CONSTRUCTION DEFECTS – INSURANCE COVERAGE ISSUES

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Construction/Homebuilding Industry

- After recession, new home sales finally growing stronger
  - E.g., "Homebuilder ETFs Soar on Hot-selling Homes," *available at* http://www.zacks.com/stock/news/182951/homebuilder-etfs-soar-on-hotselling-homes, July 23, 2015.
  - Annual revenue estimated at $66 billion. *See* http://www.ibisworld.com/industry/default.aspx?indid=169.
- Construction boom = boom in defects and lawsuits
  - E.g., "New, but Far From Perfect: Construction Defects Follow a Brooklyn Building Boom," NEW YORK TIMES, March 6, 2015.

Variety of Insurance Products for Construction-Related Claims

- E.g.: Business Owners Policy, Builders Risk Policy, OCIP, CCIP, Contractors Professional Liability, Commercial General Liability.

- Specialized products to address contractor needs: e.g., "Homebuilders Policy" offering both ongoing operations and completed operations coverage specifically for "construction defects."

Construction Defects

- Coverage for construction defects has otherwise given rise to much litigation, particularly under traditional CGL coverage.
- Large loss suits, including class actions, stemming from widespread defects in residential communities may result in substantial defense and indemnity costs.
- Latency problem also poses concern for insurers: defects will often manifest years after project completion, potentially triggering completed operations coverage under a number of policies.

Construction Defects – Coverage Issues

- Under a traditional CGL form, a number of coverage issues arise when it comes to construction defects.
- One of the major issues is whether a construction defect is an "occurrence."
- Certain states have passed "Right to Repair" laws that impact coverage.
- Other issues:
  - coverage for "pro-active" repairs
  - aggregation issues
  - trigger/allocation issues

Is a construction defect an "occurrence"?

- Whether a construction defect is properly seen as an "occurrence" under the CGL definition has given rise to a large body of case law.

- Cases are divergent, and the scope of coverage may differ widely from jurisdiction to jurisdiction.

Is a construction defect an "occurrence"?

- Starting point is to look at the standard CGL "occurrence" definition: "an accident, including continuous or repeated exposure to substantially the same general conditions."
- While generally not defined in the policy, the term "accident" is commonly understood to mean a fortuitous event.
- Per standard exclusionary language, the damage for which coverage is sought must also not be "expected or intended from the standpoint of the insured."

Is a construction defect an "occurrence"?

- Arguments made to support conclusion that defective construction is not covered under a CGL policy include:
  - Construction defects are not occurrences because claims related to faulty workmanship are reasonably foreseeable;
  - Claims for defective work constitute a business risk that is not intended to be covered by liability insurance; and
  - Coverage for construction defects would convert the policy into a performance bond or guarantee of work quality, which is not the purpose of liability insurance.

Is a construction defect an "occurrence"?

- Arguments made to support conclusion that defective construction is covered under a CGL policy include:
  - Defective work is unintentional: contractors do not intend their work to be defective or to cause damage to other property;
  - Reasonable expectations of the insured: contractors are in the construction business and their liabilities will typically relate to their construction work; and
  - Existence of "subcontractor exception" to Damage to Your Work exclusion would be unnecessary if it had truly been intended that faulty work could never be an occurrence.
    - Exclusion reads: "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 damage to work or the work out of which damage arises was performed on your behalf by a subcontractor."

Is a construction defect an "occurrence"?

- Case finding coverage:
  - *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871, 891 (Fla. 2007) ("We conclude that faulty workmanship that is neither intended nor expected from the standpoint of the contractor can constitute an 'accident' and thus an 'occurrence' under a post–1986 standard form CGL policy. We further conclude that physical injury to the completed project that occurs as a result of the defective work can constitute 'property damage' as defined in a CGL policy. Accordingly, we hold that a post–1986 standard form commercial general liability policy with products completed-operations hazard coverage, issued to a general contractor, provides coverage for a claim made against the contractor for damage to the completed project caused by a subcontractor's defective work provided that there is no specific exclusion that otherwise excludes coverage.")

- Case finding against coverage:
  - *Grp. Builders, Inc. v. Admiral Ins. Co.*, 231 P.3d 67, 73-74 (Haw. Ct. App. 2010) ("We hold that under Hawai'i law, construction defect claims do not constitute an 'occurrence' under a CGL policy. Accordingly, breach of contract claims based on allegations of shoddy performance are not covered under CGL policies. Additionally, tort-based claims, derivative of these breach of contract claims, are also not covered under CGL policies.")

Is a construction defect an "occurrence"?

- In *Cypress Point Condo. Ass'n, Inc. v. Adria Towers, L.L.C.*, 118 A.3d 1080 (N.J. Super. Ct. App. Div. 2015) a New Jersey court recently held that a construction defect is an "occurrence."
- In so ruling, the court distinguished the seminal New Jersey case, *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979), which had long been relied on by various courts to support the conclusion that property damage arising out of defective workmanship cannot constitute an occurrence. *Weedo* had found no coverage for faulty workmanship where the damages claimed were merely the cost of correcting the work, a business risk. This was distinguishable from consequential damage to other property caused by the faulty work.
- In reaching its conclusion, the *Cypress Point* court specifically cited the Florida Supreme Court's decision in *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871 (Fla. 2007), which held that construction defects constitute an "occurrences" under post-1986 CGL policies, noting that the Florida Supreme Court had also distinguished *Weedo*.
- In addition, the *Cypress Point* court noted that the Supreme Courts in Georgia, Texas, Kansas, Indiana, Minnesota, Alaska, South Carolina, Tennessee and Wisconsin had come to the same conclusion. *Cypress Point*, 118 A.3d at 1088. (The court "find[s] persuasive that "the majority rule [currently] is that construction defects [causing consequential damages] constitute 'occurrences [.]').

Is a construction defect an "occurrence"?

- **Notwithstanding** what the *Cypress Point* court asserted was the "majority rule," New York courts have declined to adopt the reasoning of other jurisdictions and continue to hold that "construction defects such as . . . faulty design, fabrication, or installation, do not constitute 'occurrences' under a commercial general liability policy." *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Turner Const. Co.*, 119 A.D.3d 103, 106-07 (1st Dep't 2014).

Is a construction defect an "occurrence"?

- In recent years, some states enacted legislation favoring coverage for construction defects, for example:
  - Arkansas: Ark. Code Ann. § 23-79-155(a) (Supp. 2011)
  - Colorado: Colo. Rev. Stat. § 13-20-808(3) (2010)
  - South Carolina: S.C. Code Ann. § 38-61-70 (B) (Supp. 2011)

Is a construction defect an "occurrence"?

- Colorado statute, for example, reads in relevant part:

(3) In interpreting a liability insurance policy issued to a construction professional, a court shall presume that the work of a construction professional that results in property damage, including damage to the work itself or other work, is an accident unless the property damage is intended and expected by the insured. Nothing in this subsection (3):

(a) Requires coverage for damage to an insured's own work unless otherwise provided in the insurance policy; or

(b) Creates insurance coverage that is not included in the insurance policy.

Is a construction defect an "occurrence"?

- Such statutes have, however, led to various constitutional challenges in the state courts, resulting in decisions that they cannot be applied retroactively, e.g.:
  - *Colorado Pool Sys., Inc. v. Scottsdale Ins. Co.*, 317 P.3d 1262, 1269 (Col. App. Ct. 2012), *cert. granted in part*, 2013 WL 471428 ("If applied here, the Builders Insurance Act would retroactively change the coverage provided under the CGL policy. And that change, in turn, would retroactively alter the reasonableness of Scottsdale's actions in refusing to defend and indemnify Colorado Pool. That sort of change is unconstitutional.")
  - *Harleysville Mut. Ins. Co. v. State*, 401 S.C. 15, 31 (2012) ("[W]e hold the retroactivity provision of Act No. 26 unconstitutional in violation of the state and federal Contract Clauses. Act No. 26 may only apply prospectively to contracts executed on or after its effective date of May 17, 2011.")

Right to repair statutes - Is there a valid "claim" under the policy?

- To address increasing construction defect lawsuits, many states enacted legislation mandating certain steps that must be taken before a suit can be filed against the builder.
- Known as "right to repair" or "right to cure" laws, these statutes generally require that notice of a defect first be given to the builder, who will then have the opportunity to remedy the defect before any litigation may be commenced.
- The question then arises whether right to repair notices meet the requirements of a claim in the policy, which may require a "suit" for damages.

Right to repair statutes - Is there a valid "claim" under the policy?

- *Cincinnati Ins. Co. v. AMSCO Windows*, 593 Fed. App'x 802 (10th Cir. 2014) (no duty to defend because notice under Nevada right to repair statute did not constitute a "suit" within the terms of a CGL policy)
- Question may also be addressed by statute. *See, e.g., Altman Contractors Inc. v. Crum & Forster Specialty Ins.* Co., No. 13-80831-CIV, 2015 WL 3539755 (S.D. Fla. June 4, 2015); *D.R. Horton, Inc. Denver v. Mountain States Mut. Cas. Co.*, 69 F.3d 1179 (D. Col. 2014).

Right to repair statutes - Is there a valid "claim" under the policy?

- Hawaii – "The notice of claim shall not constitute a claim under any applicable insurance policy and shall not give rise to a duty of any insurer to provide a defense under any applicable insurance policy unless and until the process … is completed." Haw. Rev. Stat. § 672-E-3(a).

- Florida – "… the providing of a copy of such notice to the person's insurer, if applicable, shall not constitute a claim for insurance purposes unless provided for under the terms of the policy." Fla. Stat. § 558.004(13)

Right to repair statutes – Is it the Exclusive Remedy? Apparent Split in California

- Recent conflicting rulings in California may impact subrogation cases involving construction defect claims.
- In *Liberty Mutual Ins. Co. v. Brookfield Crystal Cove LLC*, 219 Cal. App. 4th 98,108 (Cal. Ct. App. 2013), a subrogation case, the California Court of Appeals for the Fourth District distinguished between "actual" and "economic" damages, holding that while California's Right to Repair Act covers instances were construction defects were discovered before any actual damage had occurred (i.e., economic damages), "the Act does not provide the exclusive remedy in cases where actual damage has occurred because of construction defects."
- However, in *McMillian Albany LLC v. Superior Court*, 239 Cal. App. 4th 1132, 1146 (Cal. Ct. App. 2015) the California Court of Appeals for the Fifth District expressly rejected the reasoning and outcome of the Fourth District in the *Liberty Mutual*, holding that the Right to Repair Act is the exclusive remedy for "all claims arising out of defects in residential construction," whether the damages are actual or economic.

Coverage for "pro-active" repairs?

- When construction defects begin to arise in large residential communities, homebuilders may be motivated to engage in "pro-active" repairs to mitigate potential litigation costs and also to preserve their business reputation.
- Are these covered "claims" or voluntary payments?

Coverage for "pro-active" repairs?

- In certain jurisdictions, courts have concluded that "coverage for sums an insured 'becomes legally obligated to pay as damages' may be triggered even in the absence of a civil lawsuit against the insured or a court order requiring the insured to make payment." *Desert Mountain Properties Ltd. Partnership v. Liberty Mutual Fire Ins. Co.*, 225 Ariz. 194, 201 (Ariz. Ct. App. 2010).

- Other jurisdictions may take a stricter view. In *Permasteelisa CS Corp. v. Columbia Cas. Co.*, 377 Fed. App'x 260 (3d Cir. 2010), the Third Circuit rejected an insured's claim for remediation costs in connection with a construction project because the insurer was not obligated to cover costs until a judgment was entered against the insured. The court did not agree that that the insured's contract to provide a curtain wall could constitute a "legal obligation to pay" within the meaning of the policy. *Id.* at 266.

Aggregation Issues

- When construction defect claims are comprised of hundreds or even thousands of homes with an allegedly common defect, where should the line be drawn as what constitutes the "occurrence"?
- Various approaches:
  - General "occurrence" definition, i.e., "an accident, including continuous or repeated exposure to substantially the same general conditions" still will require jurisdiction-specific analysis of how broadly or narrowly an "occurrence" can be defined.
  - Tailor "occurrence" definition to apply "per project" or other limiting language.

Trigger

- Various approaches:
  - Occurrence during policy term
  - Claims Made
  - Close of Escrow
  - Hybrid – Close of Escrow during Policy Period and Claim Made During Specified Reporting Period

QUESTIONS/COMMENTS