COVERAGE ISSUES FOR CONSTRUCTION DEFECT CLAIMS

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In order to be covered under a commercial general liability (CGL) policy, the damages sought by a third-party in a lawsuit filed against an insured must fall within the insuring agreement contained in the policy. The insuring agreement contained in a standard CGL policy states:

> *We 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. …*
>
> *a. This insurance applies only:*
>
> *(1) To "bodily injury" or "property damage:"*
> *(a) that occurs during the policy period; and*
> *(b) that is caused by an "occurrence." The "occurrence" must take place in the coverage territory.*

In any analysis of coverage under a CGL policy for construction defect claims, there are certain threshold considerations that must be addressed. **First is the policyholder legally obligated to pay?** That issue may not be answerable at the time of an initial coverage evaluation, but it is an important and sometimes overlooked requirement for coverage. **Second, are there damages that constitute "bodily injury" or "property damage"?** The bodily injury question is more easily answered in a typical case, but whether there is "property damage" is often not so clear. **Third, did the property damage occur during the policy period at issue?** Subsumed in this issue is the question of what policy period is triggered? **Fourth, was the property damage caused by an occurrence?**[1] **Finally, is the cause of the damage or the damage claimed excluded from coverage under the policy?**

1. Is the policyholder legally obligated to pay?

[1] The "during the policy period" requirement and the "occurrence" requirement are addressed out of order in this manuscript. However, it is important to remember that the policy language requires that the "property damage" must occur during the relevant policy period, not the "occurrence".

The answer to this question may not be available until after the case is resolved. Often an insurer must go ahead and defend, leaving the question of legal liability open until the case moves forward. The legal obligation of the insured to pay the damages claimed is the very essence of what the lawsuit is about. However, this requirement also addresses situations where an insured may voluntarily pay without prior notice to the insurer. While there are other provisions in a typical CGL policy that prohibit voluntary payments without prior notice to the insurer, the requirement of a legal obligation to pay damages on the part of the insured reinforces that sentiment.

2. Is there "property damage"?

"Property damage" is defined in the policy as follows:

> *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.*

The court in *Hobson Construction Company v. Great American Insurance Company*, 71 N.C. App. 586, 322 S.E.2d 632 (1984) held that the cost to complete or to repair improper workmanship did not constitute property damage under a CGL policy that defined "property damage" as "physical injury to or destruction of tangible property…including the loss of use thereof at any time…or loss of use of tangible property which has not been physically injured or destroyed…" The court left open the possibility that loss of use damages could be covered, however. That rationale was also followed in a federal case, *William C. Vick Construction Co. v. Pennsylvania National Mutual Insurance Co.*, 52 F. Supp.2d 569 (E.D. N.C. 1999) *aff'd per curiam* 213 F. 3d 634 (4th Cir. 2000). There, the court stated as follows:

> These requirements,[2] in this court's opinion, infer that the property allegedly damaged has to have been undamaged

[2] "physical injury to" or "destruction of" tangible property, or "loss of use of tangible property which has not been physically injured or destroyed"

> or uninjured at some previous point in time. This is inconsistent with allegations that the subject property was never constructed properly in the first place.

Id. at 582. The court reasoned that because the water-proofing materials either arrived at the project site in a defective condition or were installed at the site in a defective manner, the property in question was never undamaged, and there was no "property damage." The *Vick* court again distinguished between loss of use damages and repair costs necessitated by poor workmanship, holding that the latter would not constitute property damage under the policy.

In the latest development on this issue, the state Court of Appeals has seemingly followed *Hobson* and *Vick,* even in a situation where loss of use damages were alleged. In *Production Systems, Inc. v. Amerisure Insurance Company,* 167 N.C. App. 601, 605 S.E. 2d 663 (2004), the dispute concerned coverage for claims arising out of defectively installed oven line systems. The damages sought were the cost of repairing the line systems and loss of use of the line systems. The insured/policyholder installed two oven line systems for use in the manufacturing of foam rubber. The systems consisted of conveyor belts, an oven, and associated components. The conveyor belt assemblies were defective, and they caused damage to other parts of the oven line system provided by the insured. The Court ruled that the policyholder was not entitled to coverage under its general liability policy for the cost of repairing the oven line systems. In so ruling, the Court recognized that the term "property damage" had been interpreted by the North Carolina courts to mean damage to property that was previously undamaged, and not the expense of repairing property or completing a project that was not done correctly in the first place. *Id.* at 606, 605 S.E.2d at 666. The Court also denied coverage for loss of use of the systems.

Since the decision in *Production Systems, Inc. v. Amerisure Insurance Co.,* the prevailing view is that defective construction that results only in damage to the product or work done by the insured does not constitute "property damage" caused by an "occurrence." Only when the defective work results in damage outside the scope of the product or work of the insured is there damage that is potentially viewed as "property damage."

Under the *Production Systems* case, it may be argued that where defective components of a policyholder's contractual undertaking cause damage to other non-defective components, the cost of bringing the project into compliance with the contractual undertaking does not constitute property damage.[3] The analysis should be impacted by the scope of work undertaken by the policyholder. For instance if the insured is the general contractor, the project or contractual undertaking is the construction of the entire project as well as the undertaking to make repairs and warrant those repairs. If the policyholder is a plumber or electrician, and the work of that trade causes damage to the work of another trade, the coverage analysis becomes more complicated.

There is some case law in North Carolina that speaks to the issue. In *Barbee v. Harford Mutual Insurance Company,* 330 N.C. 100, 408 S.E.2d 840 (1991), the Supreme Court of North Carolina interpreted an exclusion in a garagekeepers' liability policy for "faulty work you performed." There, the insured's employees on two occasions accidentally dropped foreign objects through the spark plug openings into engine cylinders while replacing spark plugs. The insured argued that the damage to those engines was resulting damage to other property, not part of the work being performed and thus not excluded. The insurer maintained that the policy excluded claims for damages caused by the insured's work product, i.e. the tune ups and spark plug replacements. The Supreme Court agreed with the insurer, citing with approval language from *Western World Insurance Company v. Carrington,* 90 N.C. App. 520, 369 S.E.2d 128 (1988) that read:

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[3] *Production Systems* involved a product, so there may be some distinction drawn between faulty work on a construction project that causes damage to the work of another contractor vs. faulty installation work involving a product that causes only damage to that product. The economic loss rule plays into the analysis in the product situation, but may not be crucial or even applicable to the analysis in the construction project model. *See e.g. Atlantic Coast Mechanical, Inc. v. Arcadis, Geraghty & Miller of North Carolina, Inc.,* 623 S.E.2d 334, 340 (N.C. App. 2006); *Land v. Tall House Building Co.,* 165 N.C. App. 880, 602 S.E.2d 1 (2004); *Gregory v. Atrium Door and Window Company,* 106 N.C. App. 142, 415 S.E.2d 574 (1992); *Wilson v. Dryvit Systems, Inc.,* 206 F. Supp.2d 749, 753 (E.D.N.C. 2002) *aff'd,* 71 Fed. Appx. 960 (4th Cir. 2003), all cases that involved application of the economic loss rule as a **defense** to negligence claims arising out of a defective **product** that caused damages to other components of the whole. Although these were not coverage cases, it may be that the economic loss rule analysis played a role in the court's analysis in *Production Systems* that there was no resulting damage to property other than the product involved, and thus no "property damage." A contrary view was taken in *Lord v. Customized Consulting Specialty, Inc.,* ___ N.C. App. ___, 643 S.E.2d 28 (2007) and *Ellis-Don Construction, Inc. v. HKS, Inc.,* 353 F. Supp.2d 603 (M.D.N.C. 2004).

> Since the quality of the insured's work is a "business risk" which is solely within his own control, liability insurance generally does not provide coverage for claims arising out of the failure of the insured's product or work to meet the quality or specifications for which the insured may be liable as a matter of contract… The cases interpreting this kind of exclusion recognize, as we do, that *liability insurance policies are not intended to be performance bonds.*

Barbee, 330 N.C. at 103, 408 S.E. 2d at 842. In *Barbee*, the Supreme Court indicated its willingness to broadly construe the concept of an insured's work product when the damages claimed are the result of faulty workmanship. The work performed by the *Barbee* employees did not include the damaged engine cylinders, but since that work damaged a part of the engine the insured's employees were working on, it was considered as part of the work encompassed by the exclusionary language.

Western World Insurance Company v. Carrington, supra involved a general liability policy issued to a subcontractor. The underlying claim consisted solely of costs incurred in replacing the allegedly defective waterproofing work done by the policyholder with a new waterproofing system. The court ultimately held that there would be no coverage for repair and replacement of the insured's work product. The court noted that the only claim was for costs incurred in substituting or replacing the protective functions which the insured's original waterproofing work should have provided. Accordingly, the damages sought were solely for bringing the quality of the insured's work up to the standard bargained for, and the policy provided no coverage for the claim. The court specifically noted, however, that there might be coverage for other types of damage, such as damage to other property (cracks in the concrete) or diminution in value. *Id.* at 525, 369 S.E.2d at 131.[4]

The most recent case where the issue of CGL coverage for construction defect claims was addressed using a "property damage" analysis is *Travelers Indemnity Co. v. Miller Building Corp.* 221 Fed. Appx. 265 (4th Cir. 2007)(unpublished). That case involved claims for defective workmanship in connection with the construction of a

[4] It should be noted that in both *Barbee* and *Western World,* a policy exclusion was the focus, not an analysis of whether there was "property damage" that triggered the coverage clause.

hotel, the Holiday Inn Sunspree at Wrightsville Beach, North Carolina. While arbitration proceedings were pending between the owner and the general contractor, Travelers, the insurer for the general contractor/Miller, filed a declaratory judgment action seeking a ruling on coverage for the claims against its insured under the CGL policy. The court ultimately determined that there was very limited coverage, relying on the state appellate court's decision in *Production Systems, Inc. v. Amerisure Insurance Co.* for the proposition that "…to the extent that [the owner] is seeking to recover from Miller the cost of correcting Miller's faulty workmanship, the claims do not fall within the scope of the policy issued by Travelers, because faulty workmanship does not constitute 'property damage.'" 221 Fed. Appx. at 268.[5] That statement in itself is not surprising or even particularly new, but the court's reliance on a case involving a **product** for damage claims arising out construction defects is important in that it shows the court's willingness to apply the same rationale outside the products arena.

Again, however, the case does not tell us how a court would rule if the insured's scope of work did not include the entire project. The insured in *Miller* was the general contractor, so all the work on the hotel could be viewed as its work product. In fact, the only damages claimed that triggered a duty to defend on the part of the insurer involved carpeting furnished by the owner. Past conventional wisdom is that damages caused to other parts of a project by faulty plumbing work, faulty electrical work, faulty framing, and so on would be viewed as "property damage" under the subcontractor's CGL policy. However, under a "Does it constitute property damage?" analysis, that may no longer be true, and neither *Production Systems* nor *Travelers v. Miller Building* gives us that answer. According to *Western World Insurance Company v. Carrington*, *supra*, resulting damage to other property should include parts of a project under the control of one contractor damaged by the work of another contractor. Consequently, the analysis has come full circle, and, as previously stated, any analysis of coverage is highly dependent on the scope of the work of the insured. If the damage is to property that the insured was responsible for constructing, then faulty workmanship will not be considered "property

[5] Typically, while the defense obligation of an insurer is determined by the facts plead, the indemnity obligation is determined by the facts proven. Accordingly, it is worth noting that the Fourth Circuit approved the district court's action in defining the scope of coverage under the policy even before the extent and nature of the damage had been proven in the underlying arbitration proceeding.

damage." If the damage is to other work, even in the same project, arguably that constitutes "property damage," and one moves to the next step in the inquiry to determine whether there is coverage.

3. Was the "property damage" caused by an "occurrence"?

CGL policies generally define "occurrence" as follows:

> *"Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.*

In *Waste Management of the Carolinas v. Peerless Insurance Company*, 315 N.C. 688, 694, 340 S.E.2d 374, 379 (1986), the North Carolina Supreme Court construed the word "accident" as used in a CGL policy as follows:

> This Court has defined "accident" as an unforeseen event, occurring without the will or design of the person whose mere act causes it; an unexpected, unusual, or undesigned occurrence; the effect of an unknown cause, or, the cause being known, an unprecedented consequence of it; a casualty.

This definition of occurrence effectively encompasses only events that are unexpected or unintended from the standpoint of the insured. However, the focus is on whether the injury was expected or intended, not upon whether the act was intended. *Washington Housing Authority v. North Carolina Housing Authority Risk Retention Pool*, 130 N.C. App. 279, 502 S.E.2d 626 (1998).

In *William C. Vick Construction Co. v. Pennsylvania National Mutual Insurance Co., supra*, the court held that shoddy workmanship does not constitute an "occurrence" under a CGL policy. The court stated, "A common element in the Supreme Court's definition of 'accident' is the notion that an accident is 'unforeseen,' 'unexpected,' 'unusual,' 'undesigned,' the effect of an 'unknown cause,' or an 'unprecedented consequence.'" 52 F. Supp.2d at 584. In so holding, the court indicated that the damages complained of were the natural and ordinary consequence of improperly performed work by the insured. *Id.*[6]

[6] That rationale was questioned by the Fourth Circuit in an unpublished decision, *Travelers Indemnity Company v. Miller Building Corporation*, 97 Fed. Appx. 431 (4th Cir. 2004). There, the Court focused on

Evaluation of the "occurrence" requirement in a CGL policy, requires a distinction in the types of risks that can arise from a contractor's work. The first is the risk of not performing the job properly, i.e. in accordance with the plans, specifications, industry standards and applicable building codes. This risk, sometimes referred to as a "business risk," should be borne by the contractor, both to satisfy his obligations under the contract to construct the specific project, as well as to satisfy the customer. Many times, coverage for this business risk is procured through a performance bond.[7] Under a performance bond, the surety or guarantor, who may pay the claim for the faulty workmanship, has the right to seek reimbursement of the claim from the general contractor who performed or was responsible for the poor work. The second risk that a contractor may face is for injuries or damages suffered by parties who were not a party to the construction contract (third-parties) as a result of the contractor's work. This risk, of accidental injury and damage to other persons or property, is the risk that is insured under a commercial general liability policy.

Recognizing the differences between the two types of risks that a contractor faces in performing his work, the South Carolina Supreme Court held in *L-J, Inc. v. Bituminous Fire & Marine Insurance Company* that the business risks of a contractor are not covered under a commercial general liability policy. Specifically, the Court held:

> We find these negligent acts constitute faulty workmanship, which damaged the roadway system only. And because faulty workmanship is not something that is typically caused by an accident or by exposure to the same general harmful conditions, we hold that the damage in this case did not constitute an occurrence. . . . As a result, the insurance policy will not stand to cover liability for the Contractor's contract liability for a claim that was for money damages to compensate for the defective work.

L-J, 366 S.C. 117, 123-24, 621 S.E.2d 33, 36 (2005). The South Carolina Court found that damages to the insured's work does not fall within the coverage provided by the

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the forseeability aspect of the damage resulting from shoddy workmanship and cited *Waste Management of the Carolinas v. Peerless Insurance Company, supra,* and *Washington Housing Authority v. North Carolina Housing Authority Risk Retention Pool, supra,* for the proposition that the crucial question is whether the insured actually and subjectively foresaw that its activity would result in the damage.

[7] Although the primary obligation assumed by the performance bonding company is the completion of the work if the principal (the contractor) defaults.

insuring agreement. More specifically, the contractor's faulty workmanship, which caused damage to his work product alone, did not meet the definition of an "occurrence" under the policy. *Id.* Recognizing that claims for faulty workmanship fall within the business risks assumed by a contractor in conducting its business, and therefore represent a risk that should not be borne by the insurance carrier, the Supreme Court held:

> Accordingly, we hold that the damage in the present case did not constitute an "occurrence." If we were to hold otherwise, the CGL policy would be more like a performance bond, which guarantees the work, rather than like an insurance policy which is intended to insure against accidents. A performance bond guarantees that the work will be performed according to the specifications of the contract by providing a surety to stand in the place of the contractor should the contractor be unable to perform as required under the contract. Consequently, our holding today ensures that the ultimate liability falls to the one who performed the negligent work – the subcontractor – instead of the insurance carrier.

Id. at 124, 621 S.E.2d at 37 (emphasis added). The South Carolina court's decision in *L-J* is representative of what the majority of states have held regarding this issue: that CGL policies provide coverage for the tort liability of a contractor for damages to other property, **not** for the contractual liability of the contractor for the performance of its own work. These cases have recognized that claims of faulty construction lack the fortuity necessarily inherent in the type of risks covered by CGL policies. *See, e.g., Firemen's Ins. Co. v. National Union Fire Ins. Co.*, 387 N.J. Super. 434, 904 A.2d 754 (2006) (New Jersey); *Kvaerner Metals Div. of Kvaerner US, Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 908 A.2d 888 (2006) (Pennsylvania); *Auto-Owners Ins. Co. v. Home Pride Co., Inc.*, 268 Neb. 528, 684 N.W.2d 571 (2004) (Nebraska); *Grinnell Mut. Reinsurance Co. v. Lynne*, 686 N.W.2d 118 (2004) (North Dakota); *State Farm Fire & Cas. Co. v. Tillerson*, 334 Ill. App. 3d 404, 777 N.E.2d 986 (2002) (Illinois); *Pursell Construc. Co. v. Hawkeye-Security Ins. Co.*, 596 N.W.2d 67 (1999) (Iowa); *Amerisure, Inc. v. Wurster Construc. Co.*, 818 N.E.2d 998 (2004) (Indiana); *Heile v. Herrmann*, 136 Ohio App. 3d 351, 736 N.E.2d 566 (1999) (Ohio); *Hawkeye-Security Ins. Co. v. Vector Construc. Co.*, 185 Mich. App. 369, 460 N.W.2d 329 (1990) (Michigan); and *U.S. Fidelity & Guar. v. Advance Roofing & Supply Co.*, 163 Ariz. 476, 788 P.2d 1227 (1989) (Arizona).

Other jurisdictions, however, have found that claims for construction defects fall within the purview of the initial grant of coverage in the insuring agreement and that faulty workmanship can be an "occurrence" as that term is used in a CGL policy. *See, e.g., Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App. – Houston [14 Dist.] 2006); *American Family Mut. Ins. Co. v. American Girl, Inc.*, 268 Wis.2d 16, 673 N.W.2d 65 (2004).

In *LamarHomes, Inc. v. Mid-Continent Casualty Company*, 2007 WL 2459193, 50 Tex. Sup. Ct J. 1162, ___ S.W.3d ___(2007), the Fifth Circuit Court of Appeals certified certain questions to the Texas Supreme Court in anticipation of deciding a declaratory judgment action between the insurer and policyholder. One of the questions certified to the Texas Court was "When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an 'accident' or 'occurrence' sufficient to trigger the duty to defend or indemnify under a CGL policy?"[8] *Id* at *3. The insurer argued that there was no occurrence because the damages alleged were only for repairs to the home flowing from the insured's contractual undertaking and were presumed to be have been forseen.[9] The Texas Court disagreed even though it conceded that in order to constitute an "occurrence," there had to be an accidental injury. The Court stated that in order to determine whether an insured's faulty workmanship was intended or accidental was dependent upon the facts and circumstances of the case, and that, under certain circumstances, faulty workmanship could be an accident and thus an "occurrence." The Court refused to make a distinction between damage to the insured's work and damage to other property, stating as follows:

> The CGL policy, however, does not define an "occurrence" in terms of the ownership or character of the property damaged by the act or event. Rather, the policy asks whether the injury

[8] The other certified question was whether the same claim constituted a claim for "property damage" under the policy. The Texas Court stated as follows: "Although certified as separate questions, the two are connected because both focus on the same property damage limitation, the home. Moreover, the CGL's insuring agreement ties the two concepts together by covering only those occurrences that cause property damage or bodily injury." *Id* at p. *3. The Texas Court ultimately held that there was both an "occurrence" and "property damage" alleged in the claim.

[9] This is similar to the rationale applied by the Eastern District in *William C. Vick Construction Co. v. Pennsylvania National Mutual Insurance Co, supra,* that the damages complained of were "the natural and ordinary consequence of improperly performed work by the insured." (see p. 7 *infra*)

> was intended or fortuitous, that is, whether the injury was an accident. As one court has observed, no logical basis within the "occurrence" definition allows for distinguishing between damage to the insured's work and damage to some third party's property.[10]

Id. at *6.

As is evident from the differing analyses among the jurisdictions, the question of whether there is an "occurrence" (accident) causing "property damage" is not an easy one to answer in a vacuum. One must consider who the insured is, what is the insured's scope of work, what are the damages claimed, what is claimed as the cause of the damages and numerous other factors on a case-by-case basis. The holdings of previous cases can be a guide for decision making, but care should be taken that the comparison is between apples and apples, since prior cases may have involved different players, different damage claims and different policy language. As if the "property damage" and "occurrence" issues are not enough, one must also consider the next issue to determine whether there is coverage, and which coverage applies.

4. Was there "property damage" during the policy period? What policy period applies?

This issue arises because of the trigger of coverage issues that have been the subject of several cases in North Carolina over the past few years. With the decision in *Gaston County Dyeing Machine Co. v. Northfield Ins. Co.*, 351 N.C. 293, 524 S.E.2d 558 (2000), North Carolina began a new era of trigger of coverage law, utilizing the date of "injury-in-fact" as the date to be used to determine what policy applies to a particular claim. Before the year 2000, North Carolina courts typically followed the rule that property damage "occurred" for insurance purposes on the date that the damages were discovered or "manifested," following the rule of *West American Insurance Company v. Tufco Flooring East, Inc.*, 104 N.C. App. 312, 409 S.E.2d 692 (1991), *review denied as improvidently granted*, 332 N.C. 479, 420 S.E.2d 286 (1992).

Gaston County was a coverage lawsuit which arose out of an underlying products liability action. The products liability case involved certain defects that were present in the design and manufacture of pressure vessels fabricated by Gaston County Dyeing

[10] The Court further stated that such a distinction was only found by the application of certain exclusions, not by limiting the definition of "occurrence."

Machine Company for another company, Rosenmund, Inc. Rosenmund sold the pressure vessels to Sterling Pharmaceuticals, Inc. for use in its production of contrast media dyes for diagnostic medical imaging. On June 21, 1992, Sterling Pharmaceuticals modified its production process by increasing the operating pressure in one of the pressure vessels. On August 31, 1992, Sterling Pharmaceuticals discovered that a leak had occurred in the vessel at the time of the modification, causing contamination of over 60 tons of the contrast media dye. Sterling Pharmaceuticals then filed a products liability suit against Gaston County Dyeing Machine Company. That case was settled for $11 million. A dispute then arose as to the applicable insurance coverage for the claim. Gaston County Dyeing Machine Company had switched carriers on June 30, 1992. Therefore, one carrier had coverage at the time that the operating pressure in the vessel was modified, and a second carrier had coverage when the damage was discovered. All parties agreed that the contamination of Sterling's contrast media dye commenced on June 21, 1992, as a result of the rupture of the pressure vessel and leakage, and that the leakage continued until discovery on August 31, 1992. Even though the policyholder argued for a continuous trigger, the Court rejected that argument stating that when the accident that causes an injury-in-fact occurs on a date certain and all subsequent damages flow from the single event, there is but a single occurrence, and only policies on the risk on the date of the injury-causing event are triggered. Although acknowledging the manifestation date rule adopted by the North Carolina Court of Appeals in *Tufco,* the court expressly overruled that case insofar as it purported to establish a "bright line rule" that the trigger date is always the manifestation date. Instead, the court ruled that the policy in effect on June 21, 1992, the date of the undisputed injury-in-fact, was the applicable coverage. Specifically, the court stated the following:

> We conclude that where the date of the injury-in-fact can be known with certainty, the insurance policy or policies on the risk on that date are triggered. This interpretation is logical and true to the policy language.

Gaston County, 351 N.C. at 303, 524 S.E.2d at 564.

The North Carolina Court of Appeals reaffirmed and expanded the *Gaston County* decision in *Hutchinson v. Nationwide Mutual Fire Insurance Co.*, 163 N.C. App. 601, 594

S.E.2d 61 (2004) in the context of a construction defect lawsuit, involving a latent defect and continuing damage over time. The *Hutchinson* plaintiffs were homeowners who argued that the damages to their retaining wall were caused by the continuing entry of water into the wall, which they alleged resulted from the insured contractor's faulty construction. The issue was "whether the property damage occurred within the policy period." *Id.* at 604, 594 S.E.2d at 63. The contractor was insured at the time of the discovery of the damage to the retaining wall but had no insurance at the time of completion of the construction. The court stated that, for purposes of determining insurance liability, "[i]f this Court can determine when the injury-in-fact occurred, the insurance policy available at the time of the injury controls." *Id.* Where damage continues over time, "if the court can determine when the defect occurred from which all subsequent damages flow, the court must use the date of the defect and trigger the coverage applicable on that date." *Id.* at 605, 594 S.E.2d at 64. Although it agreed with the plaintiff's theory of injury, the court noted that the evidence was clear that the damage to the retaining wall occurred outside the period in which the defendant insured the contractor. *See also Miller v. Owens*, 166 N.C. App. 280, 603 S.E.2d 168 (2004) (unpublished decision) [no coverage where evidence was clear that property damage was caused by contractor's actions or inactions at time of construction, which was completed four months before insurer's policy took effect].

In *Harleysville Mutual Insurance Company v. Berkley Insurance Company of the Carolinas*, 169 N.C.App. 556, 610 S.E.2d 215 (2005), the Court of Appeals followed *Hutchinson*, and held that the Berkley policy on the risk at the time of discovery that synthetic stucco had been improperly applied was not triggered because the installation work had been done by the insured/contractor prior to inception of coverage under the Berkley policy. Although not specifically overruled, it appears from the *Harleysville Mutual Insurance Company* decision that *Bruce-Terminix Company v. Zurich Insurance Company*[11] is no longer good law either, since that case was argued for the proposition that in latent defect situations, there is no date of injury-in-fact that can be known with certainty, and therefore, the date when the plaintiff knows a claim exists should be the relevant date for trigger of coverage.

[11] 130 N.C. App. 729, 504 S.E.2d 574 (1998).

The most recent case on the subject, *Nelson v. Hartford Underwriters Insurance Company*, 630 S.E.2d 221 (N.C. App. 2006), involved a homeowners' policy on a house that became infested with mold. The plaintiffs/homeowners made claims against the general contractor and subcontractors who built the house and against their homeowners' carrier whose policy was in effect at the time the mold was discovered but not at the time the house was constructed. The court held that even though the mold damage continued over time, it could determine when the defects occurred from which all subsequent damages flowed, and that the dates of the defects triggered the policy in effect on that date. Since Hartford's policy was not in effect on the trigger date of the injuries [i.e. during construction or at the time of completion of construction], it was not "on the risk" at the relevant time, and there was no error in granting summary judgment to Hartford on the plaintiffs' claim for wrongful denial of coverage.

Utilizing the date of construction or completion of construction as the trigger date for coverage in property damage claims arising from allegedly defective construction is well established by these cases. That appears to be true even though there may not have been any actual damage that in fact occurred at that specific point in time. But how far will that rationale extend? Will it be extended to other situations where there **is** a date of damage that can be known with certainty? Will that date then be the date of injury-in-fact[12], or will the courts adhere to the date of completion of the work as the date for trigger of coverage for the sake of simplicity? There are many scenarios where there may be a date known with certainty that damage actually occurred, but the gravamen of the complaint is that the damage would not have occurred in the absence of defective construction or some act or omission on the part of the defendant/insured that took place earlier.

Whether the courts will follow a different rule for bodily injury claims also remains to be seen. There is nothing in the language of the case law that indicates a different analysis will apply, and the policy language is the same for both "property

[12] thus remaining consistent with the "injury-in-fact" rule articulated in *Gaston County Dyeing Machine Co., supra*

damage" and "bodily injury" claims.[13] The timing of "injury-in-fact" for bodily injury should be readily known with certainty, except in cases of latent injury or disease.

5. Is the cause of the damage or the damage claimed excluded from coverage under the policy?

There are a number of policy exclusions that are typically invoked in any situation involving claims arising out of defective construction. Their application depends on the particular fact situation, but the more common exclusions are those consistent with the business risk analysis in section 3. herein. The typical exclusions that will arise in the construction defect claims context are those excluding coverage for:

> *"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".*

and

> ***Damage to Your work***

[13] Some guidance can be taken from *Imperial Casualty and Indemnity Co. v. Radiator Specialty Co.*, 862 F. Supp. 1437 (E.D.N.C. 1994), where the Eastern District Court evaluated several trigger of coverage options in the context of a latent bodily injury claim for asbestosis. The court held, "Given the longstanding practice of the North Carolina courts to resolve disputed insurance coverage questions in favor of the insured, the court concluded that the courts of this State would not adopt the manifestation rule in asbestos-related injury cases . . . . While this necessarily involves some speculation, the court is inclined to the view that North Carolina would adopt the exposure theory." *Id.* at 1443.

> *"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."*[14]
>
> *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.*

An exhaustive analysis of the application of these and other potential exclusions is not warranted here, but the courts of this State have been clear in their interpretation and application of exclusionary language to issues of coverage, to wit: exclusions are not favored and are strictly construed against the insurer. *Carlson v. Old Republic Insurance Co.*, 160 N.C. App. 399, 585 S.E.2d 497 (2003); *Stanback v. Westchester Fire Insurance Co.*, 68 N.C. App. 107, 314 S.E.2d 775 (1984).

Additional Insured – An Issue on the forefront

As contractors become more sophisticated, and especially in the arena of large commercial contracting, it is common for the general contractor[15] to require that the subcontractors name the general contractor (and sometimes the owner) as an additional insured on the subcontractor's CGL policy. Historically, the typical additional insured (AI) endorsement read:

> *WHO IS AN INSURED (Section II) is amended to include as an insured the person or organization shown in the Schedule, but only with respect to liability arising out of your ongoing operations performed for that insured.*[16]

Sometimes the requested coverage is accomplished by a blanket additional insured provision that will typically read as follows:

> *Who is An Insured (Section II) is amended to include as an insured any person or organization for whom you are performing operations when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional*

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[14] This is the exclusion discussed by the Texas Supreme Court in its analysis in *LamarHomes, Inc. v. Mid-Continent Casualty Company*, *supra*. [See p. 10, *infra*]

[15] Sometimes a major subcontractor will require its subcontractors to name it as additional insured along with the general contractor.

[16] [ISO Form CG 20 10 03 97]

> *insured on your policy. Such person or organization is an additional insured only with respect to liability arising out of your ongoing operations performed for that insured. A person's or organizations status as an insured under this endorsement ends when your operations for that insured are completed.*[17]

The conventional wisdom in application of these and other versions of an AI endorsement[18] was that the insurance policy only covered claims against the additional insured if those claims were based on the negligence of the named insured/policyholder. Some described the coverage as being limited to the vicarious liability of the additional insured for acts or omissions of the named insured. The crux of the analysis was that claims against the additional insured for its sole negligence were not covered. That thinking was proven to be wrong when the Court of Appeals decided the recent case of *Pulte Home Corporation v. American Southern Insurance Company,* ___ N.C. App. ___, 647 S.E.2d 614 (2007). There, the court held that the additional insured endorsement at issue covered the AI/general contractor for its own independent negligence if there was a causal nexus with the subcontractor's [named insured's] operations. The specific language of the endorsement at issue provided:

> WHO IS AN INSURED (Section II) is amended to include as an insured [Pulte Home Corporation] but only with respect to liability arising out of [TransAmerica's] operations…

Id. at ___, 647 S.E. 2d at 617. The court interpreted the phrase "arising out of" broadly, rather than restrictively, and used the term "causal nexus" as the standard. That standard was defined as requiring only that there be a nexus between the liability claimed against the additional insured and the named insured's operations. The court refused to equate the term **operations** with the term **negligence,** stating that a sufficient relationship exists if the liability of the additional insured "… is a 'natural and reasonable incident or consequence of' those operations."[19] *Id.* at ___, 647 S.E.2d at 618.

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[17] [ISO Form CG 20 33 03 97]

[18] There are many forms of AI endorsement, and those quoted are simply examples. The one consistent provision in most, however, is the attempt to refrain from conferring more coverage to the AI than is held by the policyholder.

[19] citing to *State Capital Ins. Co. v. Nationwide Mut. Ins. Co.*, 318 N.C. 534, 350 S.E.2d 66 (1986) *disc. review denied,* 349 N.C. 354, 525 S.E.2d 449 (1998).

The court's analysis confirmed a strong inclination to construe policy terms in favor of coverage, even when the claimant was not the policyholder. The court also provided clarification of the operative terms used in most form AI endorsements. In the future, we can expect that insurers will clarify what they intend to cover as well as what they intend not to cover with unequivocal language to avoid these issues in the future. If not, we can expect that the courts will continue to construe policies in favor of coverage when possible, but to interpret the policies as they are written when the language used is clear.

Conclusion

This manuscript is intended simply as a guide to the current state of affairs in the world of insurance coverage for construction defect claims and associated issues. The language employed in CGL policies changes, and it often changes as the result of rulings by the courts interpreting that language. While changes in "the rules" are sometimes necessary, those changes often create or uncover new and unanticipated issues. Policyholders want to know what they are paying for, and insurers want to know what risk they are taking on. As construction in our State continues to increase, these issues become increasingly important to the contractors, to the insurers and to the owners.