# Construction Defect Coverage Summary 2013: The Business Risks Shift To Insurers

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In 2013, courts examining insurance coverage for construction defect claims departed from earlier precedent and trended toward allowing construction companies to shift the costs of their faulty workmanship to their insurers, thereby reversing the previous public policy trend against coverage for such claims.

The tension in all construction defect insurance disputes is typically over which party—the insured or insurer—should bear the cost of the repair and replacement work to fix or complete the job that the insured was hired to do. For some time, courts have recognized that there is a public policy against allowing construction companies to get paid to perform faulty workmanship, and then to force their insurers to be the financers for the repair and replacement costs. Such courts issued landmark decisions precluding insurance coverage for construction defects in these situations.[1] This trend *against* allowing insurance coverage for the repair of faulty workmanship was alive and well in 2012.[2]

However, in 2013, court decisions focused more on the hyper-technical interpretation of policy wording and strayed from those public policy considerations upon which previous decisions relied. This 2013 trend was seen in three areas of construction defect insurance decisions in particular:

1. Decisions addressing whether an insured's faulty workmanship can be considered a covered "occurrence."

2. Even when faulty workmanship may not be an "occurrence" as it relates to the insured's work, some decisions found that the same faulty workmanship to one part of the insured's project could be an "occurrence" if it caused damage to other non-defective parts of the insured's project.

[1] *Weedo v. Stone-E-Brick, Inc.*, 81 N.J. 233, 405 A.2d 788 (N.J. 1979) (finding that a liability policy "does not cover an accident of faulty workmanship but rather faulty workmanship which causes an accident"); *Bor-Son Bldg. Corp. v. Employers Commercial Union Ins. Co. of Am.*, 323 N.W.2d 58 (Minn. 1982) (reasoning that CGL is meant to cover tort liability for damage to others, and not for the insured's contractual liability for economic loss because the insured's work is less than that for which the damaged person bargained); *Monticello Ins. Co. v. Wil-Freds Const., Inc.*, 277 Ill. App. 3d 697, 661 N.E.2d 451 (Ill.App.Ct. 1996) (construction defects that are the natural and ordinary consequences of faulty workmanship are not an "occurrence" unless there has been damage to third party property.)

[2] *Amerisure Mut. Ins. Co. v. Auchter Co.*, 673 F.3d 1294 (11th Cir. 2012); *Nautilus Ins. Co. v. JDL Dev., IX, LLC*, 10 C 3435, 2012 WL 1156917 (N.D. Ill. Apr. 4, 2012), appeal dismissed (June 12, 2012); *Aquatectonics, Inc. v. Hartford Cas. Ins. Co.*, 10-CV-2935 DRH ARL, 2012 WL 1020313 (E.D.N.Y. Mar. 26, 2012)

3. Decisions addressing whether a policy's exclusion for damage to the particular part of property on which the insured was working can be applied as intended to prevent coverage for the repair and replacement costs resulting from the insured's faulty work.

The 2013 decisions in each of these areas are addressed in the three sections below. The overall trend to be derived from these cases is that courts have gotten away from analyzing the common sense public policy considerations behind earlier precedent and have instead seized on the technical application of policy wording to allow insureds to shift more of their business risk and increase insurers' overall exposure.

## I. IS FAULTY WORKMANSHIP AN "OCCURRENCE"? SEVERAL MORE STATES SAY YES.

In 2013, while the Supreme Court of Alabama adhered to the idea that an insured ***cannot*** obtain insurance to pay the cost of repairing its own work, the highest courts in West Virginia and North Dakota went the opposite direction, even overturning their own recent precedent to make the insurance company responsible for bearing the cost to repair and replace its insured's faulty work. In order to transfer the risk of faulty construction from builder to insurer, these courts ruled that, if the defective construction was not expected or intended by the insured, then the "occurrence" requirement of the policy's insuring agreement is satisfied. Of course, the practical failing of these rulings is that it gives construction companies a "double recovery": they get paid once by the consumer to build the project, and then the cost of repairing the project gets paid by insurance. This very economic disincentive was at the heart of the early legal trend precluding coverage for such construction defects; a trend that is now slowly being reversed with almost no discussion of the economic and business havoc that will result.

### A. *Cherrington v. Erie Ins. Prop. & Cas. Co.*, 231 W. Va. 470, 745 S.E.2d 508 (March 27, 2013)

**The Supreme Court of West Virginia overturned previous precedent to find that defective workmanship causing the need to repair the construction itself constitutes an "occurrence" under a CGL policy.**

In *Cherrington*, a homeowner sued a builder for the costs to repair defects in a newly-constructed residence. There was no damage alleged to anything but the project itself. The builder's insurer denied coverage arguing, among other reasons, allegations of defective construction do not constitute an "occurrence." The insurer's position was grounded in several West Virginia Supreme Court decisions that found that poor workmanship, standing alone, does not constitute an occurrence. *Webster Cnty. Solid Waste Auth. v. Brackenrich & Associates*, Inc., 217 W. Va. 304, 617 S.E.2d 851 (2005); *Corder v. William W. Smith Excavating Co.*, 210 W. Va. 110, 556 S.E.2d 77 (2001); *Erie Ins. Prop. & Cas. Co. v. Pioneer Home Improvement, Inc.*, 206 W. Va. 506, 526 S.E.2d 28 (1999).

In an about-face, the West Virginia Supreme Court overruled its prior decisions and found that faulty workmanship can constitute an occurrence if it was not intended or expected by

the insured. The court observed that a majority of other jurisdictions found that faulty workmanship is covered by a CGL policy, either in judicial decisions or by legislative amendments to state insurance codes.[3] On this point, we note that on November 25, 2013 a bill was introduced before the New Jersey Assembly that would require CGL policies issued to construction professionals to define "occurrence" so as to include claims for faulty workmanship.

The court reasoned that, by defining occurrence, in part, as "an accident," the policy must be interpreted to provide coverage for damages or injuries that were not deliberately or intentionally caused by the insured. The court also noted that the policy contained an exclusion property damage to "your work" (exclusion l.), which implies that damage to the insured's work must be within the policy's basic insuring agreement, or there would not have been the need for the exclusion. Thus, the court reasoned that a finding that faulty workmanship is not an occurrence would be inconsistent with the "your work" exception. Therefore, the court expressly overruled its prior decisions and found that the builder's insurer had a duty to defend.

**B.** *K & L Homes, Inc. v. Am. Family Mut. Ins. Co*., 2013 ND 57, 829 N.W.2d 724 (April 5, 2013)

**The Supreme Court of North Dakota changed course and held that faulty workmanship may constitute an "occurrence" so long as the faulty work and the resulting damage was not anticipated, intended, or expected.**

Homeowners sued the insured homebuilder alleging that their house suffered damage because of substantial shifting caused by improper footings and inadequately compacted soil under the footings and foundation that had been constructed by a subcontractor of the insured.

The main issue before the North Dakota Supreme Court was whether inadvertent faulty workmanship constitutes an accidental "occurrence" potentially covered under the CGL policy. The court examined the drafting history of the standard ISO CGL form and surveyed cases nationwide. The court concluded that faulty workmanship may constitute an "occurrence" if the faulty work was "unexpected" and not intended by the insured, and the property damage was not anticipated or intentional, so that neither the cause nor the harm was anticipated, intended, or expected.

[3] *See* Colorado Revised Statutes Section 13-20-808, effective May 21, 2010 (requires courts to presume that work resulting in property damage, including to the work itself, is accidental and an "occurrence"); Arkansas Code Annotated Section 23-79-155, effective July 27, 2011 (requires general liability policies to have a definition of "occurrence" that includes property damage or bodily injury resulting from faulty workmanship); South Carolina Code Annotated Section 38-61-70, effective May 17, 2011 (mandates that property damage resulting from faulty workmanship meeting the policy's definition of "occurrence"); Hawaii Revised Statutes Section 431:1-217, effective June 3, 2011 (after a 2010 Hawaii appellate court ruling holding that construction defect claims do not constitute an occurrence, this statute was effectuated which requires courts to apply case law that was in effect at the time a policy was placed—such that pre-2010 policies may cover construction defects whereas post-2010 policies may not.)

In reaching its conclusion, the North Dakota Supreme Court specifically rejected its own prior decision in *ACUITY v. Burd & Smith Constr.*, Inc., 721 N.W.2d 33, 2006 ND 187 (N.D. 2006), which held that faulty or defective workmanship, standing alone, is not an accidental "occurrence." The court explained that the prior decision incorrectly drew a distinction between faulty workmanship that damages the insured's work or product and faulty workmanship that damages a third party's work or property. The court found that there is nothing in the definition of "occurrence" that supports the notion that faulty workmanship that damages the own work of the insured contractor is not an "occurrence." The North Dakota Supreme Court's change in approach, like the decision of the West Virginia Supreme Court in *Cherrington*, is marked by a narrow focus on whether the faulty work was purposeful, without regard to the broader concepts that insurance coverage is not meant to satisfy the insured's contractual business obligations.

**C.** *Capstone Building Corp. v. American Motorists Insurance Co.*, 308 Conn. 760, 67 A.3d 961 (June 11, 2013)

**The Supreme Court of Connecticut found as a matter of first impression that defective workmanship causing defects in the insured's own project can constitute an "occurrence."**

The insureds, a general contractor and project developer, settled construction defect claims against them brought by the University of Connecticut involving the allegedly negligent construction of a dormitory building. The settlement was for repairs necessary to correct the insured's own work and not for any other incidental property damage. After the settlement, the insured sought coverage for the settlement amount from the insurer that had issued an Owner Controlled Insurance Program policy for the dormitory project. In a matter of first impression in Connecticut, the Supreme Court of Connecticut held that defective workmanship necessitating repairs can indeed constitute an insured "occurrence," reasoning that, because the negligent work was unintentional from the point of view of the insured, such negligent work may constitute an accident or occurrence. Similar to the approach in *Cherrington* and *K & L Homes*, the court reasoned that insurance policies are designed to cover foreseeable risks, and that a deliberate act of constructing a project, when performed negligently, does indeed constitute a covered accidental "occurrence" if the effect is not intended or expected.

**D.** *Taylor Morrison Servs., Inc. v. HDI-Gerling Am. Ins. Co.*, 746 S.E.2d 587 (Ga., July 12, 2013)

**The Supreme Court of Georgia ruled that an "occurrence" does not require damage to the property or work of someone other than the insured.**

A class of 400 homeowners in California sued the insured homebuilder for negligently constructing the foundation of their homes, resulting in damage to the homes due to the cracked and buckling foundations. The homebuilder's insurer defended the class action and filed a declaratory judgment action in Georgia federal court, arguing that the claims against the insured did not allege an "occurrence" because the damages at issue were simply the repairs to the insured's faulty work. The Eleventh Circuit certified the question of whether Georgia law

requires there to be damage to property other than the insured's own work for an "occurrence" to exist under a CGL policy.

The Supreme Court of Georgia found that negligent construction which damages only the insured's own work can indeed constitute an accidental "occurrence." Like the recent decisions discussed above, the court observed that the term "accident" meant an unexpected or unintended event, and, therefore, the identity of the person whose interests were damaged is irrelevant. However, in a lengthy series of footnotes, the court further observed in *dicta* that defectively constructed property cannot be said to be physically injured by the work that brought it into existence. However, the court did not attempt to define the precise line of demarcation between defective and non-defective work when both are a part of the same project.

**E.** *Owners Ins. Co. v. Jim Carr Homebuilder, LLC*, 1120764, 2013 WL 5298575 (Ala., Sept. 20, 2013)

**The Supreme Court of Alabama confirmed that faulty workmanship, standing alone, does <u>not</u> constitute an "occurrence."**

The insured homebuilder sought coverage for an adverse arbitration award wherein it was determined that the insured had defectively constructed a home resulting in damages due to water infiltration, causing "significant mental anguish" to the homeowner. The insurer defended the insured in the arbitration, but denied indemnity coverage for the award.

The Supreme Court of Alabama agreed with the insurer, finding that, because the insured was hired to build the entire house, any property damage or bodily injury (mental anguish) that resulted from the insured's faulty workmanship was not caused by an "occurrence." The court indicated only damage to something other than the insured's own work (which was not present in this case) can be considered damage caused by an "occurrence." The implication of this case is that either property damage ***or bodily injury*** that results from faulty workmanship is not caused by an "occurrence," although the court did not expressly discuss this issue it its holding.

## II. AN INSURED'S FAULTY WORKMANSHIP TO ONE PART OF A PROJECT MAY BE AN "OCCURRENCE" IF IT CAUSES DAMAGE TO OTHER NON-DEFECTIVE PARTS OF THE INSURED'S PROJECT.

Even in jurisdictions where the costs to repair faulty workmanship is typically <u>not an "occurrence,"</u> courts do recognize that, if the same faulty workmanship of the insured damages another part of the insured's project which was not otherwise defective, then this <u>does</u> qualify as an occurrence. *See French v. Assurance Co. of Am.*, 448 F.3d 693, 706 (4th Cir. 2006) (holding that a CGL policy does not provide coverage to correct defective workmanship but that the policy provides coverage for the cost to remedy property damage to the contractor's otherwise non-defective work-product).

Examining the issue of how to treat one part of the insured's project that was damaged by a different, defective part of the same insured's project, the Sixth Circuit, predicting Kentucky law, found in 2013 that the insured subcontract's faulty workmanship that damages otherwise

non-defective part of the project is not an "occurrence" if the damage was of the type the insured was hired to prevent or control. However, the Colorado U.S. District Court went the opposite direction in ruling that the insured's faulty workmanship to one part of the project that damages other non-defective parts of the same project does indeed qualify as an occurrence.

**A.** *Liberty Mutual Fire Ins. Co. v. Kay & Kay Contracting, LLC*, Case No. 12-5791 (C.A.6 (Ky.) Nov. 19, 2013)

**The Sixth Circuit Court of Appeals predicted that, under Kentucky law, faulty workmanship that results in damage to other parts of a project is not an "occurrence" if the kind of damage that results is what the insured was hired to control or prevent.**

The insured, a foundation subcontractor, performed site preparation and constructed a building pad for a Wal-Mart store. After the store was built, cracks in the building's walls were noticed. Wal-Mart alleged that the fill under one corner of the building had settled, resulting in the structural problems. Wal-Mart demanded that the general contractor remedy the problem, who in turn demanded the same from the insured. The insured subcontractor sought coverage from its CGL carrier, which denied coverage and filed a declaratory judgment action based, in part, on basis that there was no "occurrence" because there was only faulty workmanship in need of repair.

The court observed that under *Cincinnati Ins. Co. v. Motorists Mut. Ins. Co.*, 306 S.W.3d 69, 73 (Ky. 2010) the faulty construction of the building pad (the insured's own work) was not an "occurrence." However, the court observed that the claimed damage included more than just the building pad. The court noted that the Kentucky Supreme Court had not decided the issue of whether damage to parts of a construction project ***other*** than the insured's faulty work constitutes an "occurrence." The court reasoned that even if the Kentucky Supreme Court would determine that collateral damage to property other than the insured's work is an "occurrence," it would not adopt a version of such a rule that would apply when the damage at issue was the obviously and foreseeable consequence of the insured's faulty work.

The court observed that in *Cincinnati*, the Kentucky Supreme Court emphasized the significance of the insured's control over the work in analyzing the whether an "occurrence" took place. Specifically, in *Cincinnati*, the Kentucky Supreme Court opined that events that are within the control of the insured are not truly accidental or fortuitous. The court reasoned that the alleged damage to the Wal-Mart was due solely to the soil settlement—work that was within the insured's control. The entire reason the insured was hired was to prevent the soil from settling in a manner that would cause damage to the structure. Thus, the court predicted that the Kentucky Supreme Court would not find that an "occurrence" takes place when the damage to a project that is allegedly caused by the defective workmanship of a subcontractor hired to control against ***that very damage*** from happening. Therefore, the court ordered that summary judgment be granted in favor of the insurer.

We also note that an opinion earlier this year, *McBride v. ACUITY*, 510 Fed.Appx. 451, 2013 WL 69358 (C.A.6 (Ky.) Jan. 7, 2013), The Sixth Circuit Court of Appeals predicted that,

under Kentucky law, the insured's faulty workmanship to any parts (including non-defective parts) of the insured's own project does not qualify as an "occurrence."

**B.** *Mt. Hawley Ins. Co. v. Creek Side at Parker Homeowners Ass'n, Inc.*, 2013 WL 104795 (D. Colo. Jan. 8, 2013)

**Colorado U.S. District Court found faulty workmanship of a subcontractor potentially qualified as an "occurrence" where the subcontractor's faulty workmanship caused damage to other, non-faulty parts of the project.**

A homeowners association sued the developer/builder of a residential development project seeking damages allegedly caused by construction defects. The homeowners association alleged that the developer/builder's subcontractors performed defective work that caused consequential damage to other, non-faulty parts of the project.

The district court found that the underlying lawsuit alleged an "occurrence." Citing *Greystone Constr., Inc. v. Nat'l Fire & Mar. Ins. Co.*, 661 F.3d 1272 (10th Cir. 2011) (Colo. law), the district court explained that "[f]aulty workmanship can constitute an occurrence that triggers coverage under a CGL policy if … the damage was to non-defective portions of the contractor's or subcontractor's work." The district court also found that at least some of the alleged property damage was to non-defective portions of its or its subcontractors' work on the same project. Accordingly, the district court held that there was at least a genuine issue of material fact as to whether there had been an "occurrence."

## III. EXCLUSION FOR DAMAGES TO PART OF PROPERTY ON WHICH INSURED IS WORKING.

One frequently discussed exclusion with regard to coverage for construction defect claims, is the exclusion for property damage to that part of real property on which the insured or any subcontractors are performing operations. This exclusion (along with several other "business risk" exclusions) embodies the notion that the cost of repairing or replacing the consequences of shoddy workmanship or paying for the fulfillment of a contractual commitment is not covered. In standard general liability forms, this provision appears as exclusion j(5) and states that the insurance does not apply to property damage to:

> That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the "property damage" arises out of those operations.

In 2013, the South Carolina Supreme Court held that the exclusion applies if the insured's subcontractor is still performing operations—even though the insured's own operations are complete. However, in a different case, the U.S. District Court in Massachusetts held that exclusion j(5) only applies if there is a sufficient connection between the scope of the insured's work and the damaged property. Finally, the South Dakota Supreme Court confirmed that the exclusion applies to damage while the insured's subcontractor is working, but does not bar

coverage to construction materials not yet incorporated into a project. These cases illustrate the varied applicability and interpretation of exclusion j(5) reached by different courts.

**A.** *Bennett & Bennett Const., Inc. v. Auto Owners Ins. Co.*, 405 S.C. 1, 747 S.E.2d 426 (2013)

**The Supreme Court of South Carolina found that exclusion j(5) applies if the property damage takes place while the insured's subcontractor's operations are ongoing.**

A general contractor hired a masonry subcontractor to construct a brick wall. After completion of the wall, the general contractor observed mortar and slurry dried on the face of the wall and instructed the subcontractor to correct the appearance of the wall. The subcontractor hired a power washing company to clean the bricks, which resulted in discoloration and removal of the decorative finish on the bricks. The general contractor was forced to replace the damaged wall on its own, after which the general contractor sued and obtained a default judgment against the subcontractor. The general contractor then sued the subcontractor's insurer in a declaratory judgment action.

The insurer relied in part on exclusion j(5) to deny coverage, arguing that there was no coverage for the damage to the wall because it was damage "to that part of the real property on which the insured was performing operations." The general contractor argued that the exclusion did not apply because the damage took place after the insured's operations (the construction of the brick wall) were over. The court held that whether the brick wall installation (work performed by the insured itself) was completed was irrelevant to the applicability of exclusion j(5) because the insured's operations for the purposes of the exclusion include work performed by any of the insured's subcontractors. That is, the exclusion barred coverage so long as the power washing company hired by the insured was <u>still performing operations on the insured's behalf</u> at the time the damage took place. Because the damage occurred during the insured's operations, exclusion j(5) barred coverage for the damage to the bricks.

**B.** *Gen. Cas. Co. of Wisconsin v. Five Star Bldg. Corp.*, CIV.A. 11-30254-DJC, 2013 WL 5297095 (D. Mass. Sept. 19, 2013)

**U.S. District Court for the District of Massachusetts determined that exclusion j(5) only applies to damage to "that particular part of real property" that was within the scope of the insured's work, and not other portions of the overall structure.**

An insurer filed a declaratory judgment action against its insured relating to a claim for damages at a university science center that arose from the insured's work in upgrading the center's HVAC system. The insured's work included puncturing the weather membrane in the roof and installing temporary patches at the puncture sites until the new HVAC system was complete. Heavy rain caused some of the patches to fail and water to enter the building. The insurer agreed to pay for the damage caused to the interior of the center, but refused to pay for damage to the roof, in part based on exclusion j(5), arguing that the ***entire roof*** was the "particular part" of the building on which the insured was performing operations.

The court rejected the insurer's argument, reasoning that puncturing the roof was incidental to the ventilation system upgrade. The court noted that the roof accounted for only a small part of the total work on the project and that there was an insufficient nexus between the scope of the insured's HVAC work and the damage to the roof. Unfortunately, the court seemed to ignore the fact that the temporary roof patches which failed were clearly part of the insured's work and, presumably, a necessary part of the HVAC upgrade. Nevertheless, the court concluded that exclusion j(5) was not a bar to coverage for the damage to the roof as well as the rest of the structure damaged by water intrusion.

**C.** *Swenson v. Auto Owners Ins. Co.*, 2013 S.D. 38, 831 N.W.2d 402 (May 15, 2013)

**The South Dakota Supreme Court found that building material yet to be installed at a project is not "real property" and exclusion j(5) did not apply.**

Finally, in a 2013 decision of the South Dakota Supreme Court, the court held that a "your work" exclusion in a homebuilder's policy did not bar coverage for damage to building materials that were negligently left exposed to the elements because the materials were not installed and, therefore, not yet "real property." However, the court applied the exclusion to completed parts of the structure damaged because they were left open to rain and snow. Consistent with the decision in *Bennett* (part A. above), the court observed that the exclusion applies because the insured ***or*** its subcontractor(s) were actively performing the construction work when the damage took place. As the entire structure (a new home) was the insured's work, the court was not faced with the issue in *Five Star* (part B. above).

## CONCLUSION

There is a single insurance issue at the heart of most construction defect coverage disputes: when construction work is performed negligently, is the resulting defect simply part of the business risk that the insured must pay to repair, or is the resulting defect true damage to a third party's property that may be insured under a general liability policy? During 2013, legal rulings in different states continue to demonstrate the evolution of the answer to this question. An increasing number of states appear to be ignoring the economic reality surrounding insured's responsibility for its faulty workmanship. In these states, courts focused on the term "accident" to find coverage for the repair and replacement costs arising from defective construction claims. Furthermore, even in cases where the insured's faulty workmanship itself does not constitute an "occurrence," some courts are creating an exception where the insured's negligence on one part of the project caused damage to a different non-faulty part of the same insured's project.

The legal landscape for construction defect claims appears to be shifting rapidly and posing new challenges to insurers and claims professionals, who are faced with an increasing number of lawsuits and claims alleging faulty workmanship. Perhaps 2014 may bring a renewed legal focus on the public policy and intent behind the construction defect insurance provisions, and thereby shift the risk of correcting faulty construction away from insurers and back onto the insured parties that contracted for, controlled and were compensated for the work itself.

END

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