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## Breaking Ground



Welcome to the first 2009 issue of *The Critical Path*, the on-line quarterly newsletter for DRI's Construction Law Committee. In addition to articles, case notes, and legislative summaries submitted by Committee members Joseph Bosick, Tim Epstein, Ben Heinz, Justin Lamb and Jason Reed, this issue contains the first “Recent Successes” submission from one of our Committee members, William S. Thomas. Thanks to the contributors and sponsors for making this issue possible. The next deadline for submission of materials for inclusion in *The Critical Path* is June 1, 2009. Please submit your material to me at [mhaynes@tillerlawgroup.com](mailto:mhaynes@tillerlawgroup.com). Additional publication opportunities for Construction Law Committee Members in *For The Defense* are also available. Please contact Sean Martin ([sean.martin@leitnerfirm.com](mailto:sean.martin@leitnerfirm.com)) for deadlines and publication requirements. Finally, please mark your calendars for this year's Construction Law Committee meeting at The Palace Hotel in San Francisco that will take place September 9–11, 2009.

As many of you are likely aware, the Construction Law Committee leadership recently created five Specialized Litigation Groups (SLGs). The SLGs consist of the following disciplines: (1) Construction Defect, (2) Construction Insurance Coverage, (3) Design Professionals, (4) Worksite Injury, (5) Contract and Delay Claims. Members of the Construction Law Committee can join anyone or more of Committee SLGs by contacting Committee Vice Chair Chris Belter (email address [cbelter@goldbergsegalla.com](mailto:cbelter@goldbergsegalla.com)). There is no additional cost to involvement in any of the SLGs.

I hope you enjoy this first 2009 issue of *The Critical Path*.

J. Matthew Haynes, Jr.

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Editor, *The Critical Path*

April 03, 2009

## Meng v. The Drees Company

A Loudoun County, Virginia jury recently awarded Paul and Wendy Meng \$4,750,000 for mold contamination in their \$900,000 home due to the alleged negligence and fraud of their builder, the Drees Company. The Mengs filed suit against Drees alleging negligence for all four family members' personal injuries, actual fraud, constructive fraud, breach of contract, and a violation of the Virginia Consumer Protection Act. According to Virginia Lawyers Weekly, the verdict was the third-largest 2008 Virginia verdict. `<xml:namespace prefix=ons="urn:schemas-microsoft-com:office:office"/>`

Paul and Wendy Meng purchased a new, \$900,000 home from the Drees Company in 2005. During construction, the Mengs alleged Drees failed to take proper precautions to protect the house from the weather, and consequently installed drywall while the structure's wooden frame was still wet. Furthermore, the Mengs claimed Drees improperly installed windows, allowing water to seep into the house. Despite repairs, the Mengs claimed water continued to drain into the basement through the windows as late as January of 2007.

At trial, the Mengs presented evidence that Drees knew the windows were leaking, but failed to adequately repair the leaks. Nevertheless, at the 2005 closing, the Mengs claimed Drees represented that all leaks had been sealed.

Not long after moving into the house, the Mengs and their children claimed they began to feel ill. The family dog died suddenly. Paul Meng and the couple's two daughters developed asthma, and the Meng's youngest daughter began experiencing uncontrollable nose bleeds.

Wendy Meng reported experiencing the worst symptoms. She claimed she began to suffer from migraine headaches and was bedridden for weeks. During 2006 and early 2007, Wendy Meng claimed she was rushed to the hospital seven times for maladies such as migraines, tachycardia, nervous system dysfunction, breathing difficulties, and chemical sensitivity. Wendy Meng claimed she developed a photosensitivity so severe that she had to sleep on the floor of the closet. Wendy's medical providers administered a battery of tests. The tests, looking for such culprits as adrenal-gland cancer or a brain tumor, all came back negative.

In early 2007, tests confirmed the presence of mold, and the Meng family vacated the house. The Mengs disposed of nearly \$100,000 of clothes, furniture, and personal belongings that had been exposed to the mold. In April of 2007, the Meng family rented another residence, and the house at issue remained unoccupied as of the date of trial. The cost of restoring the house was estimated at \$400,000. In September of 2008, the entire family underwent a month-long detoxification in South Carolina under the care of Dr. Allan Lieberman.

At trial, Dr. Lieberman testified that the family's health problems were caused by mold, and that they required a month-long biotoxin detoxification. According to the Mengs, the contamination not only made their home uninhabitable, but caused Wendy Meng to suffer from health problems so severe that her physicians suspected cancer or a brain tumor. Dr. Ritchie Shoemaker conducted tests on the Meng family, and testified that in his expert opinion, the Meng's illnesses were caused by the presence of mold in their home.

The jury began deliberating on the afternoon of December 22, 2008, and delivered its verdict the next day. The jury awarded Wendy Meng \$2,276,000 for her negligence claim, Paul Meng \$500,000 for his negligence claim, \$1,474,000 for the couple's constructive fraud claim, and \$500,000 for the alleged violation of the Virginia Consumer Protection Act. The presiding judge, the Honorable Thomas D. Horne, initially entered judgment against the Drees Company for the full \$4,750,000.

The Drees Company made several post-trial motions, asking the court to set aside the jury's verdict, to grant a new trial, or for remittitur. After a hearing on February 27, 2009, Judge Horne issued a memorandum opinion that reduced the total verdict to \$1,400,000.

The court held that the jury's verdicts regarding the Mengs' constructive fraud claim and Virginia Consumer Protection Act claim were invalid as a matter of law. Addressing the Mengs' constructive fraud claim, the court found that any representations regarding the Mengs' home and any reliance on those representations arose in contract. The Mengs neither pleaded nor proved fraud in the inducement. No evidence was presented at trial that the Drees Company made any misrepresentations before the contract was executed. Relying on *Richmond Metro. Auth. v. McDevitt Street Bovis, Inc.*, 256 Va. 553 (1998), the court held that any relief for the Drees Company's alleged misrepresentations would lie in contract rather than in tort.

The court also set aside the jury's verdict regarding the Mengs' Virginia Consumer Protection Act claim. The court's central basis being the jury failed to find that the Drees Company committed actual fraud. Without evidence of a knowing and deliberate decision not to disclose a material fact, the Drees Company could not be found liable for violating the Virginia Consumer Protection Act.

The court also reduced the Mengs' awards for damages on the two negligent construction counts, finding that the excessive nature of the awards created "the impression that the jury had misconceived or misconstrued the law." At trial, the Mengs presented evidence of \$577,000 in special damages. However, the Mengs presented no evidence of permanent injury. The court reduced Paul Meng's award on his allegations of negligent construction from \$500,000 to \$425,000. Wendy Meng's award was reduced from \$2,276,000 to \$975,000. The Mengs were given the option of accepting their combined awards of \$1,400,000 or submitting to a new trial. As of this time, no order has been entered indicating the Mengs' decision.

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April 03, 2009

## Defense Verdict in Fair Housing Act Claim

DR Construction Law Committee member William S. Thomas, managing principal of Rabbitt, Pitzer & Snodgrass, P.C. in St. Louis, Missouri, recently won a defense verdict involving the Fair Housing Act. His client, a local engineering firm, was sued as a third party defendant, and charged with violating the Fair Housing Act, in Federal District Court, in East St. Louis, Illinois.

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The United States Department of Justice, through its Housing and Civil Enforcement Section, brought an original action against Dan Shiels, Shanrie Co., Inc., the owner, developer and contractor, Netemeyer Engineering Associates, Inc., a structural engineer who prepared plans and specifications, and Forest Hills, L.P., the Mark Twain Trust and Brian and Pamela Bauer, the owners of certain apartment buildings, alleging they were in violation of the Fair Housing Act's "design and construct" provisions relating to handicap accessibility.

The defendants then filed a third party action against Thouvenot, Wade & Moerchen, Inc., (TWM) a civil engineering firm represented by Mr. Thomas. The third party complaint sought indemnity from TWM, claiming TWM participated in the design and construction of the apartment complex, such that they did not provide for accessibility to individuals with disabilities.

Mr. Thomas filed a Motion to Dismiss, arguing that neither the express or implied language of the FHA allowed for third party actions for contribution or indemnity. The District Court agreed, and in its opinion granting TWM's motion to dismiss, adopted Mr. Thomas' arguments.

Last summer, Mr. Thomas tried the first case brought to trial under the FHA's "design and construct" requirements, representing the same civil engineering company. After nearly three years of pretrial discovery and a week long trial, the jury deliberated for only 30 minutes and returned a unanimous 12-0 verdict in favor of TWM.

April 03, 2009

## "Defending the Stimulus Project": Application Of The Spearin Doctrine To Stimulus Package Funded Construction Projects

On February 15, 2009, Congress approved the American Recovery and Reinvestment Act, commonly known as the "stimulus package." Among other things, this package will infuse much needed funds into the construction industry. As a result, the number of government contracts with construction companies will vastly increase in a short amount of time. Therefore, contractors must be aware of the risks associated with government contracts and the means to protect themselves from the same.

The stimulus package calls for \$787 billion in spending and tax cuts nationally. The package is a compromise between the White House and Congress that creates "more jobs than the original Senate bill and costs less than the original House bill," says Senate Majority Leader Harry Reid. According to President Barack Obama, this package will create jobs particularly in the construction industry:

Not just any jobs, but jobs doing the work America needs done: repairing our infrastructure, modernizing our schools and hospitals, and promoting the clean, alternative energy sources that will help us finally declare independence from foreign oil.

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Congress earmarked a large portion of the stimulus money to benefit the construction sector. While still President Elect, Obama asked mayors and governors across the United States to suggest "shovel-ready" public projects. These public projects can begin in 90 to 120 days after the signing of the stimulus bill. As a result, the mayors and governors suggested 427 projects, costing a total of \$73 billion and potentially creating 850,000 jobs by 2010.

In total, the stimulus package provides \$134.8 billion for construction-related projects. \$49.3 billion will benefit transportation infrastructure, including \$27.5 billion going to highway and bridge construction. \$21.3 billion will benefit water and environmental infrastructure, including

clean water infrastructure and environmental clean up programs. \$29.5 billion will go towards building infrastructure, including government facilities, school construction, and public housing. \$4.7 billion will go towards work force development, with the majority for creating training and employment services. Lastly, \$29.8 billion will benefit energy and technology, including diesel emissions reduction, electricity grids, and state and local government energy grants. Due to the wide variety of sectors set to receive a sharp influx in funds, it is likely that any area of the construction industry will experience an increase in government contracts.

The construction industry is in particular need of this stimulus package. While the national employment rate is 7.6%, the employment rate in construction overall is 18.2%. In the past two years, the civil engineering sector alone lost 52,000 jobs. Additionally, investment in infrastructure will help state budgetary problems. Michael Bird, federal affairs counsel for the National Conference of State Legislators says, "infrastructure, which is designed to create jobs, can help states balance their budgets by increasing tax revenues and purchasing construction supplies."

The stimulus package will play a vital role in the revival of the construction industry. Its effects will extend far beyond the immediate future, both in the construction industry and other sectors. The increase in construction projects expected to occur in the next couple of years will consequently lead to an increase in government contracts. As such, it is imperative to anticipate the legal consequences of these specific types of contracts. One legal issue that may arise from this increase involves the application of the *Spearin* doctrine to stimulus-related construction projects. Whether or not the *Spearin* doctrine will be available to a private construction company contracting with the state or federal government afforded stimulus money is an important question needing attention from the very beginning of a project.

In 1918, the United States Supreme Court released its decision in *United States v. Spearin*, 248 U.S. 132, 39 S.Ct. 59, where it addressed the issue of implied warranties created by plans and specifications. In *Spearin*, the plaintiff contracted with the United States government to construct a drydock at the Brooklyn Navy Yard, including the relocation of a section of sewer. *Id.* at 133. The contract required that the plaintiff relocate the sewer section in accordance with the plans and specifications prepared by the government. *Id.* After the sewer had been relocated and during the continued construction of the drydock, the sewer overflowed and flooded the worksite. *Id.* at 134. It was determined that a dam existed within a portion of the sewer not worked on by the plaintiff and that such dam caused the flooding. *Id.* Neither the city nor the government's plans showed this condition. *Id.* Following this event, the plaintiff informed the government that he would not complete his work on the drydock until the sewer had been fixed. *Id.* at 135. The government annulled the plaintiff's contract and proceeded to have the project completed, under significantly different plans and specifications, by different contractors. *Id.* As a result, the plaintiff filed suit for damages, including lost profits and a balance due on the work he had performed. *Id.* The Federal Court of Claims found for the plaintiff and awarded damages. *Id.* at 133.

On appeal, the Supreme Court specifically noted that a contractor is not responsible for the consequences of defects in plans and specifications prepared by the owner when the contractor is bound to perform pursuant to such plans and specifications. *Id.* at 136 (citations omitted). As such, the Court found that by prescribing the exact dimensions and location of the sewer, the government created an implied warranty that if the plaintiff built the sewer in accordance with the plans and specifications, then the sewer would be adequate. *Id.* at 137. The Court further found that this implied warranty was not over come by standard contract clauses regarding a contractor's duty to inspect the work site, check the plans, and assume responsibility for the work until completion. *Id.* The Court then upheld the trial court's decision and found that the plaintiff was not responsible for restoring the sewer and did have the right to recover damages resulting from the government's subsequent annulment of the plaintiff's contract. *Id.* at 138.

One key aspect of the application of the *Spearin* doctrine is the difference between "design" and "performance" specifications. In *Stuyvesant Dredging Company v. United States*, this difference was explained as follows:

Design specifications explicitly state how the contract is to be performed and permit no deviations. Performance specifications, on the other hand, specify the result to be obtained, and leave it to the contractor to determine how to achieve those results.

834 F.2d 1576, 1582 (Fed. Cir. 1987). While the *Spearin* doctrine applies to design specifications, there is no warranty for the adequacy of performance specifications. *Id.* But, it should be noted that a single contract can contain both design and performance specifications. *Blake Const. Co., Inc. v. United States*, 987 F.2d 743, 746 (Fed. Cir. 1993).

Given these judicial determinations, success under the *Spearin* doctrine requires more than just a mere error in the design specifications. First, the design specifications do not have to be perfect. *Caddell Const. Co., Inc. v. United States*, 78 Fed. Cl. 406, 413 (2007). As long as the specifications are "reasonably accurate", there is no breach of the implied warranty. *Id.* Furthermore, a contractor's general duty of checking the plans and specifications still applies and prevents the contractor from relying on the implied warranty when the design specification is "patently" ambiguous, inconsistent, or wrong. *Id.* Likewise, the implied warranty is not breached when the plans and specifications, though containing errors, are nevertheless "workable" by way of slight modifications. *Id.* at 416.

Thus, the *Spearin* doctrine remains a useful tool for contractors involved with government construction projects. However, as noted above, in order for the *Spearin* doctrine to apply, the errors or inconsistencies complained of in the plans and specifications must be ones that the contractor had no option but to perform in accordance with them and must be of such significance that the only way to successfully complete the project is through a major revision of the plans and specifications.

The *Spearin* doctrine presents an issue for contractors that should be addressed before the project begins. For stimulus-related projects, contractors should make certain that the government tenders specific design specifications at the very beginning of the project. Without design specifications, a contractor cannot file suit under the *Spearin* doctrine. Furthermore, contractors should carefully check the plans and specifications given by the government because the general duty to do so still exists. The contractor would not be able to recover under the *Spearin* doctrine if the design specification was "patently" ambiguous, inconsistent, or wrong, and the contractor did not check the plans beforehand. Following this protocol, a contractor can ensure that errors by the government for stimulus-related projects will not cause an issue later on when construction begins.

The *Spearin* doctrine provokes an additional concern for contractors seeking stimulus-related projects. The federal government's dispersal of funds presents the issue of whether a contractor can file third-party lawsuits against the federal government for stimulus projects. It is important to know the signatories to government contracts to determine whether a contractor can invoke the *Spearin* doctrine against the federal government or against the state government.

At this point, states are still unsure of how the federal government will allocate the stimulus funds. As currently drafted, the stimulus distribution will be based upon the existing statutory formula, allocating the majority of funding to the states. Then, the states will reallocate the funds to project sponsors. The government will give priority to "shovel-ready" projects. To qualify for funds, the state financing authorities must award twenty-five percent of the money to contractors within ninety days. Ultimately, fifty percent needs to be spent by 2009, and the remaining fifty percent needs to be spent within two years. Congress already earmarked most of the states' fund money to certain sectors to ensure that the "money will be spent on projects that can create the most jobs," says Kelvin Atkinson of Nevada, D-North Las Vegas.

Who receives the stimulus funds will determine whether a construction contract is made with the state government or the federal government. For instance, Congress will give some of the funds to federal agencies, such as the \$9.2 billion given to the Department of the Interior and the Environmental Protection Agency to use for energy projects. In these cases, the federal government would be a signatory to any contract with a construction company. In instances where states receive funding from the federal government and use it for their own projects, especially "shovel-ready" projects that the state already negotiated, the individual state would be the signatory to the contract.

Who signs the contract is especially important when applying the *Spearin* Doctrine. In *United States v. Spearin*, 248 U.S. 132 (1918), the Supreme Court held that "if the 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." Thus, there is an implied warranty in a contract that the plans the owner gives to a contractor are both accurate and suitable for their intended use. The *owner* is liable to the contractor if the contractor cannot finish a project due to inaccurate or unsuitable plans.

For contracts as a result of the stimulus, whether the *Spearin* Doctrine applies depends on whether the state or the federal government commissioned the project. Mutual intent to contract is necessary for an implied-in-fact contract. *Rick's Mushroom Service, Inc. v. United States*, 521 F.3d 1338. If a state signed a contract that the federal government funded with stimulus money, only the state could have an implied warranty under *Spearin*. It would be difficult to attach the United States government to a contract for which it only appropriated funds because it does not have the mutual intent necessary for a contract. However, if the contract is signed with a federal agency, such as when the EPA commissioned the project, the United States government would sign the contract. Therefore, an implied warranty could exist under the *Spearin* Doctrine, allowing the contractor to sue the United States for inaccurate or unsuitable plans. In sum, the *Spearin* Doctrine assigns liability to the *owner* of the property who signed the contract, and not just the government entity who indirectly appropriated the funding.

In 1988, the Supreme Court expanded *Spearin* in *Boyle v. United Technologies Corp.*, 487 U.S. 500 (1988). In *Boyle*, the Court firmly established that government contractors could seek derivative immunity from suits by third parties arising out of the performance of their contracts (i.e. "the Government Contractor Defense"). The Government Contractor Defense is grounded in the federal government's immunity from suit for the performance of discretionary functions as codified in the Federal Tort Claims Act, 28 U.S.C. § 2680(a) (2006) (hereinafter "FTCA").

*Boyle* involved a suit against the manufacturer of a military helicopter by the father of a pilot killed when unable to escape a crashed helicopter.

due to a design flaw in the escape hatch. The Court reasoned that the selection of appropriate designs for military equipment was clearly a discretionary function. Furthermore, allowing second-guessing of such designs would ultimately result in exactly the type of financial burden on the government which the discretionary function exception in the FTCA was intended to prevent. Essentially, the Court feared the liability of contractors would be passed on to the government in the form of increased contract prices or even the inability to obtain contracts with quality contractors. *Id.* at 507.

*Boyle* established three prerequisites for application of the government contractor defense: (1) the government must have approved reasonably precise specifications; (2) the equipment must conform to those specifications; and (3) the supplier must have warned the government of any dangers associated with the equipment known to the supplier, but not the government. *Id.* at 512.

Since the Court's decision in *Boyle*, lower federal courts have been divided concerning whether the Defense should be expanded outside the realm of military procurement contracts and products liability suits, to apply to non-military contractors or to service contracts. Although some Circuits have been reluctant to expand the *Boyle* holding, many have applied the Government Contractor Defense in non-military and service contexts. For instance, the Defense has been applied to contractors participating in environmental cleanup efforts after hurricanes ( *Richard Lexington Airport District v. Atlas Properties*, 854 F. Supp. 400 (D.S.C. 1994); *Weggeman v. Ash Britt, Inc.*, 2007 U.S. Dist. Lexis 49197). Therefore, although the scope and applicability of the Government Contractor Defense varies by jurisdiction, it should certainly be a consideration for any attorney defending construction cases arising out of government work.

#### Some Practical Considerations for Contractors and Attorneys:

One weak point plaintiffs consistently, and oftentimes successfully, attack is the degree of government participation in the design process and the intensity of the government's oversight of the contractor's work. The Defense will not apply if the government has merely rubber-stamped the contractor's design or actions, although the *Boyle* opinion and subsequent decisions have clearly stated contractor involvement in the design process does not negate the application of the Defense. The rationale is that, without government participation, oversight, and substantial review, there is insufficient exercise of government discretion to bring the work under the exception to the FTCA. Thus, careful documentation of government collaboration in the design process and oversight during the project is essential and should be considered when preparing contract documents and while the work is proceeding.

Additionally, the government contractor is well advised to carefully follow the scope of work and specifications contained in the contract documents. Independent deviations from the contract specifications, whether purposeful or negligent, can also leave the contractor out in the cold. Again, such deviations from government approved plans and activities negate the necessary government collaboration and oversight to trigger the governmental discretionary function.

## CONCLUSION

In light of the recent passing of the American Recovery and Reinvestment Act ("the Stimulus Act"), contractors should be mindful of the various applications of the *Spearin* doctrine and the Government Contractor Defense. A careful review of the viability of the defenses in your jurisdiction, combined with careful drafting of contract documents and documentation of the government's participation and oversight on your "stimulus-funded" project, could lay the groundwork for a powerful defense for your clients participating in stimulus-related government work should liability arise.

This issue of *The Critical Path* has been edited by the Construction Defect Specialized Litigation Group of the Construction Law Committee. If you would like to join this SLG, please contact Kathy Davis at [krdavis@carallison.com](mailto:krdavis@carallison.com)

April 03, 2009

## 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 **alternativetosubcontractorsuretybonds** .xml:namespaceprefix=ons="urn:schemas-microsoft-com:office:office"/>

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 recovered 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 to overrun to finish the remaining 1,000 piles, for the cost of rework, 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 recovered. 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, which has offices in Pennsylvania, Ohio, and West Virginia. For questions, you are welcome to contact Joe at (412) 263 1828, e mail him at [JJB@Pietragallo.com](mailto:JJB@Pietragallo.com) ©2009 Pietragallo Gordon Alfano Bosick & Raspanti, LLP*

April 07, 2009



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April 07, 2009



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