

Workshop W3

Wednesday, October 31, 9:00 a.m. – noon

COMPLETED OPERATIONS RISKS

Presented by



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The completed operations exposure raises numerous concerns for contractors. Common issues include identifying who can bring claims against the contractor, when the contractor's exposure ends, whether the exposure differs based on the type of construction, and how completed operations risks are transferred in a merger or acquisition. This session answers all of these and other questions and offers steps for minimizing and managing the completed operations exposure.

- Reviews the protections and limitations of statutes of limitations and statutes of repose.
- Outlines differences in completed operations exposures of different construction methods, such as design-build or construction management.
- Examines potential liability for completed operations when acquiring or merging with another firm.

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Gerald I. Katz
Senior Partner
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Mr. Katz is copresenting Workshop W3, "Completed Operations Risks," on Wednesday morning. He is a partner in the law firm of Katz & Stone, L.L.P., with offices in Vienna, Virginia, Washington, D.C., and Rockville, Maryland, and specializes in resolving complex construction disputes. He has extensive experience in representing owners, contractors, sureties, and designers in contract preparation and negotiation and complex construction litigation.

Mr. Katz received both a Bachelor of Arts with Distinction and a Juris Doctor degree from the University of Virginia. Mr. Katz is a member of the Bars of the District of Columbia, Virginia, Maryland, United States Supreme Court, and United States Court of Federal Claims. He also serves as an arbitrator on the American Arbitration Association's Construction Industry Arbitration Panel and is an Associate Member of The Chartered Institute of Arbitrators.

In addition to his practice, Mr. Katz lectures and speaks frequently to owners, contractors, public building officials, subcontractors, suppliers, design professionals, sureties, and others involved in construction, on such topics as design-build procurement, construction risk management, negotiating construction contracts, construction claims and claims prevention, design liability, and construction insurance issues.

Mr. Katz has spoken and presented seminars for such construction trade associations as Institute of Surveyors of Trinidad & Tobago; Urban Development Company of Trinidad & Tobago; Petroleum Company of Trinidad & Tobago; St. Lucia Ministry of Communication, Works, Transport and Public Utilities, Caribbean Electric Utilities Services Corporation; Construction Specifications Institute; Associated Builders and Contractors; National Electrical Contractors Association; National Utility Contractors Association; American Subcontractors Association; World of Concrete; National Pavement Exposition; Associated General Contractors of America; Virginia Building Material Association; Maryland General Contractors Association; Construction Management Association of America; National Association of Surety Bond Producers; Reliance Insurance; The St. Paul Companies; Bermuda Contractors Association; Institute of Bermuda Architects; American Contractors Insurance Group; Barbados Association of Quantity Surveyors; Korean Contract Management Association; and China National Petroleum Corporation.

Mr. Katz also is regular speaker for the annual Construction Risk Conference sponsored by International Risk Management Institute where he has spoken on contractual risk transfer, surety bonds, completed operations coverage, and other construction risk topics.

Notes

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COMPLETED OPERATIONS RISKS

*Gerald I. Katz
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COMPLETED OPERATIONS RISKS¹

I. INTRODUCTION

Construction projects are complex and risky undertakings. Given the many variables and parties who must work together for a project to be successful, it is not unusual for disputes and even litigation to develop over events that occur during performance such as delays, change orders, and other claims. However, “on time and on budget” is only half the distance to the finish line. *After* completion of even the most successful and smoothly-run construction project, potential areas of trouble and liability still lurk beneath the surface. If triggered, these risks can engulf unsuspecting construction professionals and their insurers who, in the meantime, have since turned their attention to more current and demanding projects. With each crack in the slab or leak in the roof that appears and with each latent defect that becomes apparent, a completed construction project has the potential to force contractors to spend significant time and money correcting problems in order to preclude even greater liability for completed work.

Given the above, there are recurring and important issues which relate to claims stemming from completed projects. These include, among other things, (1) whether the contractor has expressly or impliedly warranted the defective work; (2) whether the claim against the contractor is time-barred by virtue of a statute of limitation or statute of repose; and (3) whether the contractor has (and, if so, whether the damage is covered by) “completed operations” insurance. Finally, in situations where one construction company wants to purchase another company, one of the many considerations for the buyer is how to structure the purchase arrangement to limit its exposure for claims relating to the *seller’s* completed contracts.

These materials deal with these important completed operations risks. While often overlooked, it is vital that construction and risk management professionals understand and prepare for the many liability issues that arise when serious construction problems emerge on completed projects.

¹Eric B. Travers, an attorney at Katz & Stone, L.L.P., assisted in preparing this document.

II. WARRANTIES

A. Generally

Warranties are perhaps the most obvious continuing obligation a contractor has under which the contractor remains potentially liable for additional work on projects which have already been completed. The term “warranties,” however, encompasses not only written (contract) warranties, but implied warranties grounded in negligence, strict liability, and combinations of all the above. The way a particular warranty is interpreted depends heavily on the state law which applies to the warranty. This being so, warranties, perhaps more so than any other area of construction law, cannot be readily simplified to general rules which are applicable in all jurisdictions. For purposes of this article, unless otherwise specified, the term “warranty” refers to an express warranty against defects in finished construction work.²

B. Contractor’s Right to Cure Warranty Breaches

While a contractor or subcontractor may assume that in the event of a warranty claim, the party protected by the warranty must request that he, the original contractor, correct the warranty breach, under most standard form warranty clauses, the contractor would be wrong. Consider the following, typical warranty:

The Subcontractor warrants to the Owner, Architect and Contractor that materials and equipment furnished under this Sub-

²Courts often use “guaranty” and “warranty” interchangeably and, indeed, the two words are commonly used in commercial transactions as one and the same to connote what is more properly termed a “warranty.” *Blacks Law Dictionary* (6th ed. 1991) notes that the terms are “derived from the same root and are, in fact, etymologically the same word, the ‘g’ of the Norman French being interchangeable with the English ‘w.’” Despite these common origins and contemporary casual usage, strictly speaking, a “warranty” is an absolute undertaking or liability on the part of the warrantor while a “guaranty” is a collateral promise which binds the guarantor to be answerable for the failure or default of *another*.

contract will be of good quality and new unless otherwise required or permitted by the Subcontract Documents, that the Work of this Subcontract will be free from defects not inherent in the quality required or permitted, and that the Work will conform to the requirements of the Subcontract Documents. Work not conforming to these requirements, including substitutions not properly approved and authorized, may be considered defective. The Subcontractor's warranty excludes remedy for damage or defect caused by abuse, modifications not executed by the Subcontractor, improper or insufficient maintenance, improper operation, or normal wear and tear under normal usage. This warranty shall be in addition to and not in limitation of any other warranty or remedy required by law or by the Subcontract Documents.³

Under warranty provisions like the above, note that the warranty beneficiary (in the above case, the owner, architect, and/or contractor) is not required to (a) give notice to the subcontractor if the subcontractor's work is not conforming, or (b) give the subcontractor an opportunity to correct, or "cure," the nonconforming work. As such, the subcontractor may be liable for costs of correction paid to a third-party. In other words, an owner may, upon recognizing the defect/breach, retain an entirely different subcontractor to "fix" the work and demand that the original subcontractor reimburse the owner, under the terms of the warranty, for the costs of the fix. Even putting aside the rather distasteful prospect of having to directly pay a competitor to "correct" your work, if an owner looks to another to remedy your breach, the resulting cost to the subcontractor who gave the warranty is almost inevitably more in dollar terms than it would have been to correct the work with its own crew.

AIA Document A201, *General Conditions of the Contract for Construction*, provides an example of language which somewhat remedies the problem inherent in the typical warranty

provision. Article 12.2.2.1, "After Substantial Completion," for example, provides in part that:

[I]f ... any of the [Contractor's] Work is found to be not in accordance with the Contract Documents, the Contractor shall correct it promptly after receipt of written notice from the Owner to do so unless the Owner has previously given the Contractor a written acceptance of such condition. ... During the one-year period for correction of Work, if the Owner fails to notify the Contractor and give the Contractor an opportunity to make the correction, the Owner waives the rights to require correction by the Contractor and to make a claim for breach of warranty.⁴

Prudent contractors and subcontractors should insist that language similar to the above be inserted into the warranty clauses of their contracts. While it is possible to argue that an owner must give notice and an opportunity to cure to the original contractor before contracting with a third-party to correct nonconforming work, with proper drafting and attention to detail in the contract negotiation stage, a contractor can successfully abort any argument about this issue by explicitly requiring the owner to look to it first in the event a warranty repair is needed.

C. Post-Completion Warranties: Express and Implied

1. Express Warranties

In the construction field, many warranty repairs are required by express contractual warranties given by the party performing the work (the "warrantor") to the party who is contracting for the construction (the "warranty"). In this situation, where the construction professional ("contractor") warrants his own workmanship, the contractor is guaranteeing that he will provide a specific standard of performance, which is usually to perform ac-

³AIA Document A401 - 1997, *Standard Form of Agreement Between Contractor and Subcontractor*, Article 4.5.1.

⁴AIA Document A201 - 1997, *General Conditions of the Contract for Construction*, Article 12.2.2.1.

ording to the project’s drawings and specifications with the degree of skill, care and workmanship expected of the average contractor in the jurisdiction. If any defects arise that were caused by the contractor’s performance (as opposed, for example, to those caused by defective drawings or abuse), under such warranties, the contractor will be responsible for correcting the problems. For a contractor to be liable under a warranty (and thus required to perform warranty repairs) there must be (a) the existence of a warranty; (b) a defect, i.e., failure of the performance to comply with the warranty; (c) an injury, monetary or otherwise, which is proximately caused by the defect; and (d) damages. While a possible issue that may arise is whether there is any legal effect on the warranty due to the fact that the owner or tenant has accepted or occupied the building, most standard form contracts and warranties are written in such a fashion as to clearly establish that owner/tenant acceptance does *not* affect the warranty unless the damage arises out of owner misuse or negligence.

Because express warranties are contractual in nature, if the work is not as warranted there is a breach of warranty regardless of whether the contractor was negligent and, at minimum, the warrantor will usually be obligated to remedy the noncompliant work. It is important to understand the distinction between an express warranty of the *quality of materials or performance* and an express warranty that a specific *result* will be achieved by the contractor. The former is a typical warranty. The latter, however, is more properly described as a “performance specification” which some courts consider a contract term describing the scope of work and *not* an express warranty.

a. Warranting the work

Warranting one’s work is not the same as warranting that the result achieved by that work will be the result desired by the owner. The Court of Appeals in California addressed the issue regard-

ing the differences between warranting the work (that the work will conform to the plans and specifications) and warranting the end-product in a case which involved a subcontract for air-conditioning work at a twenty-two unit “co-op” apartment building.⁵ The plans and specifications for the work at issue were prepared by the owner’s architect and engineer. Those drawings, the trial court found, were “incorrectly and inadequately designed for the purpose for which [they were] intended, that is, the adequate cooling of said twenty-two unit apartment.”⁶ When the inadequacy of the system became apparent the plaintiff, an assignee of the owner, sued the subcontractor’s insurer (who had posted a bond on the project) for the costs to remedy the problems related to the inferior air conditioning system.

The plaintiff claimed that the subcontractor’s bond contained a warranty that the air conditioning system the subcontractor was to install would reach certain performance limits. The bond language relied on by the plaintiff stated that the air-conditioning “[s]ystem is to establish at least a 30 degree variation from outside temperature for cooling ...” The plaintiff also pointed to language in the air conditioning specifications to support its contention that the subcontractor had warranted the performance of the installed system. The specifications contained language that the “[c]ontractor shall guarantee that the equipment installed shall satisfactorily cool ... this building in accordance with standard design temperatures; if equipment installed does not do the job satisfactorily, Contractor shall remedy same.”⁷

⁵*Kurland v. United Pacific Insurance Company*, 251 Cal. App.2d 112 (1967).

⁶See *Kurland*, 251 Cal. App.2d at 115 (1967).

⁷*Id.* at 118.

The appeals court, however, noted that even if the guaranty in the project specifications constituted part of the subcontractor's contract "it must be kept in mind that, basically, his undertaking was to do the air conditioning work in accordance with the plans and specifications which he did not prepare."⁸ As such, the court construed the alleged guaranty/warranty *not* as a warranty by the subcontractor that the system as designed was adequate to produce the results desired by the owners but as a warranty that the subcontractor's work, pursuant to the design plans and specifications, "would be done as effectively as possible to achieve those desired results."⁹ Since the defects in the design (to which the subcontractor had to adhere) insured that the "desired results" could not be reached, the appeals court refused to read the subcontractor's warranty as constituting "a basis for a transfer to the subcontractor of responsibility for defective plans and specifications provided by the owners."¹⁰ Thus, the appeals court upheld the trial court's judgment that the defendant was not liable under the warranty to pay for damages incurred to remedy the problems that arose due to the inadequate air conditioning system design.

b. The *Spearin* doctrine and warranties

The so-called "*Spearin* doctrine" complements the general rule that a warranty of work is not the same as warranty of result in that the doctrine stands for the proposition that a contractor who follows plans and specifications furnished by the owner is not liable to the owner for any loss or damage which results if those plans

and specifications turn out to be defective or insufficient. Established by the United States Supreme Court in a landmark federal construction contracting case¹¹, the doctrine has since been adopted in virtually all states as applicable to private construction as well. Note, however, that the doctrine does not shield the contractor from liability where the contractor has acted negligently or expressly warranted that the resulting structure will perform as intended.

If a contractor does propose a change to correct an error or omission in the specifications, the contractor is not generally bound by the same standard of care as the architect or engineer who originally prepared the project plans and specifications. As a consequence, the contractor *usually* will not be held to have impliedly warranted that the change will serve its intended purpose. To be safe, however, contractors who propose changes in the work in response to problems with the specifications, or for value engineering purposes, should ensure that they do not unintentionally warrant that the change will serve the same purpose as the original architect's design. For example, if the change is proposed to save money only, then the contractor should clearly indicate to the owner that the change is solely a cost-saving measure and that he is making no promises regarding the ultimate performance of the changed work as compared to the originally anticipated work.

c. Warranting the result

If a contractor goes further than warranting his work and warrants the project *plans and specifications*, the contractor is guaranteeing that the drawings and specifications—i.e., the

⁸Id.

⁹Id. at 119.

¹⁰Id.

¹¹*United States v. Spearin*, 248 U.S. 132 (1918).

design—are sufficient to achieve the result intended by the owner. This situation occurs primarily in design-build work and in situations where the contractor guarantees that the constructed item will meet certain performance specifications. As such, a warranty which covers plans and specifications involves a degree of “assumption of the risk” by the contractor. In other words, in giving such a warranty the contractor is assuming the risk that if the project drawings are defective he will bear the cost to remedy the work to achieve the intended result. Moreover, the contractor will bear that cost notwithstanding the fact that his work may comply with the plans and specifications.

Thus, for example, had the subcontractor in *Kurland* (the California air conditioning case) warranted the sufficiency of the plans and specifications he clearly *would* have been responsible for installing an air conditioning system that achieved the intended cooling level. As noted earlier, however, typically a contractor only warrants the plans and specifications when he is also furnishing the *design* of the project as part of a design-build contract. In a design-build situation, then, it is the owner who is entitled to rely on the plans and specifications as sufficient for the purpose intended. This is the opposite of the situation in the more traditional lump sum contractual arrangement where the owner bears responsibility for design deficiencies in the plans created by its architect or engineer and the contractor only warrants that his work is in accordance with the plans and specifications.

D. Implied Warranties

In the construction field, “implied warranties” are warranty obligations that courts impose as a by-product of the mere fact that a construction contract exists. Courts impose such war-

ranties to ensure that a construction professional’s work achieves a minimum level of skill and care. These obligations exist outside any contract and irrespective of the parties’ intent. In general, the implied warranties take the form of (1) an implied warranty of workmanlike construction and (2) an implied warranty of habitability. Under either warranty, a construction professional essentially has a duty to exercise reasonable care to avoid foreseeable harm, both economic and physical, to the owner, and, perhaps, third-parties as well.

Given the above, the standard for proving a claim under an “implied warranty,” particularly the warranty of workmanlike construction, actually is more analogous to the standard needed to assert a negligence claim rather than a claim under a “true” (or contractual) warranty. This is so because liability under an implied warranty depends on the conduct of the implied warrantor (the construction professional) rather than the end-result. In other words, where the focus under a “true” warranty is whether the structure meets the expected warranty standard, the principal function of the implied warranty standard is to ensure that the warrantor made a “proper effort,” in conformity with the standards of his profession, to carry out his contract obligations. The end-result—whether the structure proves deficient in some area—is almost irrelevant for purposes of the implied warranties so long as the contractor made a “reasonable effort” to fulfill his duties.¹²

1. Who Can Claim the Benefit of Implied Warranties

Implied warranties are most often enforced in residential housing situations where the aggrieved party is a homeowner or tenant. Even condominium developers and builders can be held liable to individual tenants (and, sometimes, homeowners associations) for construction which violates the implied warranties of

¹²See e.g., William K. Jones, *Economic Losses Caused by Construction Deficiencies: The Competing Regimes of Contract and Tort*, 59 U. Cin. L. Rev. 1051, at 1059 (1991).

habitability and workmanlike construction.

In commercial buildings, however, the old *caveat emptor* (“buyer beware”) doctrine probably still applies. The historic rationale for restricting business entities to express warranties is basically that businesses are considered more sophisticated persons who have a better bargaining position than “mere” consumers. Given this superior bargaining position, courts will presume businesses are (a) better able to protect themselves when negotiating construction or lease agreements and (b) have the means to make repairs, if needed, and to recover damages from the liable party later.

2. Distinguishing the Implied Warranties

When discussing the implied warranties some courts reveal an inherent confusion over the distinct nature of the two implied warranties and whether the warranties are distinguishable. Some courts, for example, define the implied warranty of habitability so that it encompasses the warranty of workmanlike performance. These courts seem to meld the obligation to perform in a workmanlike manner with the warranty of habitability. The Oklahoma Court of Appeals suggested that the implied warranties were really a single warranty when it stated that the warranty of habitability warranted “that the home is or will be completed in a workmanlike manner and will be reasonably fit for occupancy as a place of abode.”¹³ In a similar vein, the Colorado Court of Appeals has stated that the implied warranty of habitability includes “the buyer’s right to a home that is built in workmanlike manner and [is] suitable for habitation.”¹⁴

A majority of courts, however, recognize the distinct identity of the two warranties

¹³*Lucas v. Canadian Valley Area Vocational Technical School*, 824 P.2d 1140, 1141 (Okla. Ct. App. 1992).

¹⁴*Roper v. Springlake Dev. Corp.*, 789 P.2d 483, 485 (Colo. Ct. App. 1990).

and the obligations that flow from each. The Florida District Court of Appeals, for example, has noted that a developer may be liable for breaching the warranties to: (a) construct in a workmanlike manner *or* (b) construct a habitable dwelling.¹⁵ In holding that peeling exterior paint is a breach of the implied warranty of workmanship, the Supreme Court of Iowa stated that “[i]n construction contracts there is an implied warranty that the building to be erected will be built in a reasonably good and workmanlike manner and that it will be reasonably fit for the intended purpose.”¹⁶ Given the foregoing, it is important to understand the scope of each implied warranty and the conceptual differences underlying each.

3. Implied Warranty of Habitability

The implied warranty of habitability is a widely-recognized but less expansive warranty than the implied warranty of workmanlike construction. In a nutshell, the habitability warranty requires that the defects in construction be of a magnitude to render the dwelling unsuitable for human habitation. As the name implies, the habitability warranty probably only attaches to structures in which persons actually live, i.e., houses, apartments, or condominiums. Part of the confusion some courts express when they indicate that the warranty of workmanship is a component of the habitability warranty is probably due to the fact that if a building has been so poorly constructed as to be uninhabitable it was likely constructed in a manner which also violates the implied warranty of good workmanship. The reverse, however, is not true: a house may not be constructed in a workmanlike fashion but can still be “habitable.”

The danger that is posed when courts mistakenly assume the workmanship warranty is subsumed within the bounds of the

¹⁵*See Schmeck v. Sea Oats Condominium Ass’n Inc.*, 441 So.2d 1092, 1097 (Fla. Dist. Ct. App. 1983).

¹⁶*Kirk v. Ridgway*, 373 N.W.2d 491, 493 (Iowa 1985).

habitability warranty, occurs where a plaintiff attempts to recover under the “subservient” warranty. The cases discussed below illustrate typical problems that arise when courts merge the implied warranty of habitability with the implied warranty of workmanlike construction.

4. Implied Warranty of Workmanlike Construction

The implied warranty of workmanlike construction provides an owner with an action against a contractor if the contractor’s work is not of good quality, free from defects, and in conformance with the contract documents. The warranty runs alongside of, and in addition to, express warranties. In fact, the warranty of workmanlike construction seems to have evolved, at least in part, due to judicial concerns regarding the short duration of express warranties and the difficulty of proving a negligence claim against contractors.

While the exact parameters of the implied warranty of workmanlike construction are somewhat amorphous, the Texas Court of Appeals has defined the warranty as guaranteeing that the construction will occur in “the manner in which an ordinarily prudent person engaged in similar work would have performed under similar circumstances.”¹⁷ The court then affirmed a decision holding that the implied warranty covers developers as well as builders. The court explained that by “imposing this warranty, we would only impose on the developer a duty to act as an ordinary and prudent developer would.”¹⁸

The Supreme Judicial Court of Maine succinctly defined both the implied warranty of habitability and the implied warranty of workmanship when it upheld a trial court’s finding that the defendant had breached the implied warranty of workmanship by constructing a leaky chim-

ney.¹⁹ While the defendant had argued that the existence of the leak did not constitute a breach of implied warranty of workmanship because it was not a major defect, the court stated that:

[Defendant’s] argument confuses the implied warranty of habitability, breach of which requires that the defect be of sufficient magnitude to render the dwelling unsuitable for habitation, and the implied warranty of workmanlike performance, which requires only that a house be constructed in a reasonably skillful and workmanlike manner. The test is one of reasonableness, not perfection, the standard being, ordinarily, the quality of work that would be done by a worker of average skill and intelligence. The trial court did not err in awarding damages for repair of the leak around the chimney. Such a defect is within the scope of the implied warranty of workmanship.²⁰

Courts have given a litany of policy reasons favoring expansion and enforcement of the implied warranty of workmanlike construction, including:

- Consumers rely on the skill of the builder and its implied representation that the building will be constructed with reasonable skill and suitable for its intended purpose.
- The builder is the only one who has knowledge of the manner in which the structure was built.
- In applying the implied warranties to service transactions, the Texas Supreme Court noted that “the public interest in protecting consumers from inferior services is paramount to any monetary damages imposed upon

¹⁷*Granbury Properties, Inc. v. Arnold*, 843 S.W.2d 108; 1992 Tex. Ct. App. LEXIS 2708, at *19 (1992) (citing *Miller v. Spencer*, 732 S.W.2d 758, 760 (Tex. Ct. App. 1987)).

¹⁸*Id.*

¹⁹See *Wimmer v. Down East Properties*, 406 A.2d 88; 1979 Me. LEXIS 735, (1979) (citing *Schiffers v. Cunningham Shepaerd Builders Co.*, 470 P.2d 593 (Colo. Ct. App. 1970)).

²⁰*Id.* at *12.

sellers who breach an implied warranty.”

- A service provider is in a much better position to prevent loss than a consumer.
- Service providers are better able to absorb the cost of damages associated with inferior services than individual consumers.
- Since many construction defects are latent and will not be readily apparent until after a period of time, implied warranties preclude the operation of short express warranties or enforcement of “*caveat emptor*,” let the buyer beware, by extending to the buyer a meaningful opportunity to “inspect the work” before acceptance.

The Texas Supreme Court recognized the distinction between the implied warranties when it held that the failure of a builder to perform in a workmanlike manner is actionable even if the habitability of the structure was not impaired.²¹ In that case, the plaintiffs, Jack and Mary Kay Evans bought a new home from contractor J. Stiles, Inc. When problems arose relating to the brick work on the Evans’ house, the Evans sued the contractor for breach of implied warranty and to recover damages arising out of J. Stiles’ use of faulty brick.

In the underlying trial, the jury found that the house was not constructed in a good workmanlike fashion but also found that the house was suitable for human habitation. The trial court then rendered judgment for the Evans against the builder for breaching the implied warranty of workmanlike construction. On appeal, the appellate court reversed the trial court’s ruling, holding that there could be a breach of implied warranty *only* if the house was found to be uninhabitable. The Texas Su-

preme Court, however, reversed the appeals court and reinstated the trial court’s judgment. In so doing, the court expressly found that “[t]he implied warranty of construction in a good workmanlike manner is independent of the implied warranty of habitability.”²² As such, the Texas Supreme Court held that “the trial court properly rendered judgment for the [Plaintiffs] based upon the jury’s finding that the house was not constructed in a good workmanlike manner.”²³

E. Who Is Bound by Warranties

1. The Privity Doctrine and Implied Warranties

While general contractors can virtually always be held to the implied warranties, a closer question exists in situations where it was a *subcontractor* who performed the work in an unworkmanlike fashion. In large part, if a subcontractor is sued by an owner, the subcontractor can claim immunity from the implied warranties under a “privity” theory. In other words, since there is no privity between the owner and subcontractor (i.e., the owner never directly contracted with the subcontractor), the subcontractor did not expressly or impliedly warrant anything to the owner. As the following cases reveal, however, the privity doctrine is not an ironclad defense and a subcontractor can still be held responsible under the implied warranties despite the absence of privity.

For example, while privity may shield a subcontractor from suit by an owner, the subcontractor can still be liable to the general contractor under the implied warranties if the general contractor is sued by the owner for faulty work. The Supreme Court of Washington, for example, dealt with this issue in a case where a homeowner sued a general contractor for damages which resulted, the trial court found, from the installation of insufficiently

²¹*Jack Evans v. J. Stiles, Inc.*, 689 S.W.2d 399; 1985 Tex. LEXIS 836 (Texas 1985).

²²*Id.* at *3.

²³*Id.*

large flue liners in a fireplace chimney.²⁴ In turn, the general contractor sued the masonry subcontractor alleging that the chimney work had been performed in a negligent and unworkmanlike manner. The court held that the owner could recover damages against the general contractor. The general contractor, in turn, was permitted to recover those damages from the masonry subcontractor for the masonry subcontractor's deviation from the implied warranty of workmanlike construction.²⁵ Thus, while the masonry subcontractor could not be directly sued by the owner, he was still obliged to complete his work in accordance with the implied warranties because any damages resulting from the subcontractor's breach of the warranties ultimately "came back" to him through the general contractor with whom the subcontractor *did* have privity.

Yet another way in which a subcontractor may be held liable under the implied warranties is through use of the "third-party beneficiary" theory. Under this theory, while the subcontractor may have directly contracted with the general contractor to do its work, the *real* beneficiary of the work is the owner who receives the finished product. As such, the theory holds that it is fair to expand the scope of the warranty to include and protect the actual persons who receive the benefit of the work, even when such persons are not direct parties to the contract under which the work was performed. The California Court of Appeals, for example, used the theory to resolve a case where an owner sued a roofing subcontractor for damages caused by water leaking through his roof.²⁶ The owner alleged that the subcontractor's work had been performed in an unworkmanlike manner. Although the trial court dismissed the case for lack of

privity between the owner and subcontractor, the California Appeals Court reversed and remanded on the grounds that the owner was a *third-party beneficiary* of the contract between the general contractor and subcontractor.²⁷ As such, the subcontractor assumed the general contractor's duties (including the implied warranties) toward the owner with respect to the subcontractor's work on the project.

2. The Privity Doctrine and Express Warranties

Because express warranties are contractual in nature, a question can arise as to whether the warranty is transferable to subsequent purchasers. In those situations, given the lack of privity between the subsequent purchaser and the warrantor, the warranty can be ineffective. However, if the warranty has been assigned or transferred to the subsequent purchaser, the privity requirement will likely cease to be a barrier to enforcing the warranty. While courts will look to the intent of the parties to determine whether the assignor intended to transfer his warranty rights to the assignee, without an express contractual assignment of warranty rights it is generally difficult for subsequent purchasers to enforce the express warranty given to the original purchaser. This is because, in the absence of such express assignment, the subsequent purchaser must prove that it was an intended third-party beneficiary of the express warranty between the original parties.

III. STATUTES OF LIMITATION AND STATUTES OF REPOSE

Statutes of limitation and statutes of repose limit the time frame in which a plaintiff may file a lawsuit against construction professionals who design and/or build construction projects. While statutes of limitation and statutes of repose both establish a maximum time limit during which a lawsuit must be brought against a construction professional,

²⁴*Pagliari v. Maples*, 452 P.2d 727 (Wash. 1969) (As a result of this defect, the fireplace at issue began to vent smoke into the house).

²⁵*Id.* at 581–82.

²⁶*Gilbert Financial Corp. v. Steelform Contracting Co.*, 82 Cal. App.3d 65 (1978).

²⁷*Id.* at *69.

they are substantially different with respect to when the “clock starts ticking” on each limitation period. Also, statutes of limitation run within statutes of repose and can, on occasion, act to lengthen the statute of repose. For example, Illinois has a ten-year statute of repose applicable to construction actions. Illinois law, though, specifically provides that “any person who discovers [an act or omission by a construction professional] prior to expiration of ten years from the time of such act or omission shall in no event have less than four years to bring an action against the defendant.”²⁸ Most states, however, view the statute of repose as being an absolute cut-off to the right to file suit, although a few may allow a plaintiff a modest amount of time to file suit after expiration of a statute of repose provided the injury was only discovered shortly before the repose period expired.²⁹

A. Statutes of Limitation

1. Limitations Statutes Generally

The theory underlying statutes of limitation is that courts should not enforce old claims. In other words, a statute of limitations determines whether an existing claim has become a stale claim and cannot be pursued further because a party has “slept on his rights.” Each state has its own separate statute of limitations and statute of repose which sets different time limits and “trigger” points which start the statutory clock. However, in function, a limitations period under a statute of limitations generally begin to run from the time the tort or breach of contract is (1) committed (i.e., the date of the (a) breach of contract or (b) tort) or, in some states, (2) discovered by the injured party (the “discovery” rule).

Under the latter, the so-called “discovery rule,” a construction professional is sub-

jected to litigation and liability for a potentially indefinite period of time after the construction is completed. For example, take the hypothetical situation where a contractor substantially completes a building on March 1, 2001. On January 1, 2011, for no apparent reason, the floor collapses causing property damage for which the building owner must expend a substantial sum of money to repair. In a state which adheres to the “discovery rule” and has a six (6)-year statute of limitations, the owner would have until January 1, 2017 in which to file suit against the contractor involved in the original construction (e.g., for breach of contract, negligent design, construction, etc.). If the owner in fact waited and filed suit just prior to the expiration of the statute of limitations, the contractor could potentially face judgment and have to pay damages for work on a construction contract completed sixteen (16) years prior to suit being filed. In discovery rule states, there is theoretically no connection between the time construction is completed and the injury, there is only a connection between the time of injury and time of suit. Thus, in the above example, if the owner had been injured in the same fashion by the same event on January 1, 2095, the statute of limitations would not expire until January 1, 2101, *one-hundred (100) years* after the builder completed the structure.³⁰

2. Statutes of Limitation and Warranties

Statutes of limitation can operate as defenses to warranty claims. A common defense to breach of express warranty claims is that the claim was not brought within the warranty period. Issues critical to the resolution of such disputes are (a) when the statute of limitations begins to

²⁸735 ILL. COMP. STAT. ANN. 5/13-214 (West 2000).

²⁹See e.g., WIS. STAT. ANN. § 893, 89(3)(b) (West 1999)(Wisconsin has a ten-year statute of repose. However, “[i]f ... a person sustains damage during the period beginning on the first day of the 8th year and ending on the last day of the 10th year after the substantial completion of the improvement to real property, the time for commencing the action for the damage is extended for three years after the date on which the damage occurred.”)

³⁰Of course, the plaintiff in a case involving a one-hundred year building would have some obvious problems tying fault to the original contractor for damages occurring so long after-the-fact. Notwithstanding this problem, however, if (1) the plaintiff *could* make-out such a case, (2) the state adhered to the discovery rule, and (3) the state had no statute of repose, then the one-hundred intervening years would not be a bar to suit.

run; (b) the effect of a statute of limitations on the warranty duration; and (c) whether a statute of limitations can be shortened or lengthened by agreement of the parties.

Many statutes of limitation begin to run upon discovery of the defect.³¹ Most warranty periods, in contrast, begin with “substantial completion” of the construction improvement. The Supreme Court of Oklahoma has held that an action for breach of express warranty is an action based in contract.³² Thus, the limitations period for bringing suit for breach of warranty was based on the statute of limitations for an action in contract, which was five years under Oklahoma law. The case before the Oklahoma Supreme Court originated as a plaintiff’s appeal of a lower court’s ruling that the plaintiff must bring an action based on an express warranty within the warranty period. Thus, since the express warranty in that case was one year and the plaintiff had brought suit more than one year after completion of the project, the lower court dismissed the suit. The Oklahoma Supreme Court, however, overturned the trial court’s decision, stating that “[c]ontrary to the arguments presented by [the defendant] to the trial court, although the warranty itself only covered a one year period, an action based on a breach of warranty occurring within that one year could properly be brought within five years of the breach.”³³

Another issue which frequently occurs is whether the parties to a contract may contractually lengthen or shorten a state’s statute of limitations. A majority of states

hold that so long as the contractually-agreed-to period is reasonable, parties may voluntarily *reduce* the period in which one party may sue after discovery of a defect. In contrast to the above, it is less clear whether parties may contractually *extend* a statute of limitations by agreeing to a longer express warranty.

The New York Court of Appeals has held that an agreement to extend the state’s statute of limitations, if it is adopted at the *inception* of a contract is unenforceable because such agreement is valid only if in writing and signed by the promisor *after* the accrual of a cause of action.³⁴ The Colorado Court of Appeals handled a similar question by reconciling the contract warranty period with the state statute of limitations.³⁵ In short, the Colorado court essentially held that the state statute of limitations ran *within* the longer warranty period agreed-to by the parties. In that case, the parties’ roof replacement contract contained a ten (10)-year warranty against cracks and leakage. Colorado’s construction statute of limitations, on the other hand, required that claims be brought within two (2) years of “accrual.” Thus, although the roof began leaking (and the claim accrued) within the ten-year warranty period, the court barred the plaintiff’s claim because the plaintiff waited longer than two years after discovering the defects (the roof was leaking) to file suit for breach of warranty. The court held this even though the plaintiff brought suit within the repose period which required that claims be filed within ten years of substantial completion of the original contract.

Later, the same court (in a different case) affirmed its earlier decision, but noted that it had not, and still was not, deciding “whether the parties to a construction contract may agree to extend the [statute

³¹In applying the statute of limitation to a construction dispute, for example, a warranty claim, it is vital to know whether the jurisdiction whose law controls follows the “discovery” rule or views the relevant statute of limitation as starting when the breach occurred. The difference can be significant.

³²*Mounts v. Parker*, 727 P.2d 594; 1986 Okla. LEXIS 187 (citing *Putzler v. Hill*, 244 p. 1113 (Okla. 1926)).

³³*Id.* at *4 (citing *Au v. Au*, 626 P.2d 173 (1983)).

³⁴See *John J. Kassner & Co. v. New York*, 389 N.E.2d 99 (Ct. App. N.Y. 1979).

³⁵See *Mohawk Green Apartments v. Kramer*, 709 P.2d 955 (Colo. App. 1985).

of limitations].”³⁶ Similarly, the court cautioned that it was not deciding the issue of “whether an express warranty for a period longer than the contractor’s statute’s six-year period of repose can have the effect of extending that period.”³⁷ As a general rule, building professionals need to keep in mind that to the extent a state’s statute of limitations or statute of repose is shorter than an express warranty, the express warranty may be unenforceable unless the aggrieved party brings suit within the time frames set forth by the statute.

B. Statutes of Repose

1. Statutes of Repose Generally

Unlike statutes of limitations, statutes of repose set an absolute outside limit in which suit can be brought by preventing a cause of action from arising more than a specified period of time after the work is completed. In this way, statutes of repose set a definite date for the end of liability exposure because, in theory, nothing tolls the limitation period. Where the operative event which begins the statute of limitations is the date of breach or negligence (or, in some jurisdictions, discovery of the injury), the operative date for a statute of repose is the date of substantial completion of the construction project. Claims filed after the statute of repose has run will be precluded even if they are filed immediately following the injury.

Statutes of repose evolved as a legislative response to concerns about the fairness and equity of subjecting construction professionals (designers and contractors) to the economic and emotional burdens of litigation long after the work has been completed. Construction improvements to real property, after all, have lengthy useful lives, and are used, changed, and affected by many people, forces, and things after completion. The passage of time, the

nature of intervening causes (e.g., owner alteration, improper maintenance, etc.) and the difficulty of establishing a causal connection between the alleged breach or negligence of the building professional and the plaintiff’s injury are all factors which legislatures have considered as justifying the need for construction statutes of repose.

The practical difference between a statute of limitations and a statute of repose can be illustrated by returning to the previous hypothetical involving the collapse of a floor on January 1, 2011. In that scenario, in a “discovery rule” jurisdiction the 6-year statute of limitations provided the injured plaintiff (the owner) with six years after the date of injury (i.e., until January 1, 2017) to file a lawsuit against the contractor. However, if the state had an 8-year statute of repose for improvements to real property, this plaintiff would have *no cause of action* against the building professional as the collapse occurred on January 1, 2011, more than eight (8) years after substantial completion of the project (which occurred on March 1, 2001).

Note, however, that while statutes of repose preclude an injured party from recovering damages from the building professionals originally involved in construction of the structure where the injury occurred, this does not mean that the injured party necessarily has no remedy to recover her damages. The owner and/or tenant, for example, might be liable for maintaining dangerous conditions on the premises or property under their control. Thus, to return once again to the previous hypothetical, if a person had been physically injured as a result of the floor collapse, while she could not recover from the building contractor, she might recover damages for her injuries from the owner of the building.

a. Statutes of repose for contract actions, tort actions, or both

The majority of states have a general statute of limitations for contract and

³⁶*Highline Village Associates v. Hersh Companies, Inc.*, 996 P.2d 250; 1999 Colo. Ct. App. LEXIS 277, at *11.

³⁷*Id.*

tort actions and specific statutes of repose governing construction claims. For example, only Kansas, New York, and Vermont have no special statutes of repose for the construction industry. Since virtually every state has its own statute and limitations period, the scope of each varies from very specific and narrow to very general and broad in coverage. As a result, construction professionals should understand the limits and extent of the statute in the jurisdiction(s) in which they work and consult with an attorney if they have a question as to liability for defects for projects long-completed. In addition, an important distinction to understand is whether the state's statute of repose will apply to a contract action, a tort action, or both.

b. Distinction between contract and tort claims

i. Generally

The major legal difference between an action in contract and an action in tort is “privity”—a direct relationship—between the parties. In a contract claim, for example, the contract itself provides the grounds for the underlying suit based on a direct contractual relationship between the parties. Thus, defective construction can lead to actions for breach of contract, including claims for breach of an express warranty, as well as monetary damages such as contribution and indemnity. In a tort action, however, the duty breached is one imposed by general law. Thus, tort actions against a construction professional are usually limited to suits for injury, damage, or loss to personal or real property or for personal injury or wrongful death.

For example, if a partially-completed structure collapses, caus-

ing damage to a neighboring building, and the owner of the damaged *neighboring* building wants to sue the contractor who was building the collapsed structure he must do so in an action in tort. This is because that owner has no direct contractual relationship with the contractor. He can, however, allege a tort by showing that (1) the contractor owed him a duty of care not to construct a building that might collapse and foreseeably cause damage to neighboring land; (2) the contractor breached that duty; and (3) actual damage was caused. In contrast, the owner of the collapsed building can sue the contractor for damages based on *contract*. In this latter situation, the owner has a contract on which to sue (breach of contract), including express and implied warranties, and actual damage (his building collapsed). Thus, the same underlying event can lead to both contract and tort claims against the contractor.

ii. The “economic loss” rule as a limit on tort recovery

The “economic loss” rule is followed by the vast majority of states and provides that one may not recover “economic” losses for suits arising out of non-intentional torts. Put another way, while a party can recover economic damages in a suit based in contract, such damages are not recoverable in a suit grounded in negligence unless that party has suffered *physical* property damage or bodily injury.³⁸ Economic loss is defined as:

Damages for inadequate value, costs of repair and re-

³⁸*Sandarac Ass'n v. W.R. Frizzell Architects, Inc.*, 609 So.2d 1349, 1352 (Fla. Dist. Ct. App. 1992).

placement of defective product, or consequent loss of profits—without any claim of personal injury or damage to other property ... as well as “the diminution in the value of the product because it is inferior in quality and does not work for the general purposes for which it was manufactured and sold.”³⁹

The Utah Court of Appeals applied the economic loss rule to defeat a claim against a builder for construction of a home which developed water leaks.⁴⁰ In that case, a builder sold a home to a buyer. In turn, the buyer resold the home to a second buyer. After water began leaking into the house, the second buyer sued the home builder for negligent design and construction. The Utah Court of Appeals upheld the trial court’s grant of summary judgment for the builder, noting the “intrinsic difference between tort and contract law” and concluding that recovery for deficiencies in the quality of construction “must be defined by reference to that which the parties have agreed upon.”⁴¹ Since the second home owner had no contract with the builder, he could not recover economic damages relating to the water leaks when such damages were asserted solely in negligence.

In a later case, the Utah Supreme Court expressly rejected the ar-

gument of a homeowners association that applying the economic loss rule in construction cases rewards builders who construct defective housing and wrongly focuses on the consequences of the defective activity instead of the activity itself.⁴² The court described the policy rationale for applying the rule in construction cases by explaining that:

Builders who construct low quality housing that does not cause injury to persons or property may still be held liable for damages, but that liability should be defined by the contract between the parties. The law of torts imposes no standards on the parties’ performance of the contract; the only standards are those agreed upon by the parties. Tort law is concerned only with the safety of a product or action. Otherwise, the extension of tort law would result in liability in an indeterminate amount for an indeterminate time to an indeterminate class.

These rationales are particularly applicable to claims of negligent construction. Construction projects are characterized by detailed and comprehensive contracts that form the foundation of the industry’s operations. ... For example, a developer can contract for low-grade materials that meet only minimum requirements of the building code. When the developer sells those units, a buyer should not be able to turn around and sue the

³⁹2314 *Lincoln Park W. Condominium v. Mann, Gin, Ebel & Frazier, Ltd.*, 555 N.E.2d 346, 348 (Ill. 1990) (other citations omitted).

⁴⁰*Maack v. Resource Design & Construction, Inc.*, 875 P.2d 570 (Utah Ct. App. 1994).

⁴¹*Id.* at 580 (quoting *Crowder v. Vandendale*, 564 S.W.2d 879, 882 (Mo. 1978)).

⁴²*American Towers Owners Association v. CCI Mechanical, Inc. et al*, 930 P.2d 1182, 1996 Utah LEXIS 109 (Utah 1996).

builder for the poor quality of construction. Presumably the buyer received what he paid for or he can bring a contract claim against his seller. Meanwhile, if the developer has a problem with the builder, he too will have a contract remedy. A buyer can avoid economic loss resulting from defective construction by obtaining a thorough inspection of the property prior to purchase and then by either obtaining insurance or by negotiating a warranty or reduction in price to reflect the risk of any hidden defects.⁴³

Thus, the Utah Supreme Court refused to allow the plaintiff to recover on its negligence claim against the builder and affirmed the district court's grant of summary judgment for the defendants. Note, however, that operation of the economic loss rule does not relieve a contractor of responsibility for defective work if there is a contract between the parties or if the claim is brought under express or implied warranties or on unjust enrichment grounds.⁴⁴

c. Different state statutes, different scopes of coverage

Whether a particular claim, contract or tort, is barred by a statute of repose is, obviously, dependant on the stat-

ute at issue. Different states have opted, for one reason or another, to cover either both tort and contract claims or only one kind. Given the restrictive or expansive statutes, a claim that may be viable in one state may well be precluded in another.

For example, the Virginia statute of repose, which precludes actions brought more than five (5) years after substantial completion of contract performance, is expressly limited to actions "for injury to property, real or personal, or for bodily injury or wrongful death."⁴⁵ In other words, the Virginia statute only applies to tort actions.

In contrast to Virginia, the Texas statute of repose (which precludes actions brought more than ten (10) years after substantial completion of contract performance) applies to both tort and contract actions.⁴⁶ The Texas Court of Appeals looked to the language of the statute itself, as well as the statute's legislative history in determining that the legislature intended to preclude both contract and tort actions against construction professionals more than ten years after substantial completion of the project.⁴⁷ The court expressly found it important that "the *only* limitation in both statutes of repose is that the action arise out of a defective or unsafe condition of the real property."⁴⁸ Accordingly, the Texas appeals court expressly held that Texas' repose statutes applied to both tort and contract actions.

⁴³*Id.* at *25-27(internal citations and quotations omitted).

⁴⁴As a matter of fact, in the *American Towers* case, the plaintiff's homeowners association did assert, in addition to the negligence claim, claims against the builder for breach of contract, breach of express warranty, breach of the implied warranty of habitability, and unjust enrichment. The Utah Supreme Court, however, found fatal flaws in each and every claim and dismissed the entire suit.

⁴⁵VA. CODE ANN. § 12-522 (Michie 2000).

⁴⁶TEX. CIV. PRAC. & REM. §§ 1608, 1609 (West 2000).

⁴⁷*Dallas Market Center Development Co. v. Beran and Shelmire, et al.*, 824 S.W.2d 218, 1991 Tex. App. LEXIS 3272 (Tex. App. 1991).

⁴⁸*Id.* at *9 (emphasis added).

Arizona applies yet another variation to the application of time limitations to the filing of construction claims. The Arizona statute of repose reads that “no action or arbitration *based in contract* may be instituted or maintained against [building professionals] more than eight [8] years after substantial completion of improvement to real property.”⁴⁹ The Arizona statute was expressly limited to contract actions to bring the statute into compliance with the Arizona state constitution, which prohibits tort claims from being abolished before any injury occurred.

As the above demonstrates, construction professionals need to be aware of the respective lengths of their state’s statutes of limitation and repose as those statutes directly bear on the validity of any action brought after completion of the project.

C. Tolling the Statutes

What, if anything, “tolls” a statute of limitations or repose is an issue which frequently occurs. As a general rule, most courts are receptive to the argument that a statute of limitations is tolled during the time the contractor endeavors to make repairs to enable his work to comply with a warranty. The general receptiveness of courts to tolling a statute of limitations during repair periods is essentially based on the policy concern that to hold otherwise would encourage lawsuits that may be unnecessary because of the parties’ ongoing attempts to resolve the problem without resorting to the courts.

1. Tolling a Statute of Limitations

The Court of Appeals of North Carolina addressed the issue regarding whether a plaintiff’s breach of warranty claim for defective waterproofing work was barred by the state’s three-year statute of limita-

tions.⁵⁰ At issue before the court was a five (5)-year express warranty given by a waterproofing contractor (“defendant”) to the Haywood Street Development Corporation (“plaintiff”). The defendant began the waterproofing in 1987. Almost immediately after beginning its work problems surfaced as water began leaking into the plaintiff’s apartment building. The defendant attempted to repair the leaks until, on November 30, 1990, it sent the plaintiff a letter indicating that it would make no further repairs until it was paid for its past work. The plaintiff rejected the defendant’s offer and filed suit on a number of theories, including breach of the implied and express warranties. The trial court, however, dismissed the plaintiff’s lawsuit on the grounds that the claim was barred by North Carolina’s three-year statute of limitations since the defective condition arose in 1987 and suit was not filed until 1992, five years later.

The Court of Appeals, however, overturned the trial court’s decision as it pertained to plaintiff’s express warranty claims and stated two grounds for doing so: first, the court noted that the warranty given was a “prospective warranty” in that it guaranteed the *future performance* of the waterproofing for a stated period of time. The court held that since the warranty guaranteed the waterproofing would be free of defects for five years “each day the waterproofing was not free of defects, there was a new breach of the agreement. With the occurrence of each breach, a new cause of action accrued.”⁵¹ Thus, since the waterproofing deficiencies continued through the date of filing, the trial court erred in dismissing the claim.

Second, the appeals court noted that the statute of limitations had not expired for the warranty claims because “[a] statute of limitations is tolled during the time the seller endeavors to make repairs to enable

⁴⁹ARIZ. REV. STAT. ANN. § 12-552 (West 2000). (emphasis added).

⁵⁰*Haywood Street Development Corp. v. Peterson, Co.*, 463 S.E.2d 564; 120 N.C.App. 832 (1995).

⁵¹*Haywood Street Development*, 120 N.C.App. at 836 (1995).

the product to comply with a warranty.”⁵² Since the defendant continued to attempt to repair the waterproofing through November 30, 1990, and the action was filed in 1992, the warranty claim was brought within the three-year statute of limitations. The court did not address the statute of limitations issue with regard to the plaintiff’s implied warranty claim because the express warranty excluded any and all implied warranties of the product.

2. Tolling a Statute of Repose

Statutes of repose, in theory, cannot be tolled. The purpose of such statutes, after all, is to put an end, at some definite time, to all right to litigate a claim arising from construction. In practice, however, there are two situations where some courts will allow a plaintiff to bring a claim outside the repose period. The first situation is if a plaintiff pleads fraud in some phase of the construction process. The second situation is where the plaintiff argues that there is “continuing” negligence or a “failure to warn” which occurs subsequent to the original construction defect.

A number of states, including, but not limited to, Alabama, Arkansas, California, Illinois, South Dakota, Minnesota, Kansas, North Carolina, Tennessee, and Texas provide a statutory exception for fraud to the operation of their statutes of repose. Kansas’ statute, for example, is typical and provides that an action for relief on the ground of fraud must be brought within two years “but the cause of action shall not be deemed to have accrued until the fraud is discovered.”⁵³

However, other states continue to provide protection for construction professionals even where there is willful concealment of a mistake in the construction process. In 1982, for example, the New Jersey Superior Court handled a case where a homeowner sued his builder, alleging that

negligent home construction in 1962 caused the foundation walls of his house to buckle and collapse in 1980.⁵⁴ The New Jersey court refused to toll the statute of repose *even though the court found that the builder had fraudulently assured the plaintiff that the foundation (which had collapsed during its initial construction) had been repaired* and built in a professional and workmanlike manner. The trial court held, and the Superior Court agreed, that since more than ten years (the New Jersey statute of repose) had passed since completion of the house, the complaint was time-barred. The court refused to apply a fraud-based exception to the repose period, reasoning that if the statute of repose was subject to a fraud exception “virtually all latent defects in construction could probably be subject to the allegation that they were purposely concealed Such an exception would quickly engulf the statute [of repose] and render it worthless.”⁵⁵ This, the court felt, would be contrary to the clear intention of the legislature in enacting a statute which unambiguously prevents certain causes of action from arising after a ten-year period.

IV. COMPLETED OPERATIONS INSURANCE

A. Completed Operations Coverage Generally

Insurance and insurance coverage play a large role in virtually every construction project. An insurance contract is a contract between the insurer and insured. One of the basic tenants of insurance law, the “principal of indemnity,” provides that insurance is intended to cover an insured’s losses, but only to the extent those losses do not exceed the face amount of the policy.⁵⁶ “Completed operations” insurance, typically referred to in comprehensive liability

⁵²*Id.* at 837.

⁵³KAN. STAT. ANN. § 60-513(3) (1999).

⁵⁴*Stix v. Greenway Dev. Corp.*, 447 A.2d 577; 185 N.J. Super. 86 (1982).

⁵⁵*Stix*, 185 N.J. Super. at 90 (1982).

⁵⁶*See Stillwagoner v. Travelers Ins. Co.*, 979 S.W.2d 354 (Tex. App. 1998).

insurance as “completed operations hazards,” is a form of coverage for construction projects that addresses liability arising out of completed or abandoned operations. More specifically, the coverage generally includes protection against bodily injury or property damage which occurs (1) away from premises owned or controlled by the insured and (2) after the insured’s work on a particular project or activity has been completed or abandoned.⁵⁷ In the context of a building contractor’s liability protection, completed operations coverage has been analogized to products liability insurance for a manufacturer of goods.⁵⁸

Completed operations coverage arose as a response to the general weakening of the rule that an independent contractor is relieved of responsibility for a structure he erected after that structure is completed and occupied by its owner. In the mid-1960’s, as courts increasingly held contractor’s liable in tort for injury or damage which occurred after the work was completed but which was caused by the contractor’s negligence, the insurance industry revised its standard commercial general liability (CGL) policy to exclude completed operations hazards.

The industry then made completed operations hazards a *separate* insurable risk which required its own premium from the contractor.⁵⁹ Under such policies, contractor purchases coverage on a period-by-period basis for named projects and that coverage protects the insured from liability for harms during the policy period. Coverage under a completed operations policy does not continue in perpetuity, but only exists during the actual term of the policy itself. Importantly, with such insurance the *time* when the negligent act or breach occurred causing the harm is immaterial. This is because the harm in question is the physical

damage, the loss itself and not the conduct which ultimately caused the loss.⁶⁰ Thus, coverage usually begins upon completion of the project (generally defined as the period when the construction is put to its “intended use”) and extends until the policy expires or is cancelled.

The United States 11th Circuit Court of Appeals illustrated the scope of completed operations insurance when it explained that:

[A] building erected *prior* to the [completed operations] policy period which collapses during the term of the policy may give rise to a covered claim. Conversely, a building erected *during* the policy period collapsing *after* the policy expires cannot give rise to a covered claim. The rationale underlying this rule is easily discerned. Any other result would create coverage without end.⁶¹

Thus, when determining whether damage is covered under completed operations hazard insurance, it is important to remember that *only* events occurring during the policy period are potentially covered. Damage before the period commences are not covered and damages after the policy expires or is canceled will likewise not be covered by the policy.

B. Distinction between General Liability Policies and Completed Operations Coverage

The Minnesota Supreme Court has addressed the question of whether a subcontract provision which required the subcontractor to purchase insurance to indemnify a contractor from damages arising out of work performed on a construction project required the subcontractor to purchase general liability insurance and whether such insurance covered claims for damage that occurred *after* the subcontract work was completed.⁶² In the process of

⁵⁷See *Frontier Insulation Contrs. v. Merchants Mut. Ins. Co.*, 91 N.Y.2d 169, 176 (N.Y. 1997).

⁵⁸See *Southern Guaranty Ins. Co. v. Zantop International Airlines, Inc.*, 767 F.2d 795, 1985 U.S. App. LEXIS 21118, at *10 (11th Cir. 1985)(citing *Neilsen v. Travelers Indemnity Co.*, 174 F. Supp. 648, 652-53 (N.D. Iowa 1959)).

⁵⁹See e.g., *Travelers Insurance Co. v. C.F. Gayfer’s and Co. Inc.*, 366 So.2d 1199 (Fla. App. 1979)).

⁶⁰See *Southern Guaranty Ins.*, 767 F.2d 795 (citing 7A Appleman, *Insurance Law and Practice* § 4497 (W. Berdal, ed. 1979)).

⁶¹*Southern Guaranty*, 767 F.2d at 799 (11th Cir. 1985) (emphasis added).

reaching its decision, the court succinctly contrasted the different scopes of general liability and completed operations coverages.

In the Minnesota case, the owners of a low income apartment building contracted with Conroy Brothers to install a new exterior wall system for the building. In turn, Conroy Brothers subcontracted with Right-Way Caulking to provide caulking, sealing, and other services in connection with the installation of the wall system. On May 4, 1986, Right-Way completed its work on the project. Cracks in the exterior wall began appearing in November 1987, but the owner maintained the cracks were “cosmetic” and did not allow water infiltration. In April 1993, however, a large chunk of the exterior wall fell to the ground. The owner then brought suit against Conroy Brothers who, in turn, brought a third-party claim against Right-Way. Conroy Brothers subsequently settled the suit for \$400,000 and then sought to recover \$250,000 from Right-Way based upon a provision in Right-Way’s subcontract that required Right-Way to purchase general liability insurance for indemnification up to \$250,000. It was undisputed that Right-Way never purchased the required policy. The issue before the Minnesota Supreme Court was whether the disputed claim fell within the coverage of the liability insurance that Right-Way contracted to purchase. If so, Right-Way would be liable to indemnify Conroy Brothers for the full amounts of the prospective insurance policy limit.

The court noted that the injury occurred well after Right-Way had completed its work on the project and that the insurance it was supposed to purchase was “general liability” insurance and *not* completed operations coverage. The court distinguished the two types of policies as such:

A general liability policy protects the contractor from claims arising out of injuries or damage negligently caused by the contractor in the course of construction. It is designed to cover such negligent conduct

⁶²*Seward Housing Corp. v. Conroy Brothers Co. et al.*, 573 N.W.2d 364 (Minn. 1998).

as that causing damage from falling beams and other objects such as tools, as well as damage from the collapse of any part of a structure which has not been completed or, if completed, has not been put to its intended use. *This is a circumscribed exposure very different from that included in a policy which covers completed operations.* Policies covering defective or improper workmanship on a completed operation which fails in its use involve a substantially greater risk. Such coverage is, in effect, one which insures against a breach of warranty.⁶³

Based on the above, the court held that even if Right-Way had purchased the required general liability insurance, the policy would not have provided coverage for the damages at issue. For example, even if the court determined the property damage occurred in 1987 (when the cracks occurred) and not 1993 (when the wall fell), the 1987 damage still “did not occur until at least a year after any Right-Way employees worked on the construction project, and any claims asserted in this regard would fall within completed operations coverage not contemplated by the subcontract.”⁶⁴ Accordingly, the court ruled that Right-Way was not required to indemnify Conroy Brothers for the upper limits of the contracted for indemnity policy.

C. Scope of Completed Operations Coverage

The scope of completed operations coverage as to the period of coverage depends on the specific language contained in the policy. This lesson is illustrated in a California district court case which addressed the issue of the scope of completed operations coverage for liability arising out of work performed prior to the inception of the policy.⁶⁵ In this case, Pardee, a developer/contractor, contracted with several subcontractors to perform work on a residential construction project. Pardee re-

⁶³*Id.* at 367 (Minn. 1998)(emphasis added) (quoting *Security Ins. Co. v. Kaye Milling Supply Inc.*, 211 N.W.2d 519, 521-22 (1973)).

⁶⁴*Id.* at 368.

⁶⁵*Pardee Constr. Co. v. Ins. Co. of the West*, 77 Cal. App. 4th 1340, 1346-1347 (Cal. Ct. App. 2000).

quired the subcontractors to add it as an additional insured on all policies, including completed operations. Several years after completion of the project, Pardee was sued by residents of the property for damage arising out of defective work performed by the various subcontractors.

The subcontractors' insurer refused to defend Pardee on the grounds that the completed operations coverage policies were written after the alleged defective work was completed. Thus, the insurer argued that the policies were not intended to provide coverage for liability arising out of work performed by the subcontractors prior to the inception date of the policies.

The Court ruled in favor of Pardee and found that the subcontractors' completed operations coverage applied. The Court examined the language of the policy and concluded that the broad language provided coverage. The Court noted that unless coverage limitations are "conspicuous, plain and clear," they will not be given effect. Further, the Court found that had the insurer wished to limit coverage to only work performed after the inception of the policy, it could have easily done so within the definitions contained in the policy. Accordingly, the subcontractors' completed operations coverage provided coverage for Pardee because the endorsements in the policy did not limit completed operations coverage in terms of the time period in which the work was performed.

D. Exclusions of Completed Operations Coverage

Given the unique nature of completed operations coverage it is not surprising that insurance companies are careful to not extend such coverage in the typical broad "umbrella," or excess liability policy. This is designed to relieve the insurer of liability for damages for events which it has not taken into account when calculating the possibility of loss and setting a policy premium. Specific exclusions, however, usually are found in the completed operations policy itself and preclude coverage for certain events. These exclusions generally

preclude coverage for bodily injury or property damage arising out of:

- operations in connection with the transportation of property, unless the injury or damage arises out of a condition in or on a vehicle created by the loading or unloading at the construction site;
- the existence of tools, uninstalled equipment or abandoned or unused materials;
- operations for which other insurance policies on the project specifically state that the scope of policy coverage for this activity/area includes "completed operations;"
- rendering of or failure to render professional services; or
- work that has not yet been completed or abandoned.

One recent case illustrates that a professional services exclusion contained in the policy may not preclude coverage for failure to perform duties outside of the scope of the professional services contract.⁶⁶ In this case, S.T. Hudson, an engineering company was hired to inspect and reinforce a pier containing multiple restaurants and nightclubs. S.T. Hudson's last inspection indicated that the pier was critically unstable and in danger of collapsing. The pier subsequently collapsed, and the plaintiffs in the underlying action alleged that S.T. Hudson's failure to warn of the structural instability of the pier constituted negligent misrepresentation.

S.T. Hudson's insurer argued that the alleged negligent conduct fell under the professional services exclusion of the policy, which excluded damages "arising out of the rendering of or failure to render professional services." The Court disagreed, finding that coverage was provided under the subcontractor's completed operations coverage. The Court noted that while the policies contained professional ser-

⁶⁶*S.T. Hudson Engineers, Inc. v. Pennsylvania Nat. Mut. Cas. Co.*, 388 N.J. Super. 592, 598 (App. Div. 2006).

vices exclusions, the coverage sought arose out of S.T. Hudson's failure to warn and provide information, not from the company rendering professional services.

In another case, the United States District Court for the Eastern District of Louisiana decided a case which illustrates how a decision can directly turn on whether an exclusion in a completed operations hazard insurance policy applied.⁶⁷ The underlying dispute sprang from a construction contract between Dreco, Inc. ("Dreco" or "defendant") and Freeport McMoran Resources Partners, Ltd. ("McMoran" or "Plaintiff") wherein Dreco agreed to furnish and construct three derrick oil drilling rigs on a McMoran drilling platform. Unfortunately, the first derrick collapsed shortly after construction and before the defendant had finished manufacturing the remaining two derricks.

At issue before the court was whether a claim filed by the plaintiff was subject to the aggregate policy limit under Dreco's products-completed operations policy or whether the plaintiff's claim fell under Dreco's general liability policy (and thus that policy's General Aggregate Limit). The two aggregate limits were mutually exclusive. While both limits were \$2.0 million dollars, the policy issuer (National Union Fire Insurance Company of Pittsburgh, PA, or "National") had already paid \$400,000 for a claim under the completed operations policy and thus National's remaining liability under that policy was only \$1.6 million dollars. Faced with the prospect of possibly having to pay an additional \$400,000, several co-defendants in the case (underwriters and secondary insurance carriers, hereinafter "underwriters") requested the court find, through a motion for summary judgment, that

⁶⁷*Freeport McMoran Resource Partners, LP v. Kremco, Inc. et al.*, 1993 U.S. Dist. LEXIS 10166 (1993)(The court specifically noted that it was not deciding whether the defendant's work was negligent or defective, but was *only* interpreting the narrow preliminary issue of how the insurance policy would apply to the facts *if* the defendant's negligence or defective workmanship was established. The court recognized that "[c]ertainly, if plaintiff fails to establish liability, the Court's interpretation of the policy is moot here." *Id.* at *4 n.1).

if Dreco was liable for the damage, the damage was covered under the \$2.0 million dollar General Aggregate Limit policy issued by National. In turn, National filed a cross-motion for summary judgment asking the court to declare that the plaintiff's claim was subject to the *completed operations hazard policy* and the \$1.6 million dollar limit remaining under that policy.

The policy at issue was a products-completed operations hazard policy and covered all bodily injury and property damage occurring away from the insured's premises and arising out of the insured's product or work. Coverage, however, was excluded for two situations: "(1) Products that are still in the insured's possession" and "(2) Work that has not yet been completed or abandoned."⁶⁸

As an initial matter, the court determined that the damage from the oil rig collapse occurred on the *plaintiff's* platform and not on the defendant's premises. The court then looked at the policy exceptions to determine if either one of the exclusions applied.⁶⁹

At the time of the collapse Dreco had completed construction on the derrick and turned it over to a contractor who had independently contracted with the owner to "rig up" the drilling unit for operation. As such, the court determined that the rig was not in Dreco's physical possession and thus the "physical possession" exception was inapplicable. Next, the court examined whether at the time of the derrick collapse the defendant's work was completed or abandoned. The court noted that the policy defined "completed" in several ways and the facts indicated that the defendant had not completed its work under any of the definitions. First, Dreco was required under the contract to furnish three derrick drilling rigs and it had only furnished one. Thus, work remained under the contract. Second, Dreco's work had *not* been "put to its intended use" because "[a]t the time of collapse, no one had yet attempted to use the derrick for drilling, its intended purpose."⁷⁰ As such, the court held

⁶⁸*Id.* at *3-4.

⁶⁹*Id.* at *4.

that the damage did not result from a completed operation of the defendant and was not subject to the completed operations hazard insurance. Accordingly, the court granted the underwriter's motion for summary judgment and held that any damage for which the defendant was liable was subject to the full \$2 million dollars available under the defendant's General Aggregate Limit.

V. MERGERS, ACQUISITIONS, AND SUCCESSOR LIABILITY FOR COMPLETED OPERATIONS RISKS

A. Successor Liability Generally

In the sale of a construction company, a question often arises as to the best way for the buyer and seller to arrange the transaction. At issue for the buyer are two primary considerations which can sometimes be at odds with one another. First, the buyer wants to avoid liability for problems or claims relating to the seller's completed construction contracts. Second, if the buyer believes the seller's company name has considerable value, or "goodwill," the buyer may want to continue using the seller's name to take advantage of the goodwill the name-recognition brings. While there are a number of different merger and sale deals that companies can utilize, and pros and cons inherent with each (mostly relating to differing requirements pertaining to shareholder approval and tax considerations), the focus of the following discussion is limited to potential liability issues inherent in completed projects that may arise after corporate mergers or acquisitions.

1. Asset Sale

One of the more common ways to structure the purchase of a company is for the purchasing corporation to buy the selling corporation's assets, including existing contracts. Structuring the purchase as an asset acquisition has a number of advantages to traditional merger, e.g., tax benefits. Additionally, and more important

from a liability standpoint, when one company buys another's assets, the liabilities of the selling corporation do not normally pass to the buyer *unless the buyer explicitly assumes them*. Generally, in an asset sale the buyer can specify which liabilities it is assuming. In this fashion, the buyer can avoid exposure to any debts or contingent liabilities (e.g., claims or lawsuits filed after closing) that it is not aware of and does not specifically assume.

An example of how an asset sale was used to protect the buyer from liability while allowing the buyer to take advantage of the seller's corporate name is the products liability case *Flaughner v. Cone Automatic Machine Co.*⁷¹ In *Flaughner*, the appellant Carla Flaughner was injured at work on April 24, 1979, by an eight-spindle Conomatic screw machine. The machine had been manufactured in 1953 by Cone Automatic Machine Company, Inc. ("Cone I"), a Vermont corporation which no longer existed.

Substantially all of Cone I's stock had been acquired by Pneumo Corporation on July 19, 1963 and the remaining assets were transferred shortly thereafter. Cone I was dissolved on September 5, 1963. *On the following day*, the Pneumo Corporation formed "Cone Automatic Machine Company, Inc." ("Cone II") for the sole purpose of holding the Cone name. Cone II, an appellee in this case, was and always had been an inactive corporation with no employees, physical assets or place of business.

From August 31, 1963 until December 15, 1972 Pneumo Corporation operated Pneumo Dynamics Machine Tool Group ("PDMTG"), which included the assets of the dissolved Cone I, as well as assets of other machine companies acquired by Pneumo. PDMTG continued to manufacture the Conomatic line of machines. In

⁷⁰*Id.* at *10.

⁷¹*Flaughner v. Cone Automatic Machine Co.*, 507 N.E.2d 331 (Ohio, 1987).

an agreement effective December 15, 1972, the appellee (Cone-Blanchard Machine Company, or “Cone-Blanchard”) purchased the assets of PDMTG and the stock of Cone II from Pneumo for approximately \$11 million. Pneumo Corporation continued as an active, viable operation. As a result of the purchase, Cone-Blanchard took over the manufacture of the Conomatic machines.

Carla Flaughner (and her husband) sued to recover damages for her injuries and named as defendants Cone I, Cone II, Pneumo Corporation, and Cone-Blanchard. Flaughner alleged that her injuries were sustained as a direct and proximate result of the defendants’ negligent design and manufacture of the machine in question and the defendants’ collective negligence in failing to warn of the machine’s “dangerous” condition. The trial court promptly dismissed the Flaughner’s complaint against Cone I because applicable Vermont law clearly barred claims against dissolved corporations where the claim did not exist prior to dissolution. The trial court also dismissed Pneumo Corporation from the case, ruling that the Flaughner’s claim was time-barred. These rulings were not contested by the Flaughners.

Finally, the court granted the summary judgment motions of the remaining defendants (Cone II and Cone-Blanchard) since neither corporation fell within the traditional exceptions to the general rule of successor nonliability. The court refused to apply the “product line” theory of liability (which is grounded in strict liability for the manufacturer assuming liability for the risk of injury from its product), holding that the remaining defendants could not be held liable for a failure to warn because neither defendant (Cone II and Cone-Blanchard) had notice of the machine defect which allegedly caused Mrs. Flaughner’s injury.

Although the *Flaughner* case does not deal with a construction project *per se*, the reasoning the court used is typical of what a

court would employ when assessing the potential liability of a successor construction company which has purchased the assets of another contractor. That is, courts will assume no liability unless the facts fall within a recognized exception and, if no exception applies, will probably dismiss the lawsuit. Exceptions to the general rule of successor nonliability are discussed in more detail later in these materials at subsection B, *infra*.

2. Mergers

In merger-type transactions, which are generally in the form of a “stock deal,” the buyer, whether it wants to or not, essentially takes the seller’s liabilities along with its assets. This is because with stock deals, by operation of law, the buyer assumes all the seller’s liabilities. In large part this stems from the distinction that in a sale scenario, the “shareholders” of the selling contractor end up with cash (or some other fixed obligation from the buyer) and no longer have any stake in their business. In a merger, however, the seller’s shareholders still maintain an interest in the combined buyer-seller business. Moreover, the buyer’s shareholders will share ownership in their business (which now includes the seller’s construction company) with the former shareholders of the selling corporation. Thus, theoretically, where a lawsuit is filed against a “successor” corporation for damages stemming from a completed construction project, if the successor corporation is the result of a merger of one business with the contractor who did the work, then any damages recovered would come at least partially from those who benefitted from the original construction. On the other hand, if the successor corporation merely obtained the assets of the original corporation, then any recovery would come from persons who had no stake and received no tangible benefit (other than, perhaps, name goodwill) from the work the original construction company performed under the contract at issue.

B. Exceptions to the General Rule of Successor Nonliability in an Asset Sale

1. General Exceptions

Notwithstanding the general rule of nonliability for asset acquisitions, there are four widely-recognized exceptions under which an asset buyer may be held liable for contingent claims. Under those exceptions, a construction company which purchases another contractor's assets can be liable for the debts and liabilities of the selling corporation if:

1. The buyer expressly agrees to assume the seller's obligations;
2. The transaction amounts to a de facto merger or consolidation of the two companies;
3. The transaction is a fraudulent attempt to escape liability; or
4. The purchasing corporation ("buyer") is a "mere continuation" of the selling corporation.⁷²

If any one of the above four factors can be demonstrated, most courts will probably hold the buyer liable for the completed operations risks of the seller. The exceptions are largely designed to prevent situations where a specific purpose of acquiring assets is to place those assets out of reach of the predecessor's creditors. As the United States 11th Circuit Court of Appeals noted, the exceptions to the general rule of successor liability are meant to identify those situations where the buyer maintains the same or similar management but simply wears a "new hat."⁷³

⁷²See e.g., *Nissen Corp. v. Miller*, 594 A.2d 564, 565-66 (Md. 1991)(citing 1 American Law of Products Liability 3d § 7:1, at 10-12 (Travers, rev. ed. 1990)).

⁷³*Bud Antle, Inc. v. Eastern Foods, Inc.*, 758 F.2d 1451, 1458 (11th Cir. 1985).

2. "Continuity of Enterprise" Exception

a. Generally

In large part, the exceptions are self-explaining. Importantly, though, in most situations this exception, as with the others, will only be used to circumvent the general rule for asset acquisitions in products liability/personal injury cases. In other words, the continuity of enterprise exception is less likely to be employed to force an asset acquirer to pay contract or warranty damages. Bearing the above in mind, fleshing-out whether the buyer's new corporation is a "mere continuation" of the seller is an often-litigated exception for which a host of considerations have evolved. The California Court of Appeals has stated that "[a]n essential foundation of the rule [that equity will regard a new corporation as being a mere continuation of the former corporation] is the lack of consideration running from the old to the new."⁷⁴ California decisions applying the rule have further noted that "continuity" in the "traditional sense" is generally only applied "upon a showing of one or both of the following elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting claims of its unsecured creditors, or (2) one or more persons were officers, directors, or stockholders of both corporations."⁷⁵ It is only after this first hurdle is overcome that courts will then take on the more difficult task of determining whether the exception applies to the facts at hand.

The Michigan Supreme Court has called the continuity of enterprise exception the "most confused of the four exceptions" and explained that "the exception seems to encompass

⁷⁴*Ortiz v. South Bend Lathe*, 46 Cal.App.3d 842, 847 (1975).

⁷⁵*Ray v. Alad Corp.*, 19 Cal.3d 22, 29 (1977).

the situation where one corporation sells its assets to another corporation with the same people owning both corporations. Thus, the acquiring corporation is just a new hat for, or reincarnation of, the acquired corporation.”⁷⁶ As an example, the Supreme Court of Alabama has adopted a four-factor “continuity of enterprise” test.⁷⁷ If there is substantial evidence of *each* of the four factors, the court may find the buying corporation is liable for damages attributable to the seller’s work. The four factors used by the Alabama Supreme Court are similar to those used by other state courts in determining whether a buying corporation is liable as a corporate successor of the seller. The four factors are:

1. Is there a basic continuity of the enterprise of the seller corporation? This includes continuity of management, key personnel, physical location, assets, general business operations, and even the seller’s name.
2. Did the selling corporation cease ordinary business operations, liquidate, and dissolve soon after distribution of the money or other consideration received from the buyer?
3. Does the buyer hold itself out as the effective continuation of the seller corporation?
4. Did the buyer assume those obligations of the seller which would be ordinarily necessary for the uninterrupted continuation of normal business operations by the seller corporation?⁷⁸

⁷⁶*Turner v. Bituminous Cas.Co.*, 244 N.W.2d 873, 892 (Mich. 1976).

⁷⁷*Brown v. Economy Baler Co.*, 599 So.2d 1 (Ala. 1992).

⁷⁸See *Asher v. KCS International, Inc.*, 659 So.2d 598, at 599-600 (Ala. 1995)(quoting *Turner v. Bituminous Casualty Co.*, 244 N.W.2d 873, 883-84 (Mich. 1976)).

In the Alabama case, for example, the plaintiff (Nathaniel Brown) was injured on November 28, 1986, while working as a baler for the Denbo Iron and Metals Products Company. Brown sued Denbo and Economy Baler of Ohio (Economy/Ohio) for damages stemming from his injuries. Economy Baler filed a motion for summary judgment and the trial court dismissed Brown’s claim, finding that Economy Baler was *not* the successor-in-interest to the American Hoist & Derrick Company (“Amhoist”), which had manufactured the 1959 baling machine on which Brown was injured.

The timeline of the case was as follows: In 1959, the “Economy Baler Company of Michigan” (Economy/Michigan) manufactured the “Economy baler” at issue. In 1967, Economy/Michigan merged into Amhoist. In 1976, Economy/Ohio was created as a wholly owned subsidiary of the American Baler Corporation. Thereafter, Economy/Ohio purchased certain assets from Amhoist relating to Amhoist’s “Economy Baler” line. The sale was a cash for assets transaction. In its purchase agreement, Economy/Ohio disclaimed responsibility for all obligations and liabilities for “products manufactured, assembled, or sold by Amhoist.”⁷⁹ Additionally, Amhoist agreed to assume liability for claimed deficiencies in the Economy balers it had manufactured prior to the 1976 asset sale to Economy/Ohio.

Brown asserted that Economy/Ohio was liable for his injuries on the theory that it was a “mere continuation” of Amhoist (who had filed for bankruptcy shortly after Brown was injured). The court, however, applied the four-factor test and dismissed Brown’s claim, because “[w]hereas Brown may have presented substan-

⁷⁹*Economy Baler*, 1992 Ala. LEXIS at *4.

tial evidence of the first factor of the ‘continuity of enterprise test,’ and although he did present substantial evidence of the fourth factor of that test, he failed to present any evidence of the second and third factors. These factors are to be considered in the conjunctive, not in the alternative.”⁸⁰ Thus, the court refused to find that Economy/Ohio was a mere continuation of Amhoist and affirmed the lower court’s dismissal of Brown’s case against Economy/Ohio.

b. Narrow enforcement of the exception

The Ohio Court of Common Pleas of Hamilton County, in a case of broader import than its holding would suggest, has held that the continuity of enterprise exception does not apply to the provision of architectural services in certain limited circumstances. In particular, if read narrowly, the court held that the exclusion does not apply where (1) a sole proprietor is succeeded by a corporation; (2) the entire business-related assets of the first sole proprietor did not pass to the second proprietor; (3) the incorporation adds a new individual; and (4) the business activity involved is of a “uniquely individual professional type.”⁸¹

In the case before the Ohio Court, the plaintiff’s homeowners association contracted, on May 18, 1967, with defendant Turner Construction Company and architect Harry Hake, Jr. (a sole proprietor) for the construction of a parking garage at the Christ Hospital. The garage was completed in March 1968. Deterioration of the floor area of the garage was discovered in 1978, which allegedly reduced the useful life of the garage

from forty to fourteen years.⁸² The plaintiff sought over \$6 million dollars from the contractor and the apparent successors-in-interest to Harry Hake, Jr.’s business (Harry Hake & Partners, Inc., Harry Hake III, and Harry Hake and Harry Hake, Jr. & Associates—collectively “architects”) for the cost to repair and restore the garage to its “proper” condition.⁸³

The architects filed a motion for summary judgment to dismiss the claim against them. In its motion opposing summary judgment, the plaintiff alleged that the various Hake defendants were the “mere continuation” of the business entity “Harry Hake and Harry Hake, Jr.” which contracted with the Christ Hospital in 1967 for the provision of architectural services.

The Ohio court began by stating that the strongest policy reasons for applying the “continuity” exception as a basis for successor liability occurred in *products-liability* situations and that those policy reasons were of *less importance* when analyzing pure economic and contractual damages of the nature presented by the homeowners association claim. The court noted that Harry Hake, Sr. started his architectural business in the early 1900s. The business subsequently took new forms (sole proprietorship, partnership, and corporation) as succeeding generations of Hakes joined the business and/or elder Hakes passed away.

⁸⁰Id. at *9.

⁸¹*Deaconess Home Assoc. v. Turner Constr. Co. et al.*, 526 N.E.2d 1368; 38 Ohio Misc.2d 17 (1986).

⁸²Id. at 17.

⁸³Id. (Harry Hake, Jr. lived to see the completion of the project which was alleged by the plaintiff to have been defectively designed. Mr. Hake, Jr., however, died in late 1968, at which point Harry Hake III formed a sole proprietorship (Harry Hake III, d/b/a. “Harry Hake & Harry Hake, Jr.”). On December 22, 1969, Harry Hake III formed “Harry Hake & Partners, Inc.” as a corporation, which existed as a corporate entity until its dissolution on December 31, 1980.)

The court explained that the continuity exception applies to corporations because:

[A corporation] continues beyond the life of any shareholder, director, or employee. An individual does not exist legally, even by fiction, beyond his death. Thus, Milicron, Inc. continues to exist as the same basic legal, fictional unit as Cincinnati Milling Machine Company, even though the name has changed and the shareholders and board of directors are constantly changing. But Harry Hake, Jr., once deceased, is not the same unit, even fictionally, as Harry Hake III, and even less so the same unit as Harry Hake & Partners, Inc. ... In brief, there is simply no continuity here of a legal unit under traditional legal concepts.⁸⁴

Accordingly, since the plaintiff had not plead fraud by Harry Hake, III, the court refused to apply the continuity of enterprise exception and dismissed the case against the architects.

In sum, the Ohio decision, which relied heavily on reported decisions from other states, is probably of more importance than the seemingly narrow “sole-proprietor exception” it carved out. This is because the decision reveals a common analysis of a heavily-litigated exception to the general rule of successor nonliability for asset acquisitions. This analysis, with its heightened standard for contract damages and emphasis on fraudulent transactions, should ultimately protect most construction contractors from liability for economic damages stemming from completed projects of a corporation whose assets they have bought. As

such, if a contractor purchases assets with “clean hands,” he should be able to enjoy the protection offered by the general rule of nonliability for asset purchases.

C. The *De Facto Merger Doctrine*

At the outset, it should be noted that the *de facto merger* doctrine (“doctrine”) is not recognized by most states despite the fact that many of the factors considered under the doctrine closely resemble the “continuity of enterprise” test. While the doctrine is rarely invoked it is important to understand its conceptual underpinnings because its use can allow a creditor, usually a tort claimant, to go after the assets acquired by the buyer even if the assets were purchased through an “asset sale.” In this situation, if the buyer “carries on the business” of the seller, a tort claimant whose claim is basically against the seller might be permitted to sue the buyer for her injuries. If so, the claimant could recover in the same way she would be able to recover had the seller merged into the acquirer through a traditional “stock deal” transaction.⁸⁵

The courts that apply the doctrine justify its use on basically two theories: (1) “social justice”—since the acquirer has carried on the business of the seller, and has benefitted from the seller’s “goodwill,” the acquirer should assume responsibility for damages related to the seller’s work and the development of that goodwill and (2) a “cheapest cost avoider” theory—the buyer is better able to buy insurance against such claims than the tort victim.

In *Philadelphia Electric Co. v. Hercules, Inc.*,⁸⁶ the United States Court of Appeals for the Third Circuit gave a detailed breakdown of the necessary factors that must exist before Pennsylvania law will apply the doctrine. The

⁸⁴*Id.* at 20-21.

⁸⁵See e.g., *Ramirez v. Amsted Industries, Inc.*, 408 A.2d 818 (N.J. Super. 1979); and *Knapp v. North American Rockwell Corporation.*, 506 F.2d 361 (3rd Cir. 1974) (both imposing liability on acquiring company through use of the *de facto merger* doctrine.).

⁸⁶*Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3rd Cir.), cert. denied, 474 U.S. 980 (1985).

breakdown largely consisted of the same factors contained in Alabama's "continuity of enterprise" test (described earlier) but the Third Circuit specifically noted that it would *not use the de facto merger doctrine "to circumvent the parties' objective intent" if the parties have drafted an indemnification provision which excludes the liabilities of the seller.*⁸⁷

D. Reverse-triangular Mergers

"Triangular mergers" are so named because they involve three parties rather than the usual two: (1) the buyer; (2) a subsidiary; and (3) the seller. In a "forward triangular merger" the buyer creates a subsidiary with no assets except for shares of stock in itself, the "parent," which the subsidiary receives in return for issuing all of its own stock to its parent. The seller is then merged into the buyer's subsidiary. Unlike a conventional merger, the seller's shareholders do not receive stock in the surviving corporation (the subsidiary) but rather stock in the subsidiary's parent, the buyer. While a forward triangular merger has the advantage of eliminating all minority interest in the target corporation's assets it provides no additional benefit regarding the buyer's liability for the seller's completed work and thus no advantage for the purposes of this discussion.

A reverse-triangular merger is the same as a "forward triangular merger" except that the buyer's subsidiary merges into the seller, rather than having the seller merge into the subsidiary. In other words, the buyer, or "parent" corporation, forms a wholly-owned subsidiary where all shares of the subsidiary are transferred to the buyer in return for a certain number of the buyer's shares. The subsidiary and the selling corporation are then merged, but in

such a way that the subsidiary disappears and the seller is the surviving corporation. Under the merger agreement the buying corporation will convert its shares in the subsidiary into shares of the seller. In addition, the seller's shareholders will have their stock converted into the buyer's stock. When all transactions are complete, the seller's original shareholders will be left with stock in the buyer and the seller will be a subsidiary of the buyer (with the seller still holding its own assets).⁸⁸

The advantage a reverse triangular merger has over a "direct merger" is that if the seller is simply merged into the buyer, the buyer acquires all the liabilities of the seller corporation and places its own assets at risk to satisfy those liabilities. Thus, if the seller is unexpectedly sued for damages arising from a completed contract, in a direct merger situation the plaintiff in that suit, if it recovered a judgment, could collect not only against the assets that used to belong to the seller (and now belong to the buyer) but also against the buyer's pre-existing assets. However, when the reverse-triangular technique is used, the buyer has a much better chance of limiting the plaintiff to the seller's assets (which have survived the merger with the buyer's subsidiary). Finally, another important advantage with a reverse-triangular merger is that the seller survives as a separate legal entity. This means that certain legal rights of the seller (contract rights, leases, licenses, etc.) are more likely to remain intact than if the seller disappeared.

In sum, however, unless shareholder rights are a major consideration, most of the benefits of the reverse-triangular merger can be achieved, with much less red tape, through an asset purchase. For that reason, asset acquisition remains a preferred method of corporate acquisition in the construction industry.

⁸⁷*SmithKline Beecham Corp. v. Rohm and Haas Co. v. Buckeye Pipe Line Co.*, 89 F.3d 154, n.6 at 162 (3rd Cir. 1996). (The four factors mentioned by the court were: (1) continuing of the enterprise of the selling corporation; (2) a continuity of shareholders "which results from the purchasing corporation paying for the acquired assets with shares of its own stock;" (3) the seller liquidating, dissolving, and ceasing ordinary business operations as soon as possible; and (4) the buyer assuming the obligations of the seller necessary for the "uninterrupted continuation of normal business operations of the seller corporation.")

⁸⁸See e.g., *In re Catapult Entertainment, Inc. v. Catapult Entertainment, Inc.*, 165 F.3d 747, 749 (Ct. App. 9th Cir., 1999) (discussing the mechanics of a reverse-triangular merger).

VI. CONCLUSION

At one point or another virtually every construction professional will face liability issues resulting from problems that surface after a project has been completed. Given that fact, construction professionals must understand the basics of the common post-completion risks and related issues. Express or implied warranties in all forms, state statutes of limitation and statutes of repose, and the existence or non-existence of completed operations insurance carry the potential to bind a contractor to make, or pay for, repairs (and damages)

resulting from defective work. Conversely, those same issues carry the potential to allow the constructional professional to “wash his hands” of liability or out-of-pocket expense for the claimed damages. Indeed, the issue of liability for completed projects can even haunt the buyer of a construction company who does not take steps to mitigate his exposure for damages relating to completed projects of the selling contractor. In view of the above, understanding the basics of post-completion risks is a necessary step towards being able to prepare for, respond to, and manage these risks when they arise.

