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## Third-Party Contractual Risks Not Covered by Builder's Risk Insurance Policy

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26-1-3-306 (West 1980 & Supp. 1990), to the Lenders.

The court observed that the Students' claims were based on Adelphi's alleged fraudulent activities. Some claims referred to specific instances of fraud while others pointed to a breach of fiduciary duty and negligence contingent on Adelphi's alleged fraudulent activities. In addition, other purported facts, if proven, would have suggested fraud on the part of Adelphi. According to Rule 9(b) of the Federal Rules of Civil Procedure, Fed. R. Civ. P. 9(b), a plaintiff's claim of fraud must include particular statements and actions alleged to be fraudulent as well as the reasons why the statements or actions are fraudulent. In this case, the Students did not charge the Lenders with any specific wrongful actions. Hence, the court found that the Students failed to meet the particularity standard required by Rule 9(b).

Although the Students did not charge the Lenders with any wrongful conduct, the Students proposed that the claims against Adelphi should be attributed to the Lenders because of the "close connection" between the two. Adelphi had chosen the Lenders, used their preprinted forms, and represented the Students in all dealings with the Lenders. The Students suggested that this connection constituted an "origination relationship." Such a relationship exists when a lender allows a school to execute many of the lender's responsibilities associated with the making of loans, such as completing loan forms normally completed by the lender. 34 C.F.R. § 682.200 (1989). The Students argued that an origination relationship may serve as a defense to the nonpayment of loans if a school does not render educational services. The Students claimed that the "origination relationship" between Adelphi and the Lenders precluded repayment of the loans to the Lenders since Adelphi failed to provide the Students with an education.

However, for these defenses to apply, the court of appeals noted that the loans must have been Federal Insured Student Loans, Federal PLUS loans, or other loans

guaranteed by the federal government. The loans in the present case were not federally guaranteed. Rather, they were guaranteed by the Lenders which were state and private institutions. Thus, the Students' "origination relationship" argument could not stand.

The Students then attempted to hold the Lenders liable for charges against Adelphi under the FTC rule on the preservation of consumer defenses. The FTC rule states that consumer credit contracts must contain a stipulation informing holders of such contracts that they are subject to all of the debtor's claims and defenses against the seller of goods and services. 16 C.F.R. § 433.2 (1991). However, loans made, issued or guaranteed under the HEA, as the loans were in this case, were exempt from the FTC rule. Thus, the FTC rule did not apply to the Students' claims.

Finally, the students argued that they were eligible to recover under the Indiana Code provision referring to liabilities of assignees and assignors. Ind. Code. Ann. §§ 26-1-3-306 (West 1980 & Supp. 1990). Under the Code, an assignee of an instrument who is not a holder in due course is subject to defenses raised against the assignor. However, the court found that the Indiana Code was irrelevant in this case since the Lenders were never assignees of Adelphi but instead were the original holders of the notes.

Because the Students failed to show that the Lenders were liable for Adelphi's actions, the court affirmed the district court's dismissal for failure to state a claim. The court noted, however, that the students had not exhausted their remedies. The Department of Education had issued student loan write-off procedures following the decision of the district court. In addition, the students could file bankruptcy claims and assert state defenses if sued in state court for collection of the student loans.

Elizabeth A. Graber

## Third-Party Contractual Risks Not Covered By Builder's Risk Insurance Policy

In *Trinity Industries, Inc. v. Insurance Company of North America*, 916 F.2d 267 (5th Cir. 1990), the United States Court of Appeals for the Fifth Circuit held that a builder's risk insurance policy did not cover arbitration costs awarded against the policyholder to correct faulty workmanship. The court also found that the policy did not cover contractual risks agreed upon by a policyholder and a third party.

### Background

In December, 1980, Halter Marine, Inc. ("Halter"), which Trinity Industries, Inc. ("Trinity") acquired prior to judgment, agreed to build six supply boats for Leam Transportation, Inc. ("Leam"). The contract included a warranty for workmanship and provided for arbitration in the event of any dispute between the parties. The contract also required that Halter carry hull, P & I, and builder's risk insurance. The Insurance Company of North America ("INA") provided insurance under a policy that listed Halter and Leam as co-insureds and co-loss payees.

In one of the vessels built, the M/V LEAM ALABAMA, Halter misaligned two of the modular hull sections, creating a "twist" in the vessel. This twist caused one corner of the vessel to be seven to twelve inches lower than the other.

Upon receipt of the M/V LEAM ALABAMA in February 1982, Leam became aware of the twist when it had problems trimming the vessel. In accordance with the terms of the contract, Leam made a written complaint and returned the vessel to Halter for repairs. Claiming that the twist was within shipbuilding standards, Halter refused to repair the vessel. In July 1983, Leam filed for arbitration, seeking \$2.3 million in damages and return of its purchase price. Leam argued that the twist in the hull made the vessel useless.

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### Third Party Risk

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Almost two years after Leam first notified Halter of its dissatisfaction with the M/V LEAM ALABAMA, Halter contacted INA. Halter claimed that its INA builder's risk insurance policy should cover any arbitration panel award. INA denied that the policy covered such awards.

In late 1984, the arbitration panel determined that the twist did not significantly impede the operation of the vessel. The panel did find, however, that the size of the twist exceeded shipbuilding standards; Halter had violated the warranty of workmanlike performance. The panel awarded Leam \$200,000 for Halter's contract breach, attorney's fees, costs, and arbitrator's fees.

In January, 1985, the United States District Court for the Eastern District of Louisiana at New Orleans affirmed the arbitration award. One month later, Halter formally demanded that INA reimburse the company for the arbitration award. INA again denied coverage. Halter then sued INA to recover the arbitration award and the legal fees incurred in the arbitration proceedings. Claiming that INA's refusal of coverage was arbitrary, capricious, or without probable cause, Halter also sought attorneys' fees and statutory penalties under La. Rev. Stat. Ann. § 22:658(B) (West Supp. 1985).

#### Procedural History

The trial court, on cross motions for summary judgment, held that the insurance policy covered the arbitration award. The court tried three issues: (1) whether INA owed Halter the legal fees Halter incurred in the arbitration action, (2) whether the late notice of the claim adversely affected INA, and (3) whether INA's refusal of coverage was arbitrary, capricious, or without probable cause.

After a bench trial, the lower court found in favor of Halter on all issues. INA appealed the decision to the United States Court of Appeals for the Fifth Circuit.

#### The Fifth Circuit's Decision

An all risks insurance policy is one which creates a special type of coverage which would extend to risks not usually covered under other insurance policies. In this case, the INA builder's risk policy "insure[d] against all risks of physical loss of or damage to the subject matter... here insured."

In its suit against INA, Halter first argued that the INA builder's risk policy was an all risks policy. Accordingly, Halter contended that the policy should cover costs stemming from defective workmanship. In addition, Halter argued that the twist in the vessel was damage, as defined in the insurance policy. Because the arbitration award was based on the twist, Halter concluded that the INA policy covered the award.

The Fifth Circuit rejected Halter's argument that the policy covered Halter's costs of repairing the construction mistakes. The court noted that while present case law indicated that some all risks policies covered defective workmanship, such coverage was limited to cases in which the faulty workmanship had led to an accident affecting the insured structure. The award granted in each case covered rebuilding the original structure or the costs of the accident; the award did not cover repairing or correcting the defective original design of the original structure. Because the twist was negligently built into the M/V LEAM ALABAMA and not the result of an accident, the court rejected Halter's claim that the twist in the vessel was physical loss or damage, as defined in the policy.

In addition, the court noted that Halter did not file the claim to recover the costs repairing the twist but rather to recover the costs of the arbitration award. This fact, as well as the failure of either Leam or Halter to file a claim on the policy for over two years, led the court to conclude that the parties did not intend for the builder's risk policy to cover the costs of repairing the twist.

The court next addressed the issue of whether reimbursement for the arbitration award was within the scope of the builder's risk

policy. Because the arbitration award was based on the twist, Halter argued that the builder's risk policy should cover the award. The court did not accept the idea that the arbitration award itself fit the policy's definition of physical loss or damage or that it qualified as physical loss or damage to the vessel. The court thus rejected Halter's claim that the builder's risk policy should cover the award. The court noted that the arbitration award was based on a finding that the twist represented Halter's breach of his contractual warranty to Leam and not on a finding that the twist was damage to the M/V LEAM ALABAMA.

Since 1972, INA had provided a blanket policy at a uniform price for each vessel built by Halter. The court determined that because contractual clauses such as warranties would affect INA's potential liability, INA would have had to consider the individual contract terms for each vessel insured in order to set an appropriate premium. The court found that INA did not know the contract terms between Halter and Leam at the time it wrote the builder's risk policy; INA's uniform policies for all vessels built by Halter for various buyers indicated that neither party intended the policies to include Halter's special contractual risks with respect to each vessel. The court therefore concluded that Halter's contractual risks were beyond the scope of the builder's risk policy. The court held that INA was not liable to Halter for the arbitration award.

Lastly, Halter argued that the Sue & Labor clause of the builder's risk policy covered attorney's fees incurred in the arbitration proceedings. The court found that Halter had engaged in arbitration to reduce his contractual liability rather than to "defen[d], safeguard, or recover[]" the M/V LEAM ALABAMA, as required by the policy. The court noted once again that the policy did not cover contractual risks; the Sue & Labor clause did not cover Halter's attorney's fees.

The Fifth Circuit thus reversed the trial court's decision and held that the builder's risk policy did not cover the arbitration award.

The court also reversed the trial court's award of statutory penalties under La. Rev. Stat. Ann. § 22:658(B) (West Supp. 1985).

Aida M. Alaka

## Exclusive Warranties Failing In Essential Purpose Do Not Prevent Consequential Damage Recovery

In *Ragen Corp. v. Kearney & Trecker Corp.*, 912 F.2d 619 (3d Cir. 1990), the United States Court of Appeals for the Third Circuit held that warranties containing exclusive remedies, which fail in their essential purpose, do not preclude recovery for consequential damages under Wisconsin law.

### Background

Ragen Corporation ("Ragen") was a New Jersey manufacturer of component parts for computers and nuclear reactors. Since 1955, Ragen conducted business with Kearney & Trecker Corporation ("K & T"), a Wisconsin corporation that manufactured high-speed machining equipment.

In 1976, K & T began manufacturing the MM800, a fully automated machine designed to drill metal castings. For approximately two years, K & T discussed the MM800 with Ragen and submitted a proposal to Ragen for the sale of MM800 units in April 1978. The proposal described the MM800 in detail and specified the conditions of the proposed sale.

K & T's proposal stated that the entire and exclusive warranty for the MM800 was either (1) repair or replacement of the defective part or product; or, at K & T's option, (2) return of the product and refund of the purchase price. Furthermore, the proposal stipulated that under no circumstances would K & T be liable for any consequential damages arising in connection with the MM800. The proposal also provided that Wisconsin law would govern any resulting contracts between K & T and Ragen.

Ragen sent purchase orders to K

& T for eight MM800 machines. In January, 1979, K & T installed the first two MM800 units at Ragen's plant. Soon thereafter, the MM800s began to malfunction. In late 1979, after the installation of the next two units, Ragen discovered defects in the MM800s.

Pursuant to its warranty, K & T repaired and serviced the MM800 units at Ragen's plant over the next five years. However, these efforts provided only a temporary solution to the problem. Prior to and after repair, the machines could not operate at, or near, their capacity.

Along with the MM800 problems, Ragen also experienced difficulties with four Eb/1624 machines. Ragen had previously purchased these units from K & T, which retrofitted them to operate like the MM800. In November 1980, and March 1982, Ragen cancelled orders to purchase other machines from K & T.

In August 1981, in response to Ragen's threat to cancel orders for the remaining MM800 units, K & T offered to aid Ragen in maintaining an 85% operating capacity for the MM800s, if Ragen also agreed to perform preventive maintenance on the machines. Ragen accepted K & T's proposal and did not revoke the orders for the remaining MM800 units. However, by 1982, Ragen realized that K & T could not sustain the 85% operating capacity for the MM800 units; Ragen also had not been maintaining the machines as agreed. Subsequent negotiations between the parties failed. Ragen discontinued business with K & T.

In July 1983, Ragen filed suit against K & T in the United States District Court for the District of New Jersey. Ragen claimed breach of warranty, design defect, and fraud against K & T for the MM800 and retrofitted Eb/1624 units. K & T counterclaimed, contending that Ragen breached the purchase contracts for machines other than the MM800s. In its decision, the district court awarded Ragen compensation only for direct damages resulting from K & T's breach of warranty. Additionally, the court rejected K & T's counterclaim. Both parties ap-

pealed the court's verdict to the United States Court of Appeals for the Third Circuit.

### The District Court's Opinion

The district court first determined the parties' contractual rights and liabilities. Using the terms contained in K & T's proposal, the district court concluded that Ragen's contractual remedy was limited to repair or replacement of the defective machines; the contract explicitly excluded recovery for any consequential damages. The court held that this explicit exclusion was not unconscionable.

Next, the district court addressed Ragen's breach of warranty claim. The court agreed with Ragen's claim that the MM800s suffered from design defects which constituted a breach of warranty. Therefore, the contract entitled Ragen to seek the repair or replacement of the MM800s. However, since K & T was unable to repair adequately or replace the defective MM800 units, the court found that the limited remedy failed in its essential purpose. Consequently, in order to provide an appropriate remedy, the district court decided to apply section 2-719 of the Uniform Commercial Code ("UCC").

Section 2-719 allows a court to apply any remedy available under the UCC for a contract breach, such as Ragen's, whose limited warranty failed in its essential purpose. Using this rule, the court concluded that the only remedy Ragen could pursue was section 2-714(2), UCC § 2-714(2) (1989), which allowed Ragen to recover direct damages amounting to the difference in value between the MM800 units as received and the MM800 units as warranted. Although Ragen failed to submit evidence showing the difference in value between the MM800s as received and the MM800s as warranted, the district court awarded Ragen damages based on its own estimate of direct damages.

The district court did not address Ragen's fraud claims against K & T. Also, due to apparent confusion concerning machine identities, it is unclear whether the court decided the claims concern-

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