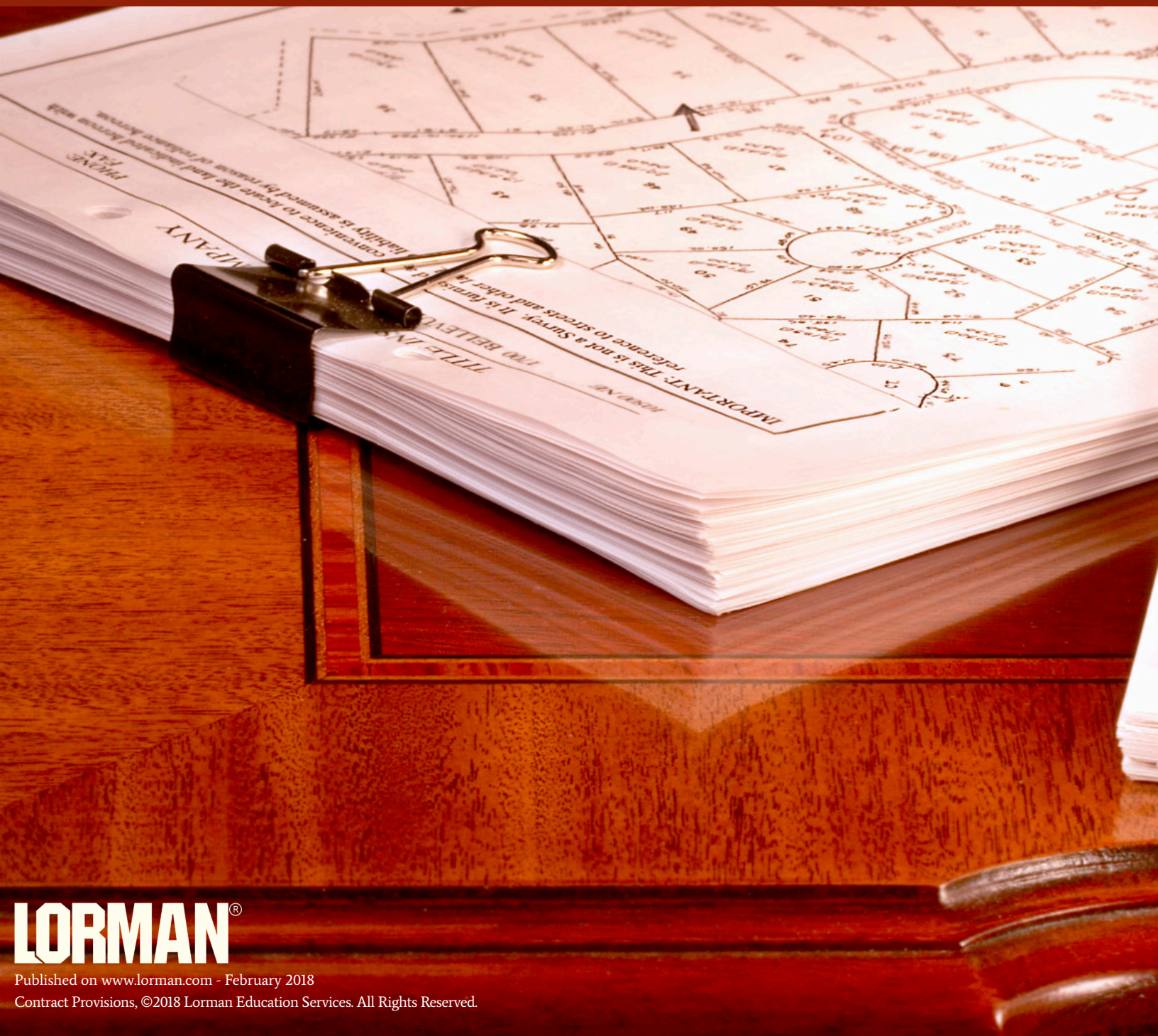
Contract Provisions

Prepared by:
Michael Kelley and Michael Jay Rune II
Shutts & Bowen LLP



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CONTRACT PROVISIONS

A. STANDARD CONSTRUCTION CONTRACTS

The reality is there are no "standard" construction contracts. Both the American Institute of Architect ("AIA") and the Associated General Contractors of America ("AGC") promulgate their recommended form contracts for construction projects. In practice, these "standard" agreements are often cut, pasted and mutilated to the point of being entirely unrecognizable to the original "form" agreement. The modification of "form" agreements poses particular challenges to the integrated nature of these standard contract documents.

In most construction projects there are a number of provisions that address particular issues to construction contracting as opposed to other forms of commercial agreements. We have tried to address the most common and recurring provisions (and often the provisions with the most contention) one encounters in negotiating and litigating in the construction arena. Those common provisions include delay, liquidated and consequential damages provisions; definition of "completion" and "substantial" completion; pay-if-paid clauses; indemnity and insurance provisions and punch-list and warranty provisions.

B. DELAY, LIQUIDATED, AND CONSEQUENTIAL DAMAGE PROVISIONS

Delay, liquidated damage and consequential damage provisions all deal with the same basic issue on construction. Time is almost always of the essence and delays to completion are almost always inevitable. By addressing the "what happens if" the job is not on time with these clauses often dictates the results on a project. Inevitably these clauses tend to more strongly favor one side of the deal and are often the subject of heated negotiations.

Delay Damage

Owners just want to say no to paying for delay damages. The typical "no-damage for delay" provisions says, for excusable delays the Owner will increase the project duration but will not pay any additional compensation to the contractor. These clauses are generally enforceable. Clauses providing for "no damages for delay" are generally enforceable. *Peter Kiewit Sons' Co. v. Iowa S. Util. Co.*, 355 F.Supp. 376 (S.D.Iowa 1973); *E. Elec. Corp. of New Jersey v. Shoemaker Const. Co*., 657 F. Supp. 2d 545, 557 (E.D. Pa. 2009); *Williams Elec. Co. v. Metric Constructors, Inc*., 325 S.C. 129, 480 S.E.2d 447 (1997); *Triple R Paving, Inc. v. Broward Cty*., 774 So. 2d 50, 54 (Fla. 4th DCA 2000); *Newberry Square Dev. Corp. v. Southern Landmark, Inc.*, 578 So.2d 750 (Fla. 1st DCA 1991); *Southern Gulf Util., Inc. v. Boca Ciega Sanitary Dist.*, 238 So.2d 458 (Fla. 2d DCA 1970). As you would imagine there has been substantial litigation over these provisions; the exceptions and the exceptions to the exceptions.

The general exception to the enforceability of these provisions is that the Owner's own "fraud, bad faith, or active interference" in the progress of construction must not be the cause of the delay. *Id; John E. Green Plumbing & Heating Co. v. Turner Const. Co.*, 500 F. Supp. 910, 911 (E.D. Mich. 1980), *aff'd sub nom. John E. Green Plumbing & Heating Co. v. Turner Const. Co*., 742 F.2d 965 (6th Cir. 1984). The concept of "active" interference requires something more

than mere negligence or "transcends mere lethargy or bureaucratic bungling". *S. Gulf Utilities, Inc. v. Boca Ciega Sanitary Dist.*, 238 So. 2d 458, 459 (Fla. 2d DCA 1970). One of the more interesting cases makes clear that failure to follow contract provisions for non-compensable time may act as a bar to recovery for compensable time due to the Owner's misconduct in causing the delay. *Marriott Corp. v. Dasta Const. Co.*, 26 F. 3d 1057, 1067 (11th Cir. 1994).

Liquidated Damage Provisions

Parties to a contract may stipulate in advance an amount of damages to be paid in the event of a breach by the other party. Clauses in contracts providing for stipulated amounts in the event of a breach, are commonly referred to as liquidated damage clauses. Generally, a liquidated damage provision in a contract will be enforceable if two conditions are met. First, the extent of damages flowing from a breach of the contract must be difficult or impossible to ascertain at the time the contract was entered. Second, the stipulated sum must bear a reasonable relationship to damages that might reasonably be expected to flow from the breach of contract and not intended to be a penalty. *Brecher v. Laikin*, 430 F. Supp. 103, 106 (S.D.N.Y. 1977); *Poinsettia Dairy Products v. Wessel Co.*, 123 Fla. 120, 122, 166 So. 306, 307 (1936); *Interstate Markings, Inc. v. Mingus Constructors, Inc.*, 941 F. 2d 1010 (9th Cir. 1991); *Southwestern Eng'g Co. v. United States*, 341 F. 2d 998 (8th Cir.), *cert. denied*, 382 U.S. 819 (1965); *National Co-Op Refinery Ass'n. v. Northern Ordinance, Inc.*, 238 F. 2d 803 (10th Cir. 1956); *Hyman v. Cohen*, 73 So.2d 393 (Fla. 1954); *Touse Const. Co. v. Penzel Const. Co.*, 750 S.W. 2d 522 (Mo. Ct. App. 1988). Liquidated damages and actual damages are generally considered to be mutually exclusive in a contract. *U.S. Fid. & Guar. Co. v. Braspetro Oil Servs. Co.*, 369 F. 3d 34, 72 (2d Cir. 2004); *Orr v. Goodwin*, 953 A.2d 1190, 1196 (N.H. 2008); *Hall Const. Co. v. Beynon*, 507 So. 2d 1225, 1226 (Fla. 5th DCA 1987). In other words, in the absence of an express provision to the contrary a party may not recover liquidated damages and actual damages arising from a delayed completion.

Generally, a construction contract will provide that for each day the contractor delays the completion of the project beyond a contractually agreed date, a per diem amount will be assessed as liquidated damages, i.e., contractor shall pay as a liquidated damage and not a penalty the sum of $500.00 per day the Project is completed beyond the date of substantial completion. Subcontractors by virtue of flow down or conduit clauses may provide that a subcontractor agrees to pay liquidated damages to the prime contractor for any delays occasioned by its failure to perform. *United Tunneling Enterprises, Inc. v. Havens Const. Co.*, 35 F. Supp. 2d 789, 796 (D. Kan. 1998) *compare Edward E. Morgan Co. v. U.S. for Use & Benefit of Pelphrey*, 230 F.2d 896, 903 (5th Cir.1956).

Where the contract provides that extensions of time may be granted for delays caused by the Owner some courts have allowed an apportionment of the liquidated damages. *Southwest Eng'g Co. v. United States*, 341 F. 2d 990 (8th Cir. 1965); *Aetna Casualty & Sur. Co. v. Butte-Mead Sanitary Water Dist.*, 500 F. Supp. 193 (D.S.D. 1980); *Japser Const., Inc. v. Foothill Jr. College Dist.*, 153 Cal. Rptr. 767 (C.T. App. 1979); *Mars Assocs. v. Facilities Dev. Corp.*, 508 N.Y.S. 2d 87 (N.Y. App. Div. 1986); *X.L.O. Concrete Corp. v. John T. Bradey & Co.*, 482 N.Y.S. 2d 476 (App. Div. 1984), *Aff'd*, 489 N.E. 2d 768 (N.Y. 1985).

Consequential Damage Waivers

Black's Law Dictionary defines consequential damages as "losses that do not flow directly and immediately from an injurious act, but that result indirectly from the act." BLACK'S LAW DICTIONARY. Waivers of consequential damages are generally enforceable. *Thrash Commercial Contractors, Inc. v. Terracon Consultants, Inc.*, 889 F. Supp. 2d 868, 876 (S.D. Miss. 2012); *Bartram, LLC v. C.B. Contractors, LLC*, 2011 WL 1299856 (N.D. Fla. March 31, 2011) (enforcing waiver of consequential damages provision in construction contract); *Doctor Diabetic Supply, Inc. v. Poap Corp.*, 41 So.3d 916 (Fla. 3rd DCA 2010) (enforcing contractual limitation of liability provision which precluded recovery of consequential damages). The types of damages that are often expressly delineated in a waiver of consequential damages provision include: (1) additional rental expenses; (2) loss of use, income, profit, financing, bonding, business and reputation; (3) loss of management or employee productivity; and (4) anticipated profits. *Bantram, supra.*

The absence of a mutual waiver of consequential damages in large construction projects potentially exposes the contractor to substantial liability. In the *Perini* case,

> [a] Casino owner sought judicial confirmation of arbitrators' award of over $14,500,000 in lost profits damages against general contractor hired to manage casino renovation project. The Superior Court, Chancery Division, found that the damages award was supported by evidence. The Superior Court, Appellate Division, affirmed. The Supreme Court, O'Hern, J., held that: (1) casino could recover damages for lost profits; (2) casino could recover damages for profits lost after renovation project was substantially completed; (3) general contractor had not substantially completed project until almost seven months after bargained-for completion date; and (4) arbitrators impliedly addressed contractor's wrongful discharge claim.

Perini Corp. v. Greate Bay Hotel & Casino, Inc., 610 A.2d 364 (N.J. 1992) abrogated on other grounds by *Tretina Printing, Inc. v. Fitzpatrick & Associates, Inc*., 640 A.2d 788 (N.J. 1994). The benefit to the Owner is often less clear. Although such clauses should preclude claims for loss opportunity costs, financing costs of the contractor and other tangential damage claims.

C. PAY-WHEN-PAID PROVISIONS

Under contract formation, the majority of transactions, services and/or liabilities may be contracted based upon the parties' "freedom to contract." Ordinarily, in construction, a general contractor bears the risk of an owner's potential insolvency or lack of funds. However, over the years, contractors have begun to negotiate a shift in the distribution of risk from the contractor to the subcontractors performing the work by making the general contractor's receipt of payment from the owner a condition precedent to the contractor's obligation to pay the subcontractors. These clauses may be enforceable even though a subcontractor has fully performed its obligations under the subcontract.

These provisions, coined "pay-if-paid," typically consist of some variation of the following:

> *Subcontractor agrees that Contractor shall be under no obligation to pay Subcontractor for any work performed or materials or equipment furnished for this Project unless and until Contractor has been paid therefore by Owner, and the making of any and all progress and final payments and the amount thereof are expressly subject to this condition precedent.* ***Subcontractor states that it relies primarily on the credit and ability of Owner to pay and not upon Contractor's credit or ability, and further, expressly accepts the risk that it will not be paid for work performed by it in the event that Contractor, for whatever reason, is not paid by Owner for such work.***

Generally, contractual language that eliminates the general contractor's duty to pay a subcontractor for its completed work is disfavored. In North Carolina, California, New York and Wisconsin, such clauses are prohibited altogether; while in other jurisdictions, these clauses are limited through judicial interpretation. *See* N.C. Gen. Stat. § 22C-2; *Wm. R. Clarke Corp. v. Safeco Ins. Co. of Am*, 15 Cal. 4th 882, 895 (Cal. 1997); *West-Fair Elec. Constr. V. Aetna Cas. & Sur. Co.*, 87 N.Y.2d 148, 158 (N.Y. 1995); and Wis. Stat. § 779.135(1). For instance, Maryland recognizes "pay-if-paid" provisions as valid and enforceable. However, the Maryland Legislature enacted a statute that provides: "A provision in an executory contract between a contractor and a subcontractor that is related to construction, alteration, or repair of a building, structure, or improvement and that *conditions payment to the subcontractor on receipt by the contractor of payment from the owner or any other third party* may not abrogate or waive the right of the subcontractor to: (1) claim a mechanic's lien; or (2) *sue on a contractor's bond*." Md. Real Property Code § 9-113 (2014) (emphasis supplied). In Florida, the Florida Supreme Court has declared that unambiguous "pay-if-paid" clauses are enforceable under the law. *See DEC Electric, Inc. v. Raphael Constr. Corp.*, 558 So. 2d 427, 429 (Fla. 1990); *J.J. Shane, Inc. v. Aetna Cas. & Sur. Co.*, 723 So. 2d 302 (Fla. 3d DCA 1998); *Robert F. Wilson, Inc. v. Post-Tension Structures, Inc.*, 522 So. 2d 79 (Fla. 3d DCA 1988), *accord, Everett Painting Co. v. Padula & Wadsworth Const. Inc*., 856 So. 2d 1059, 1061 (Fla. 4th DCA 2003); *Dyser Plumbing Co. v. Ross Plumbing, Inc.*, 515 So. 2d 250, 252 (Fla. 2d DCA 1987). Where a "pay-if-paid" provision is not enforceable, courts will construe the provision as a "pay-*when*-paid" provision governing the timing of payment. Under such a provision, the general contractor must tender payment to the subcontractor within a *reasonable time*. *Id.*

D. INDEMNITY AND INSURANCE PROVISIONS

Indemnity Provisions

Almost all construction contracts will provide for indemnity of one or more of the parities for the other contracting parties under particular circumstances. Contractual indemnity generally

allows the parties to transfer the risk of loss amongst them as they see fit, subject only to legal restraints in their jurisdiction.

These provisions are particularly important as common law indemnity is usually interpreted to require the party seeking indemnity to be wholly without fault. At common law "indemnity is a right which inures to one who discharges a duty owed by him, but which, as between himself and another, should have been discharged by the other and is allowable only where the whole fault is in the one against whom indemnity is sought." *Houdaille Indus., Inc. v. Edwards*, 374 So. 2d 490 (Fla. 1979); *Gen. Conference of Seventh Day Adventists* v. *AON Reinsurance Agency, Inc.*, 860 F.Supp. 983, 986 (S.D.N.Y.1994); Mims Crane Service, Inc. v. Insley Manufacturing Corp., 226 So.2d 836 (Fla. 2d DCA 1969); Westinghouse Electric Corp. v. J. C. Penney Co., 166 So.2d 211 (Fla. 1st DCA 1964). In typical construction claims there is usually plenty of fault to go around to all parties involved.

Usually and logically, the contractor, who has control over the site will be required to indemnify the owner of the project from any personal injury or property damage to third parties arising out of the contractor's performance. *Operadora Maritima de Graneles, S.A. v. Gamesa Wind U.S.*, LLC, 989 F. Supp. 2d 445, 450 (E.D. Pa. 2013)("Contract indemnity has been implied in these circumstances because courts have recognized that one party's expertise and control over the activity place that party in the best position to avoid harm to innocent third parties."). However, it is not uncommon to see indemnification provisions that greatly expand the contractor's indemnification obligations well beyond the original scope of third-party personal injury and property damage, whether with respect to the types of claims (e.g., breach of contract claims) or the types of damages (e.g., economic loss or other damages beyond personal injury and property damage). Contractual indemnification clauses are ordinarily construed in accordance with contract principals to follow the intent of the parties. *Cochran v. Gehrke, Inc.*, 293 F. Supp. 2d 986, 994 (N.D. Iowa 2003*); Dade Cty. Sch. Bd. v. Radio Station WQBA*, 731 So. 2d 638, 643 (Fla. 1999). However, when those clauses seek to impose an obligation to indemnify the wrongdoer for his own negligence such clauses are subject to greater scrutiny. *Id; Univ. Plaza Shopping Ctr. v. Stewart*, 272 So. 2d 507, 511 (Fla. 1973). Further, in some states statutory limitations may exist with respect to construction contracts. For example, in Florida contractual indemnification for one's own negligence is specifically restricted by statute. Florida Statute § 725.06.

Insurance Provisions

Almost all construction contracts provide for various types of insurance. Typically, a contractor will be required to furnish commercial general liability insurance, automotive insurance and workers compensation insurance. The owner of the project will typically furnish builders risk insurance. The parties are usually additional insureds to each other's policies giving them protection and standing under the policies. The contractor's insurance broadly speaking tends to protect the owner and contractor for claims of personal injury and property damage for persons on the project and third-parties. Builders risk insurance is a form of property insurance that covers the project itself from catastrophic losses such as flood, fire and hurricane or earthquake.

The contract for construction will usually provide for minimum limits of coverage. The contract will also usually include the types of insurance to be provided for by each party and any special conditions regarding insurance. Such special provisions may include requirements for additional insured status; completed operations coverage (or other coverage extending beyond the completion of the work) and waivers of subrogation. The waiver of subrogation is an important provision as it provides the parties to a construction contract, in the event of an insurance claim, to look to the insurance for coverage and not allow a paying carrier to pursue a subrogation claim against the parties to the construction project.

For example, the law is well established in Florida that a subrogation insurer stands in the shoes of its insured and has no greater rights than the insured. *Cas. Index., Exchange v. Penrod Brothers, Inc.*, 632 So. 2d 1046, 1047 (Fla. 3d DCA 1994). The law is equally well established in the State of Florida that an insurance company cannot maintain a subrogation action against its own insured. *Travelers Ins. Co. v. Warner*, 679 So. 2d 324, 330 (Fla. 1996) ("The fundamental principal of insurance law"); *Continental Ins. Co. v. Kennerson*, 661 So. 2d 325, 327 (Fla. 1st DCA 1995); *Ray v. Earl*, 277 So. 2d 73, 76 (Fla. 2d DCA 1973) ("Basic rule of law"). In the context of a construction contract, the courts have consistently held that subrogated insurers are not entitled to recover against parties to a construction contract where one party is obligated to obtain insurance covering the risk or requires them to name the other parties and the named insured under the policies. *Dyson and Co. v. Flood Engineering*, 523 So. 2d 756, 758 (Fla. 1st DCA 1988); *IN v. EL Nezlek, Inc.*, 480 So. 2d 1333, 1335 (Fla. 4th DCA 1986); *Housing I and V, Corp. v. Carris*, 389 So. 2d 689,690 (Fla. 5th DCA 1980); *Smith v. Ryan*, 142 So. 2d 139, 141 (Fla. 2d DCA 1962). The prohibition against subrogated insurers applies even if the contracting party did not carry out its contractual duty to name other parties as an additional insured under the insurance contract. *U.S. Fire Ins. Co. v. Norland Industries, Inc.*, 428 So. 2d 325, 326 (Fla. 1st DCA 1983).

E. PROVISIONS REGARDING "COMPLETION"

"Substantial Completion" is usually defined as the stage of the work is sufficiently complete in accordance with contract documents that the owner can occupy/use for its intended purpose. *J.M. Beeson Co. v. Sartori*, 553 So. 2d 180, 181 (Fla. 4th DCA 1989) ("substantial" completion occurred when "construction is sufficiently complete in accordance with the Contract Documents, so the owner can occupy or utilize the work or designated portion thereof for the use for which it is intended.") In Florida, the contractual concept of substantial completion overlaps with the concept of "substantial performance".

> The doctrine of "substantial performance" as held by this court in *Ocean Ridge Development Corp. v. Quality Plastering, Inc.*, 247 So.2d 72, 75 (Fla. 4th DCA 1971) states:
>
> "Substantial performance is that performance of a contract which, while not full performance, is so nearly equivalent to what was bargained for that it would be unreasonable to deny the promisee the full contract price subject to the promisor's right to recover whatever damages have been occasioned him by the promisee's

> failure to render full performance. See 3A Corbin on Contracts, Section 702 et sequi. To say that substantial performance is performance which is nearly equivalent to what was bargained for, as the case law defines the term, in essence means that the owner can use the property for the use for which it is intended.

J.M. Beeson Co. v. Sartori, 553 So. 2d at 182. In Florida, "substantial performance" triggers a contractor's entitlement to the full contract price less the reasonable value to correct any minor deficiencies in the work. *Id.; Blinderman Const. Co. v. United States*, 39 Fed. Cl. 529, 572 (1997), aff'd, 178 F.3d 1307 (Fed. Cir. 1998); *Murray v. Holiday Isle, LLC*, 620 F. Supp. 2d 1302, 1327 (S.D. Ala. 2009)

"Final Completion" is typically defined in a construction contract as "full" completion of the work including punch-list (correction of minor defects and deficiencies). *Jeffrey M. Brown Associates, Inc. v. Rockville Ctr. Inc.*, 7 F. App'x 197, 200 (4th Cir. 2001) ("Final Completion" was defined as "having achieved Substantial Completion plus completion of all punch list work and issuance of a final certificate of occupancy for the Project from the City of Rockville.") In the usual contract, final release of retained funds and final payment are not due to the contractor until "final completion" of the work.

"Substantial Completion" and "Final Completion" are important contractual terms to review with care in any construction contract. "Substantial Completion" is most often the trigger date for bonuses, liquidated damages, commencement of warranties and other important provisions in the contract documents. Either party to a construction contract needs to have a clear understanding of the date of completion going into the contract.

F. PUNCH-LIST AND WARRANTY PROVISIONS

Most standardized industry forms, and most manuscript forms also, will contain express warranty provisions from the contractor to the owner. *Lurgi Metallurgi GmbH v. Industrial Risk Insurers*, 691 N.Y.S.2d 485 (N.Y. App. Div. 1999). While an owner may require the contractor to provide additional express warranties, most commonly the contractor expressly warrants to the owner that materials and equipment will: (1) be new and of good quality; (2) conform to the requirements of the contract documents; and (3) be free from defects.

The first and third warranties requiring the materials and equipment to be new and of good quality and free from defects, respectively, are qualified by what is commonly referred to as the "Spearin Doctrine." *United States v. Spearin*, 248 U.S. 132, 137 (1918). In *Spearin*, the United States Supreme Court held that a contractor is bound to build according to an owner's plans and specifications and that the owner will be responsible for consequences of defects in the plans and specifications, not the contractor. Therefore, the contractor's warranty should not extend to the suitability, but rather only to the "quality" and related workmanship. The third warranty also usually requires the materials and equipment to be free from defects. This warranty does not necessarily mean that all of the materials and equipment must be utterly free from defects and substantial performance as intended may suffice to satisfy this obligation. *Oven*

Development Corp. v. Molisky, 278 So.2d 299, 303 (Fla. 1st DCA 1973); *National Constructors, Inc. v. Ellenburg*, 681 So.2d 791, 793 (Fla. 3d DCA 1996).

The second warranty requires conformity with the requirements of the contract documents. Generally, only substantial conformance with the contract documents will be required by this warranty. *Poranski v. Millings*, 82 So. 2d 675,678 (Fla. 1955). Owners may contractually insert a higher degree of conformance, strict or total conformance. In most jurisdictions such heightened performance would still be weighed against the doctrine of economic waste when considering correction. Thus, if you have to rebuild the house to correct the non-conformance often the owner recovery will be limited to diminution in value and not repairs which would otherwise be grossly disproportionate to the harm. *Granite Const. Co. v. United States*, 962 F.2d 998, 1007 (Fed. Cir. 1992); *Jacob & Youngs v. Kent*, 129 N.E. 889 (N.Y.1921); *Grossman Holdings Ltd. v. Hourihan*, 414 So. 2d 1037 (Fla. 1982) (adopting subsection 346(1)(a) of Restatement (First) of Contracts (1932) as the law in Florida regarding breaches of construction contracts).

These exclusions often include remedy for defect caused by such things as abuse, alterations to the work not executed by the contractor, improper or insufficient maintenance, improper operation, normal wear and tear and normal usage. *AES Puerto Rico, L.P. v. Alstom Power, Inc*., 429 F. Supp. 2d 713, 717 (D. Del. 2006). While courts may imply these obligations on the owner the better course is to condition warranties on these terms. Generally, implied warranties may be disclaimed, however, the disclaimer must be clear and unambiguous and clearly reflect the intent of the parties. *Reyton Cedar Knoll, LLC v. SSR, Inc.*, 2014 WL 1281449, at *7 (E.D. Ky. Mar. 27, 2014)

Most of the standard contracts also contain provisions that are often referred to as "call-back" or "correction" obligations which will require the contractor to repair or replace defective work for a specified period of time after completion of the contractor's work. The distinction between the contractor's obligation for defective construction and its "call-back" or "warranty" obligations are often confused. The "call back" or "warranty" obligation is in addition to the contractor's responsibility for defective work. Both are usually subject to the applicable statute of limitations and statute of repose as opposed to the warranty period in the contract. *Charley Toppino & Sons, Inc. v. Seawatch at Marathon Condo. Ass'n, Inc.,* 658 So. 2d 922, 925 (Fla. 1994). In other words, the warranty period in the contract imposes an obligation for a contractor to come back to correct defective work; the fact that the work is defective when originally constructed is not eliminated by a contractual warranty period and in some jurisdictions the warranty may expand the length of time to bring suit. *Spectro Alloys Corp. v. Fire Brick Engineers Co.*, 52 F. Supp. 3d 918, 929 (D. Minn. 2014) (discussing construction contracts outside of UCC and Minnesota's statute of limitations); *Rosen v. Spanierman*, 894 F.2d 28, 32 (2d Cir. 1990) (discussing warranties and statute of limitations start time under "future" warranties UCC).