



COVERAGE FOR DEFECTIVE CONSTRUCTION CLAIMS – CURRENT ISSUES

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I. Potential Sources of Insurance Coverage

- A. General liability insurance policies (primary and excess)
- B. CCIP/OCIP policies
 - 1. Contractor or Owner wrap-up policies
- C. Builder's risk policies
 - 1. First party property policy
 - 2. Usually covers the structure under construction, including materials, fixtures, supplies, machinery and equipment used in construction; property of others for which an insured may be liable; and removal of debris of covered property that is damaged in a covered loss.
- D. Professional liability policies
 - 1. Is the insured a construction manager ("CM")?
 - a. The CM is often in a supervisory role rather than a hands on contractor. As a result, it may be prudent for the CM to make sure that it is added as an additional insured on the architect's/engineer's professional policy as well as an additional insured on the GC's CGL policy.
- E. Pollution liability policies
 - 1. Soil contamination
 - 2. Mold as a result of defective construction

II. Brief History of Construction-Specific Coverage

A. 1973 CGL had broad business risk exclusions which were interpreted to exclude coverage for construction defect claims:

(n) property damage to the *named insured's products* arising out of such products or any part of such products;

(o) property damage to *work performed by or on behalf of the named insured* arising out of the work or any portion thereof; or out of materials, parts or equipment furnished in connection therewith.

B. 1976 BFPD (Broad Form Property Damage) Endorsement became available

1. Could be purchased for a higher premium

2. Deleted the original exclusion (o) and replaced it with three more specific exclusions which effectively broadened coverage:

(d) *To that particular part of any property*

(i) *upon which operations are being performed* by or on behalf of the named insured at the time of the property damage arising out of such operations; or

(ii) *out of which any property damage arises*; or

(iii) the restoration, repair or replacement of which has been made or is necessary *by reason of faulty workmanship thereon* by or on behalf of the insured.

This insurance does not apply:

... With respect to the completed operations hazard and with respect to any classification stated in the policy or in the company's manual as "including completed operations," to property damage to work performed *by the named insured* arising out of such work or any portion thereof, or out of such materials, parts or equipment furnished in connection therewith.

3. (d)(iii) removed from coverage the cost to repair defective work itself but was carefully crafted not to eliminate insurance coverage for damage to other property caused by defective work.

4. In completed operations section, BFPD Endorsement eliminated the phrase “on behalf of the named insured” previously found in exclusion (o). This alteration broadened coverage for property damage caused by subcontractors.

C. 1986 CGL policy

1. Incorporates the 1976 BFPD Endorsement
2. Makes clear that the “work” exclusion for property damage to completed operations does not apply where the property damage arises out of the work of subcontractors.
 - a. Introduces exclusion (l) subcontractor exception
3. Clarifies that the BFPD Endorsement was intended to exclude coverage under the “particular part” exclusions only for property damage that occurs while work is in progress:
 - a. See Exclusions j(5) and j(6).
4. Exclusion (k):
 - a. “Your product” excludes “real property” making clear that CGL insurance is not intended necessarily to exclude property damage to structures built by the insured.

- D. Evolution of policy exclusions demonstrates that the CGL policy is specifically designed to anticipate the “occurrence” of inadvertent construction defects, and intends to define the scope of coverage for property damage resulting from construction defects through application of the construction-specific exclusions.

III. What is Construction Defect?

A. Design deficiencies

1. Buildings and systems do not work as intended from a design standpoint

B. Material deficiencies

1. Use of inferior building materials or installed components causes certain conditions

C. Construction deficiencies

1. Poor quality or substandard workmanship manifests in certain conditions
 - a. Subsurface/geotechnical problems
 - b. Soil conditions that are not properly addressed during construction result in certain conditions

IV. CGL Insurance Requirements

A. Is there an occurrence?

1. Occurrence means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.
2. Does defective construction constitute an occurrence?
 - a. Case law conflicts/nationwide split among courts
 - i. L-J, Inc. v. Bituminous Fire & Marine Ins. Co., 366 S.C. 117, 621 S.E.2d 33 (S.C. 2005) – defective construction does not constitute an occurrence
 - ii. Broadmoor Anderson v. National Union Fire Ins. Co. of Louisiana, 912 So.2d 400 (La. App. 2 Cir. 2005); Fidelity & Deposit Co. of Maryland v. Hartford Casualty Insurance Co., 189 F.Supp.2d 1212 (D. Ken. 2002) – defective construction does constitute an occurrence
3. Who performed the defective work?
 - a. American Family Mut. Ins. V. American Girl, Inc., 673 N.W.2d 65 (Wis. 2004) – coverage for subcontractor’s work
 - b. Wanzek Construction v. Employees Insurance of Wausau, 679 N.W.2d 322 (Minn 2004) - coverage for suppliers

B. Did the occurrence result in property damage?

1. “Property damage” means:
 - a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
 - b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the “occurrence” that caused it.

2. Loss of use of tangible property that is not physically injured.
 - a. Gibson & Assoc., Inc. v. Home Insurance Company, 966 F.Supp. 468 (N.D. Tex. 1997)
 - Store’s loss of profits due to restrictions to the area as a result of City construction constituted “loss of use of tangible property that is not physically injured” despite the fact that lost profits and purely economic injuries normally do not constitute “property damage”.
 - b. Gibraltar Casualty v. Sargent & Lundy, 574 N.E.2d 664 (Ill. App. 1990).
 - Project was delayed 30 months, resulting in extra costs and ultimate abandonment of project costing Wabash (investor) its investment. The Court held that Wabash’s alleged damages were because of “loss of use of tangible property” stating:

The allegations of an increase in the cost of Wabash’s investment and construction delays were sufficient to allege a loss of use ... within the definition of property damage as a loss of use of tangible property which had not been physically injured or destroyed.
 - c. F&H Construction v. ITT Hartford Insurance Company of the Midwest, 118 Cal.App.4th 364, 12 Cal.Rptr.3d 896 (Cal. Dist. Ct. App. 3rd 2004).
 - Prevailing view is that the incorporation of a defective component or product into a larger structure does not constitute property damage unless and until the defective component causes physical injury to tangible property in at least some other part of the system.
 - Property damage is not established by failure of defective product to perform as intended nor is it established by economic losses such as the diminution in value of the structure.

C. Did property damage occur during the policy period?

1. Triggers of coverage

a. Exposure

- i. The policy triggered is the one in force at the time the injured person or property was exposed to the harm provide coverage

b. Manifestation

- i. The policy triggered is the one in force at the time a harm is first discovered.

c. Continuous/Triple

- i. Triple trigger provides that at least three policies are triggered:
 - (1) the policy in force during the time of initial exposure;
 - (2) the policy in force during the time of continued exposure; and
 - (3) the policy in force at the time of manifestation.
- ii. Continuous trigger theory triggers all policies in force from the time of initial exposure to the date of the filing of the lawsuit seeking recovery and possibly thereafter.

d. Injury-In-Fact

- i. All policies in force at the time the claimant suffered the actual injury are triggered.

2. Application of trigger of coverage

- a. States differ with respect to which trigger will apply.

b. Many states apply a different trigger depending on the injury.

- i. Bodily injury due to asbestos is often a continuous trigger (CA), but can be exposure (NC) or manifestation (PA)
- ii. Environmental property damage can be continuous (CA), injury-in-fact (PA), exposure (GA), or manifestation (NC)
- iii. Property damage, such as construction defect, can be continuous (SC), injury-in-fact (SC, FL, HI), or manifestation (LA)

3. Known Loss/Loss In Progress Rule

- a. Any “bodily injury” or “property damage” known to have occurred prior to the policy period is excluded. This includes any continuation, change or resumption of such “bodily injury” or “property damage” during or after the policy period.
- b. This alters the original coverage interpreted by Montrose Chemical Corporation v. Admiral Insurance Company, 10 Cal.4th 645, 42 Cal.Rptr.2d 324 (1995), wherein the Court held only the insured’s ultimate legal liability need be contingent or unknown for purposes of avoiding the known loss rule.

D. Are there any exclusions which bar coverage?

1. Expected or Intended Injury – Exclusion (a)

2. Pollution – Exclusion (f)
 - a. Insurance does not apply to pollution as there is a separate policy that can be purchased which covers this risk.
3. Professional services
 - a. Often excluded by endorsement to the CGL policy.
 - b. Exception to definition of “Insured Contract”:
“Insured Contract” does not include that part of any contract or agreement:
 - (2) That indemnifies an architect, engineer or surveyor for injury or damage arising out of:
 - (a) Preparing, approving, or failing to prepare or approve, maps, shop drawings, opinions, reports, surveys, field orders, change orders or drawings and specifications; or
 - (b) Giving directions or instructions or failing to give them, if that is the primary cause of the injury or damage; or
 - (3) Under which the insured, if an architect, engineer or surveyor, assumes liability for an injury or damage arising out of the insured’s rendering or failure to render professional services, including those listed in (2) above and supervisory, inspection, architectural or engineering activities.
 - c. Even if insured is a GC and has a CGL policy or is an additional insured on a subcontractor’s CGL policy, if the GC or CM performs some task which could be considered a “Professional Service” which ultimately causes “property damage” or “bodily injury” it may be excluded from coverage.
4. Business Risk Exclusions:
 - a. Exclusion j - property:

This insurance does not apply to:
“Property damage” to:
 - (1) Property you own, rent, or occupy, including any cost or expenses incurred by you, or any other person, organization or entity, for repair, replacement, enhancement, restoration or maintenance of such property for any reason,

including prevention of injury to a person or damage to another's property;

- (2) Premises you sell, give away or abandon, if the "property damage" arises out of any part of those premises";
- (3) Property loaned to you;
- (4) Personal property in the care, custody or control of the insured;
- (5) 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; or
- (6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

Paragraphs (1), (3) and (4) of this exclusion do not apply to "property damage" (other than damage by fire) to premises, including the contents of such premises, rented to you for a period of 7 or fewer consecutive days. A separate limit of insurance applies to Damage To Premises Rented To You as described in Section III – Limits of Insurance.

Paragraph (2) of this exclusion does not apply if the premises are "your work" and were never occupied, rented or held for rental by you.

Paragraphs (3), (4), (5) and (6) of this exclusion do not apply to liability assumed under a sidetrack agreement.

Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard".

- i. Exclusion j(5) – applies only to "property damage" arising during ongoing operations. See *Lennar Corporation v. Great American Insurance Company*, 2006 WL 406609 (Tex.App. 14th Dist. Feb. 23, 2006).

ii. Exclusion j(6) excludes property damage to real property on which the insured or its subcontractors actually are performing operations at the time the property damage occurs. See J.S.U.B. Inc. v. U.S. Fire Insurance Company, 906 So.2d 303 (Fla. App. 2005).

- Exclusion does not apply to property damage arising out of defects in home since work had been completed.

b. Exclusion k – your product:

This insurance does not apply to:
“Property damage” to “your product” arising out of it or any part of it.

c. Exclusion l – your work:

This insurance does not apply to:
“Property damage” to “your work” arising out of it or any part of it and included in the “products-completed operations hazard”.

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a sub-contractor.

- i. does not apply if performed by a subcontractor
- ii ISO (Insurance Services Organization) endorsement eliminating the subcontractor exception CG 22 94 10 01

d. Exclusion m – impaired property:

This insurance does not apply to:
“Property damage” to “impaired property” or property that has not been physically injured, arising out of:

(1) A defect, deficiency, inadequacy or dangerous condition in “your product” or “your work”; or

(2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to “your product” or “your work” after it has been put to its intended use.

- i. Does not apply if property damage occurs after your work has been put to its intended use.
- ii. Eliminates coverage for non-physical damage where repair or replacement of the defective product or work will restore the other property to its intended use.
- iii. Complex analysis involved in the application of this exclusion has caused some courts to pronounce the exclusion ambiguous and to refuse to enforce it to deny coverage to the insured.
 - 1. Computer Corner, Inc. v. Fireman's Fund Insurance Co., 46 P.3d 1264 (N.M. 2002).
 - 2. McKinney Builders II, Ltd. v. Nationwide Mutual Insurance Co., 1999 WL 608851 (N.D. Tex. Aug. 11, 1999).

V. Additional Insured Issues

- A. Endorsements can be issued by ISO, which become the standard form used by most, or by manuscript endorsements. Manuscript endorsements are written specifically for the policy or the additional insured. Both types of endorsements must be read carefully to ensure the coverage provided.
- B. In the 1980's and early 90's the Additional Insured Endorsements were broad and have become the endorsement of choice given the increasingly restrictive versions which have subsequently been employed.
 - 1. 1985 edition – CG 20 10 11 85
 - a. Only qualification being that the liability must “arise out of” the named insured's work for the additional insured.
 - 2. 1993 edition – CG 20 10 10 93
 - a. Substitution of “arising out of your ongoing operations” in place of “arising out of your work” was attempt by the insurance industry to restrict the scope of additional insured coverage to liabilities arising only while the named insured's work was in progress.
 - 3. 2001 edition – CG 20 10 10 01
 - a. Two attempts by ISO to restrict coverage for additional insureds
 - i. the deletion of the subcontractor exception to Exclusion 1
 - ii. the deletion of “arising out of” language
 - b. Adds provisions to clarify the coverage for bodily injury and property damage occurring within the products completed operations hazard.

- c. Also issued CG 20 37 10 01 as a companion endorsement which restored completed operations coverage as excluded in CG 20 10 10 01.

4. 2004 edition – CG 20 10 07 04

- a. Limits coverage to bodily injury and property damage “caused, in whole or in part, by the named insured’s acts or omissions” of those acting on behalf of the named insured. Significant departure from prior additional insured endorsement forms.

OLD ENDORSEMENT LANGUAGE	NEW ENDORSEMENT LANGUAGE
WHO IS AN INSURED (Section II) is amended to include as an insured the person or organization shown in the Schedule but only with respect to liability <i>arising out of</i> “your work” for that insured by you	Section II. Who Is An Insured is amended to include as an additional insured the person(s) or organization(s) shown in the schedule, but only with respect to liability for “bodily injury”, “property damage” or “personal and advertising injury” caused, <i>in whole or in part, by:</i> <i>1. Your acts or omissions; or</i> <i>2. The acts or omissions of those acting on your behalf;</i> <i>in the performance of your ongoing operations for the additional insured(s) at the location(s) designated above</i>

- C. Do not rely simply on a certificate of insurance to establish that you are an additional insured on a subcontractor’s policy. If a certificate of insurance lists you as an additional insured but the policy does not, then you are not considered an additional insured on the policy and have no coverage under the subcontractor’s policy.

D. Anti-Indemnity Statutes

- 1. Statutes prohibiting an indemnitee from passing all responsibility to an indemnitor for damages caused by the indemnitee’s own negligence.
- 2. Reflects public policy concerns of fairness and accountability.
 - a. Walsh Construction Company v. Mutual of Enumclaw, 338 Or. 1, 104 P.3d 1146 (2005). Oregon Supreme Court held that the anti-indemnity statute not only rendered unenforceable the indemnity provision but also the additional insured provision in the subcontract. Therefore, the general was not entitled to defense or indemnity from the subcontractor’s insurance carrier. See also Buckeye Union Insurance Company v. Zavarella Brothers Construction Company, 121 Ohio

App. 3d 147 (Ohio App. 1997) (Clause in subcontractor's policy naming contractor as additional insured could not be construed as covering the contractor for its own negligence.)

- b. American Casualty Company of Reading, PA. v. General Star Indemnity Company, 125 Cal. App. 4th 1510, 24 Cal. Rptr. 3d 34 (Cal. Dist. Ct. App. 2. 2005). Addresses "sole-negligence" anti-indemnity statute. The Court held that the traditional distinction between a contractual obligation to insure and an indemnification obligation in the underlying contract renders the obligation to insure the additional insured valid and unaffected by the anti-indemnity statute.

3. Common Law Indemnity

- a. Based on fairness and allows the party that may be legally required to pay for damages to shift that burden to the negligent party that actually caused the damages or injuries.
- b. Generally, the relationship between subcontractor and general contractor is insufficient to create such a special relationship allowing indemnity.

4. Allocation between insurers

- a. Multiple insurers may allow defense and/or indemnity from multiple sources.
- b. Division of payment among multiple insurers may be by amounts contributed to a settlement, the amount of "time on the risk" for which each insurer was responsible, the difference in policy limits or joint and several (usually applied in a continuous trigger situation).

VI. Legislative Trends

A. "Rights to Repair"/"Notice and Opportunity" Laws

1. AK, CO, FL, ID, IN, KS, KY, MT, NV, SC, WV, AZ, CA, MI, WA
2. California's SB 800
 - a. Requires homeowners to allow builders the right to repair a home or to waive this right, before the homeowners are allowed to file a lawsuit for construction defects.
 - b. Applies to all homes sold on or after January 1, 2003.

- c. Has a Bill of Rights that sets forth actionable defects including, water intrusion, defects in plumbing and drainage systems, defects in soil and structural components that allow cracking or deterioration of the home, and interference with the proper operation of installed components such as an HVAC unit, electrical systems, doors, and other components.
 - d. Has various statute of limitations depending on the defect.
 - 3. Florida's SB 1286
 - a. Provides for notice and opportunity to repair defects and sets forth prerequisites for bringing a construction defect action.
 - 4. Texas' HB 730
 - a. Calls for the creation of a commission to develop and enforce a set of construction standards as well as create a forum for the resolution of construction defect disputes that avoids litigation in the courts.
- B. Considering such legislation
 - OH, OR, PA
- C. More clearly defined codes for construction standards
 - TX, NV