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"Greetings! You Have Been Sued!" by Susan Harrelson with Kent J. Pagel

NOTE: Both "Dave Allen" and the Case Study situation are fictionalized composites. The hypothetical situation is not to be construed as legal advice on any particular case or problem. If you have a legal question or a situation similar to those depicted in the story, please consult an attorney licensed to practice in your jurisdiction.

THE BACKGROUND

Dave Allen* owns a small truss plant in the Western United States. He's been in business a little over ten years, and he's proud of what he's accomplished in building his company. He knows the business, he's good with customers, and his company is doing well. Dave's a decent kind of guy who takes pride in his work, and, although a little wheeling and dealing is fine, he's never cheated anyone or been involved in any shady deals. Dave's company represents the make-up of many small truss plants across the country.

THE PROBLEM

One morning, a clean-cut young man comes in and lays a thick stack of "legal documents" on Dave's counter. At the top of the page he reads, "Summons and Complaint." The young man is a process server, and the stack of papers he is delivering is notice of a lawsuit.

Dave looks at the second page in the stack to see who's suing him. The plaintiff is Mogul Housing Corp. who years ago developed many of the multi-family projects in the area. Dave has never done business with Mogul directly, as his customers are mostly framing contractors and lumberyards.

Dave continues his review and comes across the Defendant List. Included as named defendants are plumbing contractors, excavators, landscapers, door shops, concrete pumpers, roofers, drywallers and several framers, one of whom is a customer of Dave's company. Every conceivable building trade is represented on the Defendant List at least once. Dave finds his company near the end of the list. Reading further, he tries to determine what the suit is about, and gathers it has something to do with allegations of shoddy workmanship on a condominium complex. He can't begin to investigate until he knows what job to look for, but he can't find the name of the complex, or even the year it was built.

Dave doesn't have much experience with the law, and he's never been sued before. What should Dave do now to protect his interests? Before this question can be answered, Dave and other truss manufacturers must understand some fundamental concepts.

THE INSURANCE POLICY

Being served with a lawsuit is an unpleasant experience, and for most businesspeople it's unfamiliar territory. The confusion is magnified in a Construction Defect lawsuit, as it is often hard to tell from reading the Complaint who is suing whom, or even what the subject matter of the suit might be. Unfortunately, there isn't much time in which to figure it out, because the minute the Summons is served, the clock starts ticking. There is a finite period, twenty days in most states, in which to answer a complaint. If a responsive document is not filed within that time, **you lose**. Excuses asserted after this point may very well be ignored by the court, and a default judgment could be entered against you.

Construction Defect claims may not be filed for years following the completion of construction and can involve what the law terms "continuing" or "repeated" harms or occurrences. In these types of cases, every insurance carrier during the period covered by the suit will have to be notified and provided with copies of the Complaint. The company's insurance agent should be

used to facilitate this process. Agents have an inside track to the carrier's claims department, and they can route the paperwork to the right people much more efficiently than a business owner can. A company that has an ongoing relationship with its insurance agent and keeps good records of both insurance policies and completed jobs, will have far less trouble gathering and disseminating the policies, job records and related vital information than a company that has not taken the time to maintain these relationships and records.

Within a few days, the agent and the company's insurance carriers can probably arrange for a local law firm to represent the truss manufacturer. It's important for the company to cooperate with the lawyer by turning over the job file and other records as soon as possible. If the job file includes details on the quality control procedures in place when the trusses were built, and if no problems with the job are apparent, the lawyer can answer in good faith that the trusses were not defective.

Construction Defect litigation is a lot like an old description of combat: long periods of boredom punctuated by short periods of intense fear. Several months may pass before anything happens. An early development that should be expected is receiving a letter (referred to as a “Reservation of Rights” letter) from most if not all insurance carriers. Each letter will likely span several pages and will consist mainly of excerpts from the insurance policies. At first reading, the letters will seem to suggest that the truss manufacturer is not covered for the damages alleged in the current lawsuit, or for much of anything else.

There are many reasons insurance companies submit Reservation of Rights letters. Those that have been through the process may articulate the reason as “insurance companies are in the business of collecting premiums and not paying claims,” although that view is admittedly cynical. Other perhaps more legitimate reasons relate to limitations and exclusions contained in the insurance policies. For example, a typical Construction Defect type complaint will likely assert claims under both “tort” and “contract” theories.

“Tort Liability” arises when a person injures another or damages the property of another, either intentionally or unintentionally. Automobile accidents are the most familiar example of tort claims, and tort liability is the theory on which most personal injury claims proceed. Whether a tort is intentional or unintentional is critical for insurance coverage purposes. A policy of Commercial General Liability (CGL) Insurance provides coverage only for unintentional injuries. Intentional acts are generally not covered.

“Product Liability” is a type of tort, and coverage for product liability claims is included in almost every CGL policy. Product liability claims will relate to either the design, manufacturing or warnings of the product.

The typical Construction Defect suit will also assert what are referred to as “economic losses.” If a defective truss needs to be replaced, or the contractor or developer claims loss of rents due to the delays caused, the losses are purely economic in nature. In such a case, if there is no physical damage to persons or property, there is no tort, no product liability and no insurance coverage. As breach of warranty claims usually assert economic losses, they are not covered by CGL policies.

All exclusions and disclaimers set out in the Reservation of Rights letter need to be carefully reviewed and understood; and generally speaking, it is a good idea for the truss manufacturer's attorney (not the attorney hired by the insurance company to defend the case) to review and provide counsel on such language.

To the extent a construction defect case asserts claims of contract liability only, or asserts claims that are otherwise subject to one of the many limitations or exclusions in the CGL policy, why then do insurance companies nevertheless agree to become involved? Answering that question requires an explanation of two more legal concepts: the Duty to Defend and the Duty to Indemnify.

Liability insurance includes the costs of defending an insured party against claims for covered damages. This is known as the Duty to Defend. The insurance policy also contains the insurer's promise to pay damages when they arise from claims covered by the policy. This is known as the Duty to Indemnify (also referred to as the "Duty to Pay").

It is often impossible at the beginning of a claim to determine exactly what harm the Plaintiff is alleging. The insurer has a Duty to Defend, as long as there is a possibility that it will have to cover any of the plaintiff's claims (which is one of the primary reasons plaintiffs' lawyers make very broad allegations in the complaints that they file). At the conclusion of the case, however, if damages are awarded only for claims such as economic loss or breach of warranty, there may be no Duty to Indemnify. When the insurer sends a Reservation of Rights letter, it is explaining to the insured that, although it is bound to defend the claims, it is obliged to pay damages only for what it is bound to cover under the policy. Sometimes the carrier will also assert that its Duty to Defend is limited in some way.

The issue of legal representation often arises when an insurer issues a Reservation of Rights letter. The insurer hires a lawyer and pays the fees, but it is the lawyer's job to defend the insured. This arrangement usually benefits both insurer and insured, but there are occasions in which their interests may diverge. For example, an investigation may reveal that quality defects in the trusses could have caused the alleged damages, but that those damages are purely economic in nature. If it has no liability, the insurer also has no incentive to minimize the damages that may be assessed. In that case, the carrier's actions may no longer be in the insured's best interest, and separate representation may be advisable.

THE BUSINESS RELATIONSHIP

For the truss manufacturer, the identities of the plaintiffs and the defendants are often the most puzzling aspects of Construction Defect litigation. The plaintiff may be a developer or general contractor with whom the truss manufacturer has never done business. In that event, a homeowners' association (comprised of single family or condominium owners) has likely sued the developer that sold them their homes. The developer will claim that its subcontractors did the allegedly defective work and should reimburse the developer for its defense costs and damages. The developer or builder may further request that the subcontractors and suppliers defend the developer from the claims of the homeowners' association through indemnity or additional insured provisions agreed to by the parties.

The truss manufacturer may be in a better position than the other defendants named in the developer's suit. If the truss manufacturer sells to a subcontractor (e.g., a framer), it will usually not be bound by the comprehensive subcontractor agreement form, required by the developer or general contractor. These agreements generally contain all kinds of provisions designed solely to transfer liability from the general contractor to someone else. If, however, the truss manufacturer is selling directly to the contractor, it is important to utilize a carefully prepared material supplier agreement form. These agreements are not as likely to contain harsh risk transfer provisions that can cause serious liability problems for the signer. In any event, sales, service and estimating personnel should, whenever possible, use the truss company's own form for finalizing sales. If a customer insists on using a different form, the sales staff should understand that it must be reviewed by outside counsel or a qualified employee before they can complete the deal.

Terms to beware of when signing contracts include promises of indemnification and agreements to name the customer as an additional insured. The reason for caution relates to the Duty to Defend and the Duty to Indemnify. Naming the other party an additional insured entitles it to the performance of those duties by the truss manufacturer's insurance carrier. A promise to indemnify entitles the other party to the performance of those duties by the truss manufacturer. Understanding the significance of these terms before you agree to them is vital to the future of your company.

Reputable companies, your good customers, will negotiate the removal or modification of unreasonable contract terms. This means that the truss manufacturer will someday face a decision: whether or not to accept a job that comes with unfavorable terms attached. In that case, only good business judgment can and should provide the answer. Another difficult situation arises in the form of a customer who doesn't ask for unfair indemnity provisions at the beginning of the relationship, but who suddenly demands them when it's time to get paid. Resisting is more difficult when your payment is being held hostage to an overly broad indemnification agreement, but acquiescing to such demands is rarely worth the potential cost.

LIABILITY

Whether the suit is brought by a homeowners' association or a developer/contractor, a first-time litigant may wonder how everyone from the surveyor to the landscaping contractor could be responsible for the alleged defects. The short answer is that they probably aren't. Several unflattering names have been attached to the practice of naming every identifiable entity with a connection to the project: "shotgun approach," "scattershot technique" and "throwing everything at the wall to see what sticks." The idea is to name all possible parties in the hope of accumulating a large pool of insurance money and extracting the biggest possible payoff. If 200 subcontractors and suppliers each settle with the plaintiffs for $50,000, that's a $10 million payday before anybody is even found to be at fault. An especially frustrating aspect of such settlements is the fact that many alleged "defects" are cosmetic imperfections that have no effect on the structural integrity of the house.

CONCLUSION

Efforts are underway in several states to give contractors and subcontractors a statutory "right to cure," or an opportunity to fix problems with their work that become apparent after the homeowners move in. Such a right would remove some of the economic incentive to file a Construction Defect lawsuit, while continuing to protect homeowners from shoddy workmanship and unscrupulous builders. Meanwhile, it remains an unfortunate fact of business life that a truss manufacturer can be forced to incur defense costs against Construction Defect claims for which it is ultimately not liable. In many states, the expense to the truss industry, in increased insurance premiums and decreased availability of coverage, is becoming an obstacle to growth and continued prosperity. Some of the conditions that drive this trend are beyond our control, but many can be avoided through sensible planning, sound business practices with a strong emphasis on contract management, and informed engagement in the political process—a little bit more than Dave Allen may have considered!

Susan Harrelson has been with James Truss Company in Las Vegas, NV for 12 years. She is also a third-year law student at the Boyd School of Law, UNLV, and a member of the Product Safety & Loss Control Subcommittee of WTCA.

Kent J. Pagel is a senior shareholder of the Houston, Texas firm of Pagel, Davis & Hill, a Professional Corporation. Mr. Pagel serves as the outside general counsel to WTCA.

SBC HOME PAGE

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