Your Coverage Advisor

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Recent Trends Show that Contractors Should Continue to Pursue Insurance Coverage for Construction Defect Claims

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Recently, the highest courts in several states have decided whether construction defect claims will be covered by standard CGL policies, i.e. whether the particular construction defect, and resulting damage, fall within the definition of an "occurrence," or qualify as "property damage" arising from an "occurrence." As a result, the law has developed in many states to a point where policyholders can largely predict whether their standard CGL policies will cover construction defect claims. Because the trend strongly favors a finding of coverage, policyholders may be well-served to pursue coverage, even in traditionally unfavorable states.

Basic CGL Policy Definitions and Exclusions

The typical CGL policy obligates insurers to defend and indemnify the insured for claims arising from "bodily injury" or "property damage" caused by an "occurrence." An occurrence is "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The term "accident" is often undefined, and thus is afforded its ordinary

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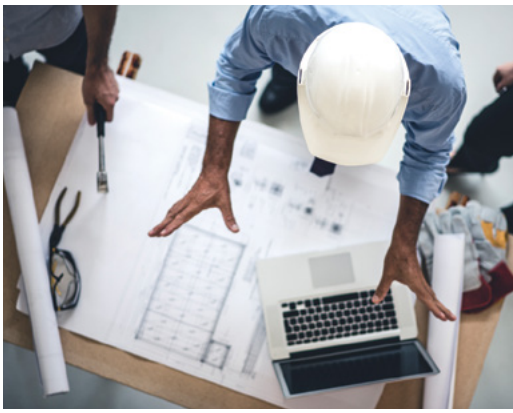

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meaning. *See e.g., Westfield Ins. Co. v. Custom Agri Sys.*, 133 Ohio App. 3d 576 (2012).

Courts evaluating whether construction defects are an "occurrence" covered by CGL policies often focus on whether such defects could reasonably be considered an "accident," or whether they were instead ordinary business risks outside the scope of unintended or unusual risks CGL policies are meant to insure against.

Coverage for Construction Defect Claims Varies by Jurisdiction

What constitutes an "occurrence" in situations involving defective construction work varies from state to state. Cases determining whether defective construction constitutes an "occurrence" generally result in one of three outcomes:

1.CONSTRUCTION DEFECTS ARE COVERED OCCURRENCES.

Some courts hold that both the defective work itself, and resulting property damage stemming from the defective work, can be a covered "occurrence." For example, the West Virginia Supreme Court recently reversed prior precedent by holding that defective workmanship "causing bodily injury or property damage is an 'occurrence' under a policy of commercial general liability coverage." *See Cherrington v. Erie Ins. Prop. & Cas. Co.*, 231 W.Va. 470, 483, 745 S.E.2d 508 (2013). *See also, K & L Holmes, Inc. v. American Family Mut. Ins. Co.*, 829 N.W.2d 724, 736 (N.D.2013); *Sheehan Constr. Co. v. Cont'l Cas. Co.*, 935 N.E.2d 160, 171 (Ind.2010).

2.CONSTRUCTION DEFECTS ARE OCCURRENCES WHERE THIRD-PARTY DAMAGE OCCURS.

Most courts find that defective construction is an "occurrence" only where there is damage to property other than the defective work itself. Those courts are often split on whether non-defective work of the insured contractor is covered, with some courts finding damage to non-defective work of the insured to be an "occurrence" and others requiring third-party property damage. *Compare Taylor Morrison Servs. v. HDI-Gerling Am. Ins. Co.*, 293 Ga. 456, 460, 746 S.E.2d 587 (2013) (definition of occurrence did not require reference to the "identity of the person whose property or work is damaged thereby...") and *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871, 890 (Fla.2007)(coverage found where a subcontractor's work damaged the insured contractor's completed, and otherwise non-defective, work) *with Rosewood Home Builders, LLC v. Nat'l Fire & Marine Ins. Co.*, N.D.N.Y. No. 1:11-CV-1421, 2013 U.S. Dist. LEXIS 45374, at *11 (Mar. 29, 2013)(finding no occurrence unless property damage was inflicted upon a third party); *Liberty Mut. Fire Ins. Co. v. Kay & Kay Contr., LLC*, 545 F.App'x 488, 494 (6th Cir.2013) (applying Kentucky law).

3.NO COVERAGE AT ALL.

Some courts have found that no occurrence exists even where there has been resulting third-party property damage, generally relying on the purported rationale that where the insured performs faulty work, it is foreseeable that the faulty work could cause additional property damage. *See H.E. Davis & Sons, Inc. v. N. Pac. Ins. Co.*, 248 F.Supp.2d 1079, 1084 (D. Utah 2002); but see *Great Am. Ins. Co. v. Woodside Homes Corp.*, 448

[1] While these cases found defective work itself to be an "occurrence," they subsequently noted that the defective work of the insured was excluded by the business risk exclusions in the applicable policy, most often the "your work" exclusion. As a result, and depending on the facts presented, the practical significance of finding defective work standing alone to be an "occurrence" may be limited. As discussed below, an important distinction is whether a subcontractor has provided the allegedly defective work.

F.Supp.2d 1275, 1281 (D. Utah 2006) (finding coverage where a subcontractor's work causes the damage).

In response to decisions limiting coverage for construction defect claims, some states have enacted statutes that require policy definitions to include "faulty workmanship" within the definition of "occurrence," or require policy language to be interpreted as including certain construction defects within the definition of occurrence. *See, e.g.*, Ark. Code Ann. 23-79-155(a)(2) (2011); Colo. Rev. Stat. 13-20-808(3) (2010). However, these statutes may not be retroactive to the issuance of the policy. *See Greystone Constr. v. Nat'l Fire & Marine Ins. Co.,* 661 F.3d 1272, 1280 (10th Cir.2011).

Recent Decisions Have Trended Towards Coverage

In addition to the West Virginia Supreme Court's change of course in Cherrington, several decisions in the recent months demonstrate a growing trend towards finding at least some coverage for contractors. In *National Surety Corp. v. Westlake Investments, LLC*, 880 N.W.2d 724 (Iowa 2016), the Iowa Supreme Court held that defective workmanship of the insured's subcontractor was covered by a CGL policy, citing a litany of recent cases in support of its holding. In ruling, the Court focused on the language of the "your work" exclusion in the policy, which excepted out work performed by a subcontractor, finding that the language would be superfluous if the policy was not otherwise applicable to defective subcontractor work. *Id.* at 740-41.

Similarly, in *Cypress Point Condo. Assn., Inc. v. Adria Towers, L.L.C.*, – A.3d -, 2016 N.J. LEXIS 847 (2016), the New Jersey Supreme Court held that defective work of a subcontractor that caused water intrusion was a covered "occurrence" under a CGL policy.

The decisions from these courts, and the recent trend towards coverage in general that guided their decisions, signal that case law on coverage arising from construction defect claims continues to develop and evolve to meet the reasonable expectations of policyholders. In this regard, courts may increasingly be willing to revisit prior decisions that have limited coverage to policyholders for these claims. ■

When Actions Speak Louder Than Words

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Ohio has long protected the rights of an abandoned policyholder to hold its insurer responsible for the policyholder's settlement of a covered underlying claim. *Sanderson v. Ohio Edison Co.*, 69 Ohio St.3d 582 (1994). "By abandoning the insureds to their own devices in resolving the suit, the insurer voluntarily forgoes the right to control the litigation and, consequently, will not be heard to complain concerning the resolution of the action in the absence of a showing of fraud, even if liability is conceded by the insureds as a part of settlement negotiations." *Sanderson* at 586.

In reaching that now bedrock principle of Ohio law, *Sanderson* relied on the firmly established tenets discussed decades earlier in *Aetna Cas. & Sur. Co. v. Buckeye Union Cas. Co.*, 157 Ohio St. 385, 392 (1952), which held that "a primary insurer violates its duty to defend at its own peril, and [] its breach of that duty will make it liable for anything the [settling party] had to pay in a good-faith settlement of the claim as a result of the [] insurer's breach of duty.... [The insurer] cannot be immunized from payment by its own breach of contract." *Id.* at 587.

In *Sanderson,* the insurer breached its obligations when it explicitly refused to defend its insured in the underlying action, even though the allegations in the underlying case clearly "presented a claim which was potentially or arguably within coverage of the policies." *Id.* at 586. But what happens when the insurer is not quite so explicit and attempts to mask its denial behind a reservation of rights letter? That is the precise question recently addressed in *J.P. Morgan Securities, Inc. v. Vigilant Insurance Company*, Sup. Ct. N.Y. No. 600979/09, 2016 WL 3943731 (July 7, 2016).

In *J.P. Morgan Securities*, the insurer argued that it was not responsible for its policyholder's ultimate settlement of underlying claims because the insured allegedly violated consent to settle and duty to cooperate provisions in the policies. But during the course of the underlying actions, although the insurer did not explicitly deny coverage, it nevertheless responded repeatedly to the policyholder's requests for coverage with "reservations of rights" letters that unjustifiably took the positions that there was no "claim" under the policy and that other policy exclusions precluded coverage.

In New York, as in Ohio, while an insured's failure to comply with its contractual obligations may excuse performance by the insurer, the insurer's prior unjustified refusal to honor its own contractual obligations may excuse those obligations of the policyholder. "'An insurer declines coverage at its own risk.'" *Id.* at 2. (Citations omitted). A denial need not be explicit; rather, in circumstances where an insurer "effectively disclaim[s] coverage" through a reservation of rights, the policyholder is excused from complying with conditions precedent - such as consent to settle terms - in a policy. *Id.* at 4.

The *Sanderson* rule is motivated by fundamental judicial policy fairness: "Fairness and justice demand that an insurer that breaches its own [contractual] dut[ies] to an insured be estopped from asserting, as a defense ..., that the insured failed to [comply with policy terms]. Neither the insured nor the injured party is required to perform conditions in a policy made vain by reason of the insurer's prior breach." *Sanderson* at 587. Although the facts in *Sanderson* involved an explicit coverage denial, there is no doubt that Ohio law excuses a policyholder from complying with contractual conditions precedent - such as consent to settle terms - in circumstances where an insurer "effectively disclaim[s]" coverage through reservations of rights or other actions. ■

World Harvest Less Than it May Appear?

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In May of this year, the Ohio Supreme Court decided *World Harvest Church v. Grange Mutual Casualty Co.*, 2016-Ohio-2913, a coverage case that has gotten a fair amount of attention. Once it is understood just how narrow the decision was, however, it becomes clear that it has gotten more attention than it deserves.

The Underlying Case

In 2006, Michael Faieta picked up his son A.F. from a daycare program run by World Harvest Church. According to Mr. Faieta, A.F. was anxious and upset, and Mr. Faieta discovered numerous fresh cuts, welts, and red marks on A.F.'s back, buttocks, and thighs. A.F. told Mr. Faieta that Richard Vaughan, an employee, had spanked him with a ruler. A.F. was taken to Children's Hospital, where physicians identified his injuries as being consistent with abuse.

The Faietas sued Vaughan for battery and intentional infliction of emotional distress and World Harvest for negligent supervision and intentional infliction of emotional distress. The trial court ultimately entered judgment in favor of the Faietas for $2,871,431.87. Of that amount, World Harvest was held solely liable for a portion of the compensatory damages, plus all punitive damages and attorney fees. Vaughan was held primarily liable for additional compensatory damages and, based on respondeat superior, World Harvest was secondarily liable for those damages.

World Harvest and Vaughan appealed, and the appellate court affirmed the judgment against them. World Harvest then settled the case, paying the Faietas $3,101,147 including interest.

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The Appellate Court's Decision In The Coverage Case

Following the settlement, World Harvest sought indemnity from its liability insurer, Grange Mutual Casualty Company, and Grange refused to indemnify it. World Harvest then filed an action against Grange for a declaratory judgment. The trial court ultimately determined that World Harvest was entitled to indemnity for the compensatory damages, attorney fees, and interest it paid the Faietas, but not for punitive damages. Both World Harvest and Grange appealed.

The appellate court first analyzed whether World Harvest or Grange had the burden of allocating the compensatory damages awarded in the underlying case among the Faietas' various claims. Grange argued that the burden was on World Harvest and, since the damages could not be allocated, World Harvest was not entitled to indemnity for any of the damages. World Harvest argued that Grange had the burden of allocating and, since allocation was impossible, if any of the torts was covered, it was entitled to indemnity for all of the damages. Inasmuch as Grange had provided a defense for World Harvest under a reservation of rights and had failed to seek allocation, the court concluded that Grange had the burden of allocating.

Grange next argued that World Harvest was not entitled to coverage for the claim that World Harvest had itself, independently of Vaughan, intentionally inflicted emotional distress. The appellate court rejected that suggestion, and noted that, to the extent the jury found World Harvest liable based on Vaughan's conduct, those claims constituted covered occurrences because they were accidents from World Harvest's perspective. *Id.* at ¶ 30. Relying upon *Safeco Ins. Co. of Am. v. White*, 122 Ohio St. 3d 562, 2009-Ohio-3718, the appellate court concluded that, because World Harvest's corporate management did not commit Vaughan's intentionally harmful conduct, that conduct was an "occurrence" under the policy. *Id.* at ¶ 37.

The appellate court next considered Grange's argument that, to the extent World Harvest's liability was founded on its negligent supervision of Vaughan, coverage under the policy was excluded by a specific exclusion for "abuse or molestation":

> This insurance does not apply to "bodily injury...arising out of... [t]he actual or threatened abuse or molestation by anyone of any person while in the care, custody or control of any insured, or... [t]he negligent...[s]upervision... of a person...

The appellate court rejected the argument that this exclusion only applied to sexual abuse and determined that it "precluded coverage for [World Harvest's] negligent supervision of Vaughan's intentionally tortious conduct." The court also rejected World Harvest's argument that an endorsement that provided that corporal punishment of a student was not bodily injury "expected or intended from the standpoint of the insured" modified the exclusion.

Therefore, the appellate court held that World Harvest was not entitled to coverage for the damages for which it was held directly liable, but that coverage for the compensatory damages for which it was secondarily liable was

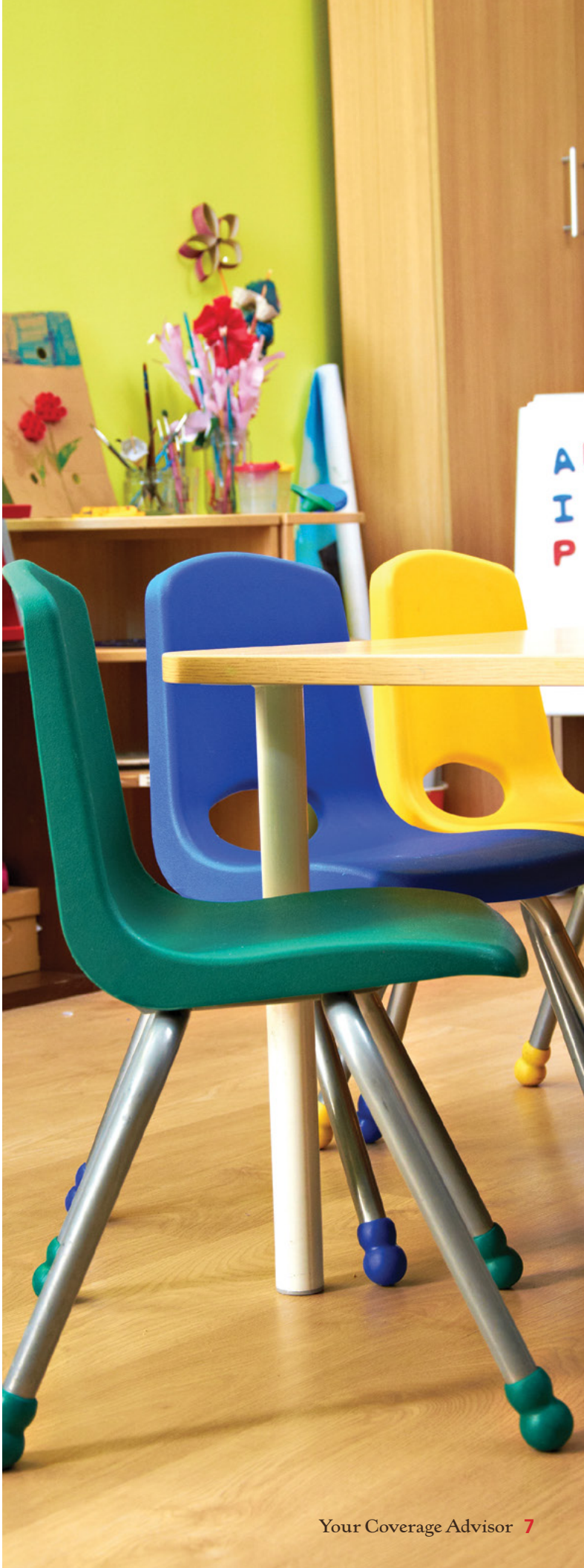
not excluded. It also affirmed the trial court's determination that World Harvest was entitled to coverage for attorney fees and interest.

The Ohio Supreme Court's Decision

Both World Harvest and Grange filed discretionary appeals to the Ohio Supreme Court. The Court declined jurisdiction over World Harvest's appeal, but accepted jurisdiction over Grange's appeal. Importantly, the Court began its analysis by emphasizing the narrow scope of the appeal, stating that "[t]he scope of this appeal is limited to whether the abuse exclusion eliminates coverage for damages awarded for [World Harvest's] vicarious liability for abuse." Thus, the Court did not analyze the various other arguments raised by the parties below.

World Harvest argued that, because the exclusion did not mention vicarious liability, it excluded only direct liability. The Court rejected that argument and reversed the determination that World Harvest was entitled to coverage for the compensatory damages awarded against it based on respondeat superior. Thus, the Court considered only the application of a very specific exclusion to a very specific claim in its decision.

It is important, however, to recognize what the Court did not decide. First, it did not decide whether the abuse and molestation exclusion applied to all types of physical abuse or was limited to sexual abuse. Similarly, the Court did not consider the significance of the corporal punishment endorsement. Perhaps most importantly, the Supreme Court did not consider whether the abuse and molestation exclusion actually excluded coverage for World Harvest's direct liability for its negligent supervision of Vaughan. The precedential value of the *World Harvest* case, then, is quite limited. ■



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Anastasia J. Wade

Attorney Highlights

Wes Lambert was appointed to the Summit County Council for Rebuilding Together NEO.

Wes Lambert was appointed to the Leadership Hudson Class of 2017.

Amanda M. Leffler spoke on August 31, 2016, at the Ohio State Bar Association's Insurance Seminar, on the issue of Discovery in Coverage Cases.

Amanda M. Leffler was appointed as an editor of the CGL Reporter Editorial Board, part of the Tort, Trial and Insurance Practice Section of the American Bar Association.

Amanda P. Parker was named as a recipient of the "30 for the Future" award by the Greater Akron Chamber.

Paul A. Rose hosted a webinar on July 12, 2016, on "The Evolution of Insurance Conflicts and Coverage Law, 1986-2016."

Save the date!

National Business Institute Seminar:
"Insurance Coverage Litigation: Secrets Insurance Companies Don't Want Attorneys to Know"
Speakers: Kerri L. Keller & Wes Lambert
December 8, 2016, 8:30 a.m. to 4:30 p.m.
Location: Holiday Inn Independence
6001 Rockside Rd.
Independence, OH 44131

Webinar: "Significant and Recent Ohio Cases Every Property and Casualty Professional Should Know"
Presented by: Amanda M. Leffler
December 13, 2016, 1:30 p.m. to 2:30 p.m.
This complimentary webinar is pending approval for 1 CLE credit hour.
Invitation coming soon via email