Insurance Coverage Issues in Construction Defect Litigation

by Brian R. Lehrer

Insurance exists because accidents happen and nobody is perfect. These clichés are made much more tolerable when insurance actually provides coverage for the mishap.

Insurance coverage for an injury on a construction site is often pretty simple. Insurance coverage for a construction defect can be a bit more complicated. Two issues that can arise are: 1) Is there coverage for the defect and, 2) if yes, when is coverage triggered?

Arguably, the most fundamental principle of insurance coverage for construction defects is that there is no coverage under a comprehensive general liability (CGL) policy for repairing damage to one's own shoddy work. The seminal case on this issue is *Weedo v. Stone-E-Brick, Inc.*[1]

In *Weedo*, two sets of homeowners sued a masonry contractor, Stone-E-Brick, for claims arising out of faulty workmanship and defective construction work. The homeowners' complaints sought damages to cover the costs of correcting the construction defect. Stone-E-Brick requested that its CGL insurer defend and indemnify it against both complaints, but the insurer refused, asserting that CGL policies exclude coverage for claims of faulty construction that require repair or replacement of a contractor's work.

The concept that insurance coverage for defects to one's own work does not exist was extended in a later Appellate Division case where a court held that claims against an insured's general contractor for the cost of replacing sub-standard condominium firewalls installed by its subcontractors did not

qualify as covered "property damage" caused by an "occurrence" under a CGL policy.[2] In *Fireman's*, the Appellate Division noted that *Weedo* had distinguished between two kinds of risks, one that is excluded by the standard CGL policy and one that is not: 1) "business risk… the risk that the contractor's work may be faulty and may breach, express or imply warranty; and 2) the risk of injury to people and damage to property caused by faulty workmanship."[3]

The *Weedo* line of cases does not settle the issue of insurance coverage for construction defects, because it addressed issues under the 1973 Insurance Services Office, Inc. (ISO) standard form CGL policy. The form was changed in 1986.

The New Jersey Supreme Court recently addressed the updated ISO form in a case involving the issue of whether rainwater damage caused by a subcontractor's faulty workmanship constituted "property damage" and an "occurrence" under a property developer's CGL insurance policy. The Court concluded that consequential damages caused by a subcontractor's defective work constituted property damage and an occurrence under the policies.[4]

Cypress Point involved the construction of a luxury condominium complex. During the construction, the developer/general contractors were issued multiple CGL policies. Pursuant to the policies, property damage included physical injury to tangible property, including all resulting loss of the use of that property; and an occurrence was defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The policies also contained an exclusion for "damage to your work." This exclusion eliminated coverage for property damage to "your work" arising out of it or any part of it. However, the policy included an exception to the exclusion, which stated that the exclusion "does not apply if the damaged work or the work out of which the damage arises was performed on the insured's behalf by a *subcontractor*."

After the completion of the project, several condominium owners experienced problems such as roof leaks and water infiltration. The condominium association also became aware of damage caused by water intrusion to the common areas and interior structures of Cypress Point. As a result, the association brought an action against the developer and several subcontractors.

Adria Towers, the developer/general contractor, requested its insurers to defend and indemnify it against the association's claims. Its carriers refused, and ultimately were brought in as direct defendants by the association seeking a determination whether its claims against the developer were covered by the CGL policies.

The trial court granted the insurers' motions for summary judgment, concluding that faulty workmanship did not constitute an occurrence under the policy and that the consequential damages caused by the faulty workmanship were not property damage under the policies. The Appellate Division reversed. The Supreme Court affirmed the Appellate Division and held that the CGL policies provided coverage.

The Court traced the history of the form CGL policy at issue, noting that the definition of occurrence had changed from the 1973 policy governing prior case law to the 1986 version, which governed the present case. In essence, the 1986 policy changed the definition of occurrence. The policy also contained an exclusion clause, which barred coverage for property damage to the insured's work arising out of it or any part of it, but contained an exception to the exclusion that had never been addressed by the Supreme Court. The exception to the exclusion provided as follows: "The your work exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor." The new version of the CGL policy was adopted after the *Weedo* line of cases and, therefore, provides the touchstone for the coverage analysis going forward.

The Court engaged in a scholarly and linear analysis of the insurance policy and the law governing coverage. The Court examined the facts of the claims to ascertain whether the policy has provided an initial grant of coverage. It then examined whether any of the exclusions applied to preclude coverage. Finally, the Court analyzed whether an exception to the pertinent exclusion applied to restore coverage.

Distilling the Court's analysis, it found that the allegations of water infiltration occurring after the project was completed, which caused mold growth and other damage to completed common areas and individual units, were covered property damage under the policies. The Court then determined that the undefined term "accident" in the policies encompassed unintended and unexpected harm caused by the faulty work of the subcontractors and, thus, constituted an "occurrence" triggering an initial grant of coverage for the claims.

The Court then turned to whether an exclusion barred coverage. The Court noted that the "your work" exclusion would seem to bar coverage for the claims. However, engaging in the third prong of its analysis, the Court pointed to an exception to the exclusion, which indicated the exclusion did not apply "if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor." Thus, the Court found that the damages caused by the insured's subcontractors was a covered loss.

> …we agree with other courts that if the insurer decides that this is a risk it does

not want to insure, it can clearly amend the policy to exclude coverage, as can be done simply by either eliminating the subcontractor exception or adding a breach of contract exclusion... The insurer's here chose not to negotiate away the subcontractor exception and instead issued the developer a series of 1986 ISO standard form CGL policies which explicitly provide coverage for property damage caused by a subcontractor's defective performance.[5]

The mere fact that insurance coverage may apply to a particular construction loss does not end the inquiry where defective construction causes insidious loss over time. Similar to environmental contamination, defective construction can cause damage to a building over a period of years before it is even detected. The Appellate Division recently addressed this issue and issued two holdings of first impression: 1) a continuous-trigger theory of insurance coverage applies to claims for third-party progressive property damage in construction defect cases; and 2) the "last pull" of the coverage trigger occurs when the inherent nature and scope of the damage is revealed.[6]

In *Air Master & Cooling*, the plaintiff had performed work as a subcontractor on a condominium project. Lawsuits were brought by the condominium association and unit owners to remediate construction defects, which included property damage resulting from the apparent progressive infiltration of water within the building.

After being named as a third-party defendant in the construction defects cases, plaintiff Air Master sought a defense and indemnity from various insurance companies that covered it under a succession of CGL policies between 2004 and 2015.

Air Master had worked as a subcontractor on the construction of a seven-story condominium building in Montclair. It installed condenser units on rails on the building's roof and HVAC devices within each individual unit. Beginning in early 2008, unit owners began to notice water infiltration and damage in their windows, ceilings and other portions of their individual units. Eventually, in April 2010, an expert consultant performed a moisture survey of the roof and identified 111 spots on the roof damaged by moisture from water infiltration. The expert noted that it was impossible to determine when moisture infiltration occurred.

Air Master sought coverage from policies with Penn National, Selective and Harleysville Insurance Company. The Penn National policies ran from 2004 to June 22, 2009, the Selective policies covered June 22, 2009 to June 22, 2012, and the Harleysville policies ran from June 22, 2012 to June 22, 2015. Both Selective and Harleysville disclaimed coverage, arguing the property damage had already manifested before the respective policy periods began.

Air Master filed suit against Selective and Harleysville. The trial court entered summary judgment, but the Appellate Division reversed. The Appellate Division held that: 1) a continuous-trigger theory of insurance coverage applies to third-party liability claims involving progressive damage to property caused by an insured's allegedly defective construction work; and 2) the "last pull" of that trigger—for purposes of ascertaining the temporal end point of a covered occurrence—happens when the essential nature and scope of the property damage first becomes known, or when one would have sufficient reason to know of it.

The most frequently offered theories defining a 'trigger' of coverage are: 1) the 'exposure' theory; 2) the 'manifestation' theory; and 3) the 'continuous-trigger' theory.

The *Air Master* court gave a brief description of each theory. The exposure theory deems the trigger date of an occurrence that causes injury to be the date on which the injury-producing agent first contacts the body. The manifestation theory entails ascertaining the point in time when an injury or disease first presented or manifested itself. Finally, the continuous-trigger theory recognizes that, because certain harms will progressively develop over time, the date of the occurrence should be the continuous period from exposure to manifestation. Under the continuous-trigger approach, all insurers over that period are responsible for the continuous development of the damage.[7]

The continuous-trigger theory of coverage recognizes that, because certain harms will progressively develop over time, the date of the occurrence should be the continuous period from exposure to the manifestation. This theory of

coverage was first adopted in New Jersey in the *Owens-Illinois* case, which involved property damage insurance claims that arose from the installation of asbestos-related products.[8] Essentially, the doctrine was fashioned to address the difficulties of establishing with scientific certainty when the harmful effects of a progressive disease or injury have occurred. The *Air Master* panel noted that the New Jersey Supreme Court implicitly approved the use of a continuous-trigger theory in a construction defect context where it was presented with the question of whether an insurer may assert, against a co-insurer, a claim for costs incurred in defending litigation over construction defects in a school roof. In that context, the Court found that a continuous-trigger analysis was appropriate, and observed that the *Owens-Illinois* methodology had been applied to a variety of disputes between policyholders and insurers.[9]

> Although *Potomac Insurance* specifically concerned the allocation of past defense costs incurred in a construction case by a common policy holder of several insurers, we discern no principle reason to refrain from applying continuous-trigger principles to cases like the present one, where issues of both past and future defense costs and indemnification are implicated. The public policies favoring a continuous-trigger approach in progressive injury matter are likewise germane here. Property damage within a building can be latent and undetected, behind walls and above ceiling tiles, and can gradually worsen and advance over time.[10]

Having concluded that the continuous-trigger theory of coverage applies to construction defect actions, the Appellate Division then wrestled with the question of when the last pull of the trigger occurs. Adopting the analysis of a prior court in a first-party construction defect case, the court held that the last pull of the coverage trigger occurs when the "essential" nature of the harm is revealed.[11] The court noted that the *Winding Hills* panel had not defined "essential," but pointed to the dictionary definition that the term means "constituting or part of the nature of something," "inherent" or "basic."

> In the present insurance context involving the 'essential' manifestation of an injury, we regard the term to connote the revelation of the inherent nature and scope of that injury. On one end of the spectrum, manifestation cannot be merely tentative...nor must the manifestation be definitive or comprehensive...the critical term 'essential,' as used in this coverage context should be understood and applied consistent with such concepts.[12]

The *Air Master* panel concluded that the sparse record in the case provided an insufficient basis to resolve the manifestation question. On the one hand, Air Master argued that the expert's report delineating the nature and extent of the rooftop moisture damage in May 2010, provided the appropriate demarcation of the time of manifestation. By contrast, Selective pointed to 2008, when residents had noticed and reported water infiltration in their units, prompting remedial investigations. The court held that no depositions had been conducted, and it could not tell with any confidence what other information about the building defects was or reasonably could have been revealed between the time of the unit owners' complaints and the time of the start of the Selective policy in June 2009. It remanded the case to ascertain that vital information.

The two cases discussed in this article have brought some clarity to coverage issues in construction defect actions. The expanded scope of coverage for damage caused by subcontractors is certainly good news for policyholders and residents of damaged buildings. On the other hand, a continuous trigger of coverage opens the door for expanded litigation, as carriers, policyholders and residents will battle over the timing and manifestation of damage caused by allegedly defective construction. It's clearly too soon to kill all the lawyers. ⚖

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ENDNOTES

1. *Weedo v. Stone-E-Brick, Inc*., 81 N.J. 233 (1979).
2. *Fireman's Insurance Co. of Newark v. National Union Fire Insurance Co*., 387 N.J. Super. 434 (App. Div. 2006).
3. *Id*. at 442-443.
4. *Cypress Point Condominium v. Adria Towers*, 226 N.J. 403 (2016).
5. *Id*. at 431.
6. *Air Master & Cooling, Inc. v. Selective Insurance Co. of America, et al*., ___ N.J. Super. ___ (App. Div. 2017).
7. *Id*., slip opinion at pages 11-12.
8. *Owens-Illinois, Inc. v. United Insurance Co*., 138 N.J. (1994).
9. *Potomac Ins. Co. v. PMA Ins. Co*., 315 N.J. 409 (2013).
10. *Air Master, supra*, slip opinion at page 18.
11. *See Winding Hills Condominium Association, Inc. v. North American Specialty Insurance Co*., 332 N.J. Super. 85 (App. Div. 2000).
12. *Air Master, supra*, slip opinion at pages 25-26.