, if a General Contractor wants insurance coverage for the costs associated with a default by a Subcontractor on an enrolled project, there is an **alternative to subcontractor surety bonds**.

Subguard Insurance is an insurance policy that indemnifies the General Contractor for direct and indirect costs incurred as a result of a default of performance by a Subcontractor. In the Subguard policy, a "default of performance" means a failure of the Subcontractor to fulfill the terms and conditions of the construction subcontract, which results in a loss to the General Contractor. This is broad language that can afford broad protection.

The **Direct Costs** that are covered under the Subguard policy are the costs of completing a Subcontractor's obligations, sums a Subcontractor is required to pay to third parties, and the cost of correcting defective or nonconforming work. Direct Costs also include fees of attorneys and consultants, as well as expenses associated with the

investigation, adjustment, and defense of disputes. The **Indirect Costs** that are covered under the Subguard policy include extended overhead, job acceleration, delay costs, liquidated damages, and other expenses associated with a default of performance.

Consider an illustration of the type of coverage that a Subguard policy could conceivably provide to a General Contractor who expends money to maintain the schedule and complete/correct the defaulted Subcontractor's work. Suppose a Pile Driving Subcontractor defaults after 1,000 of 2,000 piles are driven. In our hypothetical, Subguard would indemnify the General Contractor for the cost overrun to finish the remaining 1,000 piles, for the cost of re-work, for payment to unpaid sub-subcontractors and suppliers, for the cost to accelerate the project with respect to other trades, and for extended overhead due to inefficiencies caused by the Subcontractor's default.

This type of coverage sounds expensive. Fortunately, the General Contractor has **two options** to consider when purchasing a Subguard policy. The GC can either enter into a **retrospective premium agreement** or purchase a policy with a **high deductible**. If the contractor manages risk well and does not experience a high frequency or severity of subcontractor defaults, there is an opportunity for premium to be returned to the General Contractor with a retrospective premium agreement. If the General Contractor chooses to carry a high deductible on its Subguard policy, the cost of Subguard Insurance is less than the cost of subcontractor performance and payment bonds.

Some **additional advantages** of Subguard Insurance versus surety bonds for a **General Contractor** are the following: the insurer is contractually obligated to pay within thirty (30) days of receipt of a proof of loss; there is no dispute resolution process required to trigger coverage; and indirect costs are covered. All of which increases the likelihood of completing projects in a timely manner and within the budget.

In addition to the advantages for the General Contractor who purchases Subguard insurance instead of requiring surety bonds from its Subcontractors, there are corresponding **advantages** for **Subcontractors**. The most obvious is that Subguard Insurance eliminates the need for a surety bond from a Subcontractor, potentially preserving the subcontractor's surety capacity for other projects. It also eliminates the need for an indemnity agreement or personal guarantee from the Subcontractor. It allows the General Contractor to default the Subcontractor without terminating the subcontract, thus allowing the Subcontractor to continue to work on the project. (It is interesting to note that the GC has complete control of the default process. The insurer cannot request the GC to withhold funds owed to the Subcontractor to cover the costs of the default. This allows the GC, if it is to the GC's benefit, to continue paying the Subcontractor to prevent the Subcontractor from stopping its work on the project.) Because there is no surety bond, it gives the Subcontractor control of its claim defense without the surety's involvement in the project. Note that, at first blush, Subguard Insurance appears to eliminate the competitive advantage of a Subcontractor with a favorable surety program (price and capacity). While it is true that a worthy but unbondable Subcontractor can be selected by the General Contractor to do work on the project, the General Contractor would be wise to select a Subcontractor with a favorable surety program, good financial strength, and a reputation for operational excellence because a default by a Subcontractor will affect the Subguard policy premium during the term of a rolling retrospective premium program.

A **Project Owner** also receives some **advantages** when the General Contractor purchases a Subguard policy. One such advantage is that Subguard Insurance is looked on favorably by lending institutions that finance large projects. Another advantage is that the Project Owner is less concerned with defaulting subcontractors because the Subguard policy provides funding in the event of a subcontractor default. A third advantage is that the Subguard insurance policy provides cash for curing the Subcontractor default which has the salutary effect of keeping the project on-time and on-budget. A fourth advantage is that the Subguard policy provides coverage for latent defects caused by a defaulting contractor for ten (10) years after substantial completion of the project. Finally, the Project Owner benefits by the fact that a General Contractor can often secure a performance bond under favorable terms if the Subguard policy is in place.

Subguard Insurance is not for every General Contractor. The GC must be a substantial commercial or industrial general contractor to qualify for the insurance coverage. The GC must be a contractor who **understands**, **accepts,** and **manages risk** as part of the normal course of its business. The GC must have a revenue base that includes a high volume of subcontracted values. Typically, $75 million of enrolled subcontractors' values annually would be the norm.

Subguard Insurance is a **first-party insurance policy**. As such, it does not cover third-party injury claims. Accordingly, the General Contractor needs a general liability insurance policy and other traditional coverages. Additionally, the Subguard policy excludes professional services provided by the General Contractor. It is not an Errors and Omissions policy. Subguard Insurance is written on an "occurrence" basis (risk attaching) and not a "claims made" basis. A proof of loss must be made at the earlier of the expiration of any applicable statute of limitations, expiration of any contract limitations period, or ten (10) years after substantial completion of the subcontract.

In conclusion, Subguard Insurance offers a cost-effective alternative to requiring the purchase of surety bonds by the subcontractors on the construction project. It increases profitability so long as losses are controlled. It promotes on-time and on-budget projects. Finally, in the event of a subcontractor default, control of the project continues to remain with the General Contractor.

Joseph J. Bosick serves as Chair of the Construction Practice Consortium of the Pietragallo law firm. For questions, you are welcome to contact Joe Bosick at (412) 263-1828, e-mail him at JJB@PIETRAGALLO.com.

LEED Litigation – Opening Round

Mary March wrote about Building Green and the LEED standards in the previous issue of the *Construction Legal Edge*. By way of reminder, the non-governmental United States Green Building Council has established standards for certification of green buildings. "LEED" stands for Leadership in Energy and Environmental Design and has five levels of "green-ness." In the previous article, Ms. March identified various potential pitfalls in the LEED certification process.

As of this writing, no clear trend in LEED litigation has developed. We have located two references to LEED related litigation. The first is a lawsuit involving the construction of a condominium project on the eastern shore of Maryland. The case of Shaw Development v. Southern Builders filed in Maryland State Court was not solely related to LEED issues, and is not particularly instructive as the case settled without published opinion on the issue. The developer sought a silver LEED rating in order to take advantage of Maryland's state tax credits for energy efficient buildings. While the builder filed a mechanic's lien, the developer countersued for delays and $635,000.00 in lost tax credits from the Maryland Energy Administration, which relies upon LEED certification by the USGBC. *See* Stephen DelPercio, Shaw Development v. Southern Builders: The Anatomy of America's First Green Building Litigation, www.greenbuildingsnyc.com August 20, 2008, which notes that the contract documents were silent on responsibility for obtaining USGBC certification and lacked any risk transfer mechanism for failure to obtain such certification. The case has drawn interest from commentators around the country, as well as a construction periodical in Canada. *See* Saul Chernos, First LEED-Related Lawsuit in the U.S. Sounds Warning Bell for Builders, www.dcnonl.com January 14, 2009. As noted in the Chernos article, the owner and contractor need to be clear about the particular risks and responsibilities in achieving the desired certification. Building contractors should be cautious about making promises and assuming responsibility for results not completely under their control. Thus, if a particular LEED certification is especially important to an owner in order to qualify for funding and/or tax credits, the owner should alert the contractor to the risk in advance.

In another case arising in the United States District Court for the District of New Mexico, Judge Martha Vasquez issued an Order granting a preliminary injunction in favor of the plaintiffs in AHRI, et al. v. The City of Albuquerque. The injunction bars the enforcement of Albuquerque's Energy Conservation Code which the plaintiff had claimed was pre-empted by federal regulation. The Judge opined that federal statutes govern the energy efficiency of certain HVAC and water heating products, thus, expressly pre-empting state regulation of those products from the Code. The local code infringed on federal law and was, therefore, pre-empted by the federal statute. Thus, local governments, despite their good intentions, can run afoul of federal statutes in attempting to create a greener building code.

As these two cases point out, builders, owners, architects, and municipalities are setting sail in uncharted waters with respect to green construction.

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Home Office Overhead Component of Delay Damage Claims

In any construction project which results in litigation containing a delay damage claim, a major component of such claim is the contractor's overhead costs, which include both field overhead and home office overhead. Field overhead costs are generally readily

identifiable because they are direct costs pertaining to things such as utility costs, equipment rental charges, and labor costs.

The calculation of the home office overhead component to any period of delay, however, is a much more difficult task and commonly involves use of what is known as the Eichleay Formula. This formula attempts to calculate a contractor's extended home office overhead losses resulting from owner-caused delays by application of the following formula:

Contract Billings Total Billings for the actual contract period	x	Total Overhead	=	Overhead allocable to the contract

Overhead allowable to the contract Actual days of contract performance	=	Overhead allocable to the contract per day

Overhead allocable to the contract per day	x	number of days of delay	=	Unabsorbed overhead

It is important to understand that before the Eichleay Formula is used in an attempt to support a delay claim by calculating home office overhead, circumstances may make its use inappropriate. For example, if the project is substantially completed before the period of delay occurs, the effect of the delay on home overhead costs is significantly reduced.

One assumption underlying the appropriate use of the Eichleay Formula is that the manpower assigned to the particular construction project was not able to perform any valuable work during the delay period. If, however, the work force is able to be assigned to other ongoing projects during the period of the delay, this assumption is inaccurate, in which case, the use of the Eichleay Formula can be challenged. Even if the Eichleay Formula is not appropriate in a given set of circumstances, there are other methods approved by the courts for the calculation of the home office overhead component of delay damage claims.

For more information, contact **Eric Reif** at (412) 263-4374 or e-mail him at EPR@PIETRAGALLO.com.

Does Your Certificate of Insurance Provide Adequate Protection?

Owners or general contractors often attempt to protect themselves against tort liability arising from the project by requiring subcontractors to furnish certificates of insurance naming the owners or general contractors as additional insureds. A recent New York decision reveals that the protection can be more illusory than real.

In Home Depot U.S.A., Inc. v. National Fire & Marine Insurance Co., 2008 N.Y. App. Div. LEXIS 7648 (N.Y.S.Ct., App. Div. October 14, 2008), the court held that a

certificate of insurance issued in favor of Home Depot was ineffective to confer any right under a policy issued to Westward Contracting. Home Depot, as general contractor, required Westward Contracting, its subcontractor, to provide insurance for the job, to name Home Depot as an additional insured and to furnish a certificate of insurance. When an injured employee of Westward Contracting sued Home Depot, Home Depot commenced a third-party action against Westward Contracting for defense and indemnity. Home Depot obtained a default judgment against Westward Contracting and took an assignment of the rights against its insurer, National Fire. In the meantime, National Fire disclaimed liability to both Home Depot and Westward Contracting.

National Fire proved, by reference to the policy, that Home Depot was not named as an additional insured despite the contrary representation made in the certificate of insurance. The court upheld the disclaimer language contained on the pre-printed form used for the certificate of insurance. The disclaimer provided that the certificate was issued as a matter of information only and that it conferred no rights upon the certificate holder. Although the court did not mention these facts, such certificates also typically provide that they are mere evidence of the existence of the policy and that the certificates cannot alter the terms of the policies to which they refer.

In stark contrast to Home Depot v. National Fire, the West Virginia Supreme Court of Appeals ruled that similar disclaimer language would not defeat a certificate holder's reasonable expectation of coverage as an additional insured. In Marlin v. Wetzel County Board of Education, 212 W.Va. 215, 569 S.E.2d 462 (2002), the court held that the insurance company was estopped to deny additional insured status to the certificate holder. In both cases, the insured failed to carry out contractual requirements to ensure that the certificate holder was, in fact, designated as an additional insured in the respective policies.

The inconsistent treatment afforded certificates of insurance by the New York and West Virginia courts underscores the necessity that parties seeking protection through certificates of insurance be aware of the law in their jurisdictions. However, some states have not addressed the issue and, thus, the certificate holder may lack certainty regarding its rights, if any, under the certificate.

Short of obtaining a legal opinion from counsel, owners and general contractors can take additional steps to secure the protection that the certificate was to supply. First, they should insist that the certificate be issued by the insurer, rather than an insurance agent for the subcontractor. Second, they should obtain a copy of the policy or, at a minimum, the policy endorsement naming the owner or general contractor as additional insured. Such measures will eliminate or reduce the risk of a breakdown in the process of adding them as additional insureds. Moreover, satisfactory proof that the policy was properly endorsed to name them as additional insureds will permit them to rely upon the policy or endorsement, thereby removing any doubt as to the law regarding the effect of a certificate of insurance. Finally, when an insurer (as opposed to an insurance agent) issues the certificate, there is an increased likelihood that a court will prevent the insurer from contesting the representations regarding the coverage provided, even if the information contained in the certificate is inaccurate or incomplete in some material way.

For additional information regarding the effect of certificates of insurance, contact Louis Long at (412) 263-4395 or LCL@PIETRAGALLO.com .

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Damages Based on Breach of the Implied Covenant of Good Faith and Fair Dealing

The Wyoming Supreme Court in the case of The City of Gillette, Wyoming v. Hladky Construction, Inc., 2008 WY 134 (2008), affirmed the jury verdict of $1,125,477, as well as the trial court's award of $335,000 in attorney's fees to the contractor.

The jury ruled that the owner did not breach any of the express terms of its contract. The jury found, however, that the owner breached its implied covenant of good faith and fair dealing. On appeal, the Wyoming Supreme Court affirmed the verdict, saying that breach of the implied covenant is an independent basis to support the verdict, and that one can breach its implied covenant even where it does not breach the express terms of the written construction contract. Under Wyoming law, the implied covenant requires that neither party to a commercial contract act in a manner that would injure the rights of the other party to receive the benefits of the agreement.

The Wyoming Supreme Court also addressed the owner's argument that the contractor waived and released its claims against the owner when it signed a Change Order years before it filed suit. The Supreme Court disagreed, finding that the parties did not include any "release language" on the Change Order. The Supreme Court said that parties need to evidence any intent to release their claims with clear and specific language on the Change Order.

The Wyoming Supreme Court found that the parties' fee-shifting language in the construction contract was triggered. Because the contractor won on its implied covenant claim, but lost on its express contract claim, the Supreme Court ruled that the contractor was the "prevailing party" and thus entitled to all of its attorney's fees under the parties' construction contract.

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Architect Not Under a Duty to Warn Worker of Defect in Scaffolding

In Hain v. Borough of West Reading, 101 Berks 69 (Oct. 24, 2008), the matter before the court was the Motion of the Architect for Summary Judgment. The architectural firm of Diseroad was retained by the Borough of West Reading to provide architectural design and services for the construction of a firehouse. Plaintiff Archer Hain employed by F.L. Royer, Inc., suffered injuries when he fell from scaffolding at the construction site.

The Architect's Motion asserted that it owed no duty to Plaintiff and that even if a duty is found to exist, the Architect committed no act or omission which caused Plaintiff's injuries. The Architect's Motion also asserted that no expert witness had been offered to establish the Architect's proper standard of care, its failure to exercise its standard of care, and a causal relationship between the failure and Plaintiff's harm.

Plaintiff alleged that Defendant Envirotech & Associates, Inc. contracted with the Borough to inspect the project work site to insure that all necessary safety precautions were taken to protect the workers, and to notify the Architect of any issues noted from the inspections. The Architect was to take care of any of these issues after notification by Envirotech.

Plaintiff claimed that the Architect agreed to undertake the "supervision" of the project and to maintain safe conditions at the job site. Plaintiff further alleged that the Architect breached this duty of care by, among other things, failing to properly inspect the scaffolding, failing to confirm the presence of a safety device on the scaffolding, and failing to realize that the scaffolding was too high to be safe without the presence of a safety device, thus, allowing improper and unsafe scaffolding to be used on the job site.

The Hain court observed that in Young v. Eastern Engineering and Elevator Company, Inc., 554 A.2d 77, 381 Pa. Super. 428 (1989), the Pennsylvania Superior Court discussed whether or not an architect had a duty to discover and warn workers on a construction site of a dangerous situation and held that

> … absent an undertaking by an architect, by contract or conduct, of the responsibilities of the supervision of construction and the maintenance of safe conditions on a construction project, an architect is not under a duty to notify workers or employees of the contractor or subcontractors of hazardous conditions on the construction site.

In its review, the Hain court found that the Architect was not under any contractural obligation to warn Plaintiff of a safety hazard present at the site, and did not have the responsibility to inspect or otherwise insure the safety of the workers present at the site. The court went on to discuss a written agreement that had been executed in September 2001, entitled Standard Form of Agreement between Owner [the Borough] and Architect, AIA Document B141, 1987 edition, as modified. Referring to the document, the court noted that Paragraph 2.6.4. also states that the Architect shall be the representative of the Owner during construction. Paragraph 2.6.5 states:

> The Architect shall visit the site at intervals appropriate to the stage of construction or as otherwise agreed … to become familiar with the progress and quality of the Work completed and to determine in general if the Work is being performed in a manner indicating that the Work when completed will be in accordance with the Contract Documents. However, the Architect shall not be required to make exhaustive or continuous on-site inspections to check the quality or quantity of the Work.

The court also noted that 2.6.6 states:

> The Architect shall not have control over or charge of and shall not be responsible for construction means, methods,

> techniques, sequences and procedures, or for safety precautions and programs in connection with the Work, since these are solely the General Contractor's responsibility under the Contract for Construction.

The Architect did not agree to act as a general supervisor or to control the construction operations, but only to conduct occasional inspections for the purpose of determining generally that the work was in accordance with the contract documents.

For all of these reasons, the Court found that the Architect was under no legal duty to warn Plaintiff of a defect in the scaffolding. The Architect's Motion for Summary Judgment was granted.

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