YOU’VE GOT A FRIEND, OR DO YOU?
HOW DO THE DELIVERY SYSTEMS AND PARTY POSTURES IMPACT
LITIGATION STRATEGY AND PROCEDURES IN MULTI-PARTY
CONSTRUCTION CLAIMS?

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INTRODUCTION†

This paper is part of a three part presentation with John E. Bulman and Allison Snyder. The overall focus of the presentation and three papers are strategic decisions that arise throughout complex construction cases and the impact that project delivery systems can have on such cases. This particular paper will address the following topics:

I. Statute of Limitations and Tolling Agreements .................................................. 3
   A. What Happens When Multiple Statutes Apply? ............................................. 4
   B. Design-Build & Design-Assist ...................................................................... 5
   C. Construction Management at Risk ................................................................. 8
   D. Arbitration...................................................................................................... 9

II. Insurance ........................................................................................................... 10
    A. Commercial General Liability Policies—Generally .................................... 10
       1. Coverages .................................................................................................. 11
       2. Exclusions ................................................................................................. 22
       3. Policy Conditions: Cooperation and Timely Notice .............................. 25
    B. Professional Liability Policy .................................................................... 25
    C. Design-Build & Design Assist .................................................................. 26
    D. Construction Management at Risk ............................................................ 28
    E. Arbitration .................................................................................................. 28

III. The Economic Loss Rule and Pleading Niceties ............................................. 29
    A. Design-Build .............................................................................................. 31
    B. Construction Management at Risk ............................................................ 32

IV. Pass Through Claims & Liquidating Agreements ......................................... 34
    A. What is a Pass Through Claim? ................................................................. 35
    B. The Widespread Acceptance of Pass Through Claims ........................... 36
    C. How Pass Through Claims Are Brought: The Pass Through Agreement .... 37
    D. Motivations for Using a Pass Through Claim ......................................... 39

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I. Statute of Limitations and Tolling Agreements

Modern construction projects involve multiple relationships. As the nature of these relationships changes, so too may the applicable statute of limitations. Indeed, many construction projects involve contracts for the supply of materials, professional design services, and of course, construction services. Claims arising out of each of these contracts may be governed by a different statute of limitations. In addition to contractual claims, construction disputes may involve tort, warranty, and indemnity claims, all of which may also have separate statutes of limitations. It will often be difficult to determine which statute applies, and this issue is frequently a source of dispute among the parties. This is an especially important issue, since the applicable statute of limitations can obviously effect whether a party’s claim will make it past the pleading stage. Accordingly, parties should keep the relevant statute of limitations in mind when preparing a pleading, ensuring that they characterize their claim as one which will fall under the most favorable limitations period.
This issue is further complicated by the fact that many states have implemented construction-specific statutes of limitations or statutes of repose. These statutes often apply to disputes arising out of “construction services.” The scope of these statutes, however, varies. Even in jurisdictions in which the statutory language is similar, common law interpretations may result in significantly different applications.

A. What Happens When Multiple Statutes Apply?

For the reasons stated above, multiple statutes of limitations may appear to apply to a single claim. When faced with this issue, courts will often apply the more specific statute. If the specific always trumps the general, then one might expect a construction-specific statute of limitations to always apply in the context of construction disputes. Yet this is not always the case.

For example, in *Hersh Companies, Inc. v. Highline Village Associates*, an apartment complex owner hired a painting contractor to paint the exteriors of the owner’s apartments. The contracts involved contained warranties which “guaranteed [the painter’s] work against defects in material and workmanship for five years.” Shortly after the painting was completed, the paint began to peel. The painter initially performed limited repairs, but eventually refused to perform any further work on the apartment buildings. The owner sued the painter for, among other things, breach of warranty. There was a dispute over whether the state’s breach of warranty statute of limitations applied or the state’s construction-claim statute of limitations applied.

The court began its analysis by stating the familiar proposition that “[w]hen more than one statute of limitations could apply to a particular action, the most specific statute controls over more general, catch-all statutes of limitations.” The court noted that “[i]n
general,” warranty actions were governed by the state’s breach of warranty statute of limitations. In addition, the court stated that “[w]ith regard specifically to claims concerning” construction related contracts, the state’s construction statute of limitations applied. The construction statute of limitations at issue covered “all actions against any architect, contractor, builder, or builder vendor, engineer, or inspector performing or furnishing the design, planning, supervision, inspection, construction, or observation of construction of any improvement to real property . . . .” One might assume that the court went on to find that the specific construction statute of limitations applied to the owner’s claim. The court, however, came to the opposite conclusion.

The court first noted that the defendant was within the class of defendants protected by the construction statute of limitations. The court stated, however, that the plaintiff’s warranty claim sought relief “for defendant’s failure to provide its ‘repair-or-replace remedy for defects appearing during the term of the guarantee. Because [this claim] seek[s] recovery for the breach of a subsequent contractual duty to repair or replace rather than recover for a deficiency in the original work,” it did not fall within the construction statute of limitations. The court further noted that the language of the construction statute of limitations implied that it was not “intended to limit claims for breach of warranties to repair and replace.” Thus, the court held that the breach of warranty statute of limitations applied.

B. Design-Build & Design-Assist

As stated above, the statute of limitations that applies to a particular claim may be affected by the relationship of the parties involved in the claim. Thus, as the project
delivery system changes and the relationships of the parties change, so too do the statute of limitations issues.

First, as one might expect, the applicable statute of limitations will change based on the type of services which led to the claim. In the traditional design-bid-build context, it may be relatively easy to establish what type of services gave rise to the claim, and, therefore, which statute of limitations applies. If one is asserting a claim against an architect or engineer, then the statute of limitations for professional negligence or design-services contracts likely applies. Similarly, if one is asserting a claim against a contractor, the statute of limitations for construction services likely applies. Yet this distinction becomes blurred in the context of design-build and design-assist. Under these project delivery systems, roles regarding construction and design services become distorted since a single entity is offering both design and construction services. An owner asserting a claim against the design-build entity may have a more difficult time determining which particular service caused its damages and which statute of limitations applies. Similarly, in the design-assist context, a contractor may provide both construction and design services. Again, an owner may have more difficulty identifying the source of its claim and the applicable limitations period.

Second, statute of limitation concerns may shift loyalties between the parties, especially with respect to the design-build team members. For example, design-builders are often formed when one entity, who normally has expertise in only one type of service (e.g. a contractor with expertise in construction services), subcontracts with another entity who has expertise in the other type of service (e.g. an architect with expertise in design
services). During the course of the project, the interests of the contractor and architect coalesce.

What happens, however, if the owner starts to complain about defects in the construction? Suppose that the contractor believes that the defects are a result of the architect’s acts or omissions. The contractor may have a claim against the architect (e.g. indemnity, breach of contract, etc.). Yet the contractor may be reluctant to sue the architect for a number of reasons. The contractor may not want to alienate a potential ally in subsequent litigation, or it may want to preserve a friendly business relationship for future projects. Yet a contractor who delays suing in this situation may risk having its claims against the architect barred by the statute of limitations. The applicable limitations period may begin to run once the contractor has “notice” of its claim against the architect. If the owner’s complaints constitute notice under the applicable statute, a contractor who refrains from suing the architect may inadvertently lose its ability to assert any claim at all.

Construction statutes of repose present a similar concern to contractors who are reluctant to pursue indemnity or indemnity-like claims from a third party. Indeed, many states have adopted statutes of repose which are specific to construction related claims. These statutes generally provide that, after a specified period of time, all claims arising out of a construction project are barred. While this bar may appear fairly straightforward, it has the potential to surprise unsuspecting contractors. For example, in the scenario discussed above suppose the owner sues the contractor immediately before the relevant jurisdiction’s construction statute of repose expires. While the contractor may want to sue the architect for indemnity, the contractor first wants to wait and see what its liability
to the owner will be. Counsel for contractor may not see this as a problem, assuming that
the contractor’s indemnity claim will not fall within the state’s construction statute of
repose.

Yet counsel for contractor should beware, as the law on this issue varies from
state to state. For example, some construction statutes of repose, by their own express
terms, do not apply to claims for indemnity. Other statutes expressly apply to
indemnity claims. Some states have statutes which are silent on this issue. Among
these states, there is a split of authority on whether the construction statute of repose
does, in fact, bar claims for indemnity. Accordingly, contractors would be well-advised
to research the applicable statute of repose and associated case-law in the relevant
jurisdiction, to ensure that the contractor’s delay in filing suit does not forfeit the
contractor’s rights.

As illustrated by the discussion above, a party’s reluctance to sue when sued, in
an attempt to preserve relations, may result in that party’s reimbursement claims being
barred. Yet parties may avoid this result, while still preserving relationships, by entering
into tolling agreements. In the hypothetical discussed above, the contractor may want to
approach the architect about entering into a tolling agreement in order to prevent the
contractor’s claims against the architect from being barred. Such an agreement would
probably be less likely to spoil the parties’ relationship than an immediate lawsuit by the
contractor.

C. Construction Management at Risk

Similar statute of limitations concerns may arise in the context of a Construction
Management at Risk (“CM at Risk”) delivery system. For example, if an owner starts to
complain about construction defects to the construction manager, does that constitute notice triggering the limitations period on any claim the construction manager might have against the contractor? Of course in this scenario the construction manager may not have any qualms about suing the contractor to prevent its claim from being time-barred—the desire to preserve a relationship with the contractor is likely not present. Yet the construction manager may want to refrain from suing to prevent costly, and potentially unnecessary, litigation. For this reason, tolling agreements can again offer an acceptable compromise.

D. Arbitration

Just as in traditional litigation, parties arbitrating a construction dispute must worry about which particular statute of limitations governs their substantive claims. Furthermore, the shifting alliances discussed above do not necessarily change just because the dispute is being settled in front of an arbitrator instead of a judge. Thus, many of the statute of limitations issues which arise in traditional litigation are also present in arbitration. Arbitration, however, presents one additional statute of limitation concern which is not present in traditional litigation: the limitations period for filing a demand to compel arbitration.24

There is no federal statute of limitations for compelling arbitration for claims arising out of the Federal Arbitration Act ("FAA").25 There is, however, authority for the proposition that a court hearing a demand to compel arbitration may adopt an analogous state statute of limitations which may bar the claim.26 In National Iranian Oil Co. v. Mapco Intern., Inc., the Third Circuit recognized the FAA did not provide a statute of limitations for compelling arbitration.27 The court noted, however, that “[p]arties should
not feel free to wait unlimited numbers of years before petitioning a district court to compel arbitration.” Thus, the court found that it was appropriate to borrow an “analogous statute of limitations from [state] law.” Finding that “[a]rbitration is an action on a contract obligation,” the court found that Delaware’s statute of limitations for breach of contract should apply. Thus, the plaintiff’s action was time-barred.

II. Insurance

The construction industry is one fraught with risk. Experienced contractors and design professionals know that projects in which everything goes according to plan seldom occur in reality. Thus, these entities are forced to take measures to hedge against project risks. Insurance is one of the tools such entities use to accomplish this. The insurance industry has developed its own set of general policies designed to insure commercial construction risks. This section will discuss some of the most common construction insurance issues that arise when the project delivery system changes.

A. Commercial General Liability Policies—Generally

In order to properly understand the insurance issues that arise with respect to various project delivery systems, it is necessary to have a basic understanding of construction insurance. This section will attempt to provide the reader some background in construction insurance by discussing one of the most commonly used construction insurance policies: the Commercial General Liability (CGL) policy. CGL policies fall into two categories with respect to when coverage is triggered under the policy: (1) occurrence policies; and (2) claims-made policies. Occurrence policies, which are the most common, provide coverage for damage which occurs during the effective dates of the policy. The occurrence of the damage is the triggering event and it does not matter
when the claim is asserted. In contrast, under a claims-made policy, coverage is limited to claims which are asserted during the policy period and the date of the occurrence is irrelevant.

As an example, assume Policy A is in effect during 2004 and Policy B is in effect during 2005. A visitor is injured in an accident caused by a contractor in 2004, but the visitor does not assert a claim against the contractor until 2005. If the policies are occurrence policies, Policy A will cover the accident and claim; however, if the policies are claims-made policies, Policy B will cover. Notwithstanding the distinction with regard to when coverage is triggered, both occurrence and claims-made policies require an occurrence and a claim.

Given that claims occur at a readily identifiable time, it is usually easy to determine whether or not a specific claim was asserted during the effective dates of a claims-made policy. In contrast, it is not always clear whether or not damage occurred during the effective dates of an occurrence policy. Some damage occurs progressively over a period of time. Generally, courts which have addressed the issue of progressive damage in insurance cases have used either the exposure or the manifestation theory to determine when actual damages were sustained. Under the exposure theory, the damage occurs during any policy period in which there is exposure to the damage causing condition or agent. Under the manifestation theory, the damage occurs when the ultimate injury occurs or becomes manifest.

1. Coverages

When analyzing whether a loss is covered under any insurance policy, the natural starting point is the coverages section. The standard occurrence and claims-made CGL
policies are divided into three different coverage sections: (1) Coverage A which insures against liability for certain bodily injury and property damage; (2) Coverage B which covers liability for certain personal injury and advertising injury; and (3) Coverage C which insures against liability for medical expenses. The following section will focus on Coverage A since most construction-related claims are associated with Coverage A.

Coverage A of the CGL policy begins with a broad insuring clause (Insuring Agreement) which states that it provides payment for damages that the insured is liable to pay because of bodily injury or property damage to which the policy applies. The insuring clause then commonly limits the coverage to bodily injury and property damage which is caused by an occurrence and which takes place in the coverage territory during the effective dates of the policy.

Each CGL policy contains a definition section which must be reviewed to determine the meaning of phrases used in the insuring clause such as property damage and occurrence. The insuring clause is followed by an exclusion section which sets forth a list of specific exclusions for which the policy does not provide coverage. The standard CGL policy also contains a conditions section that sets forth certain obligations and conditions the insured must meet in order to obtain coverage or payment for a particular loss.

In order to analyze the potential CGL coverage of the damages on a construction project the insuring clause, the policy definitions, and the exclusions must be reviewed. The relevant issues to address will be whether: (1) the damages were the result of property damage, (2) the damages were caused by an occurrence, and/or (3) the damages are excluded under one or more policy exclusions.
When analyzing whether coverage exists under a CGL policy for construction
related claims, it will be helpful to keep in mind the following general principles asserted
by insurance companies and typically followed by courts: (1) there is no coverage to
repair faulty work performed by the insured; (2) there is no coverage for defective
workmanship unless it causes damage to other property; and (3) there may be coverage
for damage caused by a subcontractor’s work once the project has been completed.35

According to the insuring clause in Coverage A, the insurer will indemnify the
insured for damages for bodily injury or property damage that the insurer is legally
obligated to pay, but only if caused by an occurrence in the coverage area during the
policy period.36 Thus, in order to trigger payment, both an occurrence and either bodily
injury or property damage must have occurred.

i. Bodily Injury or Property Damage

a. Bodily Injury

A typical CGL policy defines bodily injury as “bodily injury, sickness or disease
sustained by a person, including death resulting from any of these at any time.”37
Analytically, determining whether bodily injury has taken place is a relatively simple
task. Bodily injury exists if the insured’s potential liability is based upon injury or harm
to a person.

b. Property Damage

Determining whether property damage has occurred can be much more difficult.

Often, property damage is defined as:

(a) Physical injury to tangible property, including all resulting loss of
use of that property. All such loss of use shall be deemed to occur at the
time of the physical injury that caused it; or
(b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the occurrence that caused it.\textsuperscript{38}

Clearly, property damage would include harm to property that is completely separate from the project. For instance, assume the insured is a framing contractor who accidentally drops a beam crushing the owner’s car. This is an easy case of property damage.

However, determining whether an incident constitutes property damage is rarely this simple, particularly in the construction setting. For example, if a plumbing pipe leaks, it often causes water damage to drywall, woodwork, and flooring. Under this scenario, many courts hold that the damage to other property (i.e., the drywall, woodwork and flooring) satisfies the CGL policy definition of property damage.

This issues courts wrestle with when determining if property damage has occurred were recently illustrated by the Supreme Court of Florida in \textit{Auto-Owners Insurance Co. v. Pozzi Window Company}.\textsuperscript{39} In \textit{Pozzi}, a homeowner, who had independently purchased windows for the construction of his house, noticed that the windows allowed water intrusion.\textsuperscript{40} The homeowner sued the window supplier, the prime contractor, and the subcontractor who had installed the windows.\textsuperscript{41} The window supplier, under an assignment of rights from the prime contractor, sued the prime contractor’s insurer for coverage.

In determining whether the loss constituted “property damage” under the policy, the court first noted that there was a factual dispute as to whether the water intrusion was caused by a defect in the windows themselves or a defect in the installation of the windows.\textsuperscript{42} This distinction, the court noted, was critical.\textsuperscript{43} On the one hand, “the mere
inclusion of a defective component, such as a defective window or the defective installation of a window, does not constitute property damage unless that defective component results in physical injury to some other tangible property.” On the other hand, “if the claim is for the repair or replacement of windows that were not initially defective but were damaged by the defective installation, then there is physical injury to tangible property.” In other words, under this scenario, the loss would constitute “property damage” within the meaning of the policy. Thus, the court concluded that the question of whether “property damage” had occurred depended on what was actually defective: the windows themselves or the installation.

(i) Defective Work as Property Damage

Generally, a Contractor’s own defective work cannot form the basis for a property damage claim under a standard CGL policy. Yet contractors have developed many arguments to try and establish that defective work constitutes property damage under a CGL. Three of the most common property damage arguments are discussed below.

(i) Diminution in Value

When an insured-contractor performs defective work, it decreases the value of the project as a whole. Although there is no coverage for the insured’s defective work alone, there might be coverage if the defective work is incorporated with the work of other contractors, even if the defective work does not cause physical damage to the project. For instance, in Eljer Manufacturing, Inc. v. Liberty Mutual Insurance Co., the Seventh Circuit held that incorporation of faulty pipes in homes constituted property damage even if the pipes were not yet leaking because the faulty workmanship decreased the value of the property. This is known as the incorporation doctrine.
However, not all courts follow the doctrine. Indeed, in a case involving similar facts the Illinois Supreme Court expressly rejected the Seventh’s Circuit’s finding that incorporation of defective work constituted property damage.\(^{47}\) The court held that property damage defined as physical damage to property only occurs when damage causes “an alteration in appearance, shape, color or other material dimension.”\(^{48}\)

Recent case law suggests that most courts have rejected the integration doctrine based upon revisions to the standard CGL forms released by Insurance Services Organization (ISO).\(^{49}\) Previously, property damage was defined as “injury to or destruction of tangible property.” Now, the most recent versions of the CGL define property damage as “physical injury to tangible property.”

(ii) Loss of Use

According to the CGL definition, property damage includes “loss of use of tangible property that is not physically injured.”\(^{50}\) In order to explain this form of property damage, the Seventh Circuit provided the following hypothetical:\(^{51}\) A crane manufacturer builds a defective crane and the crane collapses in front of a restaurant, blocking access to the restaurant without actually physically harming it. The restaurant loses business because people cannot access the business. This is loss of use of tangible property that is not physically injured.

In another notable case, *Anthem Electronics, Inc. v. Pacific Employers Ins. Co.*,\(^{52}\) the Ninth Circuit found property damage based upon loss of use of property. In *Anthem*, the insured was a manufacturer of defective circuit boards. The circuit boards were used by KLA in its manufacture of scanners. Later, when the defective circuit boards prevented the scanners from working, KLA asserted a claim against the insured,
including as damages its customer’s loss of use of the scanners. The insured then asserted a claim against its CGL policy. In finding property damage, the Ninth Circuit stated:

[The insured]’s defective boards clearly caused property damage to other property, as that term is defined in the policies. KLA’s customers lost the use of tangible property (their scanners) and as a result KLA suffered losses due to loaner scanners and diminished receivables. KLA itself lost the use of unshippable scanners sitting in inventory, and as a result incurred unexpected inventory costs. Though [the insured]’s boards were damaged, other parts of the scanner were not. This property damage meets the definition of “loss of use of tangible property that is not physically injured.”

The court held that the insurer had a duty to defend against KLA’s claims for: (1) depreciation expenses associated with the loaner scanners that it provided its customers; (2) inventory costs for scanners rendered unshippable; and (3) lost interest revenue as a result of KLA’s customer’s refusal to pay bills on time because of the defective scanners. Nowhere does the case suggest that either KLA or the insured sought defense or recovery for the cost to repair the scanners or the circuit boards.

(iii) Removal of Defective Work

Finally, there is the issue of whether property damage occurs when it is necessary to remove or replace other work that is connected to defective work in order to repair the defective work. While some courts have held that property damage under the CGL occurs if the work of other contractors is removed or destroyed, others courts disagree. For instance, in DeWitt Construction Inc. v. Charter Oak Fire Ins. Co., the Ninth Circuit found that the insured had alleged property damage.

In DeWitt, the insured was a subcontractor who contracted to drill and place concrete pilings. The insured’s faulty workmanship resulted in pilings that lacked the
necessary strength causing the insured to add additional pilings. The original holes and pilings were unusable and several problems ensued. Ultimately, the general contractor sued the insured and the insured submitted the claim to its CGL insurance company.

The insured asserted three categories of property damage: (1) damage to the site by impaling it with irremovable, defective pilings; (2) damage to the work of other subcontractors that had to be removed and reconstructed; and (3) damage to buried mechanical and site work. The court rejected the first category, but held that the latter two categories were property damage for the purpose of the CGL policy. Specifically, in regards to the second category, the court noted: “Opus had to hire a demolition subcontractor to tear out pile-caps that had been installed over the defective piles.”

In *Traveler’s Ins. Co. v. Eljer Manufacturing, Inc.*, the Illinois Supreme Court assumed a contrary position. In *Eljer*, the insured installed thousands of defective plumbing systems in residential homes. Approximately 60,000 claims were asserted against the insured, who in turn asserted claims against its CGL insurer. Some of the claims against the insured were based upon the diminution in value of the homes because the homes included defective plumbing, even though the pipes had not yet leaked.

The court rejected the incorporation doctrine and held that the diminution in value was not property damage. In addition, the court held that physical injury to the building in order to replace non-leaking systems was not property damage as defined under the CGL policy. Other courts similarly have refused to find property damage when repairing faulty workmanship requires the removal or destruction of work by other contractors.
ii. Occurrence

Even if bodily injury or property damage has happened, the insured can only recover if it was caused by an occurrence. According to CGL policy: “Occurrence means an accident, including continuous or repeated exposure to substantially the same general harmful condition.”

In the construction context, two issues often develop in relation to whether there is an occurrence. The first is whether faulty work constitutes an occurrence. The second issue deals with negligent or fraudulent representations. Generally, these representations are an occurrence; however, these cases present certain causation problems warranting discussion.

a. Faulty Work as an Occurrence

Courts are divided over whether faulty workmanship constitutes an occurrence for the purpose of a CGL policy. This issue develops because an occurrence is defined as an accident and accident denotes an unforeseen and unexpected event. Some courts have found that inadvertent faulty workmanship is an accident, and thus an occurrence. However, other courts have concluded that defective construction is not an accident, even if it causes property damage. For instance, in Oak Crest Construction Co. v. Austin Mutual Insurance Co., the court explicitly held that a subcontractor’s faulty workmanship in applying paint was not an occurrence. The court said that the subcontractor applied the paint intentionally not accidentally. Nevertheless, the insured argued that the accident was the unintended consequences when the paint pealed. The court responded by stating: “The policy requires that the property damage be caused by an accident not that the property damage itself be an accident.”
b. Occurrence Must Actually Cause Damage

A second issue develops when the alleged occurrence subjecting the insured to liability is a false representation by the insured. In this instance, the property damage must be caused by reliance upon the misrepresentation. Failure of the construction or the property damage to fulfill the expectations created by the misrepresentation is insufficient.

For instance, in *Hartford Accident & Indemnity Co. v. Olson Brothers, Inc.*, the insured was a roofing contractor that contracted to replace the roof on a factory. The insured suggested replacing the roof with tecum board and explicitly represented that the roof would withstand the heat and moisture associated with the factory. After the roof was complete, cracks developed in the roof because of the effect of the heat and moisture on the tecum board panels. The only damage was to the roof itself. When the owner asserted a claim against the insured, the insured filed a claim for recovery under its CGL policy. The insurer denied coverage.

According to the court in *Olson Brothers*, the clear language of the policy says that the occurrence must cause the property damage. And, in this case, the property damage “was not caused by the reliance upon the representations. It occurred in spite of such representations or reliance thereon.” Conversely, if the insured made a representation about the weight-bearing capacity of the panels and the owner, in reliance upon that representation, placed a load on the panels that ultimately collapsed causing damage to other property, this would be property damage caused by the occurrence.
iii. ISO Additional Insured Endorsement

One final issue relating to the insuring clause warrants discussion. Coverage A only provides indemnification for liability incurred by the insured. Often, in the construction setting, the insured that purchases the policy (named insured) will be required by contract to add coverage for another party on the project (additional insured). For example, the contract between the owner and general contractor will often require the general contractor to add the owner as an additional insured. The named insured adds this coverage by executing an additional insured endorsement to the CGL policy. This endorsement provides coverage in certain instances for the liability of the additional insured.

Previously, the additional insured endorsement typically provided coverage for the additional insured’s liability arising out of the named insured’s ongoing operations. Insurance companies have asserted that coverage for the additional insured was intended to be limited to the additional insured’s vicarious liability for the named insured’s negligent acts or omissions and was not intended to extend coverage to the additional insured’s sole negligence. Nevertheless, many courts interpreted “arising out of” broad enough to provide coverage for the additional insured’s sole negligence. As a result, the Insurance Services Office revised the additional insured endorsement in 2004. The new version of the additional insured endorsement attempts to exclude coverage for the additional insured’s sole negligence. The endorsement states:

Section II -- Who is an Insured, is amended to include as an additional insured the person(s) or organization(s) shown in the Schedule, but only with respect to liability for “bodily injury” caused, in whole or in part, by:

(a) Your acts or omissions; or
(b) The acts or omissions of those acting on your behalf;

in the performance of your ongoing operations for the additional insured(s) at the location(s) designated above.

According to the new endorsement, the additional insured’s liability is only covered if it is caused at least in part by the named insured’s negligence. Thus, no longer can the additional insured recover for liability based on their negligence alone.

Assuming this endorsement excludes coverage for the additional insured’s sole negligence, it creates some problems for contractors because the new endorsement might conflict with the contractor’s contract with the owner. For instance, the contract might require the contractor to acquire a CGL policy naming that owner as an additional insured and that provides coverage for the owner’s sole negligence. If so, and the contractor purchases a CGL policy containing the 2004 version of the additional insured endorsement, then the contractor would be in breach of contract. Alternatively, the contract might require the contractor to indemnify the owner for the owner’s sole negligence. This is problematic if the contractor can no longer obtain insurance coverage in the form of an additional insured endorsement that covers this particular risk.

2. Exclusions

The CGL policy includes several standard exceptions, any of which could potentially bar the insurer’s recovery from the insured. The following exclusions are often implicated in the construction context:

1. Exclusion (j): Damage to Property

2. Exclusion (k): Damage to Your Product

3. Exclusion (l): Damage to Your Work
4. Exclusion (m): Damage to Property Not Physically Injured

5. Exclusion (n): Recall of Products, Work, or Impaired Property

6. Endorsement: Professional Liability

This paper will primarily focus on item six, the endorsement excluding professional liability, since the significance of this exclusion will often vary depending on the project delivery system employed.

i. Endorsement Excluding Professional Liability

While the particular language of an endorsement excluding professional liability may vary, such an endorsement commonly states as follows:

The following exclusion is added to Paragraph 2, Exclusions of Section I - Coverage A -- Bodily Injury and Property Damage Liability and Paragraph 2, Exclusions of Section I -- Coverage B -- Personal and Advertising Injury Liability:

(1) This insurance does not apply to “bodily injury,” “property damage” or “personal and advertising injury” arising out of the rendering of or failure to render any professional services by you or on your behalf, but only with respect to either or both of the following operations:

(a) Providing engineering, architectural or surveying services to others in your capacity as an engineer, architect or surveyor; and

(b) Providing, or hiring independent professionals to provide engineering, architectural or surveying services in connection with construction work you perform.

(2) Subject to Paragraph 3, below, professional services include:

(a) Preparing, approving, or failing to prepare or approve maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; and
(b) Supervisory or inspection activities performed as part of any related architectural or engineering activities.

(3) Professional services do not include services within construction means, methods, techniques, sequences or procedures employed by you in connection with your operations in your capacity as a construction contractor.

Determining whether the professional liability exclusion applies will often be a question of fact dictated by the particular circumstances of the insured’s liability. Rather than focusing on the negligent party’s title or professional status, courts often focus whether the party was acting as a design professional. For example, in *Noyes Supervision, Inc. v. Canadian Indemnity Co.*, the representative of an oil and gas well supervision company was not providing professional services when the representative decided to proceed with a cement squeeze process in violation of company orders even though the representative was a consultant and a completion foreman.

In addition to endorsements excluding professional liability, some CGL policies contain a similar endorsement which excludes coverage for construction management services. One commonly used endorsement reads as follows:

This insurance does not apply to “bodily injury,” “property damage,” “personal injury” or “advertising injury” arising out of:

1. The preparing, approving, or failure to prepare or approve maps, drawings, opinions, reports, surveys, change orders, designs or specifications by any architect, engineer or surveyor performing services on a project on which you serve as construction manager, or

2. Inspection, supervision, quality control or engineering services done by or for you on a project on which you serve as a construction manager.

This exclusion does not apply to “bodily injury” or “property damage” due to construction or demolition work by you, your “employees” or your subcontractors.
Note that this exclusion does not apply to construction or demolition work performed by the named insured, its employees or subcontractors.\textsuperscript{71}

3. \textit{Policy Conditions: Cooperation and Timely Notice}

Generally, in order to trigger payment by the insurer, the insured must comply with the policy conditions. Indeed, CGL policies often obligate the insured to timely notify the insurer after an occurrence happens. For example, a condition may state: “You must see to it that we are notified as soon as practicable of an occurrence or an offence which may result in a claim. . . .”\textsuperscript{72}

In addition, the CGL policies often obligate the insured to cooperate with the insurer’s investigation and litigation of any suit asserted against the insured which is the basis for a claim. Indeed, this condition may state: “You and any other involved insured must . . . cooperate with us in the investigation and settlement of the claim or defense against the suit . . . .”

Many jurisdictions require an insurer to show prejudice before it may deny coverage based on untimely notice or failure to cooperate.\textsuperscript{73} Indeed, it has been held that an insured subcontractor’s delay in notifying the insurer of its claim was not a valid reason to deny coverage, when the delay did not prejudice the insurer.\textsuperscript{74} There is also authority, however, that the existence of prejudice will be irrelevant if the insured’s delay is unreasonably long as a matter of law.\textsuperscript{75}

\textit{B. Professional Liability Policy}

In addition to CGL coverage, most design professionals also carry professional liability insurance. The aforementioned CGL endorsements excluding professional
liability are generally upheld. Therefore, professional liability insurance policies are necessary to provide defense or indemnity for design professionals.\footnote{76}

These policies are sold on a claims-made basis. This means that a policy provides coverage for claims that are first made against the insured and reported to the underwriter during the policy period even if the event triggering the claim (i.e., breach of professional duty) occurred before the policy began.\footnote{77} Claims-made policies generally include a provision about the insured’s right to give notice. This allows an insured to give notice to the insurer of a potential claim even if such a claim has yet to be made.

The notice will trigger coverage if a claim is ever made even if it is made after the policy has expired. Furthermore, even if the policy does not have a right to give notice provision courts have held that a report by the insured triggers the policy. Although the notice provision appears to be strongly in favor of the insured, policies often require notice to be prompt or immediate and such requirements are generally harshly applied in favor of the insurer.

Most professional liability policies provide that expenses incurred in defending the insured will reduce the policy limits. Such a policy is often called an eroding limits, cannibalizing, or wasting policy.\footnote{78} It is important to be aware of this policy feature as it may drastically impact an insured’s overall legal strategy.

C. Design-Build & Design Assist

Design-build and design-assist project delivery methods pose unique insurance issues and have the potential to create gaps in insurance coverage. The fundamental problem with these delivery systems is that they involve a single entity performing both construction and design services—services which have historically been insured
As mentioned above, a typical CGL policy will usually include an exclusion for loss caused by professional design services. Thus, a CGL policy alone will be inadequate for a design-build entity that will undoubtedly provide professional design services. Similarly, a typical professional liability insurance policy will contain an exclusion for claims arising out of construction means and methods (construction services which are usually provided by the contractor). Since a design-build entity will inevitably provide construction means & methods services, a professional liability insurance policy alone will be inadequate. The same problems can arise in the context of a design-assist project delivery system. Accordingly, it is clear that the use of traditional commercial construction insurance policies in design-build and design-assist projects has the potential to create significant coverage gaps.

In an attempt to avoid such gaps, a design-build entity (or design-build team members) may purchase a CGL policy and a professional liability insurance policy. Yet even if both a CGL policy and a professional liability policy are purchased, litigation can arise over whether the loss was the result of design or construction services, and whether gaps in coverage continue to exist. This is especially true if the design-build entity purchases the policies from two different insurers.

Design-builders may want to ameliorate the risk associated with insuring their work by purchasing an all-inclusive “seamless” insurance policy that covers both design and construction services. This type of policy, however, may not be available from all insurers. Furthermore, since these types of policies are a relatively recent phenomenon, the provisions of such policies have not been the subject of much judicial interpretation.
Thus, the extent to which design-builders may rely on historical common law interpretations of CGL and professional liability policies may be limited.

**D. Construction Management at Risk**

The CM at Risk project delivery system poses insurance issues which are similar to those presented in the design-build context. As mentioned above, many CGL policies include an endorsement excluding construction management services. Thus, construction managers may not be covered by traditional forms of insurance. In such a situation, it would be prudent for a construction manager to obtain a professional construction manager’s errors and omissions policy. Of course this may again lead to litigation over the cause of the loss and which insurer is liable.

**E. Arbitration**

While many of the previously mentioned issues remain the same in arbitration, there is at least one insurance issue which is unique to arbitration. Under the 1973 Insurance Services Officer CGL policy, the insurer has the “right and duty to defend any suit against the insured seeking damages on account of . . . property.” Under this language, there is some dispute as to whether the insurer’s defense duties are triggered if the insured engages in arbitration rather than traditional litigation. The question is whether the word “suit” encompasses arbitration and other alternative dispute resolution methods.

The significance of this issue was substantially curtailed in 1986, when the ISO CGL policy was amended to define “suit” as including “any arbitration proceeding . . . to which [the insured] must submit.” Nevertheless, contractors should keep this potential limitation in mind, to the extent their CGL policy uses the 1973 language.
III. The Economic Loss Rule and Pleading Niceties

When a project goes south, a contractor’s mind rightfully turns to the prospect of economic recovery. In the uncertain business of construction, however, the right to recovery is neither simple nor guaranteed. The economic loss rule arguably contributes to this uncertainty. The economic loss rule generally states that should a party to a construction contract suffer damages solely to the contract property, they will not be permitted to sue and recover their economic losses on the basis of negligence or strict liability. Put succinctly, unless the party suffers personal injury or damage to other property, they can only sue for breach of contract. Similarly, third parties lacking contractual rights cannot depend—absent personal injury or damage to other property—upon theories of negligence or strict liability in recovering any economic losses. There are, however, a litany of exceptions to the economic loss rule, some of which are discussed below. Thus, counsel for contractor should carefully research the economic loss rule in the relevant jurisdiction and: (1) plead their client’s claim or defense so as to avoid application of the rule in the first instance; or (2) plead their client’s claim or defense so as to fit into one of the rule’s recognized exceptions.

The application of the economic loss rule can vary depending on the existence and content of a contract. In addition, different project delivery systems utilize different contractual relationship structures. Thus, the rule’s application may vary depending on the project delivery system involved. This section will talk about the economic loss issues that arise under various project delivery systems.

In a traditional design-bid-build project delivery system, the economic loss rule will place significant limitations on the ability of the parties to recover from others with
whom they are not in privity. For example, the contractor may not be able to pursue architects or engineers for delay damages or other impact costs resulting from such parties’ negligence. However, as mentioned above, numerous exceptions to the economic loss rule exist which parties may use to recover damages which may not be available under the relevant contract. In the context of the example above (i.e., a contractor suing a design professional for negligence), courts have generally adopted two exceptions to the economic loss doctrine. First, if a contractor’s economic loss damages are foreseeable to the design professional, then recovery may be allowed despite the lack of privity between the parties. In reality, such damages are often foreseeable since the design professional clearly knows that it is preparing the design documents for use by the contractor. Foreseeable damages may also arise out of the design professional’s supervisory duties.

Second, a contractor may be able to avoid the application of the economic loss rule if it sues the design professional for negligent misrepresentation. A negligent misrepresentation claim requires that the defendant “knew of or intended the plaintiff’s reliance” on the representation. Thus, the requirements under this exception are similar to those under the foreseeability exception. Again, this “reliance” element will often be satisfied, since design professionals almost always know (and often intend) that the contractor will rely on the design professional’s design documents and/or representations made during supervision or inspection of the contractor’s work.

Theoretically, exceptions to the economic loss rule can keep an owner out of litigation, as they allow contractors to go straight to the source of its damages: the design professional. As a practical matter, however, the contractor will almost always sue the
owner if it is going to sue the design professional. This is due in large part to the fact that the design professional may point the finger at the owner, alleging that the contractor’s damages resulted from the owner’s acts or omissions. It is in this way that exception to the economic loss rule may turn the owner and architect—two parties whose interests generally coalesce—against one another. Yet this finger-pointing may occur even if the contractor is not permitted to sue the design professional directly, and the owner is the only party who is directly involved in the lawsuit. In this situation, however, “the owner is more likely to be able to manage and maintain its relationship with the design professional . . .”

A. Design-Build

In the context of a design-build project, the significance of the economic loss rule to the contractor is reduced, as the contractor will often be in privity of contract with the design professional and—though it may be reluctant to sue its fellow design-build team member—may rely on the contract to recover against the design professional. Indeed, under this project delivery system it is the owner who often must worry about the implications of the economic loss rule. The rule may bar the owner’s recovery if, for example, the owner has contracted with a design-builder that is a separate legal entity formed by the contractor and the design professional. If the entity is undercapitalized, the owner may be left unable to satisfy a judgment granted against the entity. When the owner attempts to collect from the design-build team members that formed the entity, the economic loss rule may stand in its way, as the owner has no contract with the team members themselves.
The problem the economic loss rule poses for an owner on a design-build project was illustrated by *Kishwaukee Community Health Services Center v. Hospital Building & Equipment Company*. In *Kishwaukee*, the owner hired a contractor to design and build a hospital building. Acting as the design-build entity, the contractor subcontracted the design work to an architect. When the hospital began to show defects, the owner sued the contractor and the architect directly.

In interpreting Illinois case law on the economic loss rule, the court held that the rule prevented a plaintiff from suing a design professional in tort “if the plaintiff has an adequate contract or warranty remedy against [the] professional, and the professional’s services are product oriented . . . .” Thus, because “the architects’ design services [were] inextricably entwined with the builder’s construction services, that is, the plaintiff owner contracted with the builder and architect as one entity[,]” the owner could not maintain a tort claim against architect.

**B. Construction Management at Risk**

In the context of a CM at Risk delivery system, a contractor who wishes to sue a construction manager may face some of the same economic loss rule obstacles faced by a contractor suing a design professional in a design-bid-build context. Similarly, some courts faced with contractor versus construction manager claims have adopted exceptions to the economic loss rule which parallel the exceptions adopted for contractor versus design professional claims. Thus, a contractor will want to carefully plead its claim against a construction manager to try and fit within its jurisdiction’s exceptions.

For example, in *John Martin Co., Inv. v. Morse/Diesel, Inc.*, 819 S.W.2d 428 (1991), a subcontractor sued a construction manager for negligent misrepresentation.
The subcontractor alleged that the construction manager had been negligent in supervising the subcontractor’s work. The court found that the economic loss rule did not apply, stating that “a subcontractor, despite a lack of privity, may make [a negligent misrepresentation] claim against the construction manager based upon negligent misrepresentation, whether the negligence is in the form of direction or supervision.”

In addition to the construction-manager-specific negligent misrepresentation/supervision exception recognized in Morse/Diesel, a contractor may also be able to utilize other exceptions to the rule—which have been adopted in the context of contractor versus design professional claims—by analogy.

Not all courts, however, have recognized a “negligent supervision” exception to the economic loss rule. For example, in J. Kinson Cook of Georgia, Inc. v. Heery/Mitchell, a contractor sued a construction manager, asserting a claim of “negligence and breach of duty.” The contractor alleged that the construction manager had “breached its duties by failing to make clear and timely decisions, and making decisions that materially changed the scope of [the contractor]’s work under the terms of the [c]ontract, failing to process approved change orders, and failing to process pay requests submitted by [the contractor].” Accordingly, the court summarized the contractor’s claim as one for negligent supervision.

In determining whether the economic loss rule barred the contractor’s claim, the court noted that Georgia courts recognized negligent misrepresentation as an exception to the rule, but that no similar exception was available for a negligent supervision claim. Thus, the court concluded that the contractor’s failure to allege a negligent misrepresentation claim prevented it from falling within the rule’s exception, and its
negligent supervision claim was therefore barred. One wonders whether the plaintiff in *Heery/Mitchell* could have characterized its claim as negligent misrepresentation instead of negligent supervision, and, if so, whether the court would have accepted such a characterization.

**IV. Pass Through Claims & Liquidating Agreements**

The discussion of the economic loss rule above illustrates the importance of contractual privity in determining who may sue whom in a construction dispute. Yet this privity issue is not limited to disputes between owners, prime contractors, and design professionals. Indeed, subcontractors often wish to pursue claims against a party (e.g. an owner) with whom they are not in privity. Furthermore, the economic loss rule may prevent the subcontractor from suing the owner in tort. In such a situation, the subcontractor’s claim may be limited to its subcontract with the prime, even if the prime is not at fault for the subcontractor’s damages.

Given the inequity in limiting the subcontractor’s recovery to a claim against the Prime, it should come as no surprise that courts permit subcontractors to do indirectly what they cannot do directly—sue the owner for the harm it caused. Today, a subcontractor can recover from an owner by asserting its claim *through* the prime. Such claims are known as pass through claims (or sponsorship claims). Yet, the ability to pursue a pass through claim and the necessity of pursuing such a claim depend on the contractual relationships of the parties involved. Thus, the availability and necessity of pass through claims can vary as the project delivery system changes. This section will discuss various issues that arise with pass through claims under several different project delivery systems.
A. What is a Pass Through Claim?

The Texas Supreme Court has described a pass through claim as “a claim (1) by a party who has suffered damages (in this case the subcontractor); (2) against a responsible party with whom it has no contract (here, the city); and (3) presented through an intervening party (the contractor) who has a contractual relationship with both.” A pass through claim comes to fruition in one of two ways. First, the prime may prosecute the pass through claim on behalf of the subcontractor, often in conjunction with its own claims, by including the subcontractor’s harm in the prime’s measure of damages. Alternatively, the subcontractor may prosecute the pass through claim against the owner in the prime’s name.

Analytically, pass through claims are derived from the owner’s liability to the prime for harm caused to the subcontractor. That is, the subcontractor’s work is the prime’s work and, therefore, impacts to the subcontractor’s work are, in essence, impacts to the prime’s work. The United States Supreme Court has recognized that the prime has the “right to recover extra costs and services wrongfully demanded of the [Contractor] under the contract, regardless of whether such costs were incurred or such services were performed personally or through a subcontractor.” The prime’s right of recovery is based upon the fact that the prime is liable to the subcontractor for the harm caused by the owner under many circumstances. Thus, the owner’s acts or omissions actually injure the prime by subjecting it to liability to the subcontractor, thereby creating a cause of action for the prime – the pass through claim. Nevertheless, if the owner’s actions do not make both the owner liable to the prime and the prime liable to the subcontractor, then a pass through claim cannot be asserted.
B. The Widespread Acceptance of Pass Through Claims

Pass through claims have been asserted against the Federal Government, states, municipalities, and private individuals, and such claims are widely accepted in federal government contracting. Based upon federal common law, courts have long recognized the use of pass through claims by subcontractors to seek recovery from the Federal Government. Indeed, even the Federal Acquisition Regulations now implicitly recognize the pass through claim as a mechanism for subcontractors to obtain relief. Additionally, outside the federal contracting arena, pass through claims have been almost universally accepted based upon state law, although only 19 states have explicitly recognized them.

The widespread recognition of pass through claims is founded upon sound reasoning. First, and foremost, pass through claims promote equitable results by allowing subcontractors to seek damages from the party that caused the harm. Without a pass through claim, the owner stands to gain a windfall at the expense of the subcontractor. In addition, in cases where the prime cannot or does not implead the owner, the pass through claim prevents inconsistent results and promotes judicial efficiency by resolving two sets of claims in one lawsuit instead of two. Accordingly, the majority of jurisdictions recognize pass through agreements as an effective means of resolving construction disputes.

Nevertheless, the law governing the meaning and interpretation of agreements affecting pass through claims, as well as their enforceability, vary from jurisdiction to jurisdiction. For example, Connecticut has two cases limiting pass through claims in certain circumstances. In *Wexler Construction Co. v. Housing Authority of Norwich*,
the Connecticut Supreme Court refused the prime’s recovery on a pass through claim because the prime failed to prove it was liable to the subcontractor. The court emphasized that the subcontractor could assert a claim for implied contract directly against the owner. As a result, the court concluded that the policy rationale that provided the foundation for cases permitting the prime to claim the subcontractor’s harm without actually paying the subcontractor – guaranteeing that the prime had a legal basis for recovery – did not apply because the subcontractor had its own cause of action.

In a later case, the Connecticut Supreme Court held that the prime’s third party claim against the State seeking indemnification for the subcontractor’s harm was barred by sovereign immunity because the prime was denying liability to the subcontractor. The court explicitly stated that the prime could only recover for the subcontractor’s harm if it “admit[ed] liability to the subcontractor and incorporate[d] the subcontractor’s claim into its own.” Because a pass through claim is based upon the prime’s right of recovery against the owner, the court’s opinion suggests that the prime must admit liability to the Subcontractor before it can prosecute the pass through claim against the State of Connecticut. These cases exemplify the nuances in state law affecting pass through claims; one court even cited these cases for the assertion that Connecticut prohibits all pass through claims.

C. How Pass Through Claims Are Brought: The Pass Through Agreement

In order to prosecute a pass through claim, the prime and the subcontractor must come together and agree that the prime will pursue a claim against the owner “on behalf of” the subcontractor. Their accord is known as a “pass through agreement.” Every pass through agreement includes an understanding that either the prime will prosecute the
pass through claim on behalf of the subcontractor, or the subcontractor will prosecute the pass through claim in the prime’s name. Although a court may enforce an oral pass through agreement,\textsuperscript{138} commentators on the subject\textsuperscript{139} and sound legal judgment both recommend that the parties memorialize their arrangement in writing.

The prime and subcontractor can agree ahead of time, often in the subcontract, to permit the subcontractor to pass its claim against the owner through the prime.\textsuperscript{140} However, since the subcontract is formed long before litigation, any pass through provision that might be included in the subcontract itself tends to be general in nature and, thus, may not satisfy the parties’ true needs and motivations. As a result, once litigation becomes apparent, the prime and the subcontractor should consider entering into a separate pass through agreement, including a provision reiterating the parties’ intent to supersede any conflicting provision in the subcontract. Courts recognize that a pass through agreement may add or change the rights and obligations imposed by the original subcontract.\textsuperscript{141}

Often, the prime and the subcontractor will structure their pass through agreement in the form of a liquidating agreement. A liquidating agreement is a settlement agreement with three basic elements:

1. The imposition of liability upon the general contractor for the subcontractor’s increased costs, thereby providing the general contractor with a basis for legal action against the owner;

2. A liquidation of liability in the amount of the general contractor’s recovery against the owner; and,

3. A provision that provides for the “pass-through” of that recovery to the subcontractor.\textsuperscript{142}
Thus, a liquidating agreement essentially is a settlement agreement granting the prime a release of its liability to the subcontractor, but only after the prime prosecutes the pass through claim and passes through the recovery to the subcontractor. Although most liquidating agreements limit the prime’s liability to the subcontractor to the amount actually recovered from the owner, such agreements also may require the prime to make an additional cash payment to the subcontractor, or may leave open certain other specified claims between the prime and the subcontractor.

D. Motivations for Using a Pass Through Claim

The prime and the subcontractor have strong incentives to enter into a pass through agreement. The benefit to the subcontractor is apparent—without the prime, the subcontractor cannot pursue its claim against owner and must proceed against the prime.

Why, however, would the prime agree to allow the pass through claim? First, if the subcontractor and prime enter into a liquidation agreement, the prime minimizes and quantifies its liability which is always beneficial. Second, the pass through claim eliminates any chance that the prime will ultimately have to litigate two independent lawsuits (subcontractor vs. prime and prime vs. owner), thereby preventing inconsistent results. Third, if both the prime and the subcontractor have claims against the owner, they could decrease their overall litigation costs by working together by, e.g., sharing discovery costs and expert witness fees. Finally, the pass through claim allows the prime and the subcontractor to hold accountable the party who really caused the harm—the owner.
E. Limits on Pass Through Claims Imposed by the Severin Doctrine

The benefits of a pass through claim may not be available in all instances. Perhaps the most significant limitation on a Subcontractor’s ability to use a pass through claim is the “Severin doctrine,” a rule first articulated in Severin v. United States. According to the doctrine, the prime cannot obtain any recovery from the owner for the harm incurred by the subcontractor if either the subcontract, or a release, expressly negates the prime’s liability for the owner’s actions. The Severin doctrine is based upon the fact that the only way the Owner actually harms the prime is by exposing it to liability to the subcontractor. If, however, the subcontract or a release negates that liability, then the prime has no damages and cannot make out a legally cognizable breach of contract claim. In essence, the Severin doctrine is simply the concept of privity—the prime, as the party enforcing the owner’s contractual duty, must prove every element of that claim, including damages, which is impossible when the prime has no liability to the subcontractor for such damages.

The Severin doctrine is black letter law in claims against the Federal Government. Indeed, the Federal Government has waived sovereign immunity only for claims brought by parties in privity with it—that is, the prime. Therefore, only the prime can assert a claim against the Federal Government. Where the subcontractor cannot establish the prime’s liability, the prime lacks a legally sufficient claim under the Severin doctrine because it incurs no damage as a result of the damages incurred by its subcontractor. Thus, simply stated, the Federal Government has not waived sovereign immunity to allow a pass through claim in those circumstances where the Severin doctrine applies.
In pass through claims against owners other than the Federal Government, the Severin doctrine logically should apply because the concept of privity generally applies to all contracts. Indeed, parties have asserted the Severin doctrine defense to pass through claims prosecuted against both state governments and private owners. Nevertheless, at least one court has suggested that the Severin doctrine is based upon the Federal Government’s limited waiver of sovereign immunity and should not be applied outside that context.

F. Exceptions to the Severin Doctrine

Since 1943 when the United States Court of Claims decided Severin, the doctrine’s application has been severely limited by many courts in order to avoid the harsh results, namely, barring the subcontractor’s recovery for harm caused by the owner. In fact, the Court of Appeals for the Federal Circuit expressly admitted that the “application of the Severin doctrine has been narrowly construed.” Several well-defined exceptions have developed out of these cases.

First, at least in claims against the Federal Government, the Severin doctrine is an affirmative defense. Thus, the government carries the burden of proving that Severin applies. In addition, if the government fails to properly assert the Severin doctrine, it waives the defense.

Second, the Severin doctrine only bars claims brought for breach of contract. If the subcontractor is entitled to relief under the applicable contracts, such as equitable adjustment, then the Severin doctrine does not apply. This “exception” dramatically limits the doctrine because equitable adjustment is the most common type of construction
under Federal Government contract. However, some courts still apply the *Severin* doctrine to claims for equitable adjustment.

The last, and most important, exception to the *Severin* doctrine is the exclusion for a conditional release of liability. In order to successfully invoke the doctrine to defeat a pass through claim, the owner must prove that the subcontract, release, or other agreement provides an “iron-bound release” by the subcontractor of all claims by the subcontractor against the prime for actions of the owner. If the prime can be held liable to the subcontractor upon an occurrence of a certain event, then the prime’s release is not “iron-bound.” Based on that concept, the United States Court of Claims has refused to apply the *Severin* doctrine to those “situations wherein the prime contractor has agreed to reimburse its subcontractor for damages it has suffered at the hands of the Government, but only as and when the former receives payment for them from the Government.” Thus, so long as the prime’s liability is not released until the prime has turned over the subcontractor’s share of recovery from the pass through claim, the *Severin* doctrine will not apply, at least in the context of Federal Government contracting. Several other courts have followed the Court of Claims in recognizing the conditional liability exception in other contexts.

G. Drafting the Pass Through Agreement

1. Agreeing to Allow the Subcontractor to Pass Its Claim Against the Owner Through the Prime

First, and foremost, the prime and the subcontractor should memorialize *in writing* their intent to permit the subcontractor to pass its claim against the owner through the prime or, alternatively, their intent that the prime will prosecute the subcontractor’s claim. Absent a contractual obligation, created either in the subcontract or the pass
through agreement, the subcontractor has no right to pass through and must seek recovery from the prime. As a result, the subcontractor must either obtain the prime’s permission to prosecute the subcontractor’s claim in the prime’s name or obtain the prime’s agreement to pursue the subcontractor’s claims against the owner. A written pass through agreement evidences that permission.

The parties should exhibit care in expressing their desire to allow the pass through claim. In Owens-Corning Fiberglass Corp. v. United States,\textsuperscript{165} the court stated that most pass through agreements employ language stating that the prime prosecutes the pass through claim “for and on behalf of” the subcontractor.\textsuperscript{166} The court then noted that, \textit{inter alia}, language stating that the subcontractor would pursue the pass through claim “by and through” the prime created confusion relating to whether the subcontractor actually \textit{passed through} the prime,\textsuperscript{167} and if it did not, then lack of privity would have barred the claim.

According to Owens-Corning Fiberglass, the prime and the subcontractor should use the magic words “for and on behalf of” in their pass through agreement because this language unequivocally establishes their intent to allow the subcontractor to pass through the prime. In addition, for the purpose of clarity, the pass through agreement should explicitly state what claims pass through.

2. \textit{Dodging the Bar Created by the Severin Doctrine}

Next, the prime and the subcontractor must consider the \textit{Severin} doctrine. As discussed, the \textit{Severin} doctrine bars any recovery on the pass through claim.\textsuperscript{168} Therefore, the prime and the subcontractor must be careful to avoid inadvertently triggering the \textit{Severin} doctrine, especially when executing a settlement agreement
including a release of the prime’s liability to the subcontractor, such as a liquidating agreement.

However, before creating a pass through agreement, the prime and the subcontractor should ascertain whether the subcontract itself prohibits the prime from incurring any liability based upon the owner’s actions. The most common example is a “no damage for delay clause.” For instance, the subcontract might state: “The contactor or subcontractor shall not in any event be held responsible for any loss, damage, detention, or delay caused by the Owner . . . .” If so, the Severin doctrine bars any claim subject to this clause, and the prime and the subcontractor must circumvent the “no damage for delay clause” in order to prosecute the pass through claim.

Assuming the subcontract does not bar the pass through claim, the prime and the subcontractor can begin drafting the pass through agreement. The Severin doctrine causes problems in pass through agreements when the prime demands a release of its liability in consideration for allowing the subcontractor to pass through. As discussed above, the Severin doctrine bars the pass through claim whenever the subcontractor grants the prime a complete and total release. Instead, the prime and the subcontractor should enter into a liquidating agreement that makes the release contingent upon the prime’s pursuit of the Subcontractor’s claims. As the court in J.L. Simmons Co v. United States, noted, the liquidating agreement provides strong evidence that the prime is still liable to the subcontractor because, absent such liability, the prime and the subcontractor would have no reason to enumerate events that release a non-existent liability.
The following language was quoted in *J.L. Simmons Co. v. United States* and provides the most accepted form of liquidating agreement:

FOR THE CONSIDERATION AFORESAID, the undersigned hereby waives, releases and discharges any and all liens, claim or right of lien, which may be afforded the subcontractor by any state or federal law or otherwise, including but not limited to any lien against the above prescribed buildings and premises on which the same are located or against which any funds due or to become due [Prime] and any other claim or demand against [Prime] or its sureties, with the exception of its claim for losses because of engineering errors in design committed by the [Owner]. . . . *Either the disallowance of the undersigned’s claim by the court or the payment to the undersigned by [Prime] of the amount, if any, that may be recovered on said claim . . . shall completely extinguish all further obligation of [Prime] to the undersigned under the subcontract of . . . hereinbefore referred to, and shall operate as a full and complete release of any and all liability of [Prime] to the undersigned arising out of the performance by the undersigned of its work under said subcontract.*

The following provision also was effective in avoiding the *Severin* doctrine and, given its more direct language, is probably preferable to that noted above.

4 . . . . [Contractor] agrees to reimburse [Subcontractor] for damages or extra costs recovered from the Government but only as contemplated in the Subcontract and as provided for in this Agreement and, as a condition precedent to [Contractor’s] liability to [Subcontractor], only to the extent [Contractor] receives payment from the Government for [Subcontractor’s] Claim.

10 . . . . [Contractor] and [Subcontractor] stipulate that if the Government’s rejection of [Subcontractor] was improper, to the extent [Subcontractor] suffered damages and costs as a result, [Contractor] is liable to [Subcontractor] for its damages and costs but only as, when, and to the extent [Contractor] receives payment from the Government for [Subcontractor’s] damages and costs.

The *key* to every effective liquidating agreement is that the release of the prime’s liability becomes “operable only if and when the [prime] prosecutes [the pass through claim] against the [owner] to a final judgment.”
Although liquidating agreements that limit the prime’s liability to recovery from the owner, like the agreement in *J.L. Simmons Co.* are more common, the prime and the subcontractor should consider drafting a liquidating agreement more consistent with their specific needs and the facts of their case. For instance, the subcontractor may refuse to completely release the prime’s liability based upon the ability to prosecute the pass through claim alone. Instead, the subcontractor may negotiate a cash payment from the prime. The liquidating agreement should survive the *Severin* doctrine so long as the liquidating agreement only releases the prime’s liability after tender of the settlement amount and prosecution of the pass through claim. But, if the liquidating agreement explicitly caps the amount of the prime’s liability to the subcontractor, *i.e.* a lump sum settlement payment, the “cap” will also limit the amount that can be recovered from the owner on the pass through claim.

**H. Design-Build**

Just as in traditional design-bid-build construction, liquidating agreements may be utilized in the context of design-build. Indeed, a trade contractor may wish to pursue a pass through claim against the owner by entering into a liquidating agreement with the design-builder. Yet the significance of liquidating agreements may vary if the entity seeking to pursue a pass through claim is the design professional. In this situation, the necessity of a liquidating agreement will depend upon the structure of the design-build team.

If the design-builder is a contractor who has subcontracted with a design professional for design services, than the design professional may presumably enter into a liquidating agreement with the contractor and pursue a claim against the owner as any
other subcontractor. Of course the necessity of a liquidating agreement disappears if the
design-builder is an independent entity (e.g., a joint venture, or a LLC) in which the
contractor and design professional participate. In this circumstance, the owner’s contract
is with the design-build entity itself, and the condition which gives rise to the necessity of
liquidating agreements—lack of privity—is not present. The design professional may
cause the design-build entity to sue the owner under the design-build contract.

I. Construction Management At Risk

In the context of a CM at risk project, liquidating agreements may still be utilized
by subcontractors to pursue claims against the construction manager. Yet such
agreements will likely be of little utility to subcontractors who wish to pursue a claim
against the owner. This is because the prime contractor is not in contractual privity with
the owner. Thus, the subcontractor clearly may not remedy its own lack of privity by
asserting a claim which purports to pass through the prime contractor.

J. Arbitration

While the Severin doctrine and liquidating agreements are generally recognized
by courts, a subcontractor pursuing a claim against an owner vis-à-vis a liquidating
agreement may be barred from compelling arbitration in lieu of traditional litigation.
This may be a particularly poignant concern for cash-strapped subcontractors, who may
view arbitration as more efficient and less expensive than traditional litigation.

Indeed, this issue was recently illustrated by the Supreme Court of Rhode Island
in Board of Governors for Higher Education v. Infinity Construction Services, Inc.181 In
Infinity, the prime contract contained an arbitration clause, under which certain disputes
between the prime and the owner were subject to arbitration.182 The prime entered into a
liquidating agreement with the subcontractor in an attempt to allow the subcontractor to pursue a pass through claim against the owner.\(^{183}\) The subcontractor then sought to compel arbitration against the owner, pointing to the arbitration clause in the prime contract. The court began its analysis by citing the tried and true proposition that “[a]rbitration is a creature of contract and without a contractual agreement to arbitrate there can be no arbitration . . . [A]rbitration agreements should not be extended by implication.”\(^{184}\) Under such a rule, the court held, “the right to settle disputes by arbitration is not an assignable right.”\(^{185}\) Thus, the court held that the owner could not be compelled to arbitrate the subcontractor’s pass through claim.\(^{186}\)

\(^2\) Id.
\(^3\) See id.
\(^4\) Id.
\(^5\) Id.
\(^6\) 30 P.3d 221 (2001).
\(^7\) Id. at 222.
\(^8\) Id.
\(^9\) Id. at 223.
\(^10\) Id.
\(^11\) Id.
\(^12\) Id. at 224.
\(^13\) Id. (emphasis added).
\(^15\) Id. 224–25.
\(^16\) Id. at 225.
\(^17\) Id.
\(^18\) Id. at 225–26.
\(^20\) Id.

See generally BRUNER & O’CONNOR, supra note 1, at § 20:84.


See generally BRUNER & O’CONNOR, supra note 1, at § 20:84.


Mapco, 983 F.2d at 492.

Id. at 493.

Id.

Id. at 493–94.

MATHEW HOROWITZ et al., CGL/BUILDER’S RISK MONOGRAPH 13 (2004).

Id.

Id.

Id. at 11.

Id. at 26.

Id. at 15.

1996 ISO Occurrence Policy, § V, ¶ 3.

1996 ISO Occurrence Policy, § V, ¶ 15.

984 So.2d 1241 (2008).

Id. at 1243.

Id.

Id. at 1247.

Id.

Id.


972 F.2d 805 (7th Cir. 1992).


Id. at 496.


1996 ISO Occurrence Policy, § V, ¶ 15(b).


302 F.3d. 1049 (9th Cir. 2002).

Id. at 1057.

307 F.3d 1127 (9th Cir. 2002).

Id. at 1134. For additional cases finding property damage when the repair of defective work required the removal or destruction of work by another contractor, see Baugh Constr. Co. v. Mission Ins. Co., 836 F.2d 1164 (9th Cir. 1998); Wyo. Sawmills, Inc. v.

56 757 N.E.2d 481 (Ill. 2001).

Id. at 504.


59 1996 ISO Occurrence Policy, § V, ¶ 12.


63 Id. at 850.

64 187 Neb. 179, 188 N.W.2d 699 (1971).

65 Id. at 185, 188 N.W.2d at 702.

66 Id. at 185, 188 N.W.2d at 702–03.

67 Id. at 185, 188 N.W.2d at 703.


71 Id.

72 1996 ISO Occurrence Policy, § IV, ¶ 2.a.

73 See generally Charles C. Marvel, Annotation, Modern Status of Rules Requiring Liability Insurer to Show Prejudice to Escape Liability Because of Insured’s Failure or Delay in Giving Notice of Accident or Claim, or in Forwarding Suit Papers, 32 A.L.R. 4th 141 (1984).


77 Id.

78 Id. at 297.

79 See BRUNER & O’CONNOR, supra note 1, at § 12:94 (“The source of both great frustration and great risk to design-builders has been the failure of the insurance industry, until quite recently, to offer insurance products providing ‘seamless’ coverage for casualty and professional liability risks inherent in the design-build process.”)

80 Id.

81 Id.

82 See id.

83 See TURNER, supra note 70.

84 Id.

85 Id. at § 7:15 (alternation in original).

86 Id. (first alteration in original).

87 See BRUNER & O’CONNOR, supra note 1, at § 19:10.
88 ANTHONY L. MEAGHER & MICHAEL P. O’DAY, WHO IS GOING TO PAY FOR MY IMPACT? A CONTRACTOR’S ABILITY TO SUE THIRD PARTIES FOR PURELY ECONOMIC LOSS 2 (ABA Forum on the Construction Industry 2005)
89 Id. at 4–5.
90 See id. at 5.
91 Id.
92 Id. at 4–6.
93 Id. at 6.
94 See id.
95 Id. at 16.
96 Id.
97 Id. at 17.
98 Id.
99 See BRUNER & O’CONNER, supra note 1, at § 6:37.
100 Id.
101 See id. Of course the owner may be able to rely on veil-piercing doctrines in order to recover from the team members themselves.
102 638 F. Supp. 1492 (N.D. Ill. 1986), declined to follow on other grounds by Riggins v. Walter, 279 F.3d 422 (7th Cir. 1995).
103 Id. at 1494.
104 Id.
105 Id.
106 Id. at 1504.
107 Id.
108 See supra Section III(A) (Section discussing economic loss rule in the context of design-bid-build).
110 Id. at 429.
111 Marc M. Schneier, The Economic Loss Rule Applied to Negligence Claims Against Construction Managers—Does One Size Fit All?, CONSTRUCTION LITIGATION REPORTER, October 2008 (noting “Special Relationship,” “Functional Equivalent of Privity,” and “Duty Arising from Architect’s Control Over a Construction Project” exceptions to the economic loss rule in the context of contractor versus design professional claims; suggesting that such exceptions may be applied construction managers as well).
113 Id. at 445.
114 Id. at 446 (internal quotation marks omitted) (second alteration in original).
115 Id.
116 Id.
117 Id.
118 Interstate Contracting Corp. v. City of Dallas, 135 S.W.3d 605, 610 (Tex. 2004).
120 See Superior Gunite v. Mitzel, 12 Cal. Rptr. 3d 423, 427–28 (Cal. Ct. App. 2004) (affirming trial court’s decision that Subcontractor failed to prove right to pass through
when the prime contract prohibited monetary payment for delay); see also Severin v. United States, 99 Ct. Cl. 435 (1943).


123 Interstate Contracting Corp. v. City of Dallas, 135 S.W.3d 605, 607–08 (Tex. 2004).


126 48 C.F.R. § 44.203(c) (2004).

127 Interstate Contracting Corp. v. City of Dallas, 135 S.W.3d 605, 613 (Tex. 2004).

128 See id.

129 In these cases, the Subcontractor would have to sue the Prime, who would then bring a separate proceeding for breach of contract or indemnification. See id.

130 183 A.2d 262 (Conn. 1962).

131 Id. at 264–65.

132 Id.


135 Id.

136 Interstate Contracting Corp. v. City of Dallas, 135 S.W.3d 605, 614 n.6 (Tex. 2004).


143 See Bruner & O’Connor, supra note 1, at § 8.50.

144 Id. at § 8:51.


146 99 Ct. Cl. 435 (1943).


148 J.L. Simmons Co. v. United States, 304 F.2d 886, 887 (Ct. Cl. 1962).


151 See Dep’t of Transp. v. Claussen Paving Co., 273 S.E.2d 161, 164 (Ga. 1980) (barring pass through claim based case doctrinally similar to Severin).
See Cable Belt Conveyors, Inc. v. Alumina Partners of Jamaica, 717 F. Supp. 1021, 1024–25 (holding that Severin did not bar the claim because the liquidation agreement was not a complete release of the Prime’s liability).

Morrison Knudsen Corp. v. Fireman’s Fund Ins., 175 F.3d 1221, 1251 (10th Cir. 1999).

E.R. Mitchell Constr. Co. v. Danzig, 175 F.3d 1369, 1371 (Fed. Cir. 1999); Morrison Knudsen Corp. v. Fireman’s Fund Ins., 175 F.3d 1221, 1251 (10th Cir. 1999).

Danzig, 175 F.3d at 1371 (quoting United States v. Johnson Controls, Inc., 713 F.2d 1541, 1552 & n.8 (Fed. Cir. 1983)).

Metric Constructors v. United States, 314 F.3d 578, 582 (Fed. Cir. 2002); Danzig, 175 F.3d at 1370; Blout Bros. Constr. Co. v. United States, 346 F.2d 962, 964–65 (Ct. Cl. 1965).

Danzig, 175 F.3d at 1371.

Seger v. United States, 469 F.2d 292, 300 (Ct. Cl. 1972); Owens-Fiberglass Corp. v. United States, 419 F.2d 439, 457 (Ct. Cl. 1969); Blout Brothers, 348 F.2d at 474.


See Metric Constructors, 314 F.3d at 582 (applying Severin to equitable adjustment because parties agreed it applied); Department of Transportation v. Claussen Paving Co., 273 S.E.2d 161, 164 (Ga. 1980) (applying Severin like bar to equitable adjustment).

Cross Constr. Co. v. United States, 225 Ct. Cl. 616, 616 (1980); accord Metric Constructors, 314 F.3d at 584; Danzig, 175 F.3d at 1371.

See Metric Constructors, 314 F.3d at 583–84; Danzig, 175 F.3d at 1371; Cross Constr. Co., 225 Ct. Cl. at 616.

J.L. Simmons Co. v. United States, 304 F.2d 886, 889 (Ct. Cl. 1962).


Id. at 454.

Id.

See supra notes 146–153 and accompanying text.


The factual scenario of Severin involved a subcontract that completely absolved the prime from liability based on the owner’s actions. Severin v. United States, 99 Ct. Cl. 435 (1943).

See notes 146–153 and accompanying text.

See Calvert & Ingwalson, supra note 139, at 30 (stating that safest way to avoid Severin is by entering into a liquidating agreement).

J.L. Simmons Co. v. United States, 304 F.2d 886, 890 (Ct. Cl. 1962).

Id.

The case law consistently quotes the liquidating agreement in Simmons as an example of conditional liability that survives the Severin doctrine. See, e.g., W.G. Yates & Sons

176 J.L. Simmons Co., 304 F.2d at 887–88 (emphasis added).

177 W.G. Yates & Sons, 192 F.3d at 992.

178 J.L. Simmons Co., 304 F.2d at 890.

179 Id. at 887-88.


182 Id. at 1128.

183 Id.

184 Id. at 1129.

185 Id. at 1130.

186 Id.; see also Aetna Bridge Co. v. State Dept. of Transp., 795 A.2d 517 (2002).