VEDDER PRICE

CONSTRUCTION CITES

A periodic bulletin citing and analyzing legal and other developments affecting the construction industry

April 2003

VEDDER PRICE WINS MAJOR MECHANICS' LIEN LITIGATION

In a case of first impression under the Illinois Mechanics' Lien Act (the "Act") on September 24, 2002, the Appellate Court of Illinois for the First District affirmed the Circuit Court of Cook County's grant of summary judgment in favor of the plaintiff contractor whom Vedder Price represented, **("Contractor")**, on its claims for foreclosure of its mechanics' lien, breach of contract and prejudgment interest. The case involved a dispute with the property owner, Lawrence Ryan ("Ryan"), concerning the construction of a single family home at 1930 N. Howe Street, Chicago, Illinois. The trial court awarded, and the appellate court affirmed, an award to Contractor of the entire outstanding contract balance, plus extras, as well as Contractor's attorney's fees under Section 17 of the Act, in the amount of $58,704.00, as well as post-judgment interest thereon.

Importantly, the appellate court also affirmed the trial court's discretion in levying discovery sanctions, finding that: (1) the trial court properly struck portions of Ryan's affidavit; and (2) the trial court properly struck the defendant's experts' affidavits. The Defendant failed to timely disclose its experts' opinions and, when Ryan attempted to include affidavits of its experts in an attempt to defeat Contractor's motions for summary judgment, the trial court granted Contractor's motions to strike the same.

Finally, of critical import to Illinois practitioners, the appellate court affirmed the trial court's finding that, under Section 1 of the Act, a claimant is entitled to a lien judgment amount including 10% percent interest under the Act, from the date the claim became due to the date of the judgment. Each aspect of the court's decision will be discussed in turn.

First, the appellate court agreed that the trial court properly struck Ryan's experts' affidavits because Ryan failed to disclose one expert's report on time and because a second expert's report did not contain sufficient factual support. The appellate court rejected Ryan's argument that the trial court had abused its discretion in striking the experts' affidavits. In so holding, the court followed its earlier decisions holding that the proper remedy for late disclosure of an expert's report is to strike the report. Additionally, the appellate court reaffirmed earlier decisions finding that an expert's affidavit must contain facts admissible at trial rather than mere conclusions. Here, Ryan failed to disclose his expert's report on time and based another expert's report entirely on conclusions rather than on facts. Accordingly, the trial court properly struck these affidavits.

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Additionally, the appellate court found that Contractor was entitled to attorney's fees under Section 17 of the Illinois Mechanics' Lien Act because Ryan: (1) failed to release undisputed amounts to Contractor; (2) asserted a defense that was not well-grounded in fact or warranted by existing law; and (3) failed to pay Contractor the full contract price, including extras, "without just cause or right." Although Ryan claimed that a good faith dispute existed regarding Contractor's entitlement to "extras" to the contract, the appellate court rejected Ryan's reasoning, noting that Ryan had already ratified the "extras" and that Contractor had substantially completed the residence at the time Ryan refused to pay. The court further observed that Ryan failed to create a punch-list detailing the unfinished work or establish an escrow for the estimated costs to complete the residence until Contractor filed its lawsuit against him. The appellate court, after examining each of these undisputed facts, affirmed the trial court's determination that Ryan acted "without just cause or right" in withholding payment from Contractor.

Finally, the appellate court, in deciding an issue of first impression in Illinois, concluded that Contractor was entitled to an award of post-judgment interest of 9% per annum on its entire mechanics' lien claim. The court interpreted the plain language of the Mechanics' Lien Act and found that a mechanics' lien claim includes: (1) the amount due for the labor and materials under the parties' contract; and (2) 10% interest from the day those amounts were due. The court reasoned that because the lien amount includes the 10% interest under the Mechanics' Lien Act, awarding post-judgment interest pursuant to the Illinois Code of Civil Procedure would not amount to an award of "compound interest."

Importantly, the appellate court examined the purpose of both the Mechanics' Lien Act and the Illinois Code of Civil Procedure and found that the two Acts were both meant to penalize defendants for failing to pay amounts undoubtedly owed to plaintiffs. The Mechanics' Lien Act penalizes a defendant for withholding money from the time the money is due to the time the plaintiff obtains a judgment against him. The Illinois Code of Civil Procedure penalizes defendants for withholding money after a judgment has been obtained. The appellate court aptly noted that the law in Illinois encourages defendants to pay plaintiffs all undisputed amounts. When a defendant fails to do so, as did Ryan in this case, the law penalizes the defendant by imposing interest on the amounts he has refused to pay.

The appellate court's decision in Contractor v. Ryan, 1-01-3568 (1st Dist. September 24, 2002), marks a victory for plaintiff-contractors in Illinois. The court recognized that Contractor was entitled to payment for the work it completed constructing Ryan's home. Additionally, the court refused to permit Ryan to withhold payment under the guise of a "good faith" dispute regarding money that should have been paid to Contractor upon completion of the home. This case serves to remind potential defendants in Illinois that the courts will not tolerate a defendant's wrongful refusal to pay his contractor.

INSURANCE COVERAGE FOR JOB SITE INJURIES: INDEMNIFICATION AGREEMENTS MAY CREATE COVERAGE GAP FOR ILLINOIS EMPLOYERS

Introduction

When a job site accident occurs, the injured worker's remedy against his employer is usually limited to the amount available to him under the Workers' Compensation Act. Because this amount is typically much less than he could receive in a negligence action against a third party, it is not uncommon for an injured worker to also find a third party to sue for his injuries. For example, in addition to filing a workers' compensation claim, an injured worker may sue the general contractor, alleging it failed to provide a safe place to work.

Until February 5, 1992, when a worker sued a third party for his work-related injuries, the third party could file an action against the worker's employer, seeking contribution for that portion of the liability that arose out of the employer's negligence. For example, the general contractor might file a contribution action against the

employer alleging that the worker had been improperly trained. At trial, any judgment obtained by the worker would be apportioned between the general contractor and the employer according to their respective degrees of fault. Thus, it was not uncommon for a judgment to be entered against the employer that greatly exceeded the amount that it had previously paid the employee pursuant to the Workers' Compensation Act.

Until recently, both the amount payable by the employer under the Workers' Compensation Act and the judgment entered against it in the worker's personal injury action were without question covered under the employer's workers' compensation/employer's liability insurance policy.

Recent Illinois court decisions, however, raise doubt as to whether employers have insurance coverage for liability in excess of their workers' compensation payments where the employer entered into a construction contract requiring it to indemnify the contracting parties above it for bodily injuries occurring on the project.

Kotecki Decision

On February 5, 1992, the Supreme Court of Illinois issued its opinion in the case of *Kotecki v. Cyclops Welding Corporation*, 146 Ill. 2d 155, 585 N.E.2d 1023 (1992). In *Kotecki*, the Supreme Court held that the amount of contribution that can be obtained from an employer by a third party is limited to the amount of the employer's liability under the Workers' Compensation Act. Thus, following *Kotecki*, a third party could still file a contribution action against the injured worker's employer, but the employer's liability would be limited to the amount it had already paid in response to the employee's workers' compensation claim.

The *Kotecki* decision represented a significant benefit to workers' compensation insurers. Under the Workers' Compensation Act, the employer has a statutory lien on an award that an employee obtains against a third party. Stated differently, when an injured worker obtains a personal injury award against a third party, he must first reimburse his employer's workers' compensation insurer for any payments it made. Prior to *Kotecki*, workers' compensation insurers would often waive their lien in order to avoid a contribution action and potential liability in excess of the amounts it had already paid out. *Kotecki*, however, eliminated the risk to the employer and its insurer of a contribution award in excess of the workers' compensation lien. Therefore, post-*Kotecki*, an employer's workers' compensation insurer had incentive to participate actively in the employee's negligence action in hopes of obtaining reimbursement of its workers' compensation payments. There was no downside risk to the employer or its workers' compensation insurer.

Herington, Liccardi and Braye Decisions

Kotecki's benefit to employers and their workers' compensation insurers, however, was short-lived. In 1994, the Illinois Appellate Court, Fifth District, issued its opinion in *Herington v. J.S. Alberici Construction Co.,* 266 Ill. App. 3d 489, 639 N.E.2d 907 (1994). In *Herington*, two employees of a painting subcontractor were injured. They filed workers' compensation claims against their employer and a personal injury action against the general contractor. The general contractor, in turn, filed a contribution action against the subcontractor.

> ***"Following Herington, it appeared that both employers and their insurers once again faced a significant downside risk in contribution actions, particularly in the construction scenario, where indemnity agreements are the norm."***

The court held that the subcontractor had waived its right to rely upon the workers' compensation limits recognized in *Kotecki* as a defense to the contribution claim by agreeing to indemnify the general contractor for all liability arising out of the subcontractor's negligence. The court stated, "If an employer is free to choose

whether to raise the workers' compensation defense after suit is filed, we see no reason why an employer may not bargain away that defense as part of a subcontract. Just as an employer may choose not to raise the defense in a direct suit by an employee because it may believe it will prevail, the employer may agree to waive the defense as part of the contract bargaining process." Thus, by agreeing to include a standard indemnity/hold harmless agreement in its contract with the general contractor, the subcontractor unwittingly waived its *Kotecki* rights and exposed itself to unlimited liability in the contribution action.

Following *Herington*, it appeared that both employers and their insurers once again faced a significant downside risk in contribution actions, particularly in the construction scenario, where indemnity agreements are the norm. Current Illinois law, however, suggests that the only party who faces significant downside risk where the employer's *Kotecki* limits have been waived may be the employer itself.

Christy-Foltz Decision

On January 7, 2000, the Illinois Appellate Court, Fourth District, issued its opinion in *Christy-Foltz, Inc. v. Safety Mut. Cas. Corp.*, 309 Ill. App. 3d 686, 722 N.E.2d 1206 (2000). In *Christy-Foltz*, an employee of Christy-Foltz was injured on a construction project. He filed a workers' compensation claim against his employer and a personal injury action against the general contractor on the project. The general contractor, in turn, filed a contribution action against Christy-Foltz. In accordance with *Herington*, the court held that Christy-Foltz had waived its right to rely upon the limitations recognized in *Kotecki* by virtue of an indemnification/hold harmless agreement between the general contractor and subcontractor.

Following the court's ruling, Christy-Foltz's workers' compensation insurer, Safety Mutual, denied coverage for any contribution award against Christy-Foltz in excess of its liability under the Workers' Compensation Act. Safety Mutual asserted that Christy-Foltz was not entitled to coverage because it had voluntarily assumed liability in excess of its workers' compensation lien by virtue of a contractual indemnification agreement. The insurer relied upon a policy exclusion that stated:

> In no event shall the CORPORATION [Safety Mutual] be liable for any [l]oss or [c]laim [e]xpenses voluntarily assumed by the EMPLOYER [Christy-Foltz] under any contract or agreement, express or implied.

The court held that, under the unambiguous terms of the policy, the employer had no coverage for amounts in excess of its liability under the Workers' Compensation Act, stating:

> In agreeing to waive the right to invoke *Kotecki* as an affirmative defense, the [employer] voluntarily assumed contribution liability in excess of the liability limitations provided to employers under the Workers' Compensation Act.

Thus, the employer was not entitled to coverage under its workers' compensation policy for any judgment entered against it in the worker's personal injury action.

"Thus, the employer was not entitled to coverage under its workers' compensation policy for any judgment entered against it in the worker's personal injury action."

Courts Split on General Liability Coverage for an Employee's Personal Injury Action

Hankins Decision

Illinois courts are currently split on whether an employer's general liability policy provides coverage for an employee's personal injury action. The Fifth District

Appellate Court has held that there is no coverage. The Second District Appellate Court has held that there is coverage. In *Hankins v. Pekin Insurance Co.*, 305 Ill. App. 3d 1088, 713 N.E.2d 1244 (5th Dist. 1999), the employer operated a trucking terminal in Effingham County. It had entered into an "Independent Cartage Operator Agreement" with a motor freight carrier. Under the terms of the agreement, the employer agreed to provide a shipping and receiving terminal that the motor carrier was permitted to use to deliver and pick up loads of materials. The agreement also contained a provision whereby the employer agreed to hold the motor carrier harmless for all liability arising out of its negligence. A worker was injured while unloading a truck. He sued the motor carrier, who in turn filed a contribution action against the employer.

The employer tendered the defense of the contribution action to its general liability insurer. The insurer denied coverage on the grounds that the policy excluded coverage for liability assumed under a contract. The insurer relied on policy language that stated:

> This insurance does not apply to:
>
> b. "Bodily injury" or "property damage" for which the insured is obligated to pay by reason of the assumption of liability in a contract or agreement.
>
> This exclusion does not apply to liability for damages:
>
> (1) Assumed in a contract or agreement that is an "insured contract," provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement.
>
> The policy defined "insured contract" as:
>
> That part of any other contract or agreement pertaining to your business . . . under which you assume the tort liability of another to pay damages because of "bodily injury" or "property damage" to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement . . .

The court held that the indemnification agreement between Hankins and the motor carrier was not an "insured contract" because, under the policy definition, an insured contract is "one that provides for the contracting parties to assume someone else's tort liability, that is, someone else's liability for their own negligence." Hankins, the court held, had not agreed to assume the tort liability of the motor carrier, but rather, had only agreed to indemnify the motor carrier to the extent of Hankins' own negligence. Thus, the court found that the employer was not entitled to coverage under its general liability policy for the contribution action filed against it by the motor carrier.

The Second District of the Illinois Appellate Court disagreed with the holding in *Hankins*. In *Michael Nicholas, Inc. v. Royal Ins. Co.*, 321 Ill.App. 3d 909, 748 N.E.2d 786 (2nd Dist. 2001), the employer's general liability insurer denied coverage, relying upon the *Hankins* decision. The court rejected the insurer's argument, finding coverage under the employer's general liability policy for its injured worker's personal injury action. In conflict with the *Hankins* decision, the *Michael Nicholas* court determined that a contractual indemnification agreement qualifies as an "insured contract" under standard commercial general liability policies.

Contractors Should Report Worker Injuries to Their Workers' Compensation and General Liability Insurers

In light of these recent cases and the current conflict within the Appellate Court, it is important for contractors to report all worker injuries to both their workers' compensation and general liability insurers. Failure to report a worker's injury to the general liability insurer may result in a late notice defense being raised when the employer is joined in the worker's personal injury suit. In addition, consideration should be given to whether indemnification agreements (or *Kotecki* waivers) are

necessary. Most often, properly worded contractual insurance requirements will provide the necessary protection to all parties involved in the project.

THE USE OF ENVIRONMENTAL INSURANCE IN DEVELOPMENT IEALS

The discovery of environmental contamination at a proposed development site can result in a significant delay or complete breakdown of negotiations for the acquisition of the property. For obvious reasons, the seller of the property is often unwilling to indemnify the buyer for future environmental liabilities, and the buyer is unwilling to assume the risk of being required to clean up the property or be held liable for injuries or property damage to third parties caused by the contamination.

> ***"Insurance companies have developed policies that are designed to alleviate the environmental risk involved in real estate development deals."***

Insurance companies have developed policies that are designed to alleviate the environmental risk involved in real estate development deals. Two of these products are known as Pollution Legal Liability and Clean-Up Cost Cap. Depending upon the situation, the parties to a real estate deal can use these types of policies in cooperation with each other to remove the risk caused by known and unknown pollution conditions and help the deal go through, or, in certain circumstances, by one party to the deal to obtain a competitive advantage in negotiations over the property.

Pollution Legal Liability Coverage

Pollution Legal Liability policies, as the name suggests, are policies that cover the insured for amounts it becomes legally liable to pay as a result of clean-up costs, as well as bodily injuries and property damage resulting from contamination on, or migrating from, the insured property. Depending upon the coverage purchased, the policy may cover losses resulting from both pre-existing and new contamination. The policies are issued on a "claims-made" basis, which means that they cover only claims first made against the insured during the policy period. The following coverages are available: clean-up costs for pollution on the insured property that commenced prior to the policy period; clean-up costs for pollution on the insured property that commenced during the policy period; bodily injury or property damage sustained by a third party while on the insured property; clean-up costs for pre-existing pollution that migrated from the insured property onto a third party's property; clean-up costs for new pollution that migrated from the insured property onto a third party's property; and bodily injury or property damage resulting from pollution that migrated from the insured property onto a third party's property. In addition, the insured can purchase first-party coverage for lost profits and loss of rental income resulting from contamination on the property. The policy will cover liability arising from the insured's contractual agreement to indemnify another party, as long as the agreement is scheduled in the policy as an insured contract.

Clean-Up Cost Cap

Clean-up Cost Cap policies are designed to alleviate the risk that the clean-up of contamination will cost more than expected. The policies provide two different types of coverage. First, the policies cover clean-up costs in excess of the self-insured retention that the insured incurs for the clean-up of pollutants identified in the Remedial Plan. When applying for the policy, the insured will be required to submit a Remedial Plan which describes the clean-up of contaminants at, or migrating from, the insured property. The self-insured retention will typically be set at the estimated cost of clean-up. The policy covers any unexpected cost overruns. The policy can also be designed to cover the cost of cleaning up pollutants not identified in the Remedial Plan. In other words, if additional

contamination is discovered during execution of the Remedial Plan, the policy will cover the cost of cleaning up the newly discovered contamination. For both coverages, the additional costs must be incurred during the policy period, which can be as long as ten years or longer, depending upon the insurer. An additional benefit to a Clean-Up Cost Cap policy is that if the property is sold during the course of the clean-up, the policy remains in force after the sale for the benefit of the original insured and new property owner.

Uses for Environmental Insurance in Development Deals

These two types of environmental insurance can be used by both parties in the transaction to save the deal. Assuming that the seller is unwilling to retain, and the buyer is unwilling to assume, the risk of environmental liabilities at the site, the parties can agree to obtain Pollution Legal Liability and/or Clean-Up Cost Cap coverage. The insurance coverage will remove most of the risk of environmental liabilities in relation to the property and enable the transaction to go through. In the alternative, a party to a real estate transaction can use environmental insurance to gain a competitive advantage in negotiations for the sale of the property. For example, the buyer can agree to assume responsibility for environmental conditions at the site in exchange for a significant reduction in the sale price. He can then purchase environmental insurance for a premium that is less than the negotiated price reduction, adding additional value to the deal for himself. Likewise, a seller can agree to retain responsibility for environmental liabilities at the site in exchange for a price increase, and then purchase environmental insurance for a premium that is less than the negotiated price increase, resulting in a net gain.

Several of the major commercial lines insurers in the United States offer these types of environmental insurance policies. Terms and conditions may vary from insurer to insurer. Each policy must be evaluated in relation to the property, environmental conditions and transaction to determine the level of protection afforded.

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Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with approximately 200 attorneys in Chicago, New York City and Livingston, New Jersey.

The Construction Law Group

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