The Fun Never Ends—Key Insurance Coverage Developments from 2009 – 2010

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Table of Contents

I. Introduction ... 217
II. Insuring Agreement ... 218
  A. Overview ... 218
  B. Property Damage ... 218
  C. Occurrence ... 219
  D. Trigger of Coverage ... 221
  E. Known Losses ... 222
III. Exclusions ... 224
  A. Work Exclusions ... 224
  B. Contractual Liability Exclusion ... 226
  C. Asbestos Exclusions ... 226
IV. Additional Insured Endorsements ... 227
V. Supplementary Payments ... 227
VI. Conditions ... 228
  A. Notice ... 228
  B. Cooperation ... 228
  C. Voluntary Payments ... 229
  D. Self-Insured Retentions ... 229
  E. Special Contractor Warranties ... 230
VII. Covered versus Non-Covered Damages ... 230
VIII. Duty to Defend ... 231
IX. Conclusion ... 232

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I. Introduction

This article discusses developments in the case law from January 2009 to late July 2010 regarding selected construction related insurance issues. Most of the recent case law deals with issues involving interpretation of standard language used in occurrence-based Commercial General Liability (CGL) policies. Several courts have issued noteworthy opinions concerning non-standardized policy language and endorsements. A small handful of cases are discussed addressing special issues, such as notable developments regarding an insurance carrier's duty to defend construction defect claims.

Many cases discussed herein address the key terms and phrases used in the insuring agreement of a CGL policy for "bodily injury" and "property damage" liability. Judicial approaches and conclusions vary from state to state. While majority and minority rules have evolved on the primary issues, significant differences are reflected in the recent cases—even among courts following the same general rule or legal reasoning. Notably, a few cases shed light on the known-loss provisions, which are a relatively new section of a CGL policy's insuring agreement. Those cases discuss the extent of knowledge required to enforce the known-loss provisions, as well as other issues, including who bears the burden of proving the insured's knowledge of a pre-policy loss.

Several recent cases have addressed the application of the work exclusions—primarily, the exclusions for damage to property during ongoing operations. Viewed nationally, courts have not been wholly consistent in determining the key language of those exclusions, *i.e.*, "that particular part." Also, in light of the breadth of those exclusions—as contrasted to the narrower exclusion for "property damage" sustained after completion of operations—several cases demonstrate the importance of identifying when property is damaged in order to analyze the application of the correct work exclusion. One case demonstrates the difficulties of litigating disputes concerning covered versus non-covered damages, including the decision to use a general or special verdict form in the underlying lawsuit against the insured builder or subcontractors.

With respect to the supplementary payment provisions of a CGL policy, it appears a split of authority is developing as to whether the benefits provided under those provisions are tethered to covered damages. While case law remains sparse, it appears some courts find those benefits (*e.g.*, costs taxed against the insured) are tied to covered damages, whereas other courts conclude those benefits are payable regardless of whether the claims are ultimately within the scope of coverage.

A few cases have addressed policy conditions, including standard conditions (*e.g.*, notice, cooperation, voluntary payments) and non-standard conditions (*e.g.*, self-insured retention, contractor warranties). One recent case confirms that insured builders are generally not permitted to repair "property damage" before litigation, and thereafter seek reimbursement via their CGL policy. Other cases demonstrate that some courts will enforce conditions requiring a builder, as a pre-condition to coverage, to obtain hold harmless agreements and certificates of insurance from downstream contractors. Another case demonstrates that some courts will enforce conditions requiring that the named insured, and only the named insured, satisfy a policy's self-insured retention—a situation that can create profound complications in settling complex matters involving continuous losses, multiple policies, carriers, etc.

Several notable duty-to-defend cases have been issued, including cases applying the four- or eight-corner rule. One case demonstrates that, despite clear extrinsic evidence implicating coverage, an insurance carrier need only evaluate the pleadings and policy in evaluating its defense obligation. Also, recent case law

holds that, under the eight-corner rule, although an insured may not be entitled to a defense, the insured can still make a claim under the policy's indemnity benefit if the lawsuit produces evidence of covered damages. Finally, one court of appeal recently held that a CGL policy's defense benefit embraces pre-lawsuit alternative-dispute proceedings, such as those in California and Nevada that are legally required before certain types of certain construction defect lawsuit can be filed.

II. Insuring Agreement

A. Overview

Courts throughout the United States typically focus their analysis on one or more issue groups when evaluating whether a construction defect claim falls within the insuring agreement for "property damage" liability. Those issue groups are: property damage; occurrence; trigger of coverage; and known losses. The following subsections address each of these issue groups, along with a discussion of recent trial and appellate opinions relating to those issues.

B. Property Damage

In determining whether the "property damage" requirement is met, courts look to whether a third party's claim against the insured seeks to impose legal liability for damages because of "property damage."

The term damages, which is not defined in CGL policies, has generally been interpreted to mean a money judgment awarded in a civil court to compensate a third party's liability claim for a past loss—not for the cost of preventing future loss. Thus, courts generally seek to determine whether the complaining party seeks an award of money damages because of previously-sustained "property damage."

In the context of construction defect litigation, the existence or absence of "property damage" is often clear. In some instances, however, issues may arise as to whether the complaining party is seeking damages because of "property damage." CGL policies currently define "property damage" as follows:

> "Property damage" means:
>
> 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.

During the past two years, the majority of cases interpreting the term "property damage" focus on Part a. of the definition—namely, physical injury to tangible property.

One court found that a permeating odor may constitute "property damage." In *Essex Ins. Co. v. Bloomsouth Flooring Corp.*, 562 F.3d 399 (1st Cir. 2009), a subcontractor installed carpet in a commercial building under renovation. After moving back into the building, the employees of the building's owner noticed odor. They described the smell as that of a locker room, playdough, or sour chemicals. Some employees complained of headaches and other "ill effects." The first circuit, predicting how the Massachusetts Supreme Court would rule, noted that two state court cases had found "physical loss" under property insurance for carbon-monoxide contamination and oil fumes. The court concluded that under Massachusetts law, odor may constitute physical injury to tangible property under certain circumstances. *Id*. at 406.

Another court, applying the law of Vermont, found the change in the appearance of a residence may constitute "property damage." In *Fine Paints of Europe, Inc. v. Acadia Ins. Co.*, No. 2:08-CV-81, 2009 WL 819466

(D. Vt. Mar. 24, 2009), the insured sold defective paint that later exhibited cracking, chipping, peeling, loss of adhesion, and separation from the primer. The court held that tangible property suffers "physical injury," as used in a CGL policy's definition of property damage, where the property is altered in appearance, shape, color, or in some other material dimension. The court therefore concluded that a "claim based on defective paint that was applied to the exterior [of a residence] and materially altered the appearance of the property by cracking, peeling and separating comes within the insuring agreement's definition of property damage." *Id*. at *5.

In evaluating the "property damage" requirement, courts differ in their approach as to whether damage to the insured's work product is considered "property damage." Some courts apply a literal interpretation, finding "property damage" if the insured's work sustained a physical injury, whereas other courts appear to reach conclusions on "property damage" based on general principles and case law rules.

An example of the literal approach is a recent opinion by a federal district court, applying Kentucky law, which concluded that cracks in the insured's work product constitute "property damage." In *Generali U.S. Branch v. National Trust Ins. Co.*, No. 5:07-CV-139-R, 2009 WL 2762273 (W.D. Ky. Aug. 27, 2009), homeowners sued the insured builder for cracks in the brick veneer, footing, and drywall. Applying Kentucky's plain meaning rule of interpretation, the court concluded that damage to the insured's work product constitutes "property damage" under a CGL policy. *Id*. at *3-4.

In contrast, another court found that, under Indiana law, no "property damage" exists unless the complaining party sustains damage to property other than the interconnected systems on the structures built by the insured. *Cincinnati Ins. Co. v. Beazer Homes Inv., LLC*, 594 F.3d 441 (6th Cir. 2010). There, a general contractor built houses in a subdivision entirely through subcontractors. After completion, the homeowners complained of water intrusion and related damage to the interiors. Coverage litigation ensued when the general contractor's insurance carrier declined a reimbursement claim. Observing that under Indiana law, the entire structure is the general contractor's work, the court rejected the insured's argument that "damage to a properly constructed component of a house due to faulty workmanship of another component is 'property damage' under a CGL policy." *Id*. at 449.

Only a few recent cases have addressed Part b. of the "property damage" definition—namely, loss of use of tangible property that is not physically injured.

In a duty-to-defend case, a federal district court, applying Colorado law, apparently relied upon Part b. of the "property damage" definition where the subject property had not clearly sustained any physical injury. In *American Family Mut. Ins. Co. v. Teamcorp., Inc*., 659 F. Supp. 2d 1115 (D. Colo. 2009), the court focused on allegations that the structure would have to be torn down due to i) a violation of height restrictions; ii) improper location on the lot; and iii) improper pouring of the foundation. The court noted that the insured's alleged faulty plans and specifications caused "actual consequential damages to the entire structure that require it to be rebuilt." The court reasoned that, even if the complaint alleges no physical injury, those allegations constitute "loss of use of tangible property," and therefore satisfied the second part of the definition of "property damage." *Id*. at 1130.

C. Occurrence

In evaluating the "occurrence" requirement, courts analyze whether the "property damage" resulted from an "occurrence," a policy term defined to mean "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

Courts have historically approached the "occurrence" requirement differently depending upon the factual context and the judicial nuances reflected in the case precedent. Some courts determine whether the cause

of the "property damage," such as the original liability-producing act or omission, was accidental. Other courts also look to whether the insured expected or intended the resulting "property damage," even if the original act was deliberate, non-accidental conduct. And several jurisdictions evaluate the "occurrence" requirement in terms of the nature of the insured's liability—namely, contractual versus tort liability.

A split of authority exists as to whether or not faulty workmanship constitutes an "occurrence." A majority of courts holds that defective workmanship, standing alone, is not an "occurrence," whereas a minority of courts finds that faulty workmanship is an "occurrence." Under the majority view, faulty workmanship constitutes an "occurrence" only if something other than the insured's own work product sustains physical injury, such as a third party's personal property or non-defective work product. As recently explained by one court applying Georgia law, "while construction defects constituting a breach of contract are not covered by CGL policies, negligently performed faulty workmanship that damages other property may constitute an 'occurrence' under a CGL policy." *Hathaway Dev. Co., Inc. v. American Empire Surplus Lines Ins. Co.*, 686 S.E.2d 855, 860 (Ga. Ct. App. 2010).

A federal court applying Colorado law found that faulty workmanship, which causes consequential damages beyond that of the insured's own work, qualifies as an "occurrence." In *American Family Mut. Ins. Co. v. Teamcorp., Inc.*, 659 F. Supp. 2d 1115 (D. Colo. 2009), the insured drafted building plans and specifications that were later found to be defective and not to code. When evaluating whether there was damage to something other than the defective plans, the court found that the entire structure sustained consequential damages. Thus, because the claimed damages extended beyond the insured's faulty work product, the "occurrence" requirement was satisfied. *Id*. at 1129-130; *accord*, *Liparoto Constr., Inc. v. General Shale Brick, Inc.*, 772 N.W.2d 801, 809 (Mich. App. 2009) (Michigan law); *Auto-Owners Ins. Co. v. Newman*, 684 S.E.2d 541, 544-5 (S.C. 2009) (South Carolina law).

Many courts will find an "occurrence" where the insured does not expect damage resulting from defective workmanship. For example, in *Liberty Mut. Ins. Co. v. Pella Corp.*, 631 F. Supp. 2d 1125 (S.D. Iowa 2009), a window manufacturer sought coverage for claims arising out of water infiltration and subsequent damages caused by the manufacturer's defective windows. Applying the majority view, the federal district court found that under Iowa law, the allegations raised a potential "occurrence," because the window manufacturer may not have expected the water damage caused by the defective windows. *Id*. at 1134.

In California, however, where courts have broadly interpreted "occurrence" in the construction defect context, an intermediate appellate court focused on the insured's intent to commit the liability-producing act, *i.e.*, building a house, rather than the resulting damage caused by his unintentional encroachment. In *Fire Ins. Exch. v. Sup. Ct.*, 104 Cal. Rptr. 3d 534 (Cal. Ct. App. 2010), a homeowner built a home that encroached upon his neighbor's property, mistakenly believing he owned the subject disputed portion of the property. The court, focusing on the insured's intent to build the structure, concluded the homeowner's actions did not constitute an "occurrence." *Id*. at 540-41. The court reasoned that "the insured intended all of the acts that resulted in the victim's injury, and therefore, "the event may not be deemed an 'accident' merely because the insured did not intend to cause injury." *Id.* at 537.

Similarly, another court applying New York law focused on the insured's intent. *Trade-Winds Environmental Restoration, Inc. v. Stewart*, 653 F. Supp. 2d 649, 653 (E.D. La. 2009). There, the insured contractor, who had been hired to conduct mold remediation, used adhesive products to attach plastic sheets for use as containment barriers. The adhesives left a residue that damaged floors and walls. A court found the "occurrence" requirement was unsatisfied, holding that the contractor's choice of adhesive and placement of protective barriers with the adhesive were purposeful actions, not accidents. *Id*. at 655.

Despite the adoption of a particular view, some courts do not find an "occurrence," even when property other than the insured's faulty work has sustained damage. These courts base their findings on a variety of legal and factual underpinnings, including the theories of liability alleged against the insured and the insured's control over the construction project.

For example, courts in some jurisdictions evaluate the causes of action alleged against the insured, such as breach of contract or negligence, to determine whether the faulty workmanship was an "occurrence." In *Group Builders, Inc. v. Admiral Ins. Co.*, 231 P.3d 67 (Haw. Ct. App. 2010), a subcontractor faced potential liability for exterior and insulation work at a hotel construction project. The subcontractor sought coverage from its insurance carrier, who denied coverage because the underlying allegations against the subcontractor did not allege an "occurrence." The Hawaii intermediate appellate court agreed, finding that breach of contract claims alleging faulty workmanship do not constitute an "occurrence." The court further held that negligence claims, which are merely derivative of the breach of contract, are not an "occurrence" within the meaning of CGL policies. *Id.* at *7; see also, *Specialty Surfaces Int'l., Inc. v. Continental Cas. Co.*, No. 09-2773, 2010 WL 2267197 at *12-13 (3d Cir. June 8, 2010) (noting conflict between Pennsylvania and California law regarding whether insured's faulty workmanship and natural, foreseeable exacerbating events like rainfall were "occurrences," holding that under Pennsylvania law, "In order for a claim to trigger coverage, there must be a causal nexus between the property damage and an 'occurrence,' *i.e.*, a fortuitous event. Faulty workmanship, even when cast as a negligence claim, does not constitute such an event; nor do natural and foreseeable events like rainfall.").

In one jurisdiction, the court focused on the scope of the insured's control over the project in determining whether faulty workmanship qualifies as an "occurrence." In *Cincinnati Ins. Co. v. Motorists Mutual Ins. Co.,* 306 S.W.3d 69 (Ky. 2010), the Kentucky Supreme Court observed that the general contractor had control over the construction project, either directly or through its subcontractors. The court reasoned that "[o]ne cannot logically say, therefore, that the allegedly substandard construction of [the home] by [the general contractor] was a fortuitous, truly accidental event." Accordingly, the court found that the alleged faulty workmanship claim was not an accidental "occurrence" within the meaning of the subject CGL policy. *Id.* at 76.

Similarly, a federal court, following Arkansas law, found that the entire construction project was a general contractor's work product. In *Cincinnati Ins. Co. v. Collier Landholdings, LLC*, 614 F. Supp. 2d 960 (W.D. Ark. 2009), water had infiltrated through the building's ceilings, walls, and floors, resulting in mold growth on the interior walls. The court refused to find an "occurrence," stating that "a general contractor cannot segment his...work into that performed by various subcontractors, some of which is defective and some of which is not, in order to create an 'occurrence.'" Accordingly, the court found that there was no "occurrence" and therefore no coverage under the general contractor's CGL policy. *Id.* at 966.

D. Trigger of Coverage

Even if the "property damage" and "occurrence" requirements are satisfied, courts must still determine whether the complaining party sustained "property damage" during the policy period.

Courts nationwide have generally found that a CGL policy's coverage for "property damage" liability is limited to damage sustained during the effective dates of the policy. In most claims for "property damage," including construction defect disputes, the timing of the damage is fairly clear.

In some instances, however, the timing of "property damage" is not so clear, such as where a latent defect causes damage that first manifests long after it occurred. Or the nature of the "property damage" may implicate one or multiple policies. For example, a single event may result in one, immediate injury, such as a nail driven into a hidden waterline; or a single event may result in progressively deteriorating injury, such as poorly-installed windows allowing intermittent, continual water intrusion and resulting damages. Or a con-

tinuing event may result in one or multiple injuries over a span of time, such as continual leakage of hazardous material.

A body of case law has developed to address these and related issues, especially issues pertaining to whether multiple policies are implicated. A minority of courts apply the manifestation trigger. *E.g.*, *Arnett vs. Mid-Continent Cas. Co.*, No. 8:08-CV-2373-T-27EAJ, 2010 WL 2821981 at *7 (M.D. Fla. July 16, 2010) ("Under Florida law, the general rule is that the time of occurrence within the meaning of an 'occurrence' policy is the time at which the injury first manifests itself, that is, the date on which the damage first becomes visible.").

A majority of courts have adopted the injury-in-fact trigger, also known as the actual-injury trigger. *E.g.*, *Don's Building Supply, Inc. v. OneBeacon Ins. Co.*, 267 S.W.3d 20, 22 (Tex. 2008) (holding that "an insurer's duty to defend [is] triggered where damage is alleged to have occurred during the policy period but was inherently undiscoverable until after the policy expired[,]" reasoning that under Texas law, "the key date is when injury happens, not when someone happens upon it."); *Montrose Chemical Corp. v. Admiral Ins. Co.*, 42 Cal. Rptr. 2d 324 (1995) (holding that under California law, liability coverage under a CGL policy for "bodily injury" and "property damage" is established "at the time the complaining party was actually damaged.").

A Minnesota court recently applied the injury-in-fact trigger analysis in two cases, but reached different conclusions. In *Donnelly Bros. Constr. Co., Inc. v. State Auto Property & Cas. Ins. Co.*, 759 N.W.2d 651 (Minn. Ct. App. 2009), the insured faced liability in several lawsuits arising out of water intrusion and related damage caused by defective stucco installation. The insurance carrier declined to defend because the insured had completed its stucco operations before the carrier's policy incepted. The court disagreed, finding the carrier owed a duty to defend because, under the injury-in-fact trigger, the complaint raised the potential that the complaining party had sustained "property damage" during the carrier's policy. *Id*. at 658.

However, in *Tony Eiden Co. v. State Auto Property and Cas. Ins. Co.*, No. A07-2222, 2009 WL 233883 (Minn. Ct. App. Jan. 26, 2009), although water intrusion-related damages had occurred over a seven-year period, the facts showed the damage had ended before the inception of one insurance carrier's policy. Applying the injury-in-fact trigger, the court held that the carrier owed no duty to defend the insured or contribute along with the earlier carriers. *Id*. at *5.

E. Known Losses

The final step in analyzing the insuring agreement of a CGL policy's coverage for "property damage" liability involves determining whether the known-loss provisions apply—namely, whether any qualifying insured knew that "property damage" had occurred in whole or in part prior to the policy's inception.

Recent versions of the occurrence-based CGL policy incorporate the known-loss doctrine into the insuring agreement for "bodily injury" and "property damage" liability. The known-loss doctrine developed in the common law as a "defense to coverage by which insurers are not obligated to cover losses that either are occurring when the coverage is written or already have occurred." *Lewis v. Wolter Bros. Builders, Inc.*, No. 2009AP2037-AC, 2010 WL 1050252 at *4 (Wis. Ct. App. Mar. 24, 2010).

Only a few recent case opinions have addressed the insuring agreement's known-loss provisions. While the case law is still developing, these cases provide insights into how some courts are interpreting this relatively new, standardized language regarding the following issues: i) the necessary extent of knowledge on the insured's part of pre-policy "property damage;" ii) who bears the burden of proving the factual predicate for invoking the known-loss provisions; iii) the degree of specificity to which courts will look at particular items or categories of "property damage;" and iv) the limited application of the known-loss provisions in the duty-to-defend context.

One court suggested that to apply the known-loss provisions, the insured must subjectively know about both pre-policy "property damage," as well as the probability of being held liable for damages because of that "property damage." *Lewis v. Wolter Bros. Builders, Inc.*, No. 2009AP2037-AC, 2010 WL 1050252 (Wis. Ct. App. Mar. 24, 2010). There, a builder of five homes discovered evidence of water intrusion problems in April 2007. He was eventually sued and sought liability coverage under a policy that had incepted July 2007. The court found that under Wisconsin law,

> For the known loss doctrine to apply under a CGL policy, the insured must know more than the fact that there has been an occurrence that has caused damage to the property of a third party; the insured also must know that it is substantially probable that the insured will be liable for the damage.

Id. at *4.

Based on the evidence, including a pre-suit letter from a homeowner expressing an implied threat of litigation, the court found the known-loss doctrine "applies to relieve [the insurance carrier] of the obligation to cover [the insured's] losses." *Id*. at *4.

An important issue not fully developed in the case law concerns the burden of proof as it relates to the known-loss provisions in a CGL policy's insuring agreement. Under the laws of many states, the insured bears the burden of proving a claim falls within the insuring agreement, and if the insured satisfies its burden, the burden of proving an exclusion shifts to the insurance carrier. *E.g.*, *Aydin Corp. v. First State Ins. Co.*, 959 P.2d 1213 (Cal. 1998) ("The burden is on an insured to establish that the occurrence forming the basis of its claim is within the basic scope of insurance coverage. And, once an insured has made this showing, the burden is on the insurer to prove the claim is specifically excluded.").

While the known-loss provisions are akin to an exclusionary clause, they are technically part of the insuring agreement, and therefore arguably fall upon the insured to initially establish. One court, applying Florida law, apparently placed the burden upon the insured to demonstrate he was unaware of pre-policy "property damage." In *Arnett vs. Mid-Continent Cas. Co.*, No. 8:08-CV-2373-T-27EAJ, 2010 WL 2821981 (M.D. Fla. July 16, 2010), a home built by the insured sustained multiple items of "property damage." Five different policies were in play. In evaluating the known-loss provisions, the court looked at each category of damage, as well as the evidence regarding when the insured first knew about each particular category. As to two earlier policies, the court found the insured only knew about certain categories of pre-policy damage, and therefore found the known-loss provisions applied to only those items of damage. As to the third policy, however, the court found it did not apply, because the insured "has not demonstrated that it was unaware of the damage before the effective dates[]" of that policy. *Id*. at *4. While this opinion is somewhat unclear, and subject to differing interpretations, it appears that the district court may have required the insured to prove his lack of pre-policy knowledge.

Few state or federal courts have squarely addressed the known-loss provisions. These recent cases, however, suggest that those provisions will likely have limited application in the duty-to-defend context. This is because, at the time of tender of a construction defect lawsuit, little or no evidence exists concerning whether the insured possessed specific, subjective knowledge of each category of "property damage" before the inception of the CGL policy at issue. Accordingly, it would appear that in most instances, insurance carriers may experience difficulties, at the time of an original tender, in disclaiming a defense obligation based solely on the known-loss provisions.

III. Exclusions

A. Work Exclusions

In most construction defect disputes, many items of loss will not be within the scope of a CGL policy's liability coverage.

As noted above, some items of loss in a construction defect claim will not fall within the insuring agreement because i) the item at issue is not physically injured, and therefore does not constitute "property damage," or ii) the pertinent jurisdiction does not consider an item of loss, such as the insured's faulty workmanship, to be "property damage" even if it has sustained physical injury.

As to those items of loss falling within the insuring agreement, various exclusions for "property damage" will often preclude coverage. These exclusions are commonly referred to as "business risk exclusions." They generally preclude coverage for risks that are the "normal, foreseeable and expected incident[s] of doing business and should be reflected in the price of the product or service rather than as a cost of insurance to be shared by others." *Sterilite Corp v. Cont'l Cas. Co.*, 458 N.E.2d 338, 343 n.13 (Mass. Ct. App. 1983).

Recent case law addressing the business risk exclusions has dealt primarily with Exclusions j(5) and j(6). Exclusion j(5) precludes coverage for "[t]hat particular part of real property on which you [named insured] or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations." Exclusion j(6) precludes coverage for "[t]hat particular part of any property that must be restored, repaired, or replaced because 'your work' was incorrectly performed on it." The term "your work" is defined to mean "Work or operations performed by you [the named insured] or on your behalf."

Recent decisions have confirmed that Exclusions j(5) and j(6) operate in tandem, excluding coverage for "property damage" arising from ongoing work, but not applying to off-premises "property damage" arising from completed work. *Arnett vs. Mid-Continent Cas. Co.*, No. 8:08-CV-2373-T-27EAJ, 2010 WL 2821981 at *6 (M.D. Fla. July 16, 2010); *accord*, *Hathaway Development Co., Inc. v. American Empire Surplus Lines Ins. Co.*, 686 S.E.2d 855, 863 (Ga. App. 2009) ("[T]he damages occurred after [the plumbing subcontractor] had completed its work and left the job site, and thus (j)(5), excluding coverage for property damage to property on which the insured is 'performing operations,' does not apply.").

Traditionally, most construction defect lawsuits are limited to claims of "property damage" sustained after completion of operations. In those situations, Exclusion l., Damage to Your Work, is the pertinent work exclusion to analyze because it only applies to "property damage" sustained after completion of operations. In some instances, however, it may be unclear whether the subject property sustained damage during the named insured's operations or afterward. Consequently, issues may arise as to which exclusions would apply under the circumstances. The distinction is an important one because the exclusionary scope of Exclusions j(5) and j(6) is broader than the scope of Exclusion l., Damage to Your Work.

Exclusions j(5) and j(6) apply to property on which the named insured or subcontractors are working, whereas the Damage to Your Work exclusion applies only to damage to the named insured's work *and* is subject to a broad exception: the subcontractor exception. The subcontractor exception negates the Damage to Your Work exclusion if i) the damaged work was performed by the named insured's subcontractor; and ii) if a subcontractor's work caused the damage, even if the damage is to the named insured's work.

Thus, where the named insured is a general contractor or developer, the subcontractor exception essentially swallows the exclusion, because most of the work, if not all, is performed by subcontractors. Accord-

ingly, in evaluating which work exclusion to analyze, it is necessary to determine whether the particular item of "property damage" at issue was sustained during ongoing operations or after completion of operations.

In one recent case, a project was deemed completed for purposes of evaluating liability coverage, even though some components of the project remained incomplete. In *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207 (5th Cir. 2009), a condominium project was left partially unfinished so that the ultimate purchasers of each unit could choose and customize the finishes. During the open-ended suspension of activities by the contractor, the structure sustained water damage. The court decided that "prolonged, open-ended, and complete suspension of construction activities" did not fall within the ordinary meaning of the phrase "performing operations," as used in Exclusion j(5). Accordingly, the court found that Exclusion j(5) did not apply because the insured's operations had ceased for the foreseeable future and were not "ongoing." *Id*. at 213-4.

In another case, "property damage" that first appeared after completion of operations was found to be subject to Exclusion j(6). In *Acadia Ins. Co. v. Peerless Ins. Co.*, 679 F. Supp. 229 (D. Mass. 2010), the insured was hired to perform extensive renovations, including the removal, storage, and reinstallation of certain antique wood fixtures. A few months after reinstallation, the woodwork exhibited signs of cracking, shrinking, and separation. Ultimately, it was shown the problems related to excessive moisture during the storage and installation process. The court found that Exclusion j(6) "turns on when the insured actually inflicted the damage," and therefore applied to the damaged woodwork, reasoning that the insured had "caused damage ... while conducting its storage and installation operations." *Id*. at 244.

The most heavily litigated issue with respect to Exclusions j(5) and j(6) involves the meaning of the key phrase, "that particular part."

In Georgia, the Court of Appeals found the phrase, "that particular part," did not refer to the entire construction project. Instead, it applied only to the location and operation that the subcontractor was engaged in at the time the property sustained damage. In *Transportation Ins. Co. v. Piedmont Constr. Group, LLC*, 686 S.E.2d 824 (Ga. Ct. App. 2009), a plumbing subcontractor, while soldering copper pipes, negligently ignited a fire causing substantial damage to the building. In determining what constituted "that particular part," the appellate court framed the issue as whether "the payment of insurance proceeds effectively cause an insurance company to guarantee the contractor's work?" The court found that, although coverage was precluded for the damage to the room in which the subcontractor had negligently ignited the fire, Exclusions j(5) and j(6) did not operate to preclude coverage for damage to the balance of the building. *Id*. at 827.

In another case involving a subcontractor, a federal district court, applying the law of Florida, similarly found "that particular part" should be interpreted narrowly to include only the part of the project on which the subcontractor was working when the property sustained damage. In *Amerisure Mut. Ins. Co. v. American Cutting & Drilling Co.*, No. 08-60967-CIV, 2009 WL 700246 (S.D. Fla. Mar. 17, 2009), a subcontractor was hired to cut plumbing access holes into post-tensioned concrete floors of a construction project. While cutting the concrete, the subcontractor damaged cable embedded within the concrete. Because the subcontractor was cutting areas of the concrete floor when he inadvertently damaged the embedded cable, the court found that both Exclusions j(5) and j(6) applied to preclude coverage. *Id*. at 6-7.

However, in cases where a general contractor is the insured, some courts interpret "that particular part" broadly. For example, a federal district court case, applying Massachusetts law, found that "any work or operations performed by [the insured], as the general contractor, necessarily encompassed the [claimant's] home in its entirety[.]" *Friel Luxury Home Const., Inc. v. ProBuilders Specialty Ins. Co. RRG*, No. 09-cv-11036-DPW, 2009 WL 5227893 at *7 (D. Mass. Dec. 22, 2009). Based upon this reasoning, the court determined that Exclusions j(5) and j(6) precluded coverage for any damage to the home that was caused by the insured's faulty workmanship. *Id*. at *8.

A federal court applying the law of New Hampshire, which follows the same rule as Massachusetts, noted that Exclusion j(5) "delineat[es] a boundary…between any property on which the insured is in fact conducting operations and any property unrelated to the insured's project that may suffer incidental damage." *Acadia Ins. Co. v. Peerless Ins. Co.*, 679 F. Supp. 229, 243 (D. Mass. 2010).

Applying Ohio law, the sixth circuit in *Fortney & Weygandt, Inc. v. American Manufacturers Mut. Ins. Co.*, 595 F.3d 308 (6th Cir. 2010) also analyzed "that particular part" in relation to coverage sought by a general contractor, but arrived at a different conclusion. There, a general contractor sought coverage for a defective foundation, including the resulting damages sustained while demolishing and rebuilding the structure. The court found "that particular part" should be interpreted narrowly to include only the "building parts on which the defective work was performed, and not to the building generally." Additionally, the court stated that the term "part," as used in "that particular part," refers to distinct component parts of the building. Therefore, although Exclusion j(6) would preclude coverage for the repair and replacement of the insured's defective work, *i.e.*, the foundation, the court concluded the exclusion did not preclude coverage for the repair and replacement of the non-defective components that required replacement because of defective work. *Id*. at 310-11.

B. Contractual Liability Exclusion

All CGL policies contain exclusions for contractual liability.

But the exclusionary scope does not extend to any type of contractual liability. Rather, the exclusion applies to "bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.

Such exclusions are subject to a broad exception—namely, the exception for "insured contract." The exception applies, thereby negating the exclusion, where the contractual assumption of liability meets the definition of an "insured contract." CGL policies define this term to mean a "contract or agreement pertaining to your [the named insured's] business...under which you assume the tort liability of another party to pay for…'property damage' to a third person..."

Traditionally, most indemnity clauses in construction contracts have satisfied the definition of "insured contract," thereby invoking the exception and negating the exclusionary effect of the contractual liability exclusion. In a recent case, however, a Texas intermediate appellate court found the "insured contract" exception did not apply despite a subcontractor's written promise to indemnify the general contractor.

In *Century Surety Co. v. Hardscape Constr. Specialties, Inc.*, 578 F.3d 262 (5th Cir. 2009), a general contractor hired a subcontractor to build a pool. When the pool sustained cracks, water leakage, etc., an issue arose as to whether the contractual liability exclusion in the subcontractor's CGL policy precluded coverage. The subcontractor had agreed to indemnify and hold the general contractor harmless. Citing Texas law regarding the duty to defend, the fifth circuit noted that the "insured contract" exception would apply only if the developer's petition made "specific factual contentions that...could constitute 'a liability...imposed by law in the absence of any contract or agreement.'" Ultimately, the court found the "insured contract" exception did not apply, because the developer's petition only alleged damage to the pool, *i.e.*, the subject of the contract," and therefore sounded only in contract even though the petition alleged contract and tort theories. *Id*. at 270.

C. Asbestos Exclusions

In light of the long history of asbestos litigation and related coverage disputes, most insurance carriers modify the liability coverages afforded under a CGL policy by scheduling and affixing an endorsement that excludes "property damage" arising from asbestos.

In one recent case, a federal court applying Florida law enforced an exclusion for "'property damage'…in any way or to any extent arising out of or involving asbestos, asbestos fibers, or any product containing asbestos…." *Rolyn Companies, Inc. v. R & J Sales of Texas, Inc.*, 671 F. Supp. 2d 1314 (S.D. Fla. 2009). Focusing on the case law's interpretation of "arising out of"—originating from, having origin in, growing out of, flowing from, incident to, or having connection with—the federal district court easily found the exclusion applied to preclude coverage for the cost of replacing asbestos-related "property damage." *Id*. at 1331-2.

IV. Additional Insured Endorsements

Insurance carriers often issue additional insured endorsements that do not schedule or identify a specific person or entity. Rather, the endorsement's schedule describes a class of persons or entities that qualify as an "insured" under certain situations. A typical example is where the endorsement extends insured status to anyone, such as a general contractor, for whom the named insured has promised to procure additional insured coverage.

Ordinarily, this is easily satisfied because most general contractors insert boilerplate language into subcontract agreements, whereby the subcontractor promises to procure additional insured coverage for the general contractor. However, a general contractor's failure to properly follow through with subcontractors or maintain proper records can result in the inability to establish its status as an additional insured.

In a recent Florida case, a general contractor sought coverage pursuant to an additional insured endorsement on its subcontractor's policy. *Rolyn Companies, Inc. v. R & J Sales of Texas, Inc.*, 671 F. Supp. 2d 1314 (S.D. Fla. 2009). The policy defined additional insured as "a contractor on whose behalf you [the named insured] are performing ongoing operation, *but only if coverage as an additional insured is required by a written contract or written agreement that is an 'insured contract'*…. The subcontractor's policy defined "insured contract" as "[t]hat part of any other contract or agreement pertaining to your business…under which you assume the tort liability of another party to pay for…'property damage' to a third person or organization." The court ultimately concluded the general contractor did not qualify as an insured. Apparently, the general contractor was unable to produce a written agreement reflecting the subcontractor's written promise to both procure additional-insured coverage and to assume the general contractor's tort liability. *Id*. at 1335-336.

V. Supplementary Payments

CGL policies contain supplementary payment provisions. These provisions afford various insurance benefits that are outside policy limits. For example, the provisions promise in part that, "We will pay, with respect to any…'suit'…we defend…. The cost of bonds to release attachments, but only for bond amounts within the applicable limit of insurance…[and]…. All costs taxed against the insured in the 'suit'."

Recently, one court, applying Florida law, found that because an insurance carrier defended the lawsuit, it was required under the supplementary payments provisions to pay the post-trial cost bill, as well as any attachment bonds, "regardless of whether the claims are or are not ultimately covered." *Arnett vs. Mid-Continent Cas. Co.*, No. 8:08-CV-2373-T-27EAJ, 2010 WL 2821981 at *12 (M.D. Fla. July 16, 2010).

This holding appears to conflict with a recent holding by the California Court of Appeal, which found a link between the obligation to pay certain supplementary payments and coverage for the subject claim. *State Farm Gen. Ins. Co. v. Mintarsih,* 95 Cal. Rptr. 3d 845, 852–53 (Cal. Ct. App. 2009) (holding that "any suit we defend" language in supplementary payments provisions does not enlarge the carrier's duty to defend or obligate it to pay "costs taxed against the insured" on claims not potentially covered under the policy); but see, *Prichard v. Liberty Mut. Ins. Co.*, 101 Cal. Rptr. 2d 298, 313 (Cal. Ct. App. 2000) (holding that insurance carrier's

duty to pay taxed costs under supplementary payments provision was a function of carrier's defense obligation, not its indemnity obligation, and thus the carrier was obligated to pay costs whenever it owed duty of defense, independent of whether those costs would otherwise be covered by way of insurer's indemnity obligation.).

VI. Conditions

Relatively few cases in the past two years have addressed policy conditions. Most of the case law deals with the standard conditions in a CGL policy: notice, cooperation, and the voluntary payments conditions. Recent case law has also addressed specially endorsed conditions, such as self-insured retention endorsements and contractor warranty endorsements.

A. Notice

CGL policies impose upon the named insured a duty to promptly notify the insurance carrier of a potential loss or claim. The notice condition states that "You [the named insured] must see to it that we [the insurance carrier] are notified as soon as practicable of an occurrence or an offense which may result in a claim…." The condition further provides that "If a claim is made or suit is brought against any insured, you must…. Notify us as soon as practicable."

In one recent case, a court found that late notice, which deprives an insurance carrier of the opportunity to make pre-trial decisions, constitutes a material breach of the condition, thereby excusing the insurance carrier's contractual obligations. In *Lewis v. Wolter Bros. Builders, Inc.*, No. 2009AP2037-AC, 2010 WL 1050252 (Wis. Ct. App. Mar. 24, 2010), the insured developer learned in April 2007 that water-intrusion problems existed in five homes. A year later, he received a letter from an aggrieved homeowner threatening litigation. The homeowner eventually filed suit in November 2008, but the developer waited until February 2009 to notify the carrier. Upon finding the April 2008 letter had triggered insured's duty to notify its insurance carriers "as soon as practicable," the court required the insured to demonstrate the lack of prejudice to the carrier. Under Florida law, prejudice means "a serious impairment of the insurer's ability to investigate, evaluate, or settle a claim, determine coverage, or present an effective defense." Ultimately, the court found that the insurance carrier had sustained prejudice, because critical litigation dates had passed, thereby depriving the carrier of the ability to file amended pleadings, dispositive pretrial motions, complete discovery, etc. *Id*. at *4.

B. Cooperation

As a condition of coverage, CGL policies provide that "You [named insured] and any other involved insured must…[a]ssist us, upon our request, in the enforcement of any right against any person or organization which may be liable to the insured because of injury or damage to which this insurance may also apply."

Case law on the cooperation clause is sparse. But one recent case reveals the rigorous showing an insurance carrier must make to establish a material breach of the cooperate condition. In *Arnett vs. Mid-Continent Cas. Co.*, No. 8:08-CV-2373-T-27EAJ, 2010 WL 2821981 (M.D. Fla. July 16, 2010), a carrier claimed its insured, a general contractor, had materially breached the cooperation condition after trial by allowing the execution, levy, and public sale of its third party claims against subcontractors. Applying Florida law, the court found a carrier must prove the following to establish a material breach of the cooperation condition: i) the insured failed to cooperate; ii) the failure to cooperate constituted a material breach; iii) the rights of the carrier were substantially prejudiced; and iv) the carrier exercised diligence and good faith in seeking to bring about the cooperation of the insured. Because the carrier failed to timely reserve its right on the breach-of-condition issue, the court found it was estopped to deny coverage on this basis. *Id*. at *10-11.

C. Voluntary Payments

Generally, someone who is an insured under a CGL policy cannot expect reimbursement for payments made voluntarily and without the insurance carrier's consent. This is because CGL policies contain the following condition: "No insured will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent."

The voluntary payment condition is "designed to ensure that responsible insurance carriers that promptly accept a defense tendered by their insureds thereby gain control over the defense and settlement of the claim." *Jamestown Builders, Inc. v. Gen. Star Indem. Co.*, 91 Cal. Rptr. 2d 514 (Cal. Ct. App. 1999). This condition has been interpreted to "protect[] against coverage by *fait accompli*[,]" under the rationale that an insured cannot unilaterally settle a claim and thereafter seek coverage unless and until the insured has made a claim against the insurance policy, and the insurance carrier has rejected the claim.

In one recent case, the insured general contractor repaired the interiors of certain structures that had been damaged by the faulty work of its subcontractor. *Rolyn Companies, Inc. v. R & J Sales of Texas, Inc.*, 671 F. Supp. 2d 1314 (S.D. Fla. 2009). When its insurance carrier asserted the voluntary-payment condition, the insured argued that in unilaterally making repairs, it had "tried to do the right thing;" that it was mitigating damages; and that it had been forced to make repairs because it was facing "a big lawsuit." Ultimately, the court found the insured's cost to effect repairs was "voluntary"—interpreted to mean "acting or done without compulsion or obligation"—because the insured did not show that it had tendered the claim, and that the carrier had either consented to the repairs or declined coverage. *Id*. at 1328.

D. Self-Insured Retentions

In addition to a CGL policy's standard conditions, some insurance carriers are issuing policies subject to an endorsed self-insured retention (SIR). Such provisions, which have been described as conditions precedent, set forth a "retention" or "retained limit," which is a sum of loss that is the insured's initial responsibility to satisfy before the insurance carrier's obligations are invoked.

SIR endorsements can create many practical problems. For example, if a general contractor is facing liability for a continuous loss spanning several years, thereby implicating multiple policies and insurance carriers, but only one policy is subject to a retained limit, the general contractor may not be motivated (or financially able) to pay the retained limit, thereby satisfying a condition precedent to the insurance carrier's contractual obligations. If the carrier who issued the SIR endorsement refuses to participate in the defense and settlement until the retained limit is paid or satisfied, disputes and issues may arise as to how the retained limit can be exhausted and who can do so.

Recently, the California Court of Appeal held that, if an SIR endorsement clearly requires payment only by the named insured, that condition precedent will be enforced as written. In *Forecast Homes, Inc. v. Steadfast Ins. Co.*, 105 Cal. Rptr. 3d 200 (Cal. Ct. App. 2010), a developer sought coverage, as an additional insured, under a policy issued to a subcontractor. The subcontractor's policy had an SIR endorsement that specifically required the subcontractor to pay the retained amount, and that expressly disallowed payment by others. In coverage litigation, the developer contended its payment of defense cost satisfied the retained limit. The court disagreed, finding that the provisions of SIR endorsement to be clear, conspicuous, and therefore enforceable. *Id*. at 203.

With respect to determining retained amounts, some retained limits are determined and applied on a "per occurrence" basis. In *Liberty Mut. Ins. Co. v. Pella Corp.*, 631 F. Supp. 2d 1125 (S.D. Iowa 2009), a window manufacturer defended multiple class action lawsuits involving defects and resulting damage, incurring over $1 million in defense costs. Its various policies contained retained limits, ranging from $100,000 to $1 million

per occurrence. In determining whether the retained limits had been satisfied, a federal district court noted that Iowa had not adopted the majority or minority test for determining the number of occurrences. *Id*. at 1136. The court adopted the majority "cause" test, holding that all the lawsuits alleged damages arising from a single "occurrence." Specifically, the court reasoned that cause was "the design, manufacture, and...sale of a product containing the same latent defect." *Id*. at 1136. Accordingly, the court found that one payment of the retained limit was sufficient. *Ibid.*

Other retained limits are applied on a "per claim" basis. As illustrated in a recent case, however, an SIR endorsement may not be enforceable if the term "claim" is deemed ambiguous. In *Clarendon America Ins. Co. v. North American Capacity Ins. Co.*, No. E048176, 2010 WL 2377835 (Cal. Ct. App. June 15, 2010), two insurance carriers embroiled in contribution litigation disputed the meaning of a $25,000 per-claim retained limit that was endorsed on one carrier's policy. The underlying construction defect litigation involved multiple homes in a large residential project. Ultimately, the California Court of Appeal held the insured was only liable to make a single payment of $25,000 for the entire lawsuit. Although the SIR endorsement distinguished between "claim" and "suit," the court found the undefined term, claim, to be ambiguous, because other policy provisions used "claim" and "suit" synonymously. *Id*. at 9.

E. Special Contractor Warranties

In writing insurance for developers and contractors, many insurance carriers issue policies that are subject to specially endorsed conditions, sometimes referred to as contractor warranty endorsements. Such endorsements are intended to excuse the carrier's contractual obligations unless the insured complies with the terms and conditions therein. Those usually require the insured to obtain from each downstream contractor one or more of the following: a hold harmless agreement; a certificate of insurance; or an additional insured endorsement.

The intent of such endorsed conditions is to shift damages caused by the named insured's subcontractor to that contractor and its insurance carrier. Complying with these procedures affords the named insured and its carrier with additional layers of protection, thereby preserving the named insured's policy limits. As a practical matter, however, some developers, general contractors, and their construction supervisors fail to obtain one or more of these risk-shifting documents from each subcontractor. This may be due to the rush to complete the project on time, sloppy administrative practices and procedures, etc.

In any event, the California Court of Appeal has enforced such conditions where they are conspicuous and clear—at least in the context of contribution litigation between insurance carriers. For example, in *North American Capacity Ins. Co. v. Claremont Liab. Ins. Co.*, 99 Cal. Rptr. 3d 225 (Cal. Ct. App. 2009), two carriers sought to allocate a settlement they paid to settle a construction defect suit against their mutual insured. One carrier's policy was subject to a contractors warranty endorsement requiring hold harmless agreements and certificates of insurance. *Id*. at 229-230. Evidence revealed the insured failed to obtain required hold harmless agreements and certificates of insurance from several subcontractors. The court found the endorsement constituted a condition precedent, not an exclusion, because it "impose[d] certain duties on the insured to obtain the coverage provided by the policy." *Id*. at 290. The court, observing the endorsement was "clear and explicit," held that it "establishes a precondition of coverage as to work done by subcontractors for whom [the insured] failed to secure both a written hold harmless agreement and a certificate of insurance." *Id*. at 290-91.

VII. Covered versus Non-Covered Damages

Most construction defect lawsuits involve both covered "property damage" and items of loss that are not within the scope of coverage. Occasionally, disputes arise between insurance carriers and insureds as to

which items of loss are covered and which are not. If the liability claims against the insured proceed to trial, resulting in a general verdict against the insured, it may be very difficult or impossible to distinguish between the covered and non-covered portions of the judgment.

For example, in *Arnett vs. Mid-Continent Cas. Co.*, No. 8:08-CV-2373-T-27EAJ, 2010 WL 2821981 (M.D. Fla. July 16, 2010), the jury verdict against an insured builder did not specify the precise amount awarded to repair construction defects (not covered) or the amount to repair damage caused by those defects (covered). In subsequent coverage litigation, a federal district court, applying Florida law, held that since the carrier demonstrated the verdict embraced some unspecified, non-covered amounts, "the burden of apportioning or allocating these damages is on the party seeking to recover from the insurer." Nonetheless, the court ruled that the insured was relieved of this "impossible burden of proof," because the carrier had failed to advise the insured of the availability of a special verdict form, which was in the insured's interest, rather than a general verdict form, which was in the carrier's interests. *Id*. at *5-6. In finding the general verdict form was in the carrier's interest, the district court apparently predicated its reasoning on the fact that the insured bears the burden of proving covered damages.

VIII. Duty to Defend

Construction defect lawsuits are expensive to litigate. The right to an adequately-funded legal defense is an important insurance benefit to insured builders and subcontractors. At the same time, the cost of defending builders and subcontractors is a serious exposure to insurance carriers. In fact, the cost of a defense often exceeds a carrier's exposure for potentially-covered damages. Consequently, it is often the ongoing cost of a legal defense that drives the settlement of many construction defect disputes, even where the carrier possesses significant coverage defenses.

Duty-to-defend principles differ significantly from state to state. In some states, an insurance carrier must consider not only the facts alleged in the complaint, but also any other evidence that is extrinsic to the complaint and readily available or reasonably accessible. In other states, however, a carrier's contractual duty to defend is based solely upon the allegations of the operative pleading, as well as the contents of the subject insurance policy. As explained below, courts that apply the narrower standard—sometimes referred to as "four corner" or "eight corner" states—often find no duty to defend even where the facts extrinsic to the pleading demonstrate the insured faces liability for potentially-covered "property damage."

In *General Security Indem. Co. of Arizona v. Mountain States Mut. Cas. Co.*, 205 P.3d 529 (Colo. Ct. App. 2009), a homeowner association sued a builder for defects and resulting damage to property. Like pleadings in many construction defect lawsuits, the complaint enumerated specific defects, followed by general allegations that such defects "have caused...actual property damage, loss of use, and/or other losses to the Association, and consequential damages to...various elements of the Project..." *Id*. at 533. The builder sued the subcontractors, including an insured framer, alleging the framer had performed certain framing and siding work, and incorporating by reference the allegations in the homeowners' complaint. *Ibid*. Under Colorado's four-corners rule, a federal court found no duty to defend the framer, reasoning that, despite the general allegations applicable to all subcontractors, the framer's work was not implicated with respect to the specific allegations of "property damage" in the homeowners' complaint. *Id*. at 538-39.

In another case, the Supreme Court of Texas confirmed that under that state's eight-corners rule, extrinsic evidence is irrelevant in evaluating an insurance carrier's duty to defend. In *Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co.*, 279 S.W.3d 650 (Tex. 2009), an insured builder faced several construction defect lawsuits, one of which alleged water damage but not defective work by subcontractors. *Id*. at 652-653. In cover-

age litigation, the builder submitted evidence the work was performed by subcontractors, thereby implicating the subcontractor exception to Exclusion l., Damage to Your Work. *Id*. at 654. The court declined to recognize an exception to the eight-corners rule, reasoning that, although "[f]aulty workmanship by a subcontractor might fall under the...exception[,]" the petition against the insured did not mention any subcontractors or any negligent supervision by the builder. *Ibid*.

Interestingly, the Supreme Court of Texas ruled that even if an insurance carrier owes no duty to defend, it does not necessarily follow that the carrier will ultimately owe no duty to indemnify.

In *D.R. Horton-Texas, Ltd. v. Markel Int'l Ins. Co., Ltd.*, 300 S.W.3d 740 (Tex. 2009), homeowners sued a builder for water intrusion and mold-related damages. The builder sought coverage as an additional insured under a policy issued to the masonry subcontractor. That carrier declined to defend the builder, asserting the lawsuit's pleadings did not implicate that subcontractor. *Id*. at 741. Coverage litigation ensued after the builder settled the lawsuit. The carrier argued that, because no potential for coverage existed under the eight-corners rule, it owed no duty to indemnify the builder. *Ibid.*

The court disagreed, reasoning that "the duty to indemnify is not dependent on the duty to defend[,] and that an insurer may have a duty to indemnify its insured even if the duty to defend never arises." *Ibid*. The court further explained that the "insurer's duty to indemnify depends on the facts proven and whether the damages caused by the actions or omissions proven are covered by the terms of the policy." *Id.* at 744. Thus, although the Supreme Court of Texas affirmed the underlying ruling of no duty to defend, it remanded the matter to the trial court so that the builder and carrier could submit evidence to "establish or refute [the] insurer's duty to indemnify." *Id*. at 744-45.

Finally, the California Court of Appeal addressed the issue as to whether an insurance carrier's duty to defend a "suit" includes pre-litigation proceedings required under California law. In *Clarendon America Ins. Co. v. Starnet Ins. Co.*, 2010 WL 2904995 (Cal. App. 4 Dist., July 27, 2010), two insurers disputed whether a CGL policy's definition of "suit"—*i.e.*, "a civil proceeding in which damages...to which this insurance applies are alleged"—includes pre-litigation procedures under California law, commonly known as the Calderon Process. *Id. at* *1. The Calderon Act requires a common interest development association to satisfy certain dispute-resolution requirements with respect to the builder, developer, or general contractor before the association may file a complaint in court for construction or design defects. *Id*. Observing that the Calderon Process is mandatory, the court found it satisfied the definition of "suit," reasoning that it is "part and parcel of construction or design defect litigation initiated by an association and, as such, cannot be divorced from a subsequent complaint." *Id.* at *7.

IX. Conclusion

As reflected in the discussion above, case law concerning construction related insurance issues is far from consistent, even among courts purporting to follow the same rules. Many jurisdictions have not addressed important issues involving the known-loss provisions, supplementary payments provisions, and non-standard conditions such as self-insured retentions and contractor warranties. And in those states applying the four- or eight-corners rules on the duty to defend, it remains to be seen if and how an insured builder, who is properly denied a defense, can nonetheless invoke a CGL policy's indemnity benefit. It also remains to be seen whether courts nationally will also rule that mandatory, pre-litigation procedures for alternative dispute resolution constitute a "suit," and therefore fall within an insurance carriers' duty to defend.