AIA & Beyond – Protecting Cities as Building Owners

An Open Letter to the Members of the Texas City Attorneys Association Summer Conference – June 14 – 16, 2023

Dear Texas City Attorney:

Let's clear something up right away: I'm not a municipal lawyer. For nearly twenty years of a forty-four-year legal career, I've practiced with, around, and against municipal lawyers, but I am not one. The arcane world in which you live remains, in many ways, a mystery to me.

I'm not here to talk to you about things you know more about than I do. Virtually anyone reading this paper knows more about negotiating construction contracts for cities than I do, at least from the standpoint of governing the working relationship between the parties during construction. You know the various AIA forms, the pitfalls to look for, and how you like to tweak the standard form to meet your client's unique circumstances and needs.

But you may not have more experience than I do in litigating with contractors and design professionals when something goes wrong with the project covered by the contract. Because you have extensive expertise as a city attorney, you probably don't have extensive experience litigating construction defect cases or handling lawsuits against insurance companies for failing to pay what they owe on claims involving casualty losses to government-owned buildings.

That's what I'm here to talk about: How can you put your client in the best position when something goes wrong – when the windows leak, the HVAC system isn't up to the job, or when the foundation starts to slide down the hill? How can you make sure the city manager or city council is in a position of strength to collect from a recalcitrant insurer? And what tools exist to help?

Units of Local Government Construct and Own a LOT of Buildings

At the risk of stating the obvious, Texas municipalities build many structures. City halls, police stations, fire stations, libraries, recreational centers, parks, public works facilities, municipal courts, and other administrative buildings are a few of the types that come to mind.

The people reading this don't count only municipalities as their clients. Most of them represent, for instance, counties and special districts as well. (For ease of reference, however, I'm going to refer to lawyers who represent all kinds of units of local government as "city attorneys" or "municipal lawyers.")

So – when you add counties into the mix, you expand the field to include county courthouses, county administrative buildings, jails, sheriff's offices, and health departments, to mention a few.

Cast the net even wider to include special districts such as water districts, utility districts, healthcare districts, and transportation districts, and you encounter all manner of structures like water treatment plants, pump stations, lift stations, hospitals or clinics, depots, and administrative offices. And that's before you start talking about school districts.

You get the picture. Data may not even exist about the percentage of construction done by governmental entities, but it's significant. On top of all of that, many cities purchase existing structures. Either way, the entity is a property owner. Your job – among the scores of other things you do for them – is to protect your clients as *property owners*.

As a city attorney, you're involved in negotiating contracts to construct all of these different kinds of structures. You're also the first resource your clients turn to when something goes wrong, either during the construction or afterward, or when a casualty loss occurs.

Some Contract Concerns Particular to Potential Litigation

The theme here is that you should broaden your thinking to encompass not only the relationship of the parties during the construction process but also what will best protect the city against the contractor or design professionals if a defect claim arises – perhaps years after completion. Covering every potential provision you will encounter as a city attorney negotiating building contracts would be impossible. We'll look at some specific examples but remember, these are only examples.

<u>Architects and Engineers – (AIA B101-2007, B104-2007 – Art. 2.5 or 2.2 – "Architect's/Engineer's Responsibilities")</u>

Ensure that the amount of insurance required by the contract is sufficient to address potential damages that may arise from design-related defects. Typically, this number will exceed the $1 million per occurrence/$2 million aggregate limits customarily seen. Consider requiring an umbrella policy with limits high enough to shield your client adequately.

In other sections of the contract (e.g., §3.1 of B101-2007), the Architect will take on the duty to provide "usual and customary structural, mechanical, and electrical engineering services." Since the architect likely will hire sub-consultants to supply these services, it would be a good idea to require these subs to have the same level of insurance coverage as the architect. Here is some sample language:

> To the extent Architect employs sub-consultants to provide any part of the services required of Architect under this Agreement, Architect shall require its sub-consultant agreements to incorporate all of the terms and conditions of the Owner-Architect Agreement, including but not limited to all insurance requirements and dispute resolution provisions. In the event of a conflict between a provision of any sub-consultant agreement and this Agreement, this Agreement shall control.

Something to be aware of is that insurance policies covering design professionals are "claims made" and "diminishing limits" (aka "wasting") policies.

The "claims made" part means that contrary to general commercial liability "occurrence" policies, design professionals' policies cover the insured for claims made during the policy period, irrespective of when the damage occurs. Thus, the policy the Architect has during the project may not be the same policy in force when damages from design-related defects may arise. "Diminishing limits" means that attorney's fees and expenses of defending a claim are deducted from the funds available to pay the claim.

Design professional policies also have retroactive dates extending coverage for damage arising from work done earlier in time. Many but not all design professionals will maintain coverage with a retroactive date sufficient to cover work done within the period covered by the statute of repose (which the legislature has seen fit to truncate only for governmental entities, but that is a topic for a different time). So it might be a good idea to contractually require any entity covered by a claims-made policy to maintain insurance coverage for eight years following completion with a retroactive date to the project completion date.

Project-specific policies for design professionals that would obviate many of these timing concerns exist, but they are quite costly.

The principle that insurance coverage should be sufficient to fully compensate the Owner for all damages – i.e., the full cost of the project – applies to Contractors and Construction Managers, as well, as does the caveat about

ensuring coverage for a sufficient time to get you to the end of the statute of repose.

"Construction Phase Services" (§3.6.1 or §3.4.1)

This and other clauses in the contract incorporate other provisions of the agreement and perhaps other documents. Remember to review all documents pertinent to the project to ensure that everything is consistent. Yes, this is just good practice, but you'd be surprised the litigation battles that can arise over, for instance, inconsistencies in the definitions in the documents.

"Evaluations of the Work" (§3.6.2.5 or §3.4.2.5)

The contract typically gives the Architect the authority to make initial decisions on claims between the Owner and the Contractor. What happens when the "claim" also implicates the Architect's work? It seems like there is something of a conflict. You might want to add something like the following:

> However, the Architect shall not serve as initial decision maker for any Claims alleging design negligence or otherwise implicating the Architect's design or professional services rendered in connection with the Project. It is understood that an initial decision by the Architect is not a condition precedent to Owner's right to pursue legal action against Architect, Contractor, or any person or entity involved in the Project.

Claims and Disputes (Article 8)

Don't relinquish your rights under the Seventh Amendment to the US Constitution.

Agree to mediation as a prerequisite to litigation *only at the Owner's sole discretion*. Sometimes, pre-suit mediation can be beneficial. In most cases, however, discovery during litigation gives you much more information and better prepares you for mediation. Unless you're pretty sure that you are fully informed before suit, there is no reason to incur the expense of pre-suit mediation.

Don't agree to arbitration.

Arbitration is a private dispute resolution process. It's an alternative to the public dispute resolution process available to anyone and guaranteed by the Constitution – the courthouse.

Disabuse your city council or city staff of the notion that arbitration is cheaper, faster, fairer, or in any way better for the city than litigation because it's just not true. Besides, arbitration usually favors defendants rather than plaintiffs – and if

you are seeking to recover the cost of repair for construction defects, you will be the plaintiff.

Some people believe that arbitration is a way to avoid paying high hourly rates to lawyers. (There is a much better and actually effective way to do this, which we'll talk about in a minute.) But in arbitration, you will end up paying high hourly rates for the arbitrators.

Filing fees in arbitration cases are graduated and increase according to the amount in controversy. Most of the cases we're talking about would require an initial filing fee of $8,200 and a final filing fee of $3,200, in addition to a non-refundable filing fee for the three-member panel of arbitrators of $3,050, plus $300 for each site visit or hearing. Compare that to a $300 or $400 filing fee in state court, about $30 for a jury fee, and $95 for service of process.

The courthouse – the public, taxpayer-funded dispute resolution system – is the best and most efficient for resolving disagreements fairly for all parties.

And remember, the limits of liability of a design professional's insurance policy diminish as fees and expenses mount in defense of the claim. That includes those sky-high arbitration filing fees. By agreeing to arbitrate, you are setting a lit match to potential funds to compensate your client for their damages.

Don't waive consequential damages.

First, it's not always clear what damages will be deemed "consequential." Suppose the HVAC system is incorrectly installed in a large building, and increased operating expenses over a few years total half a million dollars. That five hundred grand is probably consequential damage.

Next, and more importantly, why on earth would you agree that your client should receive anything less than full compensation for any harm they suffer due to shoddy construction?

At the very least, you should insist that the waiver of consequential damages be limited only to those damages not covered by insurance.

<u>Acceptance of Non-Conforming Work (§12.3)</u>

Consider adding a sentence to the effect that the Owner's acceptance of non-conforming work will not be implied, whether by occupancy, payment, the passage of time, or any other reason.

Warranties

Standard agreements contain language (Article 3) that the contractor warrants that the project will be "free from defects" and "in accordance with the contract documents." They may also contain a separate warranty of repair (Article 12), limited to one year.

These are separate warranties, and you should resist any effort to combine them or time limit the general warranty.

And for goodness sake, don't agree to strike the general warranty as redundant of the 12-month warranty of repair. Again, they are *distinct* warranties; they are not duplicative or redundant.

Again, these are examples of contractual provisions to be on the lookout for and aware of because of their effect on your client's rights in case things go awry.

Some Concerns About Property & Casualty Insurance Coverage

Let's turn to the question of protecting the city once construction is completed or if the structure is purchased from a third party.

Again, I'm not trying to be comprehensive. Property and casualty insurance coverage is a subject that has spawned many seminars entirely devoted to it. My goal is to point out some areas that deserve particular attention in the context of what to do when the loss occurs, and the insurance company becomes, in effect, your client's adversary.

I say that because no matter how many marketing campaigns you see in which an insurance company implies – or outright states – that it is your good friend in the business of paying claims, don't be fooled: Insurance companies are in business to avoid paying claims. They make money by not paying claims. They make money by delaying paying claims. Every claim paid eats into their profits. (This is particularly so when the insured is a city, as we'll discuss in a minute.)

Which is not to say by any means that insurance coverage is not necessary. It is vital. But not all insurance companies are the same; not all insurance coverages are the same. You must be diligent in advising your clients about what is available, what they're getting, and what alternatives exist.

Know the Alternatives

A good insurance broker can be your client's best friend when selecting coverage for their improved real property. The variety of products is vast and confusing, and traps exist for the unwary. As a general proposition, a city can look for individual policies, group policies, or risk pool coverage.

You are probably aware that Texas law requires insurance companies to behave themselves in their dealings with their insureds, at least somewhat. There is a duty of good faith and fair dealing; there are penalties for the failure to make payments due to insureds promptly. Some types of coverage available to cities are exempt from these requirements: those protections don't exist.

A broker is valuable in determining which coverage is most appropriate for your client's situation.

The first consideration is what type of loss is covered by the policy. Most damage to a building will result from one of four causes: fire, water, wind, and hail, so you certainly will want to ensure that those risks are covered.

There are two basic types of insurance policies: specific peril and all-risk. The difference is that the cause of the loss must be listed as included for the specific peril policy to provide coverage. Under an all-risk policy – the kind most of you have covering your homes – the cause of the loss is covered unless the policy's language expressly excludes it.

This is somewhat simplistic, but assume you have a specific risk policy covering the four major perils listed above. Now, let your imagination run free for a minute and think about how a building might suffer damage from causes other than those four. It's not too hard to do, right? While most all-risk policies will have several specified exceptions to coverage (riot, civil unrest, or rising water are common examples), it's obvious that an all-risk policy is preferable to a specific risk one.

Besides Risk Protection, What are the Policy Benefits?

Other significant areas you'll want to explore with your broker – or determine if your existing policy provides – are professional fees coverage, replacement cost or "actual cash value," business interruption coverage, the type of deductible, and whether or not arbitration is required, as well as the terms of the arbitration provisions.

Professional fees coverage refers to the fact that some policy documents prohibit the insured from hiring professionals to assist with determining the character and extent of the loss or exclude those professionals' fees from payment under the policy.

Replacement cost versus actual cash value is the difference between receiving loss payments sufficient to replace any items destroyed by a covered peril or the value of the item at the time of loss, which usually is its cost minus depreciation. The thing to remember here is that actual cash value is *always* lower than replacement cost.

(As an aside, while on this subject, it's a good idea to know whether your policy waives coverage for "cosmetic damage." Imagine a hail storm sweeping through your town and making several city buildings' metal roofs look like they've been in a war. If they still serve the primary purpose of keeping the building contents dry and your policy contains a cosmetic damage waiver, you have no recourse against the insurance company for replacement.)

You might think that a city doesn't need business interruption coverage, but you should think again. This coverage can reimburse your client for things like relocation expenses and temporary premises, furniture, or equipment rental.

You know what a policy deductible is. But you may not know how your deductible is calculated, particularly if the policy covers more than one structure. For instance, if the deductible is a percentage of value, is it a percentage of "total insured value" (the combined value of all structures included in the coverage document), or is it a percentage of each building? It's a good idea to have this information in advance of a loss.

I've already made my opinion of arbitration pretty clear. In the insurance industry context, arbitration clauses often contain particularly onerous provisions. For instance, most property and casualty policies are written by companies headquartered somewhere other than Texas. Many arbitration clauses in coverage documents will require arbitration in other states, like New York, and some will require "special" arbitrator panels made up of insurance company professionals.

Another very big topic in coverage circles is the question of concurrent causation – what the policy covers when the loss is due to more than one cause and at least one of those is excluded by the policy. Again, we could devote an entire seminar to the developing law in this area. For today's purposes, just understand that the law of insurance coverage is complex, volatile, and in continual flux.

No matter what they tell you in their marketing, insurance companies are not your friends and do not have your client's best interests at heart. They are profit-driven, and the methods for maximizing those profits are myriad. Protecting your clients demands vigilance.

The last thing I want to talk to you about is what options your clients have when something goes wrong. Many of you may be aware of subchapter C of Chapter 2254, Texas Government Code, but probably only vaguely. Others of you may not be aware of it at all. Significantly, I would bet that many, and perhaps most, city staff and municipal elected officials are unaware of it.

Subchapter C of Chapter 2254 of the Texas Government Code and Why it Matters

It's no secret that any time the Texas Legislature is in session, Texas cities need to prepare for assaults on their autonomy and their budgets. This legislative session has been no exception. But it would be inaccurate to say that the legislature *never* does anything to benefit cities.

A statute first enacted in 1999 and amended in 2019 and 2021 provides governmental entities, including municipalities, with a tool that can be of significant benefit. That tool is found in Subchapter C of Chapter 2254 of the Texas Government Code: the authority to enter into contingency-fee agreements with expert outside counsel.

Most city attorneys don't do contingency fee work because they are in-house or because it doesn't fit their practice model. But sometimes, a contingency fee arrangement is the best option for your client, particularly in complex construction defect or insurance coverage cases. Let's take a look at why that is.

Reframe the Word "Contingency"

The phrase "contingency-fee agreement" often conjures the most negative perceptions of the legal profession. And it must be admitted, not all of us consistently follow the highest ethical standards.

In the right situation and properly administered, however, a contingency-fee agreement is a valuable device to pursue accountability and recovery in court when efforts at resolution short of litigation have proven unfruitful.

Why "Valuable"?

Litigation can be expensive. Okay, litigation is almost *always* expensive. And because no case in the entire history of jurisprudence has ever been a dead-cinch victory, it's risky.

Resorting to the courts without a contingency-fee arrangement — even when you are entirely in the right — requires a lot of up-front cash with no guarantee of success. Sometimes if you win, you might be able to recover some of what you spent on prosecuting the case. Sometimes not — and rarely (I'd say "never") all of it.

The two situations we've been discussing are ones where cities might face prohibitive litigation costs:

1. When the dispute involves the cost of repairing defects in city construction projects.

2. When a property insurance company refuses to acknowledge and pay the full extent of a loss.

The construction defect examples mentioned earlier – leaky windows, HVAC systems that fall woefully short of their intended task, shifting foundations triggering roadmaps of cracks inside and outside the structure — these are a few common problems a city might face shortly – or perhaps an unreasonably short number of years – after project completion.

Whether the fault lies with the contractor, the subcontractors, or the design professionals, two things are guaranteed: 1.) The city (as Owner) has the *right* to recover the costs to repair faulty construction, and 2.) the responsible parties will be averse to paying.

Tight municipal budgets and fear of expensive litigation often force cities to forgo obtaining full recovery. But the *budget-neutral* process authorized under Chapter 2254 can remove that fear.

Likewise, as we've discussed, property and casualty insurance companies' profit motives mean they will go to great lengths to avoid fully compensating insureds for the total loss for, say, hail damage to roofs. This is particularly true in cases involving municipalities because of cities' historical reluctance to avail themselves of the court system — again, because of expense.

A contingency fee agreement shifts the risk to the lawyer and – this is crucial – has *no impact* on the municipal budget. In exchange for assuming the risk and fronting all of the costs (to be repaid, like the fees, only in the event of a recovery for the city), the lawyer hopes to eventually be paid more than they would have received under a standard, hourly fee-for-service arrangement.

<u>What's the Point?</u>

The point here is that the contingency fee arrangement authorized by the legislature gives cities a position of strength from which to seek accountability and just compensation via the civil court system.

The statute contains several added safeguards for the city, which give municipal decision-makers political cover — always a practical consideration for elected officials and city staff.

Here are the high points of how the statute works:

- This arrangement applies only to cases where the expected recovery exceeds $100,000.
- The city council must give specified notice of the contemplated agreement. The council must approve the contract and explain the financial reasons for the agreement.
- To safeguard against a situation in which a lawyer might get a windfall contingency fee without expending significant effort, attorneys working under a Chapter 2254 arrangement must keep track of their time and expenses. The lawyer is paid either the total of their hourly fees multiplied by a factor of four to compensate for the risk assumed or the percentage fee, whichever is less.
- The percentage of the recovery used to calculate the contingency fee cannot exceed 35%.
- Once approved by the city council, the Texas Attorney General's Office must approve the agreement. If the OAG does not act on the request for approval within 90 days, the contract is automatically approved.
- Case expenses are reimbursed to the lawyer by the municipality in addition to the fee (i.e., out of the city's portion of the recovery), but the statute requires that expenses be reasonable and necessary.
- Any agreement to pay contingency fees that does not comply with the statute is void. However, once the Attorney General's Office has approved a contract under this statute, it cannot later be declared invalid.

Construction-Defect Recoveries on a Contingency Basis

So, a contingency-fee agreement to recover (for instance) the cost of repair for construction defects allows elected officials and city staff to act as good stewards of public funds by insisting on accountability from contractors and others whose work falls short while at the same time not putting city resources at risk.

It also allows the city to take advantage of outside counsel with specific expertise in complex cases while you, as their city attorney, act as trusted legal advisor as you always do.

The firms that use the contingency fee litigation model for construction defect and first-party insurance cases are not and don't want to be general municipal lawyers. They have developed specific expertise in a narrow area of engineering, scientific, and technical issues.

They don't know planning and development from eminent domain or public financing requirements. They will not try to poach your clients.

As a municipal lawyer, you protect your clients in hundreds of different situations, circumstances, and scenarios. When a city owns improved real property, special considerations exist, and many of those involve what happens when not everything goes as planned, or folks just don't act right. I hope this letter has helped you to think about some of those and will be of some benefit to you.

Best personal regards,

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