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Construction Defects and Limitations on CGL Coverage

Understanding and Mitigating Risk for Construction Defects

WEDNESDAY, AUGUST 24, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Stephen S. Asay, Counsel, **Pillsbury Winthrop Shaw Pittman LLP**, Washington, D.C.

Eric M. Gold, Partner, **Pillsbury Winthrop Shaw Pittman LLP**, Washington, D.C.

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Construction Defects and Limitations on CGL Coverage

Understanding and Mitigating Risk for Construction Defects

Eric M. Gold
Stephen S. Asay

Pillsbury Winthrop Shaw Pittman LLP
Washington, DC

Construction Defects as an “Occurrence”

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Myths and Misconceptions

- CGL coverage does not apply to “construction defect” claims.
- Faulty workmanship is not “accidental.”
- As a general contractor, I cannot get CGL coverage for claims alleging defects in my subcontractors’ work.

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Commercial General Liability Insurance

- Most CGL policies use or are based on ISO CGL Coverage Forms
- Insuring agreement

  "We will pay those sums that the insured becomes legally obligated to pay as damages because of . . . 'property damage' to which this insurance applies. We will have the right and duty to defend any 'suit' seeking those damages."

- Insurance applies "only if" property damage is caused by an "occurrence"

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“Occurrence”

- Definition of “occurrence”
  - “an accident, including continuous or repeated exposure to substantially the same general harmful conditions”
- The term “accident” is not defined
  - Generally means a fortuitous event
  - Something that occurs unexpectedly or by chance
  - Something that is not intended by the insured
- Continuous or repeated exposure
  - May constitute a single occurrence if it results from the same harmful circumstances

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Construction Defects as an “Occurrence”

- Starting in 2007, a few carrier markets took the position that allegations of faulty work/products were not an “occurrence”
- At one point, more than a dozen states had adverse high court rulings that allegations of faulty work/products resulted in no coverage under CGL policy
- Today, the number of states has diminished, but insurers continue to raise this position as a policy defense

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Current State of the Law

- Trend is toward recognizing an “occurrence” and possible coverage where there is damage to something other than the insured’s own defective work (but some glaring exceptions)

- Certain states have also enacted “occurrence” statutes

- **TAKEAWAY: THIS IS A HIGHLY STATE-SPECIFIC ISSUE**

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How Did We Get Here?

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Standard Form CGL Policies

- Development of “standard form” policies
  - Until 1940, liability policies were written for specific hazards
  - Insurance industry created standard form policies with goal of addressing inconsistencies and disputes resulting from manuscript forms
- Insurance Services Office (ISO)
  - Has issued the most widely used standard form policies since 1973
  - Drafts circulars and guidance regarding the intent and meaning of policy terms
- Achieving goal of standard form policies requires that insurers and courts apply the same meaning to common terms

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Standard Form CGL Policies

- Evolution of standard form CGL policies
  - Expansion of the insuring agreement
  - Narrowing of exclusions

- 1940: only covered damages “caused by an accident”

- 1966: broadened to cover damages caused by an “occurrence”
  - Included both “accidents” and “continuous exposure to conditions”
  - Coverage for accidental events that were not abrupt and short-lived

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ISO CGL Policies

"Broad Form Property Damage" (1973 to 1986)

- 1973 ISO policy form
  - Defined "occurrence" as "an accident . . . which results in . . . property damage neither expected nor intended from the standpoint of the insured"
    - Defective work standing alone was not an "occurrence" because the definition required the existence of property damage
  - Broad exclusion for "property damage to work performed by or on behalf of the named insured arising out of the work or any portion thereof"
    - No coverage existed for damage to general contractor's work resulting from subcontractor's defective work

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ISO CGL Policies

"Broad Form Property Damage" (1973 to 1986)

- Issues with 1973 ISO policy form
  - General contractors were not satisfied bearing the risk of significant unforeseeable damages caused by subcontractors without coverage
  - Insurance industry agreed CGL policies should provide coverage for defective construction claims if defective work was performed by a subcontractor

- 1976 "Broad Form Property Damage" Endorsement
  - Extended coverage to property damage claims arising from general contractor's completed work when damage arose from subcontractor's work

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ISO CGL Policies

"Broad Form Property Damage" (1973 to 1986)

- 1986 ISO policy form
  - Adopted the modern definition of "occurrence"
    - Defective work standing alone should be an "occurrence" because the definition no longer refers to property damage
  - Incorporated critical aspects of broad form property damage endorsement, including a significant exception to the "your work" exclusion
    - The policy excludes "'property damage' to 'your work' arising out of it or any part of it . . . [but the] exclusion does not apply if the damaged work or the work out of which the damage arises was performed . . . by a subcontractor"

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ISO CGL Policies

"Broad Form Property Damage" (1973 to 1986)

- July 1986 ISO circular
  - "confirm[ed] that the 1986 revisions to the standard CGL policy . . . specifically 'cover[ed] damage caused by faulty workmanship to other parts of work in progress; and damage to, or caused by, a subcontractor's work after the insured's operations are completed'"
- Certain courts have failed to recognize the significant differences between the 1973 and 1986 ISO policy forms
  - Contributes to the patchwork of state law because variations of the 1986 ISO policy form are still widely used today

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State-by-State Approach

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Sources of State Law

- Primarily courts interpreting CGL policy terms
  - Not always addressed by state supreme courts
  - Absent supreme court decisions, may be conflicting authority
    - Various trial and intermediate appellate courts
    - State versus federal courts

- A few states have enacted “occurrence” statutes
  - Usually in response to court decisions
  - Statutes have different scopes and effects

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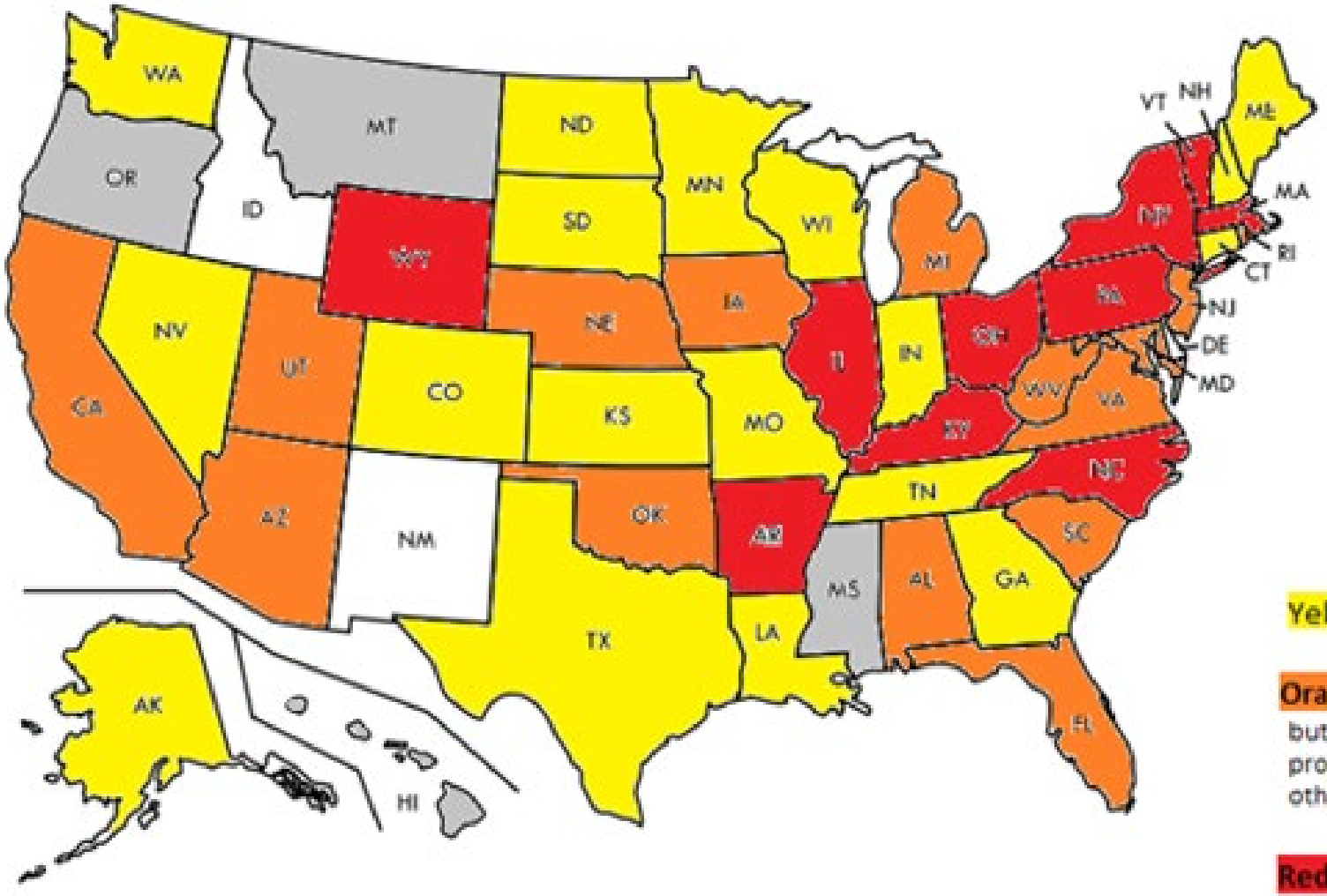

Yellow: Unintentional defective construction is an "occurrence."

Orange: Defective Construction "standing alone" is not an "occurrence," but faulty workmanship (by the insured or subcontractors) that causes property damage to property other than the defective work itself *and/or* other parts of the project is an "occurrence."

Red: Defective construction is not an "occurrence," and there can be no occurrence unless defective work causes property damage to something other than the insured's entire scope of work, the building and/or the project.

Grey: State of the law is unclear; inconsistent decisions.

White: No judicial decisions to date.

State-by-State Approach

Yellow States

- Unintentional defective construction work is an “occurrence”

- Analysis focuses on subjective intent
  - Insured did not subjectively intend to perform defective work
  - Insured did not subjectively expect damages to result

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State-by-State Approach

Yellow States

Sheehan Construction Co., Inc. v. Continental Insurance Co., 935 N.E.2d 160 (Ind. 2010)

- Court aligned itself "with those jurisdictions adopting the view that improper or faulty workmanship does constitute an accident" so long as the resulting damage was not expected or intended.
- Court explained that "if the faulty workmanship is 'unexpected' and 'without intention or design' and thus not foreseeable from the viewpoint of the insured, then it is an accident within the meaning of a CGL policy."

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State-by-State Approach

Orange States

- Defective construction “standing alone” is not an “occurrence”; property damage to “other property” is required

- Uncertainty/disagreement about scope of coverage
  - Many cases state that where property damage is only to repair and replace the insured’s own defective work, there is no “occurrence”
  - States do not agree whether there is an “occurrence” if the damage is to other non-defective work within the policyholder’s own scope of work (which can be the entire project)

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State-by-State Approach

Orange States

Cypress Point Condominium Association, Inc. v. Adria Towers LLC, 143 A.3d 273 (N.J. 2016)

- Distinguishes and effectively removes the very influential *Weedo* decision (based on 1973 ISO form) from modern law on this issue
- Holds that the defective work of a subcontractor that causes property damage to properly installed work is an "occurrence"
- Observes that this holding follows a "strong recent trend"

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State-by-State Approach

Red States

- Defective construction is not an “occurrence”
  - Damages are “foreseeable” and not fortuitous
  - Disregards subjective intent

- Damage to the insured’s entire scope of work (and possibly beyond) is not an accidental “occurrence”
  - Damage caused by subcontractors, no occurrence
  - Damage to non-defective work, no occurrence
  - Damage to personal property? No occurrence if “foreseeable”?

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State-by-State Approach

Red States – Kentucky Supreme Court Goes Red

Martin/Elias Properties, LLC v. Acuity, 544 S.W.3d 639 (Ky. 2018)

- Subcontractor did not support existing foundation before digging
  - Foundation began to crack, and eventually entire structure began to sag

- Court held that damage was not caused by an accident, and the insured had "full control" when conducting its work
  - Faulty work did not meet the definition of "occurrence"
  - Despite fact that faulty work was done in basement, resulting in damage to the entire property and making it structurally unsound

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State-by-State Approach

Red States – Arkansas Supreme Court Goes Rogue Red

Columbia Insurance Grp., Inc. v. Cenark Project Mgmt. Servs., Inc., 491 S.W.3d 135 (Ark. 2016)

- Majority opinion
  - Concludes that homeowner claims against engineer that included resulting property damage alleged only breach of contract
  - There can be no insurance coverage for breach of contract claims under existing Arkansas law

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State-by-State Approach

Red States – Arkansas Supreme Court Goes Rogue Red

- Dissenting opinion
  - Argues that the form of the claim is not determinative for coverage under the CGL policy
  - Would have held that faulty workmanship resulting in property damage to the work product of a third party constitutes an "occurrence"

- NOTE: Arkansas "occurrence" statute did not apply because the claim at issue arose prior to enactment

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Recent Construction Defect Cases

Virginia

Pa. National Mutual Casualty Insurance Co. v. River City Roofing, LLC, No. 3:21-cv-0365, 2022 WL 1185888 (E.D. Va. Apr. 21, 2022)

- Headline: "Virginia Court Reaffirms Construction Defect Claims Not Covered by CGL Policies"
- Actually recognizes that there are arguably conflicting lines of authority and no clear guidance on the issue
  - A federal appellate court found that damage to nondefective parts of the property caused by defective work was an "unintended accident" and thus an "occurrence"
  - A state trial court found that "structural defects caused to otherwise nondefective components of the [property] by the subcontractor's defective workmanship were not an 'occurrence'"

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Recent Construction Defect Cases

Virginia

Pa. National Mutual Casualty Insurance Co. v. River City Roofing, LLC, No. 3:21-cv-0365, 2022 WL 1185888 (E.D. Va. Apr. 21, 2022)

- The court applied the rule from the state trial court based on policies including the same exclusions
- However, this case and those it discusses all incorrectly rely on exclusions to determine whether there was an "occurrence"
  - The definition of "occurrence" does not rely on policy exclusions
  - Exclusions may ultimately eliminate coverage for a claim, but that does not mean there is no "occurrence"

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Recent Construction Defect Cases

Illinois

Korte & Luitjohan Contractors, Inc. v. Erie Insurance Exchange, No. 5-21-0254, 2022 WL 816379 (Ill. App. Mar. 17, 2022)

- Reaffirmed that, under Illinois law, construction defects generally do not trigger CGL coverage
  - Relied on repeated Illinois holdings that CGL policies "are intended to protect the insured from liability for injury or damage to the persons or property of others; they are not intended to pay the costs associated with repairing or replacing the insured's defective work and products, which are purely economic losses" (citing *Traveler's Ins. Co. v. Eljer Mfg., Inc.*, 757 N.E.2d 481 (Ill. 2001))
  - Because complaint only sought damages for correctly completing installation of elevators and economic losses from having to use faulty elevators, there were no allegations of "property damage" caused by "an occurrence

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Recent Construction Defect Cases

Illinois

Korte & Luitjohan Contractors, Inc. v. Erie Insurance Exchange, No. 5-21-0254, 2022 WL 816379 (Ill. App. Mar. 17, 2022)

- Correctly found it was unnecessary to determine whether any exclusions applied because the complaint did not meet the threshold requirement to trigger coverage
- Language in ruling leaves open an argument that coverage exists where a defect causes damage "to the persons or property of others"
  - *See, e.g.*, *Milwaukee Mut. Ins. Co. v. J.P. Larsen, Inc.*, 956 N.E.2d 524 (Ill. App. 2011) (insurer was obligated to defend where general contractor's complaint alleged that subcontractor's improper window caulking caused water intrusion and property damage to other parts of the building because the complaint alleged damage to other property outside the subcontractor's scope of work)

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Recent Construction Defect Cases

Pennsylvania

Main Street America Assurance Co. v. Howard Lynch Plastering, Inc., No. 21-3977, 2022 WL 445768 (E.D. Pa. Feb. 14, 2022)

- Headline: "Recent Ruling By PA Federal Court Confirms Construction Defect Claims Are Not Covered By Commercial General Liability Policies"
- Numerous homeowners asserted claims for defective work, including missing flashing, exposed wood, inadequate drainage, and other issues

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Recent Construction Defect Cases

Pennsylvania

Main Street America Assurance Co. v. Howard Lynch Plastering, Inc., No. 21-3977, 2022 WL 445768 (E.D. Pa. Feb. 14, 2022)

- Court observed that an "occurrence" does not generally include defective work
  - Liability policies are intended to cover "accidents" and defective construction is not an "accident"
  - In finding no "occurrence," the court distinguished a recent case finding coverage where a faulty product caused property damage other than to the product itself
- Another faulty workmanship case where the insured sought coverage to repair the defective work itself
  - May still be a path to coverage where faulty work causes damage to something other than the work itself
  - State and federal trial court authority exists to support this argument

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State Statutes

- Arkansas (Ark. Code Ann. § 23-79-155)
  - Applies to CGL policies sold in the state
  - Definition of occurrence must include "property damage or bodily injury resulting from faulty workmanship"

- Colorado (Colo. Rev. Stat. § 13-20-808)
  - Applies to liability policies insuring construction professionals for construction work
  - Courts interpreting policies "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"

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State Statutes

- Hawaii (Haw. Rev. Stat. § 431:1-217)
  - Applies to liability policies insuring construction professionals for construction work
  - The meaning of “occurrence” shall be construed in accordance with the law that existed at the time the policy as issued

- South Carolina (S.C. Code Ann. § 38-61-70)
  - Applies to liability policies insuring construction professionals for construction work
  - Policies shall contain or will be deemed to contain definition of occurrence that includes “property damage or bodily injury resulting from faulty workmanship, exclusive of the faulty workmanship itself”

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Practice Pointers and Alternatives

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Best Practices for Obtaining CGL Coverage

Clarify Policy Language

- Amendments to insuring agreement

- Example: Zurich “Resulting Damage To Your Work” Endorsement

  Damages because of “property damage” include damages the insured becomes legally obligated to pay because of “property damage” to “your work” or caused by “your work” and shall be deemed to be caused by an “occurrence” regardless of whether the “property damage” arises from breach of contract.

  However with regard to “property damage” to “your work” included within the “products-completed operations hazard”, such “property damage” shall only be deemed to be caused by an “occurrence” if:

  (1) The “property damage” is caused by work performed on your behalf by a subcontractor(s); or

  (2) The damaged work was performed on your behalf by a subcontractor(s).

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Best Practices for Obtaining CGL Coverage

Clarify Policy Language

- Amendments to definition of "occurrence"

- Example: Chubb "Amendment to Occurrence Endorsement"

  "Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions. "Property damage" that is unexpected and unintended and that results from an unintended and unexpected defect, deficiency, inadequacy or dangerous condition in "your work" or "your product" shall be deemed to be caused by an "occurrence" if:

  a. the "property damage" is to "your work," provided the damaged work:
     i. is caused by "your work" that was incorrectly performed on your behalf by a subcontractor; and
     ii. is not part of and is separate from "your work" that was incorrectly performed; or
  b. the "property damage" is to property other than "your work" or "your product."

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Best Practices for Obtaining CGL Coverage

Framing the Downstream Claim

- Identify all "property damage"
  - Physical injury to personal property and the property/project itself
  - Loss of use of the property/project even if not physically injured
- Property damage to the project
  - Distinguish between scopes of work performed by different subcontractors
  - Describe damage to one subcontractor's work caused by another subcontractor's work
- Assert all applicable theories/causes of action
  - E.g., negligence and statutory claims, not just breach of contract
  - If lower-tier subcontractors were used, include vicarious liability

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Additional Insured Coverage

- General contractors should require that they be named as an additional insured on their subcontractors' CGL policies
- May avoid coverage restrictions based on scope of work
  - General contractor's work is the entire project
  - Additional insured coverage is analyzed based on subcontractor's work
- Other financial benefits
  - Reduced insurance premiums (fewer claims, higher deductibles)
  - Maintain policy limits for more significant losses or claims not caused by sub

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Additional Insured Coverage

Contractual Requirements

- General contractor specifically scheduled/named in endorsement
  - No “blanket” or “automatic” additional insured endorsements
  - Can include “catchall” for parents, subsidiaries, and affiliates, as well as respective owners, partners, members, officers, employees, etc.

- ISO form CG 20 10 11 85, Additional Insured – Owners, Lessees or Contractors – (Form B)
  - Additional insured “with respect to liability arising out of ‘your work’ for that insured”
  - Some endorsements will conform coverage to this form if specifically required

- Coverage for both ongoing operations and completed operations
  - Maintained for term of contract plus period of time after completion
  - Either specific number of years or statute of repose in location of work

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Additional Insured Coverage

Contractual Requirements

- Subcontractor's policies are primary and non-contributory, and any of general contractor's policies shall be excess to all of subcontractor's policies
- Coverage to the full extent of actual policy limits, and not less than specified minimum amounts
- Subcontractor and its insurers must provide complete copies of policies upon request (if not already provided at time of contracting)
- Requirements extend equally to any umbrella or excess insurance, which shall be as broad or broader than primary insurance

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Mitigating Risk Through Contracting

- More extensive subcontractor prequalification
  - Project and claim history, quality of work, financial stability
  - Strict compliance with contractual requirements (e.g., insurance)

- Evaluate volume of work by individual subcontractors
  - Greater volume of work may increase likelihood of claims and exhaustion of available insurance
  - Consider sliding scale of contractual requirements based on volume of work

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Mitigating Risk Through Contracting

- Compliance with own contracting practices
  - Inclusion of any exhibits or additional documents
  - Long-term retention of critical contract documents

- Choice of law and/or forum selection provisions
  - Due to state-by-state approach, choice of law often dictates outcome
  - CGL policies are generally silent regarding choice of law
  - Different states apply different choice of law rules where contract is silent

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Mitigating Risk Through Contracting

- Strong defense and indemnity requirements
  - Minimum requirement that subcontractor indemnify for sole negligence
  - Anti-indemnity statutes that may limit broader indemnity provisions
  - Statutes may include other requirements, e.g., monetary limit on indemnity
- Assignment of insurance benefits if no longer in business
- Interpretation of contract without presumption against drafter

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Alternative Insurance Options

Builders Risk Insurance

- First party property insurance that insures all project participants against the risk of direct physical loss or damage to the project
- Should typically be the primary source of insurance during construction
- No fault coverage avoids having to pursue claims against the responsible party

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Alternative Insurance Options

Wrap-Up or Controlled Insurance Programs

- Owner or Contractor Controlled Insurance Programs (OCIP or CCIP)
  - Several insurance policies “wrapped up” into one insurance program
  - Typically includes, at a minimum, primary and excess liability insurance
  - May be project specific or “rolling” program

- Various benefits due to scale and unique nature of CIPs
  - May be easier to obtain clarifying “occurrence” language
  - Project participants all have same coverage, usually with higher limits
  - Should reduce gaps in coverage and need for extensive litigation

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Alternative Insurance Options

Subcontractor Default Insurance

- Intended as an alternative to traditional payment/performance bonds
- Insures a general contractor against the risk of a subcontractor's default of performance, i.e., failure to fulfill a term of its subcontract
- Coverage requires default of subcontractor and damages in excess of remaining subcontract balance

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Alternative Insurance Options

Contractor's Professional Indemnity/Liability Insurance

- Insures a general contractor for:
  - Professional liability: claims against contractor for negligent acts, errors, or omissions in the rendering of "professional services"
  - Protective indemnity: contractor's losses arising out of negligent acts, errors, or omissions in "professional services" by a design professional

- "Professional services"
  - Often defined to include services the party is qualified to perform in its capacity as a "construction manager"
  - The term "construction manager" is not defined and can be broadly interpreted to include many standard activities performed by general contractors

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Thank You

Eric M. Gold
eric.gold@pillsburylaw.com

Stephen S. Asay
stephen.asay@pillsburylaw.com

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