Managing and Litigating the Complex Surety Case

Chapter 7 – Proving and Defending Quality of Work Issues[1]

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I. Introduction

Some of the more challenging issues facing a performing surety involve defective work. Frequently, the surety investigating a bond default is confronted with obvious defective work performed by its principal. In fact, the defective work may be the primary reason why the obligee declared a default. This type of patently defective work triggers a decision tree for the surety involving evaluation of potential defenses, creation of possible leverage positions for negotiation with the obligee, and management of the correction of the defective work by a completion contractor. For patently defective work, the recognition of the defect is immediate and the consequences are somewhat predictable. More difficult to address are claims for defective work that are not detected during the investigation but arise during completion or after substantial completion by a completion contractor. These less obvious defects can lead to management headaches, disputes with the completion contractor, warranty issues, and litigation with the obligee. Complicating the surety's evaluation of defective work claims are the possible interplay with insurance and the evaluation and pursuit of claims against third-parties for losses associated with the defective work.

This chapter will consider all the various types of defective work a surety may encounter, and provide a framework for the surety to assess and respond to defective work when it arises. The surety's defenses to certain types of defective work will be analyzed, as will the surety's affirmative rights to pursue recovery from third-parties whose actions may have caused or exacerbated the defective work. Finally, this chapter will examine and provide guidance to the surety for preserving its claims and identify litigation strategies for presenting defective work claims.

II. Identifying Defective Work Following Demand and Determining its Impact on the Surety's Performance Obligation

A. Contract and Bond Requirements and Limitations

As with any demand made upon the surety's performance bond, the surety's first response is to ascertain the scope of its obligation. The terms of the bond and the referenced contract will establish whether or not the surety has an obligation under the bond and may impose limitations on the scope of the obligation. For instance, the AIA A312-2010 Performance Bond places upon the performing surety "[t]he responsibilities of the Contractor for correction of defective work."[2] Accordingly, under the AIA family of documents, the

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[2] *See, e.g.*, AIA Document A312-2010 § 7.1.

performing surety is liable for correcting the work before substantial completion and for the one year period thereafter to the same extent as its principal for work that is properly rejected or otherwise is non-conforming.[3] Given this extensive obligation, one of the most immediate concern for defective work claims involves bond limitation periods – is the claim timely raised? For claims arising prior to substantial completion, the answer to this question is nearly always affirmative. Most bonds provide coverage until the work is "substantially complete."[4] Substantial completion is defined to be "the stage in the progress of the Work when the Work or designated portion thereof is sufficiently complete in accordance with the Contract Documents so that the Owner can occupy or utilize the Work for its intended use."[5] If default occurs prior to the principal's completion of the work, then the surety stands in the shoes of the principal and is contractually obligated to ensure that the work complies with contract requirements.[6] The analysis for claims raised after substantial completion, however, is often far more complex for the surety.

Once substantial completion is achieved, the surety, like the principal, often remains contractually obligated to correct any defective work which is identified during the one-year warranty period. If, however, the bond speaks only to finishing the work in the event the principal fails to complete, the surety may at least have an argument that it is not responsible for warranty claims.[7] For latent defects discovered after the expiration of the warranty period, where the bond is conditioned upon the principal's faithful performance of all of its obligations under the contract, a majority of courts have found the surety responsible for the cost of correcting the latent defects.[8] This obligation may be tempered, however, by application of statutes of limitation or repose or the doctrine of economic waste, under which the obligee might only be entitled to the lesser of the cost of repair or diminution in value resulting from the defect.[9]

The bond may contain a limitation period that could limit the surety's exposure for claims arising post-substantial completion. For example, the AIA A312-2010 Performance Bond Form provides that "[a]ny proceeding, legal or equitable, under this bond… shall be instituted within two years after Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond,

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3 *See, e.g.*, AIA Document A201-2017 § 12.2 which becomes the obligation of the performing surety under_ AIA Document A312-2010 § 7.1 .

4 4A PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:23, 1 (2017).

5 *See, e.g.*, AIA Document A201-2017, § 9.8.1.

6 *See, e.g.*, AIA Document A201-2017 §12.2.1.

7 Keith A. Langley & Marchelle M. Houston, *Liability of the Performance Bond Surety for Damages (Under Contract of Suretyship), in* THE LAW OF PERFORMANCE BONDS 431, 452-454 (Lawrence R. Moelmann et al. eds., 2d ed. 2009); Marilyn Klinger, James P. Diwik & Kevin L. Lybeck, *Contract Performance Bonds, in* THE LAW OF SURETYSHIP 81, 116 (Edward G. Gallagher ed., 2d ed. 2000).

8 Klinger, Diwik & Lybeck, *supra* note 7, at 116.

9 Patrick Q. Hustead & John McDevitt, *Preserving the Contract Balance: Obligee's Rights to Backcharge Contract Balance and/or Make Claim Against the Performance Bond for Setoffs and Damages*, 12 (Jan. 21, 2011)(unpublished paper submitted to the ABA/TIPS Fidelity and Surety Law Committee program)(citing Grossman Holdings Ltd. v. Hourihan, 414 So. 2d 1037 (Fla. 1982).

whichever occurs first."[10] Limitations issues for claims arising post-substantial completion are complex and are discussed in more detail below.[11]

In addition to determining whether a warranty claim is still timely, the surety must evaluate whether the claim of defective work lies within the principal's scope of work established in the contract documents. Particularly where the project involves multiple prime contractors or the obligee self-performs some of the work or supplements the defaulted principal's work, the determination of whether the alleged defective work lies within the principal's scope is critical. The surety is only obligated to perform or pay the costs of performance as provided by the bond and underlying bonded contract.[12] The surety should also examine whether the obligee accepted the non-conforming work.[13]

Once the surety has determined that the claim is timely presented and within the principal's scope of work, the surety should examine whether the obligee has complied with the terms of the construction contract before making demand upon the bond. Most bonds' conditioning clauses temper the surety's obligation to perform upon the obligee's performance under the contract. In other words, in order for the surety to have an obligation to perform, the obligee must not be in breach of the bonded contract. For defective work claims, the obligee need do very little to not be in breach because most construction contracts grant the obligee broad rights to require the principal to correct defective work prior to substantial completion.[14] If the principal is obligated to correct the work and fails to do so, the surety who bonded the contract will similarly be obligated to correct defective work identified prior to substantial completion. Some construction contracts, however, impose specific notice requirements on the obligee for defective work claims, which may create a defense for the surety if the obligee fails to give the principal notice and an opportunity to correct the allegedly defective work.[15]

In *International Fidelity Insurance Co. v. Americaribe-Moriarty, J.V.*,[16] the court addressed the consequences of the contractor's failure to give proper notice to the subcontractor's surety before undertaking corrective action by hiring another company to complete allegedly defective work. Following the general contractor's notice to its pool subcontractor's surety of its intent to default the subcontractor, the parties had a conference, documents were produced to the surety and the surety indicated that it was commencing its investigation of the default.[17] Within that same span of a few days, the general contractor peremptorily obtained a completion bid,

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10 AIA Document A312-2010, § 11.

11 *See infra,* Section IV.A.1.

12 Wise Invs., Inc. v. Bracy Contracting, Inc., 232 F. Supp. 2d 390, 402 (E.D. Pa. 2002) (holding surety obligated to pay only costs of completion, not all damages including claims for liquidated damages and attorneys' fees which might be asserted under the construction contract).

13 *See, e.g.*, AIA Document A201-2017 § 12.3.

14 *See, e.g.*, AIA Document A201-2017 § 12.2.

15 *See* Sleeper Vill., LLC v. NGM Ins. Co., No. 09-cv-44-PB, 2010 U.S. Dist. LEXIS 105053(D.N.H. Oct. 1, 2010) (finding that construction contract, which provided that termination provisions of performance bond superseded the construction contract's termination provisions, gave the surety a defense to a claim for costs to complete and for corrective work where owner hired completion contractor without first complying with bond's termination provisions and allowing surety the opportunity to perform).

16 192 F. Supp. 3d 1326 (S.D. Fla. 2016).

17 *Id*. at 1328-29.

terminated the pool subcontractor's contract, and directed another contractor to commence corrective work.[18] The general contractor complied with the notice provisions of the bond and sued the surety for the cost of the corrective work. The court determined that the notice provided by the general contractor to the surety was "notice in name only" and that the surety was not afforded "actual notice and an opportunity to act" before the general contractor took "matters into its own hands and arranging for completion of the subcontract…."[19] Consistent with prior rulings, the court held that a surety facing defective work claims is entitled to reasonable notice and an opportunity to exercise its options under the bond.[20] Accordingly, the court concluded that the general contractor's actions in foreclosing those options was a breach of the bond, providing the surety with a complete defense.[21]

B. Retention of Consultants/Technical Experts

Allegations of defective work as the basis for the default may trigger the need for the surety to engage consultants or technical experts to investigate the alleged defects. Many performance bond default investigations are accomplished with the surety's in-house engineering and construction staff, but if the alleged defective work is of a highly technical or complex nature, such as controls, security, HVAC or other specialty construction, or the alleged defects are pervasive and involve multiple disciplines, the surety may be best served to retain an expert, or multiple experts, to investigate the claims. If the principal contests the quality of work claims, the surety may need to consider pertinent limitations, if any, contained in the Indemnity Agreement before retaining outside experts. The surety should also consider whether, under the circumstances, litigation is more likely than not and, if so, directing its attorney to engage and interface directly with the expert so as to preserve as privileged the communications with the expert who may end up being a testifying or non-testifying expert at trial.

Once the surety has appropriately staffed the investigation, the expert should be given access to the investigative materials obtained by the surety, including the contract documents, the principal's project records, and any other documents obtained from the obligee. The expert will likely need to conduct a site investigation and determine whether other documents or information are necessary to evaluate the defective work claims. Additional documents which may be helpful and which can be requested from the obligee, the architect or third-parties include shop drawings, requests for information, change orders, inspection or test reports, material and product submittals and substitutions, photographs or videos, bills of lading, or other documents. Part of the investigation should focus on determining whether there is defective work and who performed that work.

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18 *Id*. at 1329.

19 *Id*. at 1333.

20 *Id*. at 1333-34.

21 *Id*. at 1334 ; *see also* Milton Reg'l Sewer Auth. v. Travelers Cas. & Sur. Co. of Am., 648 F. App'x 215 (3d Cir. 2016)(holding that obligee's actions in terminating subcontractor and making claim against surety, but failing to permit either the principal or surety to cure, barred claim against the surety).

Defective work will be defined by the contract, usually in terms of whether or not it complies with the requirements of the contract documents.[22] Interpretation and application of the intent of the contract documents to determine what is "required" will necessitate an evaluation of the terms of the agreement, the scope of work and any exclusions, the plans, and the specifications utilizing the contractually supplied order of precedence. The order of precedence clause in the contract will define which part of the contract documents controls over inconsistent references in other parts and is intended to resolve any ambiguities in the contract documents.[23] In some contracts, the order of precedence might state that the requirements of the agreement control over the general conditions, specifications, and other documents. Alternatively, the clause might state that the "higher or more stringent standard" controls. An order of precedence clause assists the surety in making decisions about the scope of performance in the event of a conflict or omission in the design without having to seek guidance from the architect. The existence of an order of precedence clause can also create confusion, however, if the surety makes a decision based upon an interpretation and application of the order of the precedence that conflicts with the architect's interpretation.

Based upon an assumption that the contract documents are the result of a collaborative effort involving the owner, architect, and numerous consultants, for which no inherent order of precedence exists, the AIA has eschewed incorporating a precedence provision:

> The intent of the Contract Documents is to include all items necessary for the proper execution and completion of the Work by the Contractor. The Contract Documents are complementary, and what is required by one shall be as binding as if required by all; performance by the Contractor shall be required only to the extent consistent with the Contract Documents and reasonably inferable from them as being necessary to produce the indicated results.[24]

Under a contract where there is no order of precedence clause, the surety will have to exercise its best business judgment to determine what work is required and whether the work performed by the principal complies with contract requirements.

C. Evaluating Design v. Construction Defects – The *Spearin* Doctrine

When evaluating defective work claims, care should be taken to determine whether the work is actually defective, i.e., not performed in accordance with the plans and specifications, or whether the work complies with the plans and specifications but nevertheless does not work as intended. Because of the general applicability in most jurisdictions of the *Spearin* Doctrine, under which the owner impliedly warrants the adequacy of the plans and specifications,[25] the surety will

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22 Section 3.1.2 of the AIA Document A201-2017 document requires a contractor to "perform the Work in accordance with the Contract Documents," and Section 12.2.1 permits the architect to require the contractor to "promptly correct Work rejected by the Architect or failing to conform to the requirements of the Contract Documents, whether discovered before or after Substantial Completion and whether or not fabricated, installed or completed." AIA Document A201-2017 §§ 3.1.2, 12.2.1.

23 *See* Tarlton Constr. Co. v. Gen. Servs. Admin., GSBCA No. 10528, 94-1 BCA ¶ 26,279.

24 AIA Document A201-2007 § 1.2.1.

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

be responsible for correcting work not performed in accordance with the plans and specifications but will not be responsible for work that, while performed as shown in the plans, does not work as intended.[26]

This principle was demonstrated in *Trustees of Indiana University v. Aetna Casualty & Surety Co.*,[27] where the court held that the owner, not the contractor or surety, was responsible for the failure of the brick that it had specified by manufacturer and trade name in its specifications. Even though the brick was determined to have a latent defect, the court found the owner's implied warranty could, essentially, trump the express AIA contractor's warranty of workmanship and materials where: (1) the materials used were those specified and were properly installed; (2) the owner selected the materials, thereby impliedly warranting their suitability; and (3) the materials were unsuitable for the use required by the contract.[28] Investigation of the cause of product failure and the history of product selection can be of supreme importance in a situation where a material or product failure is the defect claimed by the obligee.

D. Defenses of the Surety to Claims of Defective Work

A fundamental part of the surety's investigation of any default is the identification and evaluation of potential defenses. Upon termination, the surety steps into the shoes of its principal and, because its liability is co-extensive with its principal, it is axiomatic that the surety is entitled to assert and rely upon the defenses of its principal.[29] These defenses often arise out of the construction contract and include the obligee's breaches of contract, breach of the implied warranty of specifications, failure of conditions precedent, or obligee caused delays.[30] In addition to its principal's defenses, the surety is entitled to certain unique, or personal, surety defenses. The surety's personal defenses include material alteration of the underlying obligation, fraud or misrepresentation by the obligee, premature payment or overpayment, statutory or contractual limitations, and frustration.[31] Depending upon the jurisdiction, the surety may be required to prove prejudice to justify either a complete or partial (*pro tanto*) discharge.[32]

When confronted with a defective work claim, one of the defenses which should always be considered is material alteration – did the contract require the obligee to inspect the work as part of the payment process and did the obligee fail to inspect or to identify work during such inspections which was later determined to be patently defective? Under such circumstances, the surety may be able to persuasively assert to a judge, or to use as leverage in the negotiation of a

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26 *See, e.g.*, Morse Boulger Destructor Co. v. City of Saginaw, 264 F.2d 847 (6th Cir. 1959) (judgment in favor of City against contractor and surety reversed where evidence showed incinerator was built in compliance with extensive design specifications prepared by the City).

27 920 F.2d 429 (7th Cir. 1990), *overruled on other grounds by* Watson v. Amedco Steel, Inc., 29 F.3d 274 (7th Cir. 1994).

28 *Id*. at 436-37.

29 David J. Krebs & Shannah J. Morris, *The Surety's Obligations Under the Performance Bond: To Perform or Not to Perform*, *in* BOND DEFAULT MANUAL 109, 186 (Mike F. Pipkin et al. eds., 4th ed. 2015).

30 *Id.* at 186-196.

31 *Id.* at 196-208.

32 Thomas J. Kelleher, Brian G. Corgan & William E. Dorris, *Defenses of the Performance Bond Surety*, *in* CONSTRUCTION DISPUTES PRACTICE GUIDE WITH FORMS (2017).

takeover agreement, that the obligee's actions in failing to inspect or negligently inspecting and paying for the work latter claimed to be defective impaired the surety's rights to the contract balance.[33]

Another defense that should be considered by the surety when faced with claims of defective work is the economic waste doctrine. This doctrine places a potentially significant limitation on the owner's recovery of damages for defective work – where "the cost of completion is grossly and unfairly out of proportion to the good to be attained," the owner's damages will be the difference in value between the work as constructed and the work as designed, which may be "either nominal or nothing."[34] This defense is not a true liability defense in that it does not provide a partial or complete bar to a claim for defective work, but it may have the effect of reducing or eliminating recoverable damages for the claim.

III. Managing Defective Work Prior to and During Completion

A. Negotiating the Takeover Agreement – Defining the Scope and Specific Provisions

A takeover agreement is an important bridge between the work performed by the defaulted principal and the completion of the project and many benefits are attained from the deployment of a comprehensive, tailored takeover agreement.[35] When defective or incomplete work is identified during the surety's investigation and the surety elects to take over, careful definition of the scope of work in the takeover agreement is critical. If possible, the defective work which has been identified should be delineated along with the agreed upon fix. If proposed "fixes" to the defects will result in something other than strict compliance with contract requirements, the parties' agreement to that alternative result should be memorialized to the extent possible.[36] The surety should avoid agreeing to terms that expand the obligation to correct defective work beyond the existing obligation under the construction contract or beyond the scope of what was identifiable at the time of the take over. This will provide the surety with the greatest opportunity to pass through post-take over claims for correcting latent defects from its completion contractor. Finally, even if there is complete agreement on the scope of the defects, the cure, and the responsibility for compensation for the cure cannot be reached, the surety should ensure the takeover agreement includes a reservation of rights so that the parties can complete the corrections and dispute responsibility and cost at a later date.[37]

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33 *See, e.g.*, Cont'l Ins. Co. v. City of Va. Beach, 908 F. Supp. 341, n.13 (E.D. Va. 1995) (finding surety entitled to pro tanto discharge and affirmative recovery of cost of retaining consulting engineer to evaluate defective work repair requests where owner not only failed to conduct reasonable inspections of the work before paying the principal for work that was later determined to be defective but one of its engineer's testified that "he did not mind paying the contractor early or paying for defective work because the suety would always be available to complete the job and/or pay for the repairs").

34 Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921).

35 *See* Christopher R. Ward & Patricia Wager, *Takeover*, *in* BOND DEFAULT MANUAL 361, 409(Mike F. Pipkin et al. eds, 4th ed. 2015).

36 *Id.* at 414.

37 *Id*.

Once a takeover agreement has been negotiated, the surety should carefully craft the terms of its completion contract with the company retained to complete the work to ensure that the surety's liability for payment of such claims is appropriately addressed. The surety should anticipate claims from the completion contractor for extra work, including additional claims for correction of defective work performed by the defaulted principal. Typically, completion contracts will contain provisions that ensure the completion contractor is only performing work within the defined scope, is not to perform work at the obligee's direction unless incorporated into a formal change order, and provides for the payment of correction of latent defects by change order only upon approval by the surety.[38] The surety should also strongly favor including provisions establishing procedural safeguards such as notification by the completion contractor of claims for additional compensation within the time limits required under the construction contract with the obligee, supported by the required documentation or scheduling analysis and cost explanation.[39]

B. Managing Obligee Expectations

Along with defining the scope of the work to be performed in the Takeover Agreement, the surety should take steps to ensure that the obligee is not given the impression that the surety will perform work outside the agreed upon scope. The surety should also monitor completion and ensure that the obligee and completion contractor both understand the limitations of the contract work and that the completion contractor does not stray beyond the agreed upon scope. In order to avoid disputes with the completion contractor over payment, it may be important for the surety to remain involved at least to some extent in the day-to-day administration of the project to avoid the situation where the completion contractor, who is focused on completing the scope and satisfying the obligee, performs work at the informal direction of the obligee that is beyond the scope of the completion contract.

C. Encountering Additional Defective Work During Completion

New or additional defective work encountered during completion by the surety must be treated as changed work vis-à-vis the completion contractor.[40] In addition, the discovery of additional defective work during completion must be evaluated to determine if it is simply more defective means and methods by the defaulted contractor, in which case the surety is most likely responsible for its correction, or whether it is defective design or work done by the obligee or its separate contractors. In the latter case, this new defective work may potentially be submitted to the owner for additional compensation (and potentially a time extension) as required by the construction contract. The definition of the scope of work will become especially important for the surety to assert that the new or additional defects are not the surety's responsibility to correct. Cooperation and monitoring of the completion contractor is essential, as obligees may attempt to

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38 *See, e.g.*, H&S Corp. v. U.S. Fid. & Guar. Co., 667 So. 2d 393, 399 (Fla. Dist. Ct. App. 1995) (rejecting completing contractor's claim that initial surety breached the completion contract by failing to pay for correction of latent defective work until after receipt of payment from obligee and completing surety's assertion of cardinal change where completion contract contained provision that latent defect work was to be handled by change orders on a cost plus 25% arrangement).

39 Theodore M. Baum and & Gregory M. Weinstein, *The Surety's Relationship with the Completion Contractor*, *in* BOND DEFAULT MANUAL 543, 555 (Mike F. Pipkin et al. eds., 4th ed. 2015).

40 *Id*.

persuade the completion contractor to fix or correct work beyond the strict scope agreed upon, either under the guise of contract language which requires "any and all work reasonably inferable" or other inclusive language or as an inducement to award additional work to the completion contractor in the future.

IV. Handling Post-Substantial Completion Claims

A. Contract, Bond and Statutory Limitations

The duration of the surety's exposure to claims for correction of defective work or claims for latent defects is determined by the bond or the applicate statute of limitations. The outside limit of the surety's obligation may be established by a statute of repose. Determination of applicable limitations must be considered by the surety when faced with a post-substantial completion claim of defective workmanship.

1. Limitations Contained in the Bond.

To avoid ambiguity about whether the performance bond obligates the surety to respond to post-completion warranty claims, the AIA A312-2010 Performance Bond, like many form performance bonds, contains an express deadline within which suit must be brought:

> Any proceeding, legal or equitable, under this Bond may be instituted in any court of competent jurisdiction in the location in which the work or part of the work is located and shall be instituted within two years after a declaration of Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond, whichever occurs first….[41]

This two-year period has been interpreted to override warranty clauses which impose a responsibility upon the principal, and surety, after the project is substantially complete.[42]

Many courts have enforced performance bond suit limitation provisions, allowing the parties to effectively shorten the time in which suit can be brought contractually to a period shorter than the applicable statute of limitations.[43] However, a number of jurisdictions, including Florida,

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41 AIA A312-2010 § 11.

42 4A PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:23, 2 (Aug. 2017 Update).

43 W. Glenn Speicher & Carol Z. Smith, *The Surety's Obligation to Correct Defective Work and Performance of Warranty Work and Their Effect on Negotiating Terms of Completion*, 11 n.17 (Jan. 21, 2011) ((unpublished paper submitted to the ABA/TIPS Fidelity and Surety Law Committee program) (citing Montreal Funeral Home, Inc. v. Ohio Farmers Ins. Co., 937 N.E.2d 159 (Ohio Ct. App. 2010) (barring obligee's performance bond claim based on the two-year suit limitations period set forth in the bond); Five Star Lodging, Inc. v. George Constr., LLC, 344 S.W.3d 119 (Ky. Ct. App. 2010) (binding obligee to the limitations provision of the bond); J.B. Mouton & Sons, Inc. v. Alumawall, Inc., 583 So.2d 157 (La. Ct. App. 1991) (finding suit limitation provision in the bond controlled even though the bond incorporated the subcontract, which had a longer warranty period); Yeshiva Univ. v. Fid. & Dep. Co. of Md., 500 N.Y.S.2d 241 (N.Y. App. Div. 1986) (barring cause of action against surety based on two- year limitation in the bond

Maryland, Mississippi, Oklahoma, and Missouri, do not allow modification of the limitation period as a matter of public policy.[44] Other states statutorily bar the shortening of a prescribed statute of limitation.[45]

2. Statutory Limitations.

Where the bond does not contain a suit limitation period, or a particular state refuses to apply the contractual suit limitation period, the state statute of limitation will apply. Those limitation periods can be long, such as in Maryland where the limitation period on bonded contracts is twelve (12) years. *Georgetown College v. Madden*[46] involved a claim by an obligee against a principal and its surety on a dormitory project where the defect to the exterior brick was first identified ten years after final payment and more than twelve years after the work was installed. The court held that the cause of action accrued with final payment, holding that the claim against the principal was extinguished under an applicable five year statute of limitations.[47] However, the surety remained liable under the longer twelve year limitation period applicable to surety bonds.[48]

Commencement of the limitation period varies from state to state. Some states start running of the statute on the date when the principal's work is completed and/or accepted.[49] In

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even though obligee's claim against the principal was still timely); and Town of Pineville v. Atkinson/Dyer/Watson Arch., P.A., 442 S.E.2d 73 (N.C. Ct. App. 1994) (enforcing bond's two-year suit limitation provision even though the claim involved latent defect and two year period was shorter than applicable statute of limitations would have been)); *but see* City of Santa Fe v. Travelers Cas. & Sur. Co., 228 P.3d 483 (N.M. 2010) (holding time limitations for suit contained in performance bond unenforceable against a governmental entity unless the governmental entity directly contracted for a shorter time than the applicable statute of limitations)).

44 *See* Robert F. Carney & Nichole M. Velasquez, *The Interpretation and Enforcement of Contractual Limitation Periods Contained in Contract Surety Bonds*, 26 CONSTR. LAW. 29 (2006). Pennsylvania, California, Arizona, South Dakota, Texas, Virginia and Utah also prohibit shortening the statute of limitations.

45 *See, e.g.*, ALA. CODE § 6-2-15 (2010) ("[A]ny agreement or stipulation, verbal or written, whereby the time for the commencement of any action is limited to a time less than that prescribed by law for the commencement of such action is void."); FLA. STAT. § 95.03 (2010); MISS. CODE ANN. § 15-1-5 (2010); MO. REV. STAT. § 431.030 (2010); MONT. CODE ANN. § 28-2-708; N.D. CENT. CODE § 9-08-05 (2010); OKLA. STAT. tit. 15 § 216 (2010); S.C. CODE ANN. § 15-3-140 (2010); VT. STAT. ANN. tit. 12, § 465 (2010)); *see also* MD. CODE ANN., INS. §12-104(a) (1997) (prohibiting enforcement of any provision in a surety contract that shortens the applicable period of limitation required by the law of the State of Maryland).

46 505 F. Supp. 557 (D. Md. 1980).

47 *Id.*

48 *Id.*

49 Speicher & Smith, *supra* note 43, 12 n.22 (citing BDI Constr. Co. v. Hartford Fire Ins. Co., 995 So. 2d 576 (Fla. Dist. Ct. App. 2008) (finding general contractor's claim against subcontractor's surety barred by five year statute of limitations in that general contractor had accepted subcontractor's work and made final payment to subcontractor more than five years before filing suit, even though the project was never completed because it was allegedly not constructed in accordance with the plans and specifications); Clark Constr. Grp. v. Wentworth Plastering of Boca Raton, Inc., 840 So. 2d 357 (Fla. Dist. Ct. App. 2003) (barring claim against surety based on five year statute of limitations, which ran from time that construction project was completed and accepted); Fed. Ins. Co. v. Sw. Fla. Ret. Ctr., Inc., 707 So. 2d 1119 (Fla. 1998) (holding claim against surety for latent defects barred by the statute of limitations, which began to run on the date of acceptance of the project)).

other states, a discovery rule may apply, which has the effect of tolling the running of the limitation period until the injury or damage is "reasonably ascertainable." [50]

3. Statutes of Repose.

Unlike statutes of limitation, which depend upon the accrual of a cause of action and may be tolled by certain events, statutes of repose set forth an absolute deadline after which claim and the right to pursue it expires. In the construction industry, statutes of repose most typically are a fixed period of time from project completion or acceptance. Statutes of repose add certainty to the construction context because they establish an absolute end to a party's risk of liability exposure at some pre-determined point following project completion.

While all but two states have enacted statutes of repose,[51] not all statutes of repose protect the same types of claims and the same categories of project participants. Some statutes of repose only apply to tort claims, while others exclude from application of the statute persons who have purposefully concealed a defect or deficiency. [52] Only four states' statutes of repose expressly include sureties.[53] However, sureties have successfully raised the statute of repose notwithstanding the lack of specific application of the statute to sureties.[54]

B. Patent v. Latent Defects

Defective or non-complying work can be categorized in two varieties, patent and latent. A patent defect is "a deficiency that is apparent by reasonable inspection"[55] upon the exercise of ordinary care. Latent defects, on the other hand, are deficiencies that were not apparent at the time

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50 *Id.* at 12 n.23 (citing Adesta Commc'ns, Inc. v. Utica Mut. Ins. Co., No. 08-cv-01817-RPM, 2010 WL 1240354 (D. Colo. March 19, 2010) (finding statute of limitations ran from the date the latent defect was or should have been discovered); Travelers Indem. Co. v. Hennepin Cnty., 918 F.2d 66 (8th Cir. 1990) (holding claim against surety for warranty work was governed by two-year statute of limitations which ran from date of discovery of defect)).

51 *Id.* at 13.

52 *Id.* at 14 n.30 and 31 (citing KAN. STAT. ANN. § 60-513(b) (2010); MASS. GEN. LAWS ch. 260, § 2B (2010); and OKLA. STAT. tit. 12, §109 (2010) for the former proposition; and then citing ARK. CODE ANN. § 16-56-112(d) (2010); CAL. CIV. PRO. CODE §337.15(f) (2010); MO. REV. STAT. § 516.097.4(2) (2010): N.H. REV. STAT. ANN. § 508:4-b.V (2010); and WIS. STAT. § 893.89(4)(a) (2010) for the latter).

53 *See, e.g.*, CAL. CIV. PRO. CODE § 337.15 (1981) (legislatively overruling Regents of Univ. of Cal. v. Hartford Accident & Indem. Co., 581 P.2d 197 (Cal. 1978) (holding that sureties not entitled to benefit of then current statute of repose which did not specifically identify sureties)).

54 *Compare* Cnty. of Hudson v. Terminal Constr. Corp., 381 A.2d 355 (N.J. 1977) (holding running of statute of repose against the principal prevented cause of action from accruing, and, because there was no cause of action against the principal,plaintiff had no cause of action against the surety), *with* Georgetown Coll. v. Madden, 505 F. Supp. 557, 564 (D. Md. 1980), *aff'd in part, dismissed in part*, 660 F.2d 91, 95 (4th Cir. 1981) (finding surety could be held liable under longer limitation period applicable to contracts under seal even though the principal's debt had been eliminated by the passage of the statutes of limitations and repose).

55 Thomas E. Miller, Rachel M. Miller & Matthew T. Miller HANDLING CONSTRUCTION DEFECT CLAIMS W. STATES SECT. 2.03 TYPES OF DEFECTS, 1 (4th ed. 2018).

the contractor's work was accepted and which could not have been discovered upon reasonable inspection.[56]

Patent defects which are obvious prior to completion of the work or the expiration of the warranty period and are timely raised are subject to correction by the principal, and, depending on its terms, by the surety under the performance bond.[57] If defective work is discovered and reported to the principal within the warranty period, the principal (and potentially its surety) must correct the work. If the defect is patent and is not reported within the warranty period, the obligee has waived its rights, and neither the principal nor the surety has any obligation to correct that defect.[58] Similarly, if final payment is made to the principal when there is defective work that is known, or should have been known, or the owner takes possession of the project when the subsequently claimed defect is patent, any claim against the surety may be deemed waived.[59]

Even if the principal is relieved of the obligation to correct the defect, the principal may still be subject to a claim for damages for breach for its non-compliance with the contract and may be subject to a breach of implied duties. The distinction between the principal's obligation to correct, which may expire or be waived, and the principal's liability for exposure to damages was explained by the North Dakota Supreme Court in *All Seasons Water Users Ass'n, Inc. v. Northern Improvement Co.*[60]:

> A warranty or guarantee is basically an agreement to repair or replace the faulty work regardless of the reason for the defect, so long as it is not due to abuse or neglect by the owner. A further duty which all contracts envision is that the contractor conform to the contract. A failure to do so subjects the contractor to liability for damage due to the failure, so long as the action is not barred by the applicable statute of limitations or there is no clear and unequivocal language in the contract which limits such liability.[61]

By definition, latent defects are discovered after project completion. To recover for a latent defect, an obligee must prove not only that the work fails to comply with the contract, but also that the obligee reasonably had no reason to know of the existence of the defect.[62] Some courts have held that performance bonds cover "latent defects" that may arise long after project completion.[63] In *Southwest Florida Retirement Center, Inc. v. Firemen's Ins. Co.*,[64] the Florida Supreme Court

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56 William J. Schwartzkopf, PRACTICAL GUIDE TO CONSTRUCTION SURETY CLAIMS §17.03 LATENT DEFECTS CLAIMS, 1(3d ed. 2018).

57 4A PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER AND O'CONNOR ON CONSTRUCTION LAW §12.23 at 2 n. 27 (2017).

58 *Subsurfco, Inc. v. B-Y Water Dist*., 337 N.W.2d 448 (S.D. 1983), *appeal after remand*, 369 N.W.2d 129 (S.D. 1985).

59 Schwartzkopf, *supra* note 56, at 4.

60 399 N.W.2d 278 (N.D. 1987)9, *appeal after remand*, 417 N.W.2d 831 (N.D. 1988)

61 399 N.W.2d at 285.

62 Schwartzkopf, *supra* note 56, at 4 n.9.

63 Shannon J. Briglia & Jarrod Stone, *Construction Contract Provisions Critical to the Performing Surety: Scope of Work, Contract Price and Time of Completion, in* BOND DEFAULT MANUAL 51, 70 (Mike F. Pipkin et al. eds., 4th ed. 2015).

64 707 So. 2d 1119 (Fla. 1998).

held that the performance bond surety was liable for latent defects discovered after substantial completion. In *Independent Consolidated School District No. 24, Blue Earth County v. Carlstrom*,[65] however, the Minnesota Supreme Court dismissed claims against the surety for latent defects discovered after the expiration of the one-year warranty period.[66] Some courts have held that the surety may be liable for post-completion warranty obligations where the contract contains a warranty provision and the bond incorporates the contract by reference.[67]

The surety's liability for correcting latent defects discovered after substantial or final completion may depend upon the language of the contract or the bond. In the absence of express warranties, the surety's obligation to ensure performance ends when the work is substantially complete.[68] Where the warranty provision states that the warranty is the owner's exclusive remedy for correction of latent defects, neither the principal nor the surety is liable for defects discovered after the warranty period. In contrast, where the bond does not define default or require termination as a condition of the surety's obligation to perform, the surety's obligation to correct latent defects has been construed to be co-extensive with the obligation of the principal.[69] That is, if the principal is liable for the correction or damages associated with the defect, so is the surety. If, however, the bond requires termination of the principal as a condition of the surety's obligation to perform, the work is substantially or finally complete and accepted when the defects are discovered, and the principal's contract is not terminated, the surety may have no liability.[70]

V. The Impact of Insurance Coverage for Defective Work Claims on the Surety

All the parties to a construction contract typically carry different types of insurance, the most common of which includes commercial general liability ("CGL") and builder's risk insurance. Where defective work is encountered by the surety on a construction project, evaluation of whether there may be insurance coverage should be undertaken. Under the typical CGL policy, insurance coverage hinges on an "occurrence," often defined as "an accidental event."[71] There are cases on both sides of the issue of whether defective work constitutes or does not constitute an

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65 151 N.W.2d 784 (Minn. 1967).

66 *Id.* at 787-88.

67 *See* C&I Entm't, LLC v. Fid. & Dep. Co. of Md., No. 1:08CV00016-DMB-DAS, 2014 WL 3640790 (N.D. Miss. July 22, 2014) (finding that, where a contract covers warranty work, a default can be declared after substantial completion*);* Sweetwater Apartments, P.A., LLC v. Ware Constr. Servs., Inc., No. 2:11-CV-155-WKW, 2012 WL 3155564 (M.D. Ala. Aug. 3, 2012) (noting it is not unprecedented for a performance bond to cover post-completion warranties where the bond incorporates the construction contract and guarantees the full and complete performance of the contractor's obligation); AgGrow Oils, LLC v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 276 F. Supp. 2d 999 (D.N.D. 2003) (same); Turner Constr. Co., Inc. v. Am. States Ins. Co., 579 A.2d 915 (Pa. Super. Ct. 1990) (same).

68 4A PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER & O'CONNOR ON CONSTRUCTION LAW §12.23 at 1.

69 *See id.* at 1 n.18.

70 *See* Stonington Water St. Assocs., LLC v. Hodess Bldg. Co., Inc., 792 F. Supp. 2d 253 (D. Conn. 2011) (holding that failure of obligee to comply with notice and termination provisions of the bonded contract defeated claim).

71 *See* Patrick J. O'Connor, Jr., *Deciding to Litigate: The Surety's Rights Against Property and Liability Insurers of the Obligee, Principal, and Subcontractors, in* MANAGING AND LITIGATING THE COMPLEX SURETY CASE 259, 268 (Philip L. Bruner, et al. eds., 2d ed. 2007).

"occurrence" for which coverage may lie.[72] Courts finding that defective work constitutes an "occurrence" seem to rely on the presumption that the insured did not intend to perform defective work and, thus, the discovery of defective work must mean that it was an accident.[73] Even if defective work qualifies for coverage, if the loss is purely physical injury to tangible property that is part of the insured's scope of work, various policy exclusions may strip away that coverage. Coverage may more readily be found where the insured's defective work caused damage to other tangible property.[74]

In addition to the potential of insurance coverage for the losses and damages associated with defective construction, the surety may also be entitled to recover defense costs associated with defending a lawsuit alleging construction defects from the principal's insurance carrier. This scenario played out in *Pierce Associates, Inc. v. St. Paul Mercury Ins. Co.*,[75] where Pierce, a mechanical subcontractor, was found to be a "protected person," or additional insured, under the owner's CGL policy for a large hotel-condominium project. When Pierce and its surety were brought in as third-party defendants by the owner and prime contractor in a suit for alleged defective mechanical and plumbing work brought by the condominium owners and other tenants, Pierce demanded the carrier defend and indemnify both Pierce and its surety. The carrier agreed to defend Pierce, but not its surety, and Pierce incurred $240,000 in legal fees on behalf of its surety to obtain dismissal of the suit.[76] Thereafter, Pierce initiated a coverage action against the insurance carrier for the costs it incurred in defending its surety.[77]

> In interpreting the policy, the court found that the duty to defend was broad and: *may* require the insurer to pay the defense costs of a third party in limited circumstances such as those presented by the [underlying state court] action. Specifically, that context is a lawsuit against a third party [the surety] where (1) the insured had been a defendant but was dismissed from the case without an adjudication on the merits, (2) the third party is present in the action solely by virtue of its role as the insured's surety, (3) resolution of the claims against the third party would require resolution of allegations about the insured's conduct, (4) the insured would be legally bound to indemnify the third party for any payment in satisfaction of a judgment, (5) the plaintiff in the suit has made closely related demands directly against the insured through a separate action, and (6) the insurer was fully aware of these circumstances.[78]

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72 *Id*. at 269 n.28 (cases holding defective work constitutes an "occurrence") and 272 n.29 (cases holding defective workmanship is not an "occurrence").

73 See, *id*. at 269 n.28.

74 *Id*. at 274.

75 421 F. Supp. 2d 11, 14 (D.D.C. 2006), *vacated on other grounds*, 437 F. Supp. 2d 16 (D.D.C. 2006) (vacating grant of summary judgment in favor of subcontractor based upon *contra proferentem* rule after insurer asserted that extrinsic evidence existed to disprove that the duty of defense arose only when the claim or suit "directly" targeted the insured).

76 421 F.Supp.2d at 15.

77 *Id*. at 16.

78 *Id*. at 19 (internal footnote omitted).

Other courts have similarly found that sureties may acquire coverage under their principal's insurance policies through subrogation or the assignment provision of an indemnity agreement.[79] Accordingly, an important part of the surety's evaluation of defective work claims is ascertaining the potential availability of insurance coverage for correction of the defective work and pursuing such coverage if reasonably achievable.

VI. The Surety's Subrogation Claims Against Third-Parties for Losses Associated with Quality of Work Issues

During its investigation or completion of the bonded contract, the surety may determine that the defective work that is discovered was not performed or caused by its principal, but instead by a party with whom the principal is in privity, such as a subcontractor or supplier, or by another third-party, such as a separate contractor working directly for the owner, or the architect or project engineer. Typically this discovery will not provide immediate funds for the surety to correct the defective work, but care should be taken by the surety to make demand on the responsible party, thus triggering the obligation for that party to put its insurance carrier on notice. Such a demand may result in negotiations with the offending party and, at a minimum, sets the stage for a possible later suit by the surety for reimbursement of the costs for correcting the defective work against the party responsible for that defective work.[80] In addition, if the party who performed the defective work was a subcontractor who provided a bond, notice and demand should be made on the subcontractor's surety, thereby augmenting the pool of responsible parties to correct the work or reimburse the surety for correcting the defective work.

A. Subcontractors/Suppliers

Where the surety determines that defective work was performed by a party with whom its principal had a contract, such as a subcontractor, the surety may stand in the shoes of its principal and pursue claims for defective work as a subrogee. This occurred in *Anderson County v. Goodstein, Hahn, Shorr & Associates*,[81] where the County and general contractor's surety sued the project's mechanical subcontractor, asserting that that the mechanical work was defective. Having made payments to the subcontractor for the work as surety for the prime contractor, the surety was subrogated to and assignee of all of the prime contractor's rights against the subcontractor.[82] Care should be taken to review the contract between the principal and subcontractor to ensure that notice is given as required under the contract, and, if appropriate, an opportunity to cure is provided before the surety corrects the defect.

B. Architects, Engineers, Inspectors and Other Third-Parties

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79 Auto Owners Ins. Co. v. Travelers Cas. & Sur. Co., 227 F. Supp. 2d 1248 (M.D. Fla. 2002) (finding that surety had standing to pursue coverage both as a first party claimant by way of subrogation and assignment and as a third-party claimant).

80 *See generally* John Gillum & Melissa Lee, *Subcontractors, Suppliers and Other Third-Party Issues*, in Managing and Litigating the Complex Surety Case, (Tracey Haley, et al., eds., 3d ed. 2018).

81 535 F. Supp. 269 (E.D. Tenn. 1982).

82 535 F.Supp. at 271-72.

A slightly different approach is necessary if the surety determines that the defective work was caused by or is the responsibility of a third-party not in privity with its principal. Many jurisdictions endorse the "Economic Loss Doctrine," which bars claims for purely economic losses sounding in negligence against parties with whom there is no contractual privity.[83] Thus, in certain jurisdictions the surety may be barred from asserting a claim against a third-party. Other jurisdictions do not strictly apply the doctrine or endorse numerous exceptions to the doctrine which might permit such claims to be pursued.[84] In addition, the performing surety, who is subrogated to both the rights of its principal and the rights of the owner, may be able to pursue claims as the owner's subrogee or assignee against the architect or engineer with whom the owner has a contract.[85] Thus, where the defective work is the result of the negligence of a party with whom the principal is not in contractual privity, the surety maygain the right to seek reimbursement from third-parties once it performs and becomes subrogated to the rights of the obligee.

VII. Quality of Work Litigation Issues

A. Documentation During an Investigation of Quality of Work Issues

Ideally, completion of the surety's investigation will yield a comprehensive identification of the status of the work at default and the existence of any patent defects. To the extent the surety elects to takeover, this information will be incorporated into the takeover agreement and should end any further discussion or dispute on issues known at that time. Where, however, defective work is uncovered during completion or post-completion, the surety should take care to document the defects, notify the obligee, and develop a game plan for pursuing the costs associated with correcting the deficiencies. In some cases, the surety will have no recourse against the obligee or other third-parties involved in the project, but, at a minimum, the surety should take care to ensure it is prepared to prove in a subsequent indemnity action the existence of the defective work, that the principal was responsible for performing it, and the cost of correcting the deficiencies.

In anticipation of later litigation concerning the defect, the surety should, proportional to the size and cost of the correcting the defects, marshal all information relevant to the identification of, evaluation of, and correction of the defect. Contemporaneous records documenting the defects,

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83 Virginia, Maryland, and Delaware, for example, all bar claims for defective work where there are only economic damages against parties not in contractual privity with the claimant. RLI Ins. Co. v. Indian River Sch. Dist., 556 F. Supp. 2d 356, 361 (D. Del. 2008) (barring surety's claim against project architect for negligently reviewing and providing information about the status of the contractor's work in the context of the payment application review process pursuant to economic loss doctrine); RLI Ins. Co. v. John H. Hampshire, Inc., 461 F. Supp. 2d 364 (D. Md. 2006) (holding subcontractor's surety's claim against architect for improper inspection of the work barred by the economic loss doctrine); Hanover Ins. Co. v. Corrpro Cos, Inc., 312 F. Supp. 2d 816 (E.D. Va. 2004) (finding that economic loss rule barred surety's claim against a quality assurance inspector).

84 Ins. Co. of N. Am. v. Town of Manchester, 17 F.Supp.2d 81, 86 (D.Conn. 1998)(following majority rule that absence of privity will not bar a negligence action by one construction professional against another for economic losses where reliance was reasonably foreseeable).

85 *See, e.g.,* Lyndon Prop. Ins. Co. v. Duke Levy and Assocs., LLC, 475 F.3d 268 (5th Cir. 2007) (permitting surety to stand in the shoes of the owner and sue engineer for breach of contract, breach of warranty and negligence*);* Berschaure/Phillips Constr. Co. v. Seattle Sch. Dist. No. 1, 881 P.2d 986, 993 (Wash. 1994) (allowing surety to pursue claims as owner's assignee against design professional).

including photographs, video, and file reports, are extremely helpful to prove the surety's right to reimbursement. Architect or engineer observations, non-compliance notices, and reports prepared by or for the obligee often serve as an independent confirmation of the defect. Submittals and test results submitted by the defaulted principal to the architect for materials, such as concrete or asphalt, should be requested if implicated and maintained until needed. Once a defect is identified, a review should be conducted of the principal's records to determine whether additional relevant submittals, data sheets, reports, or documents are available and should be requested from subcontractors or suppliers. Original commissioning reports, with sign-offs, photos, videos, and any narratives can provide clarity many years later of documented problems with a system which ultimately were traced to defective installation or materials. Where defective work or materials must be removed and replaced, consideration should be given to storing exemplars for examination or testing in the future by retained trial experts.

B. Selection and Retention of Technical Experts Who May Serve as Expert Witnesses

Most construction defect cases will require expert testimony regarding the appropriate standard of care and whether or not there was a "defect" in the particular system or systems at issue. This may be considered scientific evidence, subject to the *Daubert* standard. In many cases, *Daubert* challenges to each side's experts have become standard procedure.

In *Daubert v. Merrill Dow Pharmaceuticals, Inc.*,[86] the United States Supreme Court held that trial courts should regulate any scientific testimony or evidence admitted through experts to ensure that it was both relevant and reliable. Consequently, it is likely that each side will challenge the other's experts based on *Daubert*. The court prescribed four factors to apply when evaluating the expert's theory or method: (1) whether it can be and has been tested; (2) whether it has been subjected to peer review and publication; (3) whether its reliability is limited by a "known or potential rate of error" or by certain operating standards; and (4) whether it is generally accepted by the expert's peers.[87] In *Kumho Tire Co. v. Carmichael*,[88] the Supreme Court expanded these tests to cover all expert testimony. Later, in response to *Daubert* and *Kumho Tire,* Rule 702, Federal Rules of Evidence was amended to provide:

> If scientific, technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or date, (2) the testimony is the product of reliable principles and methods,

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86 509 U.S. 579(1993). The standard set forth in *Frye v. U.S.*, 293 F. 1013 (D.C. Cir. 1923), was the standard for many years and has been adopted by some state courts rather than the *Daubert* standard. *See,* Alice B. Lustre, Annotation, *Post-Daubert Standards for Admissibility of Scientific and Other Expert Evidence in State Courts,* 90 A.L.R. 5th 453§ 2 (2001). *Frye* applied only to novel scientific evidence. The *Daubert* opinion held *Frye* was superseded by the Federal Rules of Evidence. However, *Daubert* has created its own problems for trial courts, since it applies to *all* scientific evidence. *See* 29 Charles Alan Wright & Victor James Gold, FEDERAL PRACTICE AND PROCEDURE §6266 (2d ed. 2017).

87 509 U.S. at 2796-97.

88 526 U.S. 137 (1999).

and (3) the witness has applied the principles and methods reliably to the facts of the case.[89]

When faced with a *Daubert* or *Frye* challenge to an expert's testimony, the attorney who is using that expert must prepare for a potential evidentiary hearing on the *Daubert* or *Frye* factors, which will require a showing through testimony and literature that the expert's theory or method has been tested, has been subjected to peer review and publication, is reliable and it is generally accepted by the expert's peers. This will require the expert to be prepared to testify in support of his or her methodology and testimony.

Of course, not all "experts" need to have academic credentials. An expert drywall installer may have only a high school education, but may have thirty years of experience in drywall installation. Many times such experts are far more credible to judges, juries, and arbitrators than "hired guns" with many degrees but no real construction experience.

C. Damages

There are two basic methods for calculating an owner's damages for defective or incomplete work: (1) the cost of repair and (2) diminution in value (or difference-in-value).[90] Which methodology applies is dependent on the facts of the case. Where the work was substantially performed, the measure of damages is generally the cost of completing the work or remedying the defects that are remediable.[91] When the contractor has substantially failed to comply with the contract, the owner may seek the difference between the value of the building or thing as constructed compared to its value had it been constructed according to the contract.[92]

The Restatement (First) of Contracts adopted the cost of repair approach as the primary method of computing damages, stating:

> (1) for a breach by one who has contracted to construct a specified product, the other party can get judgment for compensatory damages for all unavoidable harm that the builder had reason to foresee when the contract was made, less such part of the contract price as has not been paid and is still not payable, determined as follows:
>
> (a) for defective or unfinished construction he can get judgment for either
>
> (i) the reasonable cost of construction and completion in accordance with the contract if this is possible and does not involve unreasonable economic waste; or
>
> (ii) the difference in value that the product contracted for would have had and the value of the performance that has been received by the

89 FED. R. EVID. 702 (2010).

90 *See* John P. Ludington, Annotation,, *Modern Status of Rule as to Whether Cost of Correction or Difference in Value of Structures is Proper Measure for Breach of a Construction Contract*, 41 A.L.R. 4th 131 §2[b] (1985).

91 *See* Balfour Beatty Rail, Inc. v. Kan. City S. Ry. Co., 173 F. Supp. 3d 363 (N.D. Tex. 2016).

92 *Id*. at 397.

> plaintiff, if the construction and completion in accordance with the contract would involve unreasonable economic waste.[93]

A number of courts have adopted the First Restatement's "cost of repair" measure of damages. For example, in *Grossman Holdings, Ltd. v. Hourihan,*[94] the Florida Supreme Court adopted the First Restatement's damages approach in the owner's suit against the homebuilder who constructed the house facing in the wrong direction.

In contrast, the Restatement (Second) of Contracts adopted the diminution in value test as the primary approach to damages computation, stating:

> § 348 Alternatives to Loss in Value of Performance
>
> (2) If a breach results in defective or unfinished construction and the loss in value to the injured party is not proved with sufficient certainty, he may recover damages based on
> (a) the diminution in the market price of the property caused by the breach, or
> (b) the reasonable cost of completing performance or of remedying the defects if that cost is not clearly disproportionate to the probable loss in value to him.[95]

Difficulties of proving the difference in market value as designed versus as constructed in all but the most egregious construction defects have resulted in an increasing reliance upon the cost of repair, either standing alone or as proof of difference in value.[96]

When the cost to repair is substantial, the "economic waste" doctrine is often raised as a defense to the owner's damages claim. Under the Restatement (First) of Contracts, damages for breach are the reasonable costs of construction in compliance with the contract, "if this is possible and does not involve unreasonable economic waste."[97] What constitutes "economic waste" in repair of a construction project is a fact question that is often hotly contested. Two situations where the "economic waste" doctrine is applied are when (1) the cost of repair greatly exceeds the original cost of construction (the "disproportionate value rule"), and (2) repairing the defect will result in the destruction of usable property (the "destruction rule").[98]

Most courts hold that the breaching contractor has the burden of proving that the cost to repair constitutes economic waste. "Without question, the contract breaker should pay the cost of construction and completion in accordance with his contract unless he proves affirmatively and convincingly that such construction and completion would involve an unreasonable economic waste."[99]

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93 RESTATEMENT (FIRST) OF CONTRACTS §346(1)(a)(i) (1932).

94 414 So. 2d 1037 (Fla. 1982).

95 RESTATEMENT (SECOND) OF CONTRACTS §348(2) (1981).

96 Ludington, *supra* note 90, at 24.

97 Magnum Constr. Mgmt. Corp. v. City of Miami Beach, 209 So. 3d 51 (Fla. Dist. Ct. App. 2016) (citations omitted).

98 Ludington, *supra* note 90, at 27.

99 Moss v. Speck, 306 N.W.2d 156, 158 (Neb. 1981) (citation omitted); *see also* Cnty. Asphalt Paving Co. v. 1861 Grp., Ltd., 908 S.W.2d 184 (Mo. Ct. App. 1995).

In *Eastlake Construction Co. v. Hess*,[100] for instance, the Washington Supreme Court held that the Restatement (Second) of Contracts formulation "represents a sensible and workable approach to measuring damages in construction contract cases." In that case, the work on the project was not substantially complete and it was argued that the cost to replace non-conforming kitchen cabinets in a condominium building constituted "economic waste" and, therefore, the owner's recovery should be limited to the difference in value between the cabinets installed and those specified.[101] The court remanded the case for a determination of damages based upon the premise that the award should be for the cost to replace the cabinets unless the cost of replacement was "'clearly disproportionate' to the value of the benefit conferred by replacement [i.e. the increase in market value produced by installing the correct cabinets]."[102]

In some cases, the owner's aesthetic objectives for a structure may overcome a contractor's economic waste arguments. For example, in *City School District of City of Elmira v. McLane Construction Co.*,[103] a school district contracted for construction of a swimming pool building featuring a roof consisting of natural wood decking supported by laminated wood beams. The appearance of the beams was central to the aesthetics of the architectural scheme.[104] The building was intended to be a showplace, the site of large regional swimming competitions and had been designed to contrast the natural wood beams and decking with other "stark unfinished concrete" elements.[105] When delivered to the site, the beams were discolored but the owner accepted them on representations they could be cleaned.[106] However, it was later determined that the beams were permanently discolored.[107] The school board sued the contractor to recover the $357,000 cost to replace the beams and recovered a verdict in this amount.[108] On appeal, the court rejected the defendant's argument that the owner's damages were limited to the cost of repairing the beams ($37,500) or the diminution in value of the structure ($3,000) on the basis that the school district's stated intention to construct "an aesthetically prepossessing structure. . . has by all accounts been frustrated."[109]

There are other potential exceptions to the application of the economic waste doctrine. If the contractor intentionally or willfully breaches a contract, courts have refused to apply the economic waste doctrine to avoid cost of repair damages.[110] The economic waste doctrine will not prevent recovery where there are significant safety concerns about the construction. In *Bhattaria v. Stein*,[111] the contractor constructed a driveway with a slope nearly twice the maximum grade

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100 686 P.2d 465, 475 (Wash. 1984).
101 686 P.2d at 470.
102 *Id*. at 475.
103 445 N.Y.S.2d 258 (N.Y. App. Div. 1981).
104 *Id*. at 259-60.
105 *Id*. at 260.
106 *Id*.
107 *Id*.
108 *Id*.
109 *Id*. at 260-61.
110 Shell v. Schmidt, 330 P.2d 817 (Cal. Ct. App. 1958); *see also* Ludington, *supra* note 90, at 28.
111 849 P.2d 1153 (Or. Ct. App. 1993).

permitted by city ordinance. The court awarded the owner the cost to reconstruct the driveway, finding that this expensive correction was not economic waste.[112]

To prove the cost of repair, the owner must present either competent testimony regarding the estimated repair costs or, if the repairs have been done, evidence of the actual costs incurred, such as cancelled checks. The owner may recover engineering and architectural fees reasonably necessary to accomplish the repairs, as well as relocation and finance costs.[113] It may be necessary to have the testimony of a contractor or other expert to verify that the amount was reasonable, in addition to the owner's testimony about the amount that was actually spent.[114]

The owner's loss of use of a new project may be proved by evidence of the reasonable rental value of the new project.[115] This may be difficult with public projects such as courthouses or athletic facilities, which have no comparable rental value. In such cases the owner should present evidence of the cost of renting alternative facilities through the testimony of a qualified expert, such as a real estate appraiser, to prove its damages for loss of use.

D. Evidentiary Issues

Presenting a construction defect case to a judge, jury, or to a panel of arbitrators is much like putting on a major theatrical production. It requires coordinating numerous details to tell a cohesive and persuasive story. The documentary evidence and pictorial and physical evidence should be organized by issue or by witness. The witnesses must be prepared for their direct and cross examination, including an explanation of any exhibits that will be introduced or used demonstratively during their testimony. Exhibits must be developed to illustrate technical points and chronologies. This often requires hours of intense preparation with counsel prior to the hearing or trial.

While it is beyond the scope of this chapter to cover all of the topics involved in effectively presenting a construction defect case at trial or arbitration,[116] the usefulness of computerized models or graphics which help explain complex building systems and defects warrants some discussion.

Computer graphics make "as-planned" and "as built" comparisons easily understandable even to a lay person. Photographs and videos from the original construction, as well as the original

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112 *Id.* at 1154-55.

113 Centex-Rooney Constr. Co. v. Martin Cnty., 706 So. 2d 20 (Fla. Dist. Ct. App. 1997).

114 Blecick v. Sch. Dist. No. 18, 406 P.2d 750 (Ariz. Ct. App. 1965).

115 *Tuttle/White Constructors, Inc. v. Montgomery Elevator Co.*, 385 So. 2d 98 (Fla. Dist. Ct. App. 1980).

116 There are many excellent books and treatises on case management and presentation, which counsel should consult for in-depth discussion of these topics. *See, e.g.*, James W. McElheney, TRIAL NOTEBOOK (4th ed. 2005); Sonya Hamlin, WHAT MAKES JURIES LISTEN TODAY (1998); GOING TO TRIAL (Daniel I. Small ed., 2d ed. 1999); Gerry Spence, HOW TO ARGUE AND WIN EVERY TIME (1998); Jeffrey T. Frederick, MASTERING VOIR DIRE AND JURY SELECTION (3d ed. 2012); Steven Lubet, MODERN TRIAL ADVOCACY (1997); Ann E. Brenden & John D. Goodue, PERSUASIVE COMPUTER PRESENTATIONS: THE ESSENTIAL GUIDE FOR LAWYERS (2001); Michael Tigar, PERSUASION: THE LITIGATION'S ART (1999); David Ball, THEATER TIPS AND STRATEGIES FOR JURY TRIALS (1997); Sam Schrager, THE TRIAL LAWYER'S ART (1999); Ronald Waicukauski, Paul Mark Sandler & JoAnne Epps, THE WINNING ARGUMENT (2002).

plans and shop drawings, can be inserted into a computer model to amplify the computer animations and enhance their reliability. The cost for these computer graphics has decreased significantly in recent years.[117] Since most people are accustomed to receiving their information visually, it is advisable to use these resources to present the technical portions of the case. "The average person in the United States views television for seven hours a day, and people who normally watch more television tend to believe what they see."[118] In short, the use of computer animations or simulations at trial will likely aid the jury in reaching decisions.

The experts should coordinate the exhibits that will be used with their testimony to insure that they are technically correct. This will require additional meetings with counsel, the expert and the computer technician, but will be worth the time to insure that the finished product is accurate and will be admissible. There is a considerable difference between computer graphics used to illustrate an expert's testimony as a demonstrative aid, computer animation or simulation used as substantive evidence, and computer-generated evidence that was created as part of a client's business records. Computer-generated evidence may require significant supervision for authentication.[119] Computer generated evidence may also need to be authenticated as a business record[120] or have other foundational predicates laid for its admissibility, *e.g.*, as a summary of voluminous records under Rule 1006 of the Federal Rules of Evidence.[121]

Because courts are often concerned about the potential for computer animations to mislead a jury if they portray an inaccurate or distorted version of the facts, the proponent of the animation must satisfy the court that the animation is trustworthy. Of course, these concerns are of less concern in a bench trial or arbitration, but counsel should still take care that such presentations are accurate. As our society has become more reliant upon visual learning from televisions and other digital information content, the use of computer animations and simulations in the courtroom has increased, making the court's gatekeeping role to ensure the reliability of such persuasive evidence even more critical.[122]

In *State v. Swinton*[123] the Connecticut Supreme Court dealt with the issue of admissibility of digital information in a criminal case. In that case a defendant convicted of murder challenged the admission of digital photographic evidence at trial. The court held that the party moving to admit composite photographs as evidence has the burden of showing how the composite was prepared and how accurately it portrays that which it is intended to portray.[124] Noting that there is no universal definition of "computer generated evidence," the court stated:

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117 *See* Howard Ashcraft, Multimedia on $5 a Day, Presentation at the ABA Forum on Construction Industry Annual Meeting (April 24-26, 1997).

118 Laura Wilkinson Smalley, *Establishing Foundation to Admit Computer-Generated Evidence as Demonstrative or Substantive Evidence*, 57 Am.Jur.Proof of Facts 3d 455, 15-18 (2018).

119 Jay Grenig & William C. Gleisner, III, 1 eDISCOVERY & DIGITAL EVIDENCE §14:3 (2006).

120 FED. R. EVID. 803(6).

121 Smalley, *supra* n. 118 at 34.

122 *Id.* at 7.

123 847 A.2d 921 (Conn. 2004).

124 847 A.2d at 936.

> Currently there is no universal definition of that term: many commentators, however, and some courts, divide computer generated evidence into two distinct categories of evidence: simulations and animations. In a simulation, data is entered into a computer which is programmed to analyze the information and perform calculations by applying mathematical models, laws of physics and other scientific principles in order to draw conclusions and recreate an incident. . . . In contrast, an animation does not develop any opinions or perform any scientific calculations and, to the contrary, is nothing more than a graphic depiction, or illustration of the previously formed opinion of any expert.[125]

The Court outlined the six factors necessary for admission of computer-generated evidence: (1) the computer was standard and in good working order; (2) the operators of the equipment were qualified; (3) proper procedures were followed; (4) reliable software was used; (5) the program operated properly; and (6) the exhibit derived from the computer.[126]

Because animations are only "illustrations" rather than substantive evidence, they are subject to a lower foundational standard. "[C]ourts have required that the event shown on the animation must conform to the testimony about that event at trial. A few courts have also required testimony from, or about the specific sources of data that were relied on by the animator. The expert whose opinion is depicted by the animation will have to testify about the basis for that opinion and the scientific or technical principles upon which it is based, as must any testifying expert, but not about the scientific or technical validity of the underlying computer program. Trial courts also give elaborate instructions to the jury concerning the limited purpose of the animation as illustrative evidence."[127]

In contrast, a "simulation" must be "authenticated as an accurate result of a system or process, pursuant to Federal Rule of Evidence 901(b), by a set of factors: (1) sufficiency of the factual basis that serves as input, and its substantial similarity to the real event; (2) reliability of the underlying technical or scientific principles; (3) accuracy of the specific computer operating system; and (4) appropriateness and accuracy of the mathematical formulae creating the model that is programmed into the computer."[128]

E. Jury Instructions

Many articles on case management and trial preparation suggest that the lawyer begin drafting jury instructions at the start of the case and focus his or her discovery and depositions around those jury instructions since those are the essential elements of the proof. Whether one follows that method of case management or not, drafting jury instructions indubitably is a critical

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125 *Id.* at 937.

126 *Id.*at 942 (citation omitted).

127 2 George E. Dix et al., MCCORMICK ON EVIDENCE §218, 2 (7th ed. 2016); *see also* Kurtis A. Kemper, Annotation, *Admissibility of Computer-Generated Animation*, 111 A.L.R. 5th 529 (2003); Kenneth Kupchak & Dyan Medeiros, Offering Computer-Generated Animations Into Evidence (Telling It Like It Was!), Presentation at the ABA Forum on Construction Industry Annual Meeting (April 24-26, 1997).

128 2 McCormick on Evidence at 2.

element in presenting the construction case. This task is made more difficult by the fact that most standard or model jury instructions do not fit the facts of most construction and surety cases.

Several ABA sections, including the Business and Commercial Litigation and the Construction Litigation Committee of the Litigation Section have prepared specially drafted jury instructions for construction cases. The Construction Litigation Committee of the ABA Litigation Section published an updated book of Model Jury Instructions for construction cases in 2015.[129] The Business and Commercial Litigation Section's instructions are limited in scope, addressing basic instructions for breach of contract, breach of the covenant of good faith and fair dealing, breach of warranty, and abandonment.[130] In addition, the ABA Tort and Insurance Practice Section issued Model Jury Instructions for Surety Cases in 2000.[131] Each of these sources provide helpful guidance for preparing effective jury instructions for a defect case.

CONCLUSION

Defective work claims are complex, often requiring intensive factual, technical and legal evaluation before the surety can determine whether it is obligated for the defects under its bond. This is particularly true of claims for latent defects arising well after substantial completion of the bonded contract work. Limitation periods contained in the bond or applicable statutes can play important roles in the surety's assessment and resolution of late filed latent defect claims. The assistance of construction consultants with the requisite technical experience is critical to successfully navigating the minefield of defective work claims, with such consultants later playing an important role in pursuing either indemnity or subrogation litigation against third-parties. The surety confronted with a defective work claim must, proportional to the economics of the claim, quickly evaluate, develop and continually adapt and execute a strategy to satisfy its bonded obligation and mitigate losses, including preparing to prove in litigation the nature and costs of such defects.

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129 ALEN ARNAUTOVIC ET AL., MODEL JURY INSTRUCTIONS: CONSTRUCTION LITIGATION (Melissa A. Beutler & Edward B. Gentilcore, eds., 2d ed. 2015).

130 Stephen V. O'Neal, *Construction*, *in* 14 BUSINESS & COMMERCIAL LITIGATION IN FEDERAL COURTS § 145.72 (Robert L. Haig ed., 4th ed. 2016).

131 No longer available through the ABA.