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Toni Scott Reed

Austin D. Jones

CONSTRUCTION AND SURETY LAW

*Toni Scott Reed**
*Austin D. Jones***

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I. INTRODUCTION

DURING late 2001 and throughout 2002, the developments in construction and surety law focused on a wide variety of substantive issues, most notably including supreme court opinions on negligence liability to subcontractor's employees, sovereign immunity, waiver of implied warranties, and the enforceability of arbitration awards. Other opinions in the various appellate courts addressed mechanic's liens, the substantial performance doctrine, limitations and the discovery rule, insurance coverage for construction defects, retainage requirements, and other notable subjects of interest to the construction practitioner.

* Toni Scott Reed received both her undergraduate degrees (B.A. 1990, B.B.A. 1990 *summa cum laude*) and her law degree (J.D. 1993 *cum laude*) from Southern Methodist University. She is a partner in the Dallas office of Strasburger & Price, L.L.P. She specializes in business and commercial litigation, with a particular focus on construction and surety matters. She is a member of the American Bar Association's Forum on the Construction Industry and Fidelity and Surety Law Committee, as well as the Construction Section of the State Bar of Texas and the Dallas Bar Association.

** Austin D. Jones received his undergraduate degree (B.A. 1997) from Southwestern University and his law degree (J.D. 2001) from the University of Texas. He is an associate in the Trial practice unit in the Dallas office of Strasburger & Price, L.L.P.

The Texas courts, and the supreme court in particular, remained quite active in deciding cases that directly affect parties to construction contracts.

II. CONTRACTOR AND OWNER LIABILITY FOR SUBCONTRACTOR'S EMPLOYEES

In December 2001 and October 2002, the Texas Supreme Court rendered important decisions on the subject of owners' and contractors' liability for negligence to the employees of contractors and subcontractors. Last year's survey article opined that the supreme court's 2001 decision in *Lee Lewis Construction, Inc. v. Harrison*[1] may prove to be controversial when extrapolated to other factual situations. The supreme court's 2002 opinion, which again analyzed the issue of liability for injuries sustained by employees of a contractor, focused upon very different factors, including the specific terms of the contract and the resulting lack of contractual obligations of the project owner to the contractor. The supreme court cases, as well as the appellate court opinion that is discussed below, illustrate the important point that the particular facts of a case will greatly impact the supreme court's analysis of the issue of liability.

A. Liability From a Finding of Retained Control

In its 2001 decision, *Lee Lewis Construction, Inc. v. Harrison*,[2] the Texas Supreme Court concluded that, under the facts presented, the general contractor in question owed a duty of care to the subcontractor such that the general contractor was liable in negligence for the injuries sustained by a particular employee of the subcontractor on a construction project.[3] In *Harrison*, a hospital hired Lee Lewis Construction ("LLC") as the general contractor to remodel the eighth floor of the hospital and to add ninth and tenth floors to the existing structure. In the course of completing the work, LLC subcontracted the interior glass-glazing work to KK Glass. Jimmy Harrison, an employee of KK Glass, fell to his death while working on the tenth story of the hospital project. Harrison, at the time of the incident, was not wearing an independent lifeline, a safety device that would have stopped his fall. LLC, as the general contractor, retained the right to control the fall protection systems on the project.

Harrison's family brought a wrongful death and survival action against LLC, based upon its status as the general contractor on the project. The family alleged that the general contractor was negligent and grossly negligent. The trial court rendered judgment against the general contractor for $7.9 million in compensatory damages and $5 million in punitive damages.[4] The appellate court affirmed the judgment after the Harrison family agreed to the court's suggested remittitur in the amount of $450,000.00

1. Lee Lewis Constr., Inc. v. Harrison, 70 S.W.3d 778 (Tex. 2001).
2. *Id.*
3. *Id.* at 782.
4. *Id.*

for unproven pain and suffering damages.[5] LLC appealed to the Texas Supreme Court arguing, among other things, that, as the general contractor, it did not owe the subcontractor a duty of care under the facts at issue. The Texas Supreme Court rejected LLC's arguments, concluding that there was legally sufficient evidence to find that: "(1) LLC retained the right to control its subcontractor's fall-protection measures and thus owed a legal duty to Harrison; (2) LLC's failure to ensure adequate fall-protection measures proximately caused Harrison's fall; and (3) LLC was grossly negligent."[6]

The supreme court began its analysis by stating the general rule: "[o]rdinarily, a general contractor does not owe a duty to ensure that an independent contractor performs its work in a safe manner."[7] The court noted, however, that the general rule is not applicable when the general contractor keeps control over the way the independent contractor performs its tasks.[8] In fact, the court found that a "general contractor's duty of care is commensurate with the control it retains over the independent contractor's work."[9] The court cited section 414 of the Restatement (Second) of Torts with approval, noting the court's previous adoption of that standard in *Redinger v. Living, Inc.*:[10]

> One who entrusts work to an independent contractor, but who retains the control of any part of the work, is subject to liability for physical harm to others for whose safety the employer owes a duty to exercise reasonable care, which is caused by his failure to exercise his control with reasonable care.[11]

The court further stated that a "general contractor can retain the right to control an aspect of an independent contractor's work or project so as to give rise to a duty of care to that independent contractor's employees in two ways: by contract or by actual exercise of control."[12] The court carefully noted that a distinction between the terms "right of control" and "retained control" does exist, because "determining what a contract says is generally a question of law for the court, while determining whether someone exercised actual control is generally a question of fact for the jury."[13] The court also noted a key procedural distinction that, on appeal, LLC merely challenged the legal sufficiency of the evidence supporting the jury's conclusion that it in fact retained the right to control safety on the jobsite, but LLC did not challenge the applicability of section 414 to

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5. *Id.*
6. *Id.*
7. *Id.* at 783 (citing Elliott-Williams Co. v. Diaz, 9 S.W.3d 801, 803 (Tex. 1999) and Hoechst-Celanese Corp. v. Mendez, 967 S.W.2d 354, 356 (Tex. 1998)).
8. *Id.*
9. *Id.* (citations omitted).
10. Redinger v. Living, Inc., 689 S.W.2d 415, 418 (Tex. 1985).
11. *Harrison*, 70 S.W.3d at 783 (citing RESTATEMENT (SECOND) OF TORTS § 414 (1965)).
12. *Id.* (citing Koch Ref. Co. v. Chapa, 11 S.W.3d 153, 155 (Tex. 1999); Coastal Marine Serv. of Tex., Inc. v. Lawrence, 988 S.W.2d 223, 226 (Tex. 1999)).
13. *Id.*

the facts of the case.[14]

Specifically, in the appeal, LLC argued that the family failed to prove that LLC, as the general contractor, exercised actual control over the subcontractor, and therefore failed to prove that the general contractor owed a duty under the circumstances. After a careful review of the evidence, the supreme court disagreed with LLC's arguments. The court concluded that the general contractor retained the right to control the fall-protection systems on the jobsite, and therefore owed a duty to the employees of the subcontractor at the time of the accident.[15]

In reaching its conclusion, the court focused specifically on the following evidence of actual control:

1. LLC's owner and president testified that he assigned LLC's job superintendent "the responsibility to routinely inspect the ninth and tenth floor addition to the south tower to see to it that the subcontractors and their employees properly utilized fall protection equipment."[16]
2. LLC's job superintendent personally observed and approved of the specific fall-protection systems KK Glass used.
3. LLC's job superintendent knew of and did not object to KK Glass' use of a bosun's chair without an independent lifeline.[17]

Harrison appears to present an extreme set of facts, under which the supreme court affirmed that a fact finder could reasonably have concluded that the contractor retained all control and all supervisory responsibilities for worker safety. Accordingly, the court's opinion appears to be a decision based upon the specific facts of the case and not a significant shift in position by the court on the subject of negligence liability. It should be applied and argued with some care by future parties, since the real issue presented was legal sufficiency of the evidence under a narrow fact situation rather than a challenge to the application of the doctrine of liability in the first instance.

Justice Hecht's thoughtful concurring opinion makes that issue clear in the context of the case's holding. The concurrence notes that section 414 of the Restatement "makes the retention of control over an independent contractor's work a necessary, *but not a sufficient*, condition of liability."[18] An additional prerequisite for liability under that rule, as noted by Justice Hecht, is that "the person harmed be among those 'others for whose safety the employer owes a duty of reasonable care.'"[19]

Justice Hecht's concurrence noted that the supreme court had been called upon to apply the general rule and exception regarding liability for

14. *Id.* The court's note on this point indicates, and should provide some guidance to parties, that the court's ruling in the case is somewhat limited to the facts of the case and to the issue of legal sufficiency of the evidence.
15. *Id.* at 783-84.
16. *Id.* at 784.
17. *Id.*
18. *Id.* at 788 (Hecht, J., concurring) (emphasis added).
19. *Id.*

a subcontractor's employee's injury in eight separate cases, the analysis of all focusing exclusively on the retention of control question.[20] The concurring opinion stated the position in the *Harrison* case was one where the additional element concerning the parties to whom the duty was owed should have been clarified.[21]

Justice Jefferson's concurring opinion in the case noted his approval of the holding, but his disagreement with the court's finding of evidence in support of "actual control."[22] Justice Jefferson stated that the finding of LLC's approval of the ineffective fall-protection system did not constitute "actual control," as that term was previously defined by the Court in *Koch Refining Co. v. Chapa*.[23] Justice Jefferson noted that for "actual control" to create liability, the evidence must show more than mere acquiescence or approval.[24] His concurrence was based upon the grounds that, "LLC had a contractual right to compel compliance with safety standards, actually witnessed repeated and flagrant safety violations, and approved those repeated violations even as it enforced its real standards for its own employees."[25] The concurrence stated that LLC would not be liable merely because it adopted a general safety program or possessed a contractual right to remove subcontractors who failed to comply with the standards, but also because LLC endorsed the subcontractor's hazardous activities in the facts of the case.[26]

The substance of the concurring opinions makes it clear that the court's decision should not be read too broadly or interpreted too quickly as a departure from the supreme court's previous positions. The *Harrison* case happened to present an extreme set of facts that, based upon the procedural content of the appeal, supported the finding of negligence against the general contractor, according to the supreme court.

B. No Liability as a Result of Contractual Terms

The *Harrison* case was not the only one that presented the supreme court with a question regarding negligence for a contractor's employees during the Survey period. In its 2002 opinion, *Dow Chemical Co. v. Bright*,[27] the supreme court made it clear that any duty of care owed by a project owner to a contractor's employees is governed by the contractual agreements between the owner and contractor.[28] The court determined, under the facts of the case presented, that Dow Chemical did not owe any duties, as a matter of law, to the employee of an independent contractor.[29] The substance of the court's discussion and ultimate conclusion un-

20. *Id.*
21. *Id.*
22. *Id.* at 800 (Jefferson, J., concurring).
23. *Id.*; Koch Ref. Co. v. Chapa, 11 S.W.3d 153 (Tex. 1999).
24. *Harrison*, 70 S.W.3d at 800.
25. *Id.*
26. *Id.* at 801.
27. Dow Chem. Co. v. Bright, 89 S.W.3d 602 (Tex. 2002).
28. *Id.* at 606.
29. *Id.* at 607.

derline the fact that it has not adopted a new approach to the analysis of liability in the context of construction projects.

In connection with the construction project in question, Dow Chemical retained Gulf States as an independent contractor, which in turn employed Larry Bright on the project. Bright was injured on the job and sued Dow Chemical, arguing that Dow Chemical was negligent and had a duty to use reasonable care to keep the premises under its control in a safe condition. Dow Chemical and Bright each filed motions for summary judgment on the issue of duty. The trial court granted Dow Chemical's motion, finding no duty existed, and denied Bright's motion.[30] On appeal, the court reversed and remanded on the basis that "the summary judgment evidence raised a fact issue about the extent of 'supervisory control' retained by Dow."[31]

Bright's injury on the construction project occurred when an overhead pipe became unstable and fell on him. A fellow employee of Gulf States put the pipe in place. In the context of these facts, the supreme court noted that whether Dow Chemical owed Bright a duty of care is governed by Texas law concerning a general contractor's duties to a subcontractor's employees, where two categories of premises defects exist: "(1) defects existing on the premises when the independent contractor entered; and (2) defects the independent contractor created by its work activity."[32]

Under the second category, which applied to the facts of the case, the premises owner generally owes no duty to the independent contractor's employees, as determined by the supreme court in *Redinger v. Living, Inc.*[33] In *Redinger*, the supreme court established the rule that "an owner or occupier does not have a duty to see that an independent contractor performs work in a safe manner . . . . However, when the general contractor exercises some control over a subcontractor's work he may be liable unless he exercises reasonable care . . . ."[34]

In its analysis in *Dow Chemical*, the supreme court found that a party can prove right to control in two ways: (1) "by evidence of a contractual agreement that explicitly assigns the premises owner a right to control;" or (2) "in the absence of a contractual agreement, by evidence that the premises owner actually exercised control over the manner in which the independent contractor's work was performed.[35] Both of those concepts are discussed in detail below.

1. Contractual Right to Control

In the context of its analysis of the contractual right to control, the supreme court outlined a number of rules:

30. *Id.* at 605.
31. *Id.*
32. *Id.* at 605-06.
33. *Id.* at 606; Redinger v. Living, Inc. 689 S.W.2d 415 (Tex. 1985).
34. *Redinger*, 689 S.W.2d at 418.
35. *Dow Chemical Co.*, 89 S.W.3d at 606.

(a) A contract may impose control upon a party thereby creating a duty of care.
(b) If the right of control over work details has a contractual basis, the circumstance that no actual control was exercised will not absolve the general contractor of liability.
(c) It is the right of control, and not the actual exercise of control, which gives rise to a duty to see that an independent contractor performs work in a safe manner.
(d) For an owner or a general contractor to be liable for an independent contractor's act, the owner or general contractor must have the right to control the means, methods, or details of the independent contractor's work. Further, the control must relate to the injury the negligence causes.
(e) Determining whether the contract gives a right of control is generally a question of law for the court to decide.[36]

The particular contract at issue in the case provided, in relevant part, as follows:

22.01 Safety- . . . CONTRACTOR shall take all necessary precautions for the safety of the employees on the work and shall comply with all safety rules and regulations of DOW as set forth in the Safety and Loss Prevention Manual for CONTRACTORS and all applicable provisions of the federal, state and municipal safety laws and building codes to prevent accidents or injuries to persons or damage to property on or about or adjacent to the premises where work is being performed.

. . .

30.01 Responsibilities–CONTRACTOR shall be an independent contractor under this Contract and shall assume all of the rights, obligations and liabilities, applicable to it as such independent contractor hereunder and any provisions in this Contract which may appear to give DOW the right to direct CONTRACTOR as to details of doing the work herein covered or to exercise a measure of control over the work shall be deemed to mean that CONTRACTOR shall follow the desires of DOW in the results of the work only.[37]

Bright argued that Dow Chemical's requirement that its independent contractors comply with the safety rules and regulations issued in its Safety and Loss Prevention Manual established Dow Chemical's right to control the premises. Dow Chemical, in response, argued that section 30.01 of the contract specifically provided that Gulf States would be an independent contractor and retain control of the work.

Based upon the language of the contract itself, the supreme court determined that the contract did not impose any duty of care to Bright upon Dow Chemical because the agreement did not delegate to Dow Chemical the right to control the means, methods, or details of Gulf States' work or give Dow Chemical the right to direct the means and methods of Gulf

36. *Id.*
37. *Id.* at 606-07.

States' work.[38] Therefore, the court determined, as a matter of law, that the contract did not impose any duty upon Dow Chemical because Dow Chemical did not retain the right to control the means, methods, or details of the work.[39]

2. Actual Exercise of Control

With respect to the actual exercise of control on a construction project, the supreme court set out the following general rules:

> (a) "A premises owner who actually exercises control over the contractor's work may be subject to direct liability for negligence."
> (b) "[M]erely exercising or retaining a general right to recommend a safe manner for the independent contractor's employees to perform their work is not enough to subject an owner to liability." "The control must relate to the injury the negligence causes."
> (c) "[I]f a premises owner exercises control by requiring a subcontractor to comply with its safety regulations, the premises owner owes the subcontractor's employees a narrow duty of care that its safety requirements and procedures do not unreasonably increase the probability and severity of injury."[40]

The supreme court determined that Dow Chemical did not exercise any actual control on the project, based upon the following undisputed facts: (1) "Gulf States assigned Bright his carpenter duties;" (2) "Dow did not instruct Bright on how to perform his job;" (3) "Dow was not involved in the decision as to how or when to secure the pipe that fell on Bright."[41] The supreme court rejected two primary arguments urged by Bright that Dow Chemical did retain control, including the argument that Dow Chemical could have stopped work had it known of the safety hazard and the argument that Dow Chemical should have refused to issue a safe work permit. With respect to the right to stop work, the supreme court noted that the Restatement (Second) of Torts states that it is not enough that a premises owner has a right to order work stopped because imposing liability for that right would deter parties from setting even minimal safety standards.[42] With respect to Dow Chemical's right to conduct an on-site inspection and pre-job safety conference with Gulf States, the supreme court held that such rights are not evidence of the right to control the work of the independent contractor, citing its opinion in *Koch Refining Co. v. Chapa*.[43]

The supreme court did acknowledge its prior holding in the *Harrison* case, noting that if the evidence regarding Dow Chemical showed that the Dow Chemical safety representative on the job had actually approved how the pipe in question was secured or instructed Bright to perform his

38. *Id.* at 607.
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.* at 607-08 (citing RESTATEMENT (SECOND) OF TORTS § 414 cmt. c (1965)).
43. *Id.* at 608 (citing Koch Ref. Co. v Chapa, 11 S.W.3d 153, 155 (Tex. 1999)).

work knowing of the dangerous condition, there might be a fact issue similar to those presented in *Harrison*. Since there was no finding of prior knowledge of a dangerous condition and no specific approval of a dangerous act, the supreme court refused to find the exercise of actual control by Dow Chemical.[44]

The discussion presented in the *Dow Chemical* case makes it clear that the court wanted to distinguish the extreme fact scenario of the *Harrison* case from the more typical factual situation where an owner or general contractor has no actual knowledge of the safety hazard. The court's holding with respect to the contractual obligations of the owner is also important because it emphasizes the specific language that will be required in a contract in order to impose a duty.

C. The Court of Appeals Perspective

Following the *Harrison* decision, the San Antonio Court of Appeals had the opportunity to rule upon the issue of retained control and exercise of control in *Victoria Electric Cooperative, Inc. v. Williams*.[45] In that case, which preceded the *Dow Chemical* opinion, the court carefully reviewed the contract at issue in order to determine whether and which duties existed on the part of the owner. In the context of that decision, the court of appeals determined that a contractor was not liable for a subcontractor's actions which injured a third party.[46] The trial court originally held Victoria Electric Cooperative liable for negligence in the transportation of its utility poles by its independent contractor, Urban Electrical Services. On appeal, the court reversed, finding "there is no evidence demonstrating Victoria Electric retained a right to control the activity leading to the injury and because the trial court erred in holding Victoria Electric vicariously liable for the negligence of its independent contractor."[47]

Victoria Electric, a rural electric cooperative that constructed and maintained lights and power lines for a municipality, entered into a contract with Urban Electrical Services to construct and maintain certain lines. Urban loaded utility poles onto a trailer and drove the trailer on a public highway. The utility poles extended beyond the end of the trailer and some warning devices that were required to be used were not. Elvin Williams, who was driving another vehicle on the highway, struck the extending poles and was killed. Williams' survivors brought a wrongful death action against Victoria Electric, Urban, and Urban's employee who was driving the trailer.

Before trial, the plaintiffs settled with Urban and Urban's employee. At trial, the jury assigned responsibility fifty percent to Victoria Electric,

44. *Id.* at 609.

45. Victoria Elec. Coop., Inc. v. Williams, 100 S.W.3d 323 (Tex. App.—San Antonio 2002, no pet. h.).

46. *Id.*

47. *Id.* at 325.

twenty-five percent to Urban, and twenty-five percent to Urban's employee. After applying a credit for the settlement amount, the trial court awarded judgment against Victoria Electric finding, among other facts, that Victoria Electric retained the right to control Urban's actions.[48]

In essence, the trial court based its decision on a finding that Victoria Electric negligently failed to exercise its right to control the actions of Urban and its driver, citing section 414 of the Restatement of Torts. Victoria Electric appealed, arguing that the evidence was insufficient to support a Section 414 claim. The court of appeals clarified that its decision would rest upon (1) whether Victoria Electric did retain a right to control such that a duty arose; and (2) whether a breach of the duty led to the actual injuries at issue.[49]

The court began its analysis with a discussion of section 414 of the Restatement of Torts, as well as a discussion of the holdings in *Redinger v. Living, Inc.* and *Hoechst-Celanese Corp. v. Mendez*[50] The court restated the rule of *Redinger* that an "employer's duty of care arises under section 414 only when the retained right of control is more than general or supervisory,"[51] noting that the "control must extend to the 'operative detail' of the contractor's work so that the contractor is not free to do the work in its own way."[52]

The court relied heavily upon the comments to section 414 of the Restatement, which were also cited and relied upon in the *Redinger* opinion, in support of its analysis:

> It is not enough that [the general contractor] has merely a general right to order the work stopped or resumed, to inspect its progress or receive reports, to make suggestions or recommendations which need not necessarily be followed, or to prescribe alterations and deviations. Such a general right is usually reserved to employers, but it does not mean that the contractor is controlled as to his methods of work, or as to operative detail. There must be such a retention of a right of supervision that the contractor is not entirely free to do the work in his own way.[53]

Thus, based upon the court's discussion, the inquiry is not merely control, but the quality and nature of the control that can be demonstrated in the particular case.

The court began its analysis with a review of the contract at issue to determine whether Victoria Electric retained a contractual right of control over the means, methods, or details of Urban's work. One particular

48. *Id.* at 326.

49. *Id.*

50. Redinger v. Living, Inc., 689 S.W.2d 415 (Tex. 1985); Hoechst-Celanese Corp. v. Mendez, 967 S.W.2d 354 (Tex. 1998).

51. *Victoria Elec. Coop., Inc.*, 100 S.W.3d at 326 (citing *Hoechst-Celanese Corp.*, 967 S.W.2d at 356).

52. *Id.*

53. *Id.* (quoting RESTATEMENT (SECOND) OF TORTS § 414 cmt. c (1965)).

section of the contract, entitled "Supervision and Inspection," provided as follows:

> a. The Contractor shall cause the construction work on the Project to receive constant supervision by a competent superintendent . . . who shall be present at all times during working hours where construction is being carried on. The Contractor shall also employ, in connection with the construction of the Project, capable, experienced, and reliable foremen and such skilled workmen as may be required for the various classes of work to be performed. Directions and instructions given to the Superintendent by the Owner shall be binding upon the Contractor.
> b. The Owner reserves the right to require the removal from the Project of any employee of the Contractor if in the judgment of the Owner such removal shall be necessary in order to protect the interest of the Owner. The Owner shall have the right to require the Contractor to increase the number of his employees and to increase or change the amount or kind of tools and equipment if at any time the progress of the work shall be unsatisfactory to the Owner; but the failure of the Owner to give any such directions shall not relieve the Contractor of his obligations to complete the work within the time and in the manner specified in this Proposal.
> c. The manner of performance of the work, and all equipment used therein, shall be subject to the inspections, tests, and approval of the Owner . . . .[54]

In another provision of the contract, the contractor agreed to "take all reasonable precautions for the safety of employees on the work and of the public, and shall comply with all applicable provisions of Federal, State, and Municipal safety laws and building and construction codes, as well as the safety rules and regulations of the Owner."[55]

While the court found that the various provisions of the contract showed that Victoria Electric retained some right of control over Urban, the court's ultimate decision was that the right to control was only supervisory in nature, and did not involve control over specific details of the work.[56] The court's decision also distinguished the holding in *Harrison*, based upon the particular facts of that case because "Victoria Electric did not contractually assume the burden of ensuring the safety of the traveling public" and because the owner's safety manual did not impose requirements other than those already mandated by law.[57]

III. IMPLIED WARRANTY ISSUES IN CONSTRUCTION

Issues involving implied warranties in the construction context continued to receive attention from the Texas courts in 2002. In the context of implied warranties, the supreme court finally issued its final opinion re-

54. *Id.* at 327-28.
55. *Id.* at 328.
56. *Id.* at 328-29.
57. *Id.* at 330.

garding the right of parties to a construction contract to waive the implied warranties of habitability and good and workmanlike construction. Additionally, two courts of appeals adopted the holding of a 2001 opinion that established that an owner has no direct cause of action against a subcontractor for breach of an implied warranty.

A. WAIVER OF IMPLIED WARRANTIES

In the context of general construction disputes, the supreme court issued its long-awaited opinion regarding the waiver of the implied warranty of habitability and implied warranty of good and workmanlike construction. In *Centex Homes v. Buecher*,[58] the supreme court held that both implied warranties can be waived under the proper circumstances, although only the implied warranty of good workmanship was effectively waived under the facts of the particular case.[59]

In the opinion issued in December 2002, the Texas Supreme Court withdrew its prior opinion of August 29, 2002, and substituted a new opinion which set forth the court's outline of requirements for a home builder to disclaim the implied warranties of habitability and good and workmanlike construction.[60] The opinion overruled the holding of the San Antonio Court of Appeals, which is discussed in detail below.

In *Buecher v. Centex Homes*,[61] decided by the San Antonio Court of Appeals in March 2000, the court held that a home builder would not be permitted to require a purchaser to sign what the court described as a "contract of adhesion," which waived the implied warranty of habitability and good and workmanlike construction in the context of new home construction.[62] In its holding, the court supported the continued viability of *Melody Home Manufacturing Co. v. Barnes*.[63] The court reasoned that it would be incongruous if public policy required the existence of the implied warranties, yet permitted the waiver or disclaimer of the warranties in the form of a pre-printed statement form disclaimer in a standard form contract.[64] The court rejected the builder's argument that *Melody Home* prohibits the waiver of implied warranties only in the context of the repair of tangible personal property.[65]

The homeowner argued that the waiver provision violated section 17.46(b)(12) of the DTPA. Centex argued the waiver was permissible because the homeowners would be adequately protected by the Residential Construction Liability Act. It also argued that the waiver of implied war-

58. Centex Homes v. Buecher, 95 S.W.3d 266 (Tex. 2002).
59. *Id.* at 268.
60. *Id.*
61. Buecher v. Centex Homes, 18 S.W.3d 807 (Tex. App.-San Antonio 2000, pet. granted).
62. *Id.* at 808.
63. Melody Homes Mfg. Co. v. Barnes, 741 S.W.2d 349 (Tex. 1997) (holding that the implied warranty to perform repair services in a good and workmanlike manner cannot be waived).
64. *Buecher*, 18 S.W.3d at 808.
65. *Id.*

ranties should be permitted because the express warranties provided in lieu of the implied warranties would serve "gap filler" function that the implied warranties are intended to satisfy.

The San Antonio court rejected Centex's arguments, citing the Texas Supreme Court's adoption of implied warranty law relating to new home construction from 1968,[66] as well as the law of *Melody Home.* Based upon those authorities, the San Antonio court concluded that the reasoning expressed in those cases applied equally to new home construction.[67]

On appeal, the supreme court stated that it agreed with the San Antonio Court of Appeals that the implied warranty of habitability cannot be waived except under limited circumstances not implicated in the particular case before it.[68] The court disagreed with the court of appeals' conclusion that the implied warranty of good and workmanlike construction cannot be disclaimed, holding instead that "[w]hen the parties' agreement sufficiently describes the manner, performance, or quality of construction, the express agreement may supercede the implied warranty of good workmanship."[69]

In the case before the court, Michael Buecher and other homeowners purchased new homes built by Centex Homes or Centex Real Estate Corporation. Each homeowner signed a form sale agreement prepared by Centex, which contained the following disclaimer:

> At closing Seller will deliver to Purchaser, Seller's standard form of homeowner's Limited Home Warranty against defects in workmanship and materials, a copy of which is available to Purchaser. PURCHASER AGREES TO ACCEPT SAID HOMEOWNER'S WARRANTY AT CLOSING IN LIEU OF ALL OTHER WARRANTIES, WHATSOEVER, WHETHER EXPRESSED OR IMPLIED BY LAW, AND INCLUDING BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF GOOD WORKMANLIKE CONSTRUCTION AND HABITABILITY. PURCHASER ACKNOWLEDGES AND AGREES THAT SELLER IS RELYING ON THIS WAIVER AND WOULD NOT SELL THE PROPERTY TO PURCHASER WITHOUT THIS WAIVER.[70]

Following the purchase of their homes, Buecher and others sued Centex for fraud, misrepresentation, negligence, and violations of the Texas Deceptive Trade Practices Act.

The Texas Supreme Court began its analysis of the question of whether and when implied warranties can be waived with a review of its decision in *Humber v. Morton,*[71] where the court originally recognized that a builder of new homes impliedly warrants that the residence is constructed in a good and workmanlike manner and is suitable for human habita-

66. *Id.* at 811 (citing Humber v. Morton, 426 S.W.2d 554 (Tex. 1968)).
67. *Id.*
68. Centex Homes v. Buecher, 95 S.W.2d at 268.
69. *Id.*
70. *Id.*
71. Humber v. Morton, 426 S.W.2d 554 (Tex. 1968).

tion.[72] The court recalled that, in imposing the warranties that superceded the concept of *caveat emptor*, it recognized both the significance of the purchase of a new home for most buyers as well as the difficulty in discovering or guarding against latent defects in construction.[73]

Next, the court discussed the development of the doctrines in its *G-W-L, Inc. v. Robichaux*[74] opinion, where it established the rule that the "Humber warranty" could be disclaimed or waived if the parties' agreement clearly expressed that intent.[75]

Finally, the court addressed the impact of *Melody Home Manufacturing Co. v. Barnes*[76] on the implied warranties. In *Melody Home*, the supreme court recognized the implied warranty of good workmanship in the repair or modification of tangible goods or property and further held that, as a matter of public policy, the implied warranty for repair services could not be waived or disclaimed.[77] The court's discussion in that case noted the incongruity of requiring the creation of an implied warranty, but permitting its waiver by a pre-printed, standard form suggesting that such disclaimers should not be allowed because they encouraged shoddy workmanship.[78] At the conclusion of that opinion, the supreme court purported to overrule *Robichaux* "[t]o the extent that it conflicts with this opinion."[79]

In the *Buecher* opinion, the Texas Supreme Court noted that the meaning and scope of the court's prior statement regarding overruling *Robichaux* was ambiguous because it is not clear to what extent *Robichaux* and *Melody Home* actually conflict, since they address different subject matters and different implied warranties.[80] Since the holding of *Melody Home* had cast some doubt regarding the validity of the *Robichaux* opinion, the supreme court re-visited its analysis in *Robichaux*.

In the context of the *Robichaux* case, which addressed an alleged defective roof on a new home, the trial court rendered judgment for the buyers based upon a jury finding that the builder failed to construct the roof in a good workmanlike manner and that the home was not merchantable at the time of completion. The supreme court reversed and rendered judgment for the builder holding that the implied "warranty of merchantability" was a sales warranty under the UCC, which did not apply to a house.[81] Further, the court determined there were, based upon the language in the sales documents, no warranties, express or implied, of any kind and that the written documents sufficiently disclaimed any im-

72. *Id.* at 555.
73. Centex Homes v. Buecher, 95 S.W.3d at 269.
74. G-W-L, Inc. v. Robichaux, 643 S.W.2d 392 (Tex. 1982).
75. *Id.* at 393.
76. Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349 (Tex. 1987).
77. *Id.* at 354-55.
78. *Id.* at 355.
79. *Id.*
80. Centex Homes v. Buecher, 95 S.W.3d at 270.
81. G-W-L, Inc. v. Robichaux, 643 S.W.2d 392, 394 (Tex. 1982).

plied warranty of habitability.[82] However, the court's opinion did not distinguish between the separate warranties of habitability and good workmanship. Moreover, the analysis did not discuss any of the public policy considerations for the implied warranty of habitability.

In *Buecher*, Centex Homes argued that the court should adhere to the *Robichaux* holding because it was consistent with the decisions from other states allowing the disclaimer of implied warranties that arise in the context of a sale of a new home. The supreme court noted, after reviewing the various states' opinions, that "[a]ll of these cases either ignored the implied warranty of habitability or treat it as part of the implied warranty of good workmanship."[83] The court found that point important, since Texas does recognize the implied warranty of good workmanship and the implied warranty of habitability as separate warranties.

The supreme court concluded that "[t]he implied warranty of good workmanship focuses on the builder's conduct, while the implied warranty of habitability focuses on the state of the completed structure."[84] The implied warranty of good workmanship recognizes that a home builder must perform with at least a minimal standard of care, and "requires the builder to construct the home in the same manner as would a generally proficient builder engaged in similar work and performing under similar circumstances."[85] The court noted that the implied warranty of good workmanship is a "gap-filler" or "default warranty" and applies only if and when the parties express a contrary intention.[86]

In contrast, the implied warranty of habitability looks at the finished product and is more limited in scope, protecting the buyer from defects that defeat the basis of their bargain.[87] In essence, "it requires the builder to provide a house that is safe, sanitary, and otherwise fit for human habitation," and protects the buyer from "conditions that are so defective that the property is unsuitable for its intended use as a home."[88]

The court noted that the two warranties do parallel each other, and may overlap in certain circumstances since a builder's inferior workmanship may render a home unsafe.[89] It also noted carefully the reason for the separate existence of the warranties and the public policy underlying the implied warranty of habitability. The court emphasized that it originally created the *Humber* warranties in order to protect the average home buyer who lacks the expertise to discover latent construction defects. In defining the way it would ultimately separate the warranties, the court concluded that while "the parties are free to define for themselves the quality of workmanship, there is generally no substitute for

82. *Id.* at 393.
83. Centex Homes v. Buecher, 95 S.W.3d at 272.
84. *Id.* at 272-73.
85. *Id.* at 273.
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*

habitability."[90]

Therefore, the court held that the warranty of habitability is an essential part of a new home sale and that the warranty of habitability can be waived only to the extent that defects are adequately disclosed to the buyer.[91] The court's example of where the waiver might apply was in the context of a sale of a problem home, where the buyer had express and full knowledge of defects that might affect its habitability. The court ultimately concluded the implied warranty of habitability, which extends to latent defects only, cannot be disclaimed generally, but does not apply to known defects, even substantial ones, that are disclosed to the buyer.[92]

In contrast, the court found that the implied warranty of good workmanship defines the level of performance expected when the parties do not expressly define that standard in their contract, functioning as a "gap-filler" in that respect.[93] As a result of that analysis, the court found that the parties can have an agreement that supersedes the "gap-filler" or implied warranty, but cannot simply disclaim it.[94] Therefore, the implied warranty of good workmanship may be impacted or overridden when the "agreement provides for the manner, performance or quality of the desired construction."[95]

B. No Direct Cause of Action for Implied Warranties Against Subcontractors

Two courts of appeals followed the Austin court's 2001 decision in *Codner v. Arellano*,[96] where it set forth the rule that a property owner has no direct cause of action against a subcontractor for breach of implied warranties.[97] In *Raymond v. Rayme*,[98] decided by the Austin Court of Appeals, and *J.M. Krupar Construction Co., Inc. v. Rosenberg*,[99] decided by the Houston Court of Appeals, the courts re-stated the rule of *Codner v. Arellano* and refused to recognize a direct cause of action between an owner and subcontractor. Both decisions are discussed in more detail in sections that follow.

IV. SOVEREIGN IMMUNITY

The issue of sovereign immunity and the interpretation of the various administrative proceedings which have been created by statute continue to be hot topics for the Texas Supreme Court, which issued still more

90. *Id.* at 274.
91. *Id.*
92. *Id.* at 274-75.
93. *Id.* at 275.
94. *Id.* at 274.
95. *Id.* at 275.
96. Codner v. Arellano, 40 S.W.3d 666 (Tex. App.—Austin 2001, no pet.).
97. *Id.* at 672-74.
98. Raymond v. Rahme, 78 S.W.3d 552 (Tex. App.—Austin 2002, no pet. h.).
99. J.M. Krupar Constr. Co. v. Rosenberg, 95 S.W.3d 322 (Tex. App.—Houston [1st Dist.] 2002, no pet. h.).

opinions on these subjects over the last year. While the new opinions tend to state the general established rules regarding waiver by conduct, they have also continued to explain where the rule may not apply and where waiver of suit may still exist.

The Texas Supreme Court's 2001 decision provides the background for this year's new decisions on sovereign immunity. In *General Services Commission v. Little-Tex Insulation Co., Inc.*,[100] the supreme court addressed the issue of waiver within the context of a sovereign immunity claim. The case and its decision focused on the issue of waiver by conduct and specifically the argument by the contractors that the state waived immunity by merely accepting the benefits of the contract. The contractors in the case argued that chapter 2260 of the Texas Government Code did not apply to waiver-by-conduct cases because "a party seeking redress under a waiver-by-conduct theory is not seeking permission under Chapter 107."[101]

The Texas Supreme Court refused to adopt the plaintiffs' arguments in the consolidated cases, concluding "that there is but one route to the courthouse for breach-of-contract claims against the State, and that route is through the Legislature."[102] The supreme court concluded that, under the new scheme set forth in the Government Code, "a party simply cannot sue the State for breach of contract absent legislative consent under Chapter 107. Compliance with Chapter 2260, therefore, is a necessary step before a party can petition to sue the State."[103]

In 2002, the supreme court's opinions appeared to have a much more liberal approach to sovereign immunity, even specifically describing exceptions to the doctrine that exist. The recent changes in the justices who occupy seats on the supreme court may signal that a refinement of the court's prior opinions may be forthcoming.

A. THE 2002 SUPREME COURT PERSPECTIVE: *IT-DAVY*

One significant sovereign immunity opinion from the Supreme Court in 2002 was *Texas Natural Resource Conservation Commission v. IT-Davy*.[104] The issue presented in the case was whether IT-Davy, a general contractor, could sue the Texas Natural Resource Conservation Commission ("TNRCC"), a state agency, for breach of contract where IT-Davy argued that it had fully performed under its contract, but the TNRCC did not fully pay for services it accepted. In response to the lawsuit, the TNRCC filed a plea to the jurisdiction, arguing that sovereign immunity barred the contractor's claims. The trial court denied the jurisdictional plea, and the court of appeals affirmed because it found that the TNRCC's conduct had waived its immunity from suit. The supreme court

100. Gen. Servs. Comm'n v. Little-Tex Insulation Co., 39 S.W.3d 591 (Tex. 2001).
101. *Id.* at 596.
102. *Id.* at 597.
103. *Id.*
104. Tex. Natural Res. Conservation Comm'n v. IT-Davy, 74 S.W.3d 849 (Tex. 2002).

reversed, based upon the particular facts of the case.[105]

IT-Davy provided services to clean up a hazardous waste site in Houston for the TNRCC. IT-Davy fully performed under its contract, and was paid its original contract price. However, IT-Davy alleged that it incurred additional expenses and lost profits because of materially different site conditions and that its contract provided for "equitable adjustments" in the event of materially different conditions. Following meetings and an informal mediation, the parties still could not agree upon the amount of equitable adjustment due. IT-Davy sought to arbitrate under the terms of its contract, but the TNRCC refused to do so. Without obtaining legislative consent, IT-Davy filed suit in the district court in Travis County seeking a declaration of its rights under the contract and damages for breach of contract and other claims.

The TNRCC lost its plea to the jurisdiction on the grounds of sovereign immunity at the trial court and appellate court levels, where the courts found that the TNRCC's conduct, beyond the mere execution of the contract, was sufficient to waive immunity from suit.[106] The Texas Supreme Court reviewed the decision, based upon an interlocutory appeal under Texas Government Code sections 22.225 and 22.001, because of the conflict between the particular decision and the most recent supreme court decisions.[107]

The Texas Supreme Court began its analysis with the basics: the difference between immunity from suit and immunity from liability. The court's decision cited two purported rules: (1) "Immunity from suit bars a suit against the State unless the Legislature expressly consents to the suit;"[108] and (2) "Immunity from liability protects the State from money judgments even if the Legislature has expressly given consent to sue."[109] The court also expressed its general approach to sovereign immunity: deference to the Legislature with respect to consent to suit, as a protection to the Legislature's policymaking function.[110]

The court also noted the general rules that when the State contracts with a private party, it waives immunity from liability, but does not necessarily waive immunity from suit.[111] The court also noted the available remedies to private parties for the State's breach of contract: (1) seeking consent from the Legislature to sue; or (2) pursuing administrative remedies under chapter 2260 of the Texas Government Code.[112]

IT-Davy argued that its right to sue arose from four separate grounds: "(1) the TNRCC's accepting full contractual benefits; (2) the TNRCC's entering into a contract with express terms allowing the parties to resolve

105. *Id.* at 851.
106. *Id.*
107. *Id.* at 852.
108. *Id.* at 853.
109. *Id.*
110. *Id.* at 854.
111. *Id.*
112. *Id.*

disputes in court; (3) legislative consent in . . . the Water Code; and (4) legislative consent in the Declaratory Judgment Act."[113] The supreme court rejected all four grounds.

With respect to the waiver-by-conduct argument, the court cited its *Little-Tex* decision that chapter 2260's administrative remedies foreclose the waiver-by-conduct exception for contracts entered into after 1999.[114] Since the contract at issue was from 1990, the court did conduct a brief analysis of the waiver-by-conduct doctrine, but concluded that merely accepting the benefits of a contract is not sufficient to establish waiver.[115] The court also rejected the contract argument (that the terms of the agreement included a provision stating that all claims would be decided by arbitration or in court), finding that the terms of the TNRCC's agreement cannot trump the Legislature's sole power to waive sovereign immunity.[116] The court similarly concluded that the provisions of the Water Code and the Declaratory Judgments Act did not apply to IT-Davy's claims.[117]

In its conclusion, the court noted again its "one route to the courthouse" rule and emphasis on Legislative consent.[118] However, the concurring opinion by Justice Hecht contains perhaps the most significant analysis and perhaps a hint about the future direction of the analysis of sovereign immunity. The concurrence stated that it agreed with the ultimate holding of the court, but disagreed with the broad language used by Justice Baker in the majority opinion. Justice Hecht noted that he doubted "whether governmental immunity from suit for breach of contract can be applied so rigidly," but declined to decide any broader issues not presented by the facts of the case.[119]

The most interesting portions of Justice Hecht's concurring opinion, which was joined by three other justices, related to the various exceptions to the sovereign immunity doctrine that exist, most notably waiver by filing suit. The *IT-Davy* concurrence reads, in pertinent part, as follows:

> In his opinion for the Court in *Federal Sign v. Texas Southern University*, Justice Baker noted that there may be "circumstances where the State may waive its immunity by conduct other than simply executing a contract so that it is not always immune from suit when it contracts." In his opinion today he appears to have abandoned this view, stating that "allowing . . . governmental entities to waive immunity by conduct that includes accepting benefits under a contract would be fundamentally inconsistent with our established jurisprudence." He does not explain this about-face. The Court was correct in *Federal Sign*. As one example, it has long been held that the State can waive immunity by filing suit. There may be others, such as debt

113. *Id.* at 856.
114. *Id.*
115. *Id.* at 857.
116. *Id.* at 858.
117. *Id.* at 858-60.
118. *Id.* at 860.
119. *Id.* (Hecht, J., concurring).

> obligations. We need not here decide the issue for all time, any more than we needed to in *Federal Sign*.[120]

Justice Enoch authored a strong dissent in *IT-Davy* that challenged application of sovereign immunity to contract disputes in general.

The future of sovereign immunity will be interesting to track. Justice Baker, who authored the opinions that expanded sovereign immunity in other contexts in *Federal Sign, Little-Tex, and IT-Davy*, is no longer a member of the Texas Supreme Court. Consequently, at least four current members of the Texas Supreme Court have unequivocally endorsed the exception to immunity where the government instituted the suit in question, as well as other possible exceptions. There are no current justices who have authored any opinions that even imply to the contrary. The recognition of these exceptions is an important concession by a supreme court that has searched for ways to extend the immunity of the State and its subdivisions, because it strongly indicates that the supreme court, going forward, may be unwilling to adopt a blanket doctrine of sovereign immunity.

B. The Supreme Court's Analysis of Administrative Remedies and Immunity

In June 2002, the supreme court issued its opinion in *Texas Department of Transportation v. Jones Brothers Dirt & Paving Contractors, Inc*,[121] which addressed a narrow subset of the sovereign immunity question: certain claims involving the Texas Department of Transportation and highway construction projects. In that case, the supreme court found that the Texas Transportation Code provided the exclusive remedy for the contractor's claims for breach of contract and declaratory relief.[122]

Jones Brothers contracted with the Department of Transportation ("TxDOT") for the construction of roads in Presidio County. During the project, TxDOT discharged a subcontractor of Jones Brothers for allegedly attempting to bribe a TxDOT inspector. Jones Brothers could not secure another subcontractor, forcing it to complete the work itself. The changes in the project caused the completion to be delayed and TxDOT assessed liquidated damages against Jones Brothers for failing to meet the contract deadline.

Jones Brothers initiated administration proceedings under the Transportation Code to recover additional costs on the project and a refund of the liquidated damages assessed against it. TxDOT's claims committee denied Jones' claim. Jones Brothers then requested a contested case hearing in the State Office of Administrative Hearings under section 201.112 of the Transportation Code. Its claim for damages was rejected, but the liquidated damages were reversed. TxDOT adopted the findings

120. *Id.* at 860-61 (internal citations omitted).

121. Tex. Dep't of Transp. v. Jones Bros. Dirt & Paving Contractors, Inc., 92 S.W.3d 477 (Tex. 2002).

122. *Id.* at 429.

of the administrative law judge. Jones Brothers then sought review of TxDOT's decision in the district court. At that time, Jones Brothers also raised claims for breach of contract and sought recovery of its attorneys' fees. TxDOT asserted sovereign immunity as a defense. The trial court affirmed the reversal of the liquidated damages, but reversed the order denying additional damages and rendered judgment in favor of Jones Brothers for damages and attorneys' fees. The court of appeals remanded the case to the trial court, finding that the trial judge had failed to rule upon the State's plea to the jurisdiction.

On appeal to the supreme court, TxDOT argued that Jones Brothers' sole remedy was through the administrative process, and that the trial court lacked jurisdiction over the original claims filed. In its decision, the supreme court cited the 1997 amendments to the Transportation Code, which established an administrative procedure through which parties could resolve disputes with TxDOT.[123] The court cited the Legislature's comment that the statutory procedure would be the exclusive remedy for determining contract disputes between TxDOT and private parties.[124]

Based upon its reading of the Transportation Code, the supreme court concluded that the court of appeals erred in remanding Jones' claims to the trial court for repleading because the Code provided the exclusive remedy for the contract claims.[125] The court noted that, regardless of how the claims might be pleaded, they would be subject to the administrative process and could not be reviewed by a trial court.[126]

V. MECHANIC'S AND MATERIALMAN'S LIENS AND RETAINAGE RIGHTS

A. LIEN DEADLINES, PRIVITY, AND IMPLIED WARRANTIES

In *Raymond v. Rahme*,[127] the Austin Court of Appeals addressed the issues of timeliness of a claimed mechanic's lien and the relationship, if any, between a property owner and subcontractor in the context of breach of contract and implied warranty claims. Raymond was a concrete subcontractor on a construction project to build a gas station on Rahme's property. As a result of a payment dispute on the project, Raymond attempted to file and foreclose a mechanic's lien on the property. Rahme, the property owner, counterclaimed for breach of contract, breach of warranty, and violations of the Deceptive Trade Practices Act. Following a bench trial, Rahme was awarded more than $65,000 on his claims. Raymond appealed, arguing that the trial court erred in finding that he failed to properly perfect his lien, breached the construction contract, and breached implied and express warranties.

123. *Id.* at 484 (citing TEX. TRANSP. CODE ANN. § 201.112 (Vernon 1999)).
124. *Id.*
125. *Id.* at 485.
126. *Id.*
127. Raymond v. Rahme, 78 S.W.3d 552 (Tex. App.—Austin 2002, no pet. h.).

The disputes arose from a contractual arrangement whereby Rahme hired JMT as a general contractor to construct the gas station. JMT had an oral contract with Raymond to perform the concrete work on the project. Beginning in September 1996, Raymond performed various work on the project. When JMT did not pay Raymond all of the fees Raymond asserted he was due, Raymond ceased work on the project. Raymond wrote Rahme a letter dated February 5, 1997, asserting that Rahme and JMT owed him more than $15,000 for his work. On February 8, 1997, Raymond signed an affidavit for a mechanic's lien, but did not file the affidavit in the real property records. On April 4, 1997, Raymond signed a second affidavit for a mechanic's lien, filed it in the real property records, and sent a copy of the document with a payment demand to Rahme and JMT.

When neither Rahme nor JMT paid Raymond, Raymond sued them for breach of contract and to foreclose the lien. Rahme answered that Raymond had not used the proper grade or thickness of concrete and had improperly performed his work, which had led to premature cracking and the need to remove and replace the defective concrete. Raymond settled with JMT and JMT paid Raymond $6,900.

Following the bench trial between Rahme and Raymond, the trial court entered a take nothing judgment against Raymond and ordered the lien extinguished. The court awarded more than $65,000 in damages to Rahme, as discussed above. Following a lengthy discussion of the factual testimony in the case, the court analyzed the mechanic's lien issue and chapter 53 of the Texas Property Code.

In its discussion, the court referred to a subcontractor's rights as a derivative claimant who must rely upon statutory lien remedies in any claim asserted against the owner of property.[128] A subcontractor may therefore seek recovery from "trapped" funds (funds not yet paid to the original contractor at the time the owner receives notice that a subcontractor has not been paid) held by a property owner or funds "retained" (fund withheld from the original contractor under the agreement or under section 53.101 of the Property Code) by a property owner.[129]

Moreover, in order to perfect a lien, the subcontractor must substantially comply with chapter 53 of the Texas Property Code, which includes giving notice to the owner "of the debt no later than 'the 15th day of the third month following each month' in which the subcontractor worked or provided materials."[130] The notice must include "a warning stating that the owner may be held personally liable and his property subjected to a lien unless he withholds payments from the original contractor."[131] If the subcontractor fails to provide such notices then the lien is not valid. Further, the subcontractor must file a lien affidavit in the real property

128. *Id.* at 559 (citing First Nat'l Bank v. Sledge, 653 S.W.2d 283, 285 (Tex. 1983)).
129. *Id.* at 559-60.
130. *Id.* at 560 (citing TEX. PROP. CODE ANN. § 53.056 (Vernon 1995)).
131. *Id.* (citing TEX. PROP. CODE ANN. § 53.056(d) (Vernon 1995)).

records of the county where the property is located no later than "the 15th day of the fourth calendar month after the day on which the indebtedness accrues."[132]

In analyzing the facts of the case, the Austin court concluded that the evidence at trial established that Raymond did not perform work after November 1996, indicating that the debt accrued on November 30, 1996. Thus, in order to assert a valid lien, the court found that Raymond would have had to file his lien affidavit no later than March 15, 1997, and to give the statutory notice no later than February 15, 1997. The court found that Raymond had complied with neither requirement and therefore did not perfect his lien.[133]

Next, the Austin court analyzed Raymond's argument that the trial court erred in holding him liable for breach of contract to the property owner. The court made short work of its analysis on that particular claim finding that no privity of contract existed between Rahme (as owner) and Raymond (as subcontractor). The court restated the well-accepted principle that "[a] person who is not party to a contract may not recover for breach of contract unless the person is a third-party beneficiary."[134] The court also noted that the law provides a presumption against third-party beneficiary status and that contracts between property owners, general contractors, and subcontractors are governed by the general rules.[135] "[A]bsent clear evidence to the contrary, a property owner is not considered a third-party beneficiary of a contract between a general contractor and a subcontractor."[136] Since there was no privity of contract between Rayme and Raymond, the court reversed the judgment of the trial court on the issue of breach of contract.[137]

In addition, the court addressed the issues of both express warranties and implied warranties. The court found, based upon the facts of the case, that Raymond did not breach the express warranty provided.[138] More interestingly, however, the court restated its own rule, as adopted in a 2001 decision, that "a property owner may not recover under an implied warranty theory from a subcontractor with whom the owner has no direct contractual relationship."[139] The court again emphasized that the property owner's remedy is against its general contractor with whom he contracted and that there is no public policy reason to impose an implied warranty against a subcontractor.[140]

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132. *Id.* (citing TEX. PROP. CODE ANN. § 53.052(a) (Vernon 1995)).
133. *Id.* at 561.
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.* at 562.
138. *Id.* at 563.
139. *Id.* (citing Codner v. Arellano, 40 S.W.3d 666, 672-74 (Tex. App.—Austin 2001, no pet.)).
140. *Id.*

B. Lien Enforcement and Funds Trapping

In an unpublished opinion in 2002, the Houston Court of Appeals reviewed the issues of lien enforcement and funds trapping in *Page v. Marton Roofing, Inc.*[141] In April 2003, the Texas Supreme Court reversed the decision of the Houston court.[142] Both decisions are analyzed here.

In 1997, Page entered into an oral contract with Custom Concrete, to remodel and expand a building in Houston for $300,000. Page made periodic payments to Custom Concrete totaling $270,000. MRI was a subcontractor on the project. MRI completed its portion of the work on the project in March 1998. In April 1998, the contractor demanded that Page advance additional funds to complete the work, but Page refused and terminated the contract.

Page then hired replacement contractors to complete the work and paid them a total of $30,657. The project was complete in July 1998, and the last payment was made at that time. When the original contractor failed to pay MRI, MRI sent notices of claims for more than $26,000 to the owner and contractors. MRI filed an affidavit for a mechanic's lien on June 15, 1998 and provided a copy to the owner. Both parties moved for summary judgment, and the trial court entered judgment in favor of MRI. Page then appealed, arguing that the trial court erred in concluding that MRI timely filed a perfected lien and complied with the fund-trapping provisions of the Property Code.

Because the contract at issue was from 1997, the Houston court analyzed the version of the Property Code in effect at that time, noting that the owner was required to retain 10% of the contract price for 30 days after work was completed, and that a claimant can perfect a lien on the retained funds if he provides the proper notices and files an affidavit claiming a lien not later than the 30th day after the work is completed.[143] While the parties acknowledged that MRI sent a proper notice, and that Page properly retained funds on the project, they disagreed about whether the affidavit was timely filed.

The Houston court applied the statutory definitions of the terms "work" and "completion." The term "work" is "any part of construction of repaid performed under an original contract,"[144] while "completion" is "the actual completion of the work, including any extras or change orders reasonably required or contemplated under the original contract, other than warranty or repair work."[145]

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141. No. 01-01-00737-CV, 2002 Tex. App. LEXIS 5614, at *1 (Tex. App.—Houston [1st Dist.] Aug. 1, 2002, no pet. h.).

142. Page v. Marton Roofing, Inc., No. 02-0845, 2003 Tex. LEXIS 41, at *1 (Tex. Apr. 3, 2003).

143. Page v. Marton Roofing, Inc., No. 01-01-00737-CV, 2002 Tex. App. LEXIS, at *4 (citing Tex. Prop. Code Ann. §§ 53.101, 53,103 (Vernon 1995)).

144. *Id.* at *6 (citing Tex. Prop. Code Ann. § 53.001(14) (Vernon 1995)).

145. *Id.* (citing Tex. Prop. Code Ann. § 53.106(e) (Vernon 1995)).

Page contended that work was completed when the original contractor demanded additional funds and the owner terminated it (April 1998). MRI contended that completion occurred in July 1998, when the other subcontractors completed the scope of work outlined in the original contract. The Houston court, after reviewing various authorities cited by the two sides, concluded that work is "completed" under an original contract when there is actual completion of all of the work under that original contract, even in a situation where the original contractor was terminated.[146] Accordingly, the Houston court concluded that completion occurred in July 1998, and that MRI's lien affidavit was timely filed.[147] The Houston court also concluded that nothing in the Property Code prevents a subcontractor from perfecting a lien separate from the original contractor's on retainage, and that because the fund-trapping provisions have been held to benefit the subcontractor separate and apart from the contract, the lien was valid.[148]

The Texas Supreme Court disagreed with the reasoning and conclusions of the Houston Court of Appeals, and reversed the judgment in April 2003.[149] In its opinion, the supreme court cited the rule it had adopted that "work must be defined in relation to a particular contract."[150] The supreme court therefore concluded that a subcontractor must file its lien affidavit within thirty days of the time that the original contract is completed, terminated, or abandoned.[151] Because Marton Roofing filed its affidavit two months after the original contract on the project was terminated, Marton Roofing's affidavit was untimely and did not perfect a lien on the retainage.[152]

The supreme court also found that Marton Roofing's attempt to perfect a fund-trapping lien failed for similar reasons.[153] The court found that it was undisputed that Page neither made nor owed any further payments to the original contractor at any time after Page received notice of Marton Roofing's claims. Once again, the court held that fund-trapping liens must be judged in relation to individual original contracts, just as retainage liens.[154] Marton Roofing's notice authorized Page to withhold funds from the original contractor which hired Marton Roofing. Page was not authorized to withhold funds from replacement contractors which had no relationship to Marton Roofing. Accordingly, the Court found that Page could not be liable under any fund-trapping statutes for funds paid to replacement contractors.[155]

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146. *Id.* at *9.
147. *Id.*
148. *Id.* at *11-12.
149. Page v. Marton Roofing, Inc., No. 02-0845; 2003 Tex. LEXIS 41 (Tex. Apr. 3, 2003).
150. *Id.* at *2-3.
151. *Id.* at *3 (citing TEX. PROP. CODE ANN. § 53.101 (Vernon 1995)).
152. *Id.*
153. *Id.*
154. *Id.* at *4.
155. *Id.*

VI. THE SUBSTANTIAL PERFORMANCE DOCTRINE

In 2002, the appellate courts addressed two separate interesting cases on the doctrine of substantial performance and its relationship to a party's ability to sue for breach of a construction contract.

A. THE RELATIONSHIP BETWEEN SUBSTANTIAL COMPLETION AND JURY FINDINGS

In *Movie Grill Concepts I, Ltd. v. CCM Group, Inc.*,[156] the Dallas Court of Appeals addressed the question of possibly conflicting jury findings on the issues of substantial completion and breach of contract.

Movie Grill contracted with CCM to renovate a movie theater and the parties signed an original contract and various change orders. CCM sued Movie Grill alleging that CCM substantially performed but that Movie Grill failed to pay all it owed on the contract. CCM alleged that Movie Grill owed more than $310,000 after allowing for credits and offsets. CCM filed claims for breach of contract, sworn account, quantum meruit, and fraud, among others. Movie Grill's counterclaim alleged that CCM failed to complete the renovation for the agreed price and failed to perform in a good and workmanlike manner, thus breaching the contract.

The jury found that both CCM and Movie Grill breached the contract, that Movie Grill was excused from compliance with the agreements because of CCM's material breach, that CCM substantially performed, and that the value of the performance was $70,445. Movie Grill appealed and argued that the trial court erroneously entered judgment for CCM because the jury's finding that CCM substantially performed was irrelevant considering the finding that Movie Grill was excused from further performance.

A careful review of the factual findings by the jury would raise some questions regarding the consistency of the findings, but the court of appeals found that it was required to reconcile apparent conflicts in the findings if reasonably possible in light of the pleadings and evidence.[157] In response to question 1, the jury found that both CCM and Movie Grill failed to comply with the agreements. In question 3, the jury found that Movie Grill's failure to comply was excused by CCM's failure to comply with material obligations of the agreement. In question 9, the jury found that CCM had substantially performed under the contract. CCM argued that nothing in the record showed that questions 3 and 9 addressed the same facts and the Dallas court agreed that it could not say, as a matter of law, that the findings conflicted.[158]

Movie Grill also argued that a finding of material breach by CCM precluded recovery on a substantial performance theory. The court held that the substantial performance doctrine is a doctrine that allows breaching

156. Movie Grill Concepts I, Ltd. v. CCM Group, Inc., No. 05-02-00892-CV, 2002 Tex. App. LEXIS 8934 (Dallas Feb. 27, 2003, pet. filed).

157. *Id.* at *4.

158. *Id.* at *7.

parties who have substantially completed their obligations to recover on a contract.[159] The court specifically referred to the doctrine that when a contractor had substantially performed a building contract, he is entitled to recover the contract price less the cost to remedy the defects that can be remedied.[160] The court also referred to the measure of damages for an owner when a contractor is in breach, which is the cost of completing the job or of remedying those defects that can be remedied.[161]

The court then found that two additional questions addressed the issues of remediable defects, where the jury found that there were no damages to Movie Grill based upon CCM's breach of the contract. As a result, the court upheld the jury verdict.[162]

B. The Impact of Substantial Completion

In *Celtic Constructors, Inc. v. Van Pelt,*[163] the Houston Court of Appeals addressed the question of whether a party who only substantially complies with a construction contract can sue for breach of contract. The Van Pelts entered into a construction contract with Celtic to remodel a home. Celtic stopped work before completion of the job because it alleged the Van pelts had stopped paying as agreed. Celtic sued the Van Pelts for breach of contract and quantum meruit. The Van Pelts counterclaimed, arguing that Celtic had not performed in a good and workmanlike manner. The trial court granted Celtic's motion for summary judgment on the counterclaims and Celtic's claims were tried to a jury. The court granted the Van Pelt's motion for a directed verdict on the issue of breach of contract. The jury, proceeding on the quantum meruit claim, found that the Van Pelts failed to comply with the agreement and that the reasonable value of the work performed by Celtic was $56,570.

With respect to the breach of contract action, the court held that "a party to a contract who is in default cannot maintain a suit for its breach."[164] The court recognized the exception to the rule in the context of construction projects where a party can establish that it has substantially completed work on the project.[165] In that claim, "the contractor has the burden of proving that it did substantially perform."[166]

Since it was uncontroverted that Celtic did not complete the contract, the only contract cause of action at trial could have been substantial performance. However, Celtic did not plead substantial performance. The court therefore concluded that the evidence of Celtic failure to complete

159. *Id.*
160. *Id.* (citing Vance v. My Apartment Steak House of San Antonio, Inc., 677 S.W.2d 480, 481 (Tex. 1984)).
161. *Id.* at *8.
162. *Id.* at *10.
163. Celtic Constructors, Inc. v. Van Pelt, No. 01-02-00012-CV (Houston [1st Dist.] Dec. 12, 2002, no pet. h.) (not designated for publication), 2002 Tex. App. LEXIS 8861.
164. *Id.* at *8.
165. *Id.* (citing Vance v. My Apartment Steak House of San Antonio, Inc., 677 S.W.2d 480, 481 (Tex. 1984)).
166. *Id.* at *8-9.

the contract, along with the fact that it failed to plead substantial performance, prevented Celtic's right to judgment on a breach of contract claim.[167]

VII. THE STATUTE OF LIMITATIONS AND DISCOVERY RULE

In 2002, the appellate courts had an opportunity to review the applicability of the discovery rule in the context of the limitations defense in construction defect cases. The courts uniformly applied the "reasonable diligence" standard for discovery by homeowners and emphasized that it is the burden of the owner to plead and prove the discovery rule's application to the facts of a case.

A. THE DISCOVERY RULE AND KNOWLEDGE OF EXPERT REPORTS

The Houston Court of Appeals had the opportunity during 2002 to review, in depth, the issue of the applicable statutes of limitations and the applicability of the discovery rule in the context of a construction dispute. In *J.M. Krupar Construction Co. v. Rosenberg*,[168] the court concluded that a homeowner should have discovered a subcontractors' alleged acts or omissions to the contractor as they related to the construction of the foundation whether presented in terms of negligence, breach of warranty, or otherwise, and therefore their claims were barred.[169] In that case, the home owner, Rosenberg, sued builder Abercrombie Builders for violations of the Residential Construction Liability Act and the Deceptive Trade Practices Act for damages resulting from the faulty design and construction of the owner's home. Abercrombie Builders filed a separate suit against Krupar, the builder of the foundation. Rosenberg intervened in Abercrombie Builders' lawsuit and non-suited the first suit. The jury found in favor of Rosenberg on his claims against Abercrombie Builders and Krupar and in favor of Abercrombie Builders in its claims against Krupar. Krupar appealed, arguing that limitations barred the recoveries.

The court found that Rosenberg noticed a crack in an exterior wall and an interior wall in the fall of 1992. The architect and builder inspected the cracks discovered by the owner and advised that they were caused by normal settling. Rosenberg hired an independent engineer to obtain a second opinion in February 1993. The engineer provided a written report detailing cracks and separations and made various suggestions for additional investigations. In May 1993, the owner challenged the tax assessed value of the house based upon the engineer's report of foundation problems. Following certain repairs, the cracks re-appeared in the fall of 1993. Rosenberg called another engineering firm, which issued a report indicating a failure of the foundation and a need for immediate repair.

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167. *Id.* at *10.

168. J.M. Krupar Constr. Co. v. Rosenberg, 95 S.W.3d 322 (Tex. App.—Houston [1st Dist.] 2002, no pet. h.).

169. *Id.*

Over the next two years, the house was inspected various times. In the fall of 1995, core drilling revealed that the slab was not built on a pad of select fill and that there was no pad at all. Rosenberg filed suit against Abercrombie Builders in December 1994. Abercrombie Builders filed its suit against Krupar in July 1996. Abercrombie Builders permitted Rosenberg to non-suit his original suit and to intervene in the second suit and agreed not to raise limitations in the second suit.

During the trial, Rosenberg and Abercrombie Builders reached a settlement. The jury found Abercrombie Builders and Krupar liable for negligence and breach of warranty and assigned responsibility 60% to Krupar and 40% to Abercrombie Builders. The jury also found that Krupar engaged in a false, misleading, or deceptive act or practice.

On appeal, Krupar alleged that a two-year limitations period barred the negligence and DTPA claims and that a four-year limitations period barred the breach of implied warranty claim. Krupar argued that, even if the discovery rule applied, the evidence did not support a finding that Rosenberg should, in the exercise of reasonable diligence, not have discovered the defects until 1995. Krupar argued that the limitations period was tolled, if at all, until fall 1992 or fall 1993.

The court noted that the "discovery rule is a limited exception to the statute of limitations" and is applied when the nature of the injury in inherently undiscoverable.[170] Under the DTPA and common law causes of action, accrual occurs when the plaintiff knew or should have known of the wrongful injury.[171] In construction cases, the limitations period begins to run when an owner becomes aware of property damage.[172]

The court determined that the proper inquiry in the case was not when Rosenberg actually discovered construction defects, but when, in the exercise of reasonable diligence, Rosenberg should have discovered the wrongful actions.[173] The court noted that Rosenberg first noticed cracks in 1992 and that he obtained two separate engineers to perform inspections during 1993. Both reports recommended core drillings. One report concluded that foundation failure was present. Based upon that evidence, the court concluded that Rosenberg should have discovered the alleged wrongful acts no later than the fall of 1993.[174] Since Rosenberg did not file claims for negligence and violations of the DTPA until 1996, the court found that both were barred by limitations.[175]

With respect to the issue of an implied warranty claim against a subcontractor, the court followed the ruling of the 2001 decision *Codner v. Arellano*,[176] concluding that the owner did not have a direct action against a subcontractor for breach of an implied warranty and that the

170. *Id.* at 329.
171. *Id.*
172. *Id.*
173. *Id.* at 330.
174. *Id.* at 331.
175. *Id.*
176. Codner v. Arellano, 40 S.W.3d 666, 674 (Tex. App.—Austin 2001, no pet.).

owner's recourse for implied warranties is against the general contractor.[177]

B. The Pleading and Proof Burden of the Owner

In an unreported opinion, *Roubein v. Marino Home Builders, Inc.*,[178] the Corpus Christi Court of Appeals addressed the applicability of the discovery rule and the burden on the homeowners to plead and prove the rule. In the context of that case, where the court found that the owners were aware of three separate construction defects in their home, the court rejected the application of the discovery rule because the owners did not conclusively prove that the defects were inherently undiscoverable or that through the exercise of reasonable diligence they could not have discovered the nature of their injury.[179] Accordingly, the court concluded that the owners did not carry their burden of proof to demonstrate that limitations barred their claim.[180]

VIII. ARBITRATION CLAUSES AND RIGHTS

During 2002, the supreme court had two separate opportunities to analyze the issue of arbitration agreements within the context of construction disputes. On both occasions, the supreme court emphasized the binding nature of arbitration, the broad powers of the arbitrators, the courts' very limited powers of review, and the parties' rights under that form of alternative dispute resolution.

A. Arbitration Awards Not Subject to Review, Except on Limited Grounds

In *Callahan & Associates v. Orangefield Independent School District*,[181] the supreme court outlined the extremely limited authority that any trial court or appeals court has in reviewing an arbitration award. The opinion emphasizes the very broad powers of the arbitrator in a case that requires arbitration and the fact that parties likely have no recourse in the courts for legal errors committed by an arbitrator.

In the case, the school district hired Callahan, an architect, to provide architectural services for the construction of an elementary school. The contract described both "basic" and "additional" services and it required the school district to pay Callahan specified fees for both. The contract also required arbitration for any disputes that arose. After substantial completion of the project, the district discovered problems with the work, including a driveway that developed soft spots and than cracked and broke. The parties entered into an agreement to resolve their disputes

177. *Rosenberg*, 95 S.W.3d at 332.
178. Roubein v. Marino Home Builders, Inc., No. 13-01-711-CV (Corpus Christi Aug. 1, 2002, pet. denied) (not designated for publication), 2002 Tex. App. LEXIS 5656.
179. *Id.* at *8-9.
180. *Id.*
181. Callahan & Assocs. v. Orangefield Indep. Sch. Dist., 92 S.W.3d 841 (Tex. 2002).

and close the project. However, several months later, the district sued Callahan for breach of contract and negligence. Callahan asserted counterclaims for additional services it performed. The trial court stayed the proceedings to allow the parties to arbitrate, as required in their original contract.

In the arbitration, Callahan sought unpaid fees from the district for both basic and additional services it alleged it performed on the driveway. The district sought damages for several matters, including the driveway and its replacement with concrete when the original material had been less expensive asphalt. The district did not present evidence of the cost to replace the driveway with asphalt.

The arbitrator denied the district's claims, but determined that Callahan was entitled to be paid additional fees of almost $90,000. The written "reasons for award" issued by the arbitrator indicated that the district could not recover damages for its costs to replace the driveway because, although both Callahan and the contractor were at fault, no evidence existed of the cost to replace the driveway with asphalt. Additionally, the arbitrator determined that Callahan had provided additional services and that the agreement entered at the end of the project did not require Callahan to perform without additional charge because they did not "effectuate" the agreement.

The trial court severed the arbitrated claims from the underlying suit and the district filed an application to vacate, modify, or correct the arbitration award. Both parties filed motions for summary judgment. The district, in its motion, argued that the arbitrator had exceeded her powers, made evident mistakes, and violated common law in awarding damages to Callahan and denying damages to the district. Callahan argued in its motion that there was no reason to modify the arbitrator's award and that the trial court should enter judgment per that award. The trial court granted Callahan's motion and entered judgment in accordance with the arbitrator's ruling.

In the court of appeals, the district argued that the arbitrator made an "evident mistake and violated common law" by not awarding the district damages to replace the defective driveway.[182] The court of appeals concluded that the record did contain evidence about the replacement cost to raise a genuine issue of material fact regarding "whether the arbitrator 'made an evident mistake or violated the common law.'"[183] The court of appeals therefore reversed the judgment in part and remanded the case to the trial court to make findings about the damages to the district. The court of appeals rejected the district's argument that the award to Callahan should be reversed because it found that the district waived its position by failing to raise it during the arbitration.[184]

182. *Id.* at 843.
183. *Id.* at 842.
184. *Id.* at 843.

On appeal to the supreme court, Callahan requested a reversal of the court of appeals' decision based upon its argument that the court did not have the authority to disturb an arbitration award. The parties and the supreme court agreed that the Texas Arbitration Act[185] governed the dispute. The court found that "[t]he Act requires a court to confirm an arbitrator's award upon a party's application unless a party offers grounds for vacating, modifying, or correcting the award."[186] The court found that "the Act does not allow a reviewing court to modify or correct an award based on an arbitrator's 'evident mistake' in failing to award damages," but rather permits a court to modify or correct an award that contains an 'evident miscalculation of figures' or an 'evident mistake in the description of a person, thing, or property referred to in the award.'"[187] The court concluded that, because an arbitrator's failure to award damages is not a ground under the Act for modifying an award, the court of appeals erred in reversing the judgment.[188]

B. Arbitration Results are Binding, Except in Limited Circumstances

In *CVN Group, Inc. v. Delgado*,[189] the supreme court once again emphasized the binding nature of arbitration and refused to reverse an arbitrator's award, even though a court of appeals found that the award was erroneous under Texas law.

In the case, the Delgados hired CVN Group to provide construction services. The written contract between the parties required arbitration of any disputes. Before construction was completed, the Delgados instructed CVN to stop work. CVN alleged that the Delgados had materially breached the contract and demanded an arbitration.

The parties submitted their dispute on documents and briefs without live testimony (as agreed upon in the original contract). CVN requested more than $156,000 in damages plus a lien against the homestead at issue. The Delgados responded that they did not owe any fees to CVN and that the lien claimed was invalid because CVN filed its lien affidavit late and did not record the original contract, as required by the Texas Property Code. The Delgados did not challenge the arbitrator's authority to decide the lien dispute. The arbitrator awarded CVN more than $110,000 in damages and found "valid statutory and constitutional mechanic's liens for the full award."[190]

CVN asked the district court to confirm the award and foreclose the mechanic's lien. The Delgados argued that the award should be vacated or modified because the award was "manifestly unjust and constituted

185. Tex. Civ. Prac. & Rem. Code Ann. § 171.001 (Vernon 1997).
186. *Callahan & Assoc.*, 92 S.W.3d at 844 (citing Tex. Civ. Prac. & Rem. Code Ann. § 171.087) (Vernon 2003)).
187. *Id.* (citing Tex. Civ. Prac. & Rem. Code Ann. § 171.091(a)(1) (Vernon 2003)).
188. *Id.*
189. CVN Group, Inc. v. Delgado, 94 S.W.3d 234 (Tex. 2002).
190. *Id.* at 235.

usury," there was no evidence that the lien satisfied the necessary constitutional and statutory requirements, and granting the lien violated the Delgados' constitutional rights and exceeded the authority of the arbitrator.[191] The trial court found that the award should be reduced to approximately $23,000 and that CVN was not entitled to foreclose its mechanic's lien because it had not complied with any of the constitutional and statutory requirements for obtaining a lien.[192] The court of appeals then reversed the trial court's reduction of the damages, but affirmed the trial court's refusal to foreclose CVN's mechanic's liens, noting that a mechanic's lien can be foreclosed by judicial action only and that a court must review the validity of a lien prior to ordering any foreclosure.[193] Factually, the court of appeals determined that CVN had failed to prove that it had a signed contract with the Delgados, it had filed the contract in the real property records, and that it had timely filed a lien affidavit.

On appeal to the supreme court, the Delgados argued that a court has the power to overturn an arbitration award that is unconstitutional or otherwise violates public policy. In the context of its discussion, the supreme court reviewed section 171.088(a) of the Texas Arbitration Act,[194] as well as its prior opinion in *Smith v. Gladney*,[195] which held that a claim arising out of an illegal transaction is not a legitimate subject of arbitration, and that an award in such a case is void and unenforceable in courts of law.[196] On both grounds, the court determined that there was no basis to overturn the arbitration award in question, because there was no proof of corruption by the arbitrator and no evidence that the transaction in question was illegal. The court's conclusion makes its point:

> Subjecting arbitration awards to judicial review adds expense and delay, thereby diminishing the benefits of arbitration as an efficient, economical system for resolving disputes. Accordingly, we have long held that "an award of arbitrators upon matters submitted to them is given the same effect as the judgment of a court of last resort. All reasonable presumptions are indulged in favor of the award, and none against it.[197]

Thus, the court concluded that "an arbitration award cannot be set aside on public policy grounds except in an extraordinary case in which the award clearly violates a carefully articulated, fundamental policy."[198] Although the Delgados argued that awarding a mechanic's lien on a homestead would satisfy that requirement, the court disagreed, holding that the issues had been submitted to the arbitrator, and decided in favor of CVN.[199] The court even stated that "[n]othing in the arbitration pro-

191. *Id.* at 236.
192. *Id.*
193. *Id.* (citing TEX. PROP. CODE ANN. § 53.154) (Vernon 1995)).
194. TEX. CIV. PRAC. & REM. CODE ANN. § 171.088(a) (Vernon 2003).
195. Smith v. Gladney, 128 Tex. 354, 98 S.W.2d 351 (1936).
196. *Id.*
197. *CVN Group*, 95 S.W.3d at 238.
198. *Id.* at 239.
199. *Id.*

ceeding indicates that the arbitrator completely disregarded the requirements for perfecting mechanic's liens," although both the trial court and court of appeals found that decision erroneous.[200]

Finally, the court disagreed with the contention in the dissenting opinion that the validity of a mechanic's lien can never be arbitrated, regardless of the parties' agreement, as a result of section 53.154 of the Texas Property Code, which requires foreclosure only an judgment of a court. The majority opinion found that "[n]othing in the language or history of section 53.154 supports the dissent's position."[201]

This decision presents an extreme set of facts, where it appears that a contractor did not fulfill the requirements of the Property Code to perfect a mechanic's lien on a homestead, but was nevertheless permitted to foreclose that lien. The decision points out the results which parties may face from agreeing to arbitration, where even an obvious error cannot be corrected by judicial action or otherwise.

IX. RESIDENTIAL CONSTRUCTION LIABILITY ACT

In 2002, substantially fewer opinions exist interpreting the Residential Construction Liability Act ("RCLA"). One notable opinion, an unpublished opinion from the Houston Court of Appeals, was *Fontenot v. Kimball Hill Homes Texas, Inc.*[202] In that case, the court reviewed summary judgments granted in the context of a case involving the RCLA.

The plaintiffs were purchasers of a new home constructed by Hill Homes Texas. The owners sent a June 1995 demand letter to the builder with respect to various defects discovered after their October 1994 purchase of the home. The builder responded with a written settlement offer, which was rejected by the owners. The owners filed suit in September 1995. Almost four years later, the owners added Reliant Energy Resources as an additional defendant. Kimball Hill and Reliant moved for summary judgment on matter of law and no evidence grounds. The trial court granted summary judgment in favor of the defendants.

Kimball Hill's first ground for the no-evidence summary judgment was no evidence of damages from a construction defect. The owners' response included expert reports listing numerous defects and estimated costs of repair. Additionally, Kimball Hill's motion included its offer to repair certain defects in accordance with the RCLA. Based upon that evidence in the record, the court of appeals found that summary judgment was improper and that the record contained some evidence of construction defects.[203]

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200. *Id.*

201. *Id.*

202. Fontenot v. Kimball Hill Homes Texas, Inc., No. 14-00-01375-CV (Tex. App.—Houston [14th Dist.] May 2, 2002, no pet. h.) (not designated for publication), 2002 Tex. App. LEXIS 3167.

203. *Id.* at *3.

Kimball Hill also moved for judgment with respect to the foundation repair claims. The motion argued that the owners' experts testified that the foundation "is performing marginally," that "foundation failure can occur if movements progress," and that "distress to the structure is considered to be due to a combination of poor workmanship, movements of the foundation, and natural causes."[204] The court found that, although the evidence did not establish that the foundation had failed, there did remain a fact question whether the builder properly designed and constructed the foundation, and summary judgment in favor of the builder was therefore improper.[205] However, the court did uphold the summary judgment in favor of the builder with respect to damages for reduction in value of the home because of the necessary foundation repair finding that recovering those damages required evidence of structural failure.[206]

Finally, Kimball Hill sought to limit the owners' damages as a result of their rejection of a "reasonable" settlement offer, pursuant to section 27.004 of the RCLA. Pursuant to the statute, a settlement offer must be sent within 45 days after receiving an initial demand letter from an owner.[207] The court found, in reviewing the evidence on file, that a fact issue existed with respect to that point because the demand letter was dated June 23, 1995, but the settlement offer was dated more than two months later (August 28, 1995). Further, the court found evidence of a second offer from April 1999, which referenced an additional demand by the owners in January 1999. The court found that the offers appeared to be untimely under the statute and that no evidence of an extension of time for making a settlement offer was presented.[208]

X. CONSTRUCTION DEFECTS AND INSURANCE COVERAGE

The question of whether an alleged construction defect can ever qualify as an "occurrence" and trigger an insurer's duty to defend and/or duty to indemnify in favor of the insured in the context of a commercial liability policy continues to raise difficult questions for Texas courts. While the courts have struggled with such questions, the most recent decisions make it clear that the Texas state courts are reluctant to expand coverage to include damages for defective work performed by the insured contractor itself, as opposed to defective work by a subcontractor or as opposed to "resulting damage" to a third party's work.

A. THE CONTRACTOR'S DEFECTIVE WORK IS NOT AN "OCCURRENCE"

In the November 2001 decision of *Hartrick v. Great American Lloyd's*

204. *Id.* at *4.
205. *Id.*
206. *Id.* at *4-5.
207. TEX. PROP. CODE ANN. § 27.004 (b) (Vernon 2000).
208. *Fontenot*, 2002 Tex. App. LEXIS 3167, at *6-7.

Insurance Company,[209] the Houston Court of Appeals predictably concluded that a builder's breach of an implied warranty did not qualify as an "accident" and, therefore, did not trigger coverage under the insurance policy in question.[210] The court, in its opinion issued in place of the prior August 2001 opinion, found that the damage which resulted from a pitching and heaving foundation was a reasonably foreseeable result of not complying with an implied warranty, even if the builder did not intend for the damage to result.[211]

The plaintiffs in the case, who purchased the house two years after its completion, discovered structural problems and defects in the poured-slab foundation. The plaintiffs sued the builder for negligence, violations of the Deceptive Trade Practices Act, and violations of the implied warranties of good and workmanlike construction and habitability. The builder's CGL carrier provided a defense for the builder in the case under a reservation of rights. At trial, the jury found in favor of the plaintiff on the warranty questions. The plaintiffs then instituted a declaratory judgment action against the insurer, seeking a judgment that the CGL policy covered the owner's damages and that the carrier had a duty to indemnify under the policy.

Great American, the insurer, denied coverage for defective workmanship under the insuring agreement and the policy definitions of "property damage" and "occurrence." The parties filed motions for summary judgment on the coverage question. The trial court granted Great American's motion and denied the owners' motion finding that the policy afforded no coverage for the damages awarded to the owners in the underlying case.[212]

The broad form commercial general liability policy provided as follows:

> 1. Insuring Agreement
>
> a. We will pay those sums that [the builder] becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies . . .
>
> b. The insurance applies to "bodily injury" and "property damage" only if:
>
> (1) the "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory"[213]

The policy defined the term "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."[214]

After reviewing the pertinent definitions of the policy, the court restated the rule that "[u]nlike the duty to defend, which arises when a

209. Hartrick v. Great Am. Lloyd's Ins. Co., 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.).
210. *Id.*
211. *Id.* at 277-78.
212. *Id.* at 273.
213. *Id.* at 275.
214. *Id.*

petition seeking damages alleges facts that *potentially* support claims covered by a liability policy, the duty to indemnify arises from proven, adjudicated facts."[215] The allegations that the builder did not properly prepare the soil or clear the land and built a foundation of inadequate compression strength with no supporting piers provided the sole factual basis for the owners' claims against the builder. The jury found the builder had breached the implied warranties of good workmanship and habitability by its actions, but did not find liability for negligence. Thus, the court found that the basis for the judgment rested on faulty and defective workmanship by the builder.[216]

The Houston court noted that, while the policy did not define the term "accident" as used in the definition of "occurrence," the Texas courts generally have held that the term "accident" includes negligently caused losses.[217] The court also noted the Texas Supreme Court's clarification of the term "accident" in the 1999 opinion in *Mid-Century Ins. Co. v. Lindsey*,[218] where the court's discussion contained the following:

> [A]n injury is accidental if "from the viewpoint of the insured, [it is] not the natural and probable consequence of the action or occurrence which produced the injury; or in other words, if the injury could not reasonably be anticipated by [the] insured, or would not ordinarily follow from the action or occurrence which caused the injury."[219]

In the *Hartrick* case, the owners pointed to the testimony of the builder that it did not intend to cause the results of its conduct, but the Houston court found that the analysis would not end with the builder's stated intent. In fact, the court found that "intent or lack of intent is not dispositive of coverage" because the inquiry involves "*both* the insured's intent *and* the reasonably foreseeable effect, or consequences, of the insured's conduct."[220]

Thus, the court found that the builder's liability resulted from of "its failure to comply with the implied promises imposed upon [it] as a matter of law as a home builder, by not preparing the soil properly and not constructing the foundation properly."[221] The court concluded that, because the builder was responsible for the damages to the home and could have reasonably foreseen those damages, its acts could not be classified as an "accident."[222] Additionally, the court rejected the argument by the homeowners that the builder's acts were an "accident" and therefore an "occurrence" because the jury failed to find that the builder knowingly

215. *Id.*
216. *Id.* at 276.
217. *Id.* (citing Glover v. Nat'l Ins. Underwriters, 545 S.W.2d 755, 763 (Tex. 1977); Argonaut S.W. Ins. Co. v. Maupin. 500 S.W.2d 633, 635 (Tex. 1973)).
218. Mid-Century Ins. Co. v. Lindsey, 997 S.W.2d 153 (Tex. 1999).
219. *Id.* at 155.
220. *Hartrick*, 62 S.W.3d at 277.
221. *Id.*
222. *Id.* at 278.

committed the acts. The court concluded that the "knowing" standard applied only to the DTPA question posed and was not conclusive on the coverage question.[223]

B. The Federal Court's Application of the Texas Rule

In *Malone v. Scottsdale Insurance Co.*,[224] an insured contractor was sued in the United States District Court for the Southern District of Texas based upon allegations that it had defectively constructed improvements to an office and warehouse complex. The owner's petition alleged that the contractor negligently constructed the project and failed to construct the improvements in accordance with the plans and specifications.

The court, citing *Hartrick v. Great American Lloyd's Insurance Company*,[225] concluded that the contractor's failure to comply with the plans and specifications was not an "occurrence" under a general liability policy, even if the allegations were framed as a negligence claim, and granted the insurer's motion for summary judgment.[226] The court concluded that the alleged omissions by the contractor (specifically the failure to construct the improvements in compliance with the plans and specifications) were voluntary and intentional in nature, not accidental, and therefore that coverage could not exist.[227]

C. The Impact of the Duty to Defend Versus the Duty to Indemnify

In *CU Lloyd's of Texas v. Main Street Homes, Inc.*,[228] the insured general contractor brought suit against its CGL carrier seeking a declaration that the carrier owed a duty to defend a lawsuit filed against the contractor alleging inadequate design of foundations. The trial court entered summary judgment in favor of the contractor finding that a duty to defend existed. On appeal, the Austin Court of Appeals concluded that the homeowners' allegations that the general contractor built homes after learning that the foundation designs were inadequate for soil conditions and failed to disclose that knowledge to the purchasers constituted an accident, and thus an occurrence, and that no business risk exclusion applied to bar the duty to defend.[229]

The case provides an example of an opinion where the court distinguished the strict interpretation of the policy required in a duty to indemnify case versus the more liberal review of the factual allegations in a pleading, which the court analyzed in the context of the duty to defend question. The Austin Court actually distinguished the holding in *Hartrick*

223. *Id.*
224. Malone v. Scottsdale Ins. Co., 147 F. Supp. 2d 623 (S.D. Tex. 2001).
225. *Hartrick*, 62 S.W.3d at 270.
226. *Malone*, 147 F. Supp. 2d at 628.
227. *Id.*
228. CU Lloyd's of Tex. v. Main St. Homes, Inc., 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.).
229. *Id.*

v. Great American Lloyds Insurance Company, discussed above, by noting the differences in a duty to defend versus a duty to indemnify case.[230] In addition, the fact that the homes involved a "completed operation," and the fact that subcontractors' actions were the real focus of the allegations in the case, caused the court to conclude that various exclusions would not supercede the duty to defend under the policy.[231]

In the *Main Street Homes* case, Main Street, the general contractor, had hired Professional Design Group and another firm to design and construct the foundations for the homes at issue. Various plaintiffs in the case discovered foundation defects after their purchase of the home, and filed suit for negligence, breach of implied warranty, fraud, and violations of the Deceptive Trade Practices Act. Lloyds denied any duty to defend the lawsuits.

The policy at issue contained a standard insuring clause for "bodily injury" and "property damage" that resulted from an "occurrence."[232] The court analyzed the meaning of the term "accident," as used in the term "occurrence," citing the *Mid-Century* discussion quoted above. Based upon the general interpretations of the term "accident," the court concluded that if a tortfeasor's acts are deemed intentionally harmful, there is no "accident" and no "occurrence."[233] The court also noted, however, that "if intentionally performed acts are not intended to cause harm but do so because of negligent performance, a duty to defend arises."[234]

The court carefully reviewed the factual allegations of the various plaintiffs, noting the allegations of negligence. Based upon those allegations, the court found that a duty to defend existed because, when construed liberally in favor of the insured, the entirety of the pleadings did not rely upon the allegation of an intentional tort by the insured.[235]

Finally, Lloyds pointed to business risk exclusions, which it alleged barred coverage. The court concluded that one exclusion, which provided that the insurance did not cover "property damage" to "that particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations . . . did not apply because the allegations regarding the builders' conduct were made long after completion of all work on the homes.[236] The court also found that the exclusion for "property damage" to "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it" did not apply since the products-completed operations hazard provided an exception to the exclusion.[237] Further, the court concluded that the "your

230. *Id.* at 694.
231. *Id.* at 696-97.
232. *Id.* at 692-93.
233. *Id.* at 693.
234. *Id.* (citing Federated Mut. Ins. Co. v. Grapevine Excavation, Inc., 197 F.3d 720, 729 (5th Cir. 1999)).
235. *Id.* at 694.
236. *Id.* at 696.
237. *Id.* at 696-97.

work" exclusion did not apply because subcontractors actually performed the work at issue.[238]

The court's decision makes it clear that it is very important to carefully review all of the coverage terms, as well as all exclusions and exceptions to exclusions, to determine how specific facts can affect a coverage analysis.

XI. MOLD AND INSURANCE COVERAGE

In 2002, the Austin Court of Appeals had the opportunity to review a trial court's award of more than $32 million in damages to a homeowner in a mold case. In *Allison v. Fire Insurance Exchange*,[239] the court reviewed the claims of Mary Ballard against Fire Insurance Exchange ("FIE"), a member of the Farmers Insurance Group. The claim originally arose as a single claim for water damage to a hardwood floor, but evolved into a mold contamination case affecting the entire structure and outbuildings. FIE argued on appeal that the evidence was legally and factually insufficient to support the jury's finding of liability. The court of appeals determined that the trial court did not abuse its discretion in the evidentiary ruling about which FIE complained.[240] The court further concluded that sufficient evidence existed to uphold the jury's finding that FIE breached its duty of good faith and fair dealing and that FIE violated the Deceptive Trade Practices Act, but insufficient evidence to support the holding of fraud, failure to appoint a competent appraiser, and knowing violations of the duty of good faith and fair dealing.[241] The court therefore affirmed the actual damages award of more than $4 million, but reversed the judgment for punitive and mental anguish damages.[242]

The plaintiff purchased the home at issue in 1990 at a foreclosure sale and FIE began to insure it in 1992. Within a couple of years before the claims at issue, which began in 1998, the home had some plumbing leaks. In 1996 and 1997, Ballard filed claims for plumbing leaks caused by frozen pipes. Plumbing leaks continued, although the next claim was not filed until 1998. Ballard continued to notice buckling and problems with the floors throughout 1998. On December 17, 1998, Ballard filed an insurance claim for the water damage to the hardwood floors. One outside adjuster opined that a foundation issue caused the damages and that the insurance policy did not cover the damage. He later reconsidered and requested additional tests. The FIE adjuster estimated the claim to be around $100,000. Ballard's estimates for repairs ranged from $89,000 to $171,000.

238. *Id.* at 697-98.
239. Allison v. Fire Ins. Exch., 98 S.W.3d 277 (Tex. App.—Austin 2002, no pet. h.).
240. *Id.* at 233.
241. *Id.*
242. *Id.* at 233-34.

The FIE adjuster and an engineer visited the home in January 1999 to inspect the damage. The engineer found two sources of moisture: a bathroom and one around the refrigerator. The adjuster later sent a letter to Ballard noting that plumbing tests had been performed but had no located any leaks. Moisture tests continued to show high levels of moisture in the hardwood floors. Following a new appraisal of the property, FIE increased the level of coverage for the home to $750,000 and the contents to $450,000. FIE requested additional time to continue its investigation. Ballard hired an attorney.

In February 1999, FIE paid approximately $108,000 for the claim for accidental water discharge damage to the floor. In March, FIE reviewed newly discovered damage to the floors. In April, Ballard began to suspect that there might be a mold problem and had testing performed. The tests did report the presence of mold and the family moved out of the residence. FIE paid additional damages for claims in April 1999. In May 1999, Ballard filed suit against FIE for breach of contract, deceptive trade practices, breach of the duty of good faith and fair dealing, and negligence.

At trial, the jury awarded $2.5 million to replace the home, $1.1 million to remediate the home, $2 million to replace the contents of the home, $350,000 for living expenses, and $176,000 for appraisal fees, plus $5 million in mental anguish, $12 million in punitive damages, and more than $8 million in attorneys' fees.[243] FIE filed multiple issues on appeal, the most significant of which are discussed below.

On appeal, the Court determined that the trial court had not erred in excluding a causation witness because the party seeking to offer the testimony of the witness did not establish a reliable foundation for the admission of the general causation evidence.[244] The Court also carefully reviewed all of the evidence presented in making its determination that there was sufficient evidence to support the finding of a breach of the duty of good faith and fair dealing, stating the legal standard that such a breach occurs when the claim is denied or payment is delayed when "the insurer's liability has become reasonably clear."[245]

243. *Id.* at 237.
244. *Id.* at 240.
245. *Id.* at 248 (citing TEX. INS. CODE ANN. Art. 21.21 § 4(10)(a)(ii) (Vernon 1981); Universe Life Ins. Co. v. Giles, 950 S.W.2d 48, 55 (Tex. 1997)).