KATZ & STONE L.L.P.
8230 Leesburg Pike, Suite 600, Vienna, Virginia 22182
703.761.3000 Fax 703.761.6179 www.katzandstone.com

# Construction Newsletter

A Summary of Important Recent Construction and Insurance Developments

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## ACCORD AND SATISFACTION: BEWARE OF SUSPICIOUS LANGUAGE ACCOMPANYING PARTIAL PAYMENTS

If an owner disputes a contractor's final billing, the owner may attempt to resolve the payment dispute by tendering a check in an amount less than that claimed by the contractor, and indicating on the check itself that the account is being "paid in full." But what effect, if any, would this language have on the contractor's ability to collect the remainder of the amount due? In *Helton v. Phillip A. Glick Plumbing, Inc.*, ___ Va. ___ (February 27, 2009), the Virginia Supreme Court addressed this issue, holding that such conspicuous language on the check amounts to an "accord and satisfaction" of the contractor's claim and, therefore, by accepting the check, the contractor waives his right to collect the remainder of the amount invoiced.

In *Helton*, Phillip A. Glick Plumbing, Inc. ("contractor") contracted with Michael Helton ("owner") to perform certain plumbing services and to install a hot water heater in the owner's home. Due to his observation that the contractor's workers "were taking extended breaks and generally working slowly," the owner kept close tabs on the time spent by the contractor installing the water heater. Upon receiving the contractor's invoice, the owner objected to the amount billed, stating that the invoice was "considerably high based on the hours worked, multiplied by the rate per hour." Accordingly, the owner "paid for the hot water heater installation but did not pay for all of the hours billed for the work."

Subsequently, the owner sent two letters to the contractor regarding the owner's complaints of overbilling and "allegations of 'goofing off' and wasted materials." Finally, the owner mailed a cashier's check to the contractor "in the amount of $1,300.00, which was $1,686.51 less than the amount billed" in the contractor's final invoice with the words "Paid in Full" on the memo line of the check. Further, the owner transmitted the check with a letter stating that no more payments would be made due to concerns of overbilling and lack of efficiency in the installation of the hot water heater. Upon receipt of the check, the contractor crossed out the words "Paid in Full" and added "No" and "Balance Due $1,686.51" on the check before depositing it.

The contractor sued the owner for $1,686.51. The owner defended on the basis that the contractor's acceptance of the owner's check constituted an accord and satisfaction by use of an instrument. "In order to prove an accord and satisfaction by use of an instrument," the Virginia Supreme Court explained, "the person against whom the claim is asserted, the debtor, must prove that: (1) he in good faith tendered an instrument to the claimant as full satisfaction of the claim, (2) the amount of the claim was unliquidated or subject to a bona fide dispute and (3) the claimant obtained payment of the instrument." Va. Code § 8.3A-311(a). The Circuit Court rejected this defense, finding that the owner had not acted "in good faith with an honest belief that a bona fide dispute existed." The owner appealed to the Virginia Supreme Court.

The court overturned the circuit court's decision, finding that, by virtue of the owner's two letters concerning overbilling and goofing off, a bona fide dispute existed. Further, the court observed that, on the face of the check and in the letter transmitting the check, the owner conspicuously explained that the check was being tendered in full satisfaction of the claim. Accordingly, the court concluded that there had been an accord and satisfaction.

The only issue remaining, therefore, was whether the contractor's alteration of the owner's check justified the contractor's argument that "acceptance of the check was for a partial

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## WHAT'S INSIDE

# IN MARYLAND, ECONOMIC LOSS DOCTRINE NO BAR TO RECOVERY FOR NEGLIGENCE

In a recent Maryland case, *Pac. Indem. Co. v. Whaley*, 572 F. Supp. 2d 626 (D. Md. 2008), the United States District Court for the District of Maryland held that the "economic loss" doctrine did not bar recovery in tort for physical damage to the interior and contents of a home that was damaged through a subcontractor's negligence.

In *Whaley*, C.H. Whaley & Son, Inc. ("contractor"), subcontracted with Compton & Sons ("subcontractor") to perform certain roofing work. After the project began, the schedule for the roofing work was accelerated and a key employee of the subcontractor was injured. As a result, the contractor hired a second subcontractor ("supplemental subcontractor") to complete some of the roofing work. On a particular day, the supplemental subcontractor removed a majority of shingles from the roof. That same day, the subcontractor became aware of an impending storm and covered the exposed roof with tarps. When the storm came, it ripped portions of the tarps from the roof, causing $800,000 in damages to the home's interior and contents.

> When a product supplied under a contract causes damage, a party cannot recover in tort for the value of any purely economic losses caused by the contractually provided product.

The homeowner's insurer, Pacific Indemnity, filed suit against the contractor, who, in turn, filed a third-party complaint against the subcontractor for indemnification and contribution. The contractor argued that the subcontractor's negligence in securing the tarps entitled the contractor to recover damages from the subcontractor if the contractor was found to be liable to Pacific Indemnity.

The subcontractor made several arguments, one of which pertained to the "economic loss" doctrine ("ELD"). The ELD marks the fundamental boundary between contracts and torts. The ELD prohibits a party from recovering in tort for purely economic losses—losses that do not involve clear danger of physical injury or death, nor damages to property other than the product itself. Typically, economic losses include the value of the product itself, the cost to repair or replace the product, and the lost profits resulting from the loss of use of the product. These purely economic losses must be recovered in contract, not tort. The ELD does not, however, preclude recovery in tort for personal injury or damages to property other than the product itself.

The subcontractor argued that the ELD precluded recovery by the contractor because the damage to the home's interior and contents was damage to the same property that the subcontractor was contractually hired to work on and that the home's interior and contents were not "other property." The court denied the subcontractor's summary judgment motion, holding that the ELD did not preclude recovery by the contractor. The court stated that the relevant product was the roof, and that the destroyed property inside the home was "other property" for which the ELD did not bar recovery in tort.

First, under the ELD, the subcontractor argued that the relevant product was the home—not the roof—and, therefore, the home's interior and contents were not "other products." The subcontractor cited case law from other jurisdictions noting that when property was "part of an integrated system," damage by an integrated component to the entire system or other components within the system is not damage to "other property." The court held that the home was not an integrated system because the roof was an easily identifiable portion of the home that the subcontractor was hired to work on, not a component in an integrated system. Accordingly, the court determined that the ELD did not bar recovery against the subcontractor.

Second, the subcontractor argued that Maryland indemnification law precluded recovery. In Maryland, if the conduct attributed to the party seeking indemnification in the original plaintiff's complaint constitutes "active" negligence, or if it is clear from the complaint that this party's liability would only arise from proof of active negligence, then there is no valid claim for indemnity. The subcontractor argued that Pacific Indemnity's complaint alleged active negligence on the part of the contractor, thereby precluding the contractor from seeking indemnity from the subcontractor. The court disagreed, however, stating that it was not clear whether or not Pacific Indemnity's complaint alleged active negligence. As such, the subcontractor's summary judgment motion was denied.

This case provides two lessons. First, even though it was the supplemental subcontractor who removed all of the shingles from the roof, the subcontractor was still potentially liable for the damage to the home's interior and contents if it was negligent in securing the tarps. Second, while the ELD usually limits the ability to recover purely economic losses in tort, the ELD will not bar recovery when "other property" is damaged.

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payment only." The Supreme Court held that Virginia law "does not allow acceptance with alteration of an instrument tendered in good faith as a full payment of the disputed debt." Accordingly, the court rejected this argument.

The lesson to be learned, therefore, is that, when a dispute arises regarding a final billing, the cautious contractor should carefully review any payment instrument (and any letter transmitting such payment instrument) if the amount tendered is less than the amount invoiced.

# TO WHAT EXTENT DOES GENERAL CONTRACTOR'S CGL POLICY COVER DAMAGE CAUSED BY SUBCONTRACTOR'S DEFECTIVE WORK?

Commercial general liability ("CGL") insurance policies insure contractors against unlikely and unforeseen damage to persons and property caused by their defective work and the defective work of their subcontractors. Typically, CGL polices cover damage to structures or properties other than those under construction by the general contractor, such as adjacent properties, but do not cover damage to the structure under construction, because such damage is both foreseeable and within the control of the general contractor. However, for some time it has remained an open question whether CGL policies apply to a subcontractor's defective work that results in damage to other, nondefective portions of the general contractor's work. A recent ruling by the Fourth Circuit Court of Appeals applying Virginia and Maryland insurance law, *Stanley Martin Companies, Inc. v. Ohio Casualty Co.*, 2009 U.S. App. LEXIS 2758 (4th Cir. 2009) answered that question in the affirmative.

Stanley Martin Companies, a general contractor for the construction of townhouses in Gaithersburg, Maryland, sued its insurer, Ohio Casualty Company, seeking a declaratory judgment that the insurer had breached its duty under a CGL policy to indemnify the contractor for costs that the contractor incurred in remediating mold damage caused by a subcontractor's defective work. There was no question that the CGL policy did not apply directly to the defective trusses installed by the subcontractor, which permitted the mold intrusion. The dispute centered on whether the CGL policy covered damage to the nondefective portions of the townhouses caused by the mold intrusion.

The sole issue at the summary judgment stage of trial was whether the mold growth constituted an "occurrence" that was covered by the CGL policy. The CGL policy stated, in relevant part, that Ohio Casualty would pay those sums that Stanley Martin Companies "becomes legally obligated to pay by reason of liability imposed… because of… 'property damage,' … that takes place during the Policy Period and is caused by an 'occurrence' happening anywhere." The policy went on to define an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

The U.S. District Court for the Eastern District of Virginia, applying Virginia law, held that "damage caused by the defective workmanship of the… insured's subcontractor and limited to the insured's work does not constitute an 'occurrence' triggering coverage." A subcontractor's defective work, damaging only the contractor's work, is not an "accident" and consequently there was no "occurrence" to trigger the policy. The District Court interpreted the CGL policy only to apply when property other than the property being constructed by the contractor is damaged. Because it is frequent that property under construction will be damaged as a result of a subcontractor's defective work, such damage is not "unexpected," and consequently is not an "occurrence." The District Court granted Ohio Casualty's motion for summary judgment on the ground that it was not required to indemnify the contractor under the terms of the CGL policy.

> The mold damage...was an unexpected, unintended accident, and thus constituted an "occurrence" under the terms of the CGL policy.

The contractor appealed. The U.S. Court of Appeals for the Fourth Circuit applied the holding of a recent Fourth Circuit case, *French v. Assurance Co. of America*, 448 F.3d 693 (4th Cir. 2006), a construction case with similar facts. In *French*, the Fourth Circuit held that, "by itself, the subcontractor's defective work did not constitute an accident or occurrence under the [CGL] policy because an insured's obligation to repair the defective work 'is not unexpected or unforeseen under the terms of the [general] contract.'" However, in *French*, the Court of Appeals ruled that the CGL policy applied because the damage caused by the subcontractor's defective work extended to "otherwise nondefective parts of the building."

The facts were strikingly similar in *Stanley Martin Companies, Inc*. Although the contractor was obligated to repair the subcontractor's defective trusses because that defective work was not "unexpected or unforeseen," the mold damage that extended beyond the defective trusses to nondefective portions of the townhouses was an unexpected, unintended accident, and thus constituted an "occurrence" under the terms of the CGL policy. For this reason, the Fourth Circuit reversed the District Court's grant of summary judgment, ruling that the CGL policy would apply if the contractor could prove that it incurred costs as a consequence of the mold intrusion.

This case is particularly significant because the language in the Ohio Casualty policy is identical to most CGL policies and because, on the issue of Virginia insurance law decided by the Fourth Circuit, Virginia law does not differ materially from Maryland law. Contractors and insurers using CGL policies should be aware of this decision when entering into insurance contracts, as it will apply throughout the Fourth Circuit, and would be considered persuasive anywhere else CGL contracts are used.

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The court concluded that Super Structures' lien was invalid because Super Structures' labor did not actually enhance the value of the property against which it claimed the lien. The lesson to be learned is that contractors may not accrue lien rights until they actually perform work on the property or their off-site labor enhances the value of the property.

## WHEN LABOR IS NOT CONSIDERED LABOR FOR THE PURPOSES OF THE VIRGINIA MECHANIC'S LIEN STATUTE

The Circuit Court for Hanover County, Virginia recently invalidated a mechanic's lien filed by a contractor for costs incurred in preparing for the construction of a steel building where none of the contractor's materials or labor actually reached the building site or were incorporated in the structure.

In *Dallan Construction, Inc. v. Super Structures General Contractors, Inc.,* Hanover County Circuit Court, Case Number CL08000473-00 (January 30, 2009), Dallan Construction, Inc. ("Dallan") filed a petition to invalidate the mechanic's lien filed by Super Structures General Contractors, Inc. ("Super Structures"). Super Structures had entered into an agreement with Dallan for the construction of a steel building and, in accordance with the agreement, commenced preparatory work on the project. Before Super Structures began the actual construction of the project, Dallan cancelled its contract with Super Structures. While Super Structures had commenced the fabrication of steel components for use in the planned building project, none of its "means, methods, or products" had actually reached the building site at the time of termination. Thus, Dallan argued that Super Structures' lien was invalid because it had not performed any labor or furnished materials to the property subject to the lien.

The court first observed that Virginia Code § 43-3 could be applied to the factual circumstances of this case because Super Structures performed labor or furnished materials for the construction of a building to be permanently annexed to the freehold, much like an architect or engineer's efforts. Further, the labor and materials produced by Super Structures corresponded with Super Structures' contractual obligations. The court noted, however, that the Supreme Court of Virginia has uniformly held against the imposition of a mechanic's lien where the labor or materials claimed in a mechanic's lien never actually reach the burdened property.

Super Structures claimed that it satisfied the "performing labor" requirement of Virginia Code § 43-3 through its preparation for fabrication of steel components to be used in the planned building project and was, therefore, entitled to lien the property. The Court rejected this argument, finding that, since Super Structures' fabricated steel never reached the building site, it could not base its lien on such work.

Next, Super Structures asserted that it was entitled to a lien by virtue of the planning and design work it performed. Though the court acknowledged that the mechanic's lien statute permits a claimant to lien for design work performed on a project, the court concluded that such lien rights must be conditioned upon the design efforts specifically enhancing the value of the burdened property. As Super Structures' planning and design work was never incorporated or used in the building actually erected on the property, such design efforts could not be the foundation of a valid mechanic's lien.

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