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ANALYSIS OF OREGON'S ECONOMIC WASTE DOCTRINE IN CONSTRUCTION DEFECT CASES

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It has long been the rule in Oregon that the "cost of replacement or repair is the correct measure of damage for defects in work unless the remedy generates undue economic waste." *Beik v. American Plaza Co.*, 280 Or. 547, 555, 572 P.2d 305 (1977) (*citing Schmauch v. Johnston*, 274 Or. 441, 547 P.2d 119 (1976) and *Turner v. Jackson*, 139 Or. 539, 560, 11 P.2d 1048 (1932)). If the remedy of replacement or repair generates undue economic waste, then damages are measured by diminution in value. *Beik*, 280 Or. at 555 fn. 3 (*citing McCormick*, *Damages* 648-49, s. 168 (1935). These principles are known as the "economic waste doctrine." *See Montara Owners Ass'n v. La Noue Development LLC*, 357 Or. 333, 346, 353 P.3d 563 (2015).

Determining whether a remedy of repair or replacement will generate undue economic waste, and thus whether the economic waste doctrine applies, is done on a case-by-case basis with guidance from the rules and the factors discussed in the cases below.

In *Beik, supra*, the Court compared the $8,700 cost of repairing defective sliding glass doors and defective air conditioners in each condominium unit to the $40,000 purchase price of each condominium. *Beik*, 280 Or. at 555. The Court held that even though the cost of those repairs was over 21% of the purchase price of each condominium, "[t]he relationship of cost of repair to purchase price is not disproportionate here, especially considering the lack of need for a structural change, the loss of habitability suffered by the plaintiffs, and the almost $65,000 that the defendants testified that they saved by installing the inferior doors and air conditioners." *Id.* Further, the court noted that an award of diminution in value would leave the plaintiffs with an inferior condominium and inadequate funds to bring the condominium up to specifications. *Id.*

In *Montara, supra*, the Oregon Supreme Court stated the principle as follows: "Economic waste occurs where 'the defect in material or construction is one that cannot be remedied without an expenditure for reconstruction disproportionate to the end to be attained, or without endangering unduly other parts of the building'." *Montara*, 357 Or. at 346 (*citing Schmauch*, 274 Or. at 447 and *Restatement (Second) of Contracts* § 348 (2)(b) (1979)). The *Montara* court held that the "end to be attained" by repair or reconstruction is restoring the loss in value resulting from the defect at issue. *Montara*, 357 Or. at 346-47 (*citing Jacob & Youngs v. Kent*, 230 N.Y. 239, 244, 129 N.E. 889 (1929)) (referring to the restoring of the loss in value as "the good to be attained").

In *Bhattarai v. Stein*, 119 Or. App. 136-37, 849 P.2d 1153 (1993), the end to be attained by awarding damages for repairs was restoring the resale marketability and value of the claimant's home, and was also correcting a serious safety problem resulting from the defective construction. The dispute in that case was the repair of a driveway which a home builder had constructed at a slope of 37.5%, which was almost twice the maximum grade of 20% allowed by city

ordinance. *Id*. at 135. Because of the overly steep grade, drivers driving up the driveway could not see if children or others were present in the garage, and when backing down the driveway, drivers could not see if anyone was present on the road. *Id*. The Court noted that while the claimants "may learn to live with the problem, no one knows if a deliveryman, visitor or some other person using the driveway may cause injury to the claimant's family, themselves, or some other member of the public." *Id*. at 137. The Court affirmed the order of the Construction Contractors Board for the home builder to pay the claimants $21,250 to repair the driveway, and rejected the home builder's contention that such repair would create economic waste when compared to the $124,618 price for construction of the home. *Id*.

Similarly, in *Schmauch*, the Court stated the test for determining economic waste in terms of the end to be attained, holding that "if on the other hand, the defect in material or construction is one that cannot be remedied without an expenditure for reconstruction disproportionate to the end to be attained, or without endangering unduly other parts of the building, then the damages will be measured not by the cost of remedying the defect, but by the difference between the value of the building as it is and what it would it would have been worth if it had been built in conformity with the contract." *Schmauch*, 274 Or. at 447.

The *Schmauch* court awarded repair costs, noting that the "defects could be remedied in a feasible manner." *Id.* at 446-47.

However, to the extent the "end to be attained" is primarily an improvement in esthetics of the project or structure, courts are more likely to find that an expensive repair or replacement would generate undue economic waste, and thereby award diminution in value damages, as demonstrated by the cases of *Thomas v. Schmidt*, 58 Or. App. 343, 345-46, 648 P.2d 376 (1982), *Wilkinson v. Jay's Contracting, Inc.*, 85 Or. App. 516-17, 737 P.2d 631 (1987), and *Jacob & Youngs, supra*.

In *Thomas*, the plaintiff owner and defendant contractor entered into a contract for defendant to re-roof plaintiff's house and garage. There was evidence that there was some discoloration or shading present on both of those roofs. *Thomas*, 58 Or. App. at 345. The trial court found that repair of the roofs would require re-roofing, for which plaintiff had obtained a bid for $2,160. *Id*. at 346. The trial court rejected plaintiff's argument that those repair costs should be awarded, holding that "re-roofing would result in gross economic waste, because the discolorations were barely visible and the damage only 'esthetic'." *Id*. The trial court awarded $325 for diminution in value and the Court of Appeals affirmed the trial court's decision. *Id*.

In *Wilkinson*, the primary issue was the defendant builder's failure to construct a sunken living room in the claimant's house, contrary to the building plans which plainly required a sunken living room. The Court noted that the cost of installing a sunken living room after-the-fact would be between $40,000 and $50,000, and affirmed the order of the Construction Contractors Board finding that such a repair "was not feasible" and would "create economic waste." *Wilkinson*, 85 Or. App. at 516. The Court affirmed the Contractors Board's decision to award "the difference in value between the type of living room required by the contract and the room that was actually built", a difference of $13,085. *Id*.

In *Jacob & Youngs*, which the Oregon Supreme Court cited in *Montara, supra*, as a "classic case on economic waste" and a decision in "accord with Oregon law", the defendant had contracted to build a home for plaintiff pursuant to a contract requiring the use of "Reading" brand pipe for the plumbing. *Jacob & Youngs*, 230 N.Y. at 241. After the house was complete, the plaintiff discovered that defendant had instead used "Cohoes" pipe, an equally good brand. *Id*. (The Court in fact noted that "Reading" pipe was distinguished from "Cohoes" pipe only by the

name of the manufacturer stamped on the pipe). The Court (Judge Cardozo) stated that replacing the pipe would require tearing down walls at great expense, and that replacing the pipe would not have increased the market price of the house because using "Cohoes" pipe had not had any effect on the market price of the house. *Id.* at 241 and 244. Judge Cardozo stated that if the cost of repair is "grossly and unfairly out of proportion to the good to be attained" as it was in that case, the measure is the "difference in value." *Id.* at 244. Because the difference in value in that case was near zero, the Court awarded only nominal damages. *Id.*

Rationale behind the economic waste doctrine

The Court of Appeals in the *Montara* case, *Montara Owners Ass'n v. La Noue Development, LLC*, 259 Or. App. 657, 667-68, 317 P.3d 257 (2013) *aff'd in part, rev'd in part on other grounds*, 357 Or. 333 (2015) explained that the rationale behind the economic waste doctrine is "to limit damages recoverable for a contractor's defective work to those costs necessary to achieve the owner's contract 'expectancy' and design intent without unjust enrichment or betterment of the work." (*citing* Philip L. Bruner and Patrick J. O'Connor, Jr., 6 *Bruner & O'Connor on Construction Law* § 19.30 (West 2010)).

Thus, it is the contractor who typically invokes the economic waste doctrine, as demonstrated by the cases discussed above in this article, with the exception being the *Schmauch* case in which the owner's evidence demonstrated that damages for diminution in value were higher than the cost of repairs. *Schmauch*, 274 Or. at 447.

The doctrine is also invoked by those other than general contractors, as in the *Montara* case, in which a subcontractor successfully argued that the economic waste doctrine could legally apply to the general contractor's claims against the subcontractor. *Montara*, 259 Or. App. at 667-68.

Conclusion

Justice Cardozo's statement in the *Jacob & Youngs* case so many years ago that "[i]t is true that in most cases the cost of replacement [or repair] is the measure", still holds true today. There are cases however where a contractor has a realistic opportunity to invoke the economic waste doctrine, but to do so the contractor must plan ahead so as to be able to present evidence at trial or arbitration of diminution of value as an alternative measure. Accordingly, the contractor should at an early point in the case consult with a real estate appraiser or other qualified expert for their evaluation and potential testimony in relation to this important doctrine of damages.

WHAT DOES *GOODWIN V. KINGSMEN PLASTERING, INC.* MEAN FOR CONSTRUCTION?

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This summer the Oregon Supreme Court resolved another long-running disputed construction litigation issue when it held in *Goodwin v. Kingsmen Plastering, Inc.*, 359 Or. 694 (2016), that negligent construction claims are subject to a two-year statute of limitation of ORS 12.110(1) with a discovery rule. For many years plaintiff and defense counsel argued as to whether ORS 12.110(1) applied to negligent construction claims or six-year statute of limitation found in ORS 12.080(3).[1] The new clarity provided by *Goodwin* eliminates one legal issue counsel can argue over, but will surely engender further disputes as to when a plaintiff discovered or should have discovered its injury along with other issues.

The facts of *Goodwin* are as follows. In December 2004 the Goodwins purchased a house originally built in 2001. Kingsmen Plastering, Inc. ("Kingsmen"), a subcontractor in the original construction, installed synthetic stucco siding on the house's exterior. That work was completed in May 2001. In March 2011, the Goodwins filed a complaint against Kingsmen for negligence and

[1] Five years ago in *Abraham v. T. Henry Construction, Inc.*, 350 Or. 29, 34 n.3 (2011), the Supreme Court stated in a footnote that the two-year limitation period applied, but the footnote was ignored by lower courts as dictum.

negligence *per se* alleging that numerous construction defects in the siding led to water intrusion causing damage to the house. The Goodwins claimed they did not learn of that damage until May 2010.

Kingsmen argued in a summary judgment motion that the claims were subject to ORS 12.110(1) and that plaintiffs had filed suit more than two years after discovery of the alleged construction defects and resultant damage. Kingsmen presented evidence that (1) the Goodwins had obtained reports from two experts before purchasing the home noting defects in the siding, (2) the Goodwins had received a bid from a contractor to fix a number of the problems, and (3) the same contractor had provided reports in 2005, 2007, and 2008 to the Goodwins noting concerns about cracks in the siding and resulting water intrusion. The Goodwins disputed the significance of the evidence and argued their claims were timely under the two-year statute of limitations. In the alternative, they argued that their claim was actually subject to the six-year statute of limitations in ORS 12.080(3), which also included a discovery rule.

The trial court agreed with the plaintiffs that their claim was subject to the six-year statute of limitations in ORS 12.080(3) and ruled that the relevant statute was not subject to a discovery rule. As a result, the six-year limitation period began to run when the siding installation was completed in 2001. The trial court accordingly granted Kingsmen's motion for summary judgment. The Goodwins appealed, and the Court of Appeals reversed, holding that both the six-year statute and a discovery rule applied, and there remained an issue of fact as to whether the Goodwins timely initiated their action. Kingsmen appealed that ruling.

The Oregon Supreme Court noted the statute of ultimate repose, ORS 12.135(1)(a), provides that an action arising from the "construction, alteration, or repair of any improvement to real property" must be commenced within "[t]he applicable period of limitation otherwise established by law." Thus, under ORS 12.135(1) construction claims are subject to differing statutes of limitation depending on the nature of the claim. The question posed to the Court in Goodwin then was what limitation period applied?

The Court determined that ORS 12.110 applied to the Goodwins' claim. Why? Well, it appears there are two reasons the first of which is rather simple and the second a bit more esoteric. First, the Court noted that ORS 12.080(3) explicitly excepts from it actions mentioned in ORS 12.135. The Court had found that the Goodwins' action was governed by ORS 12.135. Ostensibly the Court could have stopped its analysis there but it did not.

Second, the Court reasoned that ORS 12.080(3) regardless of the noted exception did not apply to the Goodwins' claims because those claims were not for "injury to any *interest* of another in real property." (Emphasis added.) Rather, the claims were for damage to real property and consequently the catch-all of ORS 12.110 applied. The Court went on to perform lengthy textual and legislative history analyses supporting its holding. The heart of the distinction appears to be that an injury to *an interest* in real property relates to the possessory interest of a person in real property but a construction defect negligence claim is simply a claim for injury to property.

There are several takeaways from the *Goodwin* opinion that are important to note.

- First and foremost, negligent construction claims are now subject to a two-year statute of limitations period with a discovery rule in Oregon. Going forward this means property owners (and their counsel) will need to be much more diligent in investigating and acting upon potential claims. It will also mean counsel on both sides will need to be prepared for the inevitable fight over when the injury was discovered or should have been discovered.
- Current negligent construction claims could have much more motion practice in light of *Goodwin*. While obviously not a universally held position, a considerable number of

attorneys believed negligent construction claims were subject to a six-year limitation period with discovery. Having this longer period often allowed plaintiff owners and counsel to take more time to decide whether it should file a claim against a contractor, conduct further investigations as to whether potential construction issues are at fault for issues in their buildings or homes, or pursue an alternative resolution. Defense counsel will be closely scrutinizing the facts of their cases for potential *Goodwin* motions.

- Insurance coverage may be affected for these claims. Typically, a commercial general liability policies cover claims for negligence but exclude breach of contract claims. Under *Goodwin* some plaintiffs may lose their negligence based claims but still have breach of contract claims against a contractor since there is a six-year limitation period for breach of contract claims as opposed to the two-year period. This could lead to uncovered claims for contractors, who should carefully examine with counsel the contract language to try to avoid these uncovered claims.
- Two things to consider regarding prior Oregon Supreme Court case law and interpretations of statutes. First, the Court means what it says in its opinions. In *Abraham v. T. Henry Construction, Inc.*, the Court explicitly noted in footnote 3 that ORS 12.110 applied to negligent construction claims. Most lower courts rejected this as dictum but the Supreme Court clearly meant it. Second, in both *Goodwin* and *Shell v. Schollander* this year, the Court conducted extensive textual and historical analyses of ORS 12.135. Both times the Court ultimately determined that the legislature means what it says and the text says what the legislature means. The results of those two cases may have gone against "conventional wisdom," but it is an important reminder that such "wisdom" is not always correct and that a strong textual argument is well received by the Court.

When are Changes on a Project Not Necessarily "Changes"?

Differentiating Between Changes, Breaches and Terminations

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One thing that is near constant in the construction industry is that things change during the course of most projects (whether in the form of differing site conditions, design changes or other changes in direction occasioned by any number of factors). Oftentimes, such changes result in changed or extra work, which may (depending on the scenario) impact payment and/or schedule. In other instances, decision-makers may decide to delete originally-contemplated portions of the work or to terminate the project altogether. This article briefly summarizes some of the potentially available options to accommodate these various types of changes to accomplish the respective goals of project participants, and some considerations that may factor into which option to pursue in order to maximize potential upside or to minimize potential exposure.

A. Terminations

One option routinely available to project owners in their construction contracts, including most public works contracts, is the right to terminate the project. Typically, contracts provide for a termination for default (*i.e.* where the contractor has materially breached an obligation under the contract), termination for convenience (*i.e.* where the owner desires to terminate for some other reason), or both. Much has been written about the differences between such terminations and the circumstances under which those remedies may be (and may not be) invoked, which issues often primarily depend on the language of the termination provisions and the exact circumstances of the project.

Generally, in order to terminate for default, the contractor must be in breach and remain in

breach after being given any prescribed notice and opportunity to cure. *See, generally, Morganti Nat'l v. United States*, 49 Fed. Cl. 110, 129 (2001). On the other hand, owners are typically given quite broad discretion to terminate the project for any number of other reasons under the termination for convenience clause. *See, generally, Northrup Grumman Corp. v. United States*, 46 Fed. Cl. 622, 626 (2000). Or even if there is no express termination for convenience clause in the contract. *E.g., Green Mgmt. Corp. v. United States*, 42 Fed. Cl. 411, 436 (1998). In some instances, an improper or unjustified termination for default simply may be converted into a termination for convenience. *See Morganti Nat'l*, 49 Fed. Cl. at 140; *Northrop Grumman Corp.*, 46 Fed. Cl. at 627.

The remedies available to the contractor following a termination depend on whether it was for default or for convenience, and on the other provisions of the contract. One Oregon case has considered what damages are due to a contractor under a termination for convenience. *See Shelter Products v. Steelwood Constr., Inc.*, 257 Or. App. 382 (2013). In that case, the Oregon Court of Appeals relied on traditional principles of contract interpretation to determine the scope and measure of recoverable damages. See *id*. at 399 (*citing Yogman v. Parrott*, 325 Or. 358, 361 (1997)); *see also United States for the Benefit & Use of EPC Corp. v. Travelers Cas. & Sur. Co. of Am.*, 423 F. Supp.2d 1016, 1026 (D. Ariz. 2006) (applying principles of contract interpretation when determining available remedies for termination for convenience). As a general proposition, following a termination for convenience of a federal government procurement contract, "[a] termination for convenience essentially converts a fixed price contract into a cost reimbursement contract." *Best Foam Fabricators, Inc. v. United States*, 38 Fed. Cl. 627, 637 (1997); *Keeter Trading Co. v. United States*, 79 Fed. Cl. 243, 262 (2007). "Thus, convenience damages are limited to costs incurred prior to termination, a reasonable profit on work performed, and certain additional costs associated with termination." *Id*. Other contracts provide for specific remedies following a termination for convenience.

Importantly, Oregon's appellate courts have also weighed in on a regularly disputed issue involving whether a party terminating a contract for convenience may offset the amounts owing to the contractor by, for example, the costs of correcting defective work. In *Shelter Products*, the general contractor terminated a subcontractor for convenience without notice that the subcontractor's work was defective and without providing the subcontractor with an opportunity to enter the site and correct defects. *Id*. at 387-88. Although the general contractor tried to re-characterize the termination as one for cause, the court rejected that argument because a termination for default would entitle the subcontractor the right to correct defective work. *Id*. at 401. Relying primarily on the language of the contract, but also citing persuasive authority, the court held, "at least in the absence of an opportunity to correct allegedly defective work, . . . where a party has terminated a contract for convenience, that party may not then counterclaim for the cost of curing any alleged default." *Id*. at 402, *citing Tishman Constr. Corp. v. City of New York*, 228 A.D.2d 292, 293 (N.Y. App. 1996); *Paragon Restoration Group, Inc. v. Cambridge Sq. Condominiums*, 42 A.D.3d 905 (N.Y. App. 2007).

B. Changes and Beyond

Another provision appearing nearly universally in construction contracts, especially in connection with public works projects, is a "changes" clause setting forth the ways in which the owner may make post-award changes to the project. The changes clause can also sometimes be utilized to delete work that was originally included in the scope of the project. Whether changing, adding or deleting work, the changes clause generally also details how modifications to the contract price and/or schedule related to such changes will be handled.

The more novel questions involve ***the extent*** to which the changes clause can be used to add or delete work. As to the former, an established body of law has developed (particularly in federal government contracting cases) that where the size, nature and extent of the change (or series of changes) is so substantial that

it essentially alters the fundamental nature of the project that was originally contemplated at the time of bidding, then it may fall outside the scope of the changes clause and constitute a "cardinal change" amounting to a breach entitling the contractor to appropriate damages. *See, e.g., Edward R. Marden Corp. v. United States*, 442 F.2d 344, 369-3770 (Cl. Ct. 1971) ("[W]here drastic consequences follow from defective specifications, we have held that the change was not within the contract, i.e., that it was a cardinal change . . . If plaintiff's allegations are true, then it performed work which was not 'essentially the same work as the parties bargained for when the contract was awarded' . . . based on the sheer magnitude of reconstruction work caused by the alleged defective specifications." (citation omitted)); *Saddler v. United States*, 287 F.2d 411, 414-15 (Cl. Ct. 1961) ("The nature of this particular contract was so changed by the added work, albeit the same kind of work described in the original specifications, as to amount to a cardinal alteration falling outside of the scope of the contract").

Less well-developed are the legal principles applicable to the corollary situation in which the Government does not substantially add to or cardinally change the scope of work, but instead seeks to delete or remove a substantial portion of the contractor's scope. In that situation, the question may arise as to whether the deductive change is permissible under the changes clause or whether it is beyond such authority. If the deletion is within the scope of the changes clause, then the appropriate vehicle is a deductive change order. In the case of dispute over the pricing, it is generally the government's burden to establish the quantum of the downward adjustment for the deleted work. *See, e.g., Nager Electric Co. v. United States*, 194 Ct. Cl. 835, 442 F.2d 936 (1971).

However, where the changes involve substantial deductions of significant portions of the work, the authorities generally hold that the termination for convenience clause – and not the changes clause – is the appropriate mechanism. *See, e.g., General Contracting & Constr. Co. v. United States*, 84 Ct. Cl. 570, 579-80 (1937); *Flatiron-Lane v. Case Atl. Co.*, 121 F. Supp.3d 515, 551-52 (M.D.N.C. 2015) ("A major, material change implicates the termination for convenience provision, while a minor change implicates only the change order provision."); *Boomer v. Abbett*, 121 Cal. App.2d 449, 484-85, 263 P.2d 476 (1953) ("a 'changes' clause does not authorize the deletion of an integral part of the work," such interpretation is "also strongly supported by public policy" to avoid contractors raising bids to guard against such losses, which would increase the cost of public work); *Appeal of G.L. Cory, Inc.*, GSBCA 4383, 77-2 BCA 12824 (1977) (board converted government's attempted deductive change order into a partial termination for convenience); *Appeal of Kahaluu Constr. Co., Inc.*, ASBCA 33248, 90-2 BCA 22663 (1990) (government's use of deductive change order improper, and converted into partial termination for convenience); *see also* 5 Bruner and O'Connor on Construction Law § 18.48 & n.5 (2002 & Supp. 2015) ("Changes can be authorized only within the scope of the contract and, if substantially altering the scope, may be classed as cardinal changes and breaches of contract. For such material alterations, the partial termination provisions of the termination for convenience clause rather than the changes clause should be invoked."); Matthew Bender & Co., *Government Contracts* (rev. 1998) § 30.50[4] ("if the government improperly uses the changes clause to delete work, a constructive termination for convenience will have occurred.") and § 30.50[4] ("If the work [deleted] is 'minor,' either the termination for convenience clause or the changes clause may be used. However, if the work is 'major' and no additional work is substituted, only the termination for convenience clause may be used.").

In the *General Contracting & Constr. Co.* case, the Government mid-Project deleted one building from the originally contemplated scope of work on a project to construct multiple buildings, utilities, roads, walks, grading and drainage at a Veterans' Hospital. 84 Ct. Cl. at 571-572. The Government attempted the de-scope by issuing a change order with what it determined was an

appropriate credit to the Government and an equitable adjustment to the contractor, and argued that the changes clause authorized such action. *Id.* at 578. The Court of Claims disagreed, explaining:

> Certainly the authority vested in the contracting officer by this [Changes] article of the contract to make "changes in the drawings (or) specifications of this contract and within the general scope thereof" did not vest him with authority to eliminate entirely from the contract Building No. 17. If he could eliminate one building from the contract under the guise of making changes in the drawings and specifications he could likewise eliminate two or any number of buildings and thus entirely change the contract. The elimination of Building No. 17 amounted to a cardinal change or alteration of the contract itself, a thing that could only be consummated with the consent of both parties to the contract. The elimination of Building No. 17 from the work to be performed under the contract without the consent of plaintiff was a plain breach of the contract by defendant.

Id. at 579-580.

C. Conclusion

As with many legal questions relating to the construction industry, exactly where a given scenario fits in the continuum between a change within the "changes" clause (whether additive or deductive) and either a cardinal change/breach or a substantial deletion amounting to a de-facto termination for convenience is highly dependent on a number of variables, including the specific facts, timing and contract provisions at issue. Oregon practitioners should keep in mind all of the above-described potential remedies in order to advise clients of the risks and benefits of avenues they are considering mid-project.

THE PRIORITY OF A CONSTRUCTION LIEN – AN IMPORTANT BUT MISUNDERSTOOD CONCEPT

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"The economy, stupid." That's the now famous phrase used by William Jefferson Clinton to defeat George Bush, Sr. in the 1992 presidential election. In honor of the 2016 election year, for construction lien claimants and construction law practitioners, that famous phrase could be modified to state: "it's about priority, stupid." While blunt, regarding construction liens, it is true. The priority of a construction lien plays a significant role in determining whether a lien claimant gets paid as a result of its construction lien. In short, the greater priority a lien has in relation to other encumbrances recorded against the subject real property, the greater chance the lien claimant will get paid.

The priority analysis starts with the basic real property rule followed in both Oregon and Washington - first in time equals first in right. In other words, absent a statutory exception, an earlier recorded encumbrance, *e.g.* a Deed of Trust, has priority over a later-recorded encumbrance. A construction lien is an example of a legislatively created exception to that rule. Thus, in some states, if the statutes are properly followed, a later-recorded construction lien may have priority over an earlier-recorded encumbrance. In other states, a construction lien does not have special priority status; however, it does still give the lien claimant a right of action against the real property where, absent the lien statutes, none would exist.

Not all liens are created equally, and Oregon and Washington treat the "same type" of liens differently. These differences can be an unwelcome trap to a lien claimant (or the unwary practitioner) who believes their lien has priority over existing encumbrances when, in fact, it does not. By way of example, an Oregon lien can, under the right circumstances, have "super priority," which means a later-recorded lien has

priority over an earlier-recorded encumbrance, *e.g.* a Deed of Trust, recorded by a lender to secure a loan. In such an instance, because its encumbrance can be extinguished by the foreclosure of the super priority lien, the lender will usually require the owner to pay the lien, or the lender will pay the lien to protect its secured interests. Thus, a construction lien that has super priority is a powerful collection tool.

However, many people erroneously assume that all liens in Oregon have super priority and that, if they record a lien, they will get paid. In Oregon, super priority does **not** apply to liens for alteration, modification, or repair of an existing structure. Generally speaking, this means that such a lien follows the "normal" first-in-time rule and falls behind existing recorded encumbrances and, if the lien is foreclosed, the superior (earlier in time) encumbrances remain unaffected. Therefore, absent the existence of construction financing which may be affected by this "type" of lien, there is no pressure on the lender or owner to deal with the lien. As a result, a contractor who does alteration or repair work on existing structures in Oregon should not rely on a construction lien to "guaranty" payment.

Crossing the Columbia into Washington leads to even more traps for the unwary. In Washington, construction liens do not have super priority and generally follow the first in time rule. Thus, a construction lien in Washington is, at best, a mediocre collection tool. The news is worse for subcontractors and material suppliers on single-family, owner-occupied residential "remodel" projects. On such a project, the subcontractor/-supplier has no right to record a lien for amounts the owner has paid the general contractor for the work or materials at issue, even if the general contractor has not paid the subcontractor or supplier!

The issue of priority is one of the most misunderstood areas of construction lien law, particularly by contractors and material suppliers. The power of a construction lien is directly tied to its priority vis a vis other encumbrances recorded against the same property. As you can see, a lien's priority can vary significantly. Thus, in order to adequately protect themselves, it is important for a contractor and/or material supplier to assess and understand the priority their lien rights may have on a particular project before starting work on that project.

CONTRACTOR BANKRUPTCIES: DEFENDING YOUR CONTRACTOR OR SUPPLIER AGAINST PREFERENCE CLAIMS

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One of the most frustrating events for a business is to finally collect payment from a slow-paying client, only to receive notice some months later that the client filed a petition for bankruptcy and the sums collected must be returned to the trustee of the bankruptcy estate. The typical demand will threaten a lawsuit if the business fails to comply within a specific time period. This demand is known as a "preference" claim on the theory that any payments made by a debtor to a creditor within 90-days prior to the debtor filing the bankruptcy petition inequitably "preferred" the creditor to others who remain unpaid. The trustee demands return of the "preference" payments in order to redistribute the funds more equitably amongst all of the debtor's creditors. However, all is not lost for the creditor, as several affirmative defenses exist which may mitigate or erase the trustee's claim.

This article describes the elements of a preference action as codified in Section 547(b), Title 11 of the United States Code (the "Bankruptcy Code"), and the defenses described in 11 U.S.C. § 547(c) which would be relevant to a creditor in the construction industry.

I. Preference Payments Defined

11 U.S.C. § 547(b) identifies the following elements of a payment subject to a trustee's preference action:

1. A transfer of an interest of the debtor in property;
2. To or for the benefit of the creditor;

3. For or on account of a debt that arose prior to the transfer by the debtor;
4. While the debtor was insolvent;
5. To a non-insider creditor within 90 days of the filing of the bankruptcy petition;
6. That leaves the creditor in a better position than what it would have been in had the transfer never occurred and the creditor had instead received a distribution from debtor's Chapter 7 liquidation.

The Trustee has the burden to prove each element by a preponderance of the evidence. A creditor's attorney should closely analyze the claim against these elements to see whether the trustee can prove the claim. The statute does not require intent by either party, nor does it matter whether or not the creditor knew the debtor was insolvent when the payment was received.

Transfer – The property transferred must be the "property of the debtor." 11 U.S.C. § 547(b). In the construction industry, recipients of joint checks may defeat preference claims on the basis that the payments were never the property of the debtor. *In re Flooring Concepts, Inc.*, 37 B.R. 957 (B.A.P 9th Cir. 1984) (no preference of payment by general contractor to materialman of debtor subcontractor because general contractor had an independent obligation to pay materialman) (*citing Keenan Pipe & Supply Co. v. Shields*, 241 F.2d 486 (9th Cir. 1956); *Selby v. Ford Motor Co.*, 590 F.2d 642 (6th Cir. 1979)). The Ninth Circuit held that payments made by a debtor to a creditor are not preferential transfers if a debtor received a third party loan for the purpose of paying that specific creditor. *In re Kemp Pacific Fisheries, Inc.*, 16 F.3d 313, 316 (9th Cir. 1994). Known as the "earmarking doctrine," the theory behind the exclusion is that the transfer simply substitutes one creditor for another, precluding any interest of the debtor in the funds.[1]

Antecedent Debt - Payments made by debtor to creditor 90 days prior to filing a petition for bankruptcy are presumed to be made while debtor was insolvent, but the payments must be for services or goods which have *already* been provided. Pre-payments, advances, installment payments or cash on delivery (COD) transactions are not antecedent debt.

Insolvency/90-Day Period – A debtor is presumed insolvent for the period 90 days before the filing of the bankruptcy petition, therefore the burden would be on the creditor to disprove the debtor's status at the time of the transfer. *In re Prime Realty, Inc.*, 376 B.R. 274 (Bankr. D. Neb. 2007). Most courts use a "balance sheet test" to determine solvency, where assets valued as going concern instead of liquidation value. *Jones Truck Lines, Inc. v. Full Serv. Leasing Corp*, 83 F.3d 253 (8th Cir 1996). In the absence of an event which clearly impacted the debtor's solvency *subsequent* to the transfer in question, challenging insolvency can be expensive because it's fact-intensive and requires expert testimony.

Leaves the Creditor in a Better Position – Under the Code, the Trustee has the burden to prove that the recipient of a payment in the preference period received more value than what would have been received from the debtor's estate in a Chapter 7 liquidation. This is commonly referred to as "the greater percentage test." *See, e.g., In re El Paso Refinery, L.P.*, 171 F.3d 249, 253-54 (5th Cir. 1999). Accordingly, prepetition payments made to a *fully secured* creditor aren't preferential because the payment has no ultimate effect on the debtor's bankruptcy estate. If the payments hadn't been made pre-petition, the debtor's estate in bankruptcy would have been diminished by the collateral liquidated to pay the creditor post-petition. When the net effect of a transfer on the debtor's bankruptcy estate is zero, and the Trustee can't avoid it.

In the construction context, this element comes into play on construction projects subject to

[1] For more information on the use of trust law to enhance creditor rights, see Doug Gallagher's article, Trust Me: Enhancing Construction Creditor Rights in Bankruptcy Through Trust Law, in Issue 43, pages 4-7 of the Construction Law Newsletter.

Oregon's Little Miller Act, which requires public entities to post payment bonds on projects, and in situations where a contractor's valid perfected lien is fully secured by the debtor's property. In those situations, payments made in the preference period to release lien claims or payment bond claims are considered fully secured. Most courts will find that contractors who waived lien rights in exchange for payment were also secured. Inchoate lienholders are considered secured creditors when: i) at the time of the payments, the lienholder remained eligible to perfect the lien pursuant to relevant state law; and ii) perfection would otherwise not have been avoidable under the Bankruptcy Code. *In re Electron Corp.*, 336 B.R. 809, 812-13 (B.A.P. 10th Cir., 2006). To hold otherwise would force contractors and material suppliers to take "the commercially unreasonable step of declining payment in order to perfect an inchoate statutory lien." *Id.* (*citing In re 360 Networks (USA) Inc.*), 327 B.R. 187, 192 (Bankr. S.D.N.Y. 2005)). Creditors may also use their release of lien rights and bond claims as an affirmative defense to preference actions, as described below. [2]

II. Affirmative Defenses To Preference Claims

If the trustee proves each element of the preference transfer, 11 U.S.C. § 547(c) provides the bases from which a creditor can defend against the claim. The creditor has the burden of proving affirmative defenses to preference claims. 11 U.S.C. § 547(g). In the context of the construction industry, the most relevant defenses are the new value defenses and the ordinary course of business defense.

A. Contemporaneous Exchange for New Value

Pursuant to Section 547(c)(1), the trustee may not avoid a transfer to the extent the transfer was:

(A) intended by the debtor and creditor to be a contemporaneous exchange for new value given to the debtor; and

(B) which was in fact a substantially contemporaneous exchange.

These types of transfers are not subject to avoidance because they have no impact on the equality of distribution of estate assets. *In re E.R. Fegert, Inc.*, 88 B.R. 258, 259 (9th Cir. BAP 1988) ("*Fegert I*") *aff'd Fegert II* (citation omitted); *In re JWJ Contracting Co., Inc.*, 287 B.R. 501 (B.A.P. 9th Cir. 2002). The value given for the transfer must actually enhance the worth of debtor's estate so as to offset the reduction in the estate caused by the transfer. *Id.*

New value can be in the form of a payment to a third-party creditor of the debtor. *In re Ballanca Aircraft Corp.,* 850 F.2d 1275, 1279-81 (8th Cir. 1988) (payments by creditor to other creditors and employees of debtor subsequent to the preferential transfer constituted new value). This makes sense because the subsequent payments to other creditors and employees of the debtor had the effect of diminishing the claims against the bankrupt estate, so there was no diminution in value to the estate.

The release of lien rights in exchange for payment constitutes new value if the lien is valid, and perfected on debtor's valid property. *In re Cocolat, Inc.*, 176 BR 540, 547 (Bankr. N.D. Cal. 1995; *In re George Rodman, Inc.*, 792 F.2d 125, 127–128 (10th Cir. 1986). A release of lien rights that also acts to release claims against the debtor's surety is considered new value. *In re E.R. Fegert, Inc.*, 88 B.R. 258, 259 (9th Cir. B.A.P. 1988) ("*Fegert I*") *aff'd Fegert II* (citation omitted). Conversely, the release of a right to file a lien on worthless property does not constitute new value. *In re Nucorp Energy, Inc.*, 902 F.2d 729, 732–33 (9th Cir. 1990).

B. Ordinary Course of Business (OCB) Defense

Payments received by a creditor in the "ordinary course of business" may not be avoided by the trustee. 11 U.S.C. § 547(c)(2). The purpose

[2] For more information on the effect of bankruptcy on a creditor's lien rights, see Doug Gallagher's article, *Preserving and Maintaining Oregon Construction Lien Claims When a Bankruptcy is Filed*, in Issue 39, pages 4-7 of the Construction Law Newsletter.

of the OCB defense is to encourage businesses to maintain normal business activities during a debtor's slide into bankruptcy. It does so by protecting payments made by the debtor to a creditor during the 90-day preference period which were consistent with the parties' history or industry practices. To qualify for the ordinary course of business exception, a creditor must prove that: the debt and its payment are ordinary in relation to past practices between the debtor and the creditor (subjective test); or, the payment was ordinary in relation to prevailing business standards (objective test). *In re Grand Chevrolet, Inc.,* 25 F.3d 728, 732 (9th Cir. 1994). In the context of the construction industry, proving either test of the OCB defense is tricky and fact-intensive. Industry standard "pay when paid" terms in contracts between the parties are not a defense as a matter of law under either test. *Sparkman v. Martin Marietta Materials, Inc.* (*In re Mainline Contracting, Inc.*) (Bankr. E.D.N.C., 2012); *Candy Fleet LLC v. Goodman* (W.D. La., Sept. 26, 2014). Instead, courts perform a data and fact-intensive analysis which generally requires expert witness testimony as to what is ordinary in the construction industry.

1. The Subjective Test

When reviewing evidence for the subjective test, Courts generally look at a baseline period occurring before the 90-day preference period and compare the pattern of payments to those made during the preference period to see if the transactions fit within the same pattern. The 6th, 7th and 9th Circuits have also found that this defense may apply to the first transaction between parties, if the court can determine what is "ordinary" in reference to the parties' practice with others. *In re Ahaza Systems, Inc.*, 482 F.3d 1118 (9th Cir. 2007)

Construction creditors provide historical payment data to establish a baseline of business practices between the parties which the Court will compare with payments in the preference period. The analysis follows a two-pronged approach: statistical analysis comparing invoice-to-payment timelines in baseline versus preference periods; and a fact-intensive review of each transaction in the preference period for evidence of collection activities or other anomalies which caused the debtor to pay the creditor to the detriment of others. Under this analysis, courts have found that late payments may be defensible as ordinary course of business if the history of the parties' conduct shows that those kinds of payments were normally late. *In re Grand Chevrolet, Inc.*, 25 F.3d 728, 732 (9th Cir. 1994). Courts use a variety of methods to compare payment timelines: average, median, range, regularity, or some variation thereof. *See, e.g.*, *In re Healthcentral.Com*, 504 F.3d 775 (9th Cir. 2007) (comparing range of payment timelines and form of payments); *Sass v. Vector Consulting, Inc.* (*In re Am. Home Mortg. Holdings, Inc.*), 476 B.R. 124 (Bankr. Del. 2012) (applying historical range payment analysis); *PN Chapter 11 Estate Liquidating Trust v. Inserts East, Inc.* (*In re Philadelphia Newspapers, LLC*), 468 B.R. 712 (Bankr. E.D. Pa. 2012) (dismissing trustee's claim because analysis showed 80% of pre-preference payments were made within 30 to 70 days).

In determining whether the preference period payments were consistent with the historical baseline, courts analyze the following factors: (1) the length of time the parties have been engaged in business with each other; (2) whether the amounts of the payments in the preference period were larger than those in the baseline period; (3) whether the debtor tendered payments in the preference period to creditor differently; (4) whether either party engaged in unusual activities to collect or pay the debt; and (5) whether the creditor took advantage of the debtor's weakened financial position. For example, a creditor's enhanced collection activities, letters, threats to discontinue services or supplies, or altering payment/credit terms at or around the time debtor made payments would most likely obviate this defense.

2. The Objective Test

Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), creditors had to prove both the subjective and objective prongs of the defense in order to prevail. Now, creditors need only prove up one of the

prongs in order to prevail. To establish the objective prong of this defense, a construction creditor would need to prove that the payment forms, timing, and amounts are consistent with industry standards, which generally requires expert testimony. Given the fact-intensive nature of this inquiry and the broad range of payment practices in the construction industry, this is typically the most difficult and expensive defense to prove.

C. Subsequent New Value

Pursuant to Section 547(c)(4), the trustee may not avoid a transfer which, after such transfer, creditor gave "new value" to the debtor that was:

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the detour did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

The underlying theory of this defense is that any creditor who provided new services or goods to a debtor on credit after receipt of payment in the preference period should be able to use the value of those new services or goods as a set off against the preference claim. In Oregon, the set off applies to all prior preference payments, though no credit is carried forward. *In re IRFM Inc.*, 52 F. 3d 228, 233-34 (C.A.9 (Cal.), 1995).

There is no question as to the application of this defense if the new value remains unpaid at the time debtor files bankruptcy. However, courts have diverged on whether new value provided to debtor and paid during the preference period ("paid new value") may be used to offset preference liability. The Ninth Circuit has ruled that paid new value can be applied against the preference balance as long as the new value was not paid by an "otherwise unavoidable transfer." *Id*. The following chart demonstrates how this defense is applied:

Date	Preference Payment	New Value	Net Preference
7/2/16	$40,000		$40,000
7/10/16		$15,000	$25,000
8/1/16		$30,000	$0
8/15/16	$15,000		$15,000
9/1/16		$10,000	$5,000
10/1/16	Bankruptcy Field		$5,000

The new value provided by the creditor on 7/10/16 and 8/1/16 will be credited fully against the 7/2/16 payment. However, the $5,000 difference will not be carried forward. The next payment of $15,000 is set off by the new value provided on 9/1/16, leaving $5,000 of the creditor's payment exposed, unless other defenses come into play.

Given the straightforward nature of the analysis, this defense can be proven quite easily, precluding the need for an expert.

D. Claim Amount

Preference claims for non-consumer debt for less than $6,425 are barred. 11 U.S.C. § 547(c)(9). Preference actions for non-consumer, non-insider debt which total less than $12,850 must be brought against defendants in the district in which they reside. 28 U.S.C. §1409.

III. CONCLUSION

As frustrating as preference claims may be for a client, litigating the claim can be unwise, as the Bankruptcy Code lacks attorney fee provisions for prevailing parties. Attorneys should closely analyze the cost-benefit of litigating the claim rather than negotiating a settlement. Although trustees must also weigh the costs of bringing a preference action, they rarely settle a claim for nothing, even if the creditor has a complete defense. In the event the creditor returns funds to the bankruptcy estate as part of a settlement, seek leave to file a claim against the estate for sums returned.

INSURERS DO NOT GET A SECOND BITE AT THE APPLE

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The Oregon Supreme Court recently issued its long awaited opinion in *FountainCourt Homeowners' Ass'n v. FountainCourt Dev., LLC et al.*, 360 Or. 341 (2016). In the opinion, the Court rejected an insurance company's attempt to re-litigate liability issues in an insurance coverage lawsuit when those issues were previously decided in an underlying lawsuit. It also concluded that a claimant in a continuous and progressive water damage case must only show that some property damage occurred during the insurance company's coverage period. These holdings resolved a number of insurance coverage issues that parties frequently encounter in construction-related litigation.

Background

The case stems from the construction from 2002 to 2004 of a multifamily housing development consisting of a number of condominiums and townhomes. After construction was complete, the residential units began experiencing water intrusion that caused property damage. In 2007, the homeowners association then filed a construction suit against the developers and general contractors that worked on the development. Eventually, the association also asserted direct claims against a number of subcontractors, including Sideco, Inc., the subcontractor responsible for installation of the siding. The association asserted that Sideco's negligent installation of the siding and windows caused the water intrusion that was damaging the units.

Sideco tendered a claim for defense and indemnity of the lawsuit under the general liability insurance policy it maintained with American Family Mutual Insurance Company from 2004 to 2006. American Family accepted Sideco's tender for a defense subject to a full reservation of rights.

The construction defect matter proceeded to trial. The jury returned a verdict in favor of the homeowners association for $2.1 million. It also allocated 23 percent of the fault to Sideco. Based on those findings, the trial court entered a judgment against Sideco for approximately $485,000.

The association then initiated a garnishment proceeding to collect on its judgment against Sideco. There, the association sought to collect payment under the American Family policy issued to Sideco. American Family argued it was entitled to re-litigate the merits of the liability determination by the jury in the underlying construction defect lawsuit. It also asserted that the association was not entitled to coverage under the siding company's policy because it could not establish the specific amount of damages that occurred during the period that the policy was effective.

Decision

The Court first concluded that an insurer is not entitled to a wholesale re-litigation of the construction defect lawsuit in the insurance coverage action. American Family argued that it was entitled to a new trial on the merits of the case against the sider because it was "not bound by the facts of the underlying lawsuit," and "not bound by the factual findings assumed within the judgment." The Court rejected the argument, acknowledging that the question in the insurance coverage lawsuit is whether the facts adduced in the underlying construction defect case fall with the coverage provided by the policy. In other words, "the insurer is not, as [it] contends, entitled to second guess of retry 'the nature of [the sider]'s liability.'" The Court did, however, acknowledge that an insurer is entitled to litigate in the coverage action issues "such as whether an exclusion applies or whether the damages awarded are otherwise covered by the policy." Importantly, this portion of the opinion holding eliminates the potential for inconsistent or contradictory decisions regarding the insured's liability or damages.

Next, the Court rejected American Family's "injury-in-fact" argument, which relied on the position that the association could not

establish that the property damage was caused by an "occurrence" because it could not establish the specific amount of damage during any one policy period. The Court concluded that a claimant must only show that some property damage occurred during the relevant policy period to trigger coverage, not the precise amount of damage that occurred during any one policy period. The Court refused to adopt American Family's strict trigger of coverage argument, citing the nature of continuous and progressive property damage which cannot be broken into discrete parts.

Open Issue

The Court also briefly addressed the issue of allocation of damages, but ultimately concluded the issue was not properly preserved. The issue arose in the case because the damage occurred over multiple policy periods. The association argued for application of the "all sums" rule. Under the all sums approach, a claimant may recover an entire judgment from a single insurer even when multiple policies are implicated by the loss. American Family argued for a "pro rata" rule in which the loss is split between the various policies that are implicated. Although the parties submitted substantial briefing on the issue, the Court determined the issue was not properly raised in the lower courts and refused to make a ruling.

In a portion of the opinion, however, the Court did not expressly disapprove of the trial court's imposition of the all sums rule. In that passage, the Court cited prior decisions that the association argued permitted it to recover all sums from American Family. The issue of "all sums" v. "pro rata" will continue to be contested in continuous and progressive property damage cases.

OREGON CONSTRUCTION CASE LAW UPDATE 2016

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STATUTE OF LIMITATIONS: Negligent-construction claims are subject to a two-year statute of limitations running from the date of discovery under ORS 12.110.

***Goodwin v. Kingsmen Plastering, Inc.*, 359 Or. 694, 375 P.3d 463 (2016).** Subcontractor completed work on a residential home in 2001. In 2011, Owner filed a complaint against Subcontractor for negligence and negligence per se, alleging that numerous construction defects in the installation of the siding had led to water intrusion and eventual damage to the home. Subcontractor moved for summary judgment, arguing that Owner's claims were time-barred under ORS 12.110(1), which requires tort claims to be initiated within two years of the date of discovery of the harm. Subcontractor presented evidence that Owner was clearly aware of the siding defects on the house in 2005, 2006, and 2008. Owner argued that its claim was subject to the six-year statute of limitations under ORS 12.080(3). The trial court applied the six-year statute of limitations, but granted Subcontractor's summary judgment motion because it ruled that ORS 12.080(3) did not contain a discovery rule. The court of appeals overturned, holding that based on *Rice v. Rabb*, 354 Or. 721, 320 P.3d 554 (2014), ORS 12.080(3) is subject to a discovery rule. Subcontractor appealed.

The Oregon Supreme Court held that Owner's negligent-construction claims were subject to the two-year statute of limitations. According to the supreme court, the six-year statute "applies to actions for interference with or injury to an 'interest' in real property, such as trespass or waste," and not to actions for damage to property itself. Claims for negligent construction, the court determined, constitute claims for damage to the property itself, and are

therefore subject to the two-years-from-discovery limitation of ORS 12.110(5)(a).

STATUTE OF REPOSE: ORS 12.135's ten-year statute of repose, which begins to run from "substantial completion," applies only to contracts that include construction, alterations, repairs, or improvements to real property.

***Shell v. Schollander Companies, Inc.*, 358 Or. 552, 369 P.3d 1101 (2016).** Owner purchased a "spec" home—a home built without preexisting construction contracts in anticipation of eventual sale to the public—from Contractor in May 2000, before the home was completed. Substantial completion of the home occurred in July 2000. Owner brought an action against Contractor for various construction defects. The complaint was filed more than ten years after the date of the sale agreement, but less than ten years after the date of substantial completion. Owner argued that its claim was timely because it had initiated the action within the ten-year statute of repose under ORS 12.135, which runs from the date of "substantial completion."

The trial court disagreed, granting Contractor's motion for summary judgment on the ground that ORS 12.115's statute of repose applied to the transaction. ORS 12.115's statute of repose begins to run from the date of the act or commission complained of. The court of appeals affirmed because Contractor had sold a home under construction by way of a real estate sale agreement rather than a construction contract, meaning that the statute of repose for construction contracts in ORS 12.135 did not apply. Owner appealed.

The Oregon Supreme Court also affirmed. The court acknowledged that each statute of repose potentially applies when a buyer enters into a purchase and sale agreement to buy an existing home. ORS 12.135, however, applies only when the buyer is also a "contractee" within the meaning of the statute, meaning someone who enters into a contract to construct, alter, or repair an improvement to real property. Here, ORS 12.115 applied because Owner's negligent-construction claims derived from a purchase and sale agreement, and not from a contract involving any construction, alterations, repairs, or improvements to the home.

INSURANCE COVERAGE: In a garnishment to collect from a contractor's CGL insurer a judgment for negligent construction, the judgment-creditor need not (1) prove physical damage to property if the underlying verdict was for property damage; or (2) segregate damage occurring only during the CGL policy period.

***FountainCourt Homeowners v. FountainCourt Develop.*, 360 Or. 341, ___ P.3d ___ (2016).** Homeowner's Association ("HOA") obtained a judgment against Subcontractor for the negligent construction of a housing development. The jury found that HOA had proved "physical damage" to the property and that a portion of the physical damage had been caused by Subcontractor's "fault or negligence." The jury did not segregate the costs to repair the "resulting loss" from the costs to correct Subcontractor's work. Nor did the jury specify when the loss had occurred or continued.

Subcontractor had a commercial general liability ("CGL") policy issued by Insurer from May 1, 2004, to May 1, 2006. HOA served a writ of garnishment on Insurer, seeking recovery of the judgment. Insurer denied coverage for the loss, and a garnishment hearing was held. The underlying trial record was admitted, along with testimony by HOA's experts, who testified that it was not possible to quantify how much damage had occurred during Insurer's policy period, nor how much of the jury award related to consequential damages versus corrections to Subcontractor's own work. The trial court held that HOA had met its prima facie burden of proving coverage and entered judgment against Insurer. The court of appeals affirmed.

The Oregon Supreme Court also affirmed. The court relied on the jury instructions, which stated that the jury was to award damages for physical damage to property, not for defective work. Therefore, the sum that Subcontractor became legally obligated to pay was for "property

damage," which was covered by Insurer's policy. The court also rejected Insurer's argument that HOA was required to prove the amount of damages that occurred during the policy period in order to demonstrate that there had been an "occurrence" to trigger coverage. Rather, because at least some property damage occurred within the policy period—an uncontested fact—there was an "occurrence" triggering coverage.

INSURANCE COVERAGE: Oregon does not appear to recognize the "owner-claimant" rule, meaning that CGL insurance covers a subsequent purchaser who acquires the property after the policy period expired.

***Am. States Ins. Co. v. PIH Beaverton LLC*, No. 3:15-cv-00960-SB, 2016 WL 3473349 (D. Or. May 3, 2016).** From 1994 to 2000, Subcontractor was covered by Insurer's CGL policy. During that time, Subcontractor performed work on a hotel. Owner bought the hotel in 2006, and shortly thereafter discovered a number of construction defects. Owner obtained a judgment against Subcontractor for negligent construction that had resulted in water intrusion and property damage. Insurer filed a federal declaratory judgment action to establish that it was not obligated to pay the state court judgment against Subcontractor.

Insurer argued that the CGL policy applied only to property damage occurring during the period of coverage and that Owner never owned the damaged property until after the period of coverage had expired. Insurer attempted to invoke the "owner-claimant rule," under which only the party that owned the property during the coverage period may recover losses incurred during the coverage period. *See Scott v. Elliott*, 253 Or. 168, 451 P.2d 474 (1969); *Wallace v. Paulus Bros. Packing Co.*, 191 Or. 564, 231 P.2d 417 (1951). Some jurisdictions reject this rule, and the Oregon Supreme Court has yet to rule on the issue. In the absence of Oregon case law, the district court concluded that the Oregon Supreme Court would reject the owner-claimant rule.

INSURANCE COVERAGE: Claims based on misrepresentation may be covered under insurance policies if the misrepresentations led to a delay in discovery of the defects and the delay resulted in additional property damage.

***Colony Specialty Ins. Co. v. Mut. of Enumclaw Ins. Co.*, No. 6:15-cv-00783-MC, 2016 WL 1271665 (D. Or. Mar. 29, 2016).** Condominium association sued Developer for failure to disclose construction defects and fraudulent misrepresentation. Developer sought defense and indemnity coverage from both its insurers, Mutual of Enumclaw Insurance Company ("MOE") and Colony Mutual. Colony proceeded to defend, while MOE refused to defend based on the lack of allegations that could establish coverage under its policy. Colony sought contribution, also asserting that MOE owed a duty to defend.

MOE argued that claims of misrepresentation against its insured could not invoke policy coverage for property damage. The court agreed that, on its own, misrepresenting the state of the property, when sold, does not invoke policy coverage for property damage. But the complaint alleged that Developer's misrepresentations had delayed the association's investigation of the property and the discovery of the defects, resulting in additional property damage. The court found that claims of property damage resulting from the delay in discovering the defects due to misrepresentation could be covered under the policy. Therefore, the allegations were sufficient to invoke MOE's duty to defend.

INDEMNITY: A contract to supply materials for a construction project is a "construction agreement" subject to ORS 30.140's limitation on indemnity provisions.

First Mercury Ins. Co. v. Westchester Surplus Lines Ins. Co., No. 3:15-cv-00192-MO, 2016 WL 344527 (D. Or. Jan. 27, 2016). Multnomah County retained Conway Construction to rehabilitate a bridge. Conway subcontracted with ZellComp to install the bridge decking system, and ZellComp in turn sub-subcontracted with Strongwell to manufacture the system. After

construction, the County discovered problems with the bridge decking system. Conway initiated a state law suit against ZellComp and Strongwell seeking to recover repair costs. Strongwell's insurer, First Mercury, provided a defense for both ZellComp and Strongwell, under the "additional insured" endorsement of Strongwell's policy, which Strongwell was required to obtain as part of the agreement with ZellComp. The court found ZellComp 40 percent responsible for the damages and Strongwell zero percent responsible, and entered judgment against ZellComp. ZellComp assigned to the County its claim against First Mercury for coverage as an additional insured. First Mercury filed a federal declaratory judgment action and moved for summary judgment based on ORS 30.140, which declares void any indemnification provision in a construction agreement that requires a person to indemnify another for damage caused in whole or in part by the indemnitee. Both parties moved for summary judgment.

The County argued that ORS 30.140 did not apply because the agreement between the general contractor and subcontractor was not a construction agreement. ORS 30.140(3) defines a construction agreement as "any written agreement for the planning, design, construction, alteration, repair, improvement or maintenance of any building, highway, road excavation or other structure, project, development or improvement attached to real estate including moving, demolition or tunneling in connection therewith." The district court rejected the County's argument based on the broad definition of "construction agreement" and the facts of the case, including Strongwell's customized manufacturing for the improvement of the bridge, design consultation, and construction site visit. Accordingly, the indemnity clause of the agreement was rendered void and First Mercury's motion was granted.

EMPLOYER LIABILITY LAW: A contractor that retains the contractual right to inspect the worksite and require additional safety measures from a subcontractor may be liable under Oregon's Employer Liability Law for injuries on the worksite.

***Yeatts v. Polygon Northwest Co.*, 360 Or. 170, ___ P.3d ___ (2016).** Contractor for a residential townhome development project engaged Subcontractor to frame the project. The subcontract obligated Subcontractor to "take necessary safety and other precautions, at all times, to prepare for and perform the work in a safe manner," but it also gave Contractor the authority to inspect the safety procedures and require greater safety measures from Subcontractor. Subcontractor's employee fell while framing the third floor of a townhome that was under construction and sued Contractor under Oregon's Employer Liability Law, ORS 654.305 to 654.336 ("ELL"). The trial court granted summary judgment in favor of Contractor on the ELL claims because, under the terms of the subcontract, Contractor did not control the risk-producing activity. The appeals court affirmed the trial court's decision.

On review, the Oregon Supreme Court reversed. While the subcontract placed the bulk of the job-safety requirements on Subcontractor, the court found that evidence existed that Contractor "retained a right to control" the pertinent risk-producing activity. Specifically, Contractor retained the right to require additional safety measures from Subcontractor and to inspect the worksite for safety. Further, the court noted that no contractual provision placed sole responsibility for safety measures on Subcontractor. Therefore, summary judgment was improper.

SETTLEMENT AGREEMENTS: *Stubblefield* was wrongly decided. A covenant not to execute a judgment against an insured does not extinguish the insured's liability. The phrase "legally obligated to pay" in common CGL policies is ambiguous.

***Brownstone Homes Condo. Assn. v. Brownstone Forest Hts., LLC*, 358 Or. 223, 363 P.3d 467 (2015).** Plaintiff, a condominium

association, sued a siding contractor for certain construction defects. Plaintiff settled with the siding contractor and one of its two insurers. The settlement required the siding contractor to stipulate to a judgment in the amount of $2 million, of which the settling insurer paid $900,000. In exchange, plaintiff covenanted not to execute the judgment against the siding contractor or the settling insurer. Plaintiff then attempted to garnish the nonsettling insurer's policy. The nonsettling insurer contested the garnishment, arguing under *Stubblefield v. St. Paul Fire & Marine*, 267 Or. 397, 400-01, 517 P.2d 262 (1973), that its potential liability was extinguished because the siding contractor was not legally obligated to pay the remaining unsatisfied portion of the judgment. The trial court agreed.

On appeal, the Oregon Supreme Court overturned the lower court decisions, concluding that *Stubblefield* had been wrongly decided. The court reject the reasoning in *Stubblefield* that an insured who receives a covenant not to execute a judgment for damages is not "legally obligated to pay" those damages. The court found that the Stubblefield decision ignored prior case law, notably *Groce v. Fidelity General Insurance*, 252 Or. 296, 448 P.2d 554 (1968), as well as the majority of decisions from other jurisdictions on the issue. At a minimum, the court found that the phrase "legally obligated to pay" was ambiguous and must therefore be construed against the insurer. The court concluded that a covenant not to execute obtained in exchange for an assignment of rights, by itself, does not extinguish an insurer's liability.

ATTORNEY FEES: An attorney-fee award need not apportion between fee-generating claims and non-fee-generating claims if the claims all arise from the same or "common" substantive allegations. Third-party defendants can recover costs directly from plaintiff under ORCP 68 B.

***Village at North Pointe Condo. Assn. v. Bloedel Constr. Co.*, 278 Or. App. 354, 374 P.3d 978 (2016).** Plaintiff condominium association sued the building's developer and the association's former president for construction defects in the condominiums. Plaintiff alleged five separate claims, including one for breach of the contract, which contained an attorney-fee provision. Defendants, in turn, brought third-party claims based on indemnity and contribution against various subcontractors. The jury returned a verdict for defendants on all of plaintiff's claims. The court awarded attorney fees to developer and the former president against plaintiff, but did not apportion the awarded fees between the various claims. The court also awarded costs to the subcontractors against plaintiff.

On appeal, plaintiff challenged the attorney-fee award, on the grounds that the trial court failed to apportion the fees between fee-generating claims and non-fee-generating claims. The court of appeals concluded that apportionment of the attorney fees was not required, except as to insurance coverage issues, because all the claims litigated involved common issues related to construction defects. Plaintiff also challenged the award of costs to the third-party defendant subcontractors. The court found that ORCP 68 B gives trial courts discretion to award costs to prevailing third parties, even as against the original plaintiff.

BOARD OF ARCHITECT EXAMINERS: An architect is permitted to develop feasibility studies and other abstract designs without being licensed in the state of Oregon, so long as the design work is not intended to be used for actual construction.

***Twist Architecture v. Board of Architect Examiners*, 276 Or. App. 557, 369 P.3d 409 (2016).** Architecture firm was formed in 2008 by its two principals and registered as a professional corporation in the state of Washington. During the relevant period, neither principal was licensed to practice in Oregon. The firm entered into an agreement to perform "concept master planning design services" for three projects in Oregon. For each project, the firm produced a feasibility study portraying an aerial view of the development project. During a contested hearing before an administrative law judge, the Oregon Board of Architect Examiners found violations as a result of the firm's preparation of the feasibility studies

without an Oregon license. It imposed a $10,000 civil penalty against each party for the unlawful practice of architecture.

ORS 671.010(7) defines "practice of architecture" as "the planning, designing or observing of the erection, enlargement or alteration of any building or of any appurtenance thereto other than exempted buildings." The term is further defined by the board's own regulation as "all analysis, calculations, research, graphic presentation, literary expression, and advice essential to the preparation of necessary documents for the design and construction of buildings, structures and their related environment whether interior or exterior." OAR 806-010-0075(1). The board interpreted the statute and regulation in tandem to include any activity undertaken in contemplation of the erection of a building. The court of appeals, on review, rejected the board's interpretation as being too broad and contrary to legislative intent. Instead, the court found that the practice of architecture includes the planning or preparing of work for use only in actual construction, rather than planning for a building in the abstract. The evidence in the record showed that the firm had not prepared the feasibility studies in contemplation of obtaining permits and actually constructing the buildings. Thus, the court reversed the board's decision and penalty.

CONSTRUCTION LIENS: A notice of right to lien that fails to include the date on which the lien arises or the property subject to the lien is insufficient notice under ORS 87.021(1). Incidental contact with the jobsite is insufficient to invoke the notice exception under ORS 87.021(3)(b).

***Multi/Tech Eng. Svcs. v. Innovative Des. & Constr.*, 274 Or. App. 389, 360 P.3d 701 (2015).** Owner engaged Engineer to provide engineering services to obtain city approval for its building, as well as to provide structural engineering services. The parties' contract contained a sample fill-in-the-blank "Notice of Right to Lien," but it was never filled out. Engineer performed the requested services, which required contact with the jobsite in order to take measurements, obtain soil samples, and gather other information necessary to perform the design work. Owner failed to pay Engineer's final invoices, and Engineer recorded a lien for the unpaid amount. The trial court found in favor of Engineer and ruled that the lien was valid. Owner appealed.

The court of appeals reversed. The court held that a blank "Notice of Right to Lien" form that omits important information, such as the date on which the lien arises and the property that is subject to the lien, is insufficient to meet the notice requirement of ORS 87.021(1). Further, Engineer was not exempt from the notice requirement under ORS 87.021(3)(b), which excludes from the notice prerequisite persons who perform labor at the site of a commercial improvement, because Engineer's contact with the jobsite was "incidental." *Teeny v. Haertl Constructors, Inc.*, 314 Or. 688, 842 P.2d 788 (1992).

LITTLE MILLER ACT: Oregon's Little Miller Act can apply to state or local government projects that receive federal funding. Notice under the Little Miller Act provided within 180 days after the last date on which labor or materials were provided is timely with respect to all work or materials associated with the project.

State ex rel. Robert Warren Trucking, LLC v. Smith & Smith Excavation, Inc., No. A156485, 2016 WL 4702337 (Or. Ct. App. Sept. 8, 2016). The Port of Tillamook Bay engaged Skanska for the construction of an industrial business park. As required by Oregon's Little Miller Act, ORS 279C.380 to 279C.625, Skanska executed and delivered a performance bond and payment bond to the Port. Skanska engaged Smith to perform initial site work and demolition on the project. The Port received federal funding for the project. Smith hired West Coast Mining & Crushing to operate a portable rock crusher off site. West Coast contracted with Warren to haul unprocessed rock from the quarry to the crusher site, and haul crushed rock from the crusher site to the project site. Warren hauled unprocessed rock from the quarry until November

2011, but continued to perform services directly for Smith until May 2012. At that time, Warren was owed approximately $40,000 for work performed for West Coast, and $28,000 for work performed directly for Smith.

In June 2012, Warren provided Skanska with a notice of bond claim. Skanska rejected the claim, arguing that (1) the federal Miller Act, not Oregon's Little Miller Act, governed Warren's claim; and (2) Warren's notice was untimely as to the work performed for West Coast. The trial court rejected Skanska's arguments, and entered judgment in favor of Warren. Skanska appealed.

The court held that the federal Miller Act did not apply merely because the Port received federal funding on the project. "A greater level of federal involvement—such as the federal government's present or intended future ownership of the project, involvement as a party to the contract, or posting of the bond against which the claim is made—is required to bring a project within the federal Miller Act." The court also rejected Skanska's claim that Warren's notice was untimely as to the work performed for West Coast, noting that Oregon's Little Miller Act does not require a party to provide a separate notice for the labor or materials provided to different entities, under separate contracts, on the same project.

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