CLM CLAIMS & LITIGATION MANAGEMENT ALLIANCE™

ADVANCING ETHICS, COOPERATION AND EDUCATION

CLM 2016 National Construction Claims Conference
September 28-30, 2016
San Diego, CA

Sharing the Misery: Defects with Construction Defect Coverage

I. A brief history of the law regarding insurance coverage in the construction industry.

Historically, Commercial General Liability ("CGL") policies were interpreted to exclude coverage for defective workmanship, as such policies were not intended to be warranty deeds, but rather provide coverage for "bodily injury" and "property damage" caused by an "occurrence". However, in many cases, including those in the Eleventh Circuit Court of Appeals and Florida appellate courts, conflicts arose as to the scope of that coverage, what constituted covered damage, and an accident or occurrence.

Notably, in Pozzi Window Co. v. Auto-Owners Ins., 446 F.3d 1178 (11th Cir. 2006), the Eleventh Circuit addressed an apparent split in Florida law between La Marche v. Shelby Mut. Ins. Co., 390 So. 2d 325 (Fla. 1980), and J.S.U.B., Inc. v. United States Fire Ins. Co., 906 So. 2d 303 (Fla. 2d DCA 2005). The Eleventh Circuit certified the following question to the Florida Supreme Court, which set in motion changes in the scope of coverage, underwriting, and ultimately led to various new policy forms:

> *Does a standard form comprehensive general liability policy with product completed operations hazard coverage, such as the policies described herein, issued to a general contractor, cover the general contractor's liability to a third party for the costs of repair or replacement of defective work by its subcontractor?*

II. Current status of Florida law on coverage for defective work.

Although traditionally CGL policies were interpreted to exclude work performed by subcontractors and faulty workmanship, in United States Fire Ins. Co. v. J.S.U.B., Inc., 979 So. 2d 871 (Fla. 2007), and Auto-Owners Ins. Co. v. Pozzi Window Co., 984 So. 2d 1241 (Fla. 2008), the Florida Supreme Court clarified the interpretation of post 1986 CGL policies under Florida law.

In J.S.U.B., the Florida Supreme Court concluded 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." The court also concluded that "physical injury to the completed project that occurs as a result of the defective work can constitute property damage." The effect of these two statements was that a claim against a contractor based upon the defective work of one of its subcontractors which resulted in damage to a completed project should be covered under a standard form CGL policy.

In Pozzi, the Florida Supreme Court further clarified that "if there is no damage beyond the faulty workmanship or defective work, then there may be no resulting "property damage." As a result of this holding, there is coverage for resultant property damage to a completed project based on the defective work caused by a subcontractor, but there is no coverage for the replacement of the defective work itself.

After J.S.U.B. and Pozzi, many policies provide new exclusions for damage to "your work" and endorsements for "faulty, defective and poor workmanship". Such exclusions are widely recognized and can be enforced.[1] However, the application of such exclusions is extremely factually specific, and often gives rise to disputes between insurers as to who may have a duty to defend or indemnify. Often, plaintiff's counsel will plead allegations in a complaint that are vague enough, both in the extent of damages and the time they occurred, to give rise to a duty to defend.

III. Trigger of coverage.

Another preliminary issue that must often be addressed, and often gives rise to disputes between insurers, is whether a covered loss occurred during the policy period. For coverage to exist most policies, there must be a covered loss occurring during the policy period. Using Florida law as an example, generally, the occurrence need not necessarily take place during the policy period, but the "property damage" must do so. See Mid-Continent Cas. Co., v. Frank Casserino Const. Inc., 721 F. Supp. 2d 1209, 1215-16 (M.D. Fla. 2010); Auto Owners Ins. Co. v. Travelers Cas. & Surety Co., 227 F. Supp. 2d 1248, 1265-66 (M.D. Fla. 2002). In other words, the rule is that the event which triggers coverage under an occurrence policy is the sustaining of actual damage and not the date or omission of the negligent act causing the damage. See Trizec Prop., Inc. v. Biltmore Constr. Co., Inc., 767 F.2d 810, 813 (11th Cir. 1985).

There are four theories regarding when "property damage" occurs under a CGL policy: (1) exposure, (2) manifestation, (3) continuous trigger, and (4) injury-in-fact. See Frank Casserino Const. Inc., 721 F. Supp. 2d at 1215-16.

> Under the exposure theory, property damage occurs upon installation of the defective product. Under the manifestation theory, property damage occurs at the time the damage manifests itself . . . The continuous trigger approach defines property damage as occurring

[1] Biltmore Const. Co., Inc. v. Owners Ins. Co., 842 So. 2d 947 (Fla. 2d DCA), rev. denied, 896 So. 2d 1198 (Fla. 2003); Aetna Cas. & Sur. Co. of Am. v. Deluxe Sys., Inc. of Fla., 711 So. 2d 1293 (Fla. 4th DCA 1998); see also J.B.D. Const., Inc. v. Mid-Continent Cas. Co., 571 F. Appx. 918, 927-28 (11th Cir. 2014) (no duty to indemnify when contractor hired to build fitness center and there was no evidence of damage to property other than completed fitness center or its components); Miranda Const. Dev. Inc. v. Mid-Continent Cas. Co., 763 F. Supp. 2d 1336, 1340-41 (S.D. Fla. 2010) (where contractor who built home sued for defective foundation, "your work" exclusion prevents claim for damages related solely to the of home itself by contractor); Assurance Co. of Am. v. Lucas Waterproofing Co., Inc., 581 F. Supp. 2d 1201, 1211 (S.D. Fla. 2008) (coverage of damage to other parts of the subject property aside from the waterproofing work performed by insured is not barred by exclusion).

> continuously from the time of installation until the time of recovery. And injury-in-fact (which is also referred to as damage-in-fact) . . . is triggered when the property damage underlying the claim actually occurs.

Id. at 1215.

Unfortunately, for the purpose of providing a definitive answer regarding the trigger of coverage, the law in Florida, as well as other states, is unsettled. One widely accepted rule in Florida is that "property damage" coverage under a CGL policy is triggered when property damage occurs under the manifestation theory. Id.; Assurance Co. of Am. v. Lucas Waterproofing Co., Inc., 581 F. Supp. 2d 1201,1206 (S.D. Fla. 2008); North River Ins. Co. v. Broward Cnty. Sheriff's Office, 428 F. Supp. 2d 1284, 1289 (S.D. Fla. 2006); Auto Owners Ins., Co., 227 F. Supp 2d at 1266; American Motorists Ins. Co. v. Southern Sec. Life Ins. Co., 80 F. Supp. 2d 1280, 1284 (M.D. Ala. 2000); Harris Specialty Chemicals, Inc. v. United States Fire Ins. Co., 2000 WL 34533982, at *11-12 (M.D. Fla. 2000); see also Travelers Ins. Co. v. C. J. Gayfer's & Co., 366 So. 2d 1199, 1202 (Fla. 1st DCA 1979) (occurrence is understood to mean the event in which the negligence manifests itself). In Frank Casserino Const., Inc., 721 F. Supp 2d at 1211, the question was not one of discovery, but of manifestation, and that the date that damage was discovered was irrelevant to the issue of trigger of coverage. Similarly, applying the manifestation theory, in Essex Builders Group, Inc. v. Amerisure Ins. Co., 485 F. Supp. 2d 1302, 1309 (M.D. Fla. 2006), the court held that although damage to property began a short period after it was completed, there was no coverage since the damage became "visible" outside the policy period.

Conversely, however, there is authority, including many recent Florida Middle District cases that suggest that the law as to trigger is not absolute so that a court can look to either continuous injury or injury in-fact theories to determine coverage. See St. Paul Fire & Marine, Inc. Co., v. Cypress Fairway Condo. Assoc., Inc., 114 F. Supp. 3d 1231 (M.D. Fla. 2015) (holding that the injury-in-fact rule is the appropriate trigger for coverage); Voeller Const., Inc. v. S.-Owners Ins. Co., 2014 WL 1779289, at *4 (M.D. Fla. 2014) (concluding that the injury-in-fact trigger is the appropriate theory for this occurrence based policy); Trovillion Const. & Dev., Inc. v. Mid-Continent Cas. Co., 2014 WL 201678, at *5 (M.D. Fla. 2014) (injury-in-fact rule is the most appropriate trigger theory for occurrence policies); Axis Surplus Ins., Co. v. Contravest Const. Co., 921 F. Supp. 2d 1338, 1348 (M.D. Fla. 2012) (the physical injury or destruction of tangible property had to occur during the policy period in order to trigger coverage, and the court applied the injury in-fact trigger theory which required the damage itself occur during the policy period); see also Trizec Prop. Inc., 767 F.2d at 813 n.6 (although not specifically ruling on the applicable trigger theory, holding that the language of the policy imposed no requirement that damages manifest during the policy period but rather applied continuous trigger theory). The courts in these cases rejected the manifestation theory on the grounds that it is not in accordance with policy language requiring "property damage" to "occur" during the policy period rather than "manifest."

Thus, the problem that often arises is that complaints can be interpreted to contain damages which manifested during multiple policy periods, and courts can easily find injury and a duty to defend, strictly within the four corners of the complaint under this theory. Likewise, and for these same reasons, courts often find coverage triggered by the injury-in-fact or continuous trigger theories. See Trizec Prop., Inc., 767 F. 2d at 813 (applying continuous trigger theory and finding that because the complaint did not allege date that damage occurred and language of complaint could be construed to allege that damage began after installation and occurred over a period of time, the complaint's allegations were broad enough to allow the inference that some damage occurred during the policy period); IDC Constr., LLC v. Admiral Ins. Co., 339 F. Supp. 2d 1342, 1350-51 (S.D. Fla. 2004) (finding duty

to defend where complaint did not specify when damage first occurred and consequently alleged facts that some damage occurred at least partially within the coverage of the policy). As Florida law is unsettled as to trigger, it is often difficult to say with certainty that no duty to defend exists or to recommend that an insurer can deny a defense.

IV. Commercial General Liability Insurance policy forms and changes.

With this history in mind, the question becomes which contractors' or subcontractors' insurers may be responsible for defending and/or providing indemnity coverage for alleged damage, and to what extend coverage may exist. Such questions must be considered when determining the underwriting risks and the endorsements to be placed on a policy given the scope of coverage sought to be provided.

1. Typically a broad insurance concept intended to protect contractors against claims connected to their work on a project.

2. Business risks, such as claims for defective work, are typically excluded from CGL policies, but can be covered under separate endorsements for an additional premium.

3. Coverage usually extends only to property damage and bodily injury.

   Typical CGL policy language:

   > Insurance company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury and property damage to which the insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false, or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient, but the company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.[2]

4. Property damage, as defined in a standard CGL policy, usually means:

   A.) Physical injury to, or destruction of, tangible property that occurs during the policy period, including the loss of use thereof at any time resulting therefrom; or

   B.) Loss of use of tangible property that has not been physically injured or

[2]See Pierce, Jotham A., Jr., "The Contractor's Claims Against Its Insurance Carrier," in Construction Litigation (Kenneth M. Cushman ed. 1981).

destroyed, provided such loss of use is caused by an occurrence during the policy period.

5. Many new exclusions as to faulty and defective work, prior completed operations (PCO), known loss, pollution, fungi and bacteria, residential construction, mold, are often endorsed onto policies.

6. Two often contested types of exclusions are: (1) insured's product exclusion; and (2) work performed (faulty work) exclusions.

    1. These exclusions attempt to exclude damage to the contractor's work itself from coverage.

    2. They do not preclude coverage for removal of an insured's defective product integrated into a larger component or other consequential damages resulting from such removal.

V. Typical construction defect causes of action.

Usually, a construction defect lawsuit involves claims for breach of contract, breach of express warranty, breach of implied warranties of fitness/merchantability, building code violations, negligence, and strict liability. The existence - and potential extent of coverage - for these types of claims is another consideration to be made when determining the risks being taken on when issuing a policy.

VI. Insurer's response.

Insurance companies often provide their insureds with earlier, more-comprehensive, reservation of rights letters which include exclusions in their policies which may be used by the insurer to contest insurance coverage. Typically, a copy of the reservation of rights is provided to the opposing parties to establish the basis for future arguments that no coverage exists in order to assist with controlling the ultimate settlement value of the case. However, the frequent existence of a duty to defend, and the cost of the defense raises new considerations when insuring the construction industry.

VI. Practical effect and considerations.

General Contractor v. Subcontractors - The general contractor has become even more of a target defendant in multi-party claims. Depending on the policy language, plaintiffs focus on general contractor's available insurance rather than direct actions against the subcontractors. This forces the general contractor to file cross-claims or third-party claims against subcontractors, and take the lead in proving the subcontractor's liability so that the subcontractor's insurer will provide coverage.

Subcontractors v. Subcontractors - It has become more difficult for subcontractors to work together in some aspects of a joint defense against plaintiffs' claims. Issues such as one subcontractor accepting another subcontractor's work becomes more important. Questions may arise including whether the prior defective work resulted in "property damage" to the subsequent subcontractor's installed product.

Another issue to be considered is the frequent attempt to obtain additional coverage through additional insured clauses and indemnity agreements. Risk allocation devices such as indemnification

clauses are often contained in the insured's contracts with third parties. These devices often result in litigation, against co-defendants or third-party defendants, with other contractors and subcontractors. Likewise, coverage is often sought directly through another contractor or subcontractor's insurer through additional insured clauses.

The tri-partite relationship is another issue which must be kept in mind by both the insurer and counsel. Defense counsel is typically hired by an insurance company to defend the insured in a lawsuit brought by a third party claiming acts or omissions by the insured which led to personal injury or property damage. Defense counsel is required to handle the case in a way that is in the best interest of the insured. Frequently, defense counsel cannot become involved in certain issues pertaining to coverage and indemnification due to potential conflicts of interest. Thus, defense counsel is often required to recommend that the insurer or the insured retain separate counsel. Nevertheless, an understanding of the impact of risk allocation and shifting devices in every case is necessary because they can potentially impact the pleadings, the assessment of liability, discovery, the ability to have a unified litigation strategy, mediation and settlement strategies, trial and jury instructions.