CONSTRUCTION DEFECT RECOVERY ISSUES

SHAUNA MARTIN EHLERT, ESQUIRE
KARI L. HATLEN, ESQUIRE
MELANIE K. CURTICE, ESQUIRE
COZEN AND O'CONNOR
1201 Third Avenue
Seattle, Washington 98101
(206) 340-1000
sehlert@cozen.com
khatlen@cozen.com
mcurtice@cozen.com

Atlanta, GA
Charlotte, NC
Cherry Hill, NJ
Chicago, IL
Columbia, SC
Dallas, TX
Los Angeles, CA
New York, NY
Newark, NJ
Philadelphia, PA
San Diego, CA
Seattle, WA
W. Conshohocken, PA
Westmont, NJ

I.
INTRODUCTION

As soon as it is determined that there is coverage for your insured's property, the next inquiry is whether subrogation is possible for the loss. This paper will address the claims where it becomes clear there was some improper construction or construction defect that caused the loss.

II.
IDENTIFICATION OF POTENTIAL TARGETS

A. When a defect in construction is the proximate cause of the loss, there are several potentially responsible parties.

1. The architect - Are the plans and specifications deficient? Are they contrary to code? Are they contrary to the industry standard; for example, do the plans specify an inadequate amount of flashing around windows?

2. The general contractor - Did he misdirect any work? Did he perform some deficient work himself? Did he fail to supervise subcontractors sufficiently? Did he negligently hire a bad subcontractor?

3. The subcontractor(s) - Did they perform work that was contrary to plans and specifications given by the architect, the general contractor, the owner or that was contrary to code?

a. What are the terms of his contract with the general contractor? Does the contract say that the general will secure insurance, or that one or the other will indemnify the other?

4. The developer - Did the developer direct the faulty work? Did the developer have knowledge of the faulty work? Did the developer direct the work contrary to plans and specifications?

5. The financier - Did the financier direct the faulty work? Did the financier have direct oversight and/or sign off on the faulty work? Did the financier agree to faulty plans or specifications or have knowledge of them?

6. The supplier(s) of building materials? Were faulty or nonconforming materials supplied? If a supplier of building materials is a target defendant, an issue arises of whether the building component is considered a product. If the building component is considered a product, the claim would be governed by the Washington Product Liability Act (WPLA). Under the Act, a product has a 12-year presumptive "useful safe life."

III.
POTENTIAL ROADBLOCKS TO RECOVERY

Regardless of who is the target for subrogation and the issues that may arise when pursuing that individual, there are two main issues that may present obstacles. In Washington, there is no tort cause of action for negligent construction, Atherton Condo Ass'n v. Blume Dev. Co., 115 Wn.2d 506, 799 P.2d 250 (1990), so a subrogation suit must proceed under other negligence theories or a breach of contract theory (more often the latter). Id.; see also Stuart v. Coldwell Banker, 109 Wn.2d 406, 745 P.2d 1284 (1987). Whichever theory one is proceeding under, the statute of limitations for that type of action must be complied with. See RCW 4.16.080 (3 years for property damage based upon tort); RCW 4.16.040(l) (6 years for property damage based upon written contract).

There are two very common bars to subrogation in case involving construction defects. The first is the Statute of Repose, and the second is contractual provisions which prohibit subrogation - either subrogation waivers or indemnity clauses.

A. The Statute of Repose

1. What is it? A statute of repose limits potential liability to a certain period of time - typically for 6, 8, or 10 years - which begins to run at the date of substantial completion of the construction on some other defined date.

Under the WPLA, the statute of repose limits the time that a product seller is subject to liability to a 12-year "useful safe life" presumption.

a. The Legislature's purpose in adopting statutes of repose is to limit the time period within which claims may be brought in order to protect persons and entities from extended tort and contract liability.

2. Who does it protect?

a. In Washington, the statute of repose protects architects, contractors, engineers, surveyors and any person involved in the construction, alteration, repair, design, planning, survey, engineering, etc., of improvements upon real property against all claims arising after the 6-year limitation period. RCW 4.16.300-.310.

The statute of repose under WPLA is intended to protect product sellers, which includes manufacturers. RCW 7.72.060.

b. Examples of other states' statutes.

Alaska - The lesser of 8 years after substantial completion or last act causing injury. AS 09.10.055(a).

California - Patent defects: 4 years after substantial completion, but within 1 year if claim arises in 4th

year (note: this does not apply to personal residences). CCP 337.1. Latent defects: 10 years after substantial completion. CCP 337.15.

Oregon - 10 years after substantial completion or abandonment (note: any action against architects and engineers must be commenced within 2 years of the discovery of the injury to the property) ORS 12.135.

Montana - 10 years after completion but within 1 year after injury of claim arises in 10th year. MCA 27-2-208.

See also, Cozen and O'Connor Western Jurisdictions Comparative Chart Limitation of Time For Commencement of Action.

3. How it works.

There are two types of Statutes of Repose:

a. An Accrual Statute. Washington has an "accrual statute." The statute is triggered when substantial completion occurs. After that date, the event triggering potential liability must occur within the 6-year time limitation period. If this event occurs within the 6-year period, then the statute of limitations "clock" begins to run. For example, if the substantial completion occurs on Jan. 1, 1990 and the loss occurs on Jan. 1, 1995, you have three years from Jan. 1, 1995, to bring a tort action. Alternatively, if the event happens 6 years and 1 day past the date of "substantial completion," on Jan. 2, 1996, a claim cannot be brought.

b. An Absolute Statute. In Hawaii, for example, the loss and the suit must occur within 10 years after substantial completion. Using the above example, if substantial completion occurs on Jan. 1, 1990, and the event occurs on Dec. 25, 1999, the suit must be brought before Jan. 1, 2000, or the statute will apply and bar the claim.

4. What determines when the "event" occurs?

In some cases, such as where the loss is a fire or other sudden event, it is clear when the loss occurred, and therefore easy to calculate whether the loss occurred within the 6-year period. However, when the loss is due to gradual damage the analysis is more difficult.

Essentially, the issue is: how does the discovery rule interact with the Statute of Repose.

a. The "discovery rule" allows the statute of limitation to be tolled to the time when the plaintiff discovers, or in the exercise of due diligence, reasonably should have discovered the facts giving rise to the cause of action.

b. When the loss started gradually and within the 6-year period, the "discovered or reasonably should have discovered" date may be the date when "substantial injury" occurred - which may be before substantial completion or arguably after discovery of the problem prior to damage. See Pepper v. J.J. Welcome Const., 73 Wn. App. 523, 871 P.2d 601 (1996). This argument is based on the facts and circumstances of each case.

c. Examples would include: cases involving rot, dry rot, pollution, and water damage.

5. How can the statute be circumvented?

a. Argue the Statute doesn't apply.

1) The statute does not apply because the construction was not "an improvement to real property." An improvement upon real property for purposes of the statute of repose, is any betterment of a permanent nature which causes the realty to become more valuable. Pinneo v. Stevens Pass, Inc., 14 Wn. App. 848, 545 P.2d 1207 (1976).

a) In Washington, it is quite difficult to make the argument that the construction was not an improvement to real property because of the courts' broad and expansive view of what constitutes "improvements to real property" which is taken from the Pinneo case cited above. See also Washington Natural Gas Co. v. Tyee Const. Co., 26 Wn. App. 235, 611 P.2d 1378 (1980) (installation of power lines was an improvement to real property); Yakima Fruit & Cold Storage Co. v. Central Heating & Plumbing, Wn.2d 106, 503 P.2d 108 (1972) (installation of a refrigeration system in a warehouse by a tenant was an improvement to real property).

2) Argue about when time began running.

a) In some states, the law is that it starts running when a certificate of substantial completion has been filed for the building, which can sometime after the date of completion. In Hawaii, for example, if the certificate of substantial completion has not been filed or published, the date of substantial completion will be deemed to be one year after the date of completion. HRS 507-43. Therefore, if no certificate has been filed or published, the statute of repose would begin to run one year after the date of completion.

b) There may be an argument, factually, about the point at which substantial completion occurred. There may be a period of time between substantial completion of the building and the filing of a certificate of occupancy. Because the certificate of occupancy often represents the latest point at which substantial completion is deemed to occur, the date when the certificate of occupancy was filed is the latest date that should be used for purposes of the statute.

3) When the statute does not apply.

a) The statute only protects certain classes of persons. It does not bar all claims against any person "involved" in construction. If the builder is also the

seller of the property, a claim can be brought against the seller for activities relating to the sale of the property. Pfeiffer v. Bellingham, 112 Wn.2d 562, 567, 772 P.2d 1018 (1989).

b) A claim may be also brought against the manufacturer of a product that was used in the construction. Under WPLA, a claimant may bring a product liability claim against a "product seller." The term "product seller" includes a manufacturer. A "manufacturer" is one designs, produces, makes, fabricates, constructs, or remanufactures the product or component part of a product before its sale to a user or consumer. RCW 7.72.010.

Under WPLA, a "product" means any object possessing intrinsic value and produced for introduction into trade or commerce. RCW 7.72-010. A "relevant product" is that product or its component part or parts, which gave rise to the claim. Thus, to be a "product" under the WPLA definition, the product must be an "assembled whole" or a "component part or parts" that is "produced for the introduction into trade or commerce."

b. Arguing that there is an EXCEPTION to the Statute

1) When issues of intentional misrepresentation, fraud or concealment are involved, the statute of repose does not shield an individual from an action. See Pfeiffer v. Bellingham, as cited above.

2) In Nevada and California, **latent vs. patent** defects are treated differently. In California, for example, a latent deficiency is one which is not apparent by reasonable inspection and is subject to a 10 year statute of repose. Alternatively, a patent defect is one that is apparent by reasonable inspection and is subject to a 4 year statute of repose.

B. Contractual Waivers

1. Far and away, the most common contractual waivers are found in the American Institute of Architects (AIA) contracts. At this time, there are two versions of the AIA contract - 1976 and 1987, with a new 1997 version forthcoming. The waivers of subrogation and the indemnification agreements are difficult to get around. The 1976 waiver reads as follows:

> 11.3.6 The Owner and Contractor waive all rights against (1) each other and the Subcontractors, Sub-subcontractors, agents, and employees ... and (2) the Architect ... for damages caused by fire or other perils to the extent covered by insurance obtained pursuant to this Paragraph 11.3 or any other property insurance applicable to the Work....

a. If you have a claim involving the 1976 contract, it is important to determine whether the loss occurred during the course of the "work" or after the "work" was completed. In many jurisdictions, courts have determined that the waiver does not apply to property damage occurring after completion of the "work" or final payment. There is other language in the 1976 contract that supports this argument.

b. Alternatively, the 1987 version of the of the standard form AIA adds an additional provision attempting to waive subrogation rights in all property policies thereafter issued on the project, following completion of the work. The provision reads as follows:

> 11.3.5 If during the Project construction period the Owner insures properties, real or personal or both, adjoining or adjacent to the site by property insurance under policies separate from those insuring the Project, or if after final payment property insurance is to be provided on the completed Project through a policy or policies other than those insuring the Project during the construction period, the Owner shall waive all rights in accordance with [other terms] for damage caused by fire or other perils covered by this separate property insurance. All separate policies shall provide this waiver of subrogation by endorsement or otherwise.

Even though this language is included, case law still suggests that the waiver provision does not survive after the completion of the work. Additionally, other portions of the contract are negated if the waiver provision is construed to live on after the completion of construction. Accordingly, contract ambiguity would be a question of fact left to the jury.

c. Changes to look for in the fifteenth (1997) edition of the AIA contract. A comparison of the text of the 1997 and the 1987 A201 waiver of subrogation provisions shows they are substantially similar. However, the scope of the waiver may have nevertheless been expanded somewhat due to changes to the contract's property insurance provision and its definition of the term "work."

Under previous editions of the AIA contract, the "work" was defined as:

> 1.1.3 **The Work** The Work comprises the completed construction required by the Contract Documents and includes all labor necessary to produce such construction, and all materials and equipment incorporated or to be incorporated in such construction.

Under the new 1997 version, the "work" is defined as:

> 1.1.3 **The Work** The term 'Work' means the construction and services required by the Contract Documents, whether completed or partially completed, and includes all other labor, materials, equipment and services provided or to be provided by the Contractor to fulfill the Contractor's obligations. The Work may constitute the whole or part of the Project.

Accordingly, if the contractor's obligations under the contract include an obligation to preserve existing work, it is conceivable that the waiver of subrogation would extend to any damage caused by that general contractor to existing property since it bears a contractual

obligation to preserve such property. See Contractual Risk Transfers - Construction Contract , § XV11.H.11 (Feb. 1998).

d. Other ways that the waiver provisions can be inapplicable:

1) The contracting parties may have crossed out the provision before signing.

2) The contract may have some pages incorporated from a prior AIA version contract.

3) The parties may not raise the issue.

Therefore, it is important to check the contract to determine what issues may be involved. In practice, it is important to secure a copy of the contract that was signed by the parties as soon as possible.

2. Other Contractual Provisions.

Contracts that are not AIA contracts may still have provisions in them that purport to prohibit subrogation. The most common provisions are waiver of subrogation provisions and indemnity agreement provisions.

a. The law surrounding such provisions provides that one cannot contract to indemnify himself against his own negligence unless this is clearly and unequivocally spelled out in the contract. Northwest Airlines v. Hughe Air Corp., 37 Wn. App. 344, 679 P.2d 968 (1984). Such agreements must be clearly expressed and will be strictly construed and any doubts and ambiguities will be resolved in favor of the indemnitor. Id.

1) The language must be clearly drawn and the parties must stand on equal terms. See e.g , McCutcheon v. United Homes Corp., 79 Wn.2d 443, 486 P.2d 1093 (1971) (the waiver was held to be against public policy because the parties did not stand on equal terms and deprived the injured party of a remedy).

b. If subrogation rights are expressly waived and the waiver resulted from negotiation between the parties, Washington courts will uphold the waiver. See Touchet Valley Grain Growers, Inc. v. Opp & Seibold General Construction Inc., 119 Wn. 2d 334, 831 P.2d 724 (1992).

IV.
WHAT CAN INSURANCE ADJUSTERS DO TO EITHER MAKE A DECISION RE: PURSUIT OF A SUBROGATION CLAIM

A. Get Copies of Construction Contracts

1. Check to see if its an AIA contract

a. What version?

b. Are any provisions missing or crossed out?

c. Is the contract signed?

2. If a non-AIA contract:

a. Any waivers in it?

b. Do they state "clearly and unequivocally" that the performer of the work will be free absolved of responsibility for damages caused by his negligence?

B. Find out as much as possible about how the damage occurred and who may be responsible.

C. If a progressive damage issue (rot, water seepage, pollution), find out as much as possible about when the damage could have started. Hire an expert to evaluate this, if necessary.

D. Notify your subrogation counsel about the loss and get instruction.

PHILA1\1310709\1 099997.000