NAVIGANT

CONSTRUCTION

PATRICK WIELINSKI

navigant.com

About Navigant

Navigant Consulting, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the Firm primarily serves clients in the healthcare, energy and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at navigant.com.

CONSTRUCTION DEFECT AND OCCURRENCE: STILL CRAZY AFTER ALL THESE YEARS[1]

The issue of whether defective workmanship constitutes an "occurrence" for purposes of coverage for the associated property damage under a CGL insurance policy has been the subject of considerable litigation for many years. While there has been an ebb and flow in that litigation, the past 18 months have seen considerable activity among the courts on this issue. Surprisingly (or not so surprisingly), the recent treatment of "construction defect as occurrence" has not provided a clear consensus as to resolution of the issue. If anything, application of the laws of various states continues to result in differing, and usually confusing, results, making it difficult for insureds to predict whether there will be coverage for claims involving construction defects. Little seems to have changed as the following overview of recent cases indicates.

A BRIEF HISTORY

Traditionally, CGL insurance coverage for many defective coverage claims turned on the applicability of exclusions relating to damage to the insured's own work. Due to coverage enhancements introduced with the broad form property damage (BFPD) endorsement to the policy in the late 1960s and the subsequent incorporation of those enhancements into the policy itself in the 1986 revision, the insurance industry found itself paying claims it may not have underwritten and for which it had not charged premiums. Many of these claims involve residential condominium or subdivision-wide construction defect litigation involving single-family homes. Many claims alleged construction defects occurring years after completion but before the expiration of the applicable statute of repose, thus triggering coverage under numerous policies within the products-completed operations hazard.

1. With deference to Paul Simon.

As to completed operations coverage, the subcontractor exception to the "your work" exclusion, exclusion l., significantly broadened the scope of coverage for general contractors and builders that used subcontractors. In addition, the "that particular part" limitation as to exclusions j(5) and j(6) provided coverage for property damage arising out of defective workmanship during operations.

As a result of the increasing frequency of construction defect claims, particularly those involving multiple policies, arguments emerged to avoid the coverage preserved by the limited property damage exclusions. One of the primary arguments was that property damage arising out of defective construction does not constitute an occurrence. While litigation addressing faulty workmanship as an occurrence can be found earlier than the late 1990s, it was during that period that arguments focusing on breach of contract, the foreseeability of property damage, and the nature of the property damaged (third-party property versus the insured's work) arising out of the performance of defective work emerged. Over the nearly 20 years since, such arguments have been increasingly raised by insurers. As a result, a review of the most recent cases mirrors many of these arguments. Perceivable "trends" are difficult to find, and the newest precedent continues to fall within existing categories:

- defective construction is an occurrence;
- resulting damage to other work is an occurrence;
- resulting damage to third-party property is an occurrence; and
- defective work is not an occurrence.[2]

CASES UPHOLDING DEFECTIVE WORK AS OCCURRENCE

Two recent cases upheld the principle that property damage arising out of defective construction can constitute an occurrence, regardless of the type of property that is damaged—that is, the insured's work versus third-party property. In *K & L Holmes, Inc. v. American Family Mut. Ins. Co.*, 829 N.W.2d 724 (N.D. 2013), a builder sought coverage for a claim brought by home owners alleging damage to their home as a result of an excavation subcontractor's defective work. The court held that faulty workmanship may constitute an occurrence if that faulty work was unexpected and unintended by the insured and the property damage was not anticipated or intentional. The court specifically rejected its prior decision in *ACUITY v. Burd & Smith Constr., Inc.*, 721 N.W.2d 33 (N.D. 2006), stating that there is no basis within the "occurrence" definition to distinguish between damage to the insured's work and damage to the third party's property. The court went on to determine coverage based on the subcontractor exception to the your work exclusion in the policy.

A similar case in which the court reversed its prior precedent is *Cherrington v. Erie Ins. Prop. & Cas. Co.*, 745 S.E.2d 508 (W. Va. 2013). In that case, the home owner sued the insured builder, alleging numerous defects. The court reversed its prior determination that defective work cannot constitute an occurrence if the property damage arising out of it was not intended or expected by the insured. The court observed that a majority of states considering the issue recently have found that defective construction can constitute an occurrence, going on to apply the subcontractor exception in the your work exclusion and finding that it would be rendered meaningless if defective construction did not constitute an occurrence.

2. A chart setting out where various states fall within these categories, as well as cases within each category, is included in this author's publication, Insurance for Defective Construction, third edition, published by IRMI.

It specifically reversed its prior opinion in *Corder v. William W. Smith Excavating Co.*, 556 S.E.2d 77 (W. Va. 2001), observing that "with the passage of time comes the opportunity to reflect upon the continued validity of this court's reasoning in the face of juridical trends that call into question a former opinion's current soundness." Based on that opportunity to reflect, the court took a 180-degree change in course on the issue.

CASES HOLDING THAT RESULTING DAMAGE TO OTHER WORK IS AN OCCURRENCE

These cases narrow the scope of an occurrence slightly, finding that property damage to defective work itself is not an occurrence, but property damage to other property, including the insured's own work, constitutes an occurrence. A case that gained considerable notoriety in this regard is *Owners Ins. Co. v. Jim Carr Homebuilder LLC*, 2014 Ala. LEXIS 44 (Ala. Mar. 28, 2014). In that case, the Alabama Supreme Court reversed its prior opinion decided only 6 months before that property damage arising out of defective workmanship constitutes an occurrence only where it causes damage to personal property or other parts of the structure that are not part of the insured's own work. That holding caused considerable concern for general contractors and home builders since, under the terms of the CGL policy, the entire project is regarded as their work.

In its opinion upon rehearing, the Alabama Supreme Court rejected its prior position and stated that determining the existence of an occurrence based on such criteria as resulting damage to third-party property not a part of the project is simply outside the definition of occurrence in the policy. Much of the notoriety of the case was due to the court's rapid rejection on rehearing that the existence of an occurrence required damage to third-party property.

A similar conclusion was reached by the court in *Taylor Morrison Servs., Inc. v. HDI-Gerling Am. Ins. Co.*, 746 S.E.2d 587 (Ga. 2013), in which the court held that an occurrence, as that term is used in the standard CGL policy, does not require damage to the property or work of others, but for there to be property damage, that damage must be to other nondefective property. In *Capstone Bldg. Corp. v. American Motorists Ins. Co.*, 67 A.3d 961 (Conn. 2013), numerous defects in the construction of a college dormitory were alleged, and the court held that the allegations of unintended defective construction by a subcontractor may constitute an occurrence if it damages nondefective work or property of third persons.

While these courts recognize the existence of an occurrence as to nondefective portions of the named insured's work, it must be noted that there is precious little basis for that conclusion in the definitions of either occurrence or property damage in the CGL policy. Property damage is defined as "physical injury to tangible property," and defective workmanship itself can sometimes be damaged within the definition of property damage. For example, assume the insured performs defective welding, and the welds crack and separate. That cracking and separation constitute physical injury to tangible property, and coverage for the insured would be determined pursuant to the business risk exclusions in the policy. Based on the circumstances of a particular claim, it is sometimes possible that the defective work itself can constitute property that has been physically injured, and this possibility is not taken into account in this line of cases.

COURTS HOLDING THAT AN OCCURRENCE REQUIRES DAMAGE TO THIRD-PARTY PROPERTY

This category of cases severely limits the scope of an occurrence for property damage arising out of defective work by determining that only property damage to third-party property is within the coverage of a CGL policy. This limitation severely impacts coverage for an insured general contractor where the entire project, by definition, is regarded as the insured general contractor's work. At the same time, it can also impact coverage for a subcontractor, the work of which is made up of various components, only one of which is defective that causes damage to other nondefective work. Since that nondefective work is not third-party property, there is still no coverage available. Therefore, this line of cases severely restricts coverage and usually finds an occurrence only under limited circumstances.

For example, in *Rosewood Homebuilders LLC v. National Fire & Marine Ins. Co.*, 2013 U.S. Dist. LEXIS 45374 (N.D.N.Y. Mar. 29, 2013), the court determined that, where only the insured home builder's product—that is, the home—was damaged due to the insured's faulty work, there was no occurrence because there was no damage to the property of a third party. Similarly, in *Oak Creek Apartments LLC v. Garcia*, 2013 Mich. App. LEXIS 550 (Mich. Ct. App. Mar. 21, 2013), the insured roofer failed to properly cover the apartment building while it was replacing the roof, resulting in interior water damage. The court upheld an occurrence because more than just the roof was damaged, even though the court noted that damages were alleged to have arisen from a breach of contract by the roofer.

Another such case is *Liberty Mut. Ins. Co. v. Kay & Kay Contracting LLC*, 545 Fed. Appx. 488 (6th Cir. Ky. 2013), in which the faulty site preparation and building pad work by the insured subcontractor was deemed not to be an occurrence, even though the faulty work resulted in damage to other property, reasoning that the subcontractor was hired to prevent that very type of damage. Therefore, the court held that because the damages were within the control of the insured subcontractor, there was no occurrence. This case takes a very narrow view of the concept of third-party property, extending it beyond the subcontractor's own work to include damage to work the protection of which the court viewed to be within the insured's contractual obligation.

In *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Turner Constr. Co.*, 2014 N.Y. App. Div. LEXIS 3546 (N.Y. App. Div. 1st Dep't May 15, 2014), a segment of a pipe rail system that was part of the curtain wall on an office building fell from the eighth floor to the street. The curtain wall did not conform to the building plans, and there were numerous other defects in it. As a result, the owners sued the insured contractor, and the court determined that, under New Jersey law, a CGL policy does not afford coverage for breach of contract or breach of warranty where the faulty construction only damages the insured's own work. The court supported its decision with the landmark case of *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979), which has been relied on by courts of various states to support the notion that property damage arising out of defective workmanship cannot be an occurrence, even though *Weedo* involved only the effect of unmodified business risk exclusions under earlier policy forms.[3]

In support of its reliance on *Weedo*, the National Union v. Turner Constr. court cited *Firemen's Ins. Co. of Newark v. National Union Fire Ins. Co.*, 904 A.2d 754 (N.J. App. Div. 2006), for the proposition that *Weedo* had been extended to the determination of existence of an occurrence under the insuring agreement of a CGL policy.

Whatever the basis relied on by courts that apply the third-party property damage limitation on the definition of occurrence, that limitation potentially denies coverage for the major portion of property damage associated with many defective workmanship claims, contrary to the terms and structure, let alone the intent, of the CGL policy.

3. The *Weedo* opinion has a long history in connection with insurance coverage for defective construction. That case addressed early policy forms that were not enhanced with the BFPD endorsement, providing coverage for a general contractor for property damage arising out of the work of its subcontractors. That case is often cited in tandem with a law review article that again addressed coverage only under earlier unenhanced CGL forms: Roger Henderson, "Insurance Protection for Products Liability in Completed Operations-What Every Lawyer Should Know," Nebraska Law Review 15 (1971): 415, 441. These authorities have been cited by 200 other courts for the proposition that the CGL policy does not provide coverage for damage to the work, and most recently, they have been cited in support of the proposition that defective workmanship does not constitute an occurrence under the CGL policy, even though those authorities do not address the BFPD endorsement, the limited exclusions in the 1986 form, or the definition of occurrence.

COURTS HOLDING THAT DEFECTIVE CONSTRUCTION IS NOT AN OCCURRENCE

The recent opinions of other courts have refused to regard defective construction as giving rise to an occurrence under a CGL policy. For example, in *McBride v. Acuity*, 510 Fed. Appx. 451 (6th Cir. Ky. 2013), the court held that faulty workmanship does not constitute an occurrence, even when it is performed by the insured's subcontractor, so that there is no coverage under a home builder's CGL policy for damage to a home, including cracks in the floors and walls caused by the defective work of its concrete subcontractor.

In *Allied Roofing, Inc. v. Western Reserve Grp.*, 2013-Ohio-1637 (Ohio Ct. App. Franklin County Apr. 23, 2013), the court denied coverage to a roofing contractor for damage to air-conditioning units located on the roof. As part of its work, the insured was required to remove and reinstall air-conditioning units that were located on the roof, and during the process of removing and reinstalling the units, their coils became twisted, causing coolant to leak out. The court relied on the recent case of *Westfield Ins. Co. v. Custom Agri Sys.*, Inc., 979 N.E.2d 269 (Ohio 2012), another case that involved only damage to the insured's own work and in which the court held that claims of defective workmanship are not claims for property damage caused by an occurrence. At this point, there is some uncertainty as to the scope of the rulings of the courts in these Ohio cases, and it will be of some interest to see whether their holdings are restricted only to damage to the work itself, or whether it will also extend to a denial of coverage for damage to other work or third-party property.

A case that also denied coverage for defective construction on the basis of a lack of occurrence is *Nautilus Ins. Co. v. 3 Builders, Inc.*, 955 F. Supp. 2d 1121 (D. Haw. 2013). In that case, an apartment owners' association sued a roofing contractor, alleging that the new roofs were defective. The court relied on Haw. Stat. § 431:1–217, which provides that an occurrence shall be construed in accordance with the law as it existed at the time the insurance policy was issued. Unfortunately, since the policy was issued in 2008, coverage was governed by *Burlington Ins. Co. v. Oceanic Design & Constr., Inc.*, 383 F.3d 940 (9th Cir. 2004), applying Hawaii law. That case held that faulty workmanship is not an occurrence under a CGL policy since defective work is considered a breach of contract and the damages are reasonably foreseeable. The *Nautilus* court determined that, because all of the claims were either contract claims or claims that arose from the contract or the contractual relationship, there was no occurrence under the *Burlington* case. As can be seen, sometimes even a legislative solution to the occurrence issue can cause unforeseen difficulties.

ANY CERTAINTY?

As can be seen after surveying the past 18 months, there is little certainty that can be derived from a review of the occurrence opinions that have been decided during that period. Nevertheless, the following points can be gleaned from them.

- There is still a disparity of approaches among the states, with most applying the four approaches discussed above: defective work is an occurrence; property damage to other property, including the insured's nondefective work, is an occurrence; only damage to third-party property arising out of defective work is an occurrence; and defective work is not an occurrence, whether due to considerations of breach of contract or foreseeability.

- The law of a particular state is often in flux due to the amount of attention that these cases receive in the appellate courts from industry organizations that frequently file amicus curiae briefs in support of either the insured or the insurer. Courts sometimes reconsider and reverse themselves. Likewise, some courts will reverse longer, more entrenched principles of law on these issues.
- For these reasons, choice of law remains critical, particularly for construction entities that do business in more than one jurisdiction. What is an occurrence in one state may not be an occurrence across the border.
- The occurrence argument is often strengthened when it can be demonstrated that, if an occurrence is found, other provisions of the policy, particularly the subcontractor exception to the your work exclusion, or the "particular part" limitation on exclusions j(5) and j(6) preserve coverage, and a finding of no occurrence renders those limitations useless.

Admittedly, the above conclusions have not changed much over the lengthy period of time that the occurrence issue has been winding its way through the courts. In that sense, of course, the defective construction as an occurrence issue is still crazy after all these years.

Opinions expressed in Expert Commentary articles are those of the author and are not necessarily held by the author's employer or IRMI. Expert Commentary articles and other IRMI Online content do not purport to provide legal, accounting, or other professional advice or opinion. If such advice is needed, consult with your attorney, accountant, or other qualified adviser.