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A primer on insurance-coverage issues in construction-defect cases

KNOW THE INSURANCE POLICIES YOU ARE DEALING WITH BEFORE YOU WADE TOO DEEPLY INTO COMPLEX LITIGATION

Handling construction-defect lawsuits can be costly and time-consuming, which is why lawyers representing homeowners, property owners, or other plaintiffs in construction-defect cases need to be able to navigate the potential pitfalls in insurance policies that may (or may not) provide coverage for damages claimed these cases. An understanding of these policies and the issues that often arise may help lawyers better frame and handle their case to avail their clients of the maximum insurance benefits available.

There are a number of common challenges that often arise in construction-defect cases and insurance is interwoven into many of them.

Policy interpretation: Insurance policies can be complex and difficult to interpret, especially when they involve custom or manuscript language. This can make it challenging for the plaintiff's lawyers to determine whether a particular policy provides coverage for a particular aspect of damage in a construction defect claim.

Coverage disputes: Even when insurance coverage exists, insurers may dispute the extent of coverage. This can create significant challenges depending on the damages being sought in a case.

Multiple parties and insurers: Even the most straightforward construction-defect lawsuits can involve multiple parties, including project owners, general contractors, subcontractors, design professionals, and insurers. Coordinating with all these parties and their insurers can be time-consuming and challenging, particularly when there are disputes about coverage or liability. Even the most basic and necessary steps in litigating a case – e.g., site inspections, written discovery, depositions – can be much more overwhelming than in a straightforward one-versus-one case.

Settlement negotiations: Given the number of parties, construction-defect lawsuits often involve extensive settlement negotiations and multiple mediation sessions before a resolution can be reached. Depending on the number of parties in the case, the nature and extent of the claimed defects, and the number of insurance carriers involved, mediation and settlement can be a grueling process fraught with expensive experts and endless finger-pointing.

Types of policies with potential coverage for construction defects

At the outset, it is important to note that insurance policies and their coverage can vary widely depending on the specific policy language and the nature of the construction-defect claim. Listed below are some of the common types of policies which may afford coverage for claims raised in a construction defect lawsuit.

Commercial General Liability (CGL) Insurance: CGL policies are the most common policies that come into play when making a construction-defect claim. CGL insurance policies provide coverage for a broad range of liability claims, including those related to construction defects. Depending on the policy, CGL insurance may cover the costs of legal defense, settlements, and judgments. Most often, a CGL policy will have coverage with limits of $1 million per occurrence, $2 million in aggregate and $2 million product/completed operations. However, plaintiff's counsel should always request a copy of the policy (at least the declarations page of the policy) to confirm the limits.

Professional Liability Insurance: Also known as errors and omissions (E&O) insurance, professional liability insurance provides coverage for claims arising from errors or omissions in professional services provided by construction professionals, such as architects, engineers, and contractors.

Builder's Risk Insurance: Builder's risk insurance is designed to provide coverage for damage to buildings and structures during the construction process. In some cases, these policies may also provide coverage for claims related to construction defects.

Homeowner's Insurance: Homeowner's insurance policies may provide coverage for construction defects that result in property damage or personal injury. However, coverage under homeowner's insurance may be limited and may not cover all types of construction defects.

Umbrella Insurance: Umbrella insurance provides additional liability coverage beyond the limits of other insurance policies. Depending on the policy, umbrella insurance may provide coverage for construction-defect claims.

Common coverage issues

The "property damage" requirement

Typical liability policies obtained by the parties involved in a construction project are only triggered when there is "property damage." The mere presence or use of defective materials or "work" by the insured does not constitute "property damage."

For purposes of liability insurance coverage, California law provides that "property damage" can be established when the claimed damage results from the incorporation of a defective component or product into a larger structure, as long as the defective component causes physical harm to other parts of the system. (*F & H Constr. v. ITT Hartford Ins.* Co. (2004) 118 Cal.App.4th 364, 371-372.) While these liability policies are not intended to cover a contractor's faulty work, coverage is triggered "when the insured's defective materials or work

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cause injury to property other than the insured's own work or products." (*Id.* at 373.)

In *F & H Constr.*, *supra*, the court determined that the expenses related to modifying pile caps that were installed by the insured and resulted in lost compensation for completing the project early were "intangible economic damages," and not "property damage" that may be potentially covered.

In construction-defect lawsuits involving residential properties, some of the claims may be premised on the plaintiff's dissatisfaction with the finished product – e.g., they may find that the finishes look inferior or are unhappy with the methods used by a particular subcontractor or tradesman. Claims by a plaintiff that arise simply out of the fact that they are dissatisfied with the quality of the finished product – no matter how genuine or well-reasoned the dissatisfaction may be – do not meet the definition of "property damage" if there is no related physical harm.

In *St. Paul Fire & Marine Ins. Co. v. Coss* (1978) 80 Cal.App.3d 888, 896-97, the insurer had issued a CGL policy to a contractor who was hired to build a home to a homeowner's custom specifications (including specified materials). Near the completion of the project, a dispute emerged between the homeowner and the contractor regarding the quality of work being done. The homeowner argued that the contractor used defective materials and that the work was faulty – but could not point to any functional issues or property damage caused by the contractor. The Court of Appeal determined that the contractor's use of defective workmanship and materials resulted in an inferior product, but it did not necessarily constitute "property damage" under the liability policy. (*Id.* at 893.)

Lastly, consequential economic damages stemming from construction-defect claims will often not be covered under the typical liability policy. Reiterating the "property damage" requirement under California law for coverage under construction policies, the Ninth Circuit held in *N.H. Ins. Co. v. Vieira* (9th Cir. 1991) 930 F.2d 696, 698-99, that loss of property value resulting from improper installation of drywall does not meet the definition of physical harm of property to satisfy the "property damage" requirement. In other words, construction-liability policies will not cover economic items of consequential damages such as loss of use, loss of expected profits, and diminution in value.

Timing of damage trigger

Policies covering construction-defect claims have occurrence-based triggers. An occurrence-based policy covers losses that happen during the time the policy was in place, regardless of when the claim is made.

Even though it involved environmental claims, *Montrose Chem. Corp. v. Admiral Ins. Co.* (1995) 10 Cal.4th 645 is the seminal California case regarding the trigger of coverage in occurrence-based policies. In *Montrose*, the Court rejected a "manifestation of damage" trigger for insurance coverage and replaced it with a "continuous trigger of damage." In other words, whether there is coverage under an occurrence-based policy should depend on whether the damage was triggered during the policy period, as opposed to whether it manifested or became apparent during the policy period.

Relying on the reasoning in *Montrose,* the court in *Pepperell v. Scottsdale Ins. Co.* (1998) 62 Cal.App.4th 1045, held that the continuous-trigger approach should be used in third-party liability insurance cases involving construction-defect claims. In *Pepperell*, the property in question was finished in November 1988, with the developer having insurance coverage from May 1988 to May 1989. The property damage first became apparent in March 1991 – long after expiration of the policy. The insurer argued that there was no coverage "[s]ince it is alleged that the defects being claimed did not manifest themselves until on or about March 8, 1991, which was after the expiration of the policy. . ." (*Id.* at 1049.) The court rejected the insurer's stance. The court held that there was still a possibility for coverage within the insurer's policy period if it could be established that the damage was triggered (went into effect) during the policy period.

Based on the controlling cases, plaintiffs can still have their claims covered even if the damage manifests after the policy period, but it is important to remember that they must allege – and may ultimately have to prove – that the damage they are claiming was triggered during the policy period. Simply claiming that a product used in the construction project was inferior and deteriorated over time and led to damage may jeopardize the ability to obtain coverage for that damage.

CGL policies: Wrap vs. traditional

Liability in construction-defect cases is not always easy to determine. Given the sheer number of parties involved in even the simplest construction project, it is difficult to determine exactly who is responsible for exactly how much of the claimed damage. Ultimately, however, the buck stops with the party managing the project (typically the general contractor). Therefore, in an effort to avoid being saddled with all of the financial responsibility if something goes wrong, the general contractor on a project will require that everyone involved in the project have adequate CGL insurance coverage. This is accomplished in one of two ways: The traditional model is when the general contractor's contract with its subcontractors requires each subcontractor have their own CGL coverage. Alternatively, the general contractor will obtain what is called a "wrap policy" that covers everyone involved.

The traditional insurance model

In the traditional insurance model, the general contractor requires each subcontractor involved in the project to have their own insurance. All parties

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involved, including both subcontractors and the general contractor, are responsible for obtaining their own insurance coverage from the source of their choice.

Even though this model presents logistical hurdles in advancing your construction-defect case towards resolution, there are some advantages. Given that each defendant may be insured by a different carrier who is trying to shift liability away from their own insured, an adversarial relationship may be created *between* the various defendants (and their respective carriers). This will allow plaintiff's counsel to pit one defendant against another during negotiations and ultimately selectively settle – or at least threaten to settle – with individual parties. Settling with defendants with carriers that are being more reasonable is a very effective way to turn up the pressure on other defendants whose carriers are less willing to put adequate money on the table towards settlement, because they may fear the possibility of being the last one left holding the bag.

However, negotiating with multiple parties with separate carriers can sometimes feel like herding cats – especially when it is unclear who is ultimately responsible for the damages the plaintiff is seeking. Therefore, if trying to reach resolution through mediation, it is important to work with a mediator who is experienced with resolving construction-defect cases. An effective construction-defect mediator will often spare plaintiffs' lawyers the misery of being the lead cat-herder and will instead work with each carrier to allocate a portion of a global settlement figure to each party.

Wrap policy model

In a wrap-insurance setup, the project owner or developer purchases a single insurance policy that covers all parties involved in the construction project, including contractors, subcontractors, and design professionals. Wrap-insurance policies are commonly used on large construction projects, such as high-rise buildings or major infrastructure projects, but it is not uncommon to see them in residential or single-family home projects. The coverage provided by a wrap-insurance policy may be primary, meaning it would be the first policy to respond to a claim, or excess, meaning it would only provide coverage after other insurance policies have been exhausted.

The existence of a wrap policy can help to streamline the construction-litigation process for multiple reasons: First, a wrap policy often ensures that all parties involved in the project have adequate insurance coverage and the lawyer representing the property owner is not forced to name every party involved in the project as a defendant in the lawsuit. In other words, if the project is covered under a wrap policy and a named defendant points the finger at another subcontractor or party who has not been named as a defendant, the insurance carrier is less likely to argue that the damage attributable to the unnamed party is not covered under their policy. In contrast, under a traditional policy, the counsel appointed by the insurance carrier is more likely to seek to name as a cross-defendant the previously unnamed party or subcontractor in order to trigger coverage under that party's own policy. This may delay progress in the case, and create more logistical hurdles in working towards trial or resolution.

Second, a wrap policy will minimize the hurdles faced when trying to work up the case. One of the common challenges in a construction-defect case is the sheer number of parties in the litigation by virtue of the number of parties involved in the underlying construction project. Even in the most straightforward construction-defect case involving a small property and a single discrete form of damage (e.g., water intrusion due to inadequate waterproofing of windows), there will inevitably be multiple parties pointing fingers at each other (e.g., the framer who framed the windows, who blames the subcontractor who did the flashing, who blames the installers who installed the windows, who blames the general contractor who hired and oversaw everyone).

In the absence of a wrap policy, a plaintiff's lawyer will be dealing with multiple insurance carriers (and multiple sets of defense counsel) when litigating the case and working towards resolution. Even with the most cooperative group of counsel, dealing with multiple sets of law firms and carriers creates needless but unavoidable inefficiencies. This becomes painfully apparent when trying to coordinate a routine site inspection, a deposition, or mediation – all of which must be attended by scores of lawyers (each with multiple experts of their own). In a wrap-policy model with just one carrier and defense firm involved, these events can be set up with a couple of emails.

Third, since only a single carrier is involved in a wrap policy, resolution of the case may be significantly easier. Unlike a traditional policy, a wrap policy obviates the need for multiple cross-complainant's carriers to fight over allocation between defendants. Given that one carrier is handling the defense and indemnity of the whole case, even if multiple defendants are named in the lawsuit, mediating a construction-defect case where a wrap policy applies is more akin to mediating a straightforward case with one party on each side, as opposed to the grueling cattle call of separately negotiating with scores of defendants.

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