

**INSURANCE COVERAGE FOR
CLAIMS OF LATENT DEFECTS:
WHAT PROTECTION IS A BUILDER BUYING?**

**Prepared for
National Association of Home Builders**

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January 2015

Executive Summary

Homebuilders often do not know what coverage is provided by their general liability insurance policies until they are faced with a claim from a homeowner. Latent construction defect claims may be covered by a builder's general liability insurance policy if the defective work or defective material out of which the claim arises was performed or furnished by a subcontractor, and if the property damage caused by the latent defect took place (or in some states was discovered) during the period covered by the policy. The builder's insurance company has a duty to defend the builder against the homeowner's suit if there is even a potential that the homeowner's claim might be covered by the policy. In addition, a builder may be entitled to coverage for construction defect claims as an "additional insured" on its subcontractor's general liability insurance policy.

Introduction

The home building business, like most businesses, is fraught with risk. One of the many risks faced by a home builder is that, long after substantial completion, the builder will be required to repair its homes because of a latent defect resulting from a defective product used in construction or from faulty work by the builder or by a subcontractor. One of the ways builders attempt to avoid the risk of latent defect claims by homeowners is by purchasing general liability insurance. The purpose of this paper is to help builders understand what kind of claims for latent defects are covered by their liability insurance policies and what kind are not.¹

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A builder's general liability policy will cover claims against the builder for latent defects if the claim meets the requirements of the policy's "insuring agreement," and if the claim does not fall within any of the policy's several "exclusions" from coverage. The insuring agreement requires (i) that a claim be asserted against the builder for damages because of *property damage*; (ii) that the alleged property damage be caused by an "occurrence," i.e., an accident; and (iii) that the property damage take place *while the policy was in effect*. As discussed below, claims against builders for latent defects generally satisfy these requirements.

The exclusions in a general liability policy attempt to exclude from coverage losses that are viewed as "business risks," i.e. losses that are within the builder's effective control. Claims for latent defects generally do not fall within any of a liability policy's exclusions, with one important exception -- the exclusion for damage to the builder's work that is caused by the builder's work. As a result of this exclusion, the builder's general liability insurance policy might not cover claims against builders for the cost of repairing latent defects in the builder's work or in materials purchased by the builder directly. Such policies do, however, cover claims against builders for latent defects in the work or materials furnished by a subcontractor.

After a general discussion of latent defects and the role of liability insurance, this paper analyzes the terms of a modern general liability policy and explains why claims for latent defects based on the work or materials of subcontractors are covered by the policy. The paper also discusses the obligation of insurance companies to defend builders against

claims for latent defects, including the possibility that a builder may be insured for such claims as an “additional insured” on its subcontractor’s general liability insurance policy.

The Builder and Latent Defects

A latent defect is one that is not known to the builder at the time the home is substantially completed and that does not manifest itself until some time after substantial completion. Discovery of the defect may occur in a particular home because the product has begun to malfunction in that home, or because a sufficiently high number of such products have begun to malfunction in other homes that the product is deemed to be defective in all homes in which it has been installed. For example, building products such as fire retardant treated (“FRT”) plywood used as roof sheathing, polybutelene pipe used in chlorinated water systems, synthetic stucco cladding (“EIFS”), Omega sprinkler systems, and Chinese drywall have taken their place in the rogues’ gallery of building products that were discovered to be defective long after they were installed in the home. Although these ill-fated products caused little bodily injury or damage to other property, the need to repair or replace the product itself has given rise to millions if not billions of dollars in claims against builders. These claims were usually brought years after the final punch list items were completed and the buyer’s final payment was made.

Builders can be exposed to liability for latent defect claims by virtue of express contractual warranties or warranties implied by law. By such warranties, the builder guarantees that its home is built in a workmanlike manner and that the materials used in the home are reasonably free from defects. Various statutes, such as state consumer

protection statutes, can also give rise to lawsuits against a builder for latent construction defects.

Such warranties and statutes can impose liability on the builder for latent defects in a home whether or not the defect resulted from the fault or negligence of the builder. Like a big band leader, the builder is responsible not only for his own performance (e.g. Benny Goodman on the clarinet) but also for the performance of all its subcontractors -- the other members of the band. If the band's trumpet player is not performing well, or the trumpet is not tuned, it is Benny who will be booed. The crowd doesn't care whether the sour notes were Benny's "fault" or not. So, too, the builder will be liable for latent defects in its homes, whether or not the defect was within the builder's control.

The Role of Liability Insurance

The builder protects itself against claims for latent defects in two ways. First, the builder tries to do a good job and thereby prevent latent defects from happening. The builder buys its construction materials from reputable manufacturers or distributors, relies on the materials' warranties, inspects the materials for obvious defects prior to installation, and supervises the work of its employees during construction. The builder also tries to hire reputable and skilled subcontractors, to inspect their work during the course of construction, and to coordinate the work of the various subcontractors.

Second, the builder buys liability insurance.² The purpose of liability insurance is to protect the builder against liability for claims that are effectively out of the builder's control -- even though warranties in the construction contract or other laws may make the

builder liable for the resulting cost of repairs. Liability insurance policies try to draw a distinction between (i) “business risks,” which are viewed as being within the builder’s ability and responsibility to avoid and hence are not insurable because they are not accidental or fortuitous, and (ii) “insurable risks,” which are viewed as being accidental in the sense of being beyond the builder’s effective control.³

To be specific, the cost of repairing the builder’s own poor workmanship or the defective materials the builder has selected is generally viewed as an uninsurable “business risk,” because such repair costs are known (more or less) to the builder in advance and are within the builder’s effective ability to control through its skill and effective management of the construction process. Only if the builder’s poor workmanship or defective materials injure someone or damage property other than the home itself would the resulting claim be covered. The rationale is that the builder cannot effectively control the extent of injury to people or damage to other property that the builder’s defective work or materials may cause.

On the other hand, modern liability policies do provide coverage to the builder for the cost of repairing defective work or materials furnished by a subcontractor. This is true even if the claim against the builder alleges that the defect violates an express warranty in the construction contract. The rationale for coverage of claims growing out of a subcontractor’s work or materials is that a subcontractor’s performance is not within the builder’s effective control and hence presents an “insurable risk” rather than a “business risk.” Benny’s own sub-par performance on the clarinet is within Benny’s control and

would be a “business risk,” but the risk that Benny’s trumpet player will play poorly and get Benny booed is outside of Benny’s effective control -- and hence is an “insurable risk.”

To apply these principles, let’s say that a home’s siding falls off, injuring the next door neighbor, causing damage to the neighbor’s house, and requiring the owner of the home to replace the fallen siding. The neighbor’s claim against the home’s builder for bodily injury and for the cost of repairing the neighbor’s house would generally be covered by the builder’s liability insurance policy. But the owner’s claim against the builder for the cost of replacing the fallen siding would generally not be covered, unless the siding had been furnished and installed by the builder’s subcontractor. Claims against the builder for latent defects caused by a subcontractor’s work or materials are covered by the builder’s general liability policy. If a subcontractor has installed material purchased by the builder, coverage will depend on the actual cause of the latent defect. Unless the supplier of the material is itself viewed as a “subcontractor” (see below), the builder would be covered only if the latent defect resulted from the subcontractor’s installation rather than from a defect in the material itself.

The Terms of Builders’ General Liability Policies

Insurance companies generally sell liability insurance on a pre-printed, standardized form prepared by insurance industry organizations. The last major revision of this form that is relevant to claims for latent defects took place in 1986. Most current liability policies use the 1986 form or a later version of it.⁴ Whether claims against a

builder for the repair of specific kinds of latent defects will be covered by the builder's general liability policy depends on the application of the terms of the policy to the facts of the specific claim. We discuss below the particular terms of a standard liability policy that bear on claims arising from latent defects. The distinction between "insured risks" and "business risks" helps explain (but does not fully explain) the kinds of claims for latent defects that such policies cover.

A. The Insuring Agreement: We've Got You Covered

The heart of a standard general liability insurance policy is the "insuring agreement" in Section I of the policy. The insuring agreement spells out what the policy covers. It provides that the insurance company "will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies."⁵ The "property damage" referred to in the insuring agreement must be caused by "an occurrence."⁶ And the property damage must occur during the policy period.⁷

All claims against the builder that arise from (i) *property damage*, (ii) caused by an *occurrence*, (iii) where the property damage takes place *during the policy period*, are covered by the builder's liability policy, *unless* the claim falls within one of the policy's exclusions, or the builder fails to comply with the policy's conditions and (in most states) such non-compliance causes prejudice to the insurance company.⁸ As discussed below, claims against builders for latent defects generally satisfy these three requirements of the policy's insuring agreement.

1. Damages because of "property damage"

Coverage for a claim against a builder for the cost of replacing or repairing a latent defect, be it defective FRT plywood in a roof, defective synthetic stucco on a house, or faulty sprinklers in an attic, will depend in large part on whether the court views the claim against the builder as one for “damages because of . . . *property damage*,” i.e. “physical injury to tangible property” (the definition of “property damage”).⁹

The answer to the question of whether a defective component of the home has caused physical injury is relatively easy if the defective component has in fact damaged other parts of the structure (e.g. defective paint that has permitted corrosion, or defective synthetic stucco that has allowed water to damage a home’s wood substrate). The physical injury to tangible property in such cases is easy to see. But what if the defective component has caused no physical injury to the larger structure, e.g. no corrosion has yet resulted from the defective paint, or no water damage has occurred behind the defective synthetic stucco? The courts are divided on this issue. But many courts have held that the mere incorporation of a defective component part into a larger structure causes “physical injury” to the larger structure. These courts reason that the defective component “is physically linked with or incorporated into the building and therefore physically affects tangible property.”¹⁰

Note that the Insuring Agreement covers not just the cost of repairing the “property damage” but rather covers “those sums that the insured becomes legally obligated to pay *as damages because of* . . . ‘property damage’.” This agreement to pay for *damages*

because of property damage, not just for property damage, is important. For example, a home with defective synthetic stucco cladding may have caused only isolated instances of property damage (in the narrow sense) around a few windows, but a jury could award the complaining homeowner as damages all costs of removing and replacing the entire synthetic stucco system on the house, or the amount by which the entire house has diminished in value. The builder's insurer might argue that it is only liable to pay for the cost of repairing the property damage, i.e. the damaged portions of the house. Such an argument, however, incorrectly focuses on "property damage" and erroneously ignores the insurance company's obligation to indemnify the builder for all sums the builder is legally obligated to pay as *damages because of* property damage.¹¹

2. **Occurrence**

To be covered, the property damage must be caused by an occurrence, that is, by "an accident."¹² The accident need not be sudden. Rather, an accident includes "continuous or repeated exposure to substantially the same general harmful conditions." The key requirement for there to be an occurrence is that the property damage be fortuitous, i.e. neither expected nor intended from the standpoint of the insured.¹³ Thus, FRT plywood that deteriorates over several years of exposure to elevated temperatures in a roof would constitute an occurrence, i.e. an accident, as long as the builder did not know prior to installation that the FRT plywood would deteriorate.

Some courts have held that a claim based on property damage consisting solely of poor workmanship or defective materials is not an occurrence because such a claim does

not involve an accident, and hence the element of fortuity is lacking. Other courts hold that defective construction standing alone, without property damage, does not constitute an occurrence. The majority of courts, however, hold that defective construction that causes property damage does amount to an occurrence, i.e., is fortuitous, unless the insured builder intentionally performed defective work or knowingly used defective materials.¹⁴ This issue of the builder's intent or knowledge can be highly fact intensive and require a finding as to the contractor's subjective state of mind in performing work or installing a product. In general, however, the occurrence requirement should not bar coverage for a latent defect claim in the vast majority of cases.

Most courts, when confronted with this issue, have held that inadvertent property damage caused by construction defects is caused by an occurrence. For example, a 2009 federal court decided that the spread of mold from defective trusses constituted property damage caused by an occurrence within the meaning of the builder's insurance policy.¹⁵ In addition, several states have passed statutes requiring that property damage caused by construction defects be treated as resulting from an occurrence.¹⁶ A minority of courts, however, have taken the opposite position, concluding that property damage caused by construction defects does not result from an occurrence because the damage was not fortuitous.¹⁷

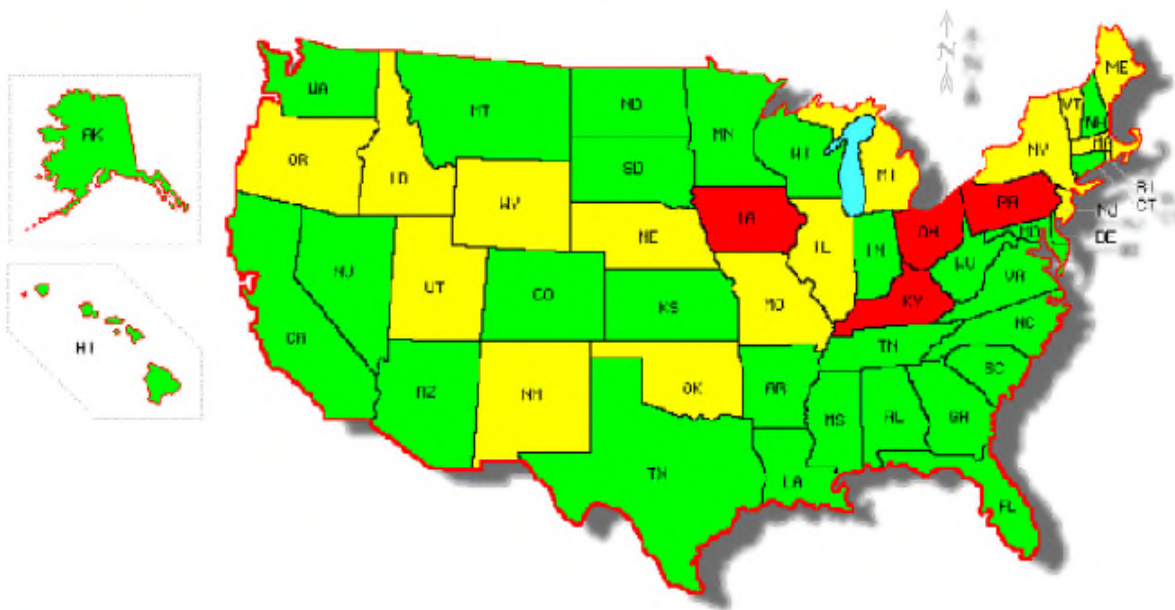
The following map shows which states have adopted the majority rule, i.e., property damage caused by construction defects constitutes an occurrence that is covered

by a general liability policy, and which states have either rejected the majority rule or have not clearly decided the issue:

Insurance for Construction Defects



- coverage (30 states)
- not addressed/mixed results (16 states)
- no coverage (4 states)



As of January 2015

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3. During the Policy Period

For a liability insurance policy to cover a claim against the builder, the alleged property damage must have taken place during the period of time the policy was in effect.

It does not matter when the claim is made or the builder is sued, as long as the property

damage occurred during the policy period. In the case of latent defects, determining exactly when the property damage took place can be difficult, especially where the property damage is gradual or progressive. For example, in the case of defective FRT plywood used as roof sheathing, does the property damage occur (i) when the defective (but not yet deteriorated) FRT plywood is first installed on the roof, (ii) when the deterioration begins, (iii) when the gradual deterioration has crossed some acknowledged threshold between insignificant and significant damage, (iv) at the point when the deterioration of the product is first discovered or became manifest, or (v) at all times that the product is deteriorating and hence is being “physically injured”?

Courts in the various states have developed different answers to this question. The two most prevalent methods for determining when property damage has taken place, i.e. when a liability policy is “triggered,” are the injury-in-fact trigger and the manifestation trigger. The majority of courts have adopted the injury-in-fact trigger, pursuant to which all policies in effect from the time property damage began until the time it was discovered provide coverage. The injury-in-fact trigger is the modern trend.¹⁸ A minority of courts follow the manifestation trigger, pursuant to which the property damage is deemed to occur only when the damage first manifests itself or becomes apparent.¹⁹ Going back to our FRT plywood example, under the injury-in-fact trigger all the builder’s liability policies from the time deterioration began (perhaps shortly after installation) until the deterioration was discovered would provide coverage for claims against the builder relating to the FRT plywood, no matter when the claims were asserted.

The injury-in-fact trigger is more likely to result in coverage than the manifestation trigger. Damage from a latent defect may not be discovered until after a builder has gone out of business or otherwise not renewed coverage. In such cases, an injury-in-fact trigger would result in coverage, but a manifestation trigger would not. In addition, the injury-in-fact trigger may invoke two or more policies that were in effect while progressive property damage continued to take place, while the manifestation trigger selects only a single point in time at which the damage is deemed to occur and hence will invoke only one policy.²⁰ When two or more policies cover the loss, more insurance dollars are usually available, and the insurance companies will probably be more willing to settle a disputed claim.

B. Exclusions: The Dirty Half-Dozen

Of the several exclusions from coverage in Section I of a standard liability policy, there are six that bear on claims arising from latent defects. Only one of these exclusions, Exclusion (l) or the “your work” exclusion, should exclude coverage for some types of latent defect claims. Nevertheless, all six exclusions are discussed below because these six exclusions together are sometimes referred to as the “business risk” exclusions, and because insurance companies often invoke one or more of these exclusions to deny coverage of latent defect claims.

1. Exclusion (b): Assumption of Liability in a Contract

Exclusion (b) in standard liability policies excludes coverage for property damage “for which the insured is obligated to pay damages by reason of the assumption of

liability in a contract.”²¹ In practice, this is a narrow exclusion that applies only to claims against the builder based on the builder’s assumption of the liability of someone else (e.g. the owner) to third persons, as in an indemnification or hold harmless agreement. This exclusion should not apply to claims by an owner against the builder for latent defects. A few courts have applied Exclusion (b) to claims for latent defects in which the homeowner asserts that the latent defect breached the builder’s contract or express warranties.²² The majority of courts, however, hold that Exclusion (b) does not apply to claims for breach of normal business contracts that contain standard warranties of performance, and most courts limit Exclusion (b) to the assumption of contractual liability in indemnity and hold harmless agreements.²³

Moreover, even if a court were to apply Exclusion (b) broadly, the builder could probably show that it did not “assume liability” for latent defect claims, either because the plaintiff’s complaint also alleged breach of implied warranties that are not in the construction contract but rather are imposed by law,²⁴ or because the plaintiff’s complaint asserted other claims not based on the construction contract.²⁵

2. Exclusion (j)(2): Alienated Premises

Exclusion (j)(2) excludes coverage for property damage to “premises” sold by the builder if the property damage arises out of those premises, but only if the premises were ever occupied, rented, or held for rental by the builder.²⁶ This is a relatively

narrow and straightforward exclusion that should apply to few builders against whom claims for latent defects are brought.

3. Exclusions (j)(5) and (j)(6): Property Damage Prior to Completion of Construction

Exclusions (j)(5) and (j)(6) apply to property damage that occurs while the builder is still “performing operations,” i.e. prior to completion of construction.²⁷ Such property damage falls within the coverage provided by the builder’s risk policy. *See* endnote 2. By its nature, the property damage involved in claims for latent defects does not occur until well after construction is completed and the builder’s operations have ceased. Hence, Exclusions (j)(5) and (j)(6) should not operate to bar coverage of latent defects claims.

4. Exclusion (l): Your Work

The “your work” exclusion will often exclude coverage for a latent defect claim against the builder, unless the defective work or material giving rise to the claim was furnished by a “subcontractor.” Exclusion (l) excludes coverage for property damage to the builder’s “work” if the damage to the work arises out of the work and occurs after construction is completed.²⁸ The builder’s “work” includes materials furnished in connection with the work. In the case of a home builder, the entire house is considered to be the builder’s “work.”²⁹ The “your work” exclusion is the principal “business risk” exclusion. The intent is to place on the builder rather than the builder’s insurance carrier the cost of repairing the builder’s defective work, because the builder is viewed

as being able to control the quality of its own work. For example, if a builder buys and installs defective FRT plywood as roof sheathing and the plywood later degrades, the builder's liability insurer would likely refuse to cover the homeowner's claim against the builder for the cost of replacing the degraded plywood on the basis of Exclusion (I).

The subcontractor exception to the "your work" exclusion was introduced in the 1986 policy form.³⁰ Following this change, the "your work" exclusion does not apply if the defective work was performed or the defective materials were furnished by a "subcontractor." The theory behind this change is that a general contractor cannot as effectively control the work of a subcontractor as it can its own work. Hence, property damage caused by the defective work or materials of a subcontractor is deemed to be accidental rather than the result of poor job performance by the general contractor.³¹ Hence, for example, if synthetic stucco that was installed by a subcontractor proves to be defective, the homeowner's claim against the builder arising from the defective stucco will not be excluded by the "your work" exclusion and should be covered.³²

The exact meaning of the term "subcontractor" in the exception to the "your work" exclusion is unclear. The term "subcontractor" is not defined in the policy. In a general sense, a subcontractor includes anyone who agrees to provide services or materials to a general contractor for use on a construction job.³³ The term "subcontractor," however, also has a narrower, more technical meaning that excludes "materialmen" -- suppliers of ordinary building materials.³⁴ Insurance companies have argued that the term "subcontractor" in the "your work" exclusion should be interpreted

in this narrow sense to exclude materialmen.³⁵ It remains to be seen how broadly or narrowly courts will construe the term “subcontractor” for purposes of the “your work” exclusion.³⁶

If courts interpret “subcontractor” narrowly to exclude materialmen, a builder would be covered for claims based on defective work or materials furnished by a subcontractor, but not for claims based on defective materials that the builder buys directly and installs itself. For example, if defective FRT plywood had been purchased and installed by the framing subcontractor, claims against the builder for the cost of replacing the defective plywood would be covered, but such claims would not be covered if the plywood had been purchased and installed by the builder itself. This is an odd result under the “business risk versus insured risk” analysis discussed above. In both cases, the builder has no effective control over the latent defects in the FRT plywood. If the goal is to cover property damage that is accidental because it is outside the builder’s effective control, it does not make sense to cover a builder for claims based on latent defects in the work or materials of a “subcontractor,” but not cover claims based on latently defective building materials that the builder buys directly.

5. Exclusion (m): Impaired Property

Exclusion (m) should not exclude coverage for claims of latent defects against builders because such claims do not involve “impaired property” as that term is defined in the insurance policy. The exclusion for “impaired property” applies to exclude coverage where (i) the policyholder’s defective product or work has been incorporated

into someone else's product or work, and impairs the usefulness of the larger product or work; or (ii) the policyholder's defective product or work impairs the usefulness of *other* tangible property (e.g. the cases of blocked ingress or egress).³⁷ Claims against builders arising out of latent defects should never satisfy the definition of "impaired property," because impaired property means "tangible property . . . *other than* . . . *your work*." Since the entire home is the builder's "work,"³⁸ a latent defect in one part of the home cannot make *someone else's* work less useful or useless. (This analysis does not apply to a subcontractor's work on the home. A latent defect in the subcontractor's work could in theory cause someone else's work, i.e. the work of the builder or another subcontractor, to become less useful or useless.)³⁹

In short, if the other requirements for coverage are met, a latent defect claim against a builder should not be excluded by virtue of Exclusion (m).⁴⁰

6. Exclusion (n): Product Recall

Exclusion (n), also known as "the sistership exclusion," excludes from coverage damages resulting from product recalls.⁴¹ This exclusion has not been applied by the courts to claims against home builders. Exclusion (n) is more applicable to manufacturers than to builders. The classic example illustrating the application of this exclusion is a manufacturer's recall of its entire line of aircraft because one such plane crashed (hence the exclusion's "sistership" label) and the manufacturer wished to prevent other accidents before they happened.

Insurance companies have asserted the application of this exclusion to latent

defect claims against manufacturers and builders where the product at issue arguably had not yet failed but was repaired or replaced in order to prevent such a failure. The courts, however, have largely rejected the application of Exclusion (n) to claims against manufacturers involving building products.⁴² Manufacturers of defective building materials have seldom recalled or withdrawn building materials from the market or from use, and courts have generally not extended Exclusion (n) beyond the traditional recall situation. For example, manufacturers of FRT plywood did not “recall” their defective FRT plywood from the market or from use after receiving claims that their product deteriorated under conditions normally found in roof structures.

In addition, builders have generally not recalled their “work” -- the houses they have built -- from the market or withdrawn them from use because of a latent construction defect. The owner is generally able to continue to occupy the home even if part of the home is repaired or replaced. Even if the homeowner were required to vacate the home during repairs, perhaps for example in the case of the replacement of polybutelene pipe, the builder would not have “withdrawn” the home from use. Rather, the owner would have voluntarily chosen to vacate while a defective component was actually being repaired. The situation would be a far cry from the typical “product recall” scenario for which the exclusion was intended.⁴³

C. The Duty to Defend: Stand by Your Builder

The insuring agreement of the standard general liability policy requires the insurance company not only to indemnify (i.e. reimburse) an insured builder for damages

covered by the policy but also to defend the builder (at the insurance company's expense) against claims seeking such damages. The policy provides:

We will have the right and duty to defend any "suit" seeking those damages. We may at our discretion investigate any "occurrence" and settle any claim or "suit" that may result.⁴⁴

The duty to defend the builder is just as valuable, if not more valuable, than the duty to indemnify the builder for covered damages. The duty to defend is separate from, and broader than, the duty to indemnify. The insurance company must defend a suit against the insured builder if there is *any* potential that the complaint might assert a covered claim.⁴⁵

For example, a builder was faced with claims that vinyl flooring in the bathrooms of several of its homes was becoming discolored and unsightly. The builder gave notice of the claims to its general liability insurance company. There were several possible causes for the discoloration of the vinyl flooring. The concrete subflooring over which the vinyl was installed may have been improperly mixed or installed (the builder poured the concrete flooring). The plumbing fixtures, supplied and installed by the plumber, may have allowed moisture to penetrate beneath the vinyl. Or the vinyl itself may have been defectively manufactured or improperly installed by the flooring subcontractor. Applying what we learned in the discussion of the "your work" exclusion above, the homeowner's claim against the builder would not be covered if the concrete were poorly mixed or improperly poured by the builder, because the "your work" exclusion would apply. The "your work" exclusion would not apply and the claim would probably be

covered, however, if the work or materials furnished by the plumber or the vinyl subcontractor were causing the problem. If the homeowner were to sue the builder, the insurance company would be required to defend the builder if there were any potential that the problems with the vinyl flooring were caused by a subcontractor or a subcontractor's materials rather than by the builder or the builder's materials.

Many states follow the "eight corners" rule to determine whether the insurance company has a duty to defend the complaint. That is, the allegations within the "four corners" of the complaint are compared to the "four corners" of the insurance policy, without reference to what the "true" facts might be.⁴⁶ The insurance company must defend the complaint even if the facts alleged are untrue or the complaint is frivolous. Other states permit a court to consider facts outside those alleged in the complaint in determining the duty to defend, but only where such facts would expand rather than limit the duty to defend appearing from the allegations in the complaint.⁴⁷

Insurance companies typically agree to *defend* lawsuits against policyholders subject to a reservation of the right not to *indemnify* the policyholder if the facts proven at trial show that the claim is not covered. A builder should respond to such "reservation of rights" letters carefully, after consulting with an attorney about the legal effect of the letter. For example, the letter may create a conflict between the insurance company and the builder that would require the insurance company to pay for a defense attorney of the builder's choice rather than an attorney chosen by the insurance company.

Note that the duty to defend is not only the insurance company's "duty" but also its "right." Several other provisions of the policy reinforce this right. The Insuring Agreement in Section I of the policy limits covered damages to those the policyholder is "legally obligated" to pay.⁴⁸ Condition 2(d) in Section IV of the policy states that:

No insureds will, except at their own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.⁴⁹

And Condition 2(c)(3) requires the policyholder to "cooperate with us in the investigation, settlement or defense of the claim or 'suit.'"⁵⁰

The significance of these provisions is that a builder is not insured for costs it *voluntarily* incurs to make repairs or otherwise "do the right thing" in response to claims for latent defects. The customer or subsequent purchaser of a home must assert a claim (in whatever form) against the builder; the builder must give the insurance company notice and an opportunity to defend the claim; and the builder must not agree to pay, make the necessary repairs, or otherwise settle the claim unless the insurance company approves the settlement (at least not if the builder wants to be reimbursed by the insurance company). Situations frequently arise in which the builder, to preserve its reputation and customer goodwill or simply to "do the right thing," would like its insurance company to make a satisfactory settlement with the complaining party but the insurance company chooses instead to defend the claim.⁵¹

Coverage for Builders as “Additional Insureds”

A builder may also be insured for claims alleging latent construction defects as an “additional insured” on its subcontractor’s general liability insurance policy. Builders routinely require their subcontractors to name the builder as an additional insured on the subcontractor’s general liability policy. Prudent builders go further, in order to assure that they are actually covered as additional insureds for latent defect claims. They specify the scope of coverage the builder must receive as an additional insureds, and they check the certificate of insurance supplied by the subcontractor to make sure that they get the required coverage. The builder who does not do so may be surprised by what little coverage the builder has actually gotten as an additional insured. This is because the forms of coverage for additional insureds vary widely, and some of the forms in fact provide very little coverage to the additional insured.

To receive the broadest coverage, builders should specify in the subcontract that the builder must be named as an additional insured on the subcontractor’s policy “for liability arising out of the subcontractor’s work.” Such coverage is provided by Insurance Services Office (“ISO”) form CG 20 10 11 85, among others. The key words are “arising out of.” The courts have construed this phrase very broadly. For example, in a recent case two employees of an excavation subcontractor were injured by a cave-in at a construction site. The employees sued not their employer (the subcontractor) but rather the contractor, alleging that the contractor failed to provide a safe workplace. The court held that the contractor was covered for the suit as an additional insured on the

subcontractor's CGL policy, even though the subcontractor itself was not sued. The court held that the contractor's alleged liability "arose out of" the subcontractor's work.⁵²

But a builder might be an additional insured on a subcontractor's CGL policy and not get the coverage the builder expects. For example, some insurance policies cover additional insureds "with respect to liability arising out of [the subcontractor's] *ongoing operations* performed for the [the additional insured]" (emphasis added). See ISO form CG 20 10 10 01. A builder who expects to be covered as an additional insured for a construction defect suit alleging property damage occurring *after* construction was substantially completed could be disappointed by such coverage. Some courts have held that such a suit does not arise out of the subcontractor's "ongoing operations."⁵³ Hence, a builder who is added to a subcontractor's policy as an additional insured by ISO form CG 20 10 11 85 for "ongoing operations" should insist that the policy also contain ISO form CG 20 37 10 01, which will add coverage for the builder as an additional insured for "completed operations."

Another very common additional insured endorsement covers the builder only for liability "caused, in whole or in part," by the subcontractor's acts or omissions. Many courts have construed the phrase "caused, in whole or in part" much more narrowly than the phrase "arising out of." In the view of such courts, the builder as an additional insured would not be covered if the lawsuit against the builder alleged that the injury or damage were caused only by the builder. For example, such courts would likely rule that the builder in the excavation cave-in example discussed above was not covered as an

additional insured on the subcontractor's policy because the suit did not allege that the builder's liability was caused, even in part, by the subcontractor.

In addition to specifying in the subcontract the mandatory scope of coverage for the builder as an additional insured, the builder should confirm that it has actually received the required coverage. The subcontract should provide that the subcontractor must furnish a certificate of insurance and that the certificate must be sufficiently detailed to show that all the insurance requirements of the subcontract have been met. The certificate should show that the builder has been added as an additional insured on the subcontractor's CGL policy and should describe the terms of coverage provided to the additional insured and/or attach the actual additional insured endorsement.

In addition, the builder needs to take the time to read the certificate and to follow up with the subcontractor if the additional insured coverage does not meet the requirements in the contract, or if the certificate is not sufficiently detailed to make that determination. A builder who does not assure that its subcontractors have provided the required scope of additional insured coverage could be in for a rude awakening after a suit is filed and the builder seeks coverage as an additional insured on its subcontractor's insurance policy.

Conclusion

In most states, claims against builders for latent construction defects, even if those defects have not caused any bodily injury or damage to property other than the home itself, will be covered by a builder's general liability insurance policy if the defective

work or materials giving rise to the claim were the responsibility of a subcontractor. The claim is not likely to be covered, however, if the defective work or materials were provided by the builder itself. Builders should contact their counsel regarding the coverage that their general liability policy, or the general liability policy of its subcontractor on which the builder is an additional insured, may afford in particular situations. Builders should also discuss with their counsel how their purchase of building products could be structured to maximize insurance coverage for claims of latent defects. To learn more about insurance coverage of claims for latent defects or other substantive technical, legal, and business issues that affect the building industry, visit www.nahb.org/constructionliability, developed by NAHB's Construction Liability, Risk Management, and Building Materials Committee. You may also contact the authors directly at (202) 799-4000 or by email at smysliwiec@dlapiper.com or jhess@dlapiper.com.

¹ There are many court decisions, sometimes conflicting, that interpret the terms used in insurance policies and apply those terms to the facts of particular claims. Some of the terms used in insurance policies can be fully understood only in light of the court decisions interpreting them. Although any discussion of insurance coverage must discuss the precise terms of the policy and the court decisions interpreting those terms, this paper attempts to confine such “legalese” to the endnotes. The endnotes will be of interest to the builder and the builder’s lawyer who may have a particular interest in the legal aspects of the insurance coverage issues discussed in the text.

² The builder’s general liability insurance policy covers claims against the builder for property damage that occurs during the policy period but *after* the builder has substantially completed construction. Property damage occurring *during* construction is covered by the “builder’s risk” insurance purchased by the owner or the builder to cover

mishaps at the site while construction is in progress. *See* Annotation, “Coverage Under Builder’s Risk Insurance Policy,” 97 ALR 3d 1270 (1980 and August 1998 Supp.); T. Brennan, “Construction Insurance: A General Perspective, 15 *The Construction Lawyer* 42, 44-47 (Jan. 1995) [hereafter “Brennan”].

³ *See, e.g., Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788, 791 (N.J. 1979) (explaining exclusion of “business risks” and denying coverage for homeowners’ claims against masonry contractor for costs of repairing defective stucco and concrete caused by contractor’s poor workmanship). *See* generally R. Franco, “Insurance Coverage for Faulty Workmanship Claims Under Commercial General Liability Policies,” 30 *Tort & Ins. L.J.* 785, 785-87 (Spring 1995) [hereafter “Franco”]; Brennan at 42, 46; P. Wielinski, “Selected Coverage Issues in a Construction Defect Claim” 8 *Coverage* 1, 9 (May/June 1998) [hereafter “Wielinski”].

⁴ Major revisions were previously made in 1973 and 1966. In addition, various minor revisions have been made after 1986. This paper will focus on the provisions of the 1986 form but will discuss the terms of the earlier forms where the prior language is helpful to understand the meaning of the current form.

⁵ S. Miller & P. Lefebvre, *I Miller’s Standard Insurance Policies Annotated*, at 409 (4th ed. 1995) [hereafter “Miller & Lefebvre”]. The term “property damage” is defined in the policy to mean:

- a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
- b. Loss of use of tangible property that is not physically injured. All such loss shall be deemed to occur at the time of the “occurrence” that caused it.

Id. at 420.

⁶ The term “occurrence” is defined to mean “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” *Id.* at 419.

⁷ *Id.* at 409.

⁸ These conditions include: (i) notifying the insurance company “as soon as practicable” of an occurrence or offense that may result in a claim; (ii) providing written notice to the insurance company “as soon as practicable” of an actual claim or suit;

and(iii) cooperating with the insurance company in its investigation, settlement, or defense of the claim. Miller & Lefebvre, at 415-16. In addition, the builder must not interfere with the insurance company's right to seek reimbursement from others for any payment the insurance company makes to the builder. *Id.* at 417.

9 The claim against the builder for damages will presumably include not only the cost of materials to replace the defective materials but also the labor costs of removing and replacing the defective materials and the cost of removing and replacing other materials necessary to reach the defective materials (i.e. shingles and felt paper in the case of defective FRT plywood roof sheathing.)

10 *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, 45 Cal. App. 4th 1, 91, 52 Cal. Repr. 2d 960, 733 (1996). See S. Turner, "Insurance Coverage for Incorporation of Defective Construction Work or Products," 18 *The Construction Lawyer* 29, 32-34 (April 1998) [hereafter "Turner"]; P. O'Connor, "Deciding to Litigate: The Surety's Rights Against Property and Liability Insurers of the Obligee, Principal, and Subcontractors," Chapter 6 in *Managing and Litigating the Complex Surety Case* (Philip L. Bruner, ed. 1988) at pp. 242-45 [hereafter "O'Connor"]; Wielinski, at 22-24.

The 1973 form contained the same definition of "property damage" as does the 1986 form. In the 1966 form, however, the word "physical" was absent from the definition of "property damage" (i.e., "injury to tangible property"). The addition of the word "physical" in the 1973 reformulation of the definition of "property damage" was not meant to restrict coverage. Turner, at 31-34.

11 See *Lennar Corp. v. Markel Am. Ins. Co.*, 413 S.W.3d 750, 756-57 (Tex. 2013), in which the Texas Supreme Court affirmed a jury verdict that Lennar's damages included not just the cost of replacing defective EIFS but also the cost of removing all EIFS from damaged houses in order to find the damage, the cost of repairing the damage, and the cost of recladding the entire house with conventional stucco. See also *Missouri Terrazzo Co. v. Iowa Nat'l Mut. Ins. Co.*, 740 F.2d 647, 650 (8th Cir. 1984) (Missouri law) (where owner sued subcontractor for defective terrazzo floor and claimed as damages the diminution in value of the building as a whole, the subcontractor's liability insurance covered the entire claim and not just the cost of repairing the defective floor); *American Alliance Ins. Co. v. Jencraft Corp.*, No. Civ. 96- 4346 (WHW), 1998 WL 702360, *2 (D.N.J. Oct. 5, 1998) (claims by homeowners against manufacturer of lead-emitting mini-blinds are covered by manufacturer's general liability policy; complaints allege property damage, and damages are cost of restoring homes to their former condition or diminution in value of homes). *Accord King County v. Travelers Ins. Co.*, No. C94-1751Z, 1996 WL 257135, *5-*7 (W.D. Wash. Feb. 20, 1996); *W.E. O'Neil Constr. Co. v. National Union*

Fire Ins. Co., 721 F.Supp. 984, 992-94 (N.D. Ill. 1989); *Western Cas. & Sur. Co. v. Polar Panel Co.*, 457 F.2d 957, 960 (8th Cir. 1972) (Minnesota law).

¹² See M. Mayerson, “Affording Coverage for ‘Gradual’ Property Damage Under Standard Liability Insurance Policies: A History,” 8 Coverage 3 (Sept./Oct. 1998).

¹³ Exclusion (a) in the 1986 form liability policy excludes coverage of property damage that was “expected or intended from the standpoint of the insured.” Miller & Lefebvre, at 409. Exclusion (a) restates in different words the requirement of an occurrence. In fact, prior to 1986, Exclusion (a) was part of the definition of an occurrence. *Id.* at 451.3.

¹⁴ H. Reynolds & P. Dunn, “General Liability Coverage for Property Damage Due to a Contractor’s Negligent Construction,” 13 The Construction Lawyer 32, 34-35 (Aug. 1993) [hereafter “Reynolds & Dunn”]; O’Connor, at 231-35; Wielinski, at 18-19. As discussed in these articles, some courts have held that a claim for breach of contract or breach of warranty can never constitute an occurrence because “accidents” are not caused by breaches of contract or warranty. The more prevalent and better reasoned view, however, is that the label attached to the claim brought against the builder does not determine whether there has been an occurrence. See Reynolds & Dunn, at 34-45; Wielinski, at 17-19.

¹⁵ *Stanley Martin Cos., Inc. v. Ohio Cas. Group*, 2009 WL 367589, at *3 (4th Cir. Feb. 12, 2009). See also *Owners Ins. Co. v. Jim Carr Homebuilder, LLC*, 2014 WL 1270629, at *6 (Ala. March 28, 2014) (faulty workmanship causing damage to home was caused by an “occurrence” within meaning of builder’s policy); *Taylor Morrison Services, Inc. v. HDI-Gerling Am. Ins. Co.*, 2013 WL 3481555, at *3 (Ga. July 12, 2013) (property damage to homes caused by allegedly defective concrete foundations was caused by an “occurrence”); *Cherrington v. Erie Ins. Prop. and Cas. Co.*, 2013 WL 3156003, at *13 (W.Va. June 18, 2013) (“[W]e therefore hold that defective workmanship causing bodily injury or property damage is an ‘occurrence’ under a policy of commercial general liability insurance”); *K&L Homes, Inc. v. American Fam. Mut. Ins. Co.*, 829 N.W.2d 724, 735-37 (N.D. 2013) (alleged faulty workmanship resulting in cracks, unevenness, and shifting of homes constituted an “occurrence” within the meaning of builder’s liability policy); *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 308 Conn. 760, 771 (Conn. 2012) (“We conclude that defective construction or faulty workmanship that causes damage to nondefective property may constitute property damage resulting from an occurrence, thus triggering coverage under the commercial general liability policy”); *Auto Owners Ins. Co. v. Newman*, 2008 WL 648546, at *2-*4 (S.C. Mar. 10, 2008) (holding that water damage to a home’s framing and exterior

sheathing caused by defective siding constituted “property damage” caused by an “occurrence” within the meaning of the builder’s CGL policy); *United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871, 891 (Fl. 2007) (holding that structural damage caused by a subcontractor’s defective soil preparation constituted “property damage” caused by an “occurrence” within the meaning of the builder’s CGL policy); *Lamar Homes, Inc. v. Mid-Continent Ins. Co.*, 242 S.W.3d 1, 16 (Tex. 2007) (holding that damage to a home caused by defective construction constituted “property damage” caused by an “occurrence” within the meaning of the builder’s CGL policy); *Travelers Indem. Co. v. Moore & Assoc’s, Inc.*, 216 S.W.3d 302, 308-10 (Tenn. 2007) (same); *Lee Builders Inc. v. Farm Bureau Mut. Ins. Co.*, 137 P.3d 486 (Kan. 2006) (same); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65 (Wis. 2004) (same).

16 The states with such statutes are South Carolina (S.C. Code Ann. 38-61-70) (2011), Colorado (Colo. Rev. Stat. §13-20-808) (2013), Arkansas (Ark. Code Ann. §23-79-155) (2014), and Hawaii (H.R.S. §431:1-217) (2011).

17 An example of such a holding is *Westfield Ins. Co. v. Custom Agri Systems, Inc.*, 979 N.E.2d 269, 273 (Ohio 2012), where the Ohio Supreme Court held that the alleged defective construction of a steel grain bin did not constitute an occurrence under the applicable CGL policy. The Ohio Supreme Court reasoned that an occurrence under the CGL policy had to be “accidental” and “inherent in the plain meaning of ‘accident’ is the doctrine of fortuity.” *Id.* The court then concluded that by requiring damage to be fortuitous, “truly accidental property damage generally is covered because such claims and risks fit within the statistical abstract. Conversely, faulty workmanship claims generally are not covered, except for their consequential damages, because they are not fortuitous. In short, contractors’ ‘business risks’ are not covered by insurance, but derivative damages are.” *Id.*

18 See, e.g., *Gelman Sciences, Inc. v. Fidelity & Cas. Co.*, 572 N.W.2d 617 (Mich. 1998); *Joe Harden Builders, Inc. v. Aetna Cas. & Sur. Co.*, 486 S.E.2d 89 (S.C. 1997); *Montrose Chem. Corp. v. Admiral Ins. Co.*, 10 Cal.4th 645, 42 Cal.Rptr.2d 324, 913 P.2d 878 (1995). See also Wielinski, at 19-21; Brennan, at 47; O’Connor, at 280-82.

19 See, e.g., *American Home Ins. Co. v. Unitramp Limited*, 146 F.3d 311, 313 (5th Cir. 1998) (Texas law); *West Am. Ins. Co. v. Tufco Flooring East, Inc.*, 409 S.E.2d 692, 695 (N.C. App. 1991). Although the injury-in-fact trigger can often be more difficult to apply than the manifestation trigger, the injury-in-fact trigger is more faithful to the terms of the policy. Nowhere does the standard liability policy require that property damage not only have taken place but also be manifest or discovered during the policy period.

20 *See, e.g., Bruce-Terminix Co. v. Zurich Ins. Co.*, 504 S.E.2d 574, 577 (N.C. App. 1998).

21 Exclusion (b) provides:

This insurance does not apply to: . . .

“Bodily injury” or “property damage” for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:

- (1) Assumed in a contract or agreement that is an “insured contract,” provided the “bodily injury” or “property damage” occurs subsequent to the execution of the contract or agreement; or
- (2) That the insured would have in the absence of the contract or agreement.

Miller & Lefebvre, at 409.

“Insured contract” is defined to include: . . .

That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for “bodily injury” or “property damage” to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

Miller & Lefebvre, at 418.

22 *See, e.g., North Star Mut. Ins. Co.*, 2014 WL 2739132, at *3 (E.D. Okla. June 17, 2014); *Pennsylvania National Mut. Cas. Ins. Co. v. St. Catherine of Siena Parish*, 16 F.Supp.3d 1370, 1380-82 (S.D. Ala. 2014), *appeal pending*; *The Rivers v. Richard Schwartz/Neil Weber, Inc.*, 459 N.W.2d 166, 171-72 (Minn. App. 1990).

23 *See, e.g., Crownover v. Mid-Continent Cas. Co.*, 772 F.3d 197, 209-10 (5th Cir. 2014); *Travelers Prop. Cas Co. v. Peaker Services, Inc.*, 855 N.E.2d 523, 535-36 (Mich. App. 2014); *Indiana Ins. Co. v. Kopetsky*, 11 N.E.3d 508, 523-25 (Ind. App. 2014); *Ewing Constr. Co. v. Amerisure Ins. Co.*, 420 S.W.3d 30, 36 (Tex. 2014); *King County v. Travelers Ins. Co.*, 1996 WL 257135 (W.D. Wash. Feb. 20, 1996); *Action Auto Stores*,

Inc. v. United Capitol Ins. Co., 845 F.Supp. 428, 442 (W.D. Mich. 1993); *Broadhead v. Hartford Cas. Ins. Co.*, 773 F.Supp. 882, 897 (S.D. Miss. 1991), *aff'd per curiam*, 979 F.2d 209 (5th Cir. 1992). *Accord Wielinski*, at 15-16.

24 *See, e.g., Gaito v. Auman*, 327 S.E.2d 870, 875 (N.C. 1985).

25 *See, e.g., Warfield v. Hicks*, 370 S.E.2d 689, 693 (N.C. App. 1988) (claim against builder based on state deceptive trade practices statute); *Oates v. Jag, Inc.*, 333 S.E.2d 222, 225 (N.C. 1985) (negligence claim against builder by subsequent purchaser based on violation of state building code).

26 Exclusion (j)(2) provides:

 This insurance does not apply to: . . .

 Property damage to: . . .

(2) Premises you sell, give away or abandon, if the “property damage” arises out of any part of those premises; . . .

 Paragraph (2) of this exclusion does not apply if the premises are “your work” and were never occupied, rented or held for rental by you.

Miller & Lefebvre, at 411.

27 Exclusions (j)(5) and (j)(6) provide:

 This insurance does not apply to: . . .

 Property damage to: . . .

(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; or

(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.”

Miller & Lefebvre, at 411.

“Products-completed operations hazard” is defined, in part, as:

all “bodily injury” and “property damage” occurring away from premises you own or rent and arising out of “your product” and “your work” except:

- (1) Products that are still in your physical possession; or
- (2) Work that has not been completed or abandoned.

Id. at 419. *See* O’Connor, at 248-52.

28 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.

Miller & Lefebvre, at 411.

“Your work” means:

- a. Work on operations performed by you or on your behalf; and
- b. Materials, parts or equipment furnished in connection with such work or operations.

“Your Work” includes:

- a. Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of “your work”; and
- b. The providing of or failure to provide warnings or instructions.

Id. at 420.

Exclusion (k) similarly excludes “‘property damage’ to ‘your product’ arising out of it or any part of it.” *Miller & Lefebvre*, at 411. “Your product,” however, is defined to exclude real property. *Id.* at 420. Hence, the “your product” exclusion would not apply to claims against builders for latent defects. *See, e.g., National Union Fire Ins. Co. v. Structural Sys. Tech., Inc.*, 756 F.Supp. 1232, 1238 (E.D. Mo. 1991), *aff’d*, 964 F.2d 759 (8th Cir. 1992).

29 *See, e.g., Commerce Ins. Co. v. Betty Caplette Builders, Inc.*, 647 N.E.2d 1211, 1212-13 (Mass. 1995); *Indiana Ins. Co. v. De Zutti*, 408 N.E.2d 1275, 1281 (Ind. 1980).

30 The earlier 1966 and 1973 standard liability policies contained an Exclusion (o), which stated that insurance did not apply:

“(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.”

Miller & Lefebvre, at 451.5 (emphasis added). The policyholder could buy a Broad Form Property Damage (“BFPD”) endorsement that deleted the phrase “or on behalf of” from exclusion (o) in the 1966 and 1973 policies. *Miller & Lefebvre*, at 452.6 Most (but not all) courts held that the BFPD endorsement provided coverage where the defective work was performed by a subcontractor. *See, e.g., Grange Mut. Cas. Co. v. Robert Locker Builder, Inc.*, No. 94-CA-1635-HR, 1996 WL 16598 (Ky. App. Jan. 19, 1996); *Harbor Ins. Co. v. Tishman Constr. Co.*, 578 N.E. 2d 1197, 1201-02 (Ill. App. 1991); *Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co.*, 864 F.2d 648, 651 (9th Cir. 1988) (Oregon law). *Accord O’Connor*, at 253-54; *Reynolds & Dunn*, at 37-39.

31 *See O’Shaughnessy v. Smuckler Corp.*, 543 N.W.2d 99, 102-05 (Minn. App. 1996); *Brennan*, at 47; *Wielinski*, at 25; *O’Connor*, at 253-56.

32 A builder should be on the alert for an endorsement that some insurers have begun to add to their policies to eliminate the “subcontractor exception” to the “your work” exclusion. This endorsement is ISO form CG 22 94 10 01. By eliminating the “subcontractor exception,” this endorsement would eliminate insurance coverage for most claims against a builder for construction defects.

33 *See Clifford F. MacEvoy v. United States*, 322 U.S. 102, 108-09 (1944) (the term “subcontractor” has no single exact meaning and “[i]n a broad, generic sense includes

anyone who has a contract to furnish labor or material to the prime contractor”).

34 For example, Congress used the term “subcontractor” in this narrower sense in the Miller Act, which requires contractors on federal projects to provide surety bonds for the protection of those who provide labor or furnish materials to subcontractors. *Clifford F. MacEvoy*, 322 U.S. at 108-09. *Accord F.D. Rich Co., Inc. v. United States*, 417 U.S. 116, 120-23 (1974) (supplier of custom millwork and exterior plywood held to be a subcontractor rather than a materialman within meaning of prime contractor’s payment bond).

35 See, e.g., *National Union Fire Ins. Co. v. Structural Sys. Tech., Inc.*, 756 F.Supp 1232, 1239-40 (E.D. Mo. 1991), *aff’d*, 964 F.2d 759, 763 (8th Cir. 1992).

36 Few courts have interpreted the term “subcontractor” in the exception to the “your work” exclusion. In one such case, *National Union*, 756 F.Supp at 1239-40, the court suggested that the term should be interpreted broadly. The court, however, based its decision on its finding that a fabricator and supplier of defective steel rods was a subcontractor rather than a materialman. Hence, a claim by the owner against the general contractor arising from the defective rods was covered by the contractor’s general liability insurance policy. In affirming this result, the court of appeals indicated that the term “subcontractor” was ambiguous. The court of appeals noted that when an insurance policy is open to different constructions, the construction most favorable to the policyholder must be adopted. 964 F.2d at 763. *Compare State ex rel. Regents of New Mexico State Univ. v. Siplast, Inc.*, 877 P.2d 38, 40-41 (N.M. 1994) (finding coverage under builder’s risk policy because supplier of roofing materials was held to be a subcontractor rather than a materialman).

37 Exclusion (m) provides:

This insurance does not apply to: . . .

“Property damage” to “impaired property” or property that has not been physically injured, arising out of:

- (1) A defect, deficiency, inadequacy or dangerous condition in “your product” or “your work”; or
- (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to “your product” or “your work” after it has been put to its intended use.

Miller & Lefebvre, at 411.

“Impaired property” is defined to mean:

tangible property, other than “your product” or “your work,” that cannot be used or is less useful because:

- a. It incorporates “your product” or “your work” that is known or thought to be defective, deficient, inadequate or dangerous; or
- b. You have failed to fulfill the terms of a contract or agreement;

if such property can be restored to use by:

- a. The repair, replacement, adjustment or removal of “your product” or “your work”; or
- b. Your fulfilling the terms of the contract or agreement.

Id. at 418. The “impaired property” exclusion was introduced in the 1986 standard liability policy and takes the place of the prior Exclusion (m) in the old 1973 form policy. Exclusion (m) in the 1973 policy, known as the “loss of use” or “failure to perform” exclusion, excluded coverage for loss of use of tangible property that had not suffered physical injury, where the loss of use resulted from the policyholder’s breach of contract or breach of warranty. Miller & Lefebvre, at 452.2.

38 *See, e.g., Commerce Ins. Co. v. Betty Caplette Builders, Inc.*, 647 N.E.2d 1211, 1212-13 (Mass. 1995); *Indiana Ins. Co. v. De Zutti*, 408 N.E.2d 1275, 1281 (Ind. 1980).

39 Exclusion (m) applies not only to property damage to impaired property but also to property damage to “property that has not been physically injured.” This aspect of Exclusion (m) merely restates the basic requirement that a covered claim must arise from “property damage,” meaning “physical injury to tangible property.” A latent defect claim that satisfies the basic requirement of “property damage” will always avoid the “property that has not been physically injured” prong of Exclusion (m). As discussed at pp. 7-8 above, latent defect claims do involve physical injury to tangible property.

40 Various commentators have described the “impaired property” exclusion as being “difficult,” “tricky,” and “too complex to receive a uniform interpretation.” *See* O’Connor, at 257. One commentator has argued that the exclusion is “unintelligible or at least ineffective to overcome the insured’s reasonable expectations of coverage.” S. Turner, *Insurance Coverage of Construction Disputes*, 307 (1992), *quoted in* O’Connor, at 258. At least one court has found the impaired property exclusion to be “ambiguous and/or in conflict with other segments of the policy defining coverage” and refused to enforce it. *Serigne v. Wildey*, 612 So.2d 155, 157-58 (La. App. 1992), *cert. denied*, 613 So.2d 994 (La. 1993).

41 Exclusion (n) provides:

This insurance does not apply to: . . .

Damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of:

- (1) “Your product”;
- (2) “Your work”; or
- (3) “Impaired property”;

if such 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.

Miller & Lefebvre, at 412. Exclusion (n) in the 1986 policy replaces a similar exclusion, Exclusion (p), in the 1973 policy. *Id.* at 451.5.

42 *See, e.g., Forest City Dillon, Inc. v. Aetna Cas. & Sur. Co.*, 852 F.2d 168, 173-74 (6th Cir. 1988) (Ohio law) (defective aluminum siding); *Superior Steel, Inc. v. Bituminous Cas. Corp.*, 415 So.2d 354, 358 (La. App. 1982) (steel anchor bolts). *See also* O’Connor, at 260-61.

43 Claims for coverage truly falling within Exclusion (n) would probably not satisfy other requirements of the policy, such as the requirement that a builder be “legally obligated” to pay for the loss at issue. Coverage is not provided for the cost of taking preventative measures designed to prevent accidents before they occur, as would be the case with a true product recall. This may be why only a few courts have even had occasion to consider the application of Exclusion (n) to builders. In *Sapp v. State Farm*

Fire & Cas. Co., 486 S.E.2d 71, 74 (Ga. App. 1997) (defective installation of wood flooring), and *Pratt v. Hamel*, 1986 WL 8650 (Ohio App. Aug. 4, 1986) (defective foundation), the courts denied coverage of claims against the builder. These courts relied on the business risk exclusions generally, including the sistership exclusion, without separately analyzing the application of the sistership exclusion. In *Charles E. Brohawn & Bros., Inc. v. Employers Commercial Union Ins. Co.*, 409 A.2d 1055, 1057- 58 (Del. 1979), the court applied the sistership exclusion to a claim against the builder of a defective concrete pedestal for a steam generator. The pedestal was found to be defective before it was put to its intended use and thus had not “failed in use.” On this basis, the court concluded that the pedestal had been withdrawn from use as a preventative measure and fell within the sistership exclusion. This case is not likely to apply to most latent defect claims against builders, in which the building product at issue will have become defective only after being put to its intended use. Rather, latent defect claims are more likely to resemble the facts in *Continental Cas. Co. v. Gilbane Building Co.*, 461 N.E.2d 209, 217 (Mass. 1984), in which a builder was sued for the cost of replacing glass panels in a defective curtain wall. The builder’s insurer denied coverage for the claim on the basis of the sistership exclusion, because most of the glass panels at issue, although allegedly dangerous, had not yet failed. The court, however, held that the sistership exclusion did not apply because coverage was sought for claims that the product at issue was defective, not for claims relating to “sister” products.

44 Miller & Lefebvre, at 409.

45 See, e.g., *LaSalle Nat’l Trust, N.A. v. Schaffner*, 818 F.Supp. 1161, 1167 (N.D. Ill. 1993); *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 119 (5th Cir. 1983) (Texas law).

46 See, e.g., *Elliott v. Hanover Ins. Co.*, 711 A.2d 1310, 1312 (Maine 1998); *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Rhodes*, 719 F.2d at 119.

47 See, e.g., *Litz v. State Farm Fire & Cas. Co.*, 695 A.2d 566, 570 (Md. 1997).

48 Miller & Lefebvre, at 409.

49 *Id.* at 416.

50 *Id.*

51 The upshot of these requirements is that a builder who wants to be pro-active and

make necessary repairs promptly in response to homeowner complaints may end up waiving insurance coverage for the builder's cost of repairs. The builder must notify the insurance company of the homeowner's claim and then obtain the insurance company's prior approval of any "settlement," e.g. agreement to make the necessary repairs, in order for the builder to be reimbursed by the insurance company for the cost of the repairs. Some courts, however, will excuse the builder's failure to obtain the insurance company's consent to a settlement between the builder and a homeowner if the insurance company was not prejudiced by the failure of the builder to obtain the insurance company's consent. This was the holding, for example, in *Lennar Corp. v. Markel Am. Ins. Co.*, 413 S.W.3d 750, 756-57 (Tex. 2013), where Lennar proceeded to settle numerous EIFS claims after seeking but failing to obtain its insurer's consent to the settlements.

⁵² *Royal Indem. Co. v. Terra Firma, Inc.*, 947 A.2d 913 (Conn. 2008). *See also* *Evanston Ins. Co. v. Atofina Petrochemicals, Inc.*, 256 S.W.3d 660 (Tex. 2008), in which the contractor's employee drowned after falling through the corroded roof of a fuel oil storage tank. The employee's estate sued the owner for negligence. The owner was covered as an additional insured on the contractor's policy, even if the owner alone was negligent.

⁵³ *See, e.g., Woodward v. Acceptance Indem. Ins. Co.*, 743 F.3d 91 (5th Cir. 2014).

S.R.M.
J.R.H.