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Preconference Workshop 3

***COVERAGE FOR CONSTRUCTION DEFECTS:
THE FUNDAMENTALS***

Presented by

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Mr. Meredith is a copresenter for Monday's Preconference Workshop 3, "Insurance for Construction Defects." He formed his own insurance coverage practice in Larkspur, California, in September 1991, after serving as partner in the San Francisco firm of Farella, Braun & Martel. He practices exclusively in the area of insurance coverage, with a primary emphasis on general liability coverage issues. The majority of his practice involves the insurance coverage available for construction defects.

Mr. Meredith is most widely known for his expertise in the area of construction defect coverage. This extensive coverage experience includes his successful argument before the Fourth District Court of Appeal in *Maryland Casualty Co. v Reeder*, 222 Cal App 3d 961 (1991), on behalf of the insureds. The Court of Appeal affirmed the breadth of the coverage provided to developers and general contractors through broad form property damage coverage in commercial general liability insurance policies. The opinion is generally regarded as a landmark decision concerning such coverage. Shortly thereafter, Mr. Meredith argued similar broad form property damage coverage issues before the Second District Court of Appeal in *State Farm v Dean* on behalf of the insureds and again prevailed against the insurers in an unpublished decision.

Mr. Meredith has developed substantial contacts with insurer representatives and outside counsel. Local Special Masters often refer clients to him for assistance in raising the insurer contributions required to settle major litigation. In addition, Mr. Meredith has served as Special Master and mediator in numerous Northern California cases involving insurance disputes.

Mr. Meredith has participated in more than 400 settlements of major construction litigation as coverage counsel for the developer or general contractor. His primary function in such cases is to work with the insurers and defense counsel to maximize the insurer funds available for the ultimate resolution of the action. This includes working with the insurers for subcontractors and others who provide additional insured or contractual indemnity coverage. Mr. Meredith is well known and respected by the insurers and is often able to use his reputation to establish shortcuts to the desired goals.

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Notes

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COVERAGE FOR CONSTRUCTION DEFECTS: THE FUNDAMENTALS

***Craig S. Meredith
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CGL COVERAGE FOR CONSTRUCTION DEFECTS

I. Introduction

- A. Construction defect litigation continuing to grow, especially in condominium and single family home construction, but expanding into apartments, hotel, resorts and other construction.
- B. Anti-construction defect litigation statutes, such as right to repair statutes, seem to have little effect in stemming the tide.
- C. Insurance market is still quite hard, with both higher premiums and more restrictive coverage for developers, general contractors, subcontractors and suppliers.
- D. A thorough understanding of the CGL coverage that may be available for construction defects is essential to everyone in the construction industry.

II. Distinction Between CGL Claims and Other Types of Construction Defect Claims

- A. CGL—Covers the potential liability to third parties for property damage or bodily injury resulting from faulty construction
- B. Builders Risk/Course of Construction
 - 1. First party coverage for damage that may occur during construction.
 - 2. May or may not name general contractor and subcontractors as additional insured.
 - 3. In homebuilding context, one claim can trigger both builders risk and CGL coverage; for example, where damage has occurred in sold homes (CGL claims) and homes still under construction (builders risk claim).
- C. Property Insurance
 - 1. First party coverage for completed buildings
 - 2. Some forms do provide limited coverage for damage resulting from construction defects—paid claims often result in the carrier's subrogation claim against contractors

III. Caution—READ THE ENTIRE POLICY

- A. No longer have the luxury of assuming that you know the policy wording.
- B. Many carriers do still use the ISO's CG0001, but then modify it substantially with manuscript endorsements.
- C. Many carriers have abandoned the CG0001 in favor of their own specially drafted forms—be careful, some look just like the CG0001!
- D. Manuscript endorsements, even those on the same topic, vary widely. "No two known loss endorsements look alike!"

IV. Recent Development in Types of CGL Coverage for Construction Defects

- A. The old standard —"occurrence" forms
 - 1. Cover property damage ("p.d.") or bodily injury ("b.i.") that occurs during the policy period.
 - 2. Generally irrelevant when the construction took place.
 - 3. In most states, generally irrelevant when the injury was discovered.
 - 4. Results in the "tail" problem—each policy covers the building being constructed in the policy period plus all of those constructed in the past within the period of the statute of repose. Some claims have no statute of repose, so exposure is potentially infinite.
- B. "Modified" occurrence coverage
 - 1. Purports to cover p.d. or b.i. that occurs during the policy period, but adds a number of restrictions such that the coverage cannot truly be called "occurrence" -based coverage.
 - 2. One example form
 - a. purports to cover p.d. and b.i. that occurs during the policy period
 - b. then adds the following: (1) must first occur during the policy period (2) must be caused by an occurrence during the policy period (3) must not be caused by work performed prior to policy period.
- C. Wraps
 - 1. Generally cover the developer, general contractor and all tiers of subcontractors; may or may not cover designers, engineers or suppliers.
 - 2. A necessity in some markets. For example, in California and Nevada, subcontractors cannot obtain their own CGL coverage for condominiums and townhomes. These projects can only be insured through wraps.

- 3. Unless modified, do provide coverage during construction period, resulting in potential conflicts or issues with builders risk carrier
 - 4. Can be project specific or “rolling” (covers buildings or homes in many projects so long as first close of escrow was in policy period)
- D. Close of escrow coverage with statute of repose or limitations extensions
- 1. Covers b.i. or p.d. arising from all homes that close escrow during policy period for the policy period plus some extension of time.
 - 2. Extension can be general (“until the expiration of the applicable statute of limitations or repose”) or specific (“for a period of 10 years after the first close of escrow”).
 - 3. One form is claims made—covers b.i. or p.d. arising from a home that first closed escrow during policy period so long as claim is first made within 10 years of first close escrow.
 - 4. Can be wrap or non-wrap.
 - 5. Solves the “tail” problem—underwriter has more certainty as to what risk is being written.
- E. “Tail” or “reservoir” policies
- 1. Generally a necessity when a builder switches from occurrence coverage to close of escrow or project coverage—need “tail” or “reservoir” coverage for prior construction.
 - 2. Cover homes that closed escrow prior to the policy period for a fixed extended period or until the expiration of the applicable statute of limitations or repose.
 - 3. Generally made excess to any other available coverage—intended to be the “coverage of last resort.”
- F. Project policies
- 1. Cover liabilities arising from a specific project, generally with a fixed policy period extension or an extension for the “applicable statute of limitations or repose.”
- G. Warranty policies
- 1. Issued with a companion “warranty” that must be given to the buyer at the time of sale.
 - 2. Policy covers most of the builders obligations under the warranty.
 - 3. Can be wrap or non-wrap.
- V. Significant Coverage Issues that Arise in Virtually Every Claim**
- A. In most states, it is the insured’s burden to prove that the claim falls within the insuring agreement, generally that p.d. or b.i. occurred during the policy period and was caused by an “occurrence.”

- B. Once insured has met this burden, it is the carrier's burden to prove that the claim is not covered, either totally or partially, by one or more exclusions.
- C. Insuring Agreement Issues (insured's burden of proof)
 - 1. Has "property damage" occurred?—in general, defined as physical injury to tangible property, including loss of use thereof, or, loss of use of tangible property not physically injured.
 - a. carriers argue that the policy covers only "resultant property damage", that is, physical injury caused by the defect, but not the defect.
 - b. typical disputed issues
 - 1) structural claims
 - 2) fire protection issues
 - 3) code violations
 - 4) the repair of the defect—but note the "legally obligated to pay as damages because of 'bodily injury' or 'property damage'" language—the insured's liability extends not only to the resultant physical damage, but also to the repair of the defect
 - 5) incorporation of defective materials
 - 2. When did the "property damage" occur?
 - a. generally non-controversial for instantaneous occurrences (but there can be exceptions).
 - b. more difficult for continuous, progressively worsening damage that spans several policy periods.
 - 1) clearly the carrier on the risk when the damage was discovered is on the hook, but what about prior carriers.
 - 2) generally a matter of proof—use customer service records and expert testimony to show that damage was occurring during prior policy periods, even though undetected.
 - 3. Has bodily injury occurred?
 - a. generally non-controversial due to broad definition of "b.i."—"bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any times."
 - b. What about "emotional distress" claims?

4. When did the bodily injury occur?
 - a. more difficult with continuous injuries than with instantaneous issues.
 - b. note “family mold claims” —different children born at different times trigger different policies.
 5. Was the injury caused by an “occurrence”?
 - a. generally defined as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”
 - b. generally, the focus is on whether the consequences were foreseen or expected, not whether the act of creating the defect was expected.
 - c. majority rule is that the typical construction defect is an “accident” within the meaning of “occurrence.”
 6. Are there “known loss” or “progressive damage” exclusionary issues within the insuring agreement?
 - a. Restrictions on coverage for known losses or progressive damage were originally included only in exclusions—burden on carrier to show that loss was known to the insured, or that damage began prior to policy period.
 - b. Some carriers now put these restrictions in the insuring agreement—burden on insured to show it didn’t know of damage prior to the policy period, or that damage did not first occur prior to policy period.
- D. Exclusion issues (burden of proof on carrier).
1. The “property owned” exclusion—no coverage for damage to property “you” own
 - a. applies only to property owned by the named insured.
 - b. must analyze from the perspective of each named insured. For example, what if developer and general contractor are separate entities, but both are named insureds?
 2. The “property alienated” exclusion—no coverage for property that “you” have “alienated” (“sell, give away or abandon”)
 - a. as with property owned exclusion, must analyze each named insured separately.
 - b. 1986 ISO form clarified that exclusion does not apply to “your work”, but only if the premises “were never occupied, rented or held for rental by you”—big problem for, e.g., builders of apartments, or condo—converters who hold property and later sell to third parties. May not fit into exception to exclusion.

3. Exclusion j(5)—precludes coverage for property damage to “that particular part” of property on which “you” or your subcontractors are working.
 - a. applies only to “that particular part” on which you are working.
 - b. applies only to damage that occurs while operations are actually taking place.
4. Exclusion j(6)—precludes coverage for “that particular part” that must be repaired or replaced because, “your work” was incorrectly performed on “it.”
 - a. does not apply to completed operations
 - b. applies to work of general contractor and its subcontractors
 - c. applies only to “that particular part”
5. Exclusion l—property damage to “your work” within the “products-completed operations hazard.”
 - a. applies only to damage that occurs after the property has been abandoned or after “your work” on the project has been completed.
 - 1) when “your work” is completed varies depending on the role of the insured.
 - 2) for a subcontractor, focus is on when all of the work called for the subcontract has been completed.
 - 3) for a developer or general contractor, focus is on when the work has been placed into its intended use by any party other than the developer or general contractor.
 - b. exception applies if the damaged work or the work out of which the damage arose was performed on behalf of the insured by a subcontractor.
 - 1) thus, general contractor could have coverage for damage for which a subcontractor may not, for example, a plumber may not have coverage for corroded, leaking pipes but the general contractor would.
 - 2) but, where subcontractors employ sub-subcontractors the subcontractor coverage may be broadened.
6. Exclusion k—property damage to “your product”—mainly a problem for suppliers of products, such as windows, water heaters, HVAC units, etc.
7. Exclusion m—the “impaired property” exclusion
 - a. precludes coverage where property cannot be used because it incorporates defective, deficient or dangerous products or work.
 - b. for the most part, does not apply to general contractors because “impaired property” is defined as property “other than ‘your work’.”

- 8. Exclusion n—precludes coverage for any loss to “your product,” “your work” or “impaired property,” if “the product, work or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it.”
 - a. potential problem in product class actions, such as the Consolidated furnace class action.
 - b. some controversy over whether exclusion applies only if there is an official governmental recall.

- 9. Known defect/progressive damage exclusions.
 - a. generally found in non-standard manuscript exclusions.
 - b. known defect—precludes coverage for any defect or damage known prior to inception of policy period.
 - 1) known to whom?; can be known to named insured’s “control group” or to “any persons.”
 - 2) what must be known—the damage? the cause of the damage?
 - 3) when is notice of a defect in one house or area of a building notice of that defect in all homes or areas?
 - c. progressive damage—precludes coverage for damage that first began prior to policy period, regardless of knowledge of that defect or damage.
 - 1) must first show that the damage is of a progressive nature, then that it began prior to policy period.
 - 2) must do so for each defect.

- 10. Mold exclusions—now on virtually every policy
 - a. non-standard manuscript endorsements—must read carefully.
 - b. some are vague and subject to attack. For example, an exclusion for damage “resulting from” mold might exclude the b.i. claim, but not the p.d. claim. The p.d. doesn’t result from the mold, the mold “results from” the water intrusion.
 - c. in any event, even with a mold exclusion the carrier will have to defend, and to some extent indemnify for, the p.d. claims because every mold case is also a water intrusion case.