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## Construction and Surety Law

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# CONSTRUCTION AND SURETY LAW

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## I. INTRODUCTION—SCOPE OF ARTICLE

**D**URING late 2000 and throughout 2001, the developments in construction and surety law focused on a wide variety of substantive issues, including lien rights, contractor liability, implied warranties, interpretation of the Residential Construction Liability Act, insurance coverage for defective construction, sovereign immunity for public owners, and various legislative matters affecting payment and performance bonds. The courts appeared to be quite active in a number of different areas which directly affect parties to construction contracts.

Possibly as a result of the extensive revisions to the Property Code in 1999, there was little legislative activity which would affect construction and surety law, with the exception of the additions to the Texas Government Code and Texas Property Code which state certain new require-

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ments for payment and performance bonds. The courts appeared to focus on the interpretation of various statutory provisions, including some recent amendments to statutes. The courts also focused on addressing some unresolved questions involving liability and immunity in the construction context. The following article summarizes some of the most significant decisions by the Texas courts.

## II. MECHANIC'S AND MATERIALMAN'S LIENS

The Texas Supreme Court and various appellate courts considered several complex questions regarding the subject of the enforceability of various mechanic's and materialman's liens over the past year. The decisions analyzed below address the Texas Constitution and its protection of homestead rights, as well as the Texas Property Code and its rather complex statutory structure which imposes retainage obligations on owners and notice and filing obligations upon contractors.

### A. MECHANIC'S LIENS AND THE TEXAS HOMESTEAD EXEMPTION

In *Spradlin v. Jim Walter Homes, Inc.*,<sup>1</sup> the Texas Supreme Court interpreted the recent revisions to the homestead provisions of the Texas Constitution in order to determine which prerequisites for a lien on a homestead apply in which circumstances.<sup>2</sup> The case involved a lien dispute in the context of new construction of a homestead property.

Jim Walker Homes ("JWH") contracted with William Spradlin to build a home and, in the process, secured a lien on Spradlin's homestead. Spradlin contested the validity of the lien by arguing that the lien did not comply with the procedural protections of subparts (A) through (D) of Texas Constitution, Article XVI, Section 50(a)(5).

The trial court granted JWH's motion for summary judgment after deciding that subparts (A) through (D) of Section 50(a)(5) did not apply to a mechanic's lien for construction of new improvements.<sup>3</sup> The Texas Supreme Court affirmed after concluding that "subparts (A) through (D) apply only to 'work and material used to repair or renovate existing improvements' on homestead property, and not to 'work and material used in constructing new improvements.'"<sup>4</sup> Thus, the Supreme Court concluded that JWH was not required to comply with the subparts of Section 50 of the Constitution in order to perfect a lien on a homestead.<sup>5</sup>

The dispute arose as a result of the 1997 amendments to Section 50 of the Texas Constitution, which provides in relevant part as follows:

Sec. 50 (a). The homestead of a family, or of a single adult person, shall be, and is hereby protected from forced sale, for the payment of all debts except for:

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1. 34 S.W.3d 578 (Tex. 2000).
  2. *Id.* at 580-81.
  3. *Id.* at 578.
  4. *Id.* at 581.
  5. *Spradlin*, 34 S.W.3d at 581.

...  
(5) work and material used in constructing new improvements thereon, if contracted for in writing, or work and material used to repair or renovate existing improvements thereon if:

(A) the work and material are contracted for in writing, with the consent of both spouses, in the case of a family homestead, given in the same manner as is required in making a sale and conveyance of the homestead;

(B) the contract for the work and material is not executed by the owner or the owner's spouse before the 12th day after the owner makes written application for any extension of credit for the work and material . . . ;

(C) the contract for the work and material expressly provides that the owner may rescind the contract without penalty or charge within three days after the execution of the contract by all parties . . . ; and

(D) the contract for the work and material is executed by the owner and the owner's spouse only at the office of a third-party lender making an extension of credit for the work and material, an attorney at law, or a title company.<sup>6</sup>

Spradlin argued that JWH's lien was invalid because JWH did not comply with subparts (B) and (D) of Section 50. Spradlin argued that the subparts of Section 50 should be read broadly to apply to both work and material used to (1) repair or renovate existing improvements, and (2) construct new improvements. JWH argued that the amendment, through its plain language and structure, specifically differentiated between the repair of existing improvements and the construction of new improvements and that the restrictions of the subparts applied only to the repair of existing improvements.

The court's decision makes it clear that the prerequisites to perfect a lien on a homestead will vary substantially, depending upon whether the work and material which are the subject of the purported lien arise from new construction or from improvements to an existing homestead. In the case of improvements to an existing structure, which are most often the subject of the so-called "equity" loans, the requirements to perfect a lien are much more extensive. Accordingly, the contractor who intends to attempt to assert a lien should be aware of the requirements at the time of the contract process and should carefully follow all of the steps set forth in the Texas Constitution.

The Texas Supreme Court agreed with JWH, holding that subparts (A) through (D), which follow the language "work and material used to repair or renovate existing improvements" apply only to that scope of work.<sup>7</sup> The Court's conclusion was based upon the plain language of the constitution's literal text, as well as the Court's presumption that the Legislature chose its words for the revisions carefully.<sup>8</sup>

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6. TEX. CONST. Art. XVI, § 50 (a)(5) (Effective Jan. 1, 1998).

7. *Spradlin*, 34 S.W.3d at 580.

8. *Id.*

## B. RETAINAGE LIENS AND CLAIM NOTICE DEADLINES

In *Page v. Structural Wood Components, Inc.*,<sup>9</sup> the court considered various questions within the context of statutorily required retainage and retainage liens. In partially reversing the trial court's decision, the court of appeals correctly refused to enforce lien rights against an owner's property but did impose a judgment against the owner personally for retained funds.<sup>10</sup>

Page, the property owner, entered into a remodeling contract with Mark Sepolio d/b/a Custom Concrete & Construction. The contract price for the scope of work required was \$300,000 and was to be paid by periodic progress payments to Sepolio. By the end of March 1998, Page had paid Sepolio a total of \$270,000 for the work which had been completed as of that date. At that time, the project was not completed. In April 1998, Sepolio refused to complete the work on the project unless he was first paid the \$30,000 remaining on the contract.

As a result of Sepolio's refusal to complete the remodeling, Page terminated the contract with Sepolio on April 14, 1998 and hired substitute contractors to complete the work. The cost of completion was \$27,074.43, and the work was eventually completed in July 1998. Based upon the evidence presented at trial, it appeared that Page paid the cost of completion from his operating accounts.

At the time Page terminated the remodeling contract with Sepolio, Sepolio owed several subcontractors for goods and services they had provided for the project. After Sepolio failed to pay Structural Wood Components ("Wood"), one of the subcontractors, Wood filed a mechanic's and materialman's lien affidavit against Page's property. Wood later sued for foreclosure of the lien and for actual damages, naming both Page and Sepolio as defendants.

At trial, the testimony indicated that Page had withheld the \$30,000 from Sepolio as retainage, pursuant to the Texas Property Code. Nevertheless, the trial court entered a judgment in favor of Wood and against Page and Sepolio, declared the lien valid, and ordered foreclosure of the lien.<sup>11</sup>

On appeal, Page challenged the validity of the lien and the court's order for foreclosure. The appellate court concluded that, under the circumstances, the subcontractor could have perfected a lien on Page's property under Chapter 53 of the Texas Property Code by using one of two methods: (1) the statutory retainage method (described in Sections 53.103 through 53.105), or (2) the fund-trapping method (described in Section 53.084).<sup>12</sup>

Based upon the trial testimony, the appellate court found that there was no evidence that Page had failed to retain ten percent of the contract

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9. 57 S.W.3d 524 (Tex. App.—Houston 2001, no pet. h.).

10. *Id.* at 530-31.

11. *Id.* at 526.

12. *Id.* at 528-29.

price as required by Section 53.101 of the Texas Property Code.<sup>13</sup> Furthermore, the court found no evidence that Page paid the substitute subcontractors with the retained funds withheld from the Sepolio contract. Accordingly, the court concluded that Wood was not entitled to a retainage lien on the house, building, structure, fixtures, or improvements under Section 53.105 of the Property Code, because Page, as the owner, had properly retained funds on the Sepolio contract.<sup>14</sup>

The appellate court noted that, although a fund-trapping claim may have been permissible under the facts of the case, Wood did not assert a fund-trapping claim on appeal, so the court found no evidence to support a fund-trapping lien in favor of Wood.<sup>15</sup> The appellate court concluded that

[t]he only possible basis for this *in rem* relief was a retainage lien that required a failure by Page to retain ten percent of the contract price. Because there was no evidence of this failure, there was no evidence to support a retainage lien against the Property or to support the foreclosure of the lien.<sup>16</sup>

Notwithstanding its judgment on the subject of the retainage lien, the court permitted the trial court's monetary judgment against Page to stand in the amount of the retained funds withheld under Section 53.101. The court, citing *Mbank El Paso Nat'l Ass'n v. Featherlite Corp.*,<sup>17</sup> indicated that the fact that Wood did not have any foreclosure rights did not affect Wood's right to a monetary judgment for the retained funds, if Wood provided timely notice of its claim.<sup>18</sup>

The central dispute on appeal, with respect to the monetary judgment, was the timeliness of Wood's required notice to Page. Under Section 53.103 of the Texas Property Code, Wood was required to file a lien affidavit no later than thirty days after the work on the project was completed.<sup>19</sup> Wood was also required to provide Page with notice of the lien affidavit by the earlier of the tenth day after the lien affidavit was filed or the date that the lien affidavit was required to be filed, pursuant to the version of the statute in effect in 1998.<sup>20</sup>

The disputes of the parties on the issue of the notice focused on the proper interpretation of the word "completed" in the context of Section 53.103 of the Property Code. Page maintained that the work in question was completed in April 1998, upon the termination of Page's contract

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13. *Page*, 57 S.W.3d at 529.

14. *Id.* at 530.

15. *Id.*

16. *Id.*

17. 792 S.W.2d 472, 477 (Tex. App.—El Paso 1990, writ denied).

18. *Page*, 57 S.W.3d at 530.

19. *Id.* (citing TEX. PROP. CODE ANN. § 53.103 (Vernon 1995)).

20. *Id.* (citing TEX. PROP. CODE ANN. §§ 53.055, 53.103 (1994 Vernon Supp.)). The court applied the version of the provisions of Chapter 53 in effect on August 31, 1997. The primary difference between the statutes in effect on August 31, 1997 and the statutes that would govern the issues today is the reduction of the time frame in § 53.055. Under the current statute, the time frame has been reduced from ten days to five. TEX. PROP. CODE ANN. § 53.055 (Vernon Supp. 2002).

with Sepolio. Conversely, Wood argued that the work was completed in July 1998, when the substitute subcontractors actually finished all of the work which was required under the original contract.

After noting that "[t]he mechanic's and materialman's lien statutes should be liberally construed for the purposes of protecting lien claimants," the court adopted Wood's position on the interpretation of "completed" and concluded that July 1998 was the applicable date.<sup>21</sup> Based upon that analysis, Wood's deadline for notice and the lien was in August 1998. The court's analysis in the case suggests that the completion date is determined by the actual completion of the project in question, regardless of which contractor completes the project. However, its conclusion appears to be results-oriented, as a means of protecting the unpaid subcontractor in this particular case.

### C. FUNDS TRAPPING AND RIGHT TO RETAINAGE FOLLOWING RELEASE

In *Stoltz v. Honeycutt*,<sup>22</sup> the court considered the issues of fund trapping rights, notices required to trap funds with an owner, and whether a subcontractor's release of a general contractor serves as a waiver of fund trapping rights.

In the case, Stoltz entered into a contract with Kyle for improvements to a commercial property leased by Stoltz. The contract price for the entire scope of work was \$37,858.35. Kyle, the contractor, then subcontracted with Honeycutt to install the air conditioning system for the project for \$7,900. Honeycutt completed the air conditioning installation on June 7, 1992. After the installation, Kyle failed to pay Honeycutt. Honeycutt provided notice to Stoltz that the \$7,900 remained unpaid and requested that Stoltz withhold Kyle's payment until Kyle paid Honeycutt.

On June 30, 1992, Kyle, Honeycutt, and Stoltz met in an attempt to resolve their payment issues. As a result of the meeting, Kyle wrote a check to Honeycutt for \$7,800. The check was post-dated to July 9, 1992. At the same time, Kyle and Honeycutt entered into an agreement to release all claims that either of them had against the other. At the same meeting, Kyle received a check from Stoltz in the amount of \$7,858.35 for the amount owed under the original contract.

On July 17, 1992, Kyle's check was returned to Honeycutt for insufficient funds. Honeycutt filed an affidavit for a mechanic's and materialman's lien against the leasehold on August 14, 1992 and later brought suit. On November 10, 1993, Stoltz obtained a \$17,000 indemnity bond in order to release the subcontractor's lien and sell the business.

In 1997, the disputes were finally tried, and the trial court awarded a

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21. *Id.* at 531 (citing *First Nat'l Bank in Graham v. Sledge*, 653 S.W.2d 283, 288 (Tex. 1983)).

22. 42 S.W.3d 305 (Tex. App.—Houston 2001, no pet. h.).

judgment in favor of Honeycutt.<sup>23</sup> The trial court imposed liability after concluding that Honeycutt properly gave notice to Stoltz to trap the funds in Stoltz's possession and that Stoltz failed to properly retain ten percent from his contract with Kyle for thirty days. Stoltz appealed the trial court's decision, arguing that the indemnity bond filed by Stoltz prohibited Honeycutt from recovering against him. Stoltz further claimed that Honeycutt could not recover, because the lien was settled and released before the lawsuit was filed.

The appellate court reversed the judgment of the trial court, concluding that, although Honeycutt's claims could survive the indemnity bond, they did not survive the prior settlement of the claims by Honeycutt.<sup>24</sup> The appellate court noted that Honeycutt had no claim under the fund trapping statute, because the trapping statute only allowed Honeycutt to trap funds not yet paid by Stoltz to Kyle.<sup>25</sup> Since Honeycutt accepted the check from Kyle and entered into a mutual release with Kyle, Honeycutt's complaint and ability to trap funds were extinguished.

The appellate court refused Honeycutt's argument that the return of the check somehow revived Honeycutt's complaint and the right to trap funds. The court concluded that, once Honeycutt signed the release and accepted Kyle's check, Honeycutt released its claim against Kyle and therefore released its right to trap funds under the statute.<sup>26</sup> Once the claim and the right to trap were released, Stoltz paid Kyle the remaining amount owed. Since Stoltz did not owe Kyle any additional funds under the original contract, there were no funds for Honeycutt to trap under the statute.

The appellate court's treatment of the retainage issue causes a bit more concern. The court noted that, unlike the trapping statute, the retainage statute does not have a specific provision releasing the owner from his obligations if the subcontractor's claim is paid or settled.<sup>27</sup> The court therefore concluded that the thirty day provision of the retainage statute appears to create a strict non-waivable requirement.<sup>28</sup> Specifically, the statutes referred to by the court provide that "during the progress of work under an original contract for which a mechanic's lien may be claimed and for thirty days after the work is completed, the owner shall retain: (1) ten percent of the contract price of the work to the owner."<sup>29</sup> Under a strict interpretation of the provision, Stoltz violated that requirement by paying Kyle the remaining ten percent of the contract prior to the expiration of thirty days.

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23. *Id.* at 308.

24. *Id.* Although the court stated that the preferable means to recover under the circumstances was an action on the bond, the court acknowledged that a claimant does have a right to pursue a personal judgment against a property owner for the unpaid amounts, even after the owner obtains a bond to remove the lien from the property. *Id.* at 312.

25. *Id.* at 313.

26. *Stoltz*, 42 S.W.3d at 313.

27. *Id.* (citing TEX. PROP. CODE ANN. §§ 53.101-53.106 (Vernon 1995)).

28. *Id.* at 314.

29. TEX. PROP. CODE ANN. § 53.101(a)(1) (Vernon 1995).



However, the court decided that Stoltz's violation of the statute did not automatically entitle Honeycutt to the retainage. According to the court, Honeycutt still had to demonstrate that he (1) gave the required notice under the property code and (2) filed a lien affidavit before the expiration of the 30 days. Although Honeycutt gave the proper notice, Honeycutt failed to file the lien affidavit within the requisite period of time.

Under the terms of the settlement, Honeycutt could not possibly have filed the lien affidavit within the requisite period of time. The project was completed on June 7, 1992. Honeycutt accepted a check that was post-dated to July 9, 1992. Accordingly, Honeycutt could not have filed a lien affidavit within the 30 day time frame, because Honeycutt could not have cashed the check within the 30 day window. The court held that "by accepting the post-dated check, Honeycutt settled his claim against Kyle and thereby waived any derivative claim he may have had on the retained amount."<sup>30</sup>

In arriving at this conclusion, the court ignored the judicial exception to the 30-day requirement created by the Texas Supreme Court in *General Air Conditioning Co. v. Third Ward Church of Christ*.<sup>31</sup> Under the judicial exception, an owner's failure to retain the ten percent for 30 days relieves the claimant's responsibility to file a lien affidavit within the 30 days.<sup>32</sup> The justification for the exception was that a lien affidavit claiming an interest in a nonexistent retainage makes no sense. Therefore, under the exception, where there is no retainage, there is no requirement that a lien affidavit be filed within 30 days of completion.

The appellate court apparently refused to apply the exception to the facts at issue on a variety of grounds. First, Stoltz did retain ten percent as required by the statute. Stoltz paid Kyle the ten percent only after Kyle and Honeycutt settled their dispute. Secondly, the court relied on the fact that "Stoltz's failure to retain the funds for 30 days did not interfere with Honeycutt's right to collect on the funds, as Honeycutt had already extinguished those rights himself."<sup>33</sup> Honeycutt extinguished his right to collect the funds by accepting a check that was post-dated outside the 30 day time frame.

### III. CONTRACTOR LIABILITY FOR SUBCONTRACTOR'S EMPLOYEES

During 2001, the Texas Supreme Court rendered a significant opinion on the subject of a general contractor's liability for negligence to the employees of subcontractors, which may prove to be controversial when extrapolated to other factual situations. While the facts of the case arguably justified the imposition of liability upon the general contractor for injury

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30. *Stoltz*, 42 S.W.3d at 314.

31. 426 S.W.2d 541 (Tex. 1968).

32. *Id.* at 544.

33. *Stoltz*, 42 S.W.3d at 314.

to the employee of a subcontractor, based upon the control and knowledge discussed by the Supreme Court, injured parties will most certainly argue for a broad application of the rule of law established by the Court.

In *Lee Lewis Construction, Inc. v. Harrison*,<sup>34</sup> the Texas Supreme Court concluded that the general contractor owed a duty of care to the subcontractor, such that the general contractor was liable in negligence for the injuries sustained by the employee of the subcontractor.<sup>35</sup> In *Harrison*, a hospital hired Lee Lewis Construction (“LLC”) as the general contractor to remodel the eighth floor of the hospital and to add ninth and tenth floors to the existing structure. In the course of completing the work, LLC subcontracted the interior glass-glazing work to KK Glass. Jimmy Harrison, an employee of KK Glass, fell to his death while working on the hospital project. Harrison was not wearing an independent lifeline that would have stopped his fall. LLC, as the general contractor, retained the right to control the fall protection systems on the project.

Harrison’s family brought a wrongful death and survival action against LLC, based upon its status as the general contractor on the project. The family alleged that the general contractor was negligent and grossly negligent. The trial court rendered judgment against the general contractor for \$7.9 million in compensatory damages and \$5 million in punitive damages.<sup>36</sup> The appellate court affirmed the judgment after suggesting a remittitur in the amount of \$450,000.00 for unproven pain and suffering damages.<sup>37</sup> The general contractor appealed to the Texas Supreme Court arguing, among other things, that the general contractor did not owe the subcontractor a duty of care under the facts at issue. The Texas Supreme Court rejected LLC’s arguments, concluding that there was legally sufficient evidence to conclude that: (1) LLC retained the right to control its subcontractor’s fall-protection measure and therefore owed a legal duty to Harrison; (2) LLC’s failure to ensure adequate fall-protection measures proximately caused Harrison’s fall; and (3) LLC was grossly negligent.<sup>38</sup>

The Texas Supreme Court began its analysis by stating the general rule: “[O]rdinarily, a general contractor does not owe a duty to ensure that an independent contractor performs its work in a safe manner.”<sup>39</sup> The Court noted, however, that the general rule is not applicable when the general contractor retains control over the manner in which the independent contractor performs its tasks.<sup>40</sup> The Court cited Section 414 of the Restatement (Second) of Torts with approval:

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34. No. 99-0793, 2001 Tex. LEXIS 132 (Tex. Dec. 20, 2001).

35. *Id.* at \*1.

36. *Id.*

37. *Id.*

38. *Lee Lewis*, 2001 Tex. LEXIS 132, at \*2.

39. *Id.* at \*5 (citing *Elliott-Williams Co. v. Diaz*, 9 S.W.3d 801, 803 (Tex. 1999) and *Hoechst-Celanese Corp. v. Mendez*, 967 S.W.2d 354, 356 (Tex. 1998)).

40. *Id.*

One who entrusts work to an independent contractor, but who retains control of any part of the work, is subject to liability for physical harm to others for whose safety the employer owes a duty to exercise reasonable care, which is caused by his failure to exercise his control with reasonable care.<sup>41</sup>

The court further stated that a “general contractor can retain the right to control an aspect of an independent contractor’s work or project so as to give rise to a duty of care to that independent contractor’s employees in two ways: by contract or by actual exercise of control.”<sup>42</sup>

On appeal, the general contractor argued that the family failed to prove that the general contractor exercised actual control over the subcontractor and, therefore, failed to prove that the general contractor owed a duty under the circumstances. After a careful review of the evidence, the court disagreed. The court concluded that the general contractor retained the right to control the fall-protection systems on the jobsite and, therefore, owed a duty to the employees of the subcontractor at the time of the accident.<sup>43</sup>

In reaching its conclusion, the Court focused specifically on the following evidence of actual control:

1. LLC’s owner and president testified that he assigned LLC’s job superintendent “the responsibility to routinely inspect the ninth and tenth floor addition to the south tower to see to it that the subcontractors and their employees properly utilized fall protection equipment.”
2. LLC’s job superintendent personally witnessed and approved of the specific fall-protection systems KK Glass used.
3. LLC’s job superintendent knew of and did not object to KK Glass’ use of a bosom’s chair without an independent lifeline.<sup>44</sup>

*Lee Lewis* appeared to present an extreme set of facts, under which a fact finder could conclude that the contractor retained all control and all supervisory responsibilities for worker safety. Accordingly, the Court’s opinion overall appears to be a decision based upon the specific facts of the case and not a significant shift in position by the Court on the subject of negligence liability.

Justice Hecht’s thoughtful concurring opinion makes that issue clear in the context of the case’s holding. The dissent notes that Section 414 of the Restatement makes the retention of control over an independent contractor’s work a necessary, *but not a sufficient*, condition of liability.<sup>45</sup> An additional prerequisite for liability under that rule, as noted by Justice Hecht, is that the person harmed be among those “others for whose

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41. *Id.* (citing RESTATEMENT (SECOND) OF TORTS § 414 (1965)).

42. *Lee Lewis*, 2001 Tex. LEXIS 132, at \*6 (citing *Koch Ref. Co. v. Chapa*, 11 S.W.3d 153, 155 (Tex. 1999); *Coastal Marine Serv. of Texas, Inc. v. Lawrence*, 988 S.W.2d 223, 226 (Tex. 1999)).

43. *Id.* at \*7-8.

44. *Id.* at \*8.

45. *Id.* at \*21.

safety the employer owes a duty of reasonable care.”<sup>46</sup>

The concurrence noted that the court had been called upon to apply the general rule and exception regarding liability for a subcontractor’s employee’s injury in eight separate cases, the analysis of all of which had focused exclusively on the retention of control question.<sup>47</sup>

The concurring opinion stated the position that the *Lee Lewis* case was one where the additional element concerning the parties to whom the duty was owed should have been clarified.

#### IV. CONTRACTUAL AND IMPLIED WARRANTY ISSUES IN CONSTRUCTION

In the context of general construction disputes, various courts addressed the question of implied warranties and whether privity is required for suit against a subcontractor, the doctrine of accord and satisfaction in the context of a construction final payment, and the issue of substantial completion as a measure of compliance with a construction contract. One court confirmed that there is no implied warranty of good and workmanlike performance in an owner/subcontractor context, while other courts applied the rules of accord and satisfaction and substantial compliance to determine the rights of the parties to construction contracts. These issues are analyzed more fully below.

##### A. IMPLIED WARRANTIES AND PRIVACY QUESTIONS

In *Codner v. Arellano*,<sup>48</sup> the Austin Court of Appeals concluded that a homeowner did not have standing to sue a subcontractor for breach of an implied warranty of workmanlike performance under the Texas Deceptive Trade Practices Act (“DTPA”).<sup>49</sup> The court reached its conclusion based upon the reasoning that no public policy exists to permit a homeowner to sue a subcontractor, because the homeowner’s remedy lies with the general contractor with whom it dealt directly.<sup>50</sup>

The disputes in *Arellano* involved the homeowner, the general contractor he hired, and Road Runner Concrete, the subcontractor hired by the general to build the foundation for the residence. When the completed home developed foundation problems, the owner sued both the contractor and Road Runner for violations of the DTPA and for negligence. At trial, the owner settled with the contractor but proceeded against Road Runner. The trial court granted Road Runner a directed verdict on the plaintiff’s claim under the DTPA, and the jury found in favor of Road Runner on the negligence claim.<sup>51</sup>

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46. *Id.*

47. *Lee Lewis*, 2001 Tex. LEXIS, at \*21.

48. 40 S.W.3d 666 (Tex. App.—Austin 2001, no pet. h.).

49. *Id.* at 673-74.

50. *Id.*

51. *Id.* at 668.

The owner appealed both findings. The court of appeals upheld the jury's finding of no negligence, and its opinion focused on the question of whether the implied warranty of good and workmanlike performance, which inures to the benefit of a consumer under the DTPA, extends to a subcontractor.<sup>52</sup>

The court determined that the DTPA does not create any warranty, but rather provides a remedy for a breach of a warranty which is separately recognized at common law or separately created by statute.<sup>53</sup> The court noted that an implied warranty will not be imposed unless there is a demonstrated, compelling need for the warranty.<sup>54</sup> In addition, the court concluded that an implied warranty should not be imposed as a matter of public policy if the owner had an adequate alternative remedy to address the alleged wrong, including a claim against the general contractor.<sup>55</sup>

In the context of its discussion, the court emphasized the fact that the builder or general contractor in a residential construction contract does impliedly warrant that the house will be constructed in a good and workmanlike manner.<sup>56</sup> It rejected the position that no privity is required for a DTPA claim in the context of the breach of implied warranty discussion and emphasized several times that it would decline to apply, as a matter of public policy, an implied warranty to a dispute between a homeowner and subcontractor.<sup>57</sup>

#### B. CONTRACT PAYMENTS—THE ACCORD AND SATISFACTION PRINCIPLE

In *Calabrian Chemicals Corp. v. Bailey-Buchanan Masonry, Inc.*,<sup>58</sup> a contractor agreed to construct a building for the owner. The compensation of the contractor was to be computed on a time and material basis. The dispute centered on whether or not there was a cap of \$68,000.00 on the construction project. The owner maintained that there was a cap, while the contractor argued that there was no cap on the project.

The construction project ran over the alleged cap, and the owner refused to pay the contractor for any expenses or costs over \$68,000.00. A dispute arose between the contractor and the owner with regard to the existence of the cap. The owner issued a check to the contractor with the following notation: "FINAL PAYMENT ON OUR PURCHASE OR-

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52. *Id.* at 671-72.

53. *Codner*, 40 S.W.3d at 672.

54. *Id.* (citing *Rocky Mountain Helicopters, Inc. v. Lubbock County Hosp. Dist.*, 987 S.W.2d 50, 53 (Tex. 1998); *Parkway Co. v. Woodruff*, 901 S.W.2d 434, 439 (Tex. 1995); *Melody Home Mfg. Co. v. Barnes*, 741 S.W.2d 349, 353 (Tex. 1987); *Dennis v. Allison*, 698 S.W.2d 94, 95 (Tex. 1985)).

55. *Id.* (citing *Rocky Mountain Helicopters*, 987 S.W.2d at 53; *Dennis*, 698 S.W.2d at 96; *Humble Nat'l Bank v. DCV, Inc.*, 933 S.W.2d 224, 239 (Tex. App.—Houston [14th Dist.] 1996, writ denied)).

56. *Id.* at 672 (citing *Humber v. Morton*, 426 S.W.2d 554, 561-62 (Tex. 1968)).

57. *Id.* at 674.

58. 44 S.W.3d 276 (Tex. App.—Beaumont 2001, pet. denied).

DER 10356 which was not to exceed 68,000.”<sup>59</sup> The contractor cashed the check.

The trial court submitted several questions to the jury, including one which asked whether the purchase order constituted the complete agreement of the parties. If the jury answered the question in the affirmative, then the jury was to consider a question addressing the issue of accord and satisfaction. The jury found that the purchase order did not constitute the entire agreement. Accordingly, the jury did not consider the issue of accord and satisfaction.

The jury concluded that the owner had agreed to pay the contractor on a time and material basis.<sup>60</sup> The jury also found that the owner had breached the agreement with the contractor, but that the breach did not damage the contractor.<sup>61</sup> The trial court disregarded the jury’s damages findings, concluding that the contractor suffered damages in the amount of \$50,548.90 and awarding attorney’s fees in the amount of \$23,818.50.<sup>62</sup>

The owner appealed the trial court’s decision and argued that it was entitled to an unconditional submission of accord and satisfaction. The appellate court agreed.<sup>63</sup> According to the appellate court, the check could have been final payment on the disputed issue, despite the fact that the purchase order was not the complete agreement.<sup>64</sup> Failure to unconditionally submit the issue of accord and satisfaction to the jury constituted reversible error. Accordingly, the appellate court reversed and remanded for a new trial where the issue of accord and satisfaction would be unconditionally submitted.<sup>65</sup>

### C. SUBSTANTIAL PERFORMANCE AS THE MEASURE OF PERFORMANCE

In *Chappell Hill Bank v. Lane Bank Equipment Co.*,<sup>66</sup> the contractor filed a lien and sued the owner for the balance due on a construction contract. Under the construction contract, the owner, a bank, hired Lane Equipment, the contractor, to construct a building to house an ATM. When the building was nearing completion, the bank began to express concerns about certain aspects of the construction. The contractor attempted to address the concerns raised. Eventually, the bank stopped making payments under the contract, and Lane Equipment filed a lien and brought suit.

Lane Equipment claimed that it was entitled to payments of \$1,385.00 for one awning, \$4,800 for a security system; sales tax of \$396, and \$5,303.02 under the construction contract. The trial court awarded Lane

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59. *Id.* at 280.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Calabrian Chems. Corp.*, 49 S.W.3d at 281.

64. *Id.*

65. *Id.*

66. 38 S.W.3d 237 (Tex. App.—Texarkana 2001, pet. denied).

Equipment \$6,743.55 in damages and \$9,000 in attorney's fees.<sup>67</sup> The bank appealed, claiming that Lane Equipment was only entitled to seventy-five percent of the contract price because the building was not completed. On the issue of completion, the trial court submitted the following question to the jury: "Do you find from a preponderance of the evidence that Lane Bank Equipment Company fully complied with all terms and conditions of the contract in doing the work?"<sup>68</sup>

Although the appellate court stated that a substantial performance question would have been more appropriate under the circumstances, the appellate court refused to find error in the question submitted by the trial court.<sup>69</sup> The court noted that, in the case of building and construction contracts, the doctrine of substantial performance by a contractor is often deemed sufficient to enable the contractor to recover the contract price less any amounts necessary to remedy any defects in the work.<sup>70</sup> In the particular case, the bank did not object to the submission of the question based upon full compliance. After reviewing that standard, the appellate court upheld the trial court's decision, finding that "the jury could properly find that Lane Equipment had fully complied with all terms and conditions of the contract in doing the work."<sup>71</sup>

#### D. WAIVER OF IMPLIED WARRANTIES

Pending before the Texas Supreme Court, in 2001, was the issue of whether the purchaser of a new home can waive the implied warranties of habitability and good and workmanlike construction. Although not decided by the Supreme Court prior to the end of 2001, the issues raised in the appeal are important ones within the context of construction disputes.

In *Buecher v. Centex Homes*,<sup>72</sup> decided by the San Antonio Court of Appeals in March 2000, the court held that a home builder would not be permitted to require a purchaser to sign what the court described as a "contract of adhesion," which waived the implied warranty of habitability and good and workmanlike construction in the context of new home construction.<sup>73</sup> In its holding, the court supported the continued viability of *Melody Home Mfg. Co. v. Barnes*.<sup>74</sup> The court's reasoning was that it would be incongruous if public policy required the existence of the implied warranties, yet permitted the waiver or disclaimer of the warranties in the form of a pre-printed statement form disclaimer in a standard form contract.<sup>75</sup> The court rejected the builder's argument that *Melody Home*

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67. *Id.*

68. *Id.* at 242.

69. *Id.*

70. *Id.*

71. *Chappell Hill Bank*, 38 S.W.3d at 244.

72. 18 S.W.3d 807 (Tex. App.—San Antonio 2000, pet. granted).

73. *Id.* at 810-11.

74. 741 S.W.2d 349 (Tex. 1997) (holding that the implied warranty to perform repair services in a good and workmanlike manner cannot be waived).

75. *Buecher*, 18 S.W.3d at 808.

prohibits the waiver of implied warranties only in the context of the repair of tangible personal property.<sup>76</sup>

The facts of the case centered around Centex's standard form sales agreement, which contained the following provision intended to waive the implied warranties of habitability and good and workmanlike construction:

PURCHASER AGREES TO ACCEPT SAID HOMEOWNER'S WARRANTY AT CLOSING IN LIEU OF ALL OTHER WARRANTIES, WHATSOEVER, WHETHER EXPRESSED OR IMPLIED BY LAW, AND INCLUDING BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF GOOD WORKMANLIKE CONSTRUCTION AND HABITABILITY. PURCHASER ACKNOWLEDGES AND AGREES THAT SELLER IS RELYING ON THIS WAIVER AND WOULD NOT SELL THE PROPERTY TO PURCHASER WITHOUT THIS WAIVER.<sup>77</sup>

In place of those implied warranties, Centex agreed to deliver its standard form Limited Home Warranty against defects in workmanship and materials.

The homeowner argued that the waiver provision violated Section 17.46(b)(12) of the DTPA. Centex argued that the waiver was permissible because the homeowners would be adequately protected by the Residential Construction Liability Act. It also argued that the waiver of implied warranties should be permitted because the express warranties provided in lieu of the implied warranties would serve a "gap filler" function, which the implied warranties are intended to satisfy.

The San Antonio Court rejected Centex's arguments, citing the Texas Supreme Court's adoption of implied warranty law relating to new home construction in 1968,<sup>78</sup> as well as the law of *Melody Homes*. Based upon those authorities, the court concluded that the reasoning expressed in those cases applied equally to new home construction.<sup>79</sup>

## V. RESIDENTIAL CONSTRUCTION LIABILITY ACT

### A. RCLA DOES NOT APPLY TO OR PREEMPT RESCISSION CLAIMS

During the past year, the San Antonio Court of Appeals considered the question of whether the Residential Construction Liability Act ("RCLA") applies to claims for relief other than claims for actual damages. Although the case was settled during the appeal and the opinion withdrawn, the court's analysis provides some interesting points for consideration which may be drawn upon in future disputes.

In *Perry Homes v. Carns*,<sup>80</sup> the homeowner sued the builder for dam-

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76. *Id.*

77. *Id.* at 809.

78. *Id.* at 811 (citing *Humber v. Morton*, 426 S.W.2d 554 (Tex. 1968).

79. *Id.*

80. No. 04-00-00185-CV, 2001 Tex. App. LEXIS 939 (Tex. App.—San Antonio Feb. 14, 2001), *withdrawn*, No. 04-00-00185-CV, 2001 Tex. App. LEXIS 2168 (Tex. App.—San Antonio Apr. 4, 2001).



ages resulting from certain defects in the construction of a home. Carns, the homeowner, alleged causes of action which included (1) DTPA violations, (2) breach of contract, and (3) negligence. Carns sought relief in the form of rescission or the form of actual damages for repairs and diminution in value. At trial, the jury concluded that Carns was entitled to restoration of the home's purchase price pursuant to DTPA section 17.50(b)(3).<sup>81</sup>

On appeal, Perry Homes argued that Carns' causes of action were preempted by the RCLA. According to Perry Homes, the damages element of Carns' rescission claim was an action to recover damages under the RCLA and should, therefore, be governed by the terms of the RCLA. To the contrary, Carns argued that his claim of rescission was not governed by the RCLA, because the RCLA applied only when a claimant was seeking monetary damages.

In the context of its analysis, the court emphasized that monetary damages and rescission are mutually exclusive remedies, because one is based upon recovery of benefits under a contract, while the other is based upon an avoidance of a contract.<sup>82</sup> While noting the statute's lack of clarity, the court focused on the specific language of the RCLA, which referred repeatedly to an "action to recover damages."<sup>83</sup>

After carefully reviewing both the text of the RCLA and the legislative history of the statute in an attempt to determine whether the RCLA would preempt Carns' causes of action, the court concluded that "[i]f the homeowner seeks an equitable remedy (like rescission), and not monetary damages, then the RCLA does not preempt the action. If the Legislature had intended the RCLA to apply to any and all claims arising from a construction defect without regard to the remedy sought, it would have so stated."<sup>84</sup>

The court was careful to note that the RCLA's language did not indicate clearly that the Texas Legislature had intended to replace a claimant's equitable remedy of rescission with an exclusive remedy of monetary damages.<sup>85</sup> The court noted that, to the contrary, the statute suggests that the Legislature sought to shield builders from liability and to impose a cap upon monetary damages.<sup>86</sup> The court concluded that, because the Legislature failed to make it clear that the RCLA limits the type of remedies to be recovered against a homebuilder, the court was unwilling to recognize such an unstated intent and unwilling to insert additional provisions into the act to establish such a limitation.<sup>87</sup>

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81. *Id.* at \*1.

82. *Id.* at \*5.

83. *Id.* at \*\*7-8 (citing TEX. PROP. CODE ANN. §§ 27.002, 27.003, 27.004, 27.0041, 27.006 (Vernon 1984 & Supp. 2000)).

84. *Id.* at \*10.

85. *Carns*, 2001 Tex. App. LEXIS at \*8.

86. *Id.*

87. *Id.* at \*11.

The concurring opinion to the case, most interestingly, stated as follows: "I do not know the correct result in this case; nor do I know how to decide what it is."<sup>88</sup> The dissent noted that a court's charge is to divine and effectuate the legislative intent of the statute, but that neither the statute itself nor its legislative history indicated the true intent or resolved the issue.<sup>89</sup> The concurring opinion concluded that "I thus do not concur in my colleagues' judgment because I agree with its statement of the law. In my view, the law will support either result. I concur in the judgment because I cannot and do not believe the legislature intended to RCLA to saddle a buyer with a home that is so defective it is not suitable for its intended purpose."<sup>90</sup>

The concurring opinion is an interesting commentary on the tangled statute that is the RCLA. It also sheds some light on the reason court opinions interpreting the RCLA have often seemed so convoluted.

#### B. RCLA DOES NOT PREEMPT DTPA CLAIM AFTER UNREASONABLE SETTLEMENT OFFER

In *Perry Homes v. Alwattari*,<sup>91</sup> the court determined that a builder's failure to make a reasonable settlement offer, as required by the RCLA, results in a forfeiture by the builder of the protections of the Act and the ability of the homeowner to pursue other claims, including claims under the DTPA.<sup>92</sup> In the *Alwattari* case, the plaintiffs purchased a new home built by Perry Homes. After purchasing the home, the plaintiffs discovered cracks in the foundation. The plaintiffs notified Perry Homes of the defects in the foundation, and Perry Homes began an investigation. Perry Homes hired an engineer to inspect the property and take elevation measurements. The engineer determined that the foundation had shifted.

The plaintiffs demanded that Perry Homes pay for an engineering report, the cost of any necessary repairs, temporary housing during the repairs, the reduction in the house's market value, and attorney's fees. Perry Homes responded to the plaintiffs' demand by offering to pay sixty percent of the total cost of installing the piers if the plaintiffs would release their claims against Perry Homes.

Plaintiffs sued Perry Homes under RCLA and DTPA. At trial, the jury concluded that Perry Homes' settlement offer was not a reasonable offer under the RCLA.<sup>93</sup> Accordingly, the jury considered the plaintiffs' negligence and DTPA causes of action and found that Perry Homes was liable under both theories.<sup>94</sup>

Perry Homes appealed the trial court's decision, arguing that the RCLA preempted the plaintiffs' negligence and DTPA claims. The plain-

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88. *Id.* at \*18.

89. *Id.* at \*19-20.

90. *Carns*, 2001 Tex. App. LEXIS at \*21.

91. 33 S.W.3d 376 (Tex. App.—Fort Worth 2000, pet. denied).

92. *Id.* at 384.

93. *Id.* at 381.

94. *Id.*

tiffs argued that Perry Homes failed to make a reasonable settlement offer under the RCLA and thereby waived the protections of the RCLA. The appellate court agreed with the plaintiffs and upheld the judgment of the trial court.<sup>95</sup>

The court's opinion cited the RCLA provision which states that "if a contractor fails to make a reasonable offer under this section . . . the limitations on damages and defenses to liability provided for in this section shall not apply."<sup>96</sup> The appellate court concluded that Perry Homes' failure to make a reasonable settlement offer to the plaintiffs resulted in Perry Homes' loss of the benefit of all limitations on damages and defenses to liability provided for in Section 27.004, including both the limitation on the types of damages recoverable by a homeowner and the limitation on the amount of damages recoverable by a homeowner.<sup>97</sup> As a result, the limitations of section 27.004 of the RCLA did not apply, and because no conflict with the RCLA would exist under the circumstances, the DTPA action was permitted.<sup>98</sup>

## VI. CONSTRUCTION DEFECTS AND INSURANCE COVERAGE

The question of whether an alleged construction defect can ever qualify as an "occurrence," and trigger an insurer's duty to defend and/or duty to indemnify in favor of the insured in the context of a commercial liability policy, continues to raise difficult questions for Texas courts. While the courts have struggled with such questions, the most recent decisions make it clear that the Texas state courts are reluctant to expand coverage to include damages for defective work performed by the insured contractor itself, as opposed to defective work by a subcontractor or as opposed to "resulting damage" to a third party's work. However, one decision from the United States District Court for the Southern District of Texas appears to raise some questions about the potential expansion of coverage by that court, depending upon how the injury is alleged in the relevant pleadings.

### A. THE CONTRACTOR'S DEFECTIVE WORK IS NOT AN "OCCURRENCE"

In *Devoe v. Great American Insurance*,<sup>99</sup> a custom homebuilder was sued by the purchasers of the home based upon the builder's alleged failure to construct the residence in question in a good and workmanlike manner. The purchasers maintained that, as the work on the home proceeded, a number of flaws became apparent, including improper and defi-

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95. *Id.* at 384.

96. *Alwatlari*, 33 S.W.3d at 382 (citing TEX. PROP. CODE ANN. § 27.004(g) (Vernon 1984 & Supp. 2000)).

97. *Id.* at 384.

98. *Id.*

99. 50 S.W.3d 567 (Tex. App.—Austin 2001, no pet. h.).

cient workmanship. The purchasers sued to recover actual damages and attorney's fees. The homebuilder demanded indemnification by its insurer. The insurer denied coverage, based upon its position that the claim was not covered, because the property damage alleged was not caused by an "occurrence."

The trial court granted summary judgment in favor of Great American Insurance Company, concluding that no "occurrence" was involved, because the defects alleged were the result of construction methods which were voluntary and intentional acts by the builder.<sup>100</sup> The Austin Court of Appeals affirmed.<sup>101</sup>

In the context of the insurance dispute, the Austin court focused on the question of whether the allegations in the case could ever be construed to constitute an "accident," and therefore an "occurrence," within the meaning of the policy in question. The general liability policy in question contained standard language, providing coverage as follows:

- (1)(a) We will pay those sums that the insured becomes legally obligated to pay as damages because of . . . "property damage" to which this insurance applies . . .
- (b) This insurance applies to . . . "property damage" only if:
  - (1) the . . . "property damage" is caused by an "occurrence" that takes place in the "coverage territory"<sup>102</sup>

The policy defined "occurrence" as an "accident," including continuous or repeated exposure to substantially the same general harmful conditions.<sup>103</sup>

The court of appeals noted various arguments made by the purchaser to attempt to describe the faulty construction at issue as an "occurrence," but rejected all such arguments and distinguished the cases cited by the purchaser.<sup>104</sup> The court quite quickly concluded that, because the home was constructed over a period of time as a voluntary and intentional act by the insured, the alleged deficiencies did not constitute an accident or occurrence, even if the poorly constructed home which resulted was unexpected, unforeseen, or unintended by the builder.<sup>105</sup>

#### B. THE "KNOWING" STANDARD DOES NOT ESTABLISH OR DEFEAT COVERAGE

The Houston court in *Hartrick v. Great American Lloyd's Insurance Co.*,<sup>106</sup> similarly concluded that a builder's breach of an implied warranty did not qualify as an "accident" and therefore did not trigger coverage under the insurance policy in question.<sup>107</sup> The court found that the dam-

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100. *Id.* at 569.

101. *Id.*

102. *Id.* at 570-71.

103. *Id.* at 571.

104. *Devoe*, 50 S.W.3d. at 572.

105. *Id.*

106. 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.).

107. *Id.* at 272.

age which resulted from a pitching and heaving foundation was a reasonably foreseeable result of not complying with an implied warranty, even if the builder did not intend for the damage to result.<sup>108</sup>

The court found that the builder's liability was a result of its failure to comply with the implied promises imposed upon it as a matter of law as a home builder by not preparing the soil properly and not constructing the foundation properly.<sup>109</sup> The court concluded that, because the builder was responsible for the damages to the home and could have reasonably foreseen those damages, its acts could not be classified as an "accident."<sup>110</sup> Additionally, the court rejected the argument by the homeowners that the builder's acts were an "accident" and therefore an "occurrence," because the jury failed to find that the builder's acts were committed knowingly. The court concluded that the "knowing" standard was applicable only to the DTPA question posed and was not conclusive on the coverage question.<sup>111</sup>

### C. THE TRADITIONAL ANALYSIS—NO COVERAGE FOR DEFECTIVE CONSTRUCTION

In *Malone v. Scottsdale Insurance Co.*,<sup>112</sup> an insured contractor was sued in the United States District Court for the Southern District of Texas, based upon allegations that it had defectively constructed improvements to an office and warehouse complex. The owner's petition alleged that the contractor negligently constructed the project and failed to construct the improvements in accordance with the plans and specifications.

The court, citing *Hartrick*,<sup>113</sup> concluded that the contractor's failure to comply with the plans and specifications was not an "occurrence" under a general liability policy, even if the allegations were framed as a negligence claim, and granted the insurer's motion for summary judgment.<sup>114</sup> The court concluded that the alleged omissions by the contractor (specifically the failure to construct the improvements in compliance with the plans and specifications) were voluntary and intentional in nature, not accidental, and therefore coverage could not exist.<sup>115</sup>

### D. THE DEPARTURE—THE "UNEXPECTED" AND "UNINTENDED" FOCUS

In *First Texas Homes, Inc. v. Mid Continental Casualty Co.*,<sup>116</sup> the United States District Court for the Northern District of Texas, applying

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108. *Id.* at 277.

109. *Id.*

110. *Id.* at 278.

111. *Hartrick*, 62 S.W.3d at 278.

112. 147 F. Supp. 2d 623 (S.D. Tex. 2001).

113. 62 S.W.3d 270.

114. *Malone*, 147 F. Supp. 2d at 628.

115. *Id.* at 627-28.

116. No. 3-00-CV-1048-BD, 2001 U.S. Dist. LEXIS 2397 (N.D. Tex. Mar. 7, 2001).

Texas law, concluded, in the context of competing summary judgment motions, that coverage existed for the allegations of faulty design and construction made against a builder/developer.<sup>117</sup> The case appears to be a significant departure from the traditional analysis applied, and it will be interesting to study how it is received by the courts which continue to review this coverage issue.

In the case, *First Texas*, the builder/developer, was sued by a homeowner for negligence, based upon allegations that a home in question was not designed or constructed in a good and workmanlike manner, as a result of certain foundation problems. The homeowner's complaints focused upon both the design and construction, which were apparently completed by *First Texas* itself. *First Texas* sought coverage under its general liability policy for the claims asserted against it.

The homeowner urged the U.S. District Court for the Northern District of Texas to adopt the approach of the Fifth Circuit Court of Appeals and another Northern District Court, which had previously determined that defective performance or faulty workmanship by the insured which injures the property of a third party can constitute an "accident" under the relevant policy definitions.<sup>118</sup>

The insurer argued that the court should distinguish the allegations in the case from prior decisions where the courts' analysis focused on allegations of damage to a third party's work, not the defective work of the insured itself. The District Court for the Northern District of Texas rejected the insurer's arguments and its attempts to distinguish damages to the insured's work versus a third party's work.<sup>119</sup> The court continued to focus on the question of whether the resulting damages (regardless of which work was affected) were unexpected and unintended.<sup>120</sup> The court summarized its analysis as follows: "[t]he relevant inquiry is not whether the insured damaged his own work, but whether the resulting injury or damage was unexpected and unintended."<sup>121</sup>

In its analysis of the issue, the court seemingly rejected, out of hand, the widely accepted conclusion that a contractor's breach of its own contractual obligations to a homeowner cannot constitute an "occurrence," since such a breach results from the intentional acts of the contractor. The court noted that the allegations made by the homeowner (that the home was not of proper quality and the foundation was insufficient) could be construed to support a claim that the damage sustained by the homeowner was not expected or intended from the standpoint of the

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117. *Id.* at \*10-11.

118. *Id.* at \*8. The homeowner urged the Court to adopt the reasoning of *Federated Mutual Insurance Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 723 (5th Cir. 1999); *Hartford Casualty Co. v. Cruse*, 938 F.2d 601, 604-05 (5th Cir. 1991); and *E&R Rubalcava Construction, Inc. v. Burlington Insurance Co.*, 147 F. Supp.2d 523 (N.D. Tex. 2000).

119. *Id.* at \*8-9.

120. *Id.* at \*9.

121. *First Texas Homes*, 2001 U.S. Dist. LEXIS 2397, at \*9.

insured.<sup>122</sup>

## VII. ENGINEERING SERVICES AND CGL COVERAGE ISSUES

In *Utica Lloyd's of Texas v. Sitech Engineering Corp.*,<sup>123</sup> the Texarkana Court of Appeals analyzed the professional services exclusion of the commercial general liability insurance policy, concluding that the exclusion is unambiguous and clearly excluded coverage for alleged negligence by the engineering firm on the construction project.<sup>124</sup>

The survivors of a construction worker who was killed in a trench cave-in sued the engineering firm on the project, alleging that the insured engineering firm was negligent in (1) failing to make daily site inspections, as required by the contract; (2) designing the excavation system in a way which failed to indicate the slope for the spoil pile adjacent to the trench; and (3) misrepresenting its qualifications to prepare the project's safety requirements. One of the amended petitions filed by the survivors alleged that certain of the negligent acts were performed by both engineering and non-engineering personnel.

The engineering firm's CGL insurer filed suit, requesting a declaratory judgment that the allegations made did not trigger coverage under the applicable policy and that the professional services exclusion specifically barred coverage. The professional services exclusion stated, in relevant part, as follows:

This insurance does not apply to "bodily injury" . . . arising out of the rendering or failure to render any professional services by or for you, including:

1. The preparing, approving, or failing to prepare or approve maps, drawings, opinions, reports, surveys, change orders, designs or specifications; and
2. Supervisory, inspection or engineering services.<sup>125</sup>

The trial court concluded that the application of the exclusion was ambiguous due to the estate's allegations that some of the insured's negligent acts were committed by non-engineering personnel.<sup>126</sup> The court of appeals reversed, holding that the exclusion unambiguously applied to the precise allegations made in the case, since the exclusion clearly defines what constitutes professional services.<sup>127</sup>

The court concluded that the factual allegations made against the insured did not change in any way when they were amended to claim that some acts were performed by non-engineering personnel, since the allegations still fell squarely within the scope of the exclusion: improper inspection or failure to inspect, negligent design, and misrepresentations.<sup>128</sup>

122. *Id.* at \*10.

123. 38 S.W.3d 260 (Tex. App.—Texarkana 2001, no pet.).

124. *Id.* at 264.

125. *Id.* at 263.

126. *Id.*

127. *Id.* at 264.

128. *Utica*, 38 S.W.3d at 264.

The court properly determined that the type of allegations made would potentially be governed by or insured by a professional liability policy, not the CGL policy.

### VIII. SOVEREIGN IMMUNITY

The Texas Supreme Court recently addressed the issue of waiver within the context of a sovereign immunity claim in *General Services Commission v. Little-Tex Insulation Co.*<sup>129</sup> The Court's opinion resulted from the consolidation of two cases: (1) *General Services Commission v. Little-Tex Insulation Co.* and (2) *Texas A&M University v. DalMac Construction Co.*, both of which analyzed sovereign immunity as a defense and waiver as an exception to that defense.

In the underlying dispute from *Texas A&M University v. DalMac*, DalMac sued the University for damages arising out of a construction contract. The trial court granted Texas A&M University's plea to the jurisdiction, but the court of appeals reversed and remanded.<sup>130</sup> The court of appeals concluded that DalMac was entitled to conduct discovery in order to prove that the University waived its immunity from suit.<sup>131</sup>

In the underlying case, *General Services v. Little-Tex Insulation Co.*, Little-Tex was awarded a state contract for asbestos abatement. After a dispute arose between the state and Little-Tex, Little-Tex filed suit in district court. As in DalMac, the trial court granted the state's plea to the jurisdiction.<sup>132</sup> The appellate court reversed and remanded after concluding that the state waived its immunity from suit by accepting the benefits from Little-Tex's performance of the contract.<sup>133</sup>

In its opinion, the Texas Supreme Court considered whether or not the state could waive its sovereign immunity through the judicially created exception of waiver-by-conduct. In its earlier opinion in *Federal Sign v. Texas Southern University*,<sup>134</sup> the Texas Supreme Court held that the State's act of contracting for goods and services did not automatically waive its immunity from suit.<sup>135</sup> However, the Court "expressly left open the question of whether the State's conduct may waive its immunity from suit."<sup>136</sup> In the wake of *Federal Sign*, several courts (including the two appellate courts involved in the underlying disputes) concluded that the State could waive its immunity by accepting benefits under a contract.

In an apparent response to *Federal Sign* and the developing case law, the Texas Legislature enacted what is now Chapter 2260 of the Texas Government Code. According to the Texas Supreme Court, "Chapter 2260 retains sovereign immunity from a suit in breach-of-contract cases

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129. 39 S.W.3d 591 (Tex. 2001).

130. *Id.* at 594.

131. *Id.*

132. *Id.*

133. *Id.*

134. 951 S.W.2d 401 (Tex. 1997).

135. *Id.* at 408.

136. *Little-Tex*, 39 S.W.3d at 595 (citing *Federal Sign*, 951 S.W.2d at 408 n.1).



against the State but provides an administrative process to resolve those claims."<sup>137</sup> According to Section 2260.001(1) of the Texas Government Code, the administrative scheme enacted by the Legislature applies to all written contracts for the sale of goods, services, or construction.<sup>138</sup>

Little-Tex and DalMac attempted to evade the provisions of Chapter 2260 by arguing that the State waived any claim to sovereign immunity by accepting benefits under the construction contracts at issue. Specifically, Little-Tex and DalMac argued that Chapter 2260 did not apply to waiver-by-conduct cases, because "a party seeking redress under a waiver-by-conduct theory is not seeking permission under Chapter 107."<sup>139</sup> According to Little-Tex and DalMac, consent was not required because the State waived its immunity by conduct. Both Little-Tex and DalMac argued that "if consent under Chapter 107 is not necessary, then, logically, neither is compliance with Chapter 2260."<sup>140</sup>

The Texas Supreme Court refused to adopt Little-Tex's and DalMac's arguments and concluded "that there is but one route to the courthouse for breach-of-contract claims against the State, and that route is through the Legislature."<sup>141</sup> The court concluded that, under the new scheme set forth in the Government Code, "a party simply cannot sue the State for breach of contract absent legislative consent under Chapter 107. Compliance with Chapter 2260, therefore, is a necessary step before a party can petition to sue the State."<sup>142</sup> According to the court, the Legislature "foreclosed the possibility for a waiver-by-conduct exception to the State's immunity from suit in certain breach-of-contract claims."<sup>143</sup>

The court carefully noted in its opinion the distinction between immunity from suit and immunity from liability. The court concluded that, while the state waives immunity from liability when it contracts as would a private citizen, it does not also waive immunity from suit. Chapter 2260 establishes the administrative claims resolution procedure which applies to such claims, and a party must comply with Chapter 2260 in order to obtain consent to sue a public entity.<sup>144</sup>

## IX. PAYMENT AND PERFORMANCE BONDS

The Texas Property Code and the Texas Government Code were revised in 2001 to include certain additional provisions governing the information that must be contained in payment and performance bonds, how notice may be given, and related issues.

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137. *Id.*

138. TEX. GOV'T CODE ANN. § 2260.001(1) (Vernon 2000).

139. *Little-Tex*, 39 S.W.3d at 596.

140. *Id.*

141. *Id.* at 597.

142. *Id.*

143. *Id.* at 600.

144. TEX. GOV'T CODE ANN. § 2260 (Vernon Supp. 2002).

## A. PERFORMANCE AND PAYMENT BOND FORMS

The substantive content required to be contained in the forms used as payment and performance bonds has been amended, with the addition of certain additional elements now set forth in parts of Section 2253 of the Texas Government Code and in parts of Section 53 of the Texas Property Code.<sup>145</sup>

In particular, the new provisions require that every performance bond and payment bond required by the statutes display the name, mailing address, physical address, and telephone number of the surety company which issued the particular bond or, in the alternative, display the toll free telephone number maintained by the Department of Insurance (DOI) and a statement that the address of the surety company to which any notice of claim should be sent may be obtained from the DOI by calling the toll free number.<sup>146</sup>

The statutes provide that the additional required information can be attached to the bond or displayed on the bond itself.<sup>147</sup>

Section 2253.021, which sets forth the basic requirements for the use of payment and performance bonds on public projects, now provides as follows:

1. *Texas Government Code § 2253.021. Performance and Payment Bonds Required*

- (a) A governmental entity that makes a public work contract with a prime contractor shall require the contractor, before beginning the work, to execute to the governmental entity:
  - (1) a performance bond if the contract is in excess of \$ 100,000; and
  - (2) a payment bond if the contract is in excess of \$ 25,000.
- (b) The performance bond is:
  - (1) solely for the protection of the state or governmental entity awarding the public work contract;
  - (2) in the amount of the contract; and
  - (3) conditioned on the faithful performance of the work in accordance with the plans, specifications, and contract documents.
- (c) The payment bond is:
  - (1) solely for the protection and use of payment bond beneficiaries who have a direct contractual relationship with the prime contractor or a subcontractor to supply public work labor or material; and
  - (2) in the amount of the contract.

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145. TEX. GOV'T CODE ANN. §§ 2253.021, 2253.024(a), 2253.026, 2253.048; TEX. PROP. CODE ANN. §§ 53.202, 53.206 (Vernon Supp. 2002).

146. *Id.*

147. *Id.*

- (d) A bond required by this section must be executed by a corporate surety in accordance with Section 1, Chapter 87, Acts of the 56th Legislature, Regular Session, 1959 (Article 7.19-1, Vernon's Texas Insurance Code).
- (e) A bond executed for a public work contract with the state or a department, board, or agency of the state must be payable to the state and its form must be approved by the attorney general. A bond executed for a public work contract with another governmental entity must be payable to and its form must be approved by the awarding governmental entity.
- (f) A bond required under this section must clearly and prominently display on the bond or on an attachment to the bond:
  - (1) the name, mailing address, physical address, and telephone number, including the area code, of the surety company to which any notice of claim should be sent; or
  - (2) the toll-free telephone number maintained by the Texas Department of Insurance under Article 1.35D, Insurance Code, and a Statement that the address of the surety company to which any notice of claim should be sent may be obtained from the Texas Department of Insurance by calling the toll-free telephone number.
- (g) A governmental entity may not require a contractor for any public building or other construction contract to obtain a surety bond from any specific insurance or surety company, agent, or broker.<sup>148</sup>

Likewise, Section 53.202 of the Texas Property Code requires as follows:

## 2. *Texas Property Code § 53.202 Bond Requirements*

The bond must:

- (1) be in a penal sum at least equal to the total of the original contract amount;
- (2) be in favor of the owner;
- (3) have the written approval of the owner endorsed on it;
- (4) be executed by:
  - (A) the original contractor as principal; and
  - (B) a corporate surety authorized and admitted to do business in this state and licensed by this state and licensed by this state to execute bonds as surety, subject to Section 1 Chapter 87, Acts of the 56th Legislature, Regular Session, 1959 (Article 7.19-1, Vernon's Texas Insurance Code);
- (5) be conditioned on prompt payment for all labor, subcontracts, materials, specifically fabricated materials, and normal and usual extras not exceeding 15 percent of the contract price; and
- (6) Clearly and prominently display on the bond or on an attachment to the bond

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148. TEX. GOV'T CODE ANN. § 2253.021 (Vernon Supp. 2002). Presently there are two subsections labeled "(f)." The error will certainly be corrected the next legislative session.

- (A) the name, mailing address, physical address, and telephone number, including the area code, of the surety company to which any notice of claim should be sent; or
- (B) the toll-free telephone number maintained by the Texas department of insurance under article 1.35d, insurance code, and a statement that the address of the surety company to which any notice of claim should be sent may be obtained from the Texas department of insurance by calling the toll-free telephone number.<sup>149</sup>

#### B. RESPONSIVE INFORMATION REQUIRED

Section 2253.024 of the Texas Government Code, which specifies the information a contractor must provide to a subcontractor, now also requires the provision of the name of the surety issuing the payment bond and the performance bond, and the toll-free telephone number maintained by the Texas Department of Insurance under Article 1.35D, Insurance Code, for obtaining information concerning licensed insurance companies.<sup>150</sup>

In addition, Section 2253.026 of the Texas Government Code, which imposes the requirement upon governmental entities to furnish bond information upon request, now specifies that the governmental entity, shall, upon receipt of a request, provide the following:

- (1) a certified copy of a payment bond and any attachment to the bond;
- (2) the public work contract for which the bond was given; and
- (3) the toll-free telephone number maintained by the Texas Department of Insurance under Article 1.35D, Insurance Code, for obtaining information concerning licensed insurance companies.<sup>151</sup>

#### C. SATISFYING NOTICE REQUIREMENTS

Additions to both the Texas Government Code and the Texas Property Code now establish that a person satisfies the notice requirements under the bonds if the person mails the required notice by certified mail to the surety either (1) at the address on the bond or the attachment to the bond, or (2) at the address on file with the DOI, and (3) at any other address allowed by law.<sup>152</sup>

#### D. CLAIMS HANDLING

Chapter 7 of the Insurance Code has been amended with the addition of Article 7.20, which regulates claims handling practices for payment bond sureties. The new provisions of Chapter 7 set forth a definition of

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149. TEX. PROP. CODE ANN. § 53.202 (Vernon 2000).

150. TEX. GOV'T CODE ANN. § 2253.024 (Vernon Supp. 2002).

151. TEX. GOV'T CODE ANN. § 2253.026 (Vernon Supp. 2002).

152. TEX. GOV'T CODE ANN. § 2253.048 (Vernon Supp. 2002); TEX. PROP. CODE ANN. § 53.206(d) (Vernon Supp. 2002).

“notice of claim” and the dates for acceptance or rejection and payment of a claim.<sup>153</sup>

Moreover, the new provisions authorize the Department of Insurance to promulgate regulations to enforce the new article, “in the event a surety company violates this article as a general business practice.”<sup>154</sup>

The legislation is a compromise measure negotiated between the surety industry and subcontractors.

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153. TEX. INS. CODE ANN. Art. 7.20 (Vernon Supp. 2002).

154. *Id.*