

CLIENT ADVISORY

Construction Defect Claims: Recent Complications and Case Law Examples

Defining “Occurrence” Can Be Difficult

A 2010 court decision in Hawaii (*Group Builders, Inc. and Tradewind Insurance Co. Ltd. vs. Admiral Insurance Co.*) has once again highlighted the divergent court interpretations of the CGL policy by finding that a breach of contract claim, based on shoddy performance, was not an occurrence. In response to this case some insurers, brokers and consultants have proposed various wording to re-define the word “occurrence” in their policy or add endorsements that allow the insured to pick the jurisdiction coverage disputes will be decided.

Prior to the Hawaii decision earlier in 2010, a Colorado Court of Appeals decision in the construction defect case of *Indemnity Company of Arizona vs. Mountain States Mutual Casualty* held that the complaint did not sufficiently allege an occurrence. In response, the state of Colorado issued legislation to attempt to clarify and support defective construction as an occurrence under the CGL.

Most States Support Coverage of Construction Defect as an Occurrence

Despite what appears to be a trend to exclude coverage for construction defect claims, the majority of states support coverage for construction defect claims as an occurrence. In the September 2010 case of *Sheehan Construction Co., Inc. vs. Continental Casualty Co.* in Indiana, the Supreme Court ruled that construction defects constitute an occurrence under the CGL. Only four states at the highest court level have found defective construction not to be an occurrence. The balance of states, whether they support defective construction as an occurrence or have a lower court ruling against it being an occurrence, leave room for pursuing coverage for defective construction. There are 18 states where at the highest court levels defective construction has been found to be an occurrence. Another 11 states support defective construction as an occurrence in their lower courts. There are also a number of states that are on the fence as well as some that support defective construction as an occurrence if there is damage to third party property.

Policy Modifications May Have Unintended Consequences

As a result of the Hawaii case, many insureds may want to modify policies through endorsements, but modifying policy wording could have unintended results. For example, adding an endorsement to pick the jurisdiction to resolve coverage disputes may seem like a good way to position the insured for a favorable ruling, but case law in any jurisdiction can change over time, and a jurisdiction favorable for one coverage area may not be favorable for another.

Modifying the definition of occurrence – a definition designed to respond to all types of losses, not just construction defect claims – could also have unintended consequences as it may impact other areas of coverage and create an untested definition for court interpretation. Modifying the policy should be done with extreme care and with the help of insurance professionals experienced in construction risks.

ISO Forms and Variations in Case Law

The Insurance Services Office (“ISO”) is in the business of drafting standardized forms that are used by many insurers. The ISO forms are to provide wording that can be a consistent base from which to tailor custom wording and to allow customers to make meaningful comparisons of price and coverage. Additionally, ISO forms are intended to help give court interpretations a more consistent meaning. Unfortunately, ISO forms are no guarantee of consistent legal ruling, as all aspects of the policy have been given various interpretations by the court system.

As a result of the varying case law, insurance coverage disputes have become common when addressing construction defect claims. Insurers may pay a construction defect claim in one state and not pay a claim in another state relying on case law to support their position. Although the ISO forms that most insurers use have a plethora of exclusions and endorsements to eliminate or narrow coverage for business risks, the trend by insurers is to attack the definition of occurrence and property damage in the context of a breach of contract claim. This is especially true in states where there are upper and lower court decisions supporting this approach or in states that are undecided. If the insurer is successful in their argument, they may not need to deal with policy wording intended to clarify the available coverage for defective construction. Likewise, if the insured is successful in establishing that there is an occurrence and property damage, the policy wording can be used to clarify what is covered.

To learn more about how AmWINS can help your clients with construction defect risks, reach out to your AmWINS contact or send email to marketing@amwins.com.

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The disputes over coverage arise over the fact that insurers only want to cover resulting damage and do not want to pay for the insured's faulty work itself as they see this as a business risk. Similar to product liability, the insured's product is generally not covered, only the resulting damage is covered. ISO has sought to eliminate the business risks by adding exclusions and definitions for "your work" in the CGL and at the same time providing a give back to the general contractor when the work, or the work out of which the damage arises, was performed on the insureds behalf by a subcontractor. Obviously in the attempt to provide some coverage for the contractor, the drafters must have felt defective construction or faulty work was an occurrence.

Definitions of "Accident" as Relating to "Occurrence"

The definition of "occurrence" in the standard ISO policy form, "CG 00 01 10 10," commonly still used (current forms have eliminated the term accident) means, "an accident, including continuous or repeated exposure to substantially the same general conditions." The definition uses the word accident, which is not defined. In everyday usage accident means an event which is unexpected or unforeseen. At one point in time the definition included "neither expected nor intended from the standpoint of the insured." This 1973 language was drafted according to ISO "in order to avoid coverage for deliberate acts and to emphasize that the injury be fortuitous from the standpoint of the insured and not the claimant."

The definition of "accident" was further clarified and today there is a separate exclusion for property damage "expected or intended from the standpoint of the insured" and further clarifying wording to define a covered occurrence. The historical reference is to point out that the drafters have continued to try to clarify the wording of occurrence to reaffirm that coverage exists for damage that is accidental, fortuitous or unforeseen.

Again, case law varies. Several cases in Illinois, a state without a high court ruling, have concluded construction defects are not accidents because they are the natural and ordinary consequences of an act, faulty construction, (*Montecello Insurance Co. vs. Wil-Freds Construction, Inc.*). This conclusion avoids the real question of whether the person performing the act leading to the result intended or expected the result from the stand point of the insured. Another Illinois case, this one in 2007, pointed out that if the person did not intend or expect the result then the result was the product of an accident (*County Mutual vs. Carr*). An important aspect of the coverage determination in these claims was the damage alleged in the complaint.

In Pennsylvania's Supreme Court 2006 decision (*Kavernar Metals Division of Kaverner U.S, Inc. vs. Commercial Union Insurance Co.*) it was found that there was no occurrence because the complaint set forth claims solely for breach of contract. In a 2007 PA Superior Court case (*Millers Capital Ins. Co. vs. Gambone Bros. Dev. Co.*) the court found the damage issue was not caused by an accident.

In Wisconsin the Supreme Court found (*American Family Mutual Insurance Co. vs. American Girl, Inc.*) that claims for breach of contract may constitute an occurrence. Likewise, in Texas in the 2007 decision (*Lamar Homes vs. Continent Casualty*) the court found that construction defect was an occurrence.

Identifying Property Damage

Sometimes identifying the resulting property damage which should be covered can also be a challenge. Additional confusion is added by some of the claims that are submitted in which the distinction between resulting damage and the insured's work is difficult to define. Consider these examples that may be difficult to define: damage claims that could be considered maintenance items; design problems that do not result in property damage; property damage that does not fall within completed operations; tear-out work done to replace a defective component or part of the structure; resulting property damage to a third party; or damage where there is a question if the insured is legally liable. Any of these can become complex issues from a coverage and investigative standpoint.

Successfully establishing coverage for each claim lies in understanding the details of the claim, the coverage provided, and the jurisdiction a claim is in. Triggering coverage for construction defect claims in the CGL policy should be based on whether there has been an occurrence as defined in the policy, whether there is property damage as defined, and whether the insured is legally liable. Essentially the claim must fall within the insuring agreement that captures these three terms. Exclusions and endorsements will further expand, narrow, or eliminate coverage. Knowing the particulars of each case and the specific applicable policy wording can help illuminate how a claim relates to the case law in the jurisdiction that will interpret coverage for the claim and help craft the necessary coverage arguments.

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