CONSTRUCTION RISK MANAGEMENT REPORTER

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ContrACT

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Contractor Beware: When a Contract is Not a Contract

NELL M. HURLEY

A stark and scary reminder to contractors courtesy of the New York County Supreme Court[1] : a contractor was left holding the bag, and is out over $ 1.5 million, when the contracts it had substantially performed did not conform to the requirements of New York's General Municipal Law Section 103. The risk of loss in such a situation was placed squarely on the contractor, despite the municipal representatives' admitted wrongdoing.

The case arose under circumstances of laudable intent by both the municipality, the City of New York, its Administration for Children's Services (ACS), and the contractor, Michael R. Gianatasio, PE, P.C. (MRG). The passage of New York's "Close to Home" legislation, which authorizes the City to house young people adjudicated as delinquents by Family Court in secure facilities near their homes, made the immediate construction of such facilities a top priority for the City. ACS reached out to MRG to build two of the facilities right away. The contracts were signed by ACS as "Managing Agent", MRG as "General Contractor" and by "Financial Conduit/ Services Provider", Leak & Watts

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So You Think You Are An Additional Insured?

KEVIN PEARTREE

In last spring's edition of ContrACT, we wrote about a court decision giving additional insureds more protection than they might deserve. Now, another court gives additional insureds proof that the law may giveth and the law may taketh away.

The Appellate Division, First Department has ruled that a particular blanket additional insured endorsement form will not in fact provide additional insured coverage to parties with whom the named insured does not have a contract. This could be an issue for many owners, contractors, subcontractors, construction managers and others.

The decision in *Gilbane Bldg. Co./TDX Construction Corp. v. St. Paul Fire and Marine Insurance Company*[1], concerned a not-at-risk construction manager's attempt to obtain coverage as an additional insured under the commercial general liability policy issued to a prime contractor. The construction manager's agreement with the project owner, the Dormitory Authority of the State of New York, obligated DASNY to require its contractors to name the construction manager as an additional insured on their commercial general liability policies.

The prime contractor agreement with the Dormitory Authority of the State of New York required it to procure CGL coverage with an endorsement naming DASNY, the State of New York, the construction manager and others as additional insureds. The certificate of insurance provided by the prime contractor did in fact name the construction manager and other required entities.

Excavation and foundation work allegedly damaged neighboring property, leading to a lawsuit by DASNY against the project architect and prime contractor that performed that work. The architect in in turn brought a claim against the construction manager, who tendered its defense to the prime contractor's carrier as an additional insured. The carrier denied coverage to the construction manager.

The particular blanket additional insured endorsement obtained by the prime contractor from its carrier was ISO Form CG 20 33 04 13, which provides:

> WHO IS AN INSURED (Section II) is amended to include as an insured any person or organization *with whom* you have agreed to add as an additional insured by written contract but only with respect to liability arising out of your operations or premises owned by or rented to you.

"You" in the endorsement refers to the named insured prime contractor. To a majority of judges deciding the case, the language of the endorsement was plain, ordinary and unambiguous. Since the construction manager did not have a contract with the prime contractor, the construction manager was not an additional insured under the language of the policy. That the prime contractor was contractually obligated to provide additional insured coverage for the construction manager did not alter the court's reading of the policy. The construction manager might have a claim against the prime contractor for breaching the insurance requirements of its contract, for what that might be worth. In

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general, the measure of damages for such a breach is additional out-of-pocket costs including deductibles and co-pays and any resulting rate increases to the party denied coverage. Only if left completely uninsured as a result of the failure to obtain additional insured coverage might the aggrieved party be able to recover the full amount of the underlying tort liability and defense costs.[2]

While the decision involved a construction manager and a contractor without a direct contract, the rationale is equally applicable to any party requesting and obtaining additional insured coverage on a construction project. Owners typically require their contractors to not only name the owner as an additional insured, but to obligate their subcontractors, with whom the owner has no privity, to do the same. If the right endorsement form is not obtained, the owner may not have the additional insured coverage it had planned on, and both the contractor and subcontractor will be in breach of their agreements. The concerns will occur in other segments of the contractual chain on a project.

While strictly speaking this decision is only binding in the First Department of New York, its impact will be broader if the rationale is adopted by other courts and carriers. At a minimum, the decision is a good reason for anyone on either side of the additional insured equation to review what they are requiring or providing.

The solution is to make sure that the party obtaining additional insured coverage for others is using an endorsement form that does not create this issue. These could include ISO CG 20 38 04 13, CG 20 10 07 04 or CG 20 37 07 04. That said, those forms need to be reviewed to make sure they provide the scope of additional insured coverage desired and contractually required. Such an analysis requires consultation with your insurance expert.

To see how a different endorsement form can lead to a very different result, see the discussion of *Mecca Contracting, Inc. v. Scottsdale Insurance Company* in the nearby Insurance Roundup on page 3. E&D

1 38 NY3d 1 (1st Dept 2016).

2 *Inchaustegui v. 666 Fifth Ave. Ltd. Partnership*, 96 NY2d 111 (2001).

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Services, Inc. (LWS). LWS was to provide the youth services at the facilities. Under the contracts, LWS was to reimburse MRG all costs incurred in connection with the services rendered once they receive payment from ACS.

MRG satisfactorily performed most of the work on both contracts, even expediting work as requested, but was only partially paid and incurred additional charges from subcontractors due to the non-payment. Pressing for payment from ACS, MRG was told of the problem with the contracts. ACS admitted that it had sought to avoid the additional time required to comply with the General Municipal Law's procurement rules (including public bidding and prevailing wage) by bringing LWS on as the financial conduit. Indeed, direct contracts with LWS for the construction of other facilities under the legislation had permitted successful evasion of the regulations, despite LWS not owning the property or having any responsibility to renovate it. However, because ACS was also a signatory to MRG's contracts, subsequent State scrutiny of them prevented payment due to its non-compliance with those rules. Efforts by ACS to "back in" to a successful contractual arrangement by orchestrating a new contract for MRG directly with LWS failed, and MRG never received payment.

MRG brought suit against the City, ACS and LWS for breach of the two contracts, quantum meruit, and unjust enrichment, and against the City and ACS for account stated and fraudulent inducement. The City and ACS argued that they cannot be held liable because the contracts were illegal and admittedly did not comply with General Municipal Law provisions requiring that such contracts go to the lowest responsible bidder. They acknowledged that timely construction of the facilities under the new legislation was its priority in contracting with MRG. LWS contended it had no obligation under the contracts as it was merely a "financial conduit" for ACS payments.

The court held that MRG failed on all counts, despite its recognition that the City and ACS acted unlawfully and treated MRG unfairly. Once a contract is proved to be awarded without the required competitive bidding, said the court, a waste of public funds is presumed and a taxpayer is entitled to have the contract set aside without showing that the municipality suffered any actual injury. As to the unlawful acts of the ACS representatives, the court noted that the very purpose of prohibiting the enforcement of illegal contracts with municipalities is "to protect the public from corrupt or ill-considered actions of municipal officials." Those dealing with municipal agents must ascertain the extent of the agents' authority, or else proceed at their own risk, added the court. The court reasoned that MRG should have been aware of the law requiring the contracts to be bid-out and could not justifiably rely on ACS's invitation to work on a no-bid contract. All of MRG's claims were dismissed.

This case highlights the importance of vigilance on the part of contractors dealing with public entities to ensure that they don't face the same fate as MRG. The policy in New York is that the risk of loss in the event of an illegal contract is placed directly on the contractor, not the public entity. So contractor beware. E&D

1 *Michael R. Gianatasio, PE, P.C. v. The City of New York*, 37 N.Y.S.3d 828 (Sup. Ct. New York Co. 2016).

Insurance Roundup

MARTHA CONNOLLY

REGO PARK HOLDINGS, LLC V. ASPEN SPECIALTY INSURANCE COMPANY[1]
This case is an important reminder to insureds to carefully read policy exclusions.

The plaintiffs sought defense and indemnification as additional insureds under a CGL policy issued by defendant Aspen, covering property owned by Rego Park Holdings. Construction work on the Rego Park property caused damage to two adjoining properties. Defendant Aspen disclaimed coverage based upon the following "Subsidence Exclusion Endorsement":

> "This policy does not apply to any liability for Bodily Injury, Personal Injury, disease or illness, including death or Property Damage or loss of, damage to, or loss of property, directly or indirectly arising out of, caused by, resulting from, contributed to or aggravated by the subsidence, settling, sinking, slipping, falling away, caving in, shirting, eroding, mud flow, rising, tilting, bulging, cracking, shrinking, or expansion or foundations, walls, roofs, floors, ceilings, or any other movements of land or earth, regardless of whether the foregoing emanate from, or is attributable to, any operations performed by or on behalf of any insured. The forgoing applied regardless of whether the first manifestation of same occurs during the policy period or prior or subsequent thereto."
>
> "It is further agreed that there is no coverage nor defense under this policy for any claims, loss, costs or expense arising from allegations against any insured resulting from or contributing to or aggravated by subsidence as described in the first paragraph of this endorsement."

The court noted that insurance policy exclusions "are to be accorded strict and narrow construction" and that it is incumbent upon the insurer relying upon the exclusion to establish that it is "stated in clear and unmistakable language, is subject to no other reasonable interpretation and applies in the particular case."

The court had no problem concluding that defendant Aspen satisfied this test and was not required to defend and indemnify plaintiffs under its policy.[2]

ZELASKO CONSTRUCTION, INC. V. MERCHANTS MUTUAL INSURANCE COMPANY[3]
The plaintiff insured sued the defendant insurer for damages arising from the insurer's breach of its payment obligations under the "physical damage" coverage provisions of a commercial auto policy. On this appeal the insurer challenged the award to plaintiff of its attorneys' fees. The appellate court reversed, finding that there was no basis for awarding the plaintiff its attorneys' fees and in doing so reviewed the basic rules relating to such awards.

The court noted that it is well accepted that an insured may not recover its litigation expenses when instituting an action against an insurer to settle rights under a policy. This is supported by the general rule that parties are responsible for their own litigation expenses unless this rule is modified by contract, statute or court order. Nothing in the relevant insurance policy altered this rule and the plaintiff was unable to cite any statute or court order to support its request for fees.

The court also noted that there was no basis for plaintiff's claim that the defendant had acted in bad faith, nor was there any reason to conclude that recovery of attorneys' fees by the plaintiff was within the contemplation of the parties at the time that the contract for insurance was entered between the parties. Accordingly, the court found no merit to the plaintiff's request for its attorneys' fees.

MECCA CONTRACTING, INC. V. SCOTTSDALE INSURANCE COMPANY[4]
Scottsdale Insurance Company challenged a lower court determination that required it to defend and indemnify general contractor Mecca Contracting, as an additional insured, in a related action involving personal injury to a sub-subcontractor's employee.

Mecca subcontracted work to Salcora pursuant to an agreement that required Salcora to provide insurance including Mecca as an additional named insured. Scottsdale provided Salcora with liability insurance which was primary coverage for Salcora. The policy contained a "Blanket Additional Insured Endorsement" which provided that any entity that Salcora was required to carry as an additional insured ***pursuant to a written contract*** would be considered an additional insured under the policy. The policy contained no other specific reference to Mecca as an additional insured. The endorsement also stated that it would provide any additional insured with "excess" coverage, unless a written contract specifically required the policy to be primary. Salcora's contract with Mecca expressly stated that the Scottsdale liability policy would be primary.

When the injured worker sued Mecca and others, Mecca sought coverage and defense from Scottsdale, as an additional insured. Scottsdale disclaimed coverage and refused to provide a defense. Mecca commenced an action seeking a declaration that Mecca was an additional insured under the policy that Scottsdale issued to Salcora, that Scottsdale was obligated to defend and indemnify Mecca in the personal injury action, and further that Scottsdale was required to reimburse Mecca the costs incurred in defending itself due to Scottsdale disclaiming coverage.

The court had no trouble finding in Mecca's favor and affirming the decision of the court below. The language of Mecca's contract with Salcora clearly evidenced Salcora's agreement to make Mecca an additional insured under its liability policy. As an additional insured, Mecca was entitled to the same rights and protections as Salcora, the named insured. Thus Scottsdale had wrongly disclaimed coverage and denied Mecca a defense.

The court, however, went ever further and held that the Scottsdale policy provided primary coverage to Mecca.

> "Since the policy provided Salcora with primary coverage, and Salcora agreed to make Mecca an additional insured, the contract between Mecca and Salcora constituted a contract requiring Scottsdale to provide Mecca with primary coverage, and satisfied the requirement of the Blanket Additional Insured Endorsement." E&D

1 140 A.D.3d 1147 (2d Dept 2016)

2 Although the court makes no mention of the cause of the damage to plaintiffs' properties, the decision certainly implies that the construction on Rego Park's property resulted in settling or subsidence of the plaintiffs' properties.

3 142 A.D.3d 1328 (4th Dept 2016)

4 140 A.D.3d 714 (2d Dept 2016)

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Ernstrom & Dreste also publishes the Fidelity and Surety Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste's website (ernstromdreste.com).

FIRM NEWS

Ernstrom & Dreste, LLP is excited to be participating in the revitalization of downtown Rochester by relocating its offices to 925 Clinton Square, Rochester, New York 14604.

Kevin Peartree spoke at the 2016 Construction Super Conference on December 6th in Las Vegas, on the topic "Which Standard Form Design-Build Contract is Right for You and Your Project".

Kevin Peartree will be presenting a "2017 Construction Law Update – Recent Court Decisions and New Regulations Every Contractor Should Know" for the Builders Exchange of Rochester on January 24th.