

Workshop L

Wednesday, November 9, 9:00 a.m.–noon

***COVERAGE FOR CONSTRUCTION DEFECTS:
AN OXYMORON IN 2005?***

Presented by

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For the past several years, contractors have seen their coverage for construction defects change dramatically. These changes have been fueled both by the insurers that write the coverage and the courts that interpret it. Insurers have slowly chipped away at contractors' coverage by adding numerous policy exclusions and placing other restrictions on coverage. The courts have compounded the problem with inconsistent interpretations of coverage, which reduce contractors' confidence in the coverage they believe they have. This two-part session will provide an overview of how both the insurance market and the legal system are responding to the issue of construction defects. See how recent court decisions—including four major state supreme court decisions—come to radically different conclusions with respect to issues such as the definition of "occurrence," the "your work" exclusion, and the business risk doctrine in defective construction cases. Attendees will leave with a better understanding of where the insurance market is on this issue and how to argue for coverage in the event of a coverage dispute.

**This year's Gary E. Bird Horizon Award winner will be named at noon
in the Grand Ballroom 114–115.**

5 reasons

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1

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2

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3

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5

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CNA

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Jeffrey D. Masters
Partner
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Mr. Masters is one of the presenters for Workshop L, "Coverage for Construction Defects: An Oxymoron in 2005?" on Wednesday morning. He is a partner in the Litigation Department and co-chair of the Development Risk Management Practice Group at Cox, Castle & Nicholson LLP.

He represents developers, homebuilders and lenders in complex insurance coverage, construction defect and real estate litigation matters. He also has extensive experience structuring insurance and risk management legal programs for projects of all sizes.

Mr. Masters is a frequent lecturer for real estate industry groups such as the Building Industry Association (BIA), PCBC, the National Association of Home Builders (NAHB), Urban Land Institute and the International Risk Management Institute (IRMI). He is coauthor of the instructional materials for NAHB's educational course, "Risk Management and Insurance for Building Professionals" (2003). He authored the chapter on "Exculpation, Indemnification and Insurance" in CEB's commercial leasing series practice guide, *Office Leasing: Drafting and Negotiating the Lease*. His articles and commentary on real estate insurance, liability defense and risk management have appeared in the *Wall Street Journal*, the *Los Angeles Times*, the *Los Angeles Business Journal*, *Builder and Developer*, *Multifamily Executive*, *Professional Builder*, *Big Builder*, *California Real Estate Journal*, *The Risk Report*, *Contractual Risk Transfer* (IRMI), and in various publications of the California Continuing Education of the Bar (CEB).

He serves as a member of the California Building Industry Association (CBIA) Construction Dispute Resolution Task Force. He also served as a technical consultant on *Broad Form Property Damage Coverage* (Third Edition) published by IRMI and on *California Liability Insurance Practice: Claims and Litigation* (California Continuing Education of the Bar).

Mr. Masters is a graduate of UCLA School of Law and UCLA Anderson Graduate School of Management.

Karen A. Reutter
Senior Vice President
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Ms. Reutter is one of the presenters for Workshop L, "Coverage for Construction Defect: An Oxymoron in 2005?" on Wednesday morning. She has extensive experience in the risk management and insurance industry, beginning her career at International Risk Management Institute, where she was responsible for content and development of reference material and books for the construction and risk management community. She was specifically responsible for *Construction Risk Management* and *Risk Financing* as well as other industry publications and speaking engagements.

She joined St. Paul Companies in 1994 where she worked as a senior account underwriter within the Construction practice in St. Paul's home office. She moved quickly into product development, strategy, and planning for the Construction practice and later for the corporation overall. Her work at St. Paul Companies included construction market research and product development while located in Johannesburg, South Africa, and Bermuda. Ms. Reutter left the St. Paul in 1999 as a senior officer of the corporation and joined the Zurich Construction staff at its home office in Minneapolis as national director.

While at Zurich, Ms. Reutter was responsible for national marketing, large account management, product development, and operations/process redesign. She has specific experience with home builder risks and products as well as subcontractor default insurance. She has a background in captives and alternative risk financing solutions. Ms. Reutter joined the Willis National Construction team in January 2002 as senior vice president based in Nashville and is now based in Minneapolis.

At Willis, Ms. Reutter is part of the national construction practice team and is responsible for assisting local office efforts throughout the nation in sales and marketing; large account management, including program structure and coverage design; national insurer relationships; planning; and strategy. In addition, she is the national leader for Willis's Homebuilder Practice and in this capacity manages and directs production of home builder and related business for Willis, develops insurance capacity and services, and leads efforts in solution development for this client base.

She holds master and bachelor of business administration degrees from the University of North Texas and has also earned the Chartered Property and Casualty Underwriter (CPCU) and Associate in Risk Management (ARM) professional designations.

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Mr. Wielinski is one of the presenters for Workshop L, "Coverage for Construction Defects: An Oxymoron in 2005?" on Wednesday morning. He is a principal in the Dallas-Fort Worth office of Cokinos, Bosien & Young.

Mr. Wielinski practices in the areas of construction, insurance coverage, and risk management. As a result, Mr. Wielinski has advised clients, and litigated and appealed insurance coverage claims involving defective workmanship for nearly 25 years. He is admitted to practice before the courts of the states of Texas and Minnesota, the U.S. Supreme Court, U.S. Fifth Circuit Court of Appeals, and other state and federal courts.

Mr. Wielinski is the Immediate Past Chair of the Insurance Law Section of the State Bar of Texas. He serves as the Chair of the Construction Insurance Subcommittee of the Construction Law Committee of Defense Research Institute and also on the Risk Management Committee of the Associated General Contractors of America. He is a member of the ABA Forum Committee on the Construction Industry and the Insurance Coverage and Construction Committees of the ABA Litigation Section. He received his B.A. degree from St. John's University and his law degree from the University of Minnesota.

Mr. Wielinski regularly lectures to construction, insurance, and legal groups on insurance coverage and risk management issues. He is the author of *Insurance for Defective Construction: Beyond Broad Form Property Damage Coverage*, published by IRMI, as well as numerous other publications for insurance, construction, and legal organizations. He is also the coauthor of *Broad Form Property Damage Coverage*, Third Edition, and *Contractual Risk Transfer: Strategies for Contractual Indemnity and Insurance Provisions*, which are also published by IRMI.

COVERAGE FOR CONSTRUCTION DEFECTS: AN OXYMORON IN 2005?

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I. Overview of Broad Form Property Damage Coverage

- A. Purpose and intent behind the coverage
- B. Evolution of the coverage from the 1973 ISO forms to the present

II. The "Occurrence" Definition

- A. Is defective construction an "occurrence"?
- B. Compare recent cases reaching differing results
- C. Necessity of property damage beyond the work?

III. The Economic Loss Doctrine and the Definition of "Property Damage"

- A. Property damage as economic loss argument
- B. Liability defense versus coverage defense

IV. The Incorporation Doctrine and the Definition of "Property Damage"

- A. Does incorporation of a defective component result in "property damage" to the larger structure?
- B. Compare recent cases reaching differing results

V. Exclusion L: Damage to "Your Work"

- A. Does Exclusion L restore coverage in construction defect claims where the work was performed by a subcontractor?
- B. Compare recent cases reaching differing results

VI. Demise of the Business Risk Doctrine?

- A. Under the "business risk" doctrine, some courts have concluded that the CGL policy is not a performance bond and should not cover the insured's liability to make good faulty work, even if the claim involves otherwise covered property damage and the work was performed by a subcontractor. The business risk doctrine has led to widespread confusion and frequently incorrect results in construction defect cases.
- B. Compare cases reaching differing results, including the Minnesota Supreme Court's interpretation of the 1986 forms, in which the court rejected the business risk rule where a general contractor was required to replace the defective work of a subcontractor. *Wanzek Construction, Inc. v. Employers Insurance of Wausau*, 679 N.W.2d 322 (Minn. Sup. Ct. 2004) (business risk doctrine inapplicable to the interpretation of CGL policies; instead, coverage must be determined by specific terms of policy).

VII. Beyond the Business Risk Doctrine?

- A. Is the "business risk doctrine" still relevant in light of current "occurrence" and "property damage" arguments against coverage?

VIII. Other Recent BFPD Cases and Their Implications

- A. Other recent BFPD cases
- B. Synthesis of arguments from the latest cases
- C. Can the divergent cases be reconciled? Are there any clear rules when dealing with BFPD and construction defect cases?
- D. New policy language and endorsements as limitations on coverage

Coverage for Construction Defects: An Oxymoron in 2005?

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25th IRMI Construction Risk Conference
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Overview of CGL Policy Construction

- During past 30 years, coverage has expanded for construction-related property damage claims by narrowing exclusions, *notwithstanding recent trends*
- Coverage narrowed via exclusions
- Broad insuring agreement
 - “Property Damage”
 - “Occurrence”

2

1973 CGL Exclusions (emphasis added)

- (n) Property damage to the ***named insured's*** products arising out of such products or any part of such products;
- (o) 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;

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1973 CGL Policy

- Courts broadly interpreted exclusions generally denying coverage for damage to work
- Issues involved denying coverage for property damage due to insured's work or work performed by subcontractors
- Issues involved in denying coverage for *all work*
- No delineation between completed operations and course of construction

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1976 – BFPD Endorsement

- Intended to address the courts’ broad denial of coverage for construction-related risks
- Endorsement for additional premium
- Intended to narrow exclusions of ’73 form and provide some coverage for inadvertent construction defects or property damage

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1976 – BFPD, Continued

- Specifically addressed the following:
 - “That Particular Part”
 - Delineated between work by insured and work performed by subcontractors
 - Delineated between ongoing operations and completed operations
- Continued interpretation confusion
 - Centered on the “faulty workmanship” exclusion

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1986 CGL

- Attempted to clarify key construction-related coverages associated with the 1973 and 1976 forms
- Specifically states that property damage arising from work performed on the insured's behalf is covered
 - Exception to the “damage to your work” exclusion

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1986 CGL, continued

- Specifically addressed timing issue related to damage to “that particular part”
 - Distinguishes that there is coverage for the particular part in completed operations, that the “particular part” exclusion applies during course of construction
- Distinguishes that the product exclusion does not apply to a building or construction project by way of excepting “real property” from exclusion

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1986 CGL Exclusions, emphasis added

- J. “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.

- “Your Product” means:
 - (a) Any goods or products, *other than real property*, ...

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Construction Defect/“Business Risk” Coverage Issues

- Breach of contract as “legal obligation”
- Construction defect as “occurrence”
- Time, number and trigger of “occurrence”
- Construction defect as causing “property damage”
- Construction defect as “business risk” – exclusion of property damage to the work

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Insuring Agreement

“We will pay those sums that the insured becomes *legally obligated* to pay *because of* ‘bodily injury’ or ‘property damage’ to which this insurance applies.”

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Insuring Agreement

- Road map for coverage
- “Legally obligated” – does it include breach of contract?
- Does it require a judgment against the insured?
- Significance of “because of” – delay damages, soft costs, liquidated damages . . .

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Definition of Occurrence

“Occurrence” means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

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Expected or Intended Exclusion

- (a) "Bodily injury" or "property damage" expected or intended from the standpoint of the insured.

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Definition of Occurrence

- Traditional: property damage neither expected nor intended from the standpoint of the insured is an accident.
- Recent: Property damage arising out of an insured contractor's breach of contract or warranty is natural and foreseeable and not an accident.

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Traditional Occurrence Cases

- *American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004)
- *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App.—Dallas 2004, pet. filed)

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“New” Occurrence Cases

- *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 2004 WL 1775571 (S.C. Aug. 9, 2004)
- *Groves v. Erie Ins. Co.*, 333 F.Supp.2d 568 (N.D.W.Va. 2004).
- *Hartrick v. Great American Lloyds Ins. Co.*, 62 S.W.3d 270 (Tex. App.—Houston [1st District] 2000, no pet.)

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Occurrence –The Myth of Third-Party Property Damage

- *Federated Mutual Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720 (5th Cir. 1999)
- *Auto-Owners Ins. Co. v. Home Pride Cos.*, 684 N.W.2d 571 (Neb. 2004)

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Definition of Property Damage

Physical injury to tangible property, including loss of use of that property;

- or -

Loss of use of tangible property that has not been physically injured.

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***Definition of Property
Damage –Physical Injury to
Tangible Property***

- *Travelers Insurance Co. v. Eljer Manufacturing, Inc.*, 757 N.E.2d 481 (Ill. 2001)
- Tangible property suffers a 'physical injury' when the property is altered in appearance, shape, color or another material dimension

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***Definition of Property Damage
The Economic Loss Rule??***

- A claim for negligence is not available when the only loss or damage is to the subject matter of the contract.
- Regarded as economic loss.
- No exclusion for "economic loss."

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Definition of Property Damage
The Economic Loss Rule

- Counter: economic loss rule determines the remedy available to the claimant: contract or negligence
- Economic loss rule does not determine coverage under the CGL policy
- Must apply the terms of the CGL policy

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Definition of Property
Damage
The Economic Loss Rule??

- *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 335 F.Supp.2d 754 (W.D.Tex. 2004)

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Definition of Property Damage The Economic Loss Rule

- *American Family Mutual v. American Girl*, 673 N.W.2d 65 (Wis. 2004)
- *Commercial Union Ins. Co. v. Roxborough Village Joint Venture*, 944 F.Supp. 827 (D.Colo. 1996)

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The Incorporation Doctrine and the Definition of Property Damage

- Does incorporation of a defective component result in “property damage” to the larger structure?
- *Shade Foods, Inc. v. Innovative Product Sales & Marketing, Inc.*, 78 Cal.App.4th 847 (2000)

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- *Watts Industries, Inc. v. Zurich American Ins. Co.*, 121 Cal.App.4th 1029 (2004)
- *F&H Construction v. ITT Hartford Ins. Co.*, 118 Cal.App.4th 364 (2004)

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Your Work Exclusion

This insurance does not apply to:

- I. '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.

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Subcontractor Exception

- Major inroad to the “Business Risk Doctrine”
- “Subcontractor” is broadly construed to include many entities
- Key to completed operations coverage
- Source of classic judicial statements of coverage for defective work

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Defective Work as Completed Operation

The work is complete at the earliest of:

- When all of the work called for in your contract has been completed.
- When that part of the work done at the job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

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Traditional Cases— Subcontractor Exception

- *American Family Mutual Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004)
- *J.S.U.B., Inc. v. United States Fire Insurance Co.*, 2005 WL 623234 (Fla.App. March 18, 2005)
- *Wanzek Construction v. Employers Ins. of Wausau*, 679 N.W.2d 322 (Minn. 2004)

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Demise of the Business Risk Doctrine?

- The business risk doctrine: CGL is not a performance bond and should not cover insured's liability to make good faulty work
- *Bor-Son* and *Knutson* cases (Minn. Supreme Court)
- Result: confusion and incorrect results

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Demise of the Business Risk Doctrine?

- The doctrine rejected: *Wanzek Construction, Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322 (Minn. 2004)
- Highly significant because all decisions which deny coverage based on the business risk doctrine now are questionable authority

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Restrictive Endorsement CG 22 94

Exclusion 1. of Section I – Coverage A –
Bodily Injury and Property Damage
Liability is replaced by the following:

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.”

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Operations Exclusion

j.(5) That ***particular part*** of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the property damage arises out of those operations.

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Faulty Workmanship Exclusion

j.(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.'

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Exclusions j(5) and (6) “Operations” and “Particular Part”

- *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 2005 WL 1123759 (W.D. Tex. April 21, 2005)

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Restrictive Endorsements Residential Exclusions

- Excludes “residential” construction as defined in the endorsement
- Varies from insurer to insurer
- Apartments, assisted living, condos, co-ops, hospitals, hotels, military housing, nursing homes, single family, dorms, townhouses, tract housing
- If no coverage for named insured, no coverage for upper tier additional insureds

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Restrictive Endorsements

EIFS Exclusions

- Excludes coverage for damage arising out of building construction, maintenance or repair using products, techniques, or operations commonly known as "Exterior Insulation and Finish Systems" (EIFS).
- Vary between insurers
- Try to restrict to actual EIFS exposure

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Restrictive Endorsements

Mold Exclusions

ISO CG 21 67 12 04:

"Bodily injury" or "property damage" which would not have occurred, in whole or in part, but for the actual, alleged or threatened inhalation of, ingestion of, contact with, exposure to, existence of, or presence of, any "fungi" or bacteria on or within a building or structure. . .

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Restrictive Endorsements

Mold Exclusions

Any loss, cost or expenses arising out of the abating, testing for, monitoring, cleaning up, removing, containing, treating, detoxifying, neutralizing, remediating or disposing of, or in any way responding to, or assessing the effects of, "fungi" or bacteria, by any insured or by any other person or entity.

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Restrictive Endorsements

Mold Exclusions

"Fungi" means any type or form of fungus, including mold or mildew and any mycotoxins, spores, scents or by-products produced or released by fungi.

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Alternatives and Solutions— Legislative Restrictions

- Right to repair laws – 27 states
- Notice requirements and deadlines
- Mediation and mandatory arbitration with original homeowners
- Homeowner may still retain right to sue
- California – Senate Bill 800
- Nevada – Senate Bill 241

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Alternatives and Solutions – Wrap-Up Programs

- OCIP versus CCIP
- Project specific or rolling
- Original impetus cost savings
- Economies of scale affect feasibility
- General liability versus workers comp
- Means to provide completed operations coverage to lower tiers

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Alternative Insurance Products

- Rip and tear policies
- Construction defect policies or endorsements
- Gap policies
- Indemnity only policies
- CPL policies

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Alternatives and Solutions – Surety/Insurance Products

- Subguard as means to control construction defects
- Relies upon contractor's underwriting of subcontractors, participation in financing limits
- Companion liability insurance

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Alternatives and Solutions – Captives and Risk Retention Groups

- Spreading of the risk among members with closely aligned interests
- May use fronting policies
- Offshore companies
- Long-term members with a share of the risk

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Alternatives and Solutions – Warranty Funds

- Contributions from owner/developer and contractor
- Source of funding for warranty repairs
- Reduce incentive to sue

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Alternatives and Solutions – Quality Assurance/Quality Control

- QA/QC reduce probability of construction defects
- Front-end prevention
- Reduce number of repairs to be funded by insurance

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Notes

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