CONSTRUCTION DEFECTS:
WHO SHOULD BE ON YOUR GUEST LIST AND WHAT'S ON THE MENU

By Jeffrey S. Youngerman, Flaherty & Youngerman PC, Chicago IL

Introduction of Materials

Construction defect practice gets more interesting and more complicated every day. The following materials reflect evolving theories of construction defect liability and the role insurance plays is financing recoveries or defenses as reflected in statutes and cases throughout the United States.

The first is my article entitled "*Construction Defects: Who Should be on your Guest List and What's on the Menu*." From the plaintiff's perspective, the article addresses the fallout of the recent great recession and the need to focus on claims that trigger insurance coverage, including design professional liability, the economic loss rule and applicable theories of recovery. A significant focus is on how the nature of the claims will affect coverage under CGL policies and the manner in which courts have treated coverage disputes.

Following the article are four compendiums assembled by developer counsel Greg L. Dillion (with assistance from Max Salling) from Newmeyer & Dillion which identify key cases and statutes dealing with "occurrence" questions arising under the typical CGL policy; a list of indemnity statutes, or, perhaps more accurately "anti-indemnity" statutes; a fifty state analysis of statutes of limitations and repose; and a summary of recent important construction law cases and statutes.

Last is an article by JAMS Mediator Craig Meredith, who, based in San Francisco by handling cases nationwide, has targeted the ten key insurance issues that arise in construction defect mediation.

CONSTRUCTION DEFECTS: WHO SHOULD BE ON YOUR GUEST LIST AND WHAT'S ON THE MENU

By Jeffrey S. Youngerman, Flaherty & Youngerman PC, Chicago IL

In the wake of the recent great recession insolvency of developers-sellers threatens to leave buyers of new homes without recourse for construction defects unless they have direct claims against contractors, architects and engineers who cause them. While some jurisdictions recognize owners can assert tort claims directly against contractors and design professionals, others do not. In those jurisdictions that do not recognize such tort claims, courts have also imposed the economic loss rule to bar claims in tort when the loss is solely for defeated commercial expectations of quality, including the cost to repair construction defects. This leaves express and implied warranty claims as the primary remedy for owners against developer-sellers, unless fraud or breach of fiduciary duty can be stated. In any event, when the developer-seller is insolvent, securing relief may turn on whether or not you trigger insurance coverage stating defect claims against all responsible parties. Because many states adhere to privity requirements, owners may not have a remedy directly against contactors and design professionals with whom they have no contract, potentially limiting the amount of insurance coverage available. Under the implied warranty of habitability, Illinois, on public policy grounds, eliminated the privity requirement to protect innocent purchasers

from latent defects, holding contractors and subcontractors directly liable to owners when the developer-seller is insolvent. Additionally, there is no reasonable basis to not apply the implied warranty of habitability to design professionals for their design defects when the developer-seller is insolvent. Whether or not the implied warranty of habitability will also be applied to design professionals for their design defects is currently before the Illinois Appellate Court.

Regardless of the legal theories available to you, insurance coverage for the entities who are responsible for creating defects play a significant role in shaping recoveries for owners. This is especially true due to recent economic carnage in the construction industry. The insurance you trigger could end up being your only recovery. The more parties you can state claims against, the more insurance you can potentially trigger, which will enhance your likelihood of a greater recovery. No matter how much insurers complain about lack of coverage, they often fund a significant portions of construction defect litigation settlements. Therefore, insurers should be guests of honor at the construction defect table. Careful consideration should also be given to evaluating claims directly against design professionals for design defects, as they often carry errors and omissions insurance coverage. This provides more robust insurance coverage for design defects, compared to the coverage for workmanship defects under standard CGL policies carried by contractors. Nevertheless, the battle over insurance coverage for workmanship defects under standard CGL insurance policies is not over. In fact, it is just getting started. A majority of the state Supreme Courts who have considered whether workmanship defects are an “occurrence” needed to trigger coverage under standard form CGL policy have done so. As more fully addressed

below, many states now recognize that CGL policy language was changed in 1986, and that change expanded coverage in exchange for higher premiums. Thus, these courts find coverage and no longer rely on earlier court decisions declining coverage where the CGL policy involved pre-1986 standard form language. Therefore, there is reason for optimism.

However, the guest list at the construction defect table should include as many invited guests as you can state claims against in good faith, even if the menu of legal theories is novel.

While Not All Jurisdictions Recognize Tort Claims Against Contractors and Construction Professionals, There Are Alternative Theories to Consider That Can Trigger Insurance Even When Faced With the Economic Loss Rule

There is no universal rule of law protecting innocent purchasers from construction defects when they purchase a new home. Some states allow owners to sue in tort to recover the cost to repair defects. The California Supreme Court recently took a giant step to protect buyers when they ruled design professionals owe unit owners in a condominium association a duty in tort arising out of their faulty design services. *Beacon Residential Community Association v. Skidmore Owings & Merrill LLP*, 59 Cal. 4th 568, 327 P. 3d 850, 173 Cal. Rptr. 3d 752 (2014). Some states make it harder than others for owners to state claims. For example, many states adhere to some form of the "economic loss rule" to bar owners from bringing tort claims against the construction trades and construction professionals when the remedy sought is for defeated commercial expectations of quality. Some jurisdictions enforce the economic loss rule strictly and others create exceptions allowing owners to sue in tort when health and safety issues are implicated, or when there are various situations resulting in

property damage arise. However, when enforced, the economic loss rule essentially leaves owners with only their contract remedies, which may be limited. When the developer-seller is insolvent, as we have seen in mass lately, if you practice in a state where tort claims are barred by the economic loss rule, should you just give up? No. Consider how Illinois protects innocent purchasers under the implied warranty of habitability.

While Illinois Follows the Economic Loss Rule It Protects Innocent Purchasers By Eliminating the Privity Requirement For Implied Warranty of Habitability Claims Against the Party Causing the Defect.

In Petersen *v. Hubschman Construction Co.*, 76 Ill. 2d 31, 38 (1979) (emphasis added), the Illinois Supreme Court recognized an implied warranty of habitability "to afford a degree of relief to vendees of new homes who subsequently discover latent defects in the structure" in order "to avoid the harshness of Caveat emptor." The Supreme Court adopted the implied warranty of habitability because (1) the nature of contemporary construction provides the buyer with "little or no opportunity to inspect," (2) the buyer "is making a major investment, in many instances the largest single investment of his life" and (3) the buyer "is usually not knowledgeable in construction practices . . . ." *Id.* at 40. The Supreme Court held that a buyer

> has a right to expect to receive that for which he has bargained and that which the builder-vendor has agreed to construct and convey to him, that is, a house that is reasonably fit for use as a residence.

In Illinois, the implied warranty of habitability applies to a "latent defect caused by improper design, material, or workmanship . . . ." *Eickmeyer v. Blietz Organization, Inc.,* 284 Ill. App. 3d 134, 143 (1st Dist. 1996); *Grove v. Huffman,* 262 Ill. App. 3d 531, 538 (4th Dist. 1994); *Naiditch v. Shaf Home Builders, Inc.,* 160 Ill. App. 3d 245, 264 (2d Dist.

1987); *Fischer v. G & S Builders,* 147 Ill. App. 3d 168, 175 (3d Dist. 1986). Illinois courts have repeatedly stated that the purpose of the implied warranty is to protect innocent purchasers. In *Redarowicz v. Ohlendorf*, 92 Ill. 2d 171, 183 (1982) (emphasis supplied), the Illinois Supreme Court noted that the implied warranty of habitability is a "judicial innovation that has evolved to protect purchasers of new homes upon discovery of latent defects in their homes." In *Board of Directors of Bloomfield Club Recreation Association v. Hoffman Group, Inc*., 186 Ill. 2d 419, 424 (Ill. 1999) (emphasis supplied), the Supreme Court again noted that the purpose of the implied warranty of habitability is "to protect residential dwellers from latent defects that interfere with the habitability of their residences." In, *VonHoldt v. Barba & Barba Construction, Inc*., 175 Ill. 2d 426, 430 (Ill. 1997) (emphasis supplied), the Supreme Court again noted that "Illinois courts applied the doctrine to the sale of new homes to protect innocent purchasers who did not possess the ability to determine whether the house they purchased contained latent defects." In Illinois, the implied warranty of habitability has steadily evolved to serve the underlying public policy of protecting new homeowners by expanding the class of plaintiffs, the types of properties covered and the class of Defendants.

1. Expansion of the Class of Plaintiffs In Illinois.

Petersen was a rescission case. Subsequent cases have permitted homeowners to recover the cost to repair defects. *See, e.g., Park v. Sohn*, 89 Ill. 2d 453, 464-65 (1982); *Redarowicz,* 92 Ill. 2d at 183. In *Petersen*, the plaintiffs were the original purchasers of a single-family home. In *Redarowicz*, the Supreme Court held that "[p]rivity of contract is not required" and expanded the class of plaintiffs protected by the implied warranty of habitability to include subsequent purchasers. *Id*.

2. Expansion of the Types of Properties Covered In Illinios.

In *Petersen*, the single-family home was being constructed for immediate sale. Subsequent decisions expanded the types of property covered. In *Park*, the Supreme Court ruled that the implied warranty of habitability applies to homes that have been lived in by the builder-vendor before sale. 89 Ill. 2d at 463. In *VonHoldt*, the Supreme Court applied the warranty to an addition to an existing home. 175 Ill. 2d at 431. In *Briarcliffe West Townhouse Owners Association v. Wiseman Construction Co*., 118 Ill. App. 3d 163, 167 (2nd Dist. 1983), the court applied the warranty to common land owned by a townhome association. In *Herlihy*, this Court applied the warranty to the common elements of a condominium association. In *McClure v. Sennstrom*, 267 Ill. App. 3d 277, 282 (2nd Dist. 1994), the court applied the warranty to a home built on an existing foundation. In *Overton v. Kingsbrooke Development, Inc*., 338 Ill. App. 3d 321, 328 (5th Dist. 2003), the court applied the warranty of habitability to a vacant lot that had been filled with dirt. In *Kelley v. Astor Investors, Inc*., 106 Ill. 2d 505, 412, 13 (Ill. 1985), the court indicated that the warranty would apply to the substantial rehabilitation or refurbishing of an existing structure as part of a condominium conversion.

3. Expansion of the Class of Defendants in Illinois.

Petersen was a case against a builder-vendor. 76 Ill. 2d at 35. Subsequent decisions expanded the class of defendants liable under the implied warranty of habitability. In *VonHoldt*, the warranty was applied to a contractor who built a substantial addition to an existing home where there was not privity. 175 Ill. 2d at 431. Thus, *VonHoldt* eliminated the “vendor” prong of “builder-vendor.” In *Tassan v. United Development Co.*, 88 Ill. App. 3d 581, 587 (1st Dist. 1980), *citing Mazurek v. Nielsen*,

599 P.2d 269, 271 (Colo. App. 1979) ("[A] seller need not be involved in the physical acts of construction before the implied warranty of habitability attaches" in applying the implied warranty of habitability to a seller who "employs architects, contractors, and subcontractors . . . ." (emphasis supplied)), the court applied the warranty to a "developer-seller," who performed none of the actual construction of the condominium. Thus, *Tassan* eliminated the "builder" prong of "builder-vendor."

Perhaps the most significant consumer protection decision in Illinois to expand the class of defendants who can be sued under the implied warranty of habitability is *Minton v.Richards Group of Chicago, 116 Ill App 3d. 852 (1st Dist. 1983).* In *Minton,* the court applied the warranty to a painting subcontractor where the homeowners lacked recourse against the builder-vendor of the home, where there was no privity between the subcontractor and owner, holding:

> In this case we agree with the reasoning in *Redarowicz* that the purpose of the implied warranty is to protect innocent purchasers. **For that reason, we hold that in this case where the innocent purchaser has no recourse to the builder-vendor and has sustained loss due to the faulty and latent defect in their new home caused by the subcontractor, the warranty of habitability applies to such subcontractor. (Emphasis Added)**

4. In Illinois Expansion of the Implied Warranty of Habitability Has Been Driven by the "Concept" Supporting the Policy of Protecting Homeowners that the Cost of Repair Should Be Borne by the Party "Who Created the Defect."

In Illinois, many cases, particularly those expanding the class of defendants, the courts focused on the fact that the cost of repair should be borne by the party "who created the defect." In *Redarowicz*, the Supreme Court stated that "repair costs should be borne by the responsible builder-vendor who created the latent defect." 92 Ill. 2d at 183 (emphasis supplied). In *1324 W. Pratt Condominium Association v. Platt*

*Construction Group Inc.,404 Ill App. 3d 611("Pratt I") (1st Dist. 2010) the c*ourt noted that the implied warranty of habitability's policy of protecting homeowners is supported by "three concepts," including "placing the costs of repair on the builders who created the defect." 404 Ill. App. 3d at 617 (emphasis supplied). Accordingly, in *Pratt I,* the court indicated that the policy considerations behind the warranty result in the core principle of the implied warranty of habitability is the party who created the defect should be responsible for it, "because they are in the best position to ensure that the residences they build are habitable and free of defects that unsophisticated home buyers are unable to detect." *Id*. It should be noted though in a subsequent appeal in the *Pratt* case, the Illinois appellate court recognized a limited exception to the expansion of the implied warranty of habitability to place the costs of repair on the builder "who created the defect" by ruling that *Minton* does not apply to the subcontractor who created the defect if the buyer has recourse to the general contractor. *1324 W. Pratt Condominium Association v. Platt Construction Group, Inc*., 2012 WL 2369561 (1st Dist. June 21, 2012) ("*Pratt* II").

5. Architects Should Not Be Exempted From *Minton Because It* Would Defeat the Compelling Public Policy Underlying the Implied Warranty of Habitability.

Illinois appellate court authority holds the implied warranty of habitability applies broadly to all latent defects in "design, materials or workmanship." *Eickmeyer*, 284 Ill. App. 3d at 143; *Grove*, 262 Ill. App. 3d at 538; *Naiditch*, 160 Ill. App. 3d at 284; *Fischer*, 147 Ill. App. 3d at 175. Accordingly, under *Minton*, if subcontractors are liable directly to owners for workmanship defects when the developer-seller is insolvent, why is not an architect directly liable to an owner for design defects? They should be. There are

many compelling policy reasons to apply *Minton* to design professionals, chief among which is that innocent purchasers, who already obtain protection for latent defects, are equally deserving of protection from design defects as they are for workmanship defects. Is a design defect any less capable of being a latent defect than workmanship defect? Of course, the answer is no. And it is not just developers going bust due to the recent great recession recently driving the need to protect owners from design defects and workmanship defects by holding architects and contractors directly liable to owners. All too often, condominium developers set up single-purpose entities which retain no assets following the sales of the last units. *See, e.g.*, Whitley, *Weighing the Risks for Contractors Who Build Condos*, The Associated General Contractors of America (May/June 2007) ("Developers of condominium projects typically create 'single-purpose' entities without assets, other than the project itself, to shield itself from liability."); Quatman, *Condominium Market – A Red Hot and Risky Business*, The Missouri Bar (2006) ("The developer of the project, often a single-purpose limited liability company (LLC), may disappear once all the units are sold off, may be insolvent, uninsured or not even exist a few years after project completion.") Therefore, due to the fact that the business plan for many developers is to leave the purchasers without recourse, allowing direct claims against responsible parties, no matter who they are, advances the policy of protecting innocent purchasers.

The Supreme Court in *Redarowicz* suggested an appropriate test for assessing any application of *Minton* to defendants when it agreed with the Wyoming Supreme Court's statement that "any reasoning which would arbitrarily interpose a first buyer as an obstruction to someone equally as deserving of recovery is incomprehensible." 92

Ill. 2d at 185, *quoting*, *Moxly v. Laramie Builders, Inc*., 600 P.2d 733, 736 (Wyo. 1979). Accordingly, in determining whether architects are exempt from *Minton*, this Court should assess whether its ruling will advance or frustrate the public policy of protecting homeowners from latent defects and must reject any arbitrary obstruction to the protection of homeowners equally deserving of recovery. Therefore, before you give up design claims due to insolvency of the developer-seller, consider bringing an implied warranty claim against the design professionals who caused the design defects.

It is Time To Start Fighting For Insurance Coverage For Workmanship Defects Under Broad Form Property Damage Coverage Given That Courts Are Finally Waking Up To Recognize Post-1986 CGL Policies Expanded Coverage For Workmanship Defects.

Beginning in the 1970s, the insurance industry developed Broad Form Property Damage ("BFPD") coverage that was available for an increased premium through an endorsement. The BFPD Endorsement quickly grew to become the most popular endorsement to CGL policies. Accordingly, in the 1986 revisions, BFPD Coverage was incorporated into the standard CGL policy. The majority of state Supreme Court decisions recognize that the BFPD Coverage in the post-1986 standard CGL policy provides insurance coverage to general contractors for property damage to the completed construction project either to a subcontractor's work or that is caused by a subcontractor's work.

Because today's standard CGL policies include standard form provisions that are contained in policies issued by most insurers, those provisions have been interpreted by state Supreme Courts throughout the country. The majority of these decisions hold that such CGL policies provide insurance coverage to a developer or general contractor for property damage that occurs after completion of construction either (1) to work that was

performed by any subcontractor or (2) to any part of the project that arises out of any work performed by a subcontractor. Where the insured is a subcontractor, such policies cover property damage to parts of the construction project other than the insured subcontractor's own work.

Many of these decisions trace the evolution of CGL coverage from its inception, when all damage to the project was excluded, to its current form that covers property damage to a subcontractor's work or caused by a subcontractor's work, an evolution resulting from conscious changes to the form provisions. Decisions that do not understand that evolution often reach an incorrect conclusion based on earlier insurance language.

> The various revisions sometimes involved subtle changes in wording that were intended to have profound effects on the coverage provided by the policy. Therefore, when interpreting the effect of a particular policy provision on coverage, it is imperative to rely on those authorities, whether insurance industry commentaries or legal precedent, which address or interpret the same revision or endorsement of the policy language being interpreted. Unfortunately, however, this is not always accomplished, and the evolution of the policy forms is sometimes overlooked by the courts or others when interpreting the coverage provided by the policies.

P. Wielinski & J. Gibson, *Broad Form Property Damage Coverage* 1 (IRMI 1992). Two opinions that trace the evolution of CGL coverage are *Am. Family Mut. Ins. Co. v. Am. Girl, Inc*., 268 Wis. 2d 16, 33-56 (2004), and *United States Fire Ins. Co*. *v. J.S.U.B., Inc*., 979 So.2d 871, 877-83 (Fla. 2007).

The first standard form "Comprehensive General Liability" insurance policy was drafted by the insurance industry in the late 1930's and first issued around 1940. *See* 20 Eric Mills Holmes, *Holmes' Appleman on Insurance 2d*, §129.1, at 7 (2002). In 1986, the "Comprehensive General Liability" policy was renamed the "Commercial General Liability" policy, but the acronym "CGL" is commonly used to refer to both. *Id*. Most CGLs are written on standardized forms developed by an association of domestic property and casualty insurers known as the Insurance Services Office (the "ISO"). *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 772 (1993) ("ISO develops standard policy forms and files or lodges them with each State's insurance regulators; most CGL insurance written in the United States is written on these forms."). CGL policies are designed to protect an insured against certain losses arising out of business operations. *See Travelers Indem. Co. of Am. V. Moore & Assocs., Inc*., 216 S.W.3d 302, 305 (Tenn. 2007). CGL policies are divided into several components, including the "insuring agreement," which "sets the outer limits of an insurer's contractual liability," and the "exclusions," which "help define the shape and scope of coverage" by excluding certain forms of coverage. *Id*.

Since 1940, the standard policy has been revised several times over the years, expanding the insuring agreement and narrowing the exclusions. 21 *Holmes' Appleman on Insurance 2d*, §129.1, at 7–8. The insuring agreement was expanded from providing coverage only for damages caused by an "accident" to providing coverage for damages caused by an "occurrence," which is defined as "an accident, including continuous or

repeated exposure to substantially the same general harmful conditions."[1] *Compare* 16 *id*. § 117.1, at 215, *with* 20 *id*. § 129.2, at 104.

The exclusions that are of significance to CGL coverage for construction projects are the "business risk" exclusions, including what was originally the "work performed" and "your product" exclusions. These two exclusions have been significantly narrowed over the years, resulting in expanded coverage for damage to completed construction projects. *See generally* 21 *Holmes' Appleman on Insurance 2d*, § 132.1–132.9, at 5–158.

1. CGL policies initially included an exclusion for damage to "work performed by or on behalf of the named insured."

Prior to 1986, the standard CGL policy contained broad exclusions for damage to "your product" and "your work" stating that the insurance did not apply

> (n) to property damage to the named insured's products arising out of such products or any part of such products;

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[1] In 1996 when CGL policies first switched from insuring an "accident" to insuring an "occurrence," occurrence was defined as:

> an accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured.

In 1986, the definition of occurrence was revised to:

> an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

The reference to "damage neither expected nor intended from the standpoint of the insured" became exclusion a. Expected or Intended Injury. "[T]he 1986 break up of 'occurrence' into a definition essentially stating that it is an accident, plus a separate exclusion for expected or intended property damage, should have little effect on the manner in which the occurrence requirement is applied by the industry and interpreted by the courts." *Broad Form Property Damage Coverage* 14-15.

(o) to property damage to work performed by or on behalf of the named insured arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith.

21 *Holmes' Appleman on Insurance 2d*, §132.1, at 11 (emphasis added); *see, e.g., LaMarche v. Shelby Mut. Ins. Co..* 390 So.2d 325, 326 (Fla. 1980).

These expansive exclusions effectively eliminated any coverage for property damage to completed construction projects. A widely-quoted commentary on CGL coverage following 1966 revisions stated:

> The risk intended to be insured is the possibility that the goods, products or work of the insured, once relinquished or completed, will cause bodily injury or damage to property other than to the product or completed work itself, and for which the insured may be found liable.

Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations - What Every Lawyer Should Know,* 50 *Neb. L. Rev.* 415, 441 (1971). Thus, in *Weedo v. Stone-E-Brick, Inc*., 81 N.J. 233, 240-41 1979), the New Jersey Supreme Court quoted Henderson before concluding that the "injury to persons and damage to other property constitute the risks intended to be covered under the CGL" and that exclusions (n) and (o) are "[t]he standardized provisions in the CGL intended to convey this concept."

2. The 1976 Broad Form endorsement narrowed the "Work Performed" exclusion only to work performed by the named insured.

By 1976, the insured could purchase for an additional premium a Broad Form Property Damage Endorsement (the "BFPD Endorsement") to expand coverage. *See*, *Am. Girl, Inc*., 268 Wis. 2d at 52; *United States Fire Ins.*, 979 So.2d at 878. The BFPD

Endorsement expanded coverage by replacing exclusion (o) for "work performed by or on behalf of the named insured," set forth above, and exclusion (k), which excluded damage to property owned by or within the control of the insured. Exclusion (k) was replaced with more specific exclusions that narrowed the exclusion for damage that occurs during construction operations, and exclusion (o) for damage to "work performed by or on behalf of the named insured" was replaced with an exclusion that "with respect to the completed operations hazard" excluded property damage only to "work performed by the named insured." The 1976 BFPD Endorsement provided, in relevant part:

> (A) Exclusions (k) and (o) are replaced by the following:
>
> (2) except with respect to liability under a written sidetrack agreement or the use of elevators
>
> . . .
>
> (d) to that particular part of any property, not on premises owned by or rented to the insured,
>
> (i) upon which operations are being performed by or on behalf of the insured at the time of the property damage arising out of such operations, or
>
> (ii) out of which any property damage arises, or
>
> (iii) the restoration, repair or replacement of which has been made or is necessary by reason of faulty workmanship thereon by or on behalf of the insured;
>
> (3) with respect to the completed operations hazard and with respect to any classification stated in the policy or the company's manual as "including completed operations," to property damage to work performed by the named insured arising out of such work or any portion thereof, or out of such materials, parts or equipment furnished in connection therewith.

21 *Holmes' Appleman on Insurance 2d*, §132.9, at 149 (emphasis added); *Broad Form Property Damage Coverage* 9.[2] Thus, with regard to completed operations, the endorsement eliminated the exclusion for work performed "on behalf of" the named insured.

Wielinski and Gibson summarize the completed operations coverage for construction projects under the 1976 BFPD Endorsement:

1. The insured would have no coverage for damage to his work arising out of his work.
2. The insured would have coverage for damage to his work arising out of a subcontractor's work.
3. The insured would have coverage for damage to a subcontractor's work arising out of the subcontractor's work.
4. The insured would have coverage for damage to a subcontractor's work, or if the insured is a subcontractor, the insured would have coverage for damage to a general contractor's work or another subcontractor's work arising out of the insured's work.

Broad Form Property Damage Coverage 79 (emphasis in original).

3. The 1986 CGL policy incorporated BFPD Coverage by (1) dividing the "Work Performed" exclusion into separate "Damage to Property" and "Damage to Your Work" exclusions, (2) making the "Damage to Property" exclusion inapplicable to completed construction projects and (3)

[2] Expanding completed operations coverage by limiting the exclusion only "to work performed by the named insured" to provide coverage for damage to work performed "on behalf of the named insured" began with the 1969 BFPD Endorsement which was issued in a form "Excluding Completed Operations" and one "Including Completed Operations." *Broad Form Property Damage Coverage* 3, 6-8. The insured paid an increased premium for expanded completed operations coverage. *Broad Form Property Damage Coverage* 8.

providing an exception to the "Damage to Your Work" exclusion where "the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor."

BFPD Coverage was so popular that the BFPD Endorsement was added to most CGL policies in the early 1980s and "was such a standard practice by 1985 that all of the coverages granted by the endorsement were included in the standard policy form promulgated by the ISO that year." *Broad Form Property Damage Coverage* 10; *see also,* 21 *Holmes' Appleman on Insurance 2d*, §132.9, at 149, 153.

The 1986 revisions divided the "work performed" exclusion into separate "Damage to Property" and "Damage to Your Work" exclusions. BFPD Coverage was incorporated into the standard CGL policy by significant provisions in each of those separate exclusions. New exclusion (j)(6) for faulty workmanship expressly does not apply to completed construction projects. Exclusion j(6) excludes:

"Property damage" to:

. . .

(6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

. . .

Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard."

21 *Holmes' Appleman on Insurance 2d*, §132.9, at 145, 153 (emphasis added) New exclusion "l. Damage to Your Work" contains an exception that makes the exclusion inapplicable to work performed on the insured's behalf by a subcontractor (the "Subcontractor Exception"). Exclusion l provides:

> [This insurance does not apply to:] "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

Id. at 145, 152 (emphasis added); *Broad Form Property Damage Coverage* 93.

The 1986 standard CGL policy included the Subcontractor Exception because the construction industry wanted such coverage and the insurance industry considered it to be an attractive product to sell:

> [T]he insurance and policyholder communities agreed that the CGL policy should provide coverage for defective construction claims so long as the allegedly defective work had been performed by a subcontractor rather than the policyholder itself. This resulted both because of the demands of the policyholder community (which wanted this sort of coverage) and the view of insurers that the CGL was a more attractive product that could be better sold if it contained this coverage.

See 2 Jeffrey W. Stempel, *Stempel on Insurance Contracts*, § 14.13[D] at 14–224.8 (3d ed. Supp. 2007).

The ISO promulgated a circular on July 15, 1986, confirming that the 1986 revisions to the standard CGL policy incorporated the BFPD Endorsement that specifically "covers 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." Insurance Services Office Circular, Commercial General Liability Program Instructions Pamphlet, No. GL–86–204 (July 15, 1986).[3]

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[3] A copy of the ISO Circular is available at: http://blognetwork.kilpatricktownsend.com/

Wielinski and Gibson summarize the completed operations coverage for construction projects under the 1986 standard CGL policy as identical to the completed operations coverage that was provided by the 1976 BFPD Endorsement:

1. The insured would have no coverage for damage to his work arising out of his work.
2. The insured would have coverage for damage to his work arising out of a subcontractor's work.
3. The insured would have coverage for damage to a subcontractor's work arising out of the subcontractor's work.
4. The insured would have coverage for damage to a subcontractor's work, or if the insured is a subcontractor, the insured would have coverage for damage to a general contractor's work or another subcontractor's work arising out of the insured's work.

Broad Form Property Damage Coverage 92-93 (emphasis in original).

4. The 1986 revisions to the standard CGL policy modified the definition of "Your Product" to expressly exclude "real property."

"Since a separate CGL exclusion, the work performed exclusion, addressed the exposures of the construction industry, the damage to products exclusion was never intended to apply to completed operations." *Broad Form Property Damage Coverage* 110. Nevertheless, insurers continued to assert the damage to products exclusion to deny coverage for the property damage to completed operations that was intended by

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insurancerecovery/files/2014/06/Insurance-Services-Office-Circular.pdf

the 1976 BFPD Endorsement. Accordingly, the 1986 standard CGL policy revised the definition of "your product" to explicitly exclude "real property." *Broad Form Property Damage Coverage* 105-06. Because "product" by definition does not include real property, the exclusion for damage to the insured's product does not apply to completed construction operations. *Cincinnati Ins. Co. v. G.L.H., Inc*., 2008 WL 2940663, slip op. p. 7 (Ohio App. 2008) (condominiums were not the developer's "product" due to the "real property" exception to the definition of "your product").

5. Courts continued to misapply coverage by continuing to refer to commentaries and authorities that predated the expanded BFPD Coverage.

Both the insurance industry and the construction industry clearly intended to extend coverage for property damage to completed construction projects caused by the work of subcontractors. Nevertheless, as indicated by Wielinski and Gibson, many courts reached erroneous conclusions about BFPD Coverage by failing to recognize or understand the impact of the conscious changes in policy language. *Broad Form Property Damage Coverage* 1. Both the Henderson article and the *Weedo* decision discussed the 1996 standard CGL coverage containing both the original exclusions (n) for the insured's products and (o) for damage to work "performed by or on behalf" of the named insured. Nevertheless, some cases continued to cite the Henderson article and the *Weedo* decision long after the policy language had been changed to provide BFPD Coverage for damage to completed construction projects caused by a subcontractor's work. Such cases "seized on the 'business risk analysis' at the expense of focusing on the actual language contained in the policy." *Broad Form Property Damage Coverage* 84. "[M]any other courts … collapsed the products exclusion and work performed

exclusion into a 'work product exclusion' in applying them to claims involving work performed by an insured contractor." *Id*. Such decisions ignore the intent of BPFD Coverage to cover damage to the competed project to or caused by the work of subcontractors.

> The conscious decision by the insurance industry to provide coverage for property damage to or arising out of subcontractors' work is compatible with the rationale behind exclusion of business risks that are within the control of the named insured. Due to the complexities of a construction project, a general contractor cannot as effectively control the risks associated with the work of subcontractors as he can his own, so that coverage for that risk is provided through the addition of … BFPD [coverage]. Consistent with the business risk rationale, property damage due to a subcontractor's defective work is fortuitous and not subject to intentional manipulation by an insured general contractor.

Id.

6. The majority of state Supreme Court decisions rule that property damage to a competed construction project to a subcontractor's work or caused by a subcontractor's work results from an "occurrence."

The majority of Supreme Court decisions from other jurisdictions (the "Majority Rule Decisions"[4]) that actually examine the relevant authorities make clear that the majority rule is to find an "occurrence" in cases such as these. The significance of the Majority Rule Decisions is that they interpret the post-1986 standard form CGL policy containing BFPD Coverage, the same post-1986 standard form CGL policy containing BFPD Coverage issued by West Bend. Many of these decisions reverse these courts' previous rulings that there was no coverage in recognition of the intention to provide such coverage evidenced by the changes in the language of the CGL policies made in incorporating BFPD Coverage. The West Virginia Supreme Court sagely explained its own reason for doing so:

> With the passage of time comes the opportunity to reflect upon the continued validity of this Court's reasoning in the face of juridical trends that call into question a former opinion's current soundness. It has been said that "[w]isdom too often never comes, and so one ought not to reject it merely because it comes late." … [D]oes defective workmanship constitute an occurrence under a policy of CGL insurance? We find that, consistent with the decisions rendered by a majority of our sister jurisdictions, it does.
>
> In order for a claim to be covered by the subject CGL policy, it must evidence "bodily injury" or "property damage" that has been caused by an

[4] For an extensive list of such decisions, *see K&L Homes, Inc. v. American Family Mutual Ins. Co.*, 829 N.W.2d 724, 729-31 (N.D. 2013); *Cherrington v. Erie Ins. Property and Casualty Co.*, 745 S.E.2d 508, 519 n. 19 (W. Va. 2013).

> "occurrence." An "occurrence," in turn, is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."…
>
> It goes without saying that the damages incurred by Ms. Cherrington during the construction and completion of her home, or the actions giving rise thereto, were not within the contemplation of Pinnacle when it hired the subcontractors alleged to have performed most of the defective work. Common sense dictates that had Pinnacle expected or foreseen the allegedly shoddy workmanship its subcontractors were destined to perform, Pinnacle would not have hired them in the first place.

Cherrington v. Erie Ins. Property and Casualty Co., 745 S.E.2d 508, 520 (W. Va. 2013). *Accord, K&L Homes, Inc*. *v. American Family Mutual Ins. Co.*, 829 N.W.2d 724, 729 (N.D. 2013) ("Currently the majority of state supreme courts who have decided the issue of whether inadvertent faulty workmanship is an accidental 'occurrence' potentially covered under the CGL policy have decided that it can be an 'occurrence.'"); *Greystone Construction, Inc. v. National Fire & Marine Ins. Co*., 661 F.3d 1272, 1282 (10th Cir. 2011) (applying Colorado law) ("[M]ost federal circuit and state supreme court cases line up in favor of finding an occurrence in the circumstances we consider here."); *Lamar Homes, Inc. v. Mid-Continent Casualty Co*., 242 S.W.3d 1, 14-15 (Tex. 2007) (criticizing the dissent's faulty reliance on a supposed "majority rule" of non-coverage).

In *Architex Association, Inc. v. Scottsdale Ins. Co*., 27 So. 3d 1148, 1155 n. 13 (Miss. 2010), the court found coverage where a subcontractor's faulty work caused damage to the structure in question, noting "the fact that the general contractor receives

coverage will not relieve the subcontractor of ultimate liability as an insurer will have subrogation rights against the subcontractor who performed the defective work."

In *American Family Mutual Ins. Co. v. American Girl, Inc*., 673 N.W.2d 65, 76, n. 5 (Wis. 2004), the court explained that the inclusion of warranties in construction contracts is consistent with a finding that construction defects are "accidents" and "occurrences" because "the provision of a general warranty does not support a conclusion that the contract parties expected a particular loss to occur." Indeed, the policy definition of “Your Work” includes “Warranties.” The court rejected as an "overbroad generalization[]" the suggestion that "a loss actionable only in contract can never be the result of an 'occurrence' within the meaning of the CGL's initial grant of coverage." *Id*.

Examples of Majority Rule Decisions finding coverage for property damage to completed construction projects include the following: *Lee Builders, Inc. v. Farm Bureau Mutual Ins. Co*., 137 P.3d 486, 493-95 (Kan. 2006) (water damage to constructed building caused by subcontractor's faulty work constituted "property damage" caused by an "occurrence"); *Travelers Indemnity Co. of America v. Moore & Associates, Inc*., 216 S.W.3d 302, 308-10 (Tenn. 2007) (same); *United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 883-91 (Fla. 2007) (structural damage caused by subcontractor's faulty work constituted "property damage" caused by an "occurrence"); *Sheehan Construction Co., Inc. v. Continental Casualty Co*., 935 N.E.2d 160, 169-71 (Ind. 2010) (“[F]aulty workmanship [that] is ‘unexpected’ and ‘without intention or design’ and thus not foreseeable from the viewpoint of the insured … is an accident within the meaning of a CGL policy.” (water damage to homes caused by the faulty workmanship of

subcontractors)).

As the foregoing decisions make plain, the majority rule and prevailing trend is to recognize coverage for "property damage" to a completed construction project caused by and/or to a subcontractor's work by an "occurrence" consisting of exposure to the same general harmful conditions. Courts must now recognize the significance of the changes in the policy language made by the insurance industry in incorporating BFPD Coverage in the standard post-1986 CGL policy and should follow the Majority Rule Decisions finding coverage for property damage caused by subcontractors' work.

7. Recognizing BFPD Coverage for property damage caused by a subcontractor does not transform the CGL policy into a performance bond.

Some courts refuse to apply BFPD Coverage as written under the mistaken impression that doing so would convert the CGL policy into a performance bond. Such reasoning "is simply wrong and reflects a basic lack of understanding of the realities and intricacies of both the financing of a modern construction project as well as elementary risk management principles. *Broad Form Property Damage Coverage* 89. Insurance is an indemnity contract, while a performance bond guarantees the contractor's obligation to complete the project. Insurance is based on an evaluation of risks and losses actuarially linked to premiums where losses are expected. A performance bond is underwritten on the basis of essentially a credit evaluation of the particular contractor's ability to perform its obligations with the expectation that there will be no losses. The performance bond underwriting process is very similar to a lender's process. *Id*.

A performance bond is issued to the owner and protects the owner rather than the contractor. If the contractor cannot complete the project, the surety may fulfil the

bond by providing additional financing to the original contractor to complete the project, finding another contractor to complete the project or paying the owner to complete the project itself. The surety retains a right to indemnity against the contractor. Insurance, by contrast, protects the contractor, and the insurer has no subrogation rights against its insured contractor. *Id*. 89-90. *Accord, Commercial Union Assur. Cos. v. Gollan*, 118 N.H. 744, 748 (1978) ("A performance bond is a guaranty by a surety that 'the building will be completed within the contract price without extra cost to the owner . . . [and that] payment will be made by the contractor to sub-contractors and to those who furnish labor and materials.'") The court in *Architex* also recognized that insurance is distinct from a performance bond, which simply pays to complete the work if the contractor cannot. Insurance, by contrast, only pays for property damage that occurs during or after completion of the work. Insurance spreads risk instead of guaranteeing completion of performance. However, even in the context of guaranteeing completion, "the performance bond offers no indemnity for the contractor; it protects only the owner." 27 So. 3d 1155 n. 13

Conclusion

Save a seat at the construction defect table for insurers. When the developer-seller is insolvent, the errors and omissions insurance policies for design professionals could end up being the main course. Design professionals' policies are generally more responsive to defect claims compared to standard form CGL policies carried by contactors. Therefore, you should consider bringing a claim for breach of implied warranty directly against design professionals for their design defects, especially if you are in a state where the economic loss rule bars owners from bringing direct claims

against them. Deleting design professionals from your guest list could leave owners without any remedy for design defects as there are no assurances the insolvent developer will defend the case and bring third party design defect claims against them. When the developer-seller is insolvent, even absent privity, owners should also consider bringing implied warranty claims directly against the contractors and subcontractors who cause workmanship defects. While in many jurisdictions standard form CGL policy may not provide coverage to the extent provided by errors and omissions polices to design professionals, there is a trend developing across the country in favor of coverage for workmanship defects that cause property damage. That should make your glass at the construction defect table more than half full.

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