Construction Defect Claims: A 2017 Update — Part One

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Commentary

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While decisional authority addressing potential coverage for construction defect claims under commercial general liability policies continues to evolve, many decisions in 2017 relied upon long-recognized doctrine to decide contested matters. While such decisions allow the construction industry a reasonable basis to anticipate what might fall within the coverage of their policies, a few decisions offer a reminder to practitioners to monitor developing case law. For example, a South Carolina court considered a case involving building code violations, structural deficiencies, and significant water-intrusion problems observed shortly after purchasers occupied their newly built condominium units. In the ensuing declaratory judgment action, the insurer alleged it had no duty to indemnify, but the court held that the insurer’s reservation of rights letter was inadequate. The court explained that “an insured must be provided sufficient information to understand the reasons the insurer believes the policy may not provide coverage.” The court added that “generic denials of coverage coupled with furnishing the insured with a copy of all or most of the policy provisions (through a cut-and-paste method) is not sufficient.” The plaintiff’s failure to properly reserve prevented the plaintiff from disputing coverage as to actual damages.

Similarly, the Florida Supreme Court recently reviewed the following question of law certified by the United States Court of Appeals for the Eleventh Circuit: “Is the notice and repair process set forth in Chapter 558, Florida Statutes, a “suit” within the meaning of the commercial general liability policy issued by C & F to Altman?” The court concluded that “alternative dispute resolution” means “[a] procedure for settling a dispute by means other than litigation” and, therefore, Chapter 558 falls within this definition as a statutorily required pre-suit process intended to encourage a claimant and insured to settle claims for construction defects without resorting to litigation.

This article, the first of two parts, highlights numerous decisions from across the country over the past twelve months that affirm certain rules upon which the construction industry has long relied, along with several other rulings that offer new developments the industry should monitor going forward.
A general contractor constructed a resort community. The insured manufactured stucco used in the construction of the community. The community brought suit for construction defects against the general contractor who in turn brought a third party claim against the insured, alleging that the property damage alleged in the underlying suit was caused by defective stucco.

The insurer defended the stucco manufacturer subject to a reservation of rights and also commenced a declaratory judgment action to determine whether stucco was excluded from coverage. The insured asserted a counterclaim seeking reformation of the policy to cover all paint and coating products, including those used in the construction of the resort community. The insurer moved to dismiss the reformation counterclaim.

The court granted the insurer’s motion to dismiss the reformation counterclaim. The court observed that grounds for reformation were limited to (1) mutual mistake or omission by both parties or (2) unilateral mistake accompanied by fraud or inequitable conduct of the remaining parties. The court added that a reformation claim was subject to a heightened pleading standard because it included elements of fraud and/or mistake.

The court stated the insured failed to plead mutual mistake because it failed to allege that the insurer also expected the policy would cover coating products. Moreover, the insured failed to plead unilateral mistake accompanied by fraud or misrepresentation because the insurer did not act inequitably by filing a declaratory judgment action. The court noted the policy signed by the insured contained the language at issue and that the insured did not seek clarification for months.

**Practice Point:** Reformation claims are subject to a heightened pleading standard in federal court and require more than claims that mistakes occurred.

The plaintiffs—a California limited partnership, a California corporation, and a Delaware corporation—brought a bad faith action against defendant insurers in California state court. The case arose from an underlying suit by the Palmquist family for alleged construction defects. The plaintiffs had tendered the Palmquist claims to the defendants and the defendants denied coverage. The defendants removed the bad faith suit to federal court based on diversity jurisdiction.

Following removal, defendant ASIC merged with TIG Insurance Company, a California corporation. TIG was the surviving corporation. The plaintiffs subsequently filed a motion to add TIG as a defendant, to add claims against ASIC and TIG with regard to a second construction defect underlying lawsuit and, if allowed, to remand to state court.

The court observed that the request to add/substitute TIG as a defendant and the request to add TIG and claims related to a second construction defect action were analytically distinct. The court stated further that the request to substitute TIG for ASIC was governed by Federal Rule of Civil Procedure 25, rather than Federal Rule 19. Under Rule 25 and relevant decisional authority, a party added via Rule 25 does not destroy diversity jurisdiction; however, the court noted a motion under Rule 25 to substitute had not been made, so the court declined to substitute TIG.

The court noted that the initial inquiry in this matter was whether the court had jurisdiction to consider whether claims could be added against ASIC and TIG for a second construction defect. The court held that the request was not governed by Rule 25 because it sought to add claims against TIG because of its own conduct and not solely because of the merger. Therefore, the court held that it did not have jurisdiction because the proposed new claims were brought under state law, the parties were not diverse, and the court’s supplemental jurisdiction did not apply because the two underlying construction defect claims did not share a
common nucleus of operative fact. Consequently, the court denied requests and the request to remand.

**Practice Point:** The addition or substitution of parties and claims is dependent on the facts. A litany of rules and statutes may apply that not only affect the ability to add or substitute parties or claims but can also affect the court’s ability to decide the case.

**Nevada**

**Potential For Allegations That Trigger Coverage Insufficient To Trigger Duty To Defend**


The plaintiffs were numerous insurance companies that had provided a defense to 15 construction defect lawsuits brought against numerous construction companies. The plaintiffs brought the present action against the defendant claiming that it had a duty to defend the underlying lawsuits and should share in the defense costs. The plaintiffs argued that there was a potential for coverage because the complaints in the underlying lawsuits were so vague.

The defendant’s insurance policy provided coverage for “property damage” but excluded “continuous or progressive injury,” which entailed any damage that occurred prior to the inception of the policy. The policy also deemed any damage caused by an insured’s work to have begun prior to the inception of the policy if the work was performed before the policy start date. However, there was an exception to the exclusion that provided coverage for “sudden and accidental” damage.

The court reiterated that the duty to defend is broad and that it must be construed in an insured’s favor. The court then stated that despite its breadth, the duty to defend was not limitless. The court rejected plaintiffs’ argument that the duty was triggered in the 15 construction defect lawsuits because they were so vague. The court noted that there were no allegations of “sudden and accidental” damage; and furthermore noted that even if a complaint’s ambiguity introduced the possibility that it could encompass covered allegations in the future, this alone is not sufficient to trigger a duty to defend. The court stated that the thrust of the complaints was that the homes were defectively built before the defendant’s policies started. Thus, the court held that the defendant had no duty to defend.

**Practice Point:** While the duty to defend is broad, it still has its limits. Actual allegations triggering coverage—as opposed to the potential for allegations triggering coverage—are necessary to require a defense.

**Pennsylvania**

**Faulty Workmanship Does Not Qualify As An Occurrence**


The defendant was a subcontractor on a condominium project. The condominium association sued the project’s contractor who in turn brought suit against the defendant. The project’s contractor alleged that the defendant installed carpeting and flooring at the condominium project and that any defects with the carpet or flooring were the result of defective work performed by the defendant.

The plaintiff insured the defendant. The insurance policy, in general, provided coverage for “property damage” caused by an “occurrence.” The plaintiff brought the present lawsuit claiming that it had no duty to defend or indemnify the defendant from the claims made in the condominium project litigation.

After review of Pennsylvania law, the court stated that “for an occurrence to trigger coverage under the policy, the underlying complaint must allege something besides faulty workmanship against a contractor or subcontractor.” The court stated that in the condominium project litigation, the only allegations against the defendant were for faulty workmanship. Therefore, the court held that the plaintiff had no duty to defend.

**Practice Point:** While the court held that faulty workmanship did not qualify as an “occurrence,” it indicated that other allegations such as allegations of a defective product or damage beyond the work itself could qualify. Thus, insurers and their counsel must closely analyze every complaint.
Minnesota
No Duty To Furnish Bond And Unallocated
Stipulated Judgments Are Unenforceable

Kuepers Construction, Inc. designed and constructed
homes in a common interest community, which
Interlachen Properties, LLC sold to members of the
Interlachen Property Owners Association, Inc. After
discovering a number of design and workmanship
defects in the buildings, the Interlachen Property Own-
ers Association sued Kuepers and Interlachen Proper-
ties. The defendant insurer had issued a commercial
general liability policy to Kuepers. The defendant
insurer provided Kuepers a defense to the construction
defect action pursuant to a reservation of rights, but did
not provide Interlachen Properties with a defense.

The court granted summary judgment for Interlachen
Properties and partial summary judgment for Kuepers,
leaving only breach of warranty and negligent repair
claims against Kuepers in the construction defect
action. The defendant then issued Kuepers a second
reservation of rights letter stating that the remaining
warranty claims were not covered and that the negligent
repair claims were only considered to the extent the
work caused resulting damages. These claims went to
trial. The jury awarded Interlachen Property Owners
Association over $2 million dollars and the court
awarded it costs and interest.

The court in the construction defect action would have
stayed the judgment pending appeal if Kuepers issued a
supersedeas bond in the amount of the judgment. Kue-
ners asked the defendant to procure the bond as it was
on the verge of bankruptcy, but the defendant refused
to procure the bond. Ultimately, Kuepers and the Inter-
lachen Properties entered into stipulated judgments
with the Interlachen Property Owners Association
that stated that the judgments could be collected exclu-
sively from the defendant.

With regard to coverage, the court held that the defen-
dant did not breach its duty to defend by not procuring
a supersedeas bond for Kuepers. The court held that the
policy only required the defendant to pay the cost to
the bond and did not obligate it to furnish the bond itself.
Second, it held that Interlachen Properties qualified as
an insured as a “real estate manager.” The court stated
that the plain meaning of the term “real estate manager”
included “one who conducts, directs, or supervises
another’s real estate.” Third, the court held that the
defendant did not breach the duty to indemnify Inter-
lachen Properties, which had no legal obligation to pay,
as it won summary judgment and the stipulated judg-
ment reserved the right to seek payment from the
defendant, not Interlachen Properties.

Fourth, the court held that the stipulated judgments
were unenforceable as a matter of law. The court stated
that the policy contained an exclusion for “damage to
your work.” The court then stated that part of the
stipulated judgments were to remedy faulty construc-
tion, which would not be covered. The court concluded
that the stipulated judgments were unenforceable
because they did not allocate the award among covered
and uncovered claims.

Practice Point: It is critical to under-
stand the enforceability of stipulated
judgments in your jurisdiction.

Pennsylvania
Foreseeable Resultant Damages From Faulty
Workmanship Did Not Allege An Occurrence
Northridge Vill., LP v. Travelers Indem. Co. of Connecti-

The plaintiffs purchased vacant land with the intention
of developing a planned community. The plaintiffs
then sold the lots to contractors, who in turn built
homes and sold them to individual unit owners. The
plaintiffs also constructed common facilities for the
planned community and maintained and controlled a
community association until it was transferred to indi-
vidual unit owners. The community association ulti-
mately brought suit against the plaintiffs and the
contractors claiming the plaintiffs performed deficient
construction. The defendant insurer had issued com-
mercial general liability and excess policies to plaintiffs,
but denied the plaintiffs coverage for the community
association’s lawsuit.

The court initially held that the term “occurrence” did
not include faulty workmanship. The court also held
that the definition of “occurrence” excluded negligence
claims premised on faulty workmanship. The court
then stated the allegations in the community association’s lawsuit truly were for faulty workmanship.

The court rejected plaintiffs’ argument that the lawsuit alleged an “occurrence” because it alleged “property damage” to related property beyond the plaintiffs’ work. The court stated that case law finding that faulty work does not constitute an “occurrence” has been extended to other property where the damage is a foreseeable result of the insured’s faulty workmanship. The court stated that the allegations in the community association lawsuit regarding consequential damage were directly linked to the defective work and entirely foreseeable.

The court also rejected the plaintiffs’ argument that the community association lawsuit alleged negligent construction and negligent supervision, mandating a different result. The court stated that faulty workmanship claims recast as negligence do not constitute an “occurrence.”

Finally, the court held that the real estate development activities exclusion was unambiguous and applied because the allegations in the community association lawsuit alleged the plaintiffs were responsible for planning, development, and creation of the planned community and engaged in the business of developing real property.

Practie Point: In some instances, damages resulting from faulty workmanship may be excluded if they are foreseeable from the faulty workmanship.

South Carolina
Reservation Of Rights Letters Must Be Specific, Punitive Damages Can Constitute An Occurrence, And Punitive Damages Are Not Subject To Time On Risk Reduction

Defendants constructed two condominium complexes between 1997 and 2000. After construction was complete and the units were sold, the purchasers became aware of construction problems, such as building code violations, structural deficiencies, and significant water-intrusion issues. In 2003, the purchasers filed suit to recover damages for necessary repairs to their homes. The defendant had obtained several primary and excess liability insurance policies with the plaintiff insurer between 1997 and 2000.

The plaintiff defended the suits pursuant to a reservation of rights. At the outset of each trial, counsel for the defendant conceded liability and, in both trials, the trial court directed a verdict in favor of the purchasers on the negligent construction cause of action. In one action, the jury returned a general verdict for $6.5 million dollars in actual damages and $2 million dollars in punitive damages. In the second action, the jury returned a verdict of $4.25 million dollars in actual damages, $250,000 in punitive damages, $250,000 in loss-of-use damages, and $750,000 in punitive damages.

The plaintiff subsequently filed a declaratory judgment action claiming it had no duty to indemnify and asked the court for an accounting to determine which portion of the juries’ verdicts constituted covered damage, if it had a duty to indemnify.

With regard to punitive damages, the court held that the defendant’s reservation of rights letter was inadequate. The court explained that “an insured must be provided sufficient information to understand the reasons the insurer believes the policy may not provide coverage.” The court added that “generic denials of coverage coupled with furnishing the insured with a copy of all or most of the policy provisions (through a cut-and-paste method) is not sufficient.” Due to the plaintiff’s failure to reserve properly, the plaintiff was prevented from disputing coverage as to actual damages.

Practie Point: Reservation of rights letters must meet the standard for the applicable jurisdiction. The risk of waiving the right to contest coverage can be severe.
California

Incorrect Standard Interpretation Of Additional Insured Provision Subjects Insurer To Extra-Contractual Damages


The plaintiff was the general contractor and developer of two residential projects. In 2011 and 2013, two groups of residents sued the plaintiff for damages in separate construction defect lawsuits. The defendant issued several comprehensive general liability policies to three of the plaintiff’s subcontractors and it added endorsements to those policies that named the plaintiff as an additional insured. The defendant declined to provide the plaintiff with a defense of the construction defect lawsuits. The plaintiff initiated this coverage action.

The trial court found that the defendant had a duty to defend on at least one of the policies. The court also found that defendant breached its implied covenant duties through its bad faith conduct in claims handling that denied a defense.

On appeal, the court first addressed the scope of the additional insured coverage. The applicable policy language provided that the plaintiff was an additional insured, but only for liability arising out of its work and only ongoing operations. The defendant argued that the language regarding ongoing operations indicated that the provisions did not provide products-completed operations hazard coverage. The court rejected this argument and stated that the additional insured provisions did not clearly restrict coverage to only ongoing operations simply by linking the ongoing operations phrase to the “liability arising out of the work” clause.

The court addressed the faulty workmanship exclusions which excluded coverage for “property damage” to “[t]hat particular part of real property on which you... are performing operations, if the ‘property damage’ arises out of those operations1D; and for “... property damage” for “[t]hat particular part of any property that must be restored, repaired, or replaced because ‘your work’ was incorrectly performed on it.” The court found that the exclusions did not apply because “the record does not contain a showing by the insurer that all of the damage the homeowners were claiming was limited to the particular location where one or another of the subcontractors was performing their work...”

The court also addressed the finding of bad faith. The court held that the finding of bad faith was proper and stated that there is a clear pattern and practice of refusing to defend additional insureds in construction defect cases based on the multiple tenders by plaintiff in this matter and the hundreds of denials of other additional insured tenders. The court remanded the issue of attorney’s fees awarded to the plaintiff back to the trial court due to the change in the how the attorney’s fees were charged by the plaintiffs' counsel during the litigation. The court also indicated that the punitive damages award should be recalculated on remand due to the correlation with the attorney’s fees award.

**Practice Point:** Each tender must be assessed independently in conjunction with each jurisdiction’s standards for the duty to defend. No tender should be routinely or automatically rejected.

California

Settlement Payments


In a coverage matter brought to determine settlement payments of various insurers for an underlying construction defect settlement, the Northern District of California addressed four summary judgment motions.

After settling a construction defect lawsuit, St. Paul Fire and Marine Insurance Co. filed a lawsuit against its insured’s other insurers, seeking contribution. The underlying suit was premised on negligent construction of housing dormitories. The insured was the drywall subcontractor and water damage occurred after the project was completed. A cross-complaint was filed against the insured for breach of contract, negligence, strict products liability, and equitable and contractual indemnification.

The insured maintained several policies with different insurers during the applicable time period, including
Penn, St. Paul, Travelers, Zurich, American Guarantee and Liability Insurance Co., and Everest National Insurance Co. All primary policies had policy limits of $1 million per occurrence and $2 million in the aggregate, except for the Zurich policies which had limits of $2 million per occurrence and $4 million in the aggregate for multiple occurrences.

The insured settled all claims for $4 million, with Travelers, Zurich, Penn and Everest agreeing to pay $1 million each toward the settlement. The insurers filed claims against each other and moved for summary judgment. Commenting on Penn’s motion, the court opined that there was a triable dispute of material fact whether the “known loss” provision excluded coverage under the first Zurich policy. As to an excess policy with American Guarantee, the court held that the policies were triggered and that they were “specific excess” policies since “other insurance” provisions did not impact the “specific excess” language. The Penn policy was also a “specific excess” policy, requiring Penn and American Guarantee to provide the same “level” of coverage.

Addressing Travelers’ and Zurich’s Motions, the court held that Travelers and Zurich failed to show that the general contractor’s alleged negligent supervision was connected to the claimed damages. It also found that there was a triable issue of material fact if the faulty installation actually caused the property damage. The court held that Penn’s claims against Travelers and Zurich for costs was unrecoverable because “taxed costs” are damages. In addition, the court held that the insurer must pay a second SIR in order to obtain coverage for a second “occurrence” under the Zurich Policy. Moreover, the court “found a triable issue of material fact as to whether there were one or two occurrences and whether one of the Zurich policies applies. Lastly, the amount of liability that Penn owed depended on the liability of the other insurers in this case.

As to St. Paul’s motion, the court opined that Penn did not provide any evidence that the insured knew of any water damage during the St. Paul policy period and thus no coverage was owed. In this regard, St. Paul was likewise not responsible for attorney fees under the “Additional Payments” provision.

Practice Point: Courts closely analyze the specific provisions, especially definitions, of policies which provide coverage for an insured for the same loss in order to determine priority and amounts of contribution.

Oregon Expert Policy Interpretation; Uniform Coverage Position


The plaintiffs purchased a farm owners insurance policy for their house and outbuildings. The policy provided “broad” form coverages.

After a windstorm blew off two roof panels of a horse arena, the plaintiffs submitted a claim to replace the entire roof. The insurer denied the claim, offering to replace only the two panels, which was below the $1,000 policy deductible. The insurer’s adjuster and engineer stated that the roof was improperly constructed. The plaintiff’s expert disagreed, finding the wind pulled out the roof screws, causing the panels’ displacement. This expert also opined that more panels were likely to be displaced during the next windstorm. The plaintiffs sued for breach of contract.

The defendant filed a motion to strike the plaintiff’s expert report interpreting the insurance policy. The plaintiff eventually agreed to strike their expert’s “legal opinions and insurance-related testimony.” However, the court held that the “plaintiffs have presented evidence that the April 15, 2015 windstorm ‘set in motion a train of events,’ that caused the rest of the roof to be damaged, and have sufficiently raised question of fact whether the windstorm or initial faulty construction was the efficient proximate cause of the roof’s compromised condition.” The court also found that the insurer’s agreement to replace two panels belied its argument that the cause of the damage was faulty construction: “[the defendant] appears to want it both ways by accepting the windstorm as the cause of the damage to the two panels but claiming faulty construction as the cause of the damage to the rest of the roof.” The court denied the insurer’s motion for summary judgment.

Practice Point: An insurer should maintain a uniform coverage position if it plans on denying coverage so as not to
be found to have issued inconsistent coverage determinations to its insured.

**Minnesota**

**Miller-Shugart Agreement**


An insured was sued for design and construction defects. The insurer defended the insured even though the policy only covered design defects and continued to do so after the design defect claims were dismissed. The insured was found liable for the construction defect claims and appealed. The insurer demanded the insured post a bond during the appeal and the insurer refused. The underlying plaintiff and the insured executed a Miller-Shugart Agreement, wherein the plaintiff and the insured agreed to a judgment in exchange for the plaintiff seeking recovery for the settlement amount only against the insurer.

The insurer commenced this declaratory judgment action arguing that the Agreement was unenforceable. In agreeing that the Agreement was unenforceable, the court found that the insurer never breached the policy and the insured never notified the insurer of the Agreement, and additionally noted concerns about the reasonableness of the Agreement.

**Practice Point:** Conditions precedent must be met for a Miller-Shugart Agreement to be enforceable.

**Florida**

**The “Notice and Repair” Process Set Forth In Chapter 558 Of The Florida Statutes Is A “Suit” Within The Meaning Of A Commercial General Liability Policy**


Altman Contractors, Inc. (“Altman”), a general contractor, brought an action against its insurer, Crum & Forster Specialty Insurance Company (“C&F”), seeking coverage under a commercial general liability policy with regard to a statutorily-required pre-suit process to resolve a claim for construction defects. The Florida Supreme Court reviewed the following question of law certified by the United States Court of Appeals for the Eleventh Circuit: “Is the notice and repair process set forth in Chapter 558, Florida Statutes, a “suit” within the meaning of the commercial general liability policy issued by C & F to Altman?”

Altman maintained seven consecutive one-year commercial general liability policies containing the materially same terms. The policy provided in pertinent part: “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. We will have the right and duty to defend the insured against any suit seeking those damages.” The policy defined “suit” as “… a civil proceeding in which damages because of bodily injury, property damage, or personal and advertising injury to which this insurance applies are alleged.” The policy added that the term “suit” includes:

a) An arbitration proceeding in which such damages are claimed and to which the insured must submit or does submit with our consent; or

b) Any other alternative dispute resolution proceeding in which such damages are claimed and to which the insured submits with our consent.

The policy did not provide further definitions for “civil proceeding” or “alternative dispute resolution proceeding” as used within this definition of “suit.”

Chapter 558, titled “Construction Defects,” sets forth procedural requirements before a claimant may file an action for a construction defect. See § 558.03, Fla. Stat. (2012). The statute provides that a claimant must “serve written notice of claim on the contractor, subcontractor, supplier, or design professional, as applicable” before the claimant may file an action for a construction defect. § 558.004(1), Fla. Stat. (2012). The Court observed that the issue whether C & F had a duty to defend Altman during the Chapter 558 process is determined by whether the process is a “suit” as defined by the policy.

The court held that Chapter 558 sets forth a pre-suit process whereby the claim may be resolved solely by the parties through a negotiated settlement or voluntary repairs without ever filing a lawsuit. Therefore, the 558 process is not a “civil proceeding” within the policy
definition of “suit.” However, the court also held that subparagraph (b) broadens the definition of “suit” to “[a]ny other alternative dispute resolution proceeding in which such damages are claimed and to which the insured submits with our consent.” The Court concluded that “alternative dispute resolution” means “[a] procedure for settling a dispute by means other than litigation” and, therefore, Chapter 558 falls within this definition as a statutorily required pre-suit process intended to encourage a claimant and insured to settle claims for construction defects without resorting to litigation.

**Practice Point:** A pre-suit process may qualify as a “suit” under a policy provision defining “suit” as “any other alternative dispute resolution proceeding.”