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Construction Coverage Questions:
Thorny Problems, Recent Developments, and Practical Solutions

I. Overlap Between Commercial General Liability and Professional Liability Coverages for Design-Build Projects

A. Triggers under General Liability and Professional Liability Policies

Commercial general liability (CGL) policies cover bodily injury or property damage caused by an occurrence which took place during the policy period. In the context of construction defect claims, CGL policies generally cover the general contractors and subcontractors. The Professional Liability (PL) coverages are triggered if the alleged damage is the result of negligent professional services, incomplete or shoddy work, mistakes or omissions by the professional. Professional liability policies are generally claims-made policies. In this context, professional liability policies focus on construction project's design and engineering risks. The PL policies include professional services such as architectural and other design, planning and scheduling, land surveying, mechanical, electrical and other engineering, construction management.

B. Covered Damages under Professional Liability Policies

Damages covered by the PL policies are often broader that those covered by the CGL policies. PL policies typically do not require bodily injury or property damage to trigger coverage. They can provide coverage for nonphysical or purely economic damages which are not covered by the CGL policy.

C. Products-Completed Operations in Commercial General Liability Policies

The standard products-completed operations hazard (PCOH) provision applies to bodily injury or property damage arising from the insured's "work" or the insured's "products" as long as:

- the injury or damage occurs away from premises owned or rented by the insured;
- the products are no longer in the insured's physical possession; and
- the work has been completed.

PCOH coverage is defined as coverage for damage that occurs after the insured's work is complete.

D. Professional Liability Exclusion in Commercial General Liability Policies

In addition to the PCOH coverage, the "professional services" exclusion is often a standard part of CGL policies. It bars from coverage damages related to the “rendering of or failure to render any professional services or treatments.” The idea is that there is separate errors & omissions (E&O) coverage on the market to cover claims akin to professional "malpractice," and that the CGL policy is designed to cover accidents arising from ordinary negligence. There is a potential overlap between what might constitute the "ordinary" negligence of someone with a specialized area of expertise and the "professional" negligence of that same skilled person.

While certainly there are numerous professional services exclusions that can be added to the CGL by endorsement, the exclusionary endorsement that has been the subject of the most substantial litigation has been the exclusion of professional services on the CGL policy of a contractor. One of the crucial issues is related to what constitutes professional services and what does not for purposes of application of the exclusion. The ISO introduced two professional services exclusions.

E. Overlap Between Commercial General Liability and Professional Liability

In *North Counties Engineering, Inc., et al. v. State Farm General Insurance Company*, the California Court of Appeal explains how the two provisions can exist side by side without either defeating the coverage for the insured or writing the exclusion out of the policy. In sum, the California Court of Appeals held that If the injury or damage a party seeks against a contractor occurred on the job and during construction, it is then -- and only then -- that a professional services exclusion might apply. If the damage occurs after the job is complete, PCOH coverage applies but the professional services exclusion never should. The products-completed operations coverage, for the failure to provide warnings, does not emanate from the performance or failure to perform actual professional services, but from the giving or failure to provide information. The nature of the act or omission in each is different. It is the nature of the act or omission, not the nature of the resulting damage that is determinative of coverage. The excluded acts in the CGL policy are the actual professional services, whereas the acts that fall within products-completed operations coverage relate to the giving of information, i.e., instructions and warnings, albeit resulting from either the performance or non-performance of the contracted-for professional services

F. Owners’ Professional Protective Indemnity Policies (OPPI) and Contractors’ Professional Protective Indemnity Policies (CPPI)

These policies are alternatives to professional liability policies. The OPPI policy is offered to owners of construction projects who hold contracts with design professionals. It provides first-party indemnity to the owner (insured) for damage it incurs as a result of negligence of the design professionals. It does not extend coverage to the design team, so the possibility of defense costs eroding the limit of liability is drastically reduced, if not eliminated. The OPPI is procured in the name of the owner and sits excess of the design professional's professional liability insurance and essentially supplements coverage and capacity that the design firms bring to the project via their practice programs. No design professionals are named to the policy. This is a very limited market.

The CPPI policy coverage is designed to indemnify the contractor for losses arising out of design or engineering services. It provides excess coverage over the subcontracted architect or engineer's (A/E) professional liability policies. CPPI is a first party coverage that indemnifies the named insured, excess of the design professional's professional liability insurance, for costs the named insured incurs, and is legally entitled to recover, as a result of negligent acts, errors, and omissions of design professionals with which the named insured holds a contract.

II. Developments in Additional Insured Law

A. *Pulte v. American Safety*, 223 Cal.Rptr.3d 47 (Cal. App. 2017)

Pulte was the general contractor and developer on two residential housing projects consisting of single family homes. The project began in 2003, and Pulte began selling homes in 2005 and 2006. In 2011 and 2013, homeowners in the two developments filed lawsuits against Pulte alleging multiple construction defects, including some that implicated the work of certain subcontractors, including two insured by ASIC. Pulte tendered to ASIC, which declined coverage. Pulte filed a declaratory judgment action against ASIC, alleging wrongful denial and bad faith claims.

The ASIC policies were each endorsed with one of several versions of an additional insured endorsement (all of which were substantively similar), which provided additional insured coverage to Pulte, but only regarding ongoing operations or ongoing work. The term "ongoing operations" was not defined in any of the policies or endorsements. The court found that the policy language provided coverage for completed operations, which was not expressly excluded by the reference in the endorsements to ongoing operations or work. The court then referenced that ASIC's disregard of unpublished California federal district court opinions contrary to its coverage position in finding the refusal to defend to be in bad faith, stating that ASIC had engaged in a "demonstrated pattern and practice of issuing AIEs, then using every conceivable argument to deny coverage, regardless of the merit of the arguments." Noting that construction defect claims may result long after the completion of the project and may take place over an extended period of time spanning multiple policy periods, the court rightly stated that it is prudent for the general contractor to obtain completed operations coverage from its subcontractors as part of its additional insured coverage.

Indeed, Pulte stated that it was its reasonable expectation, in requiring its subcontractors to obtain completed operations coverage, that it would receive the same coverage as an additional insured. Observing that ASIC wrote its own manuscript additional insured endorsements, the court construed the language of the endorsements against ASIC.

The court rejected the notion that the language limiting the additional insured coverage to the named insureds "ongoing operations" or "ongoing work" was effective in precluding "completed operations" coverage for additional insureds. The court also found it significant that the definition of "property damage" did not require that the eventual claimant own the property at the time it is damaged for coverage to attach. The court also found that there was a lack of evidence about when the work of the subcontractors was performed.

The court found ASIC's focus on when the property owners became financially damaged through their purchases to be incorrect, noting that the correct focus is on when the property itself

became physically damaged. ASIC was on notice that some of the insured subcontractors' work could have been "ongoing and/or completed" during its policy periods. The court found that ASIC failed to demonstrate any coverage is potentially limited to ongoing operations, specifically finding that the fact that the definition of "your work" included warranties and representations inherently indicates that completed work was meant to be included within the coverage of the additional insured endorsements. The court therefore found that ASIC had failed to state clearly that completed operations were not covered and that the coverage of the additional insured endorsement is applicable only to ongoing operations; the fact that the endorsement applied to the named insured's work created an ambiguity, so the court found a duty to defend Pulte. The additional insured endorsement did not adequately define the term "your work" as work "now being performed or to be performed during the term of the policy."

The court stated, alternatively, that if the "ongoing operations" language was meant as an exclusion, it must be narrowly construed. If ASIC had intended for the ongoing operations language to preclude coverage for completed operations, it must state expressly that coverage is limited to claims arising from work performed during the policy period.

The court also briefly addressed the j (5) and j (6) exclusions, determining that it was factually unclear, based on the allegations of the complaint, that no coverage was possible at the site. Because there was no reliable way to determine which subcontractors' work had been damaged or whether it had damaged its own work or the work of others, the court found that the exclusions did not apply to preclude coverage for the underlying lawsuits.

This decision will have a significant impact on evaluation of coverage under additional insured endorsements related to claims in California. Unless there is specific language stating that completed work is not covered by the additional insured endorsement or addressing the perceived ambiguity between the inclusion of warranties and representations within the definition of the named insured's work and the exclusion of products/completed operations, absent a specific allegation regarding whose work damaged what (which would be highly unusual in a pleading), there is a very high chance that a court applying the logic of the Pulte decision will find that coverage applies for an additional insured.

Though a subcontract may not specify that an additional insured is entitled to "completed operations" coverage under its additional insured coverage for a period, it may still be entitled to the coverage under the Pulte framework. It is not sufficient merely to evaluate whether such coverage was contemplated by the contract. Note, however, that the ASIC endorsements were manuscript endorsements. Still, the language quoted in the decision is similar to those in ISO forms before the CG 20 10 10 01. The court did not discuss whether there was a separate endorsement addressing completed operations coverage for additional insureds on the policies at issue.

B. *McMillin Management v. Financial Pacific Insurance, 225 Cal.Rptr.3d 221 (Cal. App. 2017)*

McMillin was a developer and general contractor of a residential development completed in 2005. Several homeowners later sued, complaining of defects arising out of the construction of their homes. The subcontractors on the development were insured by Financial Pacific and Lexington, both of which denied additional insured coverage for McMillin. Lexington argued that

there was no potential for coverage for construction defect claims under its policies because there could be no liability to the homeowners until after the close of escrow on each property. Lexington further claimed that there could be no liability under its policies for property damage that took place when the contractors were working on the project when the individuals who incurred the damage did not own the property at the time of the damage. McMillin argued that the claimants' lack of ownership did not establish that the ultimate liability for the damage that took place did not arise out of ongoing operations and, in any event, the endorsements did not specify when the liability itself must arise.

The Court found that McMillin was entitled to coverage under the Lexington policies, noting that the language "arising out of" is interpreted broadly. There must be a link between the liability, through a minimal causal connection or incidental relationship to the subcontractors' ongoing operations, and the damages. The Court particularly noted that "arising out of" was not a defined term and was not synonymous with "during." The endorsements did not specify that coverage was provided solely for liability occurring during the ongoing operations, so the Court refused to read that limitation into the endorsement. Further, the Court noted that the fact that there were no homeowners at the time that the subcontractors ceased operations did not mean that the liability could not have arisen out of the ongoing operations. Again, since the complaints did not rule out that the property damage began during construction, there was potential coverage under the policies.

C. *Burlington Insurance v. NYC Transit Authority*, 79 N.E.3d 477 (N.Y. 2017)

Burlington insured Breaking Solutions, Inc., the tunnel excavation subcontractor on a Transit Authority project. Breaking Solutions agreed to name the Transit Authority and New York City as additional insureds on its policy. The undisputed facts of the underlying case were that a Transit Authority employee fell off an elevated platform when he tried to avoid an explosion when a Breaking Solutions machine touched a live electrical cable buried at the excavation site. The employee sued the City and Breaking Solutions.

The City tendered to Burlington, which accepted the defense under a reservation of rights. The City also filed indemnification and contribution claims against the Transit Authority based on a lease between the Transit Authority and the City. The Transit Authority tendered to Burlington, which accepted the defense under a reservation of rights. During discovery, the facts showed that the Transit Authority failed to identify, mark or protect the cable and failed to turn off the power and that the Breaking Solutions operator could not have known of the location or electrification of the cable. Further, the Transit Authority acknowledged sole responsibility for the accident in two internal memoranda that were produced during discovery. The court in the underlying case dismissed the claims against Breaking Solutions with prejudice. Burlington denied coverage, basing its decision on the fact that the Transit Authority was solely responsible for the accident that caused the injury and that the named insured was not negligent.

The court concluded that where the coverage provided by an additional insured endorsement is limited to liability for bodily injury or property damage cause in whole or in part by the acts or omissions of the named insured, the coverage applies only to injury proximately caused by the named insured; a mere causal link is not enough to trigger such coverage for an additional insured, and an additional insured may not collect under the policy for injury proximately caused

solely by its own negligence. Though not a construction defect case, the analysis is still pertinent in evaluating potential additional insured issues.

III. Trigger and Allocation – Rulings in Key States

A. California – *Pulte* and *McMillin*

The *Pulte* and *McMillin* cases, cited above, further solidify that a "continuous" trigger is used in the context of a construction defect claim. The Courts in those cases noted that, for purposes of evaluation under a general liability policy, the alleged property damage is deemed to have occurred "over the entire process of the continuing injury," not only when the damage is discovered. *McMillin*. Significant to this analysis is the notion that damages may occur during operations but not be discovered until much later. The Court in *Pulte* also focused on the progressive deterioration process that is at least potentially at the heart of construction defect claims. *Pulte*.

B. Florida – *Carithers v. Mid-Continent Cas. Co.*, 782 F.3d 1240 (11th Cir. 2015) (no error in applying injury-in-fact trigger)

In *Carithers*, a balcony, which was defectively constructed, caused damage to a garage. The district court recognized that, under Florida law, the defectively constructed balcony was not covered by the policy. However, the district court found as a fact that, to repair the garage, the balcony had to be rebuilt. The insurer claimed that the plaintiff could not recover for any defective work, even where repairing that work is a necessary cost of repairing work for which there is coverage. The Eleventh Circuit held that the district court did not err in awarding damages for the cost of repairing the balcony.

The Court held that under Florida law although the defective balcony was not covered "property damage" under policy because it was the defective work of a subcontractor, the policy covered costs of repairing damage to the garage caused by defective work.

C. Texas – *OneBeacon Ins. Co. v. Don's Building Supply, Inc.*, 267 S.W.3d 20 (Tex. 2008) ("actual damage" trigger, confirmed by *Vines-Herrin Custom Homes LLC v. Great American Lloyds Ins. Co.*)

In *One Beacon*, the United States Court of Appeals for the Fifth Circuit laid out the Supreme Court of Texas's responses to certain certified questions regarding the proper rule under Texas law for determining the time at which property damage occurs for purposes of an occurrence-based commercial general liability insurance policy and how that trigger applied in the context of a claim of latent damages.

In response to the first question, the Supreme Court held that: property damage under the CGL policy occurred when actual physical damage to the property occurred. The policy defined property damage as "[p]physical injury to tangible property," and explicitly stated that coverage is available if and only if " 'property damage' occurs during the policy period." Thus, in the *One Beacon* case, property damage occurred when a home suffered wood rot or other physical damage. The date that the physical damage is or could have been discovered is irrelevant under the policy.

In response to the second question, the Supreme Court held that:

> the insurer's duty to defend the contractor depends on whether the homeowners' pleadings allege property damage that occurred during the policy term. Under the Texas actual-injury rule, a plaintiff's claim against the contractor that any amount of physical injury to tangible property occurred during the policy period and was caused by the contractor's allegedly defective product triggered OneBeacon's duty to defend. This duty is not diminished because the property damage was undiscoverable, or not readily apparent or "manifest," until after the policy period ended. Nor does it depend on whether the contractor has a valid limitations defense.

In *Vines-Herrin Custom Homes LLC. v. Great American Lloyds Ins. Co.*, the Texas Court of Appeals held that as a matter of law, actual damages must occur no later than when they manifest; in other words, by the time damages manifest, they necessarily have occurred. For coverage to be triggered, that actual damage must occur during the policy period.

IV. Recent Developments in Coverage Law for Construction Defects

A. California – *Global Modular, Inc. v. Kadena Pacific, Inc*., 222 Cal.Rptr.3d 819 (Cal. App. 2017)

The United States Department of Veterans Affairs hired Kadena Pacific as the general contractor to oversee construction of a rehabilitation center in Menlo Park. Kadena hired Global Modular to build, deliver, and install modular units for the center. Kadena hired a separate contractor to install the roofing, so Global delivered the units covered by a base sheet of plywood / roof deck substrate. Delivery was delayed, leaving the roofless units exposed to the rain. Global attempted to protect the units by covering them with plastic tarps, but they were still damaged by water. Kadena and Global agreed to terminate their contract, and Kadena oversaw the remediation of the interiors and completion of the project. Global sued Kadena for failure to pay, and Kadena sued Global for breach of contract. At the end of the litigation, Global paid Kadena to release all of its claims from the project other than those covered by Global' s insurance policy with North American Capacity ("NAC"). Kadena presented evidence on the scope of its water remediation and claimed that Global was contractually responsible for the damage. The jury awarded Kadena just over $1 million in damages. NAC argued that it was not required to indemnify Global for the damages award.

Kadena argued that Global bore the risk of loss for the water remediation and delay damages because the units were not complete when they were damaged. Global countered that Kadena was responsible because, as the general contractor, it should have developed a plan to protect the units. As to coverage, NAC claimed that it was not obligated to pay for the remediation because the j (5) and j (6) exclusions applied to the costs of repairing and replacing the wet drywall, insulation, framing and ducting. NAC also argued it was not obligated to pay the delay damages because they were not damages because of "property damage" or were otherwise excluded from coverage by exclusion m.

The court evaluated the j (5) exclusion, noting that it applied only if the damages arose out of the named insured's operations and only if the damage was to the particular part of real of the real property upon which the named insured was performing operations at the time of the

damage. NAC claimed that this refers to works in progress and applies when the property damage occurs before construction is complete. Kadena argued that the exclusion was narrower and applied only to the component that Global was physically working on at the time of the damage. The court concluded that the use of the active present tense within the exclusion indicated that the exclusion only applies to damage caused during physical construction activities, noting that the insurer could have drafted the language to apply broadly to damage to any work in progress, suggesting "property damage to that particular part of real property on which your operations are not yet complete" or "property damage to your work arising out of your operations." The court found that, applying the ordinary definition and giving meaning to every word, the exclusion could not be broadly interpreted to exclude coverage for damage to property on which the insured "did perform operations, will perform operations, or has contracted to perform operations." The court specifically rejected the notion that the exclusion would apply to any period before the insured's work is complete – rather, the insured must be physically present and working at the time of the damage.

Regarding the j (6) exclusion, NAC argued that the exclusion applied because the "particular part" of Global' s work that had to be repaired because of the incorrectly performed work, the failed efforts to waterproof the unites. Kadena disagreed, arguing that the waterproofing efforts were fine but that the heavy rains simply overwhelmed the methods they used. Further, they argued that, to the extent the work was incorrectly performed, the incorrect work was performed on the plywood, not to the interior parts of the units – those parts were not defective or the subject of incorrect work. The court agreed, finding that the repair costs were not excluded, rejecting the notion that the exclusion should apply to the entirety of the insured's project or the entire area affected by its defective work. The court adopted a very narrow interpretation and found that the "particular part" must be very particular, indeed.

The court also rejected the argument that delay damages were excluded from coverage by exclusion m and specifically found that delay damages that arise from "property damage" fall within the exclusion. In this instance, the remediation period was time that Kadena could have spent completing the project had the unit interiors not been damaged. The court found this was a "consequential loss" occasioned by the water intrusion and was therefore part of the damages because of property damage.

Great care must be taken not only in determining the general scope of the insured's work, but also which component of an insured's work was allegedly damaged. Since it is rare in pleadings for the claimant to allege specific damage caused by specific faulty work at a specific time, this decision may increase the scope of complaints that will be required to be defended. Claimed delay damages must also be very carefully examined to determine whether they flowed naturally from the claimed property damage.

B. Florida

1. *MWH Constructors, Inc. v. Brown and Brown Electric, Inc.*, 2018 WL 2087687

In this federal trial court case, Palm Beach County's Water Utilities Department entered into a contract with MWH Constructors to serve as the general contractor on a large water treatment structure. In that contract, there were liquidated damages provisions that were triggered by

failure to deliver the project on time. MWH then subcontracted certain electrical work on the project to Brown & Brown (B&B). After B&B began to fall behind in its work, MWH declared B&B in default pursuant to the contract and offered B&B several opportunities to bring its work back up to schedule. The County then threatened to seek liquidated damages based on the delay in the delivery of the electrical work. Eventually, MWH replaced B&B with another licensed electrical contractor.

The Court found that because B&B breached the contract, it was liable for indemnity to MWH for all direct and indirect costs incurred by MWH in performing B&B's work under the indemnification agreement. Decisions such as this may impact coverage under the "insured contract" exception" to the "contractual indemnity" exclusion of the policy.

2. *Suffolk Constr. Co. v. Rodriguez & Quiroga Architects Chtd.*, 2018 U.S. Dist. LEXIS 42652 (S.D. Fla. Mar. 15, 2018)

In *Suffolk*, the Plaintiff alleged that the architect exercised sufficient control over the contractor to be held liable for negligence. The federal court noted that Florida law provides that a duty of an architect as to contractors may arise if the defendant's conduct creates a foreseeable zone of risk and the defendant creates or controls that risk. The Court relied on a 1973 case, *A.R. Moyer, Inc. v. Graham*, 285 So. 2d 397 (Fla. 1973), wherein the Florida Supreme Court applied this law to hold that an architect owed a duty to a contractor despite lack of privity. In *Moyer*, the Supreme Court noted that as a matter of policy, supervising architects simply have too much control over a contractor not to owe the contractor a legal duty. Florida courts have limited *Moyer*. However, an architect may still be liable to a contractor in tort in the absence of privity where the architect exerts control over the contractor. Such control may be established where the architect maintains a supervisory role on a project, or where the architect acts with knowledge that the contractor will rely on its designs or plans. The *Suffolk Construction* district court held that Plaintiffs' allegations were sufficient to show that Defendants maintained control over Plaintiffs such that a legal duty could be imposed. This decision may impact analysis related to various risk transfer mechanisms under the insurance contract on construction projects.

D. South Carolina

The South Carolina Appellate Court has recently interpreted the set-off statute in a manner that raises concerns about the application of set-off principles in South Carolina construction defect cases. *See The Oaks at Rivers Edge v. Daniel Island Riverside,* Opinion No. 5507 (Ct. App. August 2, 2017).

South Carolina's set-off statute provides as follows:

> When a release or a covenant not to sue or not to enforce judgment is given in good faith to one of two or more persons liable in tort <u>for the same injury</u> or the same wrongful death:
>
> (1) it does not discharge any of the other tortfeasors from liability for the injury or wrongful death unless its terms so provide, <u>but it reduces the claim against the others to the extent of any amount stipulated by the release or the</u>

> covenant, or in the amount of the consideration paid for it, whichever is the greater; and
>
> (2) it discharges the tortfeasor to whom it is given from all liability for contribution to any other tortfeasor.

S.C. Code Ann. 15-38-50.

In *The Oaks at Rivers Edge*, the plaintiff homeowners' association (HOA) settled with the window manufacturer, window installer, and framers prior to trial against the general contractor and developer. After a verdict for essentially all that the HOA was seeking, the general contractor and developer moved for setoff, contending they were entitled to a setoff equaling the total amount of the settlements related to the windows and resulting damage.

The trial court declined to apply any set-off to reduce the verdict and the appellate court agreed, reasoning that in response to the prior settlements achieved with co-defendants, the HOA had removed certain window-related line items from its repair scope at trial. Thus, the damages awarded at trial were not for the "same injury" as the earlier settlements. Of note, the court cited with approval the following view of the impact of settlements on non-settling defendants:

> A plaintiff who enters into a settlement with a defendant gains a position of control and acquires leverage in relation to a non-settling defendant. This posture is reflected in the plaintiff's ability to apportion the settlement proceeds in the manner most advantageous to it. Settlements are not designed to benefit non-settling third parties.

The Oaks at Rivers Edge at p. 8. It is our assessment that this opinion serves as an invitation to plaintiff's counsel to manipulate the characterization of settlements with co-defendants to try to avoid a set-off following trial.