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Construction Defect Coverage Recap For 1st Quarter

Law360, New York (April 18, 2014, 6:11 PM ET) -- 2014 has already yielded several noteworthy decisions from courts examining insurance coverage for construction defect claims. These cases have dealt with, among other things, the "occurrence" requirement, contractual liability exclusion and "other insurance" clauses. We provide brief summaries of the key cases below:

Owners Insurance Co. v. Jim Carr Homebuilder LLC

The Alabama Supreme Court reversed itself within months of its prior decision in the same lawsuit and held that construction defects constitute an "occurrence."

In September 2013, the Alabama Supreme Court preliminarily held in September 2013 that faulty workmanship in and of itself does not constitute an occurrence. See Owners Insurance Co. v. Jim Carr Homebuilder LLC (2013). In a surprising reversal, the Alabama Supreme Court has flip-flopped on its earlier decision.

In Jim Carr, the insured homebuilder sought coverage for an adverse arbitration award wherein it was determined that the insured — a general contractor — had defectively constructed a home resulting in water infiltration and mental anguish to the homeowners. The Alabama Supreme Court agreed with the insurer that faulty workmanship was not caused by an occurrence and that allegations of damage to something other than the insured's work must be alleged. Therefore, there was no coverage for the award against the general contractor.

Just six months later, on an application for rehearing, the Alabama Supreme Court has reserved itself to find that there was "property damage" caused by an "occurrence." As a result of this finding, the Alabama Supreme Court withdrew its Sept. 20, 2013, opinion and replaced it with the March 28, 2014, holding.

While previously the court had required damage to something other than the insured's work to find property damage caused by an occurrence, the court now rejected this argument. The court explained that the term occurrence is not defined in the policy by reference to the nature or location of the property damage, and therefore found that the term occurrence does not include these types of limitations.

The Alabama Supreme Court raised the concern that coverage in some instances could be considered illusory if an occurrence only takes place where something other than the insured's work is damaged. For example, the court noted that a general contractor of an entire structure would never be afforded coverage for damage arising out of faulty workmanship since its work was the entire project. As a result, the Alabama Supreme Court found coverage for the insured.

The Jim Carr decision, again, illustrates the trend in favor of allowing insurance coverage for claims of faulty workmanship that was widely seen in 2013. Claims professionals evaluating construction defect claims are well-advised to be aware of recent changes in the relevant jurisdiction — even if the issue seems to have been recently settled.

Pennsylvania National Mutual Casualty Insurance Co. v. Snider

An Alabama federal court found that faulty workmanship resulting in claims of breach of contract and implied warranty against a residential contractor does not constitute an "occurrence."

The insured — a general contractor — was sued by homeowners who discovered several construction defects in their home, including a cracked retaining wall and water intrusion into the home. As a result of the water intrusion, the homeowners discovered mold, buckling to the wood floors, damages to the electrical system and a musty odor to the residence. Furthermore, the homeowners alleged their residence was not completed within the time frame agreed. The insurer provided a defense, but argued that there was no indemnification obligation since the claims did not constitute an accident or "occurrence." The insurer sued the insured and the homeowners, seeking declaratory judgment it had no indemnification obligation for the underlying lawsuit.

The policy defined "occurrence" to include an "accident," but did not define what constitutes an accident. The court applied the standard definition of accident as "something unforeseen, unexpected or unusual." Further, the district court explained that the cause of the damage must be accidental as opposed to the damage itself. Relying on prior case law, the court stated that the policy was not intended to be a guarantee or a warranty for the timeliness and quality of the insured's work, and therefore did not cover breach of contract claims.

Moreover, the residents' breach of implied warranty of habitability claim was merely a claim of faulty workmanship. Recognizing that faulty workmanship may lead to an occurrence if it damages personal property. The court explained that there was no such personal property damaged in the case, but instead there was only the faulty workmanship of the final product — which was not insured under the general liability coverage at issue.

This case illustrates the splintered approaches to construction defect claims across jurisdictions. Some courts have remained focused on the public policy considerations against finding coverage for faulty workmanship damages, although this approach is increasing being confined to claims — like this one — grounded in breach of contract.

Woodward LLC v. Acceptance Indemnification Insurance Co.

The Fifth Circuit, interpreting Mississippi law, found that an insurer has no duty to defend a general contractor because the claim that the insured failed to comply with plans and

specifications is a claim that accrued when the project was completed, and was not a claim arising from the insured's ongoing operations.

A general contractor was sued by a real estate developer over the failure of the general contractor and its concrete subcontractor to comply with the construction plans and specifications of a condominium development. The suit alleged that the concrete foundation piers were not constructed according to specifications, but did not allege that the nonconformity led to other damage.

The general contractor was an additional insured under a policy issued to the concrete subcontractor, but only for liability arising from the concrete subcontractor's ongoing operations. The general contractor tendered the suit to the concrete subcontractor's insurer, which denied coverage — arguing that the claim against the general contractor did not arise from the insured's ongoing operations. The insurer denied coverage and the general contractor filed a declaratory judgment action.

The Fifth Circuit first noted that the insurer had waived any argument as to the "occurrence" requirement by not sufficiently raising the issue in the trial court. The court explained that the central issue was whether the general contractor's liability arose out of the concrete subcontractor's ongoing operations. The court also observed that liability arises out of ongoing operations if the alleged damage took place while the insured is still performing its work. The court observed that, in the underlying lawsuit, the general contractor's liability arose solely from the concrete subcontractor's failure to comply with plans and specifications, and not from damage to other property.

The court reasoned that the allegations of failure to comply with the plans constitute a breach of contract claim, which arose when the plaintiff received the completed building. Thus, the general contractor's liability did not arise out of the concrete subcontractor's ongoing operations. Because the general contractor's liability arose after the concrete subcontractors operations were completed, there was no additional insured coverage available to the general contractor. Consequently, the Fifth Circuit reversed the district court holding the insurer had no duty to defend the general contractor.

The difference between ongoing operations coverage and completed operations coverage can have a big impact on determinations of coverage for construction defect claims, sometimes in unexpected ways. This case illustrates that, a breach of contract claim — which might be covered — may not be if there is no coverage for completed operations since the construction contract is not breached until an improperly constructed property is delivered.

Ewing Construction Company Inc. v. Amerisure Insurance Co.

In answering certified questions from the Fifth District, the Texas Supreme Court found that the contractual liability exclusion failed to preclude coverage for an insured's agreement to perform its construction work in a good and workmanlike manner.

Ewing, a general contractor, was retained to renovate and build additions to a school, including a tennis court. Shortly after construction, the tennis courts started flaking, crumbling and cracking, rendering them unusable for tennis matches. The school filed suit against Ewing alleging the

company breached its contract with the school and that it was negligent by breaching its duty to use ordinary care in performing its contract. Ewing sought coverage from its general liability insurer, which denied coverage based on the contractual liability exclusion, and not based on the insuring agreement.

Ewing sued its insurer in Texas federal court, which found the insurer had no duty to defend because the underlying claims sounded only in contract and were excluded under the contractual liability exclusion. The Fifth District Court of Appeals certified questions to the Texas Supreme Court as to: (1) whether the contractual liability exclusion barred coverage and, if so, (2) whether the "insured contract" exception restored coverage.

The Texas Supreme Court first noted that according to its prior decision in Gilbert Texas Construction LP v. Underwriters at Lloyd's London (2010), the contractual liability exclusion does not apply only to liability the insured assumes for the conduct of a third party, but [in contrast to many other jurisdictions] also applies to claims that the insured failed to correctly perform its contractual obligations, so long as those obligations are an expansion upon the insured's duties under common law. In the case at bar, the court observed that Ewing's agreement to construct the tennis courts in a good and workmanlike manner did not enlarge its obligation because Ewing was obliged under common law to exercise its contractual obligations using ordinary care. The court held that Ewing's contract with the school was not an "assumption of liability" falling within the contractual liability exclusion and, consequently, the insurer was required to defend.

Claims professionals that handled Texas matters are well aware of the unorthodox approach to coverage issues sometimes adopted by courts in the state. Here, the Texas Supreme Court appears to have undermined its own unusually wide interpretation of the contractual liability exclusion — that it excludes claims of improper performance, but finding that parties to a contract have duties in tort to perform their contracts using ordinary care. Claims professions should therefore tread carefully when dealing with faulty workmanship claims alleging breach of contract.

Nautilus Insurance Co. v. Lexington Insurance Co.

The Hawaii Supreme Court responded to certified questions from the Ninth Circuit, holding that an insurer may not disclaim the duty to defend on the basis that it is made excess by virtue of "other insurance" provisions in the policy.

A developer and a subcontractor were sued by Maui, Hawaii, residents for damages arising from a construction project on the island. Lexington insured the developer under a primary commercial general liability policy, which contained an other insurance clause that provided that Lexington was excess any additional insured coverage available to the developer.

The subcontractor was insured under a primary policy issued by Nautilus, which also provided additional insured coverage to the developer for any liability of the developer arising out of the subcontractors' negligence. The allegations of the underlying complaint triggered both the Lexington and Nautilus policies, although Nautilus alone funded the defense of both the developer and the subcontractor.

The developer was ultimately found to be solely negligent, and Lexington indemnified the developer for the judgment. Lexington refused to reimburse Nautilus for defense costs incurred on behalf of the developer — arguing that Lexington's additional insured coverage was excess to the additional insured coverage provided by Nautilus. Nautilus filed suit against Lexington seeking equitable contribution.

The trial court found that Lexington was permitted to look to the Nautilus policy in determining Lexington's duty to defend and that because the Lexington policy was excess, Lexington had no duty to defend and Nautilus' claim for contribution was denied.

On appeal, the Ninth Circuit certified the issues presented to the Hawaii Supreme Court. The court held that a primary insurer is not permitted to look to other insurance policies in disclaiming a duty to defend and that a carrier that is made excess by virtue of another policy an its own other insurance clause must nevertheless defend the insured on a primary basis. The court further held that other insurance provisions could be enforced against other carriers, and an insurer that paid defense expense properly owed by another insured could assert a claim for contribution to recover what the other carrier would have paid.

In the case at bar, this meant that Lexington had a duty to defend from the outset. Moreover, after the resolution of the underlying case, it was determined that Lexington's insured was solely at fault. Thus, the developers' liability did not arise out of the subcontractor's negligence and, therefore, the underlying suit fell outside the additional insured coverage provided by Nautilus. Consequently, Nautilus was able to recover all defense expense paid on behalf of the developer from Lexington.

This case illustrates the risks of denying coverage based on the availability of other insurance. The presence of additional insured coverage can often give rise to a number of thorny issues that the claims professional must sift through in determining the priority of coverage.

Other Items of Note

A wrap-up exclusion was held to be unambiguous, and relieves a CGL insurer of a duty to defend claims arising from a project for which an owner-controlled insurance program policy was in place.

As owner, contractor and developer controlled insurance programs continue to become popular, there is very little precedential authority on how such programs are to be interpreted. One issue is the enforceability and application of an OCIP or wrap-up exclusion in a construction professional's CGL policy when an OCIP has been obtained for a specific project.

Recently in First Mercury Insurance Co. v. Waterside Condominium Association (2013), the court found that a wrap-up exclusion unambiguously excluded coverage for any project for which a wrap-up policy was in place. Thus, the CGL carrier had no duty to defend an underlying construction defect lawsuit.

Despite the increasing popularity of wrap-up insurance programs with construction professionals and insurers, there is relatively little case law evaluating the interplay between the wrap-up programs and program participants own policies. This case joins the small number decisions that

support the enforceability of wrap-up exclusions, thus giving effect to the business expectations of both insureds and their carriers.

Appeal to the Colorado Supreme Court in Colorado Pools has been dismissed, meaning insurers in Colorado will have to wait longer for final word on the retroactive application of Colorado's Construction Professional Commercial Liability Insurance Act.

Finally, it appears that the Colorado Supreme Court will not soon weigh in on the retroactivity of the Colorado's Construction Professional Commercial Liability Insurance Act. This recent statutory enactment requires, among other things, that a court presume alleged faulty workmanship that results in damage, including damage to the work itself or other work, is an accident — and thus an "occurrence" — unless the property damage is intended and expected by the insured.

In Colorado Pool Systems Inc. v. Scottsdale Insurance Co. (2012), the Colorado Court of Appeals held that the law only applies to those policies in effect on or after May 25, 2010, the date of enactment. Although the case was appealed to the Colorado Supreme Court, it appears that the dispute settled in January 2014 and the appeal dismissed.

—By John A. Husmann and Jocelyn F. Cornbleet, BatesCarey LLP

John Husmann is a partner and Jocelyn Cornbleet is an associate in BatesCarey's Chicago office.