Residential

By Jeremy P. Brummond

Insuring Against Construction Defects

Most contractors have in place commercial general liability (CGL) insurance policies to protect themselves against liability arising out of their work on a construction project. These policies clearly cover certain damage claims – for example, assume a contractor is working on a remodel project for office space. While moving materials, someone loses control of a cart and the cart runs into a woman who was walking in the hallway. The contractor's CGL policy would generally cover a damage claim such as a claim by the woman to recoup her medical expenses. Similarly, if the cart ran into existing office equipment (not being provided by the contractor), the CGL policy would also cover that property damage.

But what if the project was completed, and later it is discovered that the contractor or one of its subcontractors improperly installed windows on the project or installed defective windows, leading to water intrusion? Does a contractor or subcontractor's CGL policy cover the cost to replace or repair the defective windows to stop the water intrusion? Does the CGL policy cover wood rot caused by the water intrusion? The short answer: it depends on the language of the CGL policy and how applicable state courts have interpreted the policy language. Under the same or similar circumstances, the answer could differ depending on the state in which the work was performed. State and federal courts vary widely on their interpretations of standard CGL policy, making it difficult to declare, in generalities, whether the cost to replace defective work or resulting property damage is covered under a CGL policy.

What's Covered?

Generally, CGL policies only insure for damages a contractor is obligated to pay because of "bodily injury" or "property damage" to others that results from an occurrence or "accident." Some courts, when interpreting standard CGL policy language, have held that defective work by a contractor or subcontractor is not "accidental," so losses resulting from defective work can never be covered by the CGL policy because these policies only cover losses caused by "accidents." Those

courts generally find that defective work is not an "accident" because the contractor intended to perform its work or intended to hire subcontractors to perform that work, and problems with defective work are the natural and foreseen consequences of not performing that work correctly.

Sometimes, if the only damages are to the defective work, courts find that while an "accident" occurred (the contractor did not intend to perform the work incorrectly), the cost to replace defective work is not covered because defective work is not considered "property damage" as the term is used in the CGL policy. Again, CGL policies generally only cover losses resulting from or caused by "bodily injury" or "property damage." While most courts hold that "property damage" has occurred if property or aspects of the project other than the contractor's work product are harmed by the defective construction or defective materials, if the only damages sustained are the cost to repair or replace the defective work, and there are no damages to other aspects of the project or other property, the insured has not caused any "property damage," which is required to trigger coverage under the CGL policy.

Courts who hold that defective work is an occurrence or "accident" under the CGL policy, sometimes deny coverage for some or all of the claimed damages because, according to those courts, the damages did not result from "property damage" under the CGL policy.

Recently, some courts have found a contractor's CGL policy did cover the cost to replace defective work even though the problematic work itself was not "property damage." This is because to access and replace the covered "property damage" at issue in those cases, the contractor would necessarily have to remove and replace the defective work. For example, in one case, a defectively installed balcony was a covered loss because in order to repair covered water damage to a garage (caused by the defective balcony), the balcony would have to be rebuilt.

Most CGL policies include a provision that excludes coverage for damage to the contractor's "work," leading some courts to hold that the cost to replace defective work of an insured contractor can never be a covered loss under a CGL policy. Many CGL policies, however, assert that coverage for the cost to replace defective work by a subcontractor is not excluded under the policy. This can lead to coverage for the cost to replace the work – if the work was performed by subcontractors – assuming the court believes that a sufficient "accident" and "property damage" has occurred. Notably, insurers in some states have taken steps to eliminate this "subcontractor exception" by supplemental endorsement.

Owners are becoming increasingly aware of the law regarding insurance coverage under CGL policies for construction defect claims. Because the law in this area can be inconsistent and varies among states, owners sometimes seek protection through other means such as warranty and maintenance bonds. After work has been performed, in the face of a defect claim, some owners' attorneys have tried to make claims on the contractors' performance bonds even though it is generally understood by contractors and their sureties that obligations under a performance bond cease when the project is completed. To adequately gauge risk in this area and to know how to respond in the face of a defect claim, contractors should be aware of how their state courts have interpreted the standard CGL policy by discussing the matter with their counsel or insurance professional. ◆

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