What Every Plaintiff in a Construction Defect Case Should Know
(A Municipal Perspective)

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I. Introduction

Design professionals were chosen, bids received, a contractor selected, construction started, and ultimately a new city building was raised. Perhaps it was a new convention center, police department, or fire station. Regardless of its purpose, a new city building is typically welcomed and applauded. The city looks forward to many productive years in the new facility and hopefully the public finds comfort in the fact that the city is growing and expanding. The city begins utilizing the new building for its designated purpose and all seems to be right in the municipal world.

However, in the not too distant future, perhaps two, three or five years down the road and much earlier than expected, the building starts to break down. It could be continuous roof leaks, higher than anticipated energy costs, defective mechanical or plumbing systems, faulty wiring, or a myriad of other construction related problems. Assuming the issue is a result of faulty design or construction, the city is now faced with a "construction defect." And the question is – now what?

The purpose of this paper is to discuss some of the legal issues that a city, as an owner and potential plaintiff in a construction defect case, should be familiar with and consider before and during litigation. An experienced construction litigation attorney should always be consulted (and hired) when a city is faced with a potential construction defect case. Nevertheless, there are a few basic concepts that every city attorney should know. The intent of this paper is to highlight those concepts and hopefully provide some initial insight should your city find itself the owner of a defective building.

II. Some Disclaimers

First, the advice and guidance provided in this paper assumes that the underlying construction contract for the building at issue allows for a lawsuit to be filed in district court. In other words, the contract does not limit your city to mandatory arbitration or mediation. The discussion that follows is geared toward traditional litigation.

Second, the paper focuses on the construction of buildings or vertical construction, however the principles discussed would also apply the horizontal construction such as roads, sewer lines, or water lines.

Third, you must always be guided by the specific language in your construction contract. I believe that the paper addresses somewhat universal litigation issues. However, your specific

contract language may change the general rule. For example, a discussion of recoverable damages is included below, but what is recoverable may be limited by your construction contract so it is important to have a thorough understanding of the contract language.

Last, the paper is meant to provide general legal guidance. If you encounter any of the following issues in a construction defect case, you should perform thorough research and analysis to determine how the issue relates to your particular case and/or enlist the help of outside counsel.

III. Who done it?

After a construction defect is discovered, your city is initially tasked with trying to determine who is responsible for the defect. Is it a construction defect that would implicate the general contractor or a subcontractor? Is it a design defect that the architect or engineer is on the hook for? Or was a faulty product installed and the manufacturer or supplier of that product is to blame? These questions are usually not easy to answer and some level of initial investigation will be required. Even at this point in the process, there are a couple of things to keep in mind as you look forward to potential litigation.

A. Certificate of Merit

As stated above, initial investigation into the possible causes of the defect will almost always be required. Hiring a competent expert to assist with that investigation will help down the road because the initial investigation and its results will be scrutinized during litigation. Even if you are unsure whether litigation will occur, it is always a good idea to hire experts who could provide competent testimony and reports during the litigation phase.

This is especially important if the defect appears to be a *design* defect because in any case against a licensed architect or engineer a "certificate of merit" must be filed with the original petition. Section 150.002 of the Civil Practice and Remedies Code requires that the plaintiff file an affidavit of a third-party licensed architect, licensed professional engineer, registered landscape architect, or registered professional land surveyor "in any action or arbitration proceeding for damages arising out of the provision of professional services by a licensed or registered professional." Tex. Civ. Prac. & Rem. Code § 150.002(a) (LEXIS through 2011 Sess.). "Licensed or registered professional" is defined as a licensed architect, licensed professional engineer, registered professional land surveyor, registered landscape architect, or any firm in which such licensed or registered professional practices, including but not limited to a corporation, professional corporation, limited liability corporation, partnership, limited liability partnership, sole proprietorship, joint venture, or any other business entity." *Id*. § 150.001(1).

The professional providing the certificate of merit must:

(1) be competent to testify;
(2) hold the same professional license or registration as the defendant;
(3) be knowledgeable in the area of practice of the defendant and offer testimony based on the person's:

(A) knowledge;
(B) skill;
(C) experience;
(D) education;
(E) training; and
(F) practice.

(4) be licensed or registered in Texas; and

(5) be actively engaged in the practice of architecture, engineering or surveying.

Id. § 150.002(a)-(b).

The certificate must "set forth specifically for each theory of recovery for which damages are sought, the negligence, if any, or other action, error, or omission of the licensed or registered professional in providing the professional service, including any error or omission in providing advice, judgment, opinion, or a similar professional skill claimed to exist and the factual basis for each such claim." *Id*. § 150.002(b).

There have been several cases focused solely on whether the plaintiff's certificate of merit was sufficient and met all requirements of § 150.002. This is not surprising because an insufficient certificate of merit could lead to dismissal *with prejudice* of the complaint. Subsection (e) of § 150.002 states that the plaintiff's failure to file a proper certificate of merit shall result in dismissal of the petition against the defendant and the dismissal may be with prejudice. *Id*. § 150.002(e).

Additionally, keep the following in mind:

- The certificate of merit must be filed with the original petition (i.e. the first-filed petition). *See Sharp Eng'g v. Luis*, 321 S.W. 3d 748, 752 (Tex. App.—Houston [14th Dist.] 2010, no pet.) (holding that § 150.002 requires a plaintiff to file a certificate of merit with the first-filed complaint). If a claim for damages against a licensed or registered professional is not included in the original petition, the certificate of merit must be filed with the amended petition that first asserts such claims. *See JJW Dev., LLC v. Strand Sys. Eng'g, Inc.*, 378 S.W. 3d 571, 576 (Tex. App.—Dallas 2012, pet. filed) ("Section 150.002 requires a party to file a certificate of merit when it files a complaint that asserts a claim for damages arising out of the provision of professional services by a licensed or registered professional.").
- You must provide separate certificates of merit for each defendant that is a licensed or registered professional. *See Navarro & Assocs. Eng'g, Inc. v. Flowers Baking Co. of El Paso, LLC*, 389 S.W.3d 475, 481-82 (Tex. App.—El Paso 2012, no pet.) (explaining that it cannot be assumed that any time two defendants are accused of similar conduct that valid claims exist against both and that if such claims do exist, the expert must discuss those specific claims against each defendant separately). The expert must be able to list the valid claims that exist against each individual defendant unless the alleged liability of one defendant is entirely vicarious of the alleged liability of another defendant. *See Howe-Baker Engineers, Ltd. v. Enterprise Prods. Operating, LLC*, 2011 Tex. App. LEXIS

> 3237 *16 (Tex. App.—Houston [1st Dist.] 2011, no pet.) (holding that § 150.002 "did not require the plaintiff's supporting affidavit to set forth a negligent act, error or omission attributed to a defendant whose alleged liability for a claim covered by the statute is entirely vicarious of the alleged liability of another defendant as to which the affidavit did satisfy the statute."); *M-E Engineers, Inc. v. City of Temple*, 365 S.W.3d 497 (Tex. App.—Austin 2012, pet. denied) (upholding the sufficiency of a certificate of merit even though certificate did not specifically mention M-E Engineers ("M-E") because the City's claims against M-E were based on vicarious liability and the alleged negligence of M-E's employee).

In order to avoid the possibility of dismissal, start thinking about the certificate of merit early on in the process. Any expert who is hired by your city to investigate possible design defects must be able to meet the requirements of § 150.002. Outside counsel that is hired subsequently (if not already hired) will appreciate your city's awareness of the statute and its attempt to hire an expert who can meet its requirements.

B. Statute of Repose

Section 16.061 of the Texas Civil Practice and Remedies Code provides that a political subdivision of the State, including an incorporated city or town, is not barred by the two or four year limitations periods found in §§ 16.003 and 16.004.[1] Two of the most common causes of action in a construction defect case are negligence and breach of contract. A claim for negligence has a two year statute of limitation and a claim for breach of contract has a four year statute of limitation, neither of which applies to a city by virtue of § 16.061.

However, that isn't to say that a city can bring a construction defect case twenty years after substantial completion of the building. The statutes of repose found in §§ 16.008, 16.009, and 16.012 do limit the time within which a claim must be brought.

Section 16.008 applies to claims against architects, engineers, interior designers, and landscape architects furnishing design, planning, or inspection of construction improvements. Tex. Civ. Prac. & Rem. Code § 16.008(a) (LEXIS through 2011 Sess.). A claim for damages arising out of a defective or unsafe condition of real property, an improvement on real property, or equipment must be brought against those previously listed "not later than 10 years after the

[1] Section 16.061 also exempts cities from several other sections of Chapter 16, however the two and four year limitations periods are the applicable sections for the purposes of this paper. The full text of § 16.061(a) is provided below:

> (a) A right of action of this state or a political subdivision of this state, including a county, an incorporated city or town, a navigation district, a municipal utility district, a port authority, an entity acting under Chapter 54, Transportation Code, a school district, or an entity created under *Section 52, Article III*, or *Section 59, Article XVI, Texas Constitution*, is not barred by an of the following sections: 16.001-16.004, 16.006, 16.007, 16.021-16.028, 16.030-16.032, 16.035-16.037, 16.051, 16.062, 16.063, 16.065-16.067, 16.070, 16.071, 31.006, or 71.021.

Tex. Civ. Prac. & Rem. Code § 16.061(a) (LEXIS through 2011 Sess.).

substantial completion of the improvement or the beginning of operation of the equipment." *Id*. This statute of repose applies to claims for (1) injury, damage or loss to real or personal property, (2) personal injury, (3) wrongful death, (4) contribution, and (5) indemnity. *Id*. § 16.008(b). The 10-year limitations period may be extended for an additional two years if the claimant presents a written claim for damages to the potential defendant within the 10-year period. *Id*. § 16.008(c). The new two year period starts the day the claim is presented. *Id*.

Similarly, § 16.009 provides a 10-year limitations period for claims against persons who construct or repair an improvement to real property. *Id*. § 16.009(a). Any claim must be brought within 10 years of substantial completion of the improvement in any action arising out of a defective or unsafe condition of the real property or a deficiency in the construction or repair of the improvement. *Id*. Section 16.009 also applies to claims for (1) injury, damage or loss to real or personal property, (2) personal injury, (3) wrongful death, (4) contribution, and (5) indemnity. *Id*. § 16.009(b). There are two possible extensions. First, if the claimant presents a written claim for damages, contribution, or indemnity to the person performing or furnishing the construction or repair work during the 10-year period, the period is extended for two years from the date the claim is presented. *Id*. § 16.009(c). Additionally, if the damage, injury or death occurs during the 10th year, the claimant may bring suit not later than two years after the date of the damage, injury or death. *Id*. § 16.009(d). Section 16.009 does not bar a claim based on a written warranty, guaranty, or other contract that expressly provides for a longer effective period or a claim based on the willful misconduct or fraudulent concealment in connection with the performance of the construction or repair at issue. *Id*. § 16.009(e).

Lastly, a products liability action, which includes any action against a manufacturer or seller for recovery of damages or other relief for harm allegedly caused by a defective product, must be brought before the end of 15 years after the date of the sale of the product by the defendant. *Id*. § 16.012(a)-(b). If a manufacturer or seller expressly warrants in writing that the product's useful life is longer than 15 years, the products liability action must be brought before the end of the number of years warranted after the date of the sale of the product. *Id*. § 16.012(c).

C. Mitigation of Damages and Betterment

After a defect is discovered and some amount of investigation into the cause has occurred, your city will have to decide whether immediate repair of the defect is necessary. The city may have several options regarding how and when repairs are completed. While trying to make this decision, the city should keep in mind two defenses that are likely to be raised by a defendant in litigation. Those defenses are failure to mitigate damages and betterment.

The common law mitigation of damages doctrine "prevents a party from recovering for damages resulting from a breach of contract that could be avoided by reasonable efforts on the part of the plaintiff." *City of McAllen v. Casso*, 2013 Tex. App. LEXIS 3860 *36 (Tex. App.—Corpus Christi 2013, no pet. h.) (citing *Great Am. Ins. Co. v. North Austin Mun. Util. Dist. No. 1*, 908 S.W.2d 415, 426 (Tex. 1995)); *see also Walker v. Salt Flat Water Co.*, 96 S.W.2d 231, 232 (Tex. 1936) ("Where a party is entitled to the benefits of a contract and can save himself from the damages resulting from its breach at a trifling expense or with reasonable exertions, it is his duty to incur such expense and make such exertions."). Failure to mitigate damages is an

affirmative defense which puts the burden of proving that failure on the defendant. *Casso*, 2013 Tex. App. LEXIS 3860 *37 ("A defendant claiming failure to mitigate damages has the burden of proving lack of diligence on the part of the plaintiff, and the amount by which the damages were increased as a result of the failure to mitigate."). If a defendant is successful in proving a failure to mitigate, the plaintiff is not permitted to recover any damages that could have been avoided or were incurred as a result of the failure to mitigate. *Pinson v. Red Arrow Freight Lines, Inc.*, 801 S.W.2d 14, 15 (Tex. App.—Austin 1990, no writ). The defense can be used in both tort and contract cases. *Pulaski Bank & Trust Co. v. Texas Am. Bank/Fort Worth, N.A.*, 759 S.W.2d 723, 735 (Tex. App.—Dallas 1988, writ denied).

Betterment, on the other hand, is the argument that the plaintiff did *too much* to repair the defect. There is little case law discussing the issue of betterment, but I have seen it raised as a defense in all the construction defect cases I have worked on. Essentially, a defendant is arguing that in repairing the defect and resulting damage, the plaintiff made the building better than it was before. For example, assume that the building has a defective air conditioning system. The plaintiff is forced to replace the entire system. If the plaintiff choses a replacement system that is more expensive or more efficient that the original system placed in the building, the defendant may argue that the plaintiff is only entitled to recover the cost of replacing the defective system with the same model that was originally installed or something comparable. Betterment, like failure to mitigate damages, is another way for the defendant to limit the plaintiff's recovery.

The issues discussed above illustrate another reason why it is important to retain competent experts from the start. A knowledgeable expert will help the city decide whether immediate repair is necessary and to what extent repair is needed. And more importantly, the expert will be able to defend the city's actions during litigation. Also, it is always a good practice to take photographs and videos during any type of destructive testing or during remedial construction. The photographs and videos may be your best argument against a defendant's contention that repairs were either unnecessary or that the work constituted a betterment.

D. Should the Original Contractor and Design Professional be Consulted?

When the city first learns of construction related defects in a relatively new building, the natural instinct will often be to ask the original contractor and design professionals to identify and fix the problem. In many cases, particularly where the building is fairly new, the contractor and design professional will, at least initially, be ready and willing to address the city's concerns. In that situation, the city would be describing the observed problems (e.g., the roof is leaking), and asking the contractor and design professionals to work together to see if the underlying problem is design-related or construction-related, or some combination of the two.

For small claims (small in scope or in cost), this approach can be successful. After all, contractors and design professionals who do a lot of work for cities know how important their reputations are, and they will usually try to do the right thing. But there are a number of potential pitfalls to look out for. First, the city is likely to find that the contractor and design professional seem to be more concerned about showing that the other party is responsible than in working to find a win-win solution to the problem (e.g., "it's not a design issue, it's a contractor/sub issue").

Second, as the cost of any potential remediation increases, the respective insurers for the contractor and design professionals will begin to get involved. The involvement of insurance companies typically won't stop there. Any of the subs working for the design professionals or the general contractor will have their own insurance companies. Those insurance companies will all want to know what their share of the remediation cost will be—before any remediation work actually begins.

Third, it's likely that your contractor and design professionals (and their respective insurers) will want the city to sign a release before remediation work is done. But without the city's own independent assessment of the cause behind the construction defects, it is in no position to know whether any proposed solution will fix all of the defects. Therefore, signing a release before remediation is underway can be detrimental to the city's position.

Unless the city can convince the contractor and/or design professionals to investigate and fix any construction-related problems without requiring the city to release them from any further liability, it's generally going to be to the city's advantage to conduct its own independent causation study.

IV. Potential Claims

A. Breach of Contract

The "go-to" claim in a construction defect case is a breach of contract claim. A construction project is built on contracts that set forth, among other things, the scope of work and the responsibilities of the parties. In many cases, the city will contract directly with the architect, engineer, and general contractor. Those entities will then contract directly with any subcontractors providing services and/or materials for the project. You will want to evaluate whether the city has a breach of contract claim against a few or all of these entities.

The city may claim breach of contract against any entity it directly contracted with for the project. As stated above, that could be the architect, engineer, general contractor, and in some cases, a subcontractor. The elements of a breach of contract claim are:

(1) the existence of a valid contract between the plaintiff and the defendant;
(2) the plaintiff tendered performance or was excused from doing so;
(3) the defendant breached the terms of the contract; and
(4) the plaintiff sustained damages as a result of the defendant's breach.

West v. Triple B. Servs., LLP, 264 S.W.3d 440, 446 (Tex. App.—Houston [14th Dist.] 2008, no pet.).

It is important to carefully read your contract language to determine if any additional conditions must be met before bringing a claim for breach of contract. Also, don't forget to file a certificate of merit with your original petition if you are bringing a breach of contract claim against an architect or engineer. The importance of this requirement cannot be overstated.

What if the city's investigation reveals that the defect was most likely caused by a subcontractor with which the city did not directly contract? In that case, the city would be unable to meet the first element of a breach of contract claim which is the existence of a valid contract between the city and the subcontractor. However, the city may still have a viable breach of contract claim if it can prove that the city was a "third party beneficiary" to the contract between the subcontractor and the general contractor, architect or engineer, whatever the case may be.

Arguing third party beneficiary status is tough. There is a presumption against conferring third party beneficiary status on noncontracting parties. *Sharyland Water Supply Corp. v. City of Alton*, 354 S.W.3d 407, 420 (Tex. 2011). In deciding whether the city may enforce a contract between others, the court will look to the contracting parties' intent. *Id*. at 421. The intent to confer a direct benefit on the city must be "clearly and fully spelled out" in the contract. *Id*. (citing *S. Tex. Water Auth. v. Lomas*, 223 S.W.3d 304, 306 (Tex. 2007)). Incidental benefits that flow to the city are not enough to confer the right to enforce the contract and the contracting parties must specifically intend to secure some benefit for the city. *Id*. There is no question that a city does benefit from a contract between a general contractor and subcontractor when that contract is for the construction of a city building. However, the fact that the city is directly affected or that it may have a substantial interest in the contract's enforcement does not automatically confer third party beneficiary status. *Id*.

Even though the third party beneficiary argument carries a high burden, it is always important to ask for copies of all subcontracts early in the discovery process, if the city does not have copies before a petition is filed. There may be language in the contract that will bolster the city's argument. Also, keep this in mind when drafting contracts. It may be possible, through the city's direct contract with its general contractor, architect, or engineer, to require third party beneficiary language in all subcontracts.

B. Negligence

Negligence is also a common cause of action in a construction defect case. To prove negligence, the plaintiff must show the existence of a duty, breach of that duty, and damages which were proximately caused by the breach. *C.J. Doe v. Boys Clubs of Greater Dallas, Inc.*, 907 S.W.2d 472, 477 (Tex. 1995).

Chapter 33 of the Texas Civil Practice and Remedies Code titled "Proportionate Responsibility" applies to any cause of action based in tort. Tex. Civ. Prac. & Rem. Code § 33.002(a) (LEXIS through 2011 Sess.). Chapter 33 requires that the trier of fact determine the percentage of responsibility for each claimant, defendant, settling person and responsible third party who is found to have caused or contributed to cause in any way the harm for which recovery of damages is sought, whether by negligent act or omission, by any defective or unreasonably dangerous product, or by other conduct or activity that violates an applicable legal standard. *Id*. § 33.003.

In practice, this means that under the negligence question on the charge, the city will be listed as a "claimant" and the jury will determine whether the city's acts or omissions caused any part of the harm for which recovery of damages is sought. If the jury determines that the city did

cause a portion of the harm, the jury will assign a percentage of responsibility to the city. The city may not recover damages if its percentage of responsibility is greater than 50%. *Id.* § 33.001. If the city's percentage is less than 50%, the court shall reduce the amount of damages to be recovered by the city by a percentage equal to the city's percentage of responsibility. *Id.* § 33.012(a). In other words, if the jury finds the city's percentage of responsibility to be 20%, then the city's recoverable damages will be reduced by 20%. The court will further reduce the city's recoverable damages if the city has settled with one or more parties. *Id.* § 33.012(b). That reduction will be based on the sum of the dollar amounts of all settlements. *Id.*

A defendant is liable to the city only for the percentage of the damages found by the jury that is equal to the defendant's percentage of responsibility. *Id.* § 33.013(a). However, if the defendant's percentage of responsibility is more than 50%, the defendant is jointly and severally liable for the city's damages. *Id.* § 33.013(b). A defendant that is jointly and severally liable can be made to pay more than his percentage of responsibility, but that defendant will have a claim for contribution against each other liable defendant to the extent that a defendant has not paid the percentage of damages equal to its percentage of responsibility. *Id.* § 33.015(a).

The worrisome thing about Chapter 33 is that it also gives the defendant the ability to designate a "responsible third party" and have that party's percentage of responsibility allocated on the charge. A responsible third party is defined as "any person who is alleged to have caused or contributed to causing in any way the harm for which recovery of damages is sought, whether by negligent act or omission, by any defective or unreasonably dangerous product, by other conduct or activity that violates an applicable legal standard, or by any combination of these." *Id.* § 33.011(6). A responsible third party must be designated on or before the 60th day before the trial date. *Id.* § 33.004(a). A plaintiff may object to the designation and the objection must be filed on or before the 15th day after the date the defendant's designation is served. *Id.* § 33.004(f). If the responsible third party is found by the jury to be responsible for a percentage of the plaintiff's damages, the finding does not itself impose any liability on the responsible third party and the finding may not be used in any other proceeding to impose liability on the party. *Id.* § 33.004(i).

It is important to be aware of Chapter 33 and its implications. A defendant will always seek to place some blame on the plaintiff for the plaintiff's damages, but if Chapter 33 applies and the defendant is successful in shifting blame to the plaintiff, the result could mean no recovery in some cases. Additionally, it is possible for a defendant to designate as a responsible third party an entity or person whom the plaintiff cannot sue directly. This could result in a percentage of responsibility being allocated to an entity against which there is no recovery. During the discovery phase, the city should be alert to arguments or evidence gathering by the defendant that may seek to point blame at the city or a possible responsible third party. The city should work to negate those arguments at an early stage.

C. Breach of Warranty

A warranty can be either express or implied. In a construction defect case, most express warranties will be found in the contract, therefore breach of an express warranty is considered a breach of contract claim. *La Sara Grain Co. v. First Nat'l Bank,* 673 S.W.2d 558, 565 (Tex.

1984). Implied warranties, on the other hand, are created by operation of law and are grounded more in tort. *Id.*

One statutory source for warranties is the Uniform Commercial Code ("UCC") found in Chapter 2 of the Texas Business and Commerce Code. The UCC provides statutory warranties for the sale of goods, however certain sections may be helpful in a construction defect case such as § 2.313 setting forth when an express warranty is created, § 2.314 regarding the implied warranty of merchantability, and § 2.315 defining the implied warranty of fitness for a particular purpose.

D. Products Liability

A products liability claim is governed by Chapter 82 of the Civil Practice & Remedies Code. A products liability claim is defined as "any action against a manufacturer or seller for recovery of damages arising out of personal injury, death, or property damage allegedly caused by a defective product whether the action is based in strict tort liability, strict products liability, negligence, misrepresentation, breach of express or implied warranty, or any other theory or combination of theories." Tex. Civ. Prac. & Rem. Code § 82.001(2) (LEXIS through 2011 Sess.). A "seller" is an entity or person "engaged in the business of distributing or otherwise placing, for any commercial purpose, in the stream of commerce for use or consumption a product or any component part thereof." *Id.* § 82.001(3). In comparison, a "manufacturer" is a person who is "a designer, formulator, constructor, rebuilder, fabricator, producer, compounder, processor or assembler of any product or any component part thereof and who places the product or any component part thereof in the stream of commerce." *Id.* § 82.001(4).

The distinction between a manufacturer and seller is important because a seller that did not manufacture a product is not liable to the plaintiff for harm caused by the product. *Id.* § 82.003. To invoke the liability of a non-manufacturing seller, the city would have to prove that (1) the seller participated in the product's design; (2) the seller altered or modified the product and the city's harm was caused by the alteration or modification; or (3) the seller installed the product or had the product installed and the city's harm was caused by that installation. *Id.* Section 82.003 sets forth other scenarios where a non-manufacturing seller may be liable for the plaintiff's harm which includes when the manufacturer of the product is insolvent or not subject to the jurisdiction of the court. *Id.*

If the city is alleging a design defect, the burden is on the city to prove by a preponderance of the evidence that there was a "safer alternative design" and that the defect was a producing cause of the city's damages. *Id.* § 82.005. A "safer alternative design" is one that would have prevented or significantly reduced the risk of the city's damages and was economically and technologically feasible. *Id.*

Chapter 82 should be studied before a products liability claim is asserted. The chapter places a substantial burden on the plaintiff and evidence to meet those burdens should be gathered early in the discovery process.

E. Economic Loss Rule

If you haven't had much experience with the "economic loss rule," consider yourself lucky. It is one of those elusive legal concepts that is hard to clearly define and apply. In broad terms, the economic loss rule is "a judicially created limitation on the recovery of economic damages in some forms of tort actions." Jim Wren, *Applying the Economic Loss Rule in Texas*, 64 Baylor L. Rev. 204, 208 (Winter, 2012). There have been several Texas Supreme Court and Courts of Appeals cases discussing this concept, but little clear direction on when it is applied. However, a 2011 Texas Supreme Court case, *Sharyland Water Supply Corp. v. City of Alton*, did a good job of explaining the current state of the economic loss rule in Texas. 354 S.W.3d 407 (Tex. 2011).

Sharyland Water Supply Corporation ("Sharyland") sued the City of Alton and the city's contractors after it was discovered that the contractors installed sewer lines above portions of Sharyland's water system in violation of a section of the Texas Administrative Code which required certain minimum distances between potable water and sanitary sewer lines. *Id*. at 409. The improperly placed sewer lines had not yet caused damage to Sharyland's water system, but due to the placement of the sewer lines, Sharyland's system was no longer in compliance with state regulations and certain repairs had to be performed. Sharyland sued the city for breach of their Water Supply Agreement and the contractors for negligence. *Id*. The contractors argued that Sharyland had suffered only economic losses therefore Sharyland could not recover those losses in a negligence action against the contractors. *Id*. at 415.

In its opinion, the Texas Supreme Court gave a helpful historical analysis of the economic loss rule in Texas. The Court first explained that it is misleading to refer to the "economic loss rule" because "there is not one economic loss rule broadly applicable throughout the field of torts, but rather several more limited rules that govern recovery of economic losses in selected areas of the law." *Id*. In Texas, for example, the economic loss rule bars a strict products liability claim when the damage or loss is limited only to the product and there is no personal injury or damage to other property. *Id*. *See also* Wren, at 234. In this scenario, recovery for loss of the product is limited to remedies grounded in contract, such as breach of contract, breach of warranty, and claims under the Uniform Commercial Code. *Sharyland*, 354 S.W.3d at 415. *See e.g., Signal Oil & Gas Co. v. Universal Oil Prods.*, 572 S.W.2d 320, 325 (Tex. 1978) ("Where only the product itself is damaged, such damage constitutes economic loss recoverable only as damages for breach of an implied warranty under the [Business and Commerce Code]"); *Mid Continent Aircraft Corp. v. Curry Cnty. Spraying Serv. Inc.*, 572 S.W.2d 308, 313 (Tex. 1978) ("Injury to the defective product itself is an economic loss governed by the Uniform Commercial Code.").

This iteration of the economic loss rule could be important in a construction defect case if it is determined that the construction defect was caused by a defective product. If the defective product caused no personal injury or other property damage, the city would not be able to bring a strict products liability claim and would be limited to claims under the UCC, breach of contract, or breach of warranty. If the city does plead a strict products liability claim along with these other theories, be sure to state that the defective product caused personal injury or other property damage and be able to provide proof to that effect. Otherwise, a defendant will surely argue that

the economic loss rule applies and the city is barred from bringing a strict products liability claim.

The second common application of the economic loss rule states that when a party has suffered only economic loss that is the subject of a contract with the defendant, the plaintiff's action sounds in contract alone. *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986). In other words, if a plaintiff has not suffered personal injury or damage to other property because of the defendant's conduct and the only damage suffered by the plaintiff is to the subject matter of the contract (i.e. economic loss), the plaintiff will be limited to a breach of contract claim. The facts of *Jim Walter Homes* provide a good example of this application. Homeowners in that case sued their builder for breach of contract and gross negligence. *Id*. The jury found the defendant grossly negligent and awarded punitive damages. *Id*. But the Court found that the plaintiffs had suffered only economic loss – "the house they were promised and paid for was not the house they received." *Id*. at 618. The Court held that "this can only be characterized as a breach of contract" and punitive damages cannot be awarded under a breach of contract claim. *Id*.

An architect, engineer or general contractor that is sued by the city for breach of contract and negligence will typically argue that the city is barred from bringing a negligence claim because the city has only suffered economic loss. It is also important to note that the economic loss rule is not an affirmative defense that must be pleaded. *See Equistar Chems., L.P. v. Dresser-Rand Co.*, 240 S.W.3d 864, 867-68 (Tex. 2007); Wren, at 208. It is viewed by the courts as a "statement or legal consideration of what is and is not to be considered as part of the proper measure of damages in a case to which it applies." Wren, at 208. This characterization of the rule is concerning for plaintiffs because it means the argument can be raised by a defendant at any time, including when discovery is finished or at summary judgment. For this reason, it is important to recognize when the economic loss rule could be argued and to gather evidence to rebut the rule even if it isn't initially raised by the defendant.

Going back to the *Sharyland* opinion, the Court recognized the two situations outlined above as the typical cases in which the economic loss rule will apply. But in *Sharyland*, the Court was not dealing with a products liability claim and it was not dealing with two parties in contractual privity (i.e. the typical situations where the economic loss rule would apply). Sharyland sued the city's contractors for negligence and there was no contractual privity between the parties. The contractors argued that Sharyland could not recover on a negligence claim because Sharyland had only suffered economic loss. The court of appeals had agreed which essentially set forth a different economic loss rule – one that says that you can never recover economic losses in a tort claim. *Sharyland*, 354 S.W.3d at 418. The Texas Supreme Court disagreed:

> Thus, we have applied the economic loss rule only in cases involving defective products or failure to perform a contract. In both of those situations, we held that the parties' economic losses were more appropriately addressed through statutory warranty actions or common law breach of contract suits than tort claims. Although we applied this rule even to parties not in privity (e.g. a remote manufacturer and a consumer), we have never held that it precludes recovery

> completely between contractual strangers in a case not involving a defective product – as the court of appeals did here…To say that the economic loss rule "precludes tort claims between parties who are not in contractual privity" and that damages are recoverable only if they are accompanied by "actual physical injury or property damage," overlooks all of the tort claims for which courts have allowed recovery of economic damages even absent physical injury or property damage.

Id. at 418. (citations omitted).

This statement by the Court is important because it remains an open question as to whether a property owner may sue a general contractor's subcontractor for negligence when there is no direct contractual privity between the owner and subcontractor. The Court's opinion in *Sharyland* does not specifically preclude such a case, however later in the opinion the Court makes a distinction between the facts presented in *Sharyland* and construction defect cases which "usually involve parties in a contractual chain who have had the opportunity to allocate risk." *Id*. at 420. So the questions remains unfortunately – can an owner assert a negligence claim against a subcontractor with which the owner has no contractual privity if the owner has only suffered economic loss? For this reason, a plaintiff should always plead a negligence case against a subcontractor. It remains to be seen whether the economic loss rule will apply in that situation.

V. Hiring Outside Counsel

Construction defect cases are usually complex, expensive, and time consuming. Having a competent and knowledgeable attorney handling the case can save time, money and heartache for the city. Research and interview attorneys with experience in construction defect cases. Don't be afraid to ask for references and follow up with those references. Also, negotiate your contract with outside counsel. An attorney's hourly rate or contingency fee should be negotiable up front. If the city will enter into a contingency fee contract, there are multiple ways to structure it. For example, the contract may entitle outside counsel to a certain percentage before suit is filed, a larger percentage after suit is filed, and perhaps an even larger percentage if the case goes to trial or through appeal. Attempt to keep the percentages low throughout the litigation process.

Insurance coverage plays a major role in a construction defect case. The defendants will typically be represented by an attorney who is hired by their respective insurance companies and those insurance companies may also have separate coverage attorneys. Those coverage attorneys will know the insurance policy backwards and forwards (which, if you have ever read an insurance policy, you know that is an impressive feat). The coverage attorneys will think of every possible argument to deny coverage which makes the litigation process and importantly, settlement negotiations, harder on the city. To combat this, the city should consider hiring its own coverage attorney. This can be done in addition to the city's lead outside counsel on the case or the city can seek out a lead attorney who is also knowledgeable in coverage issues. Either way, the city will want insurance coverage expertise to help it understand the available coverage and how certain arguments or events can affect that coverage.

Similarly, if the city finds itself gearing up for mediation, it is important to find a mediator that has a thorough understanding of construction defect litigation and insurance coverage issues. This is a tall order since both areas of the law are complex, but such mediators do exist. Find someone who has worked with large insurance companies and knows how to maneuver the relationship between the insurance companies and their insureds (i.e. your defendants). Construction defect cases are rarely settled in a day and the city will want a mediator that is willing to put in the extra time to reach a resolution.

VI. Recoverable Damages

A. Actual Damages

At common law, a plaintiff may recover "actual damages." *Arthur Anderson & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 816 (Tex. 1997). Actual damages are broken down into "direct" or "consequential" damages. *Id*. Direct damages flow naturally and necessarily from the wrong. *Id*. Direct damages are intended to make the plaintiff whole for a loss that is presumed to be foreseen by the defendant for his wrongful conduct. *Id*.

Consequential damages also result naturally, but not necessarily, from the defendant's wrongdoing. *Id*. Consequential damages do not have to be the usual result of the wrongdoing, but they must be foreseeable and directly traceable to the wrongful act. *Id*. Oftentimes, contracting parties will include language that prohibits or limits the recovery of consequential damages.

In a construction defect case, the general rule is that a plaintiff may recover the lesser of the reasonable cost of remedying the defects or the difference in value of the structure contracted for and the value of the structure in its defective condition. *Greene v. Bearden Enters., Inc.*, 598 S.W.2d 649, 652 (Tex. Civ. App.—Fort Worth 1980, writ refused n.r.e.). In determining the proper measure of damages, the court will consider the physical and economic feasibility of correcting defects. If the correction of defects would harm the existing structure or require the plaintiff to spend more than the value of the existing structure, then the measure of damages will be the difference in value of the structure as constructed and its value had it been constructed defect-free. *Id*.

It is the plaintiff's burden to plead and prove the measure and amount of damages. *Id*. A competent expert should be able to help the city determine which measure of damages is the most appropriate. Again, the correct measure of damages is something to thoroughly consider at the outset. The city's decisions on remediation of a construction defect will be highly scrutinized during the discovery phase and at trial. If the city fully considers all options up front and documents the reasons why a certain path was chosen, it may avoid tough arguments such as failure to mitigate damages and betterment down the road.

B. Attorney's Fees and Court Costs

In a breach of contract claim, a plaintiff may also recover attorney's fees if the plaintiff prevails on the breach of contract claim and is awarded damages on that claim. Tex. Civ. Prac. & Rem. Code § 38.001 (LEXIS through 2011 Sess.); *Green Int'l., Inc. v. Solis*, 951 S.W.2d 384,

390 (Tex. 1997). To determine the reasonableness of attorney's fees, the court should use the eight factors set forth in *Arthur Andersen & Co. v. Perry Equipment Corp*. The factors are:

> (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill required to perform the legal service properly;
> (2) the likelihood…that the acceptance of the particular employment will preclude other employment by the lawyer;
> (3) the fee customarily charged in the locality for similar legal services;
> (4) the amount involved and the results obtained;
> (5) the time limitations imposed by the client or by the circumstances;
> (6) the nature and length of the professional relationship with the client;
> (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
> (8) whether the fee is fixed or contingent on results obtained or uncertainty of collection before the legal services have been rendered.

Arthur Andersen, 945 S.W.2d 812, 818 (Tex. 1997).

The above factors apply even if the city has entered into a contingency fee agreement with outside counsel. *See id*. at 818-19. A contingency fee agreement will be considered by the fact finder, but it must be considered in combination with the above factors. *Id*.

A city may recover in-house counsel fees if an outside attorney is not hired. *See AMX Enters., L.L.P. v. Master Realty Corp.*, 283 S.W.3d 506, 517 (Tex. App.—Fort Worth 2009, no pet.). In-house counsel fees will be calculated at the current market rate for hiring outside counsel. *Id*. at 517-18.

In addition, Texas Rule of Civil Procedure 131 allows the successful party to recover all "costs incurred." Tex. R. Civ. P. 131 (LEXIS through February, 2013). However, be aware that expert witness fees are not recoverable under Rule 131. *Richards v. Mena*, 907 S.W.2d 566, 571 (Tex. App.—Corpus Christi 1995, writ dism'd by agr.). As a practice tip, the contract should allow for the recovery of expert witness fees if the city prevails in a breach of contract action.

C. Insurance – What is Really Covered?

Insurance coverage is of paramount concern in a construction defect case. Typically, a local general contractor or architect will not have a large amount of money sitting in the bank to cover an adverse judgment. Those entities are usually relying on their insurance policies to cover defense costs and large settlements or judgments. But there is much debate about whether certain construction defect claims are even covered under a general liability policy. For this reason and as discussed briefly above, employing outside counsel who is knowledgeable in coverage issues and/or hiring a separate coverage attorney is a smart move. In the following discussion, I have highlighted only a couple of important insurance coverage issues.

Construction projects require a commercial general liability ("CGL") policy that covers a contractor's liability to third parties for bodily injury and property damage. In addition, an

engineer or architect's work will usually be covered by an errors and omissions policy which provides limited coverage to an insured performing or rendering professional acts or services. Both policy types will include a duty to defend and a duty to indemnify the insured. The duty to indemnify will be limited by the liability coverage amount (i.e. the policy limits). However, some policies are known as "wasting" or "eroding" policies which means that the policy limits are reduced by the attorney's fees and expenses incurred in defending a lawsuit. Lee H. Shidlofsky, A Primer on What Every Construction Lawyer Should Know About Insurance 7 (2011) (unpublished manuscript). For example, the policy limit in an eroding policy may be $5 million. Attorney's fees and expenses will be subtracted from the policy limits as the case progresses. At the point of settlement or judgment, a defendant will not have $5 million available to cover an agreed settlement or a judgment award. In a non-eroding policy, attorney's fees and expenses do not reduce the policy limits and an insured would always have $5 million in coverage. It is important to know the defendants that are covered by an eroding policy and the status of that policy at important milestones such as mediation and trial. A long trial will only eat away at the policy limits and reduce the amount available for the city's recovery. At some point, the city may have to decide whether settlement with that defendant makes sense in order to obtain as much insurance coverage as possible. This is especially true if the city is concerned about the defendant's ability to pay a large judgment without the benefit of its insurance coverage.

In a construction defect case, the question is whether the city has suffered "property damage" that would invoke the insurance coverage of the general contractor, architect or engineer. "Property damage" is defined, in part, as "physical injury to tangible property, including all resulting loss of use of that property…or loss of use of tangible property that is not physically injured." Shidlofsky, 11. Importantly, a construction defect alone does not qualify as property damage. *Id*. But, if the construction defect causes damage to other property, that resulting damage is property damage that would be covered under the insurance policy. For example, defective masonry work by a contractor would not qualify as property damage. If the defective masonry allowed water to seep into the interior walls causing damage to insulation and sheetrock, that damage would be considered property damage and a covered loss under the insurance policy. Because of this distinction, it is important in the city's pleadings and discovery to not only highlight defective work, but also all resulting damage caused by the defective work.

VII. Conclusion

Like most litigation, construction defect cases can be complex, time consuming and expensive. The purpose of this paper is to make you aware of some, but not all, of the important issues your city may face in a construction defect case. I would advise to always seek help from competent experts and outside counsel early on in the process and keep in mind the issues discussed above.