PLRB Regional Adjusters Conference

Construction Defect Coverage: Emerging Issues

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Learning Objectives

- **Construction Defect Coverage: Emerging Issues**
  - Trace recent developments on the issue of whether faulty workmanship is an "occurrence" under CGL policies
  - Identify and describe emerging issues regarding CGL policy coverage triggers and priority
  - Assess developments in CGL policy coverage for policyholders' pre-claim loss settlements and remediation

Introduction

- **Litigation increasing!**
  - Property owners sue general contractors
  - Contractors turn to their commercial general liability (“CGL”) policies.
- **Insurers**
  - Add more exclusions
  - Seek narrower interpretations of policy language
- **Policyholders lobby for broader coverage.**
- **Courts not sure where to draw the line**
  - Which claims are covered?
  - Which policies are triggered?
- **In some states, legislatures intervene to instruct the courts**

IS FAULTY WORKMANSHIP AN OCCURRENCE?

- **Typical CGL coverage only if lawsuit alleges "property damage" caused by an "occurrence."**
  - "Occurrence" usually defined as "an accident, including continuous or repeated exposure to the same general harmful conditions."
  - Accident defined by statute and case law
- **The jurisdictions don't agree**
  - 1990s: majority of jurisdictions hold that faulty workmanship not an "occurrence"
  - Today: trend in favor of coverage construction defect claims

States are steadily moving towards coverage

- Beginning in the late 1990s, the states rethink their position:
  - **Alabama**: construction defects may constitute a covered occurrence.
    Owners Insurance Co. v. Jim Carr Homebuilder, LLC, 157 So.3d 148 (Ala. 2014)
  - **West Virginia**: claims of faulty workmanship fall under the definition of an "occurrence" under a CGL policy
    Cherrington v. Erie Insurance Property & Casualty Co., 745 S.E.2d 508 (W. Va. 2013)
    BPI, Inc. v. Nationwide Mutual Insurance Co., No. 14-0799 (W. Va. May 20, 2015)
  - **Wisconsin:** instead of finding that the insured *actions* must be unintentional, found that the *injury suffered* must be unintentional and accidental.
    American Family Mutual Insurance Co. v. American Girl, Inc., 673 N.W.2d 65 (Wis. 2004)
- The Supreme Courts of Alabama, Alaska, California, Florida, Georgia, Indiana, Kansas, Maine, Mississippi, Missouri, Nebraska, New Hampshire, North Dakota, South Carolina, South Dakota, Tennessee, Texas, Washington, and Wisconsin have all specifically held that claims for construction defects may qualify as occurrences under a CGL policy.

States are steadily moving towards coverage

- How do they come to this conclusion?
- Three general premises:
  1. Lacking a definition of the term “accident” to describe the meaning of the word “occurrence,” the courts determine that the *injuries suffered* to the property must be unintentional and accidental instead of finding that the insured’s *actions* must be unintentional, or
  2. Exclusion of construction defect claims from coverage is inconsistent with policy language when read as a whole, or
  3. As blanket rule declining to extend coverage to all construction defect claims is too broad and unworkable in practical application.

The Past (and Present) Standard in Some Places

- Not a universal change.
- **Kentucky** and **Pennsylvania:** construction defect claims cannot be considered “occurrences” because poor workmanship is not accidental.
- Other courts: CGL insurers are not meant to serve as sureties for construction contractors’ defective work.
  - The purpose of a CGL policy is not to provide contractual indemnity for economic losses
  - CGL policy to provide protection against accidents that cause bodily injury or property damage.

Legislative Response

- States' stances on the treatment of faulty workmanship have not been exclusively the result of judicial interpretation. To date, four states have enacted legislation addressing the issue.

Colorado

- In 2010, the Colorado legislature passed C.R.S. § 13-20-808 in order to address recent Colorado case law holding that claims for faulty workmanship were not “occurrences.”
- The statute creates a **presumption** that construction defects that cause property damage are **accidents**, and, therefore, should be considered “**occurrences**” under CGL policies. C.R.S. § 13-20-808(3). Further, the statute clarifies that, although a court must presume that the claim is an “occurrence,” the statute **does not override the business risk exclusion** which removes the insured’s own work from coverage. *Id.* § 13-20-808(3)(a).

Hawaii

- Hawaii's H.B. 924, signed into law in 2011, states that the term "occurrence" in a liability policy "shall be **construed in accordance with the law as it existed at the time that the insurance policy was issued**." Haw. Rev. Stat. § 431: 1-217 (2011).
- The bill was drafted in response to a Hawaiian appellate court's decision in *Group Builders v. Admiral Insurance*, which held that construction defect claims are not "occurrences." 231 P.3d 67 (Haw. Ct. App. 2010).
- The law has created little certainty, with Hawaiian courts reaching differing conclusions with regard to this issue.
- Hawaiian courts and the Hawaiian legislature are slowly moving towards the majority view.

Arkansas

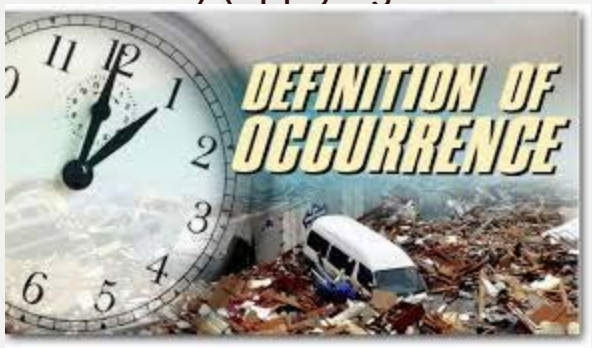
- Arkansas enacted Arkansas Code § 23-79-155 in 2011.
- Statute provides that commercial general liability policies issued in Arkansas must define the term "**occurrence**" to include "property damage or bodily injury resulting from **faulty workmanship**." Ark. Code Ann. § 23-79-155 (2011).
- The statute clearly sides with the majority view, and there should be no question to litigants in Arkansas that construction defect claims constitute occurrences.

South Carolina

- South Carolina statute provides that commercial general liability policies issued in South Carolina "shall contain or be deemed to contain a definition of '**occurrence**' that includes **property damage** or bodily injury resulting from **faulty workmanship**, exclusive of the faulty workmanship itself." S.C. Code Ann. § 38-61-70 (2011).
- Though the statute was intended to apply retroactively, the South Carolina Supreme Court has limited its application to policies issued after the statute's enactment. *Harleysville Mut. Ins. Co. v. State*, 736 S.E.2d 651 (S.C. 2012).

TRIGGER OF COVERAGE

- If an occurrence, it must have taken place during the policy period.
- So *when* did the occurrence take place?
- Different jurisdictions approach the question differently. The approaches include:
  - (1) the **exposure** theory, *see Porter v. Am. Optical Corp.*, 641 F.2d 1128, 1145 (5th Cir. 1981) (applying Louisiana law);
  - (2) the **manifestation** theory, *see Eagle Picher Indus., Inc. v. Liberty Mut. Ins. Co.*, 682 F.2d 12 (1st Cir. 1982);
  - (3) the **continuous trigger** theory, *see Keene Corp. v. Ins. Co. of N. Am.*, 667 F.2d 1034 (D.C. Cir. 1981); and
  - (4) the **injury-in-fact theory**, *see Abex Corp. v. Maryland Cas. Co.*, 790 F.2d 119, 129 (D.C. Cir. 1986) (applying New York law).



Manifestation

- According to the manifestation theory the term “occurrence” is “generally understood to mean the time and/or event when negligence manifests itself by **causing actual damages**, rather than the commission of the causative negligence.”
- Although a negligent act may occur prior to a policy period, if the resulting property **damage** from that negligent act **occurs during the policy period**, the insurer will be liable for those damages.
- The manifestation theory has the effect of transforming all policies into “claims made” policies, since the only policy which will be liable for damages will be the one in effect when the claim is first noticed.
- Application of this theory is somewhat **dangerous to insurers**, as damages caused during a completely different policy period but which “manifest” later will be covered.

Injury-in-Fact

- Jurisdictions which utilize the injury-in-fact trigger find that **the date** on which the **actual injury and damage occurs** is the date to which courts should look when determining if the damage occurred during the policy period.
- The date on which the injury is **discovered is largely irrelevant**. Therefore, an insurer's policy is triggered if some physical damage to tangible property actually occurs during its policy period.
- These cases generally reject efforts to trigger coverage under successive policies for ongoing property damage.
- Courts applying the injury-in-fact theory have found it difficult to determine the exact date on which the injury occurred; therefore, this theory is not as practical as others.
  - Many times, the date on which the injury occurred will be a factually-intensive inquiry, and insurers are forced to defend policyholders even without a specific finding or allegation that the injury actually occurred during the policy period.

Exposure

- Under the exposure theory, courts hold that property damage or bodily injury occurs upon **exposure to the defective product**.
- This theory does not generally apply to construction defect claims, as it arises in situations involving **environmental** claims or **bodily injury** claims based on long-term exposure to a harmful substance.
- One generally need not consider this theory when evaluating a claim for faulty workmanship.

Continuous (*Montrose*)

- The continuous trigger theory holds that claims based on a delayed manifestation of the injury create **liability for each insurance policy** in effect from the exposure to the harm through the manifestation of the injury.
  - *Montrose Chemical Corporation v. Admiral Insurance Company*, 913 P.2d 878 (Cal. 1995): **any policy** in effect during **any part of a period** in which damage occurs is liable for damages.
- Obviously, courts' utilization of the continuous trigger for construction defect claims is **extremely dangerous** to insurers.
- Before issuing policies, insurers should make certain to draft clear and unambiguous exclusions for damages which begin to occur prior to their respective policy periods less they become susceptible for damages which may have begun to accrue prior to the policy's inception.

PRIORITY OF COVERAGE AND ALLOCATION

- Exhaustion
- Pro-Rata or “All Sums”

Exhaustion

- In some instances, multiple insurance policies will be triggered by the **same occurrence**.
- Such instances often include coverage by **primary** and **excess** insurers.
- When considering the question of exhaustion courts must determine:
  - Whether an excess insurer must “drop down” to provide indemnification for a loss before other primary policies are exhausted (vertical exhaustion); or
  - Whether an excess policy will only come into play once all triggered primary policies have been exhausted (horizontal exhaustion).
- It should not come as a surprise that excess insurers advocate for horizontal exhaustion.
- Vertical exhaustion will often be preferred by the policyholder since it will often permit them to select the triggered policy which contains the most coverage

Pro Rata or "All Sums"?

- When it is determined that multiple policies are triggered by an occurrence, courts must determine how costs should be apportioned between insurers – if at all:
  - Through the "all sums" allocation method, the insured is entitled to select one of the triggered policies to redeem (up to its policy limits) for all of the sums lost due to the occurrence.
  - Through the pro rata method of allocation, each triggered policy will pay their proportionate share of a loss.
- Though the pro rata method is the majority approach, state supreme courts have continued to split on the issue.

EXCLUSIONS

- In an effort to avoid the pitfalls of the different theories of exposure outlined above, and in response to emerging patterns of claims, insurers incorporate specific exclusions in their policies.

Progressive Law

- The decision in *Montrose*, was the seminal decision that created a need to develop the **progressive loss exclusion**.
  - The core of all of these exclusions sought to limit policies' exposure to the term of the policy by restricting coverage of damages that had **occurred prior to inception**, or were in **progress of occurring at inception** of the policy.
- Unfortunately, the inconsistent language used in these various exclusions has not produced a coherent body of law, but some patterns have emerged.
  - First, courts have continued to apply their standard policy interpretation rules to resolve the meaning of any purported exclusion of coverage, and resolving ambiguities in favor of coverage.
  - Second, many states read policy language excluding pre-existing damage as redundant assertions of the loss-in-progress doctrine, whereby the courts apply the state's own loss-in-progress or known loss doctrines.

Residential Developments

- Excludes from coverage all property damage arising out of the insured's **work** or **product** "in, around, on, or incorporated into" any condominium, townhouse, residential housing, planned unit, or mixed used development."
- Despite the fact that case law interpreting this exclusion is scant, its application seems to generally be favorable for insurers.
- Additionally, based on its seemingly clear-cut language, jurisdictions across the United States should continue this favorable application of the Residential Development Exclusion.

EIFS

- The EIFS/DEFS exclusion precludes coverage for property damage “resulting from arising out of, or in any way related to the application or manufacture of any exterior insulation finish system (‘EIFS’), or any product that is a component of an EIFS system.”
- The vast majority of cases to consider the EIFS exclusion have broadly interpreted it to exclude coverage.
- While the interpretation of the EIFS/DEFS exclusion is currently favorable to insurers, as more and more insurers begin to use the endorsement to deny coverage, courts will likely be inclined to examine it more carefully and potentially find in favor of coverage.

Imported Building Materials

- This exclusion typically excludes injuries “arising out of, caused by, related or attributable to, in whole or in part, drywall, plasterboard, sheetrock, gypsum board, or any materials used in the manufacture of [those items]… that were manufactured in, originated or exported from China or incorporated any component parts or materials made in, originated or exported from China.”
- There has yet to be any application of this exclusion, but, as with the EIFS exclusion, its clear language should foreclose any ambiguity assertion and result in its successful application in court.

PRE-CLAIM LOSS SETTLEMENT AND REMEDIATION

- Pre-loss settlements, or, more often, remediation programs, occur when an insured discovers some potential harm or defect and voluntarily takes action to remedy the situation.
- While such affirmative action may be admirable in some instances, and certainly makes good business and branding sense, such steps would seem to be in direct contravention of standard policy language that excludes offers of settlement, voluntary payments, the assumption of any obligation, or the incurrence of any expense – except at the insured's own expense – in the absence of the insurer's consent.
- Thus far, there have been few other opinions addressing voluntary remediation programs.

CONCLUSION

- As is clear from the discussion above, even with the increased litigation in the construction defect arena, there remains uncertainty – especially regarding the strength of any given exclusion and what events constitute an “occurrence.”

Questions???

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