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Legal Highlights:

- U.S. District Court awards punitive damages against insurer who denied claim without proper basis.
- Where insured property is damaged at least in part by a covered peril, absent proof by carrier that a loss, either in whole or in part, is covered by an exclusion, carrier will be liable for full amount.
- Revised AIA Document A201 anticipated for publication in Fall, 2007.
- Pass through clauses in contracts shift or limit the ability of a subcontractor to recover for extras and claims.

Insurer Bad Faith and Punitive Damages

By *Enrique M. Lopez, Esq.*

In *Broussard v. State Farm Fire and Casualty Company*, 2007 WL 113942 (S.D. Miss.) the United States District Court for the Southern Division of Mississippi examined the issue of whether an insurer was required to provide coverage for an entire loss, otherwise covered under an insurance policy, if the insurer was unable to demonstrate that a portion of the loss fell under a policy exclusion.

Broussard involved damages sustained by homeowners in the wake of Hurricane Katrina. The parties stipulated that the homeowners sustained an accidental direct physical loss of their dwelling and further suffered a loss of the contents of their dwelling as a result of Hurricane Katrina, which was a windstorm for purposes of the policy. Additionally, the parties stipulated as to the value of the homeowner's dwelling and contents. The values agreed to represented the policy limits for the dwelling and contents under the insurance policy. Although the Court did not cite a specific provision in the insurance policy, the Court noted that "[u]nder the terms of the homeowners insurance

policy, State Farm would owe this entire loss unless it can be established that some or all of this loss was attributable to water damage, a type of loss excluded from coverage under this policy." *Broussard* at 2. It is noteworthy that despite language elsewhere in the Court's opinion seemingly favorable to insureds with respect to the carrier's burden of proof, the Court does not identify whether there was specific language in the policy requiring that the carrier demonstrate the amount of damages attributable to an exclusion in order to exculpate itself from paying.

The evidence in the case conclusively established that the dwelling sustained wind damage during the hurricane and that the dwelling was ultimately a total loss. Once the homeowner had established the prima facie case based upon the stipulations and evidence, it was then incumbent upon the insurance carrier "to establish, by a preponderance of the evidence, what portion of the total loss is attributable to flood damage and is therefore outside the policy coverage." *Id.* The Court also noted that "where an exclu-

(Continued on page 4)

Featured this Issue:

<i>Insurer Bad Faith and Punitive Damages: Examining Broussard v. State Farm Fire and Casualty Company</i> , 2007 WL 113942 and insurance in the wake of the storm	1
<i>Negotiating the AIA A201 Document — What Really Matters?</i> A brief look at potential and anticipated revisions to AIA Document A201	2
<i>Examining Pass-Through Claims: Up, Down and Sideways</i>	5

Negotiating the AIA Documents —

By *Stuart H. Sobel, Esq.*



Individuals involved with construction projects should be aware that a revised version of the AIA A201 is anticipated for release in the Fall, 2007.

“Since the A201 is incorporated into many of the various AIA documents for project delivery, it will be the focus of this discussion. This article addresses the more significant changes from the 1997 edition of the same document, with emphasis on the practical impact (and need to modify its various provisions in order effectively to share the risk that is inherent in every project)”



The new AIA document recognizes the digital age in which we live and work. The requirement that records be maintained in digital format may be imposed and, if so, facilities for viewing such digital documents must be made available to the Owner and Architect at the site.

The topic of this article is supposed to be: Negotiating the New AIA – What Really Matters. What really matters for the purpose of this article, however, is that the issuance of the new AIA documents has not occurred by the deadline for publication. The substance for this article has been gleaned from drafts of the new AIA A201 and commentaries which the author was able to finagle from here and there. Thus, before any practitioner relies on the suggestions set forth, one would be well served to verify that the changes addressed actually made their way into the 2007 documents.

The AIA A201, [hopefully] revamped in 2007, and the contracts into which it is incorporated, contain dozens of pages of “boilerplate” – meaningless until the life of your project depends on the turn of a phrase or the interplay of seemingly irreconcilably conflicting provisions. Since the A201 is incorporated into many of the various AIA documents for project delivery (A101, A111, A114 and A131), it will be the focus of this discussion. This article addresses the more significant changes from the 1997 edition of the same document, with emphasis on the practical impact (and need to modify its various provisions in order effectively to share the risk that is inherent in every project). It presumes that the reader is generally familiar with the 1997 version of the AIA A201.

Changes will be noted with the impact and suggestions for use, by section. The risk allocation will be from the point of view of a Project Owner/Developer, although the author suggests that the best contract is also the fairest – one that allocates anticipated risk appropriately, creates a method for addressing unanticipated risk and does not force one party or the other to fight in order to avoid ruination.

CHANGES IN THE NEW (DRAFT) VERSION OF THE AIA A201 (2007)

§1.6 – Ownership and Use of Drawings

Drawings remain the property of the design professionals as instruments of service. This should be addressed in the Owner/Architect Agreement so that should the relationship end, the Owner need not start over with new design professionals. Architects typically will agree to allow the Owner license to use their drawings limited to the particular project – unless arrangement for prototypes are made – and then only in the event the Architect does not claim that Owner is in breach of the agreement for non-payment.

§2.2 – Information and Services Required of Owner

The 2007 version still requires the Owner to furnish the Contractor with evidence of financial arrangements, upon request, at the commencement of the project. However, it limits

What Really Matters

the obligation of the Owner to furnish that information during the project, to circumstances where “the Contract Sum is changed materially.” The prohibition on the Owner varying financial arrangements is now limited to those which “affect materially the Owner’s payments to the Contractor”.

§3.2 – Review of Contract Documents and Field Conditions

The new 201 recognizes the Contractor’s desire not to be responsible for design issues. Thus, the Contractor’s review of the documents is expressly “as a contractor and not as a licensed design professional.” This really is consolidating the old §3.2.2 into 3.2.1 rather than introducing any new concept.

§3.2.2

The Contractor’s duty to discover and report errors and omissions in the Contract Documents based not just on actual knowledge, but constructive knowledge: “The Contractor shall not be liable...unless the Contractor recognized or *should have recognized*...” The introduction of a negligence standard raises many questions and may be ill-advised. Additionally, the liability of the Contractor for failing to report such errors or omissions in the plans no longer requires a “*knowing*” failure.

§3.7 – Permits, Fees and Notices

A new section, 3.7.5 is added, requiring suspension of operations and notice to the Owner and Architect whenever the Contractor encounters “wetlands, burial or archeological sites or other legally protected features not indicated on the Contract Documents”. A claim for equitable adjustment to the Contract Sum and Contract Time is also authorized.

§3.11.1 – Documents and Samples at Site

The new AIA document recognizes the digital age in which we live and work. The requirement that records be maintained in digital format may be imposed and, if so, facilities for viewing such digital documents must be made available to the Owner and Architect at the site. See also: §3.12. Note, however, that the digital information may not be readable without proprietary software and the document is silent on the duty to furnish access to the software.

§3.12.6 – Shop Drawings, Product Data and Samples

The Contractor is now held to having reviewed and approved the submittals of itself and its subcontractors and suppliers when it submits them. It also represents, by the fact of submission, that it has verified materials and field measurements.

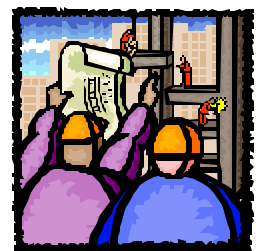
§3.18.1 – Indemnification

The 2007 A201 does away with Project Management Protective Liability Insurance entirely (See §11.3 in the 1997 edition, eliminated in the 2007 draft) and so eliminates it as a limitation on the obligation of the Contractor to indemnify the Owner and Design Professionals from claims arising out of its performance of the Work. (Continued on page 6)



A Contractor’s review of the documents is expressly “as a contractor and not as a licensed design professional” pursuant to one of the proposed revisions to the A201.

“The [proposed] 2007 A201 does away with Project Management Protective Liability Insurance entirely ... and so eliminates it as a limitation on the obligation of the Contractor to indemnify the Owner and Design Professionals from claims arising out of its performance of the Work”



One proposed revision to the A201 holds a contractor to having reviewed and approved the submittals of itself and its subcontractors and suppliers when it submits them.

Insurer Bad Faith and Punitive Damages

(Continued from page 1)

sion is specifically pleaded as an affirmative defense the burden of proving such affirmative defense is upon the insurer.” *Id.* Citing *Fidelity & Guaranty Co. v. Planters Bank & Trust Co.*, 77 F.3d 863 (5th Cir. 1996).

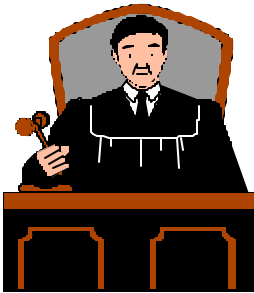
Although the insurance carrier attempted to demonstrate that the entire amount of damage to the property was caused by rising water, its own expert testified that it was more probable than not that at least some roof damage resulted from wind and further testified that based on the available data, he was unable to determine the extent of the wind damage to the dwelling before the storm surge arrived. Although there was sufficient evidence to demonstrate that the force and duration of the storm surge was enough to completely destroy the dwelling, the Court noted that “[t]he key issue is how much damage had occurred as a result of wind before the storm surge arrived. That preceding wind damage would be covered, and any additional damage caused by the arrival of the flood would be excluded...In these circumstances, it is the allocation of the burden of proof that is critical, for one party or the other must bear this total loss in the absence of evidence by which the two types of losses may be reasonably identified and separated.” *Broussard* at. 2. The Court held that the insurance carrier was obliged

under the policy to pay for all portions of

the loss which it could not demonstrate, by a preponderance of the evidence, were caused by flooding. Given that the insurance carrier “failed to meet its burden of proof as to the extent of the damage caused by water, and since the [homeowners] have established by stipulation that they sustained a total loss of their dwelling and its contents as a result of Hurricane Katrina, a covered windstorm peril, [the Court finds] that [the insurer] is liable to the plaintiffs for the limits of coverage.” *Id.* at 3.

The Court also held that the insurer lacked any legitimate or arguable ground under Mississippi law and under the unambiguous terms of the of the insurance policy for failing to unconditionally tender the policy benefits in light of its own expert’s findings. Despite the information of its expert, the insurance carrier attempted to shift its burden of proof onto the homeowners. Due to the carrier’s apparent lack of good faith in investigating and paying legitimate claims, the Court denied the carrier’s motion for partial summary judgment as to punitive damages. The Court awarded contractual damages and remanded the case to the jury on the issue of punitive damages.

**This article appears in its original form in the 2007 Florida Construction Law Supplement and more information on these issues is available in Chapter 8 therein.*



In instances where an exclusion is pleaded as an affirmative defense by an insurer, the burden of proving such affirmative defense is upon the insurer.

“...In these circumstances, it is the allocation of the burden of proof that is critical, for one party or the other must bear this total loss in the absence of evidence by which the two types of losses may be reasonably identified and separated.”



An insurance carrier may be obligated under a policy to pay for all portions of a loss which it can not demonstrate, by a preponderance of the evidence, were caused by an exclusion.

Pass Through Claims — Up, Down, & Sideways

By Stuart Sobel, Esq.

Pass through clauses in contracts shift or limit the ability of a subcontractor to recover for extras and claims. Such subcontract clauses can require a subcontractor to limit its claim for extras asserted against a general contractor to that which the general recovers from the owner (passing the sub's claim "up" through the general to the owner). Similar clauses can require the sub to defend and indemnify a general facing a claim from an owner due to actions or omissions of the sub (passing the owner's claim "down" through the general to the sub). Still other clauses purport to eliminate a sub's right to recover directly from the general for interferences by a general contractor's other subcontractors, requiring the sub, instead, to make claim against the other sub (passing the injured sub's claim "through" to the guilty subcontractor).

Pass through claims may require a subcontractor to participate in dispute resolution proceedings between that sub's general and the project owner, the sub's general and other sub's or even between the sub's general and the various design professionals, either with or independent of the sub's dispute resolution directly with the general. Pass through clauses may require participation by way of timely notice of claims, provision of supporting documentation of claim, provision of testimony and expert support, participation of the sub's counsel at trial or arbitration where the sub is not a party, and even sharing in the general's expense of asserting or defending such claims. Some such clauses, notably those purporting to limit a sub's right of action against a general for the wrongful actions of another sub of the general may be difficult to enforce, given variations on the Economic Loss Rule in a particular jurisdiction and the absence of privity between the subs.

In effect, pass through claims may impose a condition upon a sub's right of payment from the general contractor – that is, the sub may have to wait until circumstances giving rise to a claim that is not solely the responsibility of the general, are resolved in a dispute between the general and owner, before the sub is entitled to payment for the costs associated with those events.

Active participation by the sub in the dispute between the owner and general that is impacting payment to the sub may be required by contract – or at least will be in the sub's best interest. That participation may take the form of having the sub's witnesses available to the general, the sub's lawyers examine the owner's witnesses in arbitration or trial or the responsibility to compensate the general for attorney and expert fees and costs involved in resolving the dispute itself.

Pass through clauses, in effect, liquidate certain claims of subcontractors and are, occasionally referred to as Liquidating Agreements. They do not always appear in contracts under article headings such as "Limitation on Claims." They can be imposed as indemnity provisions or through other, less obvious headings. Care must be taken to understand them and their implications. **This is an excerpt from an article presented at the ABA Forum on the Construction Industry on April 13, 2007.*



Pass through clauses, in effect, liquidate certain claims of subcontractors and are, occasionally referred to as Liquidating Agreements.

"[Pass through clauses in subcontracts] can require a subcontractor to limit its claim for extras asserted against a general contractor to that which the general recovers from the owner...Similar clauses can require the sub to defend and indemnify a general facing a claim from an owner due to actions or omissions of the sub."



In effect, pass through claims may impose a condition upon a sub's right of payment from the general contractor.

(Continued from page 3)

§4.3.1 – Claims and Disputes

An important change in the 2007 edition is the deletion of the requirement that “claims must be initiated by written notice.” This could open the door to increased disputes over whether notice of a claim was given, since it now can be given verbally, at a job meeting, over the phone or in other ways hard to dispute or prove. It is suggested that the requirement of written initiation of a claim be reinstated.

§4.4 – Resolution of Claims and Disputes

This section has been renamed Dispute Resolution. All of what was Article 4.4, 4.5 and 4.6 (submission of dispute to architect, mediation and arbitration) has been moved to Article 15, logically after the termination and suspension provisions in Article 14. Changes to the dispute resolution provisions in the A201 will be discussed infra.

§9.6.2 – Progress Payments

The Contractor is now required to pay Subcontractors “no later than seven days after receipt of payment from the Owner...” and must “promptly inform the Owner, Architect and Subcontractor, upon request, of the reason for any non-payment...” The new edition put a specific deadline, in lieu of the vague “prompt” obligation on the Contractor to pay its subs. It also imposes a duty to explain reasons for non-payment to a subcontractor despite payment of the Contractor by the Owner. Since the Contractor must certify entitlement to payment, including that of the Subcontractor’s work, situations where the Contractor will be entitled to withhold money from the Subcontractor will likely be limited to those where the Contractor is supplementing the Subcontractor’s work or has other backcharges that it has not passed through to the Owner (Subcontractor delays that caused the Contractor to accelerate to stay on schedule, or the like).

§9.6.4 – Progress Payments

This new section gives the Owner the express right (previously existing by statute in many states) to contact Subcontractors directly in order to determine whether they have properly been paid to date. That right is conditioned upon the Owner’s first seeking to obtain the information from the Contractor. If the Contractor fails to provide it, within seven days of the Owner’s request, the Owner may then contact the Subcontractors directly.

§11.3 – Property Insurance

The 2007 draft switches the obligation to procure and maintain property insurance (“builder’s risk” or “all-risk”) from the Owner to the Contractor and requires the Contractor to pay the deductibles.

§15 – Dispute Resolution

In previous versions of the A201, the Architect served as the decision maker of first resort (before more formal dispute resolution). Now, although the Architect is still the default “Initial Decision Maker”, the parties are free to name anyone upon whom they can mutually agree at the time of contract. The 2007 draft, seemingly paradoxically, states that the Initial



An important potential change in the 2007 AIA is the deletion of the requirement that “claims must be initiated by written notice.”

Under the proposed revisions, the “Contractor is now required to pay Subcontractors ‘no later than seven days after receipt of payment from the Owner...’ and must ‘promptly inform the Owner, Architect and Subcontractor, upon request, of the reason for any non-payment...’”



One potential change in the 2007 draft switches the obligation to procure and maintain property insurance from the Owner to the Contractor and requires the Contractor to pay the deductibles.

Decision Maker's "initial decision" "shall be final and binding on the parties but subject to mediation and" should mediation fail, "to binding dispute resolution." How, then, is the Initial Decision binding? If the party that disagrees with the Initial Decision fails timely to invoke the next step in the process (mediation), the initial decision becomes binding upon the Owner and Contractor and is no longer subject to further dispute resolution. Similarly, even where the parties go to mediation, absent a timely demand for binding dispute resolution, the Initial Decision becomes binding. The parties have 30 days after the Initial Decision to invoke mediation and another 30 days after mediation to invoke binding dispute resolution.

§15.2.2

The default, absent modification, requires mediation to be administered by the American Arbitration Association in accordance with their Construction Industry Mediation Rules. The parties should consider, when negotiating the Contract, administering mediation privately, independent of any particular organization (or with organizations other than the AAA), under rules that the parties can adopt from such organizations or which they fashion themselves. The practice may result in a more efficient, economical mediation. The author has also been involved in successful pro-active dispute resolution where the parties named a mutually agreeable person or panel to adjudicate disputes during the project under a written set of rules, enforceable through judicial oversight of the contract. These suggestions, however, require substantial thought, planning and cooperation and are well beyond the scope of this article.

§15.3 – Arbitration

Arbitration is no longer the default for formal dispute resolution. The parties can still choose it and, if they do, the A201 requires that it be administered by the AAA under its Construction Industry Arbitration Rules. As with mediation, the parties might consider other organizations, private arbitration. The present AAA Construction Industry Arbitration Rules invest the arbitrator(s) with the power to determine their own jurisdiction, do not require adherence to the substantive law of the jurisdiction where the project is located or guarantee a speedy, efficient and fair resolution of the dispute.

CONCLUSION

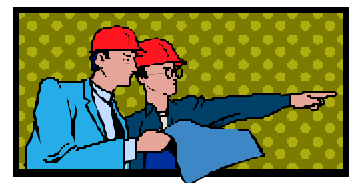
Presuming that the draft A201 is substantially similar to the final version that is adopted and issued in the near future, the AIA has made significant strides in improving a workhorse document in our industry. With care and understanding and a little gentle massage, it can provide the basis for a fair allocation of risk in your next construction project.

***The foregoing is an abridged version of a more extensive article that will be presented at the International College of Shopping Centers Law Conference to be held on October 24-28, 2007.*



In one possible revision, although the architect is the default "Initial Decision Maker", the parties are free to name anyone upon whom they can mutually agree at the time of contract.

"Arbitration is no longer the default for formal dispute resolution. The parties can still choose it and, if they do, the A201 requires that it be administered by the AAA under its Construction Industry Arbitration Rules."



Possible new Section 9.6.4 gives the Owner the express right to contact Subcontractors directly in order to determine whether they have properly been paid to date.

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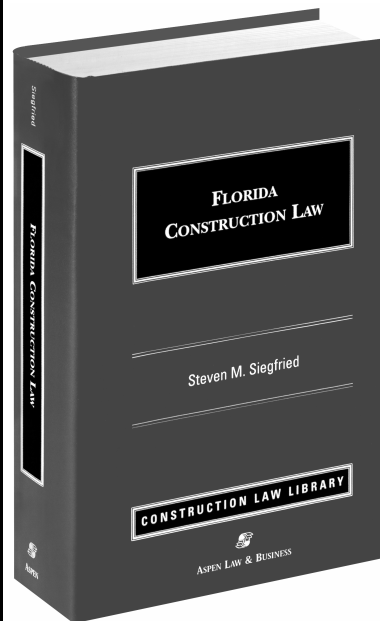
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