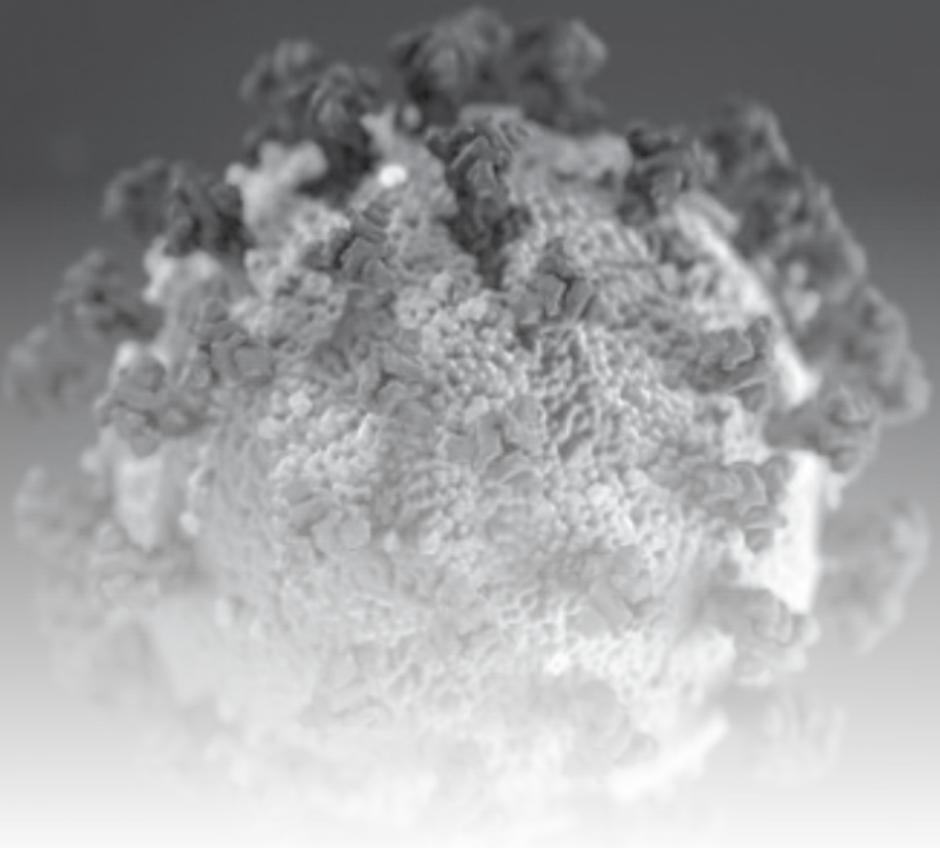


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THE RISE OF MODULAR
CONSTRUCTION:
COMMON LEGAL
ISSUES

WHY WOMEN WANT:
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ADDICTION IN FEMALES

THE RISE OF MODULAR CONSTRUCTION: COMMON LEGAL ISSUES

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INTRODUCTION

This article provides a general overview of modular construction, and an outline of common legal issues defense counsel might face when advising construction companies involved in such construction.

What is modular construction? Modular construction refers to one or more structures or units constructed off-site, used as components within a finished building. The components can range from a single wall or bathroom, to a full unit or “full stack.” The components are fabricated off-site, typically in a manufacturing plant.

These prefabricated modules are completed with interior finishes, as well as the electrical, mechanical and plumbing, and then fitted together into the finished building. The finishes (such as walls, windows, HVAC, electrical and plumbing) are precision designed and fabricated to interconnect and mesh effortlessly on-site, much like a giant Lego® set. The timing of delivery is coordinated to

ensure that the units arrive exactly when the site is ready, so that each unit can be installed shortly after it arrives. Such coordination and design require extensive planning on the front end to meet demands of the evolving industry. Lack of attention to design or engineering can result in units that do not mesh properly in the field, requiring significant refabricating on-site, or even delays in installation leaving units exposed to weather damage.

Modular units are built to endure transportation and storage, meaning they are somewhat portable and protected from the elements. Before leaving the factory, the units are protected to endure transport — by ship, train or crane — as well as weather and unforeseen delays. But even with the best coordination and planning, the units may experience unintended consequences. Multiple, focused inspections at the factory are conducted both for compliance and to mitigate risk.

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A recent rise in large scale modular construction, including hotels, apartments, and healthcare and industrial facilities, poses multiple issues for construction counsel. See *Reinventing Construction: A route to higher productivity*, McKinsey Global Institute and McKinsey's Capital Projects & Infrastructure Practice, February 2017, McKinsey.com. Construction counsel should be well-versed in these legal issues.

APPLICABILITY OF THE UCC: GOODS OR SERVICES?

Historically, courts across the country, including in Minnesota, have generally construed traditional construction contracts to be primarily contracts for services, and thus have found that the Uniform Commercial Code ("UCC") does not apply. See *McCarthy Well Co. v. St. Peter Creamery, Inc.*, 410 N.W.2d 312, 315 (Minn. 1987) (contract for restoration of artesian well construed as services contract); *Dilorio v. Structural Stone & Brick Co., Inc.*, 845 A.2d 658, 663 (N.J. Super. A.D. 2004); *Openaire, Inc. v. L.K. Rossi Corp.*, 940 A.2d 724, 726 (Vt. 2007) (contract to build and install a swimming pool enclosure was a contract for services); *Lincoln Pulp & Paper Co. v. Dravo Corp.*, 436 F.Supp. 262, 275 (D. Me. 1977) (finding UCC inapplicable to contract relating to the sale, engineering and construction of heat recovery unit).

Modular construction, however, has the potential to challenge that premise because most of the construction takes place off-site, often in a manufacturing facility owned and operated by a third-party. In such cases, a modular construction may be considered a contract for the sale of goods, rather than services, potentially triggering the application of the UCC, rather than traditional construction contract principles.

DETERMINING WHETHER THE UCC APPLIES

Minnesota will likely use the "predominant purpose test" to determine whether the UCC applies to a modular construction project.

The UCC, as adopted in Minnesota, is codified as Chapter 336 of Minnesota Statutes, and defines goods as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale." Minn. Stat. § 336.2-105(1).

When a transaction involves both goods and services, Minnesota courts use the "predominant factor test" to determine whether the transaction is a sale under the UCC. *Duxbury v. Spex Feeds, Inc.*, 681 N.W.2d 380, 386-87 (Minn. Ct. App. 2004) (citing *Valley Farmers' Elevator v. Lindsay Bros. Co.*, 398 N.W.2d 553, 556 (Minn. 1987)). Under this test, the courts examine whether the predominant factor in the transaction is the transfer of goods or the provision of services. *Id.* Relevant considerations include the language of the contract, the business of the supplier, and the "intrinsic worth" of the goods involved.

Minnesota courts' treatment of mobile and modular homes (through the application of the predominant factor test) suggests that the UCC may play a larger role in the future of modular construction. See *Carpenter v. Anderson Homes, Inc.*, 2007 WL 5129716 (Minn. Dist. Ct. June 11, 2007) (concluding that the sale of a modular home was governed by Article 2 of the UCC); *Peterson v. Bendix Home Sys., Inc.*, 318 N.W.2d 50, 53 (Minn. 1982) (breach of warranty action involving sale of mobile home).

Indeed, one Minnesota federal court recently applied the predominant purpose test to find a contract for the design and construction of six sugar storage silos to be a contract for the "sale of goods" governed by the UCC under Minnesota law. See generally *S. Minn. Beet Sugar Coop. v. Agri Sys.*, 17-CV-5552 (WMW/BRT), 2019 WL 6873050, at *2 (D. Minn. Dec. 17, 2019). In reaching this conclusion, the court found that the purpose and central focus of the contract was the procurement of the sugar-storage silos, which were goods. See *id.* at *2. The court noted that the cost of materials used to construct the silos was vastly higher than the labor, engineering, and construction costs, which the court found to be a significant consideration supporting the conclusion that the agreement at issue was a contract for goods. *Id.*

DOES IT MATTER?

As discussed above, there is an increased likelihood that the UCC will apply to modular construction contracts. The impact on contract interpretation could be significant.

The parties to a modular construction contract may not anticipate that the UCC will apply, leading to additional and unnecessary complications. For instance, and significantly, the UCC imposes contract terms on certain key provisions to the extent they go unaddressed in the parties' written contract. For example, under Section 2-207 of the UCC, a party can accept an offer even if it "states terms additional to or different from those offered or agreed upon" See Minn. Stat. § 336.2-207(1). This opens up the possibility that the parties to a modular contract, due to its "movable" nature, may be bound to contractual terms to which they did not agree, or did not want.

To avoid this (and the application of the UCC altogether), construction counsel should consider advising contracting parties to avoid using form contracts when procuring modular units in favor of a crafted agreement that sets forth all terms of the transaction. The contract may include a specific provision that renders the UCC inapplicable, if that is the intent. Doing so will help minimize, and hopefully eliminate, the risk of triggering an inadvertent application of the UCC. Alternatively, the parties may include provisions affirmatively addressing application of the UCC, if that is their intended course. Either way, construction counsel should be aware of the potential, and the contract should affirmatively anticipate the possibility.

WARRANTIES

Article 2 of the UCC covers various warranties, both express and implied, which impose certain obligations on sellers and manufacturers of goods. Therefore, a seller or manufacturer of modular units and components ought to familiarize itself with how such warranties are created and enforced.

Under the UCC, express warranties are created when a seller makes an affirmation of fact or promise relating to the goods that becomes part of the reason the buyer purchases the goods. Minn. Stat. § 336.2-313(1)(a)-(c)). Thus, express warranties are created as a result of being specifically mentioned by the seller at the time of purchase.

The UCC also provides two types of implied warranties that, unlike express warranties, are created regardless of whether they are specifically mentioned by the seller at the time of purchase: (1) a warranty of merchantability and (2) a warranty that the goods are fit for a particular purpose. Minn. Stat. § 336.2-314.

As a word of caution, a court may find that the foregoing warranty protections are available even if the contract is found to be for services. In fact, the drafters of Article 2 recognized this possibility in the following Official Comment:

Although this section is limited in its scope and direct purpose to warranties made by the seller to the buyer as part of a contract for sale, the warranty sections of this Article are not designed in any way to disturb those lines of case law growth which have recognized that warranties need not be confined either to sales contracts or to the direct parties to such a contract.

See UCC § 2-313, comment 2. Thus, any contracting party wishing to disclaim these Article 2 warranties must expressly do so during the contract negotiation and drafting process.

Additional statutory and contract warranties apply to the sale of modular units. Notably, the sale of a modular home is the sale of a dwelling, subject to the statutory home warranties set forth in Minn. Stat. § 327A.02. The statutory warranties in section 327A.02 would also apply to the sale of modular residential units within a condominium.

CONTRACT PERFORMANCE UNDER UCC

Application of the UCC may also impose significant consequences to construction contractors from a contract performance standpoint. Under Minnesota common law, a contractor does not materially breach a construction contract if it substantially performs its obligations. *Material Movers, Inc. v. Hill*, 316 N.W.2d 13, 18 (Minn. 1982). By contrast, under the UCC, “if the goods or the tender of delivery fail in

any respect to conform to the contract, the buyer may reject the whole, accept the whole, or accept particular units and reject the rest.” Minn. Stat. § 336.2-601. Thus, the UCC has a far less lenient standard for contract performance compared to common law.

For the reasons highlighted above, the UCC presents many additional, and often unnecessary, complications that typically do not arise in the traditional construction contract context governed by common law. At a minimum, these issues should serve as a reminder that construction counsel should be aware of these differences when advising clients involved in a modular construction project.

UCC LIENS

Are modular units real or personal property for purposes of filing a UCC lien statement? It depends. If bank loans are used to make improvements to the units so that any such improvements become comingled, it may give the bank rights in that property. The analogous situation is a bankruptcy case in which a debtor corporation did not have rights in the modular, non-fixture building property sufficient to grant the creditor a security interest where the individual officers and owners of the debtor corporation who purchased the property never formally conveyed the property to the corporation. *In re Hot Shots Burgers & Fries, Inc. v. Fas Fax Corp.*, 169 B.R. 920, 925 (E.D.Ark.1994); See also *M & M Dev. Inc. v. LS Monticello JV Inc.*, 599 N.Y.S.2d 137, 138 (N.Y. App. Div. 3d Dept. 1993) (finding that modular homes were “fixtures” under the UCC and therefore supplier had priority over mortgage covering property on which fixtures were located); *Green Tree Financial Servicing Corp. v. Sutton*, 264 Neb. 533, 650 N.W.2d 228 (Neb. 2002).

DOES PRODUCT LIABILITY THEORY APPLY TO THE MODULAR UNIT?

Some failed building components are considered defective products, subject to typical product liability claims. Consider an air handling unit that causes a fire and burns a strip mall, or a bathroom fan that burns a home. There is little question those products would be subject to a potential claim and typical product liability theory would apply. The key in those instances is the type of damage — damage to other property.

Determining whether modular building components would be subject to a potential product liability claim involves the same factual and legal analysis. It would depend on the circumstances, including the nature of the damage caused by the component, as well as the claimant.

As a general rule, if the plaintiff is the owner of the building, or any party in the contracting chain, and pleads typical breach of contract claims against the manufacturer of the

modular building components, and if the alleged damage is only to the modular units themselves, product liability theories will fail. Minnesota does not allow tort claims for damages flowing from a breach of contract. Additionally, the economic loss doctrine would prohibit such claims for damage to the product itself. Moreover, “when a plaintiff seeks to recover damages for an alleged breach of contract,” Minnesota law limits the claim “to damages flowing only from such breach except in exceptional cases where the defendant’s breach of contract constitutes or is accompanied by an independent tort.” *Wild v. Rarig*, 302 Minn. 419, 234 N.W.2d 775, 789 (1975). [W]hen “a tort claim is based on a breach of duty that is indistinguishable from the breach of contract, the tort claim will fail.” *Zimmerschied v. JP Morgan Chase Bank, N.A.*, 49 F. Supp. 3d 583, 597 (D. Minn. 2014) (quotations omitted).

Product liability claims would be subject to dismissal under the economic loss doctrine, unless the modular units have caused damage to other property. Under Minn. Stat. § 604.101, “a buyer may not bring a product defect tort claim for compensatory damages unless the defect ‘caused harm to the buyer’s tangible personal property other than the goods or the buyer’s real property.’” *Daigle v. Ford Motor Co.*, 713 F.Supp.2d 822, 829 (D. Minn. 2010) (quoting Minn. Stat. § 604.101, subd. 3). On the flip side, if a modular component damages or injures a third party, not in the contracting chain, a product liability claim could survive.

INTELLECTUAL PROPERTY ISSUES

Given the large capital outlays associated with development, modular providers will no doubt guard the ideas behind their manufacturing processes through utility patent or trade secret protection. Likewise, the expression or ornamental features of the finished designs are well-suited to copyright, design patent and trade dress protections. The creator of the intellectual property—whether inventor, architect or engineer—will typically retain rights to it, although ownership or more likely licensure for other contracting parties to use those rights in some capacity can and should be handled through contract. The key aspects of the contractual provisions, however, will lie in the whether and how well the grant of these rights is defined.

Although numerous issues may arise, a potential trouble spot will be the scope of rights vested in the purchaser of modular units from the creator of the intellectual property, particularly as they relate to the ornamental features or “look and feel” of the design of the singular modular units as compared to the completed project comprised of multiple modular units. The intellectual property owner likely will desire to maintain ownership over intellectual property in the modular unit so, for example, it can be repurposed to other projects. At the same time, the purchaser needs flexibility with respect to the finished project.

For some purchasers, an obvious approach might be to obtain license rights to use the intellectual property for all purposes relating to the finished project or the particular property in question. Thus, when the modular units are combined into a finished building, the purchaser would be protected in its ability to use, at its discretion, all intellectual property subsisting in that final product, as opposed to the modular unit. But such an approach will prove insufficient for others. Some companies (e.g., hotel chains) that maintain numerous properties, all of which require a consistent look and feel to build brand value, will require rights broader than just a single project or property. Such rights will need to be anticipated and spelled out. But intellectual property owners, generally, may be reluctant to grant broad rights. Doing so may dilute value, which makes little sense given the amount of initial investment required by an owner to develop and obtain the intellectual property. Moreover, the owner may wish to retain the right to use some or all components of a modular unit in subsequent transactions. So a broad grant of rights, with an attendant risk of loss of control over the intellectual property, seems unlikely.

Thus, defining the scope of intellectual property rights with clarity from the outset is critical. As with the UCC considerations discussed above, form contracts must be avoided. Given the unique issues associated with each modular construction, they will either not address the allocation of intellectual property rights properly or, worse yet, fail to address them at all. Foresight and collaboration between contracting parties is a must to ensure that each possesses necessary protections and flexibility to maximize the value of their assets without uncertainty or fear of unnecessary limitations.

INSURANCE ISSUES — “YOUR WORK” AND “YOUR PRODUCT” EXCLUSIONS

A benefit to modular construction is reduced risk when units are manufactured off-site in a controlled environment. But new risks must be contemplated, such as damage during transportation or storage, as well as who performs repairs to the units if they are damaged during this process, or the potential that the units might not be as designed when they arrive on the site despite an intense inspection process.

Insurance coverage issues in the modular construction context may include application of the “your product” and “your work” exclusions typically found in a commercial general liability policy.

The “your work” exclusion has been enforced in Minnesota in claims involving repairs to the insured’s own work and has been heavily litigated in other states in the modular construction context. See e.g., *Glob. Modular, Inc. v. Kadena*

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P., Inc., 222 Cal. Rptr. 3d 819, 822 (Cal. App. 4th Dist. 2017); *Scottsdale Ins. Co. v. Tri-State Ins. Co. of MN.*, 302 F. Supp. 2d 1100, 1104 (D. N.D. 2004).

Commercial general liability insurance policies limit property damage coverage through exclusions, including exclusions j(5), j(6), l, and m—known as the “business risk exclusions”—which insurers argue exclude coverage for damages arising out of the insured’s own work on the project. Minnesota case law, however, is not so clear cut. Minnesota cases discussing the “your work” exclusion under the business-risk doctrine hold that it bars coverage for the costs associated with repairs of the insured’s defective work, finding no coverage for damages related to “redoing” of the insured’s own defective work. *Corn Plus Coop. v. Cont’l Cas. Co.*, 516 F.3d 674, 680 (8th Cir. 2008) (citing *Bright Wood Corp. v. Bankers Standard Ins. Co.*, 665 N.W.2d 544, 548-49 (Minn. Ct. App. 2003) (barring coverage for damages associated with the cost of repairing or replacing an insured’s defective product or work); *see also* 22 Britten D. Weimer, Clarence E. Hagglund & Andrew F. Whitman *Minnesota Practice*, § 5:11 (2018 ed.)

The “your product” exclusion in the standard commercial general liability policy excludes “‘property damage’ to ‘your product’ arising out of it and any part of it.” *See* 9A Couch on Ins. § 129:20 (citations omitted.) This exclusion bars coverage for damage to an insured’s product arising out of a defect with that product.

The standard definition of “your product,” however, expressly provides that real property is not included within the purview of this phrase. And under Minnesota law, the “your product” exclusion does not apply to services. *Western World Ins. Co. v. H.D. Engineering Design & Erection Co.*, 419 N.W.2d 630, 636 (Minn. Ct. App. 1988). Thus, work performed by contractors on dwellings, buildings, structures and any other form of realty is therefore not considered to be the product of the insured.

Other jurisdictions focus on the location of the modular units at the time of the occurrence giving rise to the claim. In such cases, if property damage to a modular unit occurs after the unit is built into the project, it no longer fits within the definition of “your product,” and the exclusion should not apply. *See Scottsdale Ins. Co. v. Tri-State Ins. Co. of MN.*, 302 F. Supp. 2d 1100 (D.N.D. 2004) (manufactured building module); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 104 P.3d 997, 1004 (Kan. Ct. App. 2005) (holding custom home constructed by insured was real property outside of “your product” exclusion); *Scottsdale Ins. Co. v. Tri-State Ins. Co. of MN.*, 302 F.Supp.2d 1100, 1104 (D. N.D. 2004); *Cincinnati Ins. Co. v. Fab Tech`21, Inc.*, No. CIV.03-CV-410-SM, 2005 WL 1492377 (D. N.H. June 24, 2005).

CONCLUSION

Modular construction is clearly an evolving area, and construction counsel should be well-versed in the legal issues surrounding this novel and growing field.