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ARTICLES CONTAINED IN THIS ISSUE OF THE CLE:

Contractors: Think You Have Coverage? Your Insurer May Disagree

A common misconception among many general contractors and subcontractors in the construction industry is that the basic commercial general liability insurance policy (CGL), which their insurance agent sold them, will protect them from any and all claims including faulty and/or negligent workmanship. Such a belief is simply incorrect. To the contrary, absent the purchase of different or additional coverage, your CGL policy is unlikely to protect you and your company against claims for faulty workmanship.

Time and time again, contractors have submitted faulty workmanship claims to their CGL insurance company seeking a defense and indemnification, only to learn that the CGL policy that was supposed to protect them does not. Under a CGL policy, the insurance company generally has two duties. The first is a duty to defend the insured. That is, the insurance company is required to obtain an attorney to represent the insured/contractor and pay for the defense of its insured. The second is the duty to indemnify or, put another way, the duty to pay the claim if it has merit. Neither duty is triggered, however, unless there is coverage under the policy, and this is where disputes between insurance companies and contractors begin.

Unfortunately for most contractors, this is also where the Pennsylvania courts have sided with the insurance companies and decided that under almost all circumstances, there is neither a duty to defend

nor to indemnify the insured under a CGL policy when the claims are for faulty workmanship.

In 2006, the Supreme Court of Pennsylvania considered whether an insurance company had a duty to defend its insured/contractor, under a CGL policy, against a suit brought by a third party for faulty workmanship and resulting property damage. *Kvaerner Metals Division of Kvaerner U.S., Inc., v. Commercial Union Insurance Co.*, 589 Pa. 317, 908 A.2d 888 (2006). In Kvaerner, the claim filed by Bethlehem Steel Corp. asserted that the insured/contractor failed to construct a coke oven battery that met the contract specifications. Bethlehem Steel identified several defects in the contractor's work, but the only property damage was to the oven itself. The insured/contractor submitted the claim to its CGL insurance company and requested that the insurance company defend and indemnify the contractor. The insured/contractor challenged the denial of coverage.

The court initially determined that a insurance company's duty to defend an insured against a third party's claim depends upon whether the complaint triggers coverage. It distinguished the insurance company's duty to defend its insured, a duty that is broader than its duty to indemnify. That is, the insurance company must defend its insured if any claim in the complaint is *potentially* covered while indemnification is only required if the claim is *actually* covered under the policy. The court, however, then stated that an insurer is not required to defend its insured when it is apparent on the face of the complaint that none of the losses falls within the coverage of the policy.

Most contractors believe their CGL policies clearly provide coverage for their work and any resulting damages under the "products–completed operations hazard". The Supreme Court of Pennsylvania, however, disagreed and determined that the contractor's insurance company had neither a duty to defend nor indemnify its insured. In reaching this conclusion, the court had to determine what constitutes an "occurrence" or, put another way, the acts or omissions that trigger coverage under the policy. The Supreme Court reasoned that "faulty workmanship does not constitute an accident as required to set forth an occurrence under the CGL policies." 908 A.2d at 900. The court explained, "that the ordinary definition of accident implies a degree of fortuity that is not present in a claim for faulty workmanship." Id. at 896. The court also rejected the insured's argument that faulty or negligent workmanship constitutes an accident as long as the insured did not intend for the subsequent damage to occur. *Kvaerner*, therefore, became the touchstone case for insurance companies when faced with claims arising from allegations of faulty workmanship.

Since *Kvaerner*, numerous insureds have attempted to circumvent that decision in both state and federal courts, with little to no success. In the first four months of 2012 alone, the United States District Court for the Eastern District of Pennsylvania has relied on *Kvaerner* twice to determine that an insurance company did not have a duty to defend or indemnify its insured under a CGL policy when the claims were based on faulty or negligent workmanship. Louis C. Long provides a detailed discussion of the more noteworthy case in the following article.

So when does a CGL offer a contractor a defense and indemnification?

The simple answer is that it depends on the specific facts in the case.

For example, in *Schuylkill Stone Corp. v. State Auto Mut. Ins. Co.*, 735 F.Supp.2d 150 (D.N.J. 2010), the court, applying Pennsylvania law, determined that the insurance company did have a duty to defend its insured/contractor because the 39 claimants alleged claims for negligent failure to comply with industry standards during the construction of their homes. They sought to recover for bodily injuries, as well as property damages, due to mold and mildew exposure, secondary to water infiltration. The court stated that such bodily injury claims took the case "well beyond *Kvaerner*" into the realm of a fortuitous event covered by the policy. Id. at 159.

At first blush, one may be tempted to say that the bodily injury claims were the deciding factor in favor of the insured contractor in that case. There is no doubt that the court considered those claims as a basis to distinguish *Kvaerner* and its progeny, for most, if not all, cases decided after *Kvaener* involved property damages alone. Perhaps the better basis to reconcile the two cases is on the genesis of the duties allegedly breached. In *Kvaerner*, the duties were derived from the parties' contractual relationship, that of owner and contractor. However, the duties allegedly breached by Schuylkill Stone were industry standards. Such allegations are commonly part of a negligence claim, rather than a breach of contract claim. Property damage claims, particularly those involving damage to the insured's own work or products, are more likely to present breaches of duties originating in the parties' contract.

So what should you do?

Be proactive! The first thing we suggest that you do is obtain copies of all of the insurance policies in place for you and your business. Second, consult with legal counsel or an independent insurance professional to determine exactly what coverage is in place and what may be lacking before claims are made and your company is placed in jeopardy. Once it is determined what coverage is lacking, your advisors can assist you in obtaining an insurance program that will cover even those faulty workmanship claims not covered by your CGL policy. While this process may be a little more involved than merely meeting with your insurance agent, it will assist in better protecting your company.

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Kvaerner Case Applied By Federal Court To Claims To For Faulty Workmanship By Subsequent Home Buyers

Westfield Insurance Co. v. Bellevue Holding Co., 2012 WL 631883 (E.D. Pa. February 24, 2012) continued the trend of Pennsylvania courts to deny coverage to contractors under commercial general liability policies for claims arising from faulty workmanship. What is unique about this decision is the extension of the "no occurrence" rationale to claims brought against the contractors by remote purchasers of the allegedly defective homes. This inexorable expansion of the law heightens the need for contractors to have appropriate insurance or bonding programs to handle claims for faulty workmanship, as standard commercial general liability policies will not provide the desired level of protection.

Bellevue Holding Co. was a residential contractor and developer. It built a new development in the Philadelphia suburb of Avondale. Eight of the homes in the development manifested various problems, including defective stucco walls and defective windows. Many of the homes suffered from water infiltration, which caused further problems with the stucco cladding and rotted the framing of the structures. This led to the filing of eight separate suits in state court against Bellevue Holding and its related companies. Each of the suits alleged claims for negligence; breaches of express and implied warranties; negligent, fraudulent and intentional misrepresentation; unfair trade practices and consumer protection violations; and products liability. Each complaint sought substantial compensatory and punitive damages.

Bellevue Holding tendered each of the suits to its commercial general liability insurer, Westfield. Westfield undertook the defense of the cases subject to reservations of rights and it also brought a declaratory judgment action. In the declaratory judgment action, Westfield asked the federal court to deny coverage to Bellevue Holding on the basis that there was no covered occurrence in any of the state court suits because, at bottom, each of the suits alleged claims for faulty workmanship.

Westfield argued, and the court agreed, that claims for faulty workmanship did not involve the degree of fortuity required by Pennsylvania law to constitute an accident or occurrence. Likewise, Westfield contended, and the court agreed, that such claims are essentially contractual in nature and, as such, they are beyond the scope of the typical commercial general liability insurance policy. Further, consistent with the trend of Pennsylvania cases, the court also accepted Westfield's argument that even when faulty workmanship claims are dressed in the garb of negligence claims asserting foreseeable damages from the faulty workmanship, they likewise fall outside the ambit of such policies.

In a last ditch attempt to obtain some relief from the no occurrence rationale, Bellevue Holding argued that the reasoning adopted by the court should not apply to four of the cases because the plaintiffs therein were not the original purchasers of the homes. As such, the contractor maintained that there was no contractual relationship between the contractor and the disgruntled homeowners. The court rejected that attempted distinction and applied the no occurrence reasoning anyway.

According to the court, it was not the existence of the contract *per se* that made the claims at issue not to be occurrences. Rather, it was the fact that all of the claims stemmed from faulty workmanship and sought damages for the work product of the insured. Each of the claims involved breaches of legal duties that arose from the terms of the contract of parties to the homebuilding transaction, not legal duties that arose from social duties. Moreover, despite the lack of contractual privity, the plaintiffs in those four particular cases nonetheless averred breach of warranty claims.

By closing the door on coverage for claims brought by remote purchasers of the allegedly defective homes, the court reinforced the notion that commercial general liability policies ought not to be treated as substitutes for other types of protection that may be more aptly suited to cover contractors for claims of faulty workmanship. Such protection may be available under performance bonds or errors and omissions policies.

Any contractor seeking to guard against the possibility that claims for defective workmanship would directly and negatively affect its bottom line will need to consult with its insurance advisors to ensure that the insurance portfolio includes proper coverage for this type of loss.

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Are Binding Contracts Created By Using Subcontractor's Bids In A General Contractor's Bid Proposal?

Pennsylvania's Commonwealth Court decided a case of first impression when it held that inclusion of a subcontractor's bid by a general contractor on a bid for a city public works project, did not constitute an "acceptance of the subcontractor's offer". See *Ribarchak v. Municipal Authority of the City of Monongahela*, ___A.3d ___, 2012 WL 1825264 (Cmwlth. 2012). In *Ribarchak*, the City of Monongahela (Authority) solicited bids from various contractors for work at a sewage treatment plant. Galway Bay Corporation (Galway) submitted a bid for the project that included Ribarchak,

d/b/a Fisher Associates (Fisher), as a subcontractor. Galway was awarded the project. According to the contract between the Authority and Galway, no substitutions were to be permitted after 30 days from the contract award date. More than thirty days after the project was awarded, Galway requested that the Authority consent to the substitution of Kiski Valley Systems (Kiski) as a subcontractor in place of Fisher. The Authority agreed.

Fisher then filed an action for breach of contract and negligence against the Authority and Galway claiming that Fisher had a valid contract with both defendants as a result of its inclusion in Galway's bid to the Authority and the Authority accepting Galway's bid.

Fisher's motion for partial summary judgment was denied. The Commonwealth Court affirmed the denial of Fisher's Motion. In reaching its decision, the Court addressed the underlying principles of contract offer and acceptance applicable to bids. Citing *Muncy Area School District v. Gardner*, 91 PA. Cmwlth. 406, 497 A.3d 683, 686 (1985), the Court noted that it is "well established that the submission of a bid constitutes an offer and becomes a binding contract when the bid is accepted by the agency." Fisher argued that inclusion of its bid proposal by Galway it is general contractor's bid to the Authority constituted acceptance by Galway. In addition, Fisher urged that this acceptance was further confirmed by the Authority's acceptance of Galway's bid in which Fisher was named as a subcontractor.

Although other jurisdictions have rejected this notion, that use of a subcontractor's bid by a general contractor constitutes legal acceptance, there have been no Pennsylvania cases which have directly addressed this issue. Relying on *Hedden v. Lupinsky*, 405 Pa. 609, 176 A.2d 406 (1962) for guidance, the Commonwealth Court emphasized that to have a contract, "the acceptance of the offer must be absolute and identical with the terms of the offer." Id. At 612, 176 A.2d at 408. Following in the footsteps of numerous other jurisdictions, the Court held that no contractual relationship is created between the subcontractor and the general contractor even though the bid is used as a part of the general over-all bid by the general contractor and accepted by the awarding authority. In this case, Fisher made an offer to Galway, but neither Galway nor the Authority expressly accepted Fisher's offer.

Fisher alternatively argued that its proposal was accepted by Galway due to Galway's failure to substitute Kiski within the 30 day time period required under the contract with the Authority. Thus, Fisher claimed it was a third-party beneficiary of the contract between the Authority and Galway and was entitled to challenge the untimely substitution. In rejecting this argument, the Court stated that "[A] party becomes a third party beneficiary [to a contract] only where both parties to the contract express an intention to benefit the third party in the contract itself …" *Scarpitti v. Weborg*, 530 Pa. 366, 372, 609 A.2d 147, 150 (1992) (emphasis and citations omitted). In this case, the contract was made for the benefit of the Authority and Galway and there was no express intent to benefit Fisher. Because Fisher was not a party to the contract, nor a third-party beneficiary, it could not enforce any of the terms of the contract.

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Supreme Court of Pennsylvania Clarifies Judge's Role As Gatekeeper of Expert Testimony

The In a new opinion, the Supreme Court of Pennsylvania in *Betz v. Pneumo Abex* has clarified the standards and procedure for trial judges to follow when acting as gatekeeper for novel expert testimony. The *Betz* case was designated by Judge Robert J. Colville and plaintiffs' and defense counsel from a pool of similar asbestos cases pending in the Court of Common Pleas of Allegheny County. Two of the defendants in those cases had filed global motions to exclude expert testimony on the "single breath" theory of causation of asbestos related disease espoused by the plaintiffs' experts. That theory, based on extrapolation, holds that the inhalation of just one asbestos fiber from an asbestos containing product, no matter what other asbestos exposure and extent of exposure the plaintiff may have had, causes asbestos related disease. The defendants argued that the theory was novel and not based on accepted scientific principles. Judge Colville instructed the parties to designate a case as a test case for the *Frye* challenge raised by the defendants. [A *Frye* challenge is the Pennsylvania state courts' method of challenging expert testimony, as opposed to the federal courts which are governed by the U.S. Supreme Court's decision in *Daubert*. While interesting, the distinctions between the two will not be discussed here.] In doing so, Judge Colville ordered the parties to exchange expert reports on the theory and held a full evidentiary hearing.

The mechanism to challenge expert testimony at trial is set forth in the Pennsylvania Rule of Civil Procedure 207.1 which states that when a party moves the court to exclude expert testimony which relies on novel scientific evidence, on the basis that it is inadmissible under Pa. Rule of Evidence 702 or 703, the court shall initially review the motion to determine if, in the interests of justice, the matter should be addressed prior to trial. The court, without further proceedings, may determine that any issue of inadmissibility of expert testimony be deferred until trial.

It is within the discretion of the trial court to determine what manner in which it determines the *Frye* motion. The Supreme Court's official note to Rule 207.1 specifically states that the judge may choose to decide the motion prior to when the expert witness testifies at trial based on evidence offered outside of the presence of the jury, or after the expert witness has testified at trial, in which event the trial judge would strike the testimony of the expert witness if it is found to be inadmissible under Rule 702 or 703. Judge Colville explained his rejection of the plaintiffs' expert's extrapolation theory, using the analogy that very small amounts of alcohol or poison are not harmful, but that in large or very large amounts can injure or kill.

The Superior Court reversed Judge Colville's ruling in *Betz*, criticizing his treatment of the *Frye* challenge, specifically, the finding of novelty and stated that he had abused his discretion in finding that the plaintiffs' expert's extrapolation based methodology was not generally accepted science.

In an earlier opinion the Superior Court has stated that a *Frye* hearing is not appropriate every time science enters the courtroom citing *Commonwealth v. Dengler*, 586 Pa. 554, 890 A.2d 372, 382 (2005). The Superior Court sitting *en banc* in *Trach v. Fellin*, 817 A.2d 1102, 1110 (Pa. Super. 2003) said to do so would be "a result that is nothing short of Kafkaesque to contemplate" painting the procedure as one of senseless complexity. This quote was not lost on the Supreme Court which quoted it at page 7 of its opinion in *Betz* in highlighting the plaintiff's position.

The Superior Court panel in *Betz* noted that under Rule 207.1, as well as *Grady v. Frito Lay, Inc.*, 576 Pa., 839 A.2d 1038 (2003) (a case involving the expert theory that Doritos are dangerously sharp) and *Trach*, a *Frye* motion requires the Court to engage in a two-step process. First, upon the filing of a Rule 207.1 Motion, the trial court must determine whether the evidence the moving party seeks to exclude is "novel scientific evidence." To do so, the trial court must consider the proffered basis for excluding the evidence and the evidence presented in support of that basis, and decide whether the moving party has demonstrated that there is a legitimate dispute regarding the reliability of the expert's conclusions. If the trial court determines that the Rule 207.1 motion has identified "novel scientific evidence," then it must proceed to a second step, applying the *Frye* standard to decide whether the expert's methodology "has general acceptance in the relevant scientific community." Citing *Grady*, 756 Pa. at 555, 839 A.2d at 1043-44.

In *Trach*, a pharmaceutical product liability case, Judge Klein, in his dissenting opinion specifically criticized the trial judge for not conducting a *Frye* hearing, stating "from the record we cannot determine whether [the expert]'s testimony did or did not meet the *Frye* standard. Therefore, I would remand for a full *Frye* hearing. If it is determined that the *Frye* standard was met, there would be no need for a new trial. If the *Frye* standard was not met, then there should be a new trial." 817 A.2d at 1120. Judge Klein explained:

> Therefore, we as an appellate court cannot determine whether or not the basic premise upon which [plaintiff's expert] extrapolated to reach his conclusion is generally accepted science. If it is, then the extrapolation is justified. If it is not, then the extrapolation fails because the basis of the extrapolation is not supported.
>
> We have made the interpretation of the *Frye* principle far too complex. We should be able to come up with a commonsense approach to the "gatekeeper" function of the trial court when it comes to scientific evidence.
>
> I believe we can conduct this analysis by following four simple principles.
>
> 1. *Frye* applies to scientific testimony whenever there is a legitimate dispute as to whether

the expert's conclusions or methodology are generally accepted.

2. If the expert's conclusion is generally accepted, then there is no need to evaluate his or her methodology.

3. If the expert's conclusion is not generally accepted, then courts must determine whether the underlying methodology is reliable.

4. The challenger bears the burdens of production and proof. The trial court should deny the motion without a hearing unless the movant has presented and supported a *prima facie* case that the evidence is not generally accepted.

817 A.2d at 1123. Judge Klein then immediately cited Rule 207.1 and its explanatory comment, which seems to provide the basis of his suggested procedure. At the end of his analysis under *Frye*, Judge Klein stated in any event, trial courts are to comply with Pa.R.Civ.P. 207.1, which provides that, where a party files a *Frye* motion with the trial court, the court , in its discretion, can hold a *Frye* hearing before trial, or defer it to trial, and further that nothing in the rule precludes raising the issue during trial. Judge Klein's criticism of the trial court's handling of the application of *Frye* in *Trach* was that the trial court denied the defendant's motion in limine without a hearing, but then granted the defendant's post trial motion which again raised the issue, also without holding a *Frye* hearing. Had the court held a *Frye* hearing, preferably at the motion in limine stage, or at least prior to reversing the verdict, the record would have been fully developed. 817 A.2d at 1126-1127.

It appears the Supreme Court in *Betz* has vindicated Judge Klein's position in *Trach*, and brought the issue full circle, in that it is the *en banc* Superior Court's acceptance of extrapolation methodology in *Trach* that the Superior Court relied on in reversing Judge Colville's decision in *Betz*. The Supreme Court specifically approved of Judge Colville's utilization of the *Frye* hearing pursuant to Rule 207.1 prior to trial and specifically commented that his ruling under *Frye* was supported by the record from the *Frye* hearing where experts called by plaintiff and defendants testified as to the methodology. In so doing, the Supreme Court noted Judge Shogan's concurring opinion crediting Judge Colville for his well-intentioned and conscientious efforts to address a confusing area of the law arising in a mass tort setting. *Betz*, slip op. at 26.

Counsel should be prepared to challenge their opponents' experts' novel methodologies prior to trial with fully substantiated motions pursuant to Rule 207.1, and the trial court will be less likely to defer the issue of admissibility until hearing the expert's trial testimony, given the Supreme Court's holding in *Betz*. Although the Supreme Court of Pennsylvania has continued to reject adopting the *Daubert* standard, perhaps we will see *Frye* hearings scheduled in state courts as routinely as *Daubert* hearings are in the federal courts. The effect of the *Betz* ruling

will not be limited to asbestos cases and can apply to any novel theory espoused by an expert and could affect construction cases in many ways, including on issues of damages analysis, mold litigation, and building product cases, to name a few.

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Architects and Engineers: Lexington Insurance Provides Value-Added Risk Management Services

Architects and Engineers who are insured by Lexington Insurance receive the protection of a package of risk management services designed to mitigate critical Errors and Omissions exposures. These services may include the following:

- Contract review services by experts who identify and make recommendations to limit an insured's liability and optimize the insurance provisions of a contract. This service is sensitive to bidding deadlines.
- Pre-claim prevention services when a potential claim situation is brewing but has not yet resulted in a demand or lawsuit.
- Risk Management Seminars to educate A&E insureds on key risk issues.
- A web site devoted to A&E insureds.

This article will focus on the www.lexAEHelp.com web site that can be accessed by Lexington insureds through the use of a user name and password. Among various choices on the web site there is a "Risk Management Tools" category that currently provides the following topics:

- Your Legal Exposures
- Contract Guidelines
- Client Selection
- Claims Scenarios
- Glossary
- State Laws
- Professional Practices
- Recommended Reading
- Articles
- Newsletters
- Useful Links

If the topic "Your Legal Exposures" is selected, there is a discussion about a well-written contract and the implementation of formal ongoing risk management protocols. If the topic "State Laws" is chosen, then the state laws of all the various states as they relate to A&E insureds are summarized. If you click on the topic "Useful Links," various websites that provide risk management resources are accessable via links.

The web site has a section called FAQ's, which provides answers to Frequently Asked Questions in the areas of Business and Insurance.

The lexAEHelp.com web site also provides Educational Programs in the form of webcasts.

Lexington Insurance has created a system that helps Architects and Engineers manage risk. It is available to Lexington's insureds without charge.

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