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Legislating Construction Accidents: The Trend of "Occurrence" Statutes to Create Insurance Coverage for Construction Defect Lawsuits

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Introduction

One of the more significant issues that arise in the insurance coverage arena of law is whether construction defects (or their resulting damage) constitute "occurrences" under a commercial general liability ("CGL") policy. This issue alone has spawned countless disputes and lawsuits in the last several decades, and will continue to be a hotly contested issue. However, in 2011, three states (and one additional in 2010) attempted to overrule court decisions on this issue, passing legislation that specifically addresses the issue of whether faulty workmanship is an "occurrence" or "accident."

Below we provide the backdrop for these legislatures' laws, discuss the laws themselves, and provide some of our ideas for how these laws may impact litigation of the "occurrence" issue in years ahead and affect the insurance industry at large.

Brief Overview of Divergence in Case Law

The Insurance Services Office, Inc. ("ISO") CGL policy form provides as follows with respect to the insurer's obligations under the policy:

We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies.

* * *

This insurance applies to "bodily injury" and "property damage" only if:
(1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory"...

The ISO CGL policy form defines "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

While different policies can have variations of or amendments to the above definitions, this language is identical or substantively similar to the language several courts around the country have analyzed in different contexts,

including the construction defect context. The issue of whether defective work on a construction job (or its ensuing damage, if any) constitutes an "occurrence" under a CGL policy has become an often-litigated issue that has been given treatment, analysis, and decisions by courts across the country. The issue arises, in part, because the standard CGL policy does not define what an "accident" is as that term is used in the "occurrence" definition, so it has been left to various courts to interpret and analyze its meaning.

Case law nationwide on the issue can be primarily broken down into two overarching lines of decisions. One line of cases holds that construction defects are *not* accidents (and thus not "occurrences"). Cases so holding have based their decision on one or more of a variety of reasons. Some cases hold that because defective construction is the natural consequence of performing substandard work, construction defects can never constitute accidents. Others reason that to hold that construction defects can constitute "occurrences" would turn liability insurance into a performance bond and insurers into guarantors of an insured's performance of a contract—something not contemplated by a general liability policy. Still others base their decision on a theory that to shift the risk of faulty work from insured to insurer would not incentivize insureds to make good choices, such as avoiding the use of unqualified subcontractors.

There are several examples from around the country of cases in which construction defects were found to not be "accidents," and thus not "occurrences." *See*, *e.g.*, *Essex Ins. Co. v. Holder*, 261 S.W.3d 456, 460 (Ark. 2008) ("Faulty workmanship is not an accident; instead, it is a foreseeable occurrence, and performance bonds exist in the marketplace to insure the contractor against claims for the cost of repair or replacement of faulty work."); *Cincinnati Ins. Co. v. Motorists Mut. Ins. Co.*, 306 S.W.3d 69 (Ken. 2010) (holding that faulty construction-related workmanship, standing alone, is not an "occurrence"); and *Corder v. William W. Smith Excavating Co.*, 556 S.E.2d 77, 83 (W. Va. 2001) ("commercial general liability policies are not designed to cover poor workmanship. Poor workmanship, standing alone, cannot constitute an 'occurrence' under the standard policy definition of this term as an 'accident including continuous or repeated exposure to substantially the same general harmful conditions.'").

This first line of cases can be further broken down into those cases that hold that, although the construction defect itself is not an "occurrence" as a matter of law, resulting damage can be an occurrence. *See*, *e.g.*, *Greystone Constr. v. Nat'l Fire & Marine Ins. Co.*, 2011 WL 5148688 (10th Cir. Nov. 1, 2011); *Corder*, 556 S.E.2d 77. On the other hand, some courts in this first line of decisions have found that neither construction defects nor resulting property damage is an "occurrence." *See*, *e.g.*, *Group Builders, Inc. v. Admiral Ins. Co.*, 231 P.3d 67 (Haw. App. 2010).

The second line of cases holds that construction defects *are* accidents (and thus constitute "occurrences"). These cases reason that construction defects are not normally expected by the insured (without a showing of same). Some of these cases argue that to construe the definition of "occurrence" as excluding construction defects based on the "natural consequence" argument would render the expected or intended injury exclusion of the CGL policy superfluous. Some courts also find that to interpret the definition of "occurrence" as excluding construction defects ignores that there are other ways of excluding such coverage, such as through the business risk exclusions of the CGL policy.

Examples of cases typical to this second approach are: *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1, 4 (Tex. 2007) ("We conclude that allegations of unintended construction defects may constitute an 'accident' or 'occurrence' under the CGL policy...."); *United States Fire Ins. Co. v. J.S.U.B.*, 979 So.2d 871, 883 (Fla. 2007) ("[W]e fail to see how defective work that results in a claim against the contractor because of injury to a third party or damage to a third party's property is 'unforeseeable,' while the same defective work that results in a claim against the contractor because of damage to the completed project is 'foreseeable.'"); *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 308 (Tenn. 2007) ("We decline to adopt a construction of 'accident' which would so drastically limit the coverage under a CGL.").

The above-cited cases are only a small sampling of the many decisions around the country on this issue; many of the cases discussed above in turn contain their own survey of the law on this issue throughout the United States.

The Response of Legislatures in Some States

This past year saw increasing activity in a trend where state legislatures have stepped in and responded to court decisions on this issue, presumably (and sometime explicitly) when the legislature believes a case has been decided improperly by the courts of that jurisdiction. Arkansas, South Carolina, and Hawaii all passed laws this past year to, in effect, supersede the case law that had developed in those jurisdictions. Colorado also passed a law in 2010, which we discuss below to round out the discussion of state legislatures' involvement in this area of law. While no two of these new laws are the same, each is intended to produce the effect of increasing coverage under CGL policies for construction defect claims.

Colorado

Section 13-20-808 of the Colorado Code went into effect on May 21, 2010.

This statute provides:

> In interpreting a liability insurance policy issued to a construction professional, a court shall presume that the work of a construction professional that results in property damage, including damage to the work itself or other work, is an accident unless the property damage is intended and expected by the insured.

C.R.S. 13-20-808(3).

The legislature has specifically stated that nothing in the statute: (a) requires coverage for damage to an insured's own work unless otherwise provided in the insurance policy; or (b) creates insurance coverage that is not included in the insurance policy. *Id.*

The statute itself specifically addresses *General Security Indemnity Company of Arizona v. Mountain States Mutual Casualty Company*, 205 P.3d 529 (Colo. App. 2009), stating that the case "does not properly consider a construction professional's reasonable expectation that an insurer would defend the construction professional against an action or notice of claim." C.R.S. 13-

20-808(1)(b)(III). In *General Security*, the Colorado Court of Appeals held that "claims of defective workmanship, standing alone, do not constitute an 'occurrence.'" 205 P.3d at 531.

The Tenth Circuit has recently held that the Colorado statute does not apply retroactively and, thus, does not apply to insurance policies whose policy periods have expired. *Greystone Constr.*, 2011 WL 5148688. Having found that the statute did not apply, the *Greystone* court proceeded to analyze whether damage arising from construction defects is an "occurrence" in a pre-statute world. The *Greystone* court held that it believed the Colorado Supreme Court would not follow the intermediate appellate court's decision in *General Security*, and in doing so took issue with much of that court's legal analysis and reasoning. The Tenth Circuit also held as follows: "We predict the Colorado Supreme Court would construe the term 'occurrence,' as contained in standard-form CGL policies, to encompass unforeseeable damage to nondefective property arising from faulty workmanship." *Id.*

No published Colorado cases have applied or examined the new Colorado statute. However, commentators have noted that in situations in which the statute does not apply (because it is not applicable retroactively), there could result in an awkward split in authority because *General Security* presumably governs decisions in state courts while *Greystone* is controlling for district courts. Thus, in interpreting this issue under policies not yet subject to the Colorado statute, the venue for the case and removal jurisdiction (from state to federal court) could be important issues.

Arkansas

Under the new Arkansas statute (enacted on March 23, 2011), a commercial general liability policy must contain a definition of "occurrence" that includes: "Property damage or bodily injury resulting from faulty workmanship." A.C.A. § 23-79-155(a)(2). The statute specifically provides: "(b) This section is not intended to restrict or limit the nature or types of exclusions from coverage that an insurer may include in a commercial general liability insurance policy." A.C.A. § 23-79-155.

There are no published cases yet specifically on this statute, and the retroactive effect of this statute is unclear.

South Carolina

South Carolina enacted code section 38-61-70 on May 17, 2011. The statute provides that CGL policies "shall contain or be deemed to contain a definition of 'occurrence' that includes:

1. an accident, including continuous or repeated exposure to substantially the same general harmful conditions; and

2. property damage or bodily injury resulting from faulty workmanship, exclusive of the faulty workmanship itself."

It is not clear at this time what effect this statute will ultimately have. The constitutionality of the statute has been challenged in South Carolina Supreme Court. Moreover, some have commented that the statute (and any challenge to it) has been rendered unnecessary by a South Carolina Supreme Court decision. In *Crossman Communities of North Carolina, Inc. v. Harleysville Mutual Ins. Co.*, 2011 WL 93716 (S.C. Jan. 7, 2011), the South Carolina Supreme Court held: "where the damage to the insured's property is no more than the natural and probable consequence of faulty workmanship such that the two cannot be distinguished, this does not constitute an occurrence." *Id.* However, several months later, the South Carolina Supreme Court rendered a new opinion in *Crossman Communities of North Carolina, Inc. v. Harleysville Mutual Ins. Co.*, 2011 WL 3667598 (S.C. Aug. 22, 2011). This new opinion withdrew the prior opinion, finding the definition of "occurrence" ambiguous, and finding that "negligent or defective construction resulting in damage to otherwise non-defective components may constitute 'property damage,' but that defective construction would not."

To date, there are no published cases on this new South Carolina statute. The statute, however, applies retroactively.

Hawaii

Hawaii passed a new statute effective as of June 3, 2011 that provides:

> For purposes of a liability insurance policy that covers occurrences of damage or injury during the policy period

> and that insures a construction professional for liability arising from construction-related work, the meaning of the term "occurrence" shall be construed in accordance with the law as it existed at the time that the insurance policy was issued.

H.R.S. § 431:1-217.

The statute and legislative history is not completely clear what the "before and after" laws were or are. However, 2011 Haw. Sess. Laws, Act 83, § 1, provides "The legislature further finds that the 2010 decision of the Hawaii Intermediate Court of Appeals in *Group Builders, Inc. v. Admiral Ins. Co.*, 231 P.3d 67 (Haw. Ct. App. 2010) creates uncertainty in the construction industry, and invalidates insurance coverage that was understood to exist and that was already paid for by construction professionals."

In *Group Builders*, the Hawaii Court of Appeal stated as follows: "We hold that under Hawai'i law, construction defect claims do not constitute an 'occurrence' under a CGL policy. Accordingly, breach of contract claims based on allegations of shoddy performance are not covered under CGL policies. Additionally, tort-based claims, derivative of these breach of contract claims, are also not covered under CGL policies." *Id.* at 73-74.

The precise effect of this statute has been the source of much speculation and conjecture, and there are no published Hawaii cases construing this statute. Some have argued that claims of construction defects and arising out of construction defects would not be covered if the insurance policy to which such claims are applicable was issued prior to the date of the *Group Builders* opinion on May 19, 2010, but that the *Group Builders* decision would apply to policies issued after that date. Whether subsequent Hawaii courts would be willing to make a finding of "no occurrence" after the legislature's criticism of the *Group Builders* case—despite the inapplicability of the statute—is something that has yet to be determined.

There are two recent, unpublished decisions from the district court in Hawaii that have discussed the statute. In *State Farm Fire & Cas. Co. v. Vogelgesang*, 2011 WL 2670078 (D. Haw. July 6, 2011), while the decision is not very clear, it appears the court found that the new statute did not affect

the court's ruling that the claims of breach of contract over a defective house were not covered under a CGL policy, as the court's decision was based on Hawaii law existing prior to the *Group Builders* case. *Id.* In *Nat'l Union Fire Ins. Co. v. Simpson Mfg. Co.*, 2011 WL 5374355 (D. Haw. Nov. 7, 2011), while the court did not directly apply the statute, the court noted that it is "unsettled at this point" what is meant by the Hawaii statute's language that the definition of an "occurrence" "shall be construed in accordance with the law as it existed at the time that the insurance policy was issued." *Id.*

What is in Store for 2012 and Beyond

There is little doubt that this is a fascinating and evolving area of insurance coverage law, and one that will continue to keep insureds and insurers alike on their toes in 2012 and in years ahead. The fact that the state legislatures in Colorado, Arizona, South Carolina, and Hawaii have become involved in this issue raises interesting questions regarding the future of insurance coverage in the construction defect context across the nation. These questions include:

- How will this new legislation affect litigation in the four states that have passed laws?
- Does this legislation signal a national trend?
- What does this legislation mean for the insurance industry and litigation of insurance issues in general?

We address these in turn below.

How will this new legislation affect litigation in the four states that have passed laws?

While to date there has been little litigation on the precise meaning of the statutes themselves, we expect that the various statutes will not completely end litigation of the "occurrence" issue in construction defect cases in those jurisdictions and that there may be litigation regarding the meaning and scope of these statutes. For example, the meaning of the phrases "results in" and "resulting from" in the Colorado and Arkansas statute may spawn litigation of their own regarding the scope of the statutes. However, those statutes (or legislative history) that have specifically called out presumably

offending cases will provide additional guidance to assist parties and courts in construing these statutes.

In addition, we have already seen that in one state—South Carolina—the legislation is being challenged on constitutionality grounds, but it is unclear whether that case will be going forward in light of subsequent state court precedent. One may assume similar lawsuits will be filed in other states.

Importantly, each of the pieces of new legislation affects only the "occurrence" (or "accident") term of insurance policies, whether the statutes legislate the definition (as in the new statutes of Arkansas or South Carolina) or the interpretation to be applied to the definition (as in the new statutes of Colorado and Hawaii). Some commentators on these statutes have wrongly concluded that the statutes signify that there will be coverage for construction defect claims. To the contrary, these statutes do not legislate other terms of the CGL coverage form (and, indeed, the Arkansas statute specifically so states). For example, the following issues that frequently arise in cases regarding coverage for construction defects are not affected by these statutes:

- Whether any alleged damage constitutes "Property damage" under the definition of that term in the CGL policy form
- Whether "'Property damage' occurs during the policy period"
- Whether, prior to the policy period, the insured knew that "Property damage" had occurred
- Whether alleged claims are excluded by the "expected or intended injury" exclusion
- Whether alleged claims are excluded by the contractual liability exclusion
- Whether "Property damage" was to "That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations" and will be excluded from coverage
- Whether "Property damage" was to "That particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it" and will be excluded from coverage

- Whether any alleged damage is to "your work" and will be excluded from coverage, among other basis for denial of insurance coverage

Given the many other issues that consistently and often arise in construction defect insurance coverage litigation, the statutes may prove to accomplish little else except changing the coverage issues that are litigated in courts interpreting the laws of Colorado, Arkansas, South Carolina, or Hawaii. Thus, we expect that in 2012 and years ahead, litigation regarding coverage for construction defects in these jurisdictions will focus more on these other provisions of CGL policies. It obviously remains to be seen whether the legislatures of these (or other) jurisdictions will further legislate coverage for construction defects that will impact the applicability of these other coverage terms.

It may prove to be the case that these alternative coverage issues (especially the exclusions of the CGL form) are harder ones to demonstrate in the duty to defend context, where the insurer's obligations are determined based solely on the insurance policy and underlying complaint. Thus, insurers may be less likely to seek (or be able to obtain) an early determination of "no duty to defend" given the existence of these statutes. This will depend in great part on the specific allegations of the underlying complaint that will have to be addressed on a case-by-case basis.

Does this legislation signal a national trend?

We do not currently know of any other state legislatures that are considering legislation similar to the statutes discussed above, and thus it may be premature to address whether the statutes of Colorado, Arkansas, South Carolina, and Hawaii indicate an overall trend in how these issues are handled. However, on balance, we think it is unlikely that this is a trend that will sweep the nation, though it would not be altogether surprising if a few more states attempt—and even pass—similar legislation. Obviously in those states where the courts have found that construction defects (or any resulting damage) do constitute "occurrences," there is little reason for legislatures to intervene on behalf of insureds.

When it comes to insurance coverage under CGL policies, states generally have been relatively "hands off," leaving resolution of coverage issues to

the courts. There are other hot-button issues that have made as much as, if not more of, an impact on coverage disputes under CGL policies, and that has resulted in a very divisive body of law, but with which legislatures as a whole have declined to interfere. For example, we have not seen a swell of state legislatures addressing coverage under CGL policies for environmental pollution and the effect of pollution exclusions; these issues have been left mostly to the courts. The reluctance of legislatures to intervene in this area of coverage law may be compared with other lines of insurance, such as some personal lines like auto or health, which tend to be more heavily regulated. The fact that the legislatures of Colorado, Arkansas, South Carolina, and Hawaii felt it necessary to pass these laws at this time represents the influence that the construction industry has on these states, and may be representative of the current economics of the construction industry as a whole.

It may be that other states that are considering legislation along the lines of these four states will take a "wait and see" approach to determine whether these statutes have the desired effect. In the meantime, we can expect to see further development of the law in this area in courts around the country.

What does this legislation mean for the insurance industry and litigation of insurance issues in general?

One question that is being asked is whether legislation of this issue is, on a whole, a positive development. This obviously depends at least to some extent on whether one is (or is representing) an insured or an insurer. However, the commentary on this various legislation is voluminous and reflects that even at the insured side of the table, there is disagreement regarding whether the legislature hurts or helps. For example, there are those that believe that the legislation itself will breed litigation and uncertainty, or that the legislation leaves too much unresolved (such as the variety of other coverage issues identified above).

Other critics of the statutes have opined that it may increase the cost of CGL insurance for insureds in those jurisdictions, making it difficult or impossible for an insured to obtain CGL insurance at all. These critics reason that some of the risks legislated by the states were never intended to be covered by CGL insurers, and thus insurers will have to raise premiums

in exchange for covering these additional risks. One counter-argument to this is that there are other provisions of the CGL policies that still limit the coverage to that which insurers anticipated in issuing CGL policies. Other critics have suggested that some CGL insurers may pull out of these states' insurance markets altogether. For this reason, some have suggested that states would be better served to require insureds to obtain construction bonds. Only time will reveal whether these various concerns are borne out in the marketplace.

From a practical standpoint (for those that practice insurance coverage litigation—both on the insured and the insurer side), these statutes certainly reinforce that the law to be applied to litigating these issues may be paramount, especially in the construction defect context. Before embarking on an assessment of liability or settlement negotiations, it is essential that the applicable law be determined. That being said, with respect to the determination of whether construction defects (and any ensuing damage) constitutes an "occurrence" under a CGL policy, choice of law has always been a concern given the substantially varying approaches among the states on this issue. What the legislation means, though, is that if the law of Colorado, Arkansas, South Carolina, or Hawaii is potentially applicable, it may make it more likely that an insured will succeed in any insurance dispute or litigation. This may result not only in choice of law disputes, but in venue disputes, as different jurisdictions have different choice of law rules.

Legislation or not, there is little doubt the construction, insurance, and legal industries will continue to closely monitor appellate court decisions interpreting these statutes, as well as decisions on the issue in jurisdictions where there is no legislation on the topic.

Conclusion

The recent legislation on the issue of whether construction defects (and any resulting damage) constitute "occurrences" under CGL policies is an interesting development in insurance coverage litigation, and a development that will be monitored by a variety of industries in the year ahead. Counsel and litigants would be well-served by being mindful of choice of law issues and the law (statutory or otherwise) of the particular states potentially at

issue. What law applies will no doubt influence the strategy to be employed in a coverage dispute or coverage litigation arising from construction defects.

Key Takeaways

- In analyzing the "occurrence" issue, courts around the country have drawn a distinction between claims of mere construction defect and claims of damage resulting from construction defect, and between claims of intended conduct and those involving the natural consequence of faulty work. It is therefore important to closely read a complaint to determine an insurer's duty to defend and to pursue factual information going to these issues to determine an insurer's duty to indemnify.
- Closely monitor the new "occurrence" legislation and the case law that will interpret them, in addition to continuing to monitor whether the law in other states changes in any way.
- Determine the applicable law before embarking on an assessment of liability or settlement negotiations. Choice of law and choice of venue are always important concerns, given the substantially varying approaches among the states on CGL "occurrence" issues.

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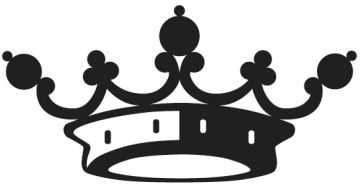

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