Should Insurance Cover Defects?

Article by Gary Bague

The notion of fortuity is a central underpinning of insurance. Intuitively, we understand that it would be difficult to purchase insurance for an accident that has already happened, and even if such insurance were somehow to be made available, that by definition it would be impossible to price it. Whether faulty workmanship that results in construction defects can be considered an "occurrence" under a comprehensive general liability (CGL) policy strikes at the essence of insurance. If insurance is intended to protect insureds against losses from accidents, then an insured contractor who is sued for unintended damage because of accidental faulty workmanship should arguably be covered for such loss. But can damage from faulty workmanship ever be considered accidental if the work provided by the contractor was completed as intended and loss flowing from poor workmanship inevitable? This question continues to fuel litigation over whether and to what extent insurance should cover construction defects. A divergence of opinion has also led at least four states – Arkansas, Colorado, Hawaii and South Carolina – to enact legislation on the point.

Commercial general liability insurance policies are set up to address contingent loss. While typically covering specific types of damages, as defined mainly by "property damage" and "bodily injury," all standard policies require that damages be caused by an "occurrence," a defined term that introduces the requirement that any such damages result from an accident. Regarding the specific issue of whether construction defects caused by faulty workmanship constitute an occurrence, courts are split.

For example, the Supreme Court of Florida has held that there is coverage for claims made against a general contractor for damage to a completed project caused by a subcontractor's defective work. Florida's high court reasoned that this damage is neither expected nor intended from the contractor's standpoint, thereby constituting property damage caused by an occurrence.

Although the rule in Florida reflects the majority rule, a number of states, including Iowa, Kentucky, Nebraska, Ohio, Oregon, Pennsylvania and West Virginia, have held to the contrary. Those states follow the rule that damage to a contractor's work arising from defective construction can never constitute a covered occurrence. Most recently, in October 2012, the Supreme Court of Ohio issued a decision holding that claims against a subcontractor, alleging defective construction and workmanship of a steel grain bin manufactured by the subcontractor, were not covered under the subcontractor's policy because they were not claims for property damage caused by an occurrence.

In between the extreme (always and never) holdings are decisions such as that by the Fourth Circuit Court of Appeals, which held that under Maryland law, a subcontractor's defective installment of stucco did not constitute an accident and therefore could not be considered an occurrence. Nonetheless, insurance was held to cover the loss because the subcontractor's defective workmanship resulted in damage to property other than the work itself—the contractor's otherwise non-defective work product.

DEFINING 'OCCURRENCES'

In response to state court decisions holding that faulty workmanship is not an occurrence, Colorado, South Carolina, Arkansas and Hawaii each recently passed legislation favoring coverage. Colorado's House Bill 10-

1394 requires that policies be construed under a presumption that property damage caused by a construction professional's work, including damage comprising the contractor's own work, be viewed as an accident and therefore qualify as an occurrence triggering coverage. The Colorado General Assembly declared in its findings accompanying the bill that it was prompted by a Colorado Court of Appeals decision that the Assembly believed did not properly consider a construction professional's reasonable expectation that an insurer would defend the professional against a claim for damage. The Colorado courts have held that the statute is not retroactive and therefore does not apply to policies expiring before May 21, 2010.

South Carolina's statute, South Carolina Code Section 38-61-70, is nearly identical to Colorado's and mandates that the term "occurrence" in CGL policies be interpreted to include loss caused by faulty workmanship. This legislation, like that of Colorado's, was compelled by a disfavored court decision from the Supreme Court of South Carolina, which reasoned that damages resulting from faulty workmanship were not an occurrence because they were the "natural and probable cause" of that work.

Arkansas Code Section 23-79-155 similarly requires that all CGL policies issued in Arkansas contain a definition of occurrence that includes "property damage or bodily injury resulting from faulty workmanship." The legislature was compelled by its dislike of a decision from the Arkansas Supreme Court that held that "faulty workmanship is not an accident." The statute is silent on whether it applies retroactively, nor does it address typical exclusions, leaving them subject to further judicial interpretation.

In a more roundabout way, Hawaii Revised Statute Section 431-1 seems to preserve comprehensive general liability coverage for construction defects by providing that the term "occurrence" shall be construed in accordance with the law as it existed at the time that the insurance policy was issued. While no further explanation is included to delineate that law, the statute is expressly based on a rejection of a decision by the Hawaii Intermediate Court of Appeals that invalidated insurance coverage "that was understood to exist and that was already paid for by construction professionals." It appears that the Hawaii legislature was more interested in restoring coverage as it existed prior to the court decision, but was content to leave open for court interpretation such issues as whether coverage for the insured's own work should be restored.

Each of these four statutes increases the likelihood of coverage for construction defect claims. The statutes of Colorado, South Carolina and Hawaii, however, leave intact an insurer's right to refuse to cover damage to the insured's own work, while the Arkansas statute is somewhat less clear on this. But despite what may be a trend toward legislating coverage for construction defects, the courts will still ultimately resolve most of the details surrounding whether damages caused by faulty workmanship constitute an occurrence.

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