TADC CONSTRUCTION LIABILITY NEWSLETTER

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This letter is intended to summarize recent cases and legislation that significantly impact the construction law practice. It is not a comprehensive digest of every case involving insurance issues during this period or of every holding in the cases discussed. This newsletter was not compiled for the purpose of offering legal advice. Any opinions expressed herein are those of the authors and do not necessarily reflect the views of Thomas, Feldman & Wilshusen, L.L.P.

I. CONTINGENT PAYMENT LEGISLATION

On September 1, 2007 *Senate Bill 324*, relating to contingent payment clauses (also known as "pay-if-paid" clauses) in construction contracts, went into effect. This legislation, which was signed into law by Governor Perry on June 16, 2007, addresses how and to what extent "pay-if-paid" clauses can be used in certain construction contracts.

The new provisions will be codified in *Section 35.521 of the Texas Business and Commerce Code*.

Highlights of the new legislation include the following:

1. The legislation does not apply to design services, residential construction, road and bridge construction or civil construction.

2. The Legislation applies to state and federal public projects.

3. The legislation applies to contingent payment clauses in first-tier subcontracts between the general contractor and first-tier subcontractors and in lower-tier subcontracts between upper-tier subcontractors and lower-tier subcontractors. For purposes of this article, I will only describe how the legislation impacts first-tier subcontracts.

4. If an owner does not make timely payment to a general contractor because of problems with the general contractor's performance, the contingent payment clause in the first-tier subcontract is not enforceable. However, if the owner does not make timely payment to a general contractor because of problems with a subcontractor's performance, the contingent payment clause is enforceable against that particular subcontractor.

5. If an owner does not make timely payment to a general contractor because it is insolvent, the contingent payment clause in the first-tier subcontract is enforceable only if doing so is not unconscionable.

   Enforcement is not unconscionable if the general contractor a) exercises diligence in ascertaining and communicating to the subcontractor information regarding the owner's financial viability and the existence of adequate financial arrangements for payment for construction, and b) makes reasonable efforts to collect amounts owed by the owner or assigns its causes of action against the owner to the subcontractor.

   The legislation provides specific steps that a general contractor can take to show that it has "exercised diligence" in ascertaining and communicating to the subcontractor information regarding the owner's financial viability and the existence of adequate financial arrangements for payment for construction. In particular, the general contractor must communicate the information to the subcontractor before the subcontract becomes enforceable.

   Additionally, the specific financial information that a general contractor must acquire from the owner and communicate to a subcontractor differs depending on whether the particular construction project is private project, state project or federal project.

6. If a properly submitted progress payment application remains unpaid for 45 days, on the 46th day after submission a subcontractor can send written notice to general contractor objecting to the further enforceability of the subcontract's contingent payment clause.

   The subcontract's contingent payment clause will become unenforceable on a date certain (see legislation for how to calculate date certain) unless the general contractor timely (see legislation for deadlines) notifies the subcontractor that the

owner's nonpayment is due to problems with the subcontractor's performance.

On a public project, a subcontractor's notice objecting to further enforceability will render a contingent payment clause unenforceable, if the owner successfully asserts a sovereign immunity defense and the general contractor has exhausted all rights and remedies in its contract with the owner.

7. The limitations of contingent payment clauses created by this legislation cannot be waived by contract.

8. Owners cannot demand that general contractors omit contingent payment clauses from subcontracts.

II. SOVEREIGN IMMUNITY

A. "Sue and be sued" and "plead and implead" are <u>not</u> waivers of a municipality's sovereign immunity.

Tooke v. City of Mexia, 197 S.W.3d 325 (Tex. 2006).

The Tooke Plaintiffs, who contracted to provide curb-cleaning services, sued the City of Mexia for breach of contract. In response, Mexia asserted that it was not liable because it possessed sovereign immunity from suit for breach of contract. The Tooke Plaintiffs challenged the assertion of sovereign immunity by arguing, among other reasons, that Mexia's sovereign immunity from suit had been waived by the "plead and be impleaded" language in section 51.075 of the Texas Local Government Code (applying to home-rule cities, and similar language is found in numerous other Texas enabling statutes and municipal charters). The trial court rendered a judgment in favor of the Tooke Plaintiffs, and Mexia appealed. The appellate court reversed the trial court holding that Mexia had not waived its sovereign immunity. The Tookes appealed to the Texas Supreme Court.

In *Tooke*, the Texas Supreme Court held that the "plead and implead "language was not a clear and unambiguous waiver of Mexia's (and thus other Texas municipalities') sovereign immunity from suit. Additionally, the Texas Supreme Court expressly overruled *Missouri-Pacific Railroad Co. v. Brownsville Navigation District, 453 S.W.2d 812 (Tex. 1970)*, which without analysis held that the "sue and be sued" language in a state statute creating a state agency was an unambiguous waiver of sovereign immunity.

However, the Court also recognized that while the *Tooke* matter was pending, the Texas Legislature had passed *House Bill 2039*, which specifically waived a municipality's sovereign immunity defense in certain breach of contract matters (This legislation is codified in *Tex. Loc. Gov't. Code 271.151, et seq. (Vernon 2000)*. The Texas Legislature made *House Bill 2039* retroactive so that it potentially applied to the contract at issue in *Tooke*.

Ultimately, the new legislation did not help the Tooke Plaintiffs; the Texas Supreme Court did utilize House Bill 2039 in several other pending breach of contract cases to allow contractors the opportunity to further litigate whether the particular municipality had indeed waived its sovereign immunity to suit. *See Satterfield Pontikes Construction, Co. v. Irving Indep. Sch. Dist, 123 S.W. 3d 63 (Tex. App. – Dallas 2003, rev'd by 197 S.W.3d 390 (Tex. 2007).*

B. Texas Legislature waives municipality's sovereign immunity from breach of contract claims.

Tex. Loc. Gov't. Code 271.151, et seq. (Vernon 2000).

Section 271.152 states

> A local governmental entity that is authorized by statute or the constitution to enter into a contract and that enters into a contract subject to this subchapter waives sovereign immunity to suit for the purpose of adjudicating a claim for breach of the contract, subject to the terms and conditions of this subchapter.

The legislature limited the types of claims and damages that are recoverable under the new legislation. Specifically, consequential damages, exemplary damages and damages for unabsorbed home office overhead cannot be recovered. Also, reasonable and necessary attorney's fees are not recoverable by a prevailing party unless a governmental entity has agreed as such in a written agreement.

C. Texas Legislature's waiver of a municipality's sovereign immunity does not apply to quantum meruit claims.

City of Houston v. Swinerton, NO. 01-06-00870-CV, 2007 Tex. App. LEXIS 4835 (Tex. App. – Houston [1st] June 21, 2007, no pet. h.).

Swinerton Builders, Inc., a general contractor, entered into a contract with the City of Houston to perform

construction on the George R. Brown Convention Center. Swinerton incurred more expenses than originally anticipated on the project. Consequently, Swinerton sued the City of Houston for, among other causes, breach of contract and quantum meruit. In response to the quantum meruit claim Houston asserted sovereign immunity. Swinerton argued that *Section 271.152* waived the City's sovereign immunity from quantum meruit claims.

The Houston Court of Appeals [1st Dist.] held that pursuant to the specific language in *Section 271.152* ("adjudicating claims for breach of contract") the waiver of sovereign immunity applies only to breach of contract claims, and not to quantum meruit claims. In further support of its ruling that immunity was expressly limited to only breach of contract claims, the court noted that the Texas Legislature chose not to describe the limited waiver as applying to claims "arising under a written contract".

D. A governmental entity's claim for affirmative relief waives sovereign immunity for counterclaims seeking an offset.

State of Texas v. Fidelity and Deposit Company of Maryland, 223 S.W.3d 309 (Tex. 2007).

A general contractor on a Texas Department of Transportation ("TxDOT") non-roadway building project defaulted on its contract. The general contractor's surety took over and completed the project. After the project was completed, a payment dispute between TxDOT and the surety arose. Before the surety was able to pursue its payment claim within TxDOT's administrative dispute resolution system, TxDOT filed suit against the surety and the defaulted contractor alleging that as a result of the surety's failure to perform under its performance bond TxDOT suffered economic damages. In response, the surety filed a counterclaim alleging that TxDOT, not the defaulted contractor, breached the contract. Thereafter, TxDOT filed a plea to the jurisdiction asserting, among other things, that sovereign immunity protected it from the counterclaim.

The Supreme Court of Texas, relying on *Reata Construction Corp. v. City of Dallas, 197 S.W.3d 371 (Tex. 2006)*, held that TxDOT by seeking affirmative relief from the court waived its sovereign immunity to counterclaims that were "sufficiently related" to its claim for affirmative relief. Note, that the waiver of sovereign immunity is limited to only an amount of damages necessary to offset the governmental entity's claim for affirmative relief. Amounts of a counterclaim that exceed the amount necessary to fully setoff a governmental entity's damages are not recoverable, because the governmental entity is still protected by sovereign immunity for those excess damages. *See City of Irving v. Inform Construction, Inc. 201 S.W.3d 693 (Tex. 2006).*

III. Jury Trial

A. Contractual waiver of right to jury trial must be knowing and voluntary.

Mikey's Houses, LLC v. Bank of America, NO. 2-05-397-CV, 2007 Tex. App. LEXIS 3471 (Tex. App. – Ft. Worth May 3, 2007, no pet. h.).

Mikey's Houses, a company that buys, renovates and sells foreclosures, contracted to purchase a foreclosed home from Bank of America ("BOA"). After both parties had executed the purchase contract, BOA required Mikey's Houses to sign an addendum that contained a jury waiver clause. A dispute arose when Mikey's Houses realized that BOA did not own title to the house, but only owned a portion of the land on which the house sat. Mikey's Houses brought suit against BOA, and BOA moved to enforce the jury waiver clause. The trial court granted BOA's motion.

Mikey's Houses appealed the ruling. The Fort Worth Court of Appeals reversed the trial court's ruling by holding that BOA failed to produce prima facie evidence that Mikey's Houses knowingly, voluntarily, and intelligently with sufficient awareness of the relevant circumstances and likely consequences agreed to waive its constitutional right to trial by jury.

The appeals court began its analysis by establishing that there is a presumption against waiver of the constitutional right to a jury trial. The court also stated that the pleading and proof burdens applicable to arbitration clauses do not apply to jury waiver clauses. (An arbitration clause constitutes an agreement to avoid the judicial process altogether, while a jury waiver clause constitutes an agreement to limit one's rights following the invocation of the judicial process.)

Next, the court explained how the presumption against waiver of the constitutional right to a jury trial can be rebutted. To rebut the presumption, the party attempting to enforce a contractual jury waiver must show that the other party knowingly and voluntarily waived its right to a jury trial. When analyzing whether a party has knowingly and voluntarily agreed to a jury trial waiver, the court considers the following factors: 1) The parties experience in negotiating the

particular type of contract signed, 2) Whether the parties were represented by counsel, 3) Whether the waiving party's counsel had an opportunity to examine the agreement, 4) The parties' negotiations concerning the entire agreement, 5) The parties' negotiations concerning the waiver provision, if any, 6) The conspicuousness of the provision, and 7) The relative bargaining power of the parties.

Here, BOA failed to rebut the presumption against waiver of the constitutional right to a jury trial, because it did not produce evidence showing that Mikey's Houses knowingly, voluntarily and intelligently with sufficient awareness of the relevant circumstances and likely consequences agreed to waive its constitutional right to trial by jury. The evidence presented at the trial court did not address several of the factors (such as whether any aspect of the contract or addendum was negotiated), but did show that Mikey's Houses was not represented by counsel, the jury waiver was not conspicuous and the relative bargaining power was not equal.

IV. Alter Ego

A. Principal of a construction company can be personally liable for company's judgment debt.

Vanounou v. Cantu, No. 13-05-00453-CV, 2007 Tex. App. LEXIS 7168 (Tex. App. – Corpus Christi Aug. 28, 2007, no pet. h.).

A buyer filed suit against Mega Custom Homes, Inc. and Gabriel Vanounou, the sole shareholder of Mega Custom Homes, Inc. ("Mega Homes"), for construction defects to a town home on South Padre Island that it purchased from Mega Homes. Mega Homes, and Vanounou, individually under an alter ego theory, were found to be liable for the construction defects.

Vanounou appealed the alter ego verdict. However, the alter ego verdict was affirmed, because the evidence showed that there was such unity between Mega Homes and Vanounou that appropriate separateness did not exist, and thus it would be unjust to only hold Mega Homes liable.

Mega Homes was found to be the alter ego of Vanounou because: 1) Vanounou owned and controlled Mega Homes, 2) Vanounou exclusively made all the decisions regarding Mega Homes vision, 3) Vanounou, individually, purchased the property on which the town homes were built and transferred ownership to Mega Homes, 4) Mega Homes did not have a separate checking account, 5) Mega Homes did not employ anyone other than Vanounou, 6) Mega Homes had no work other than the construction of three town homes on South Padre Island, 7) Mega Homes received its mail at Vanounou's main office, 8) The construction agreement that Vanounou had with his general contractor stated that Vanounou would supply the specifications, materials and subcontractors and 9) Vanounou paid Mega Homes $150,000 for one town home, while charging $195,000 and $206,000 for the other two town homes.

Construction industry participants including developers, owners and small contractors need to exercise caution when considering how to keep their business affairs distinct from their personal affairs and determining to what extent they should implement corporate formalities in their business affairs.

V. Civil Procedure

A. When quasi-admissions can be treated as judicial admissions.

Hickman v. Dudensing, No. 01-06-00458-CV, Tex. App. LEXIS 4053 (Tex. App. – Houston [1st] May 24, 2007, pet. filed).

In *Hickman,* an owner filed suit against a remodel contractor for breach of contract and violation of the Deceptive Trade Practices Act (" DTPA") alleging that the remodeling work to buildings originally constructed in 1890, was not done in a good and workmanlike manner. During the trial, the contractor and several of his workers, testified that they performed the renovations in a good and workmanlike manner. However, they also testified that some of the paint peeled off before a reasonable period of time, that the roof rusted sooner than it should have, that the stairs should not shake from side to side and that the contractor did not employ a licensed electrician or plumber. However, after reviewing all the evidence, the jury returned a verdict in favor of the contractor.

The owner appealed the verdict asserting that the contractor's admissions regarding problems with the remodel work established as a matter of law that the contractor failed to perform its work in a good and workmanlike manner. In effect, the owner claimed such admissions were judicial admissions that should have taken the matter away from the jury.

Relying on *Mendoza v. Fid. & Guar. Ins. Underwriters, Inc., 606 S.W.2d 692 (Tex. 1980)*, the Houston Court of Appeals analyzed whether the

contractor's testimonial statements were quasi-admissions (testimony that is contrary to a party's position) that should be treated as judicial admissions that would preclude the jury returning a verdict in favor of the contractor.

In *Mendoza*, the Texas Supreme Court stated that in some instances, as a matter of public policy, quasi-admissions could be treated as judicial admissions. The underlying public policy is that "it would be unjust to permit a party to recover after he has sworn himself out of court by clear, unequivocal testimony." As such, in Texas a quasi-admission will be treated as a judicial admission if 1) the declaration was made during the course of a judicial proceeding, 2) The statement is contrary to an essential fact embraced in the theory of the defense asserted by the person giving the testimony, 3) The statement is deliberate, clear and unequivocal, 4) Giving conclusive effect to the declaration will be consistent with the public policy upon which the rule is based, and 5) The statement is not also destructive of the opposing party's theory of recovery.

Here, the Appeals Court held that the particular testimonial declarations of the contractor that the owner asserts should be treated as judicial admissions (the paint peeled off before a reasonable period of time, that the roof rusted sooner than it should have and that the stairs should not shake from side to side and that the contractor did not employ a licensed electrician or plumber) were not deliberate, clear and unequivocal when viewed in light of the entirety of the contractor's testimony (such as it performed work in a good and workmanlike manner, the paint [job] is still good, the licensed electrician turned down the job).

As an aside, baseball has its "Mendoza Line" and so does Texas jurisprudence!

B. Res Judicata has limited application to lower trial court verdicts.

Kizer v. Meyer, Lytton, Alen and Whitaker, Inc., 228 S.W.3d 384 (Tex. App. – Austin 2007, no pet. h.).

In a county court at law a homeowner sued the structural engineering firm that designed and installed his home foundation. The homeowner sued on negligence, warranty and DTPA causes of action, complaining about the defendant's failure to install a "capping slab" on the top of his foundation. The county court at law, based on a take-nothing verdict, entered judgment denying the homeowner's claim.

After discovering additional defects with the home, such as cracking in the exterior rock and interior walls and molding, the homeowner filed suit against the same structural engineering firm in district court for negligence and breach of contract. The factual basis of the district court suit was alleged defects with the overall design of the foundation. The defendant engineering firm answered and moved for summary judgment on the basis of res judicata. The district court granted the summary judgment.

On appeal, the homeowner, relying on *section 31.004 of the Texas Civil Practices and Remedies Code,* asserted that res judicata did not bar his breach of contract claim, because, unlike his negligence claim, the breach of contract was not actually litigated in the county court at law.

Section 31.004 of the Texas Civil Practices and Remedies Code states, in part,

> a) A judgment or a determination of fact or law in a proceeding in a lower trial court is not res judicata and is not a basis for estoppel by judgment in a proceeding in a district court, except that a judgment rendered in a lower trial court is binding on the parties thereto as to recovery or denial of recovery. . .
>
> c) For purposes of this section, a "lower trial court" is a small claims court, a justice of the peace court, a county court, or a statutory county court.

The Austin Court of Appeals held that *Section 31.004* restricts the common law doctrine of res judicata (barring the relitigation of claims that have been finally litigated and of related claims that with the use of diligence should have been litigated) so that a cause of action that was unlitigated in a lower trial court, is not barred from being litigated at a later date in a district court, even if the unlitigated cause of action arises out of the same facts made the basis of a previously litigated cause of action in a lower trial court.

The Court did note that "such a result is not allowed under the common law and is, we believe difficult to defend as sound policy. However, it is the result mandated by section 31.004." The Court also stated that "this result is particularly problematic when section 31.004 includes all statutory county courts. In many instances, these courts have either largely overlapping or even identical jurisdiction to district courts."

It will be interesting to see when and how this potential "second bite at the apple" issue will be addressed by the Texas Legislature and/or the Texas Supreme Court

VI. Statute of Limitations

A. Unjust Enrichment has a two (2) year limitations period.

Elledge d/b/a Elledge Construction Company v. Friberg-Cooper Water Supply Corp., 50 Tex. Sup. Ct. J. 1060, 2007 Tex. LEXIS 706 (Aug. 27, 2007) (publication status pending).

To clear up confusion regarding the limitations period that governs unjust enrichment claims, the Supreme Court specifically held, "In order to bring unequivocal 'predictability and consistency to the jurisprudence', we declare categorically today what we have indicated twice previously: Unjust enrichment claims are governed by the two-year statute of limitations in *section 16.003 of the Civil Practices and Remedies Code*."

B. Discovery Rule's rare application to breach of contract claims.

Via Net v. TIG Insurance Co., 211 S.W.3d 310 (Tex. 2006).

While the facts of *Via Net* do not arise out of a construction dispute, its holding will likely have a direct impact on construction contract disputes. The Texas Supreme Court held that in this particular instance the discovery rule would not defer the accrual of a breach of contract claim.

More importantly, in regard to breach of contract claims in general, the Court stated:

> We do not hold today that the discovery rule can never apply to breach of contract claims . . . Some contract breaches may be inherently undiscoverable and objectively verifiable. But those cases should be rare, as diligent contracting parties should generally discover any breach during the relatively long four-year limitations period provided for such claims.

Construction contractors need to make every effort to exercise diligence in identifying, and then pursuing, disputes and incidents that might culminate in breach of contract claims.