COVERAGE FOR CONSTRUCTION DEFECTS

An Illinois Perspective

Scott W. Hoyne
Johnson & Bell, Ltd.
33 W. Monroe Street
27th Floor
Chicago, Illinois 60603
312.984.0233

Joseph F. Spitzzeri
Johnson & Bell, Ltd.
33 W. Monroe Street
27th Floor
Chicago, Illinois 60603
312.984.6683

JOHNSON & BELL Ltd.
Attorneys at Law

Coverage For Construction Defects

Insurers, insureds and the courts have struggled for years to set forth clear rules concerning what is covered under the standard CGL policy in construction defect litigation. The struggle is understandable. On the one hand, all concerned parties recognize that policies of liability insurance must provide insureds with reasonable protection for claims arising out of the accidental destruction of another's property. At the same time, the coverage provided cannot be so broadly construed that the CGL policies are converted into something akin to performance bonds which guarantee the workmanship of the insureds.

General Considerations

The Insuring Agreement of the standard CGL policy provides in pertinent part as follows:

> We will pay those sums that the insured becomes legally obligated to pay as damages because of … "property damages" to which this insurance applies ... only if … the "property damage" is caused by an "occurrence".

See, ISO Form CG 0001 10 01, Section 1, ¶ 1b(1).

The term "occurrence" is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." "Property damage" is defined as:

> 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 of use shall be deemed to occur at the time of the "occurrence" that caused it.
>
> *** * ***

ISO Form CG 0001 10 01, Section V, ¶17.

The courts' interpretations of these definitions in the construction defect context have varied. For example, the seemingly simple term "accident" (which is not defined in a standard CGL policy) has caused substantial confusion. As one court lamented:

> What is an accident? Everyone knows what an accident is until the word comes up in court. Then it becomes a mysterious phenomenon, and, in order to resolve the enigma, witnesses are

> summoned, experts testify, lawyers argue, treatises are consulted and even when a conclave of twelve world-knowledgeable individuals agree as to whether a certain set of facts made out an accident, the question may not yet be settled, and it must be reheard by an appellate court.

Melrose Hotel Co. v. St. Paul Fire & Marine Ins. Co., 432 F.Supp.2d 488, 506 (E.D. Pa. 2006) (quoting *Resource Bancshares Corp. v. St. Paul Mercury Ins. Co.*, 407 F.2d 631, 637 n.5 (4th Cir. 2005)). A large part of the confusion concerning the term "accident" stems from the fact that intentional acts often have unintended consequences. Generally, in determining whether there is an accident, the courts have focused on whether the alleged injuries were expected or intended rather than whether the act itself was intended, *Illinois Farmers Ins. Co. v. Kure*, 364 Ill.App.3d 395, 401-02, 846 N.E.2d 644, 650 (3d Dist. 2006); *United States Fidelity & Guaranty Co. v. Wilkin*, 144 Ill.2d 64, 77-78, 578 N.E.2d 926, 932 (Ill. 1991).

In Illinois, the courts have held that the term "accident" does not include the "natural and ordinary consequences of an act." *Pekin Ins. Co. v. Miller*, 367 Ill.App.3d 263, 266, 854 N.E.2d 693, 696 (1st Dist. 2006); *Viking Construction Mgt., Inc. v. Liberty Mutual Ins. Co.*, 358 Ill.App.3d 34, 53, 831 N.E.2d 1, 15 (1st Dist. 2005). As the *Viking* court noted:

> Although the policy does not define "accident" it has been defined as "...an unforeseen occurrence, usually of an untoward or disastrous character or an undesigned sudden or unexpected event of an inflictive or unfortunate character".

Viking, 358 Ill.App.3d at 42. *See also, State Farm v. Tillerson*, 334 Ill.App.3d 404, 777 N.E.2d 986 (5th Dist. 2002). Given this definition it is not surprising that the Illinois courts have held that a "CGL policy will not cover a general contractor's suit for breach of contract" and that "there is no 'occurrence' when a subcontractor's defective workmanship necessitates removing and repairing work." *Viking*, 358 Ill.App.3d at 42; *30 Tort & Insurance L.J.* at 789.

Viking Management: A Good Overview Of The Law In Illinois

Most lawyers struggling with a coverage question look for that one case which explains it all. In questions of coverage for construction defects *Viking Construction Management v. Liberty Mutual*, 358 Ill.App.3d 34, 831 N.E.2d 1 (1st Dist. 2005) is that case. *Viking* provides a comprehensive and relatively easy to read overview of the law in Illinois. The case also suggests a common sense approach for analyzing the coverage questions which lawyers and claims professionals routinely face when dealing with construction defect litigation.

In *Viking*, the Woodland School District ("Woodland") retained Viking Construction Management, Inc. ("Viking") to provide construction management services with regards to the design and construction of a new middle school building. Woodland retained Frederick Quinn ("Quinn") as the general contractor for the project. Quinn then retained Crouch-Walker ("Crouch") as its masonry subcontractor.

During the course of construction a masonry wall collapsed due to inadequate temporary bracing by Crouch. Parts of the building under construction were damaged in the collapse. Woodland filed a single count breach of contract complaint against Viking. Viking tendered its defense to Liberty Mutual under a CGL policy. Liberty refused the tender. In the ensuing declaratory action the trial court granted summary judgment to Viking finding that Liberty Mutual had a duty to both defend and indemnify Viking. Liberty Mutual appealed.

The Appellate Court suggested a three step approach to the coverage questions presented:

> We must first determine whether there was an "occurrence" within the policy. . . Once an "occurrence" has been established, we must determine whether there was "property damage". . .If both an "occurrence" and "property damage" have been established, we must determine whether any exclusions apply.

Viking, 358 Ill.App.3d at 42.

The Appellate Court noted that the general rule in Illinois was that a CGL policy will not cover a general contractor's suit for breach of contract and that there is no "occurrence" when a contractor's defective workmanship necessitates removing and repairing work. The court also noted that the standard CGL policy definition of "property damage" differentiates between physical damage to tangible property and intangible property losses, such as economic interests. The courts in Illinois do not consider damage to economic interests to be "property damage". Similarly, a breach of contract claim does not constitute "property damage" since it does not result from a fortuitous event.

The Court observed that the majority rule in the United States was that faulty workmanship, standing alone, is not generally covered under a CGL policy. "Illinois considers construction defects to not constitute an accident or occurrence necessary to trigger coverage under CGL policies." Citing the decision in *Indiana Insurance Company v. Hydra Corp.*, 245 Ill.App.3d 926, 615 N.E.2d 70 (2d Dist. 1993) the Court said:

> If the contractor uses inadequate building materials, or performs shoddy workmanship, he takes a calculated business risk that no damage will take place. If damage does take place it flows as an *ordinary and natural consequence of the contractor's failure to perform* the construction properly or as contracted and there can be no coverage for such damage.

358 Ill.App.3d at 43 (emphasis added).

1. Step One: Is There An "Occurrence"?

The *Viking* court engaged in a reader friendly review of the law in Illinois concerning the term "occurrence" in the context of construction defect litigation. After a detailed discussion of the decisions in *Monticello Insurance Company v. Wilford's Construction*, 277 Ill.App.3d 697, 661 N.E.2d 451 (2d Dist. 1996), *State Farm Fire and Casualty Co. v. Tillerson*, 334 Ill.App.3d 404, 777 N.E.2d 987 (5th Dist. 2002), *Hartford Fire Insurance Company v. Flex Membrane International, Inc.*, 2001 U.S. Dist. Lexis 11700 (N.D. Ill. August 1, 2001) and *Pekin Insurance Company v. Richard Marker Associates*, 289 Ill.App.3d 819, 682 N.E.2d 362 (1997) the court found that the underlying complaint filed by Woodland against Viking did not allege an "occurrence" as that term is defined in Illinois. The court noted that an "accident" does not include the "natural and ordinary consequences" of an act. The collapse of the wall on the Woodland project was the ordinary and natural consequence of improper bracing, *i.e.*, faulty construction work which resulted, at least in part, from Viking's breach of its contract with Woodland.

The *Viking Management* court found it significant that Woodland alleged only damage to the project upon which Viking was working and that no damage to other property was alleged. The court distinguished cases such as *Richard Marker* (where the court found an occurrence in the context of a construction defect case) because the underlying complaint in *Richard Marker* alleged damage to "other property". Specifically, in *Richard Marker*, the underlying complaint alleged damage to furniture, clothing and other items of personal property damaged as a result of the contractor's faulty workmanship which caused condensation to drip upon the furniture, clothing and other personal property. The Viking court thus highlighted the most significant exception to the "breach of contract is not an occurrence" rule; *i.e.*, the "damage to other property" exception. A clever attorney pursuing a contractor in a construction defect case will almost always seek to allege "damage to other property" if he wishes to trigger the CGL carrier's duty to defend the defendant contractor.

2. Step Two: Is There "Property Damage"?

The *Viking* court next considered the question of whether the underlying Woodland complaint alleged "property damage" as that term is defined in the standard CGL policy. The court found that no "property damage" was alleged.

Citing a long line of Illinois cases the court noted that the underlying complaint alleged only damages in the nature of repair and replacement of defective product or construction. Such damages constituted only "economic losses" and did not constitute "property damage". Said the court:

> CGL policies are not intended to pay the costs associated with repairing and replacing the insured's defective work and products which are purely economic losses.

Viking, 358 Ill.App.3d at 47. Where plaintiffs in the underlying case merely sought either the repair or the replacement of the defective work or the diminishment in value of the structure caused by the defective work then no property damage was alleged.

3. Step Three: Are There Exclusions Which Apply?

Since the *Viking* court found that the underlying complaint filed by Woodland against Viking alleged neither an "occurrence" nor "property damage" the court found it unnecessary to consider the various exclusions which had been raised by Liberty Mutual in defense of the demands for coverage made by Viking. Fortunately, there are several recent Illinois cases which provide practitioners with substantial insight into the application and breadth of these so called "business risk exclusions".

Coverage counsel should take note of the recently decided *Lyrella v. AMCO Insurance* 2008 U.S. App. LEXIS 16478 (7th Cir. Ill. Aug. 4, 2008). In *Lyrella*, the Seventh Circuit held that the trial court properly granted the insurance company's motion for summary judgment in an action alleging that defendant breached its commercial general liability insurance policy by failing to defend the plaintiff-insured in the underlying action. The underlying action alleged that plaintiff failed to construct the residential home pursuant to agreed-upon plans and failed to build the home in a workmanlike manner. The Seventh Circuit found that the insurer was not required to defend plaintiff in the underlying lawsuit since damages to construction project result from construction defendant is neither an "accident" or "occurrence" as contemplated under defendant's policy. The damages represent the natural and ordinary consequences of faulty construction. Moreover, the underlying lawsuit did not allege that plaintiff's faulty workmanship resulted in damage to the home. *Lyrella v. AMCO Insurance* 2008 U.S. App. LEXIS 16478 (7th Cir. Ill. Aug. 4, 2008).

In another recent decision, the Illinois Appellate Court held that damages to a building constructed by the insured contractor did not constitute an "occurrence". In reaching this decision the court distinguished one case on the basis that it alleged negligence, while the case before it alleged a breach of contract. It also concluded that the cracks in the building were not an occurrence because they were the natural and ordinary consequence of the defective workmanship, namely poor soil compacting. The court ruled that damage to the building was not property damage, even though it may have been due to the poor work by a subcontractor. The court rejected the idea that the subcontractor's exception to the "your work" exclusion created coverage. *Stoneridge Dev. Co. v. Essex Ins. Co.*, 888 N.E.2d 633 (Second Dist. 2008).

The Business Risk Exclusions

The exclusions which are generally at issue in construction defect situations are clustered together in the standard ISO CGL form as exclusions j through m. The relevant portions of exclusion j provide:

This insurance does not apply to:

* * *

j. Damage to Property

"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 within the "products-completed operations hazard".

While these exclusions appear at first blush to apply to most construction defect claims, their exceptions severely limit their application. For example, j(5) excludes damage to real property on which the insured or its subcontractors are performing operations if the property damage arises out of the operations. However, the use of the present tense, "are performing operations", limits this exclusion to property damage that occurs while the work is being performed, not damage that arises later due to improperly performed work.

Likewise, j(6) excludes damage to property that must be restored, repaired or replaced because of the insured's poorly performed work, which is what most construction defects involve. Again, however, there is an exception: the exclusion does not apply to completed operations. Thus, property damage which manifests itself after the insured's work on the project is done, *i.e.*, the typical construction defect, does not fall within the exclusion.

Exclusions k and l provide as follows:

This insurance does not apply to:

* * *

k. Damage to Your Product

"Property damage" to "your product" arising out of it or any part of it.

l. Damage to Your Work

"Property damage" to "your work" arising out of it or any part of it and included within 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.

Thus, damage to the insured's work or product is not covered. This, of course, raises the question of what the insured's work is, particularly in the case of general contractors. The policy defines "your work" as "work or operations performed by you or on your behalf; and … [m]aterials, parts or equipment furnished in connection with such work or operations". Thus, the definition of the insured's work includes not just the work performed directly by the insured but also work performed on the insured's behalf.

There is, however, an exception to exclusion 1 for work damaged or work causing damage if the work was done by a subcontractor (this provision was inserted into ISO CGL policies in 1986, and incorporated the "broad form property damage" endorsement). A general contractor's work would generally be considered to include all the work done on a project (or the whole building if the project was for new construction) since the definition of "your work" includes work done on the insured's behalf, which would include work done by a subcontractor. Nevertheless, the subcontractor exception to the "your work" exclusion means that damage caused by a subcontractor's work or damage to a subcontractor's work does not fall within the exclusion.

The final exclusion relevant to construction defect cases is exclusion m, the "impaired property" exclusion. This exclusion excludes:

m. Damage to Impaired Property Or Property Not Physically Injured

"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.

"Impaired property" is defined as follows:

> "Impaired property" means 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.

The easiest way to consider the application of this exclusion is by an example. Assume that the insured is an electrical contractor who installed the wiring to a new home. It is later determined that the wiring was incorrectly installed and is thus a fire hazard. The fire inspector has ordered the owners of the house to evacuate it until the problem is fixed. There is arguably "property damage" since there is loss of use of property. The only way to alleviate the fire risk is to take out the insured's wiring and replace it with better wiring, which can only be accomplished by tearing out large portions of the walls of the home.

The home is "impaired property" because it is not the insured's work or product, and is less useful or cannot be used because it incorporates the insured's work, the wiring. It can be restored to use by repairing or replacing the insured's work. Even if the home did not meet the definition of "impaired property", it falls within the exclusion because the home has not been physically injured (yet), and the damage arises out of the incorporation of the insured's product.

The exclusions discussed above are generally known as the "business risk" exclusions because they are premised on the theory that liability policies are not intended to provide protection against the insureds own faulty workmanship or product, which are normal risks associated with the insured's business. *U.S. Fidelity & Guaranty v. Wilkin*, 144 Ill.2d 64, 84, 578 N.E.2d 926 (Ill. 1991) According to the Illinois Supreme Court, CGL policies "are meant (only) to afford coverage for damage to other property caused by the insured's work or product". 144 Ill.2d at 84.

The courts in Illinois have, on occasion, given the business risk exclusions an expansive reading. Thus, in *Pekin Ins. Co. v. Ross Willet*, 301 Ill.App.3d 1034, 704 N.E.2d 923 (2d Dist. 1998), the court relied upon exclusion j(5) and j(6) of the standard CGL policy to reverse a summary judgment for the insured, a swimming pool service company. The insured had agreed to service, clean and paint an in ground pool. While the pool was empty and before the insured's work was complete, a heavy rain caused the pool to push out above the ground. The entire pool was destroyed.

The insured claimed that exclusions j(5) and j(6) did not apply because the entire pool was not the insured's product and because the underlying complaint did not allege that the insured's work on the surface of the pool damaged the pool. The court rejected both arguments and held that the exclusions excluded coverage for the entire pool and not just that portion of the pool in which the insured was working.

A Caveat On The Business Risk Exclusions

The expansive reading given the business risk exclusion by the court in *Ross Willet* will probably cause headaches for coverage counsel and insurers alike. The hapless insured in *Ross Willet* contracted to paint a pool and was left without coverage when the pool was destroyed. As a result of *Ross Willet* are all contractors naked when a mistake or mishap destroys the structure on which work is being performed? Is the house painter without coverage when his heat gun ignites the siding and burns down his customer's home? Is the carpenter without coverage when his cabinet installation dislodges a gas line causing an explosion? Is an electrician installing a $10.00 light fixture without insurance when his failure to properly ground the fixture causes a massive fire? Insurers can probably anticipate that the courts will be less inclined to enforce the business risk exclusions when the magnitude of the loss appears to be disproportionate to the scope of the insured's work.

Conclusion

Coverage questions abound whenever suit is filed against a contractor for alleged construction defects. A three step approach is suggested. The practitioner or claims professional should first determine if the underlying complaint alleges an "occurrence", then next determine if "property damage" has been alleged and finally consider the application of the various "business risk" exclusions.

The courts in Illinois have made it clear that the standard CGL policy generally does not obligate the insurer to defend and indemnify its insured for breach of contract claims. Defective workmanship, including the cost to remove and replace the same, is not covered.

When the insured's bad work causes damage to "other property" then coverage is triggered. The law is unsettled with regards to precisely what qualifies as "other property". Personal property certainly qualifies. Other real property attached or connected to the property on which the insured is working might, under some circumstances, qualify.

Serious coverage issues must be addressed in a declaratory judgment action. When the loss is large enough the insurer may well wish to consider offering a defense through independent counsel while pursuing declaratory relief.