



1999

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Recommended Citation

Michael F. Albers, et al., *Construction Law*, 52 SMU L. Rev. 859 (1999)
<https://scholar.smu.edu/smulr/vol52/iss3/12>

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CONSTRUCTION LAW

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THE diversity of issues presented under the umbrella referred to as Construction Law requires an array of expertise from its practitioners, making the practice area both interesting and challenging. Once thought of by the un-initiated as the baileywick of mechanics' liens, subcontractor disputes, and the occasional delay and disruption claim, this year's Article reflects the breadth of this industry driven practice. Each year there are more cases decided by Texas courts, and by federal courts applying Texas law, relating to construction disputes than can, or should, be reported in this Annual Survey. Fortunately, most of them are either reiterations of well established law, involve narrow points of law, or are so fact intensive that the editing process is somewhat simplified. Nevertheless, this year's collection is somewhat thematic in nature, and it is therefore possible that a noteworthy case has by necessity been omitted. With apologies to those who feel we have left out your favorite case, the following is a survey of significant and interesting construction law cases presented during the period.

I. SOVEREIGN IMMUNITY

Of great importance to contractors doing business with the State of Texas, and the lawyers representing them, is the applicability of the Doctrine of Sovereign Immunity to contracts with the state or state agencies. The Doctrine of Sovereign Immunity is based upon the ancient common

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law principle that "the King can do no wrong." The modernized restatement of this rule is a form of the Golden Rule: he who has the gold makes the rules. Texas courts have held for many years (in fact since statehood), that the Sovereign Immunity Doctrine immunized the state from lawsuits brought without its consent.¹ Accordingly, practitioners in the construction law field and their clients have anticipated perhaps even bated breath for the Texas Supreme Court's pronouncement in the case of *Federal Sign v. Texas Southern University*.² This case was argued before Texas' highest court on November 28, 1996, and was decided on June 20, 1997, with a motion for rehearing overruled on October 2, 1997. The result was disappointing, to say the least, and should be cause for concern to every contractor doing business with the State of Texas.

Federal Sign submitted a bid to Texas Southern University (TSU) for the construction and delivery of basketball scoreboards for TSU's new Health and Physical Education facility. After accepting Federal Sign's bid, TSU instructed the company to begin building the scoreboards. However, before Federal Sign delivered the scoreboards, TSU notified Federal Sign that its bid was unacceptable and entered into a contract with another manufacturer. Federal Sign thereafter filed suit for breach of contract and violation of competitive bidding and open meeting laws.³ The trial court rendered judgment for Federal Sign's breach of contract claim and awarded Federal Sign damages.⁴ The Fourteenth Court of Appeals reversed the trial court on the basis of immunity from suit and remanded the case with instructions to dismiss.⁵

In what should have been an unsurprising opinion by the Texas Supreme Court, the issue was laid to rest, or, at least it appears that a majority of the court intended to lay to rest, the issue of sovereign immunity. Justice Baker, writing for the court, held that while waiving immunity from liability by contracting, a state agency could not be sued for breach of contract unless the State Legislature consented to such a suit.⁶ Essentially, the court recognized two distinct principles of sovereign immunity: (1) immunity from suit; and (2) immunity from liability.⁷

The court held that both principles of sovereign immunity, unless waived, protect the State from suits for damages and provide immunity from liability.⁸ In this case, Federal Sign did not receive legislative permission to sue TSU prior to filing suit. However, the court held that when the State contracts with private citizens, the State waives immunity from liability, but not immunity from suit.⁹ During the Survey period, the

1. *Federal Sign v. Texas S. Univ.*, 951 S.W.2d 401, 405 (Tex. 1997) (citing *Hosner v. DeYoung*, 1 Tex. 764 (1847)).

2. *Id.*

3. *See id.* at 403.

4. *See id.*

5. *See id.* at 404.

6. *See id.* at 408.

7. *See id.* at 405.

8. *See id.*

9. *See id.* at 405-06.

Texas Supreme Court dealt with additional appellate court opinions that seem to erode the Sovereign Immunity Doctrine. The court concluded that these cases essentially are based upon the old Texas Supreme Court opinion in *Fristoe v. Blum*,¹⁰ but that reliance upon the *Fristoe* opinion was not appropriate because *Fristoe* neither involved a breach of contract claim against the state nor directly involved sovereign immunity.

After resolving what the court viewed as a conflict of authority on whether the State, by entering into a contract with a private citizen, waives immunity from suit, the court noted:

We hasten to observe that neither this case nor the ones on which it relies should be read too broadly. We do not attempt to decide this issue in any other circumstances other than the one before us today. There may be other circumstances where the State may waive its immunity by conduct other than simply executing a contract so that it is not always immune from suit when it contracts.¹¹

It is apparent from this observation that while the court intended to lay to rest the sleeping giant of sovereign immunity, the court did everything but pour cold water on it. Not only did the court restrict its rationale to the facts of this case, but the majority based its decision on the principle of *stare decisis* and deferred to the legislature as the concurring opinion emphasized.¹² The court stated that “[t]oday, we again hold that it is the Legislature’s province to modify sovereign immunity if it is inclined to do so and therefore refuse Federal Sign’s invitation to undertake that task.”¹³ It appears that after such statement, we find ourselves in agreement with the master of malapropisms, Yogi Berra, because at least in this arena, “it ain’t over ’til it’s over,” and it ain’t over.

The court then went on to reject Federal Sign’s assertions that sovereign immunity violates the Texas Constitution’s Open Courts and Due Course of Law clauses.¹⁴ Attempting to persuade the court to judicially dispose of sovereign immunity in the contract context, Federal Sign raised a number of issues including lack of mutuality of remedy, curtailment of legislative power to contract and to delegate the power to contract, the contravention of the open court provision of the State Constitution, lack of due course of law, and lack of due process. All of these arguments, while facially appealing, were rejected by the court. The court stated that although Federal Sign had a remedy if it sought the legislature’s consent to sue, Federal Sign just chose not to avail itself of such relief.¹⁵ However, as noted by the dissent and the concurrence, since the enactment of Chapter 107 of the Texas Civil Practice And Remedies Code in 1987, only nine out of 173 proposed resolutions were passed granting consent—a

10. 92 Tex. 76, 45 S.W. 998 (1898).

11. *Federal Sign*, 951 S.W.2d at 408 n.1.

12. *See id.* at 412-13.

13. *Id.* at 409.

14. *See id.* at 409-11.

15. *See id.*

rate of six percent.¹⁶

The hypothetical situation of full performance proposed, but left unresolved, by Justice Hecht in the concurrence was addressed in *Alamo Community College District v. Obayashi Corp.*¹⁷ Some have argued that the supreme court's denial of a writ of error in *Fireman's Insurance v. Board of Regents of the University of Texas System*¹⁸ on the same day the court decided *Federal Sign* and subsequently overruled a motion for rehearing closed the door on this issue. *Fireman* involved alleged breaches after performance by the contractor and its surety. However, the *Alamo* court noted that a denial of a writ of error does not "necessarily reflect the court's approval or even its consideration of the merits of the case."¹⁹ The *Alamo* court ultimately held that a community college waived its sovereign immunity from suit by conduct other than the mere execution of the contract and that the Texas Legislature waived immunity from suit pursuant to sections 11.151(a), 130.084, and 130.162 of the Texas Education Code.²⁰ The court interpreted *Federal Sign* as holding "no more than that the State's mere execution of a contract does not waive its sovereign immunity from suit."²¹

The court focused on the "same fundamental principles of equity [it] believe[d] prompted the *Federal Sign* concurring and dissenting opinions" in concluding that the community college's conduct, other than entering into the contract, waived its sovereign immunity.²² Specifically, the community college waived its immunity by: (1) giving instructions to the plaintiff to exclude specific costs from its bid; (2) establishing a contractual means to cover these costs with an "equitable adjustment clause;" and (3) accepting the plaintiff's performance as full and satisfactory, as indicated by its payment of the full base price and four of the plaintiff's thirty-two equitable adjustment claims.²³ It appears that the courts will decide the issue of sovereign immunity on a fact specific basis and will apply the broad rationale and suggestions of the majority, concurring, and dissenting opinions of *Federal Sign*.

Another result of *Federal Sign* is proposed legislation that would add a chapter allowing a contractor to make a breach of contract claim against the State to the chief administrative officer of the contracting unit of the state governmental agency (excluding the Texas Department of Transportation).²⁴ If the claim is not resolved, it will go to mediation. If the claim remains unresolved, it returns to the chief administrative officer for a de-

16. *See id.* at 417.

17. 980 S.W.2d 745 (Tex. App.—San Antonio 1998, pet. filed).

18. 909 S.W.2d 540 (Tex. App.—Austin 1995, writ denied).

19. *Alamo*, 980 S.W.2d at 749.

20. TEX. EDUC. CODE ANN. §§ 11.151(a), 130.084, & 130.162 (Vernon 1981 & Supp. 1999).

21. *Alamo*, 980 S.W.2d at 749.

22. *Id.* at 750.

23. *Id.*

24. *See* Tex. S.B. 629, 76th R.S. (1999); *see also* Tex. H.B. 69, 76th R.S. (1999).

cision.²⁵ The contractor may then appeal to a State Office of Administrative Hearings. In an apparent attempt to avoid the political problems of appropriating funds to pay the claim, the agency is to pay claims of \$500,000 or less within thirty days, if so directed by an administrative judge.²⁶ If the award exceeds \$500,000, the proposal is forwarded to the Speaker of the House and the Lieutenant Governor for a recommendation of an appropriation. Also, the awards are specifically limited to twice the value of the contract. As stated, this legislation is not yet in final form. However, the fallout from *Federal Sign* has apparently just begun. Hopefully, the controversial and certainly political issue of sovereign immunity will become somewhat more settled in the years to come, but the wisdom of the great philosopher Yogi Berra should not be forgotten.

II. IMPLIED DUTY TO COMPLY WITH LOCAL CODES

In the case of *Robert D. Tips v. Hartland Developers, Inc.*,²⁷ the San Antonio Court of Appeals determined that no Texas case confirms an implied duty in a construction contract for the contractor to comply with local codes. Having so stated, the court went on to rule that contractors impliedly agree to comply with relevant municipal and county building codes so that buildings are suitable for their intended purpose in order to give effect to the expectations of the parties.²⁸ However, the court held that an implied duty may be negated by other provisions in the contract, such as the one in *Tips*.²⁹

The rationale of the court was that contractors, not owners, are in the best position to know about and comply with relevant building codes.³⁰ Furthermore, a builder is "uniquely situated to know or discover compliance requirements and to bid his or her contract accordingly."³¹ The court went on to hold that the breach of this implied covenant is a breach of contract.³² While the court concluded that, since the parties had agreed otherwise, there was no implied covenant, the implied covenant of compliance with building codes created by the court is of substantial significance to contractors in Texas.

III. Deceptive Trade Practices Act

In *Associated Indemnity Corp. v. CAT Contracting, Inc.*,³³ the contractor was put in default by the owner, who demanded that the surety per-

25. *See id.*

26. *See id.*

27. 961 S.W.2d 618, 621 (Tex. App.—San Antonio 1998, no pet.).

28. *See id.* at 623.

29. *See id.* (The clear intention of *Tips* and *Hartland* was to leave compliance with the local code issues for resolution at a later time and presumably to cover by change order.).

30. *See id.* at 622.

31. *Id.*

32. *See id.*

33. 964 S.W.2d 276 (Tex. 1998).

form under the contract. The surety thereafter allegedly settled with the owner without notice to the contractor. The surety then sued the contractor pursuant to its indemnity agreement. The contractor counterclaimed against the surety for breach of contract, breach of fiduciary duty, breach of the duty of good faith and fair dealing, violations of the Deceptive Trade Practices Act (DTPA), fraud, tortious interference with contract, and negligent misrepresentation. The contractor claimed the surety had failed to keep him informed, failed to adequately investigate and assert the contractor's claim of design error, and failed to protect the contractor's interests during the settlement process. Early in the project, the contractor felt that the soil conditions might be too unstable. The owner's engineers told the contractor to continue with the project with assurances that the design was sound. As the contractor expected, leaks were found during testing. The contractor blamed the owner's design, while the owner faulted the installation. The owner declared the contractor in default after the contractor refused to continue or to make repairs. To mitigate damages, the surety subsequently agreed to make repairs at a cost of over \$242,000.³⁴ Meanwhile, a consultant hired by the surety opined that the owner may have created an "impossible spec to achieve" given the soil conditions.³⁵

While the dispute continued as to whether the owner or contractor was responsible for the leaks, the surety, without the contractor's knowledge, settled with the owner and demanded indemnity from the contractor.³⁶ As stated herein, one part of the contractor's counterclaim was that the surety had violated the DTPA by engaging in unconscionable conduct, committing misrepresentations, and concealing information. The contractor contended that by settling the dispute without its knowledge or consent, the surety had infringed on the contractor's opportunity to resolve the dispute through arbitration.

Justice Phillips held that, regarding the contractor's DTPA claims, there was no evidence that any alleged deceptive acts caused damage to the contractor.³⁷ The contractor orally informed the surety that he intended to pursue arbitration. However, the contractor took no further efforts to enforce its contractual arbitration rights. The Texas Supreme Court found no evidence that the surety did anything to prevent the contractor from making a timely arbitration demand nor that the surety interfered with the contractor's right to enforce the arbitration agreement.³⁸ Therefore, there was no evidence of causation.³⁹ Ultimately, *Associated Indemnity* did not decide whether the surety committed deceptive acts, in that the evidence did not prove causation as

34. *See id.* at 279.

35. *See id.*

36. *See id.* at 280.

37. *See id.* at 287.

38. *See id.*

39. *See id.*

required under the DTPA.⁴⁰

IV. DUTY OF GOOD FAITH

Also in *Associated Indemnity*, the contractor argued in its counterclaim that the surety had a common law duty of good faith and fair dealing in settling any of the contractor's claims with the owner. The Texas Supreme Court declined to impose this common law duty of good faith, because, as it had stated previously, there is no special relationship between a surety and its principal giving rise to unequal bargaining power.⁴¹ The terms of the indemnity agreement at issue are standard in the industry and have been widely upheld by courts.⁴² The Texas Supreme Court noted that, while the contractor may not have been able to negotiate specific terms of the indemnity agreement, this in itself did not justify imposing a special duty, because the contractor, unlike typical insureds, was a construction company with considerable business sophistication.⁴³ For this reason, and other policy considerations, the Justices refused to equate suretyship with insurance and held that a bond surety does not owe a common law duty of good faith to its principal.⁴⁴

V. INDEMNITY

In *Associated Indemnity*, the Texas Supreme Court also recognized the distinction between a condition precedent for a surety's right to indemnification and a promise to exercise good faith.⁴⁵ While the court did not uphold a common law duty of good faith and fair dealing between a principal and its surety, it did hold the surety to the contractually agreed standard.⁴⁶ In this case, the language of the indemnity agreement required the surety to exercise good faith in settling claims before it was entitled to reimbursement from the contractor. Therefore, good faith was a condition precedent, not a promise, to the surety's right of indemnity.⁴⁷

The Texas Supreme Court agreed with the surety's argument that "in the surety context, bad faith requires more than an unreasonable or negligent investigation; it requires wilful misconduct or improper motive."⁴⁸ In determining the parameters of "good faith" in the particular indemnity agreement, the Texas Supreme Court adhered to a stricter standard and held that good faith specifically "refers to conduct which is honest in fact, free of improper motive or wilful ignorance of the facts at hand."⁴⁹ Further, good faith does not require proof of a "reasonable" investigation by

40. *See id.*

41. *See id.*

42. *See id.*

43. *See id.*

44. *See id.*

45. *See id.* at 283.

46. *See id.* at 276.

47. *See id.* at 283.

48. *Id.* at 284.

49. *Id.* at 285.

the surety.⁵⁰ Noting the fact that the surety did not retain an independent engineering firm to evaluate the leaks that the surety suspected were, at least in part, caused by faulty design specification, the court concluded that this was some evidence of bad faith and upheld that portion of the contractor's claim.⁵¹ The surety did not meet its condition precedent of good faith under the indemnity agreement and was precluded from relief under the indemnity agreement.⁵² While the court set forth standards of good faith favoring the duties of sureties to principals, the specific language of every indemnity agreement is crucial. As contractors and sureties are vividly aware, indemnity agreements, whether payment or performance bonds, are one of the most heavily negotiated clauses in any construction contract. As a result of *Associated Indemnity*, it will continue as such and require detailed review prior to any construction project and/or dispute.

VI. CHANGE ORDERS

The decision in *Buxani v. Nussbaum*⁵³ demonstrates that an owner and contractor may vary the written terms of their contract by the way they conduct themselves during performance of their contractual duties. In this case, the owner and contractor mutually disregarded a contract provision requiring that all change orders be in writing. The owner entered into two written agreements with the contractor for the purpose of remodeling and expanding the owner's jewelry store. Both contracts contained a clause reading, "Any alteration or deviation from above specifications involving extra costs will be executed only upon written orders, and will become an extra charge over and above the estimate."⁵⁴

During the course of the remodeling, the owner orally requested extra work from the contractor and the subcontractors. The extra items requested included: "suspended ceilings, a 'bunch of extras' from the electrician, one-way mirrors with bronze tint instead of aluminum tint, painting of items not included in the original written contracts, additional brick work, and the purchase and installation of hand driers."⁵⁵ The contractor performed the requested work and presented the owner an itemized statement of the additional work performed. The owner refused to pay for it, and the contractor ceased performance. The contractor sued the owner for breach of contract, seeking the amount due for the work performed at the owner's oral request. The owner countersued for breach of the written contract. The trial judge ruled in favor of the contractor, and the owner appealed to the Texas Court of Appeals, San Antonio Division, which also ruled in favor of the contractor.⁵⁶

50. *See id.*

51. *See id.*

52. *See id.* at 286-87.

53. 940 S.W.2d 350, 352 (Tex. App.—San Antonio 1997, no writ).

54. *Id.* at 351.

55. *Id.*

56. *See id.*

On appeal, the owner asserted that there was no oral contract for the extra work; hence, there was no “meeting of the minds,” or mutual assent. “When only the meeting of the minds is disputed, the existence of a contract is a question of fact,” and mutual assent can be deemed to arise from the one party’s acts and conduct from which the other can reasonably draw the inference of a promise.⁵⁷ The court ruled that the trial court easily could have found mutual assent based on the acts and conduct of the owner.⁵⁸ The owner assented to the terms of the oral agreement expressly and through his conduct; the contractor previously told the owner that an additional charge would be required for the extra items, and the owner agreed to pay for the extra work. Thereafter, the owner allowed the items to be installed and the services to be performed without objecting to anything until time for payment arrived.⁵⁹

The ruling in this case may prove helpful to contractors seeking additional compensation in the face of “written change orders only” language in their contracts. Conversely, owners may elaborate or expand their “written change orders only” language by adding a clause similar to the one set out below (despite this language, there can be no assurance that another court would not rule the same way as did the *Buxani* court):

No oral agreement, action, omission, conduct, prior failure, or course of conduct by the Owner shall act to waive, amend, modify, change, or alter the requirement that change orders must be in writing signed by the Owner and the Contractor, and that such written change orders are the exclusive method for effecting any change; and the Contractor understands and agrees that the Contract cannot be changed by oral agreement, actions, inactions, course of conduct, or implied change order.

VII. DAMAGE LIMITATIONS

Construction claims most often arise out of defective plans, an unforeseen work stoppage, encountering an unknown condition, or some combination thereof. Such claims are made under a “changes,” “extra work,” “suspension of work,” or “differing site conditions” clause contained in the contract. Most construction contracts attempt to limit or restrict the contractor’s right to recover delay damages, home office overhead, profit, and related items. Consequently, contractual remedies may prove insufficient in certain instances—particularly if the owner’s conduct has been particularly egregious—and in such cases the contractor may look beyond the contract for avenues of relief and avoidance of the contractual limitation on remedies. *Formosa Plastics Corp. v. Presidio Engineers & Contractors, Inc.*⁶⁰ illustrates this concept.

57. *Id.* at 352 (citing *Hallmark v. Hand*, 885 S.W.2d 471, 476 (Tex. App.—El Paso 1994, writ denied)).

58. *See id.*

59. *See id.*

60. 960 S.W.2d 41 (Tex. 1998).

In this case, the contractor, Presidio, was the low bidder on a contract to build 300 concrete foundations in connection with the expansion of a Formosa owned plant. Pursuant to the court's findings, the bid package for the project specifically represented that: "(1) Presidio would arrange and be responsible for the scheduling, ordering, and delivery of all materials, including those paid for by Formosa; (2) work was to progress continually from commencement to completion; and (3) the job was scheduled to . . . be completed in 90 days."⁶¹

In actuality, Formosa took over the scheduling, ordering, and delivery of concrete and permitted multiple disruptions to Presidio's operations by other contractors. Thus, the project took eight months to complete. As a result, rather than the \$370,000 included in the bid for direct costs, Presidio incurred some \$831,000 in direct costs to complete the work.⁶²

Presidio filed suit based on fraudulent inducement of contract, among other causes of action. At trial, Presidio introduced evidence that Formosa had implemented "an intentional, premeditated scheme to defraud the contractors working on its expansion project."⁶³ Though the contract specifically stated that Formosa would pay for delays caused by its own actions, "when the contractors requested delay damages under the contract, Formosa would rely on its superior economic position and offer the contractors far less than the full and fair value of the delay damages."⁶⁴ The "head of Formosa's contract administration division, [even] testified that Formosa, in an effort to lower costs, would utilize its economic superiority to string contractors along and force them to settle."⁶⁵ Based on this evidence, the jury awarded Presidio tort damages for fraudulent inducement of the contract. Included in the award were amounts for lost profits and punitive damages in the amount of \$10,000,000.⁶⁶

Formosa challenged the award on appeal, in part, claiming that Presidio could not recover pure economic losses in tort for injuries that arose solely from a contract. The Texas Supreme Court disagreed. It held that each person has an independent legal duty to refrain from inducing another into entering a contract through fraudulent misrepresentation.⁶⁷ Moreover, "a party is not bound by a contract procured by fraud."⁶⁸ As such, "tort damages are recoverable for a fraudulent inducement claim irrespective of whether the fraudulent representations are later subsumed in a contract or whether the plaintiff only suffers an economic loss related to the subject matter of the contract."⁶⁹

61. *Id.* at 43.

62. *See id.* at 49-50.

63. *Id.* at 44. Under the scheme, Formosa misrepresented conditions to be encountered, including control of deliveries of materials and access to the work, in order to save money. *See id.*

64. *Id.*

65. *Id.*

66. *See id.* at 44.

67. *See id.* at 46.

68. *Id.* at 46.

69. *Id.* at 47.

The *Formosa Plastics* decision does not mean that contractual limitations and restrictions on damage recoveries are unenforceable or lightly regarded. It and similar cases do mean, however, that such clauses can not be used as “get out of jail free cards,” exculpating parties for extracontractual liability arising from tort conduct. As is true in all construction dispute cases, three key factors will shape the outcome—the facts, the facts, and the facts.

The rule stated by the court in *Formosa Plastics* demonstrates one possible method of avoiding contractual limitations on damages—establishment of an independent tort. Other vehicles may also be available, as demonstrated in other jurisdictions. In *Warner Construction Corp. v. City of Los Angeles*,⁷⁰ the contractor sued for fraudulent concealment of material facts related to subsurface conditions. After finding that the public entity had withheld material facts, a California court held that the affected contractor could recover, assuming proper proof of loss, lost profits, and costs associated with impairment of capital, loss of business, restriction of research, reduction of bonding capacity, and destruction of a former advantageous competitive position.⁷¹

After issuing its opinion in *Formosa Plastics*, the court was given another opportunity to consider the requirements of those seeking recovery outside the parameters of their contract, similar to the issue presented to the California court in *Warner*. In *D.S.A., Inc. v. Hillsboro Independent School District*,⁷² the Texas Supreme Court distinguished *Formosa Plastics*. In *Formosa Plastics* the court rejected any requirement of an independent injury in fraudulent inducement claims; in *D.S.A., Inc.* the court held that unlike fraudulent inducement claims, negligent misrepresentation claims only invoke liability for out-of-pocket damages.⁷³ The court refused to afford recovery of benefit of the bargain damages where the basis of the claim is negligent misrepresentation. In so ruling, the court relied on Restatement (Second) of Torts section 552B in distinguishing between fraudulent inducement and negligent misrepresentation.⁷⁴ The court also rejected a claim for finding of exemplary damages based on a theory of grossly negligent misrepresentation.⁷⁵ While *Formosa Plastics* might have led some to expect a different outcome in this regard, the court's position is consistent with the existing rule that since an intentional breach of contract does not entitle one to exemplary damages, a breach of contract involving gross negligence on the part of the party in breach cannot support such an award.

In *State Bank & Trust Co. v. Insurance Co. of the West*,⁷⁶ a bank made a claim for conversion when a surety used the tools and equipment of the

70. 466 P.2d 996 (1970) (en banc).

71. See *id.* at 1007.

72. 973 S.W.2d 662, 663 (Tex. 1998).

73. See *id.* at 664.

74. See *id.*

75. See *id.*

76. 132 F.3d 203 (5th Cir. 1997).

defaulting subcontractor to complete the project. In the case at issue, the prime contractor defaulted on its prime contracts and on its loan with the bank. The surety subsequently entered into takeover agreements and, in performing the work, used various materials stored at the project sites. When the bank demanded to be provided with its collateral (i.e., the materials or their value), the surety refused, arguing that its rights as the takeover surety took priority over the bank's security interest in the construction materials.⁷⁷ The bank then brought suit against the surety in state court, alleging conversion. The suit was subsequently removed to federal court, which granted summary judgment for the surety.⁷⁸ The bank appealed.

The Fifth Circuit Court of Appeals noted that in a typical surety arrangement, the surety bonds a contractor's performance with the project owner.⁷⁹ "If the bonded contractor defaults, forcing the surety to complete the performance, the completing surety 'has an equitable right to indemnification out of a retained fund.'"⁸⁰ "The surety is [then] subrogated to the rights of the project owner/obligee so that the retained contract price inures to the completing surety's benefit."⁸¹

The court further pointed out that the completing surety's right of subrogation arises "as an outgrowth of the suretyship relationship itself; it is not dependent on assignment, lien, or contract."⁸² As such, the surety's right of subrogation is not subject to the filing requirements of the UCC.⁸³ The court of appeals noted that in reaching its decision, the district court relied on *Interfirst Bank* to hold that "by virtue of equitable subrogation [the surety] was entitled to use [the contractor's] construction materials located at the project sites to complete the construction, notwithstanding [the bank's] pre-existing, perfected security interest in those materials."⁸⁴

The district court reasoned that (1) there is no conceptual difference between permitting a surety to apply contract balances towards project completion and permitting it to use the defaulting subcontractor's tools, equipment, and inventory for the same purpose, and (2) because, under *Interfirst Bank*, a surety's equitable right to contract proceeds has priority over a secured creditor's right to execute on its security interest in the same proceeds, the [surety's] right to use [the contractor's] construction materials has priority over [the bank's] security interests in the same property.⁸⁵

77. *See id.* at 205.

78. *See id.*

79. *See id.*

80. *Id.* (citing *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962)).

81. *Id.* (citing *Trinity Universal Ins. Co. v. Bellmead State Bank of Waco*, 396 S.W.2d 163, 168 (Tex. Civ. App.—Dallas 1965, writ ref'd n.r.e.)).

82. *Id.* at 206 (citing *Interfirst Bank Dallas v. U.S. Fidelity and Guar. Co.*, 774 S.W.2d 391, 399 (Tex. App.—Dallas 1989, writ denied)).

83. *See id.*

84. *Id.*

85. *Id.*

[The bank] argue[d] that surety priority under *Interfirst Bank* is limited to situations in which the surety and the secured creditor [here, the bank] make competing claims to contract proceeds; that when, [as in the case presented], the collateral on which the secured creditor seeks to execute is tangible personal property, equity does not entitle the surety to be equitably subrogated to its principal's rights in the property. In support of its argument, the bank maintains that, as between the surety and an assignee of the contract proceeds, equitable subrogation gives the surety priority because the assignee's interest in the proceeds never becomes an actuality. The assignee's interest is derivative of the assignor/contractor's right to the proceeds.⁸⁶

The court agreed "that when tangible personal property—distinct from contract proceeds—is at issue, the rationale for elevating the surety over the secured creditor has no application."⁸⁷ "[S]ecured creditors holding perfected security interests in a defaulting contractor's tangible personal property retain their priority over a completing surety's equitable claims."⁸⁸ The surety's argument that: (a) it is only claiming an equitable right to use the property—not an outright ownership in it; (b) the bank's security interest is still intact; and (c) fundamental fairness dictates that the surety use the defaulting contractor's tools and supplies to minimize loss and expense, was rejected by the court as "misguided."⁸⁹ In the court's view:

The surety's right to contract proceeds flows not from cost minimization considerations but from 'the common sense proposition that the contract retainage funds would never become available to any creditor unless the surety completed the project.' On the other hand, when collateral consists of tangible personal property, the surety's completion of the contract is not a condition precedent to the conception of the collateral itself; rather, the creditor who holds a perfected security interest in a contractor's tools, equipment, and inventory may execute on its collateral regardless of whether the contractor has performed its obligations to third parties. Thus, equity need not intervene to elevate the surety over the secured creditor as 'the surety has done nothing with respect to [the tools, equipment, and inventory] which raises up in the surety an equity superior to that of later judgment creditors.'⁹⁰

The court held that a perfected security interest has priority over the surety's rights under the doctrine of equitable subrogation.⁹¹ The court reasoned that the issue was tangible personal property, to which the security interest attaches, and not the contract proceeds, to which the doc-

86. *Id.* at 206-07.

87. *Id.* at 207.

88. *Id.*

89. *See id.* at 208.

90. *Id.* (citing *United States Fidelity and Guar. Co. v. United Penn Bank*, 524 A.2d 958, 965 (1987), *appeal denied* 536 A.2d 1333 (1987)).

91. *See id.* at 207.

trine of equitable subrogation is relevant.⁹² Since the bonding company offered no proof or authority that its rights in the contract proceeds should be elevated above the security interest in the property, the court found that the bank's security interest took priority over the bonding company's interest.⁹³

92. *See id.*

93. *See id.*