

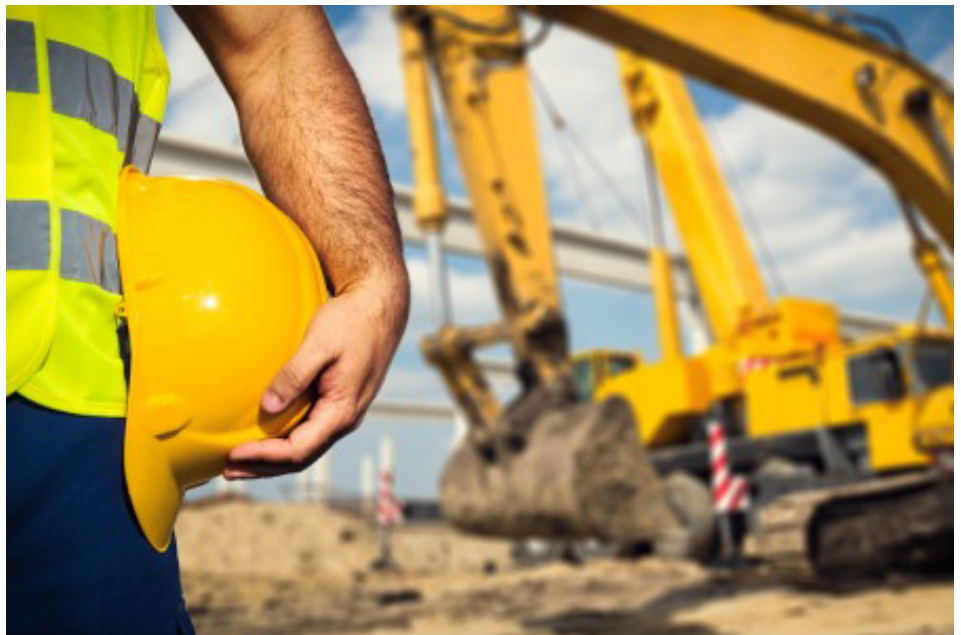
Is There Insurance Coverage for Defective Construction?

The key is resultant property damage to other parts of the project or building.

In many scenarios involving allegedly defective construction, the injured party—be it a homeowner, a commercial project developer or a homeowners association—asks that the issue be turned over to the contractor's insurance company. While this sounds prudent, it is often a dead end because in most instances, contractors (and subcontractors as well) are not insured for defective construction per se. In almost every case, they have purchased commercial general liability (CGL) insurance that requires an "occurrence" and "property damage" in order to trigger coverage. And sadly for the homeowner, project developer or HOA, defective construction by itself, rarely constitutes either an "occurrence" or "property damage."

BACKGROUND OF INSURANCE COVERAGE FOR DEFECTIVE CONSTRUCTION

Twenty seven years ago, a California appellate court explained that CGL policies "are not designed to provide contractors and developers with coverage against claims their work is inferior or defective." *Md. Cas. Co. v. Reeder* (1990) 221 Cal.App.3d 961, 967. As another court noted: "In short, a liability insurance policy is not designed to serve as a performance



bond or warranty of a contractor's product." *F & H Constr. v. ITT Hartford Ins. Co.* (2004) 118 Cal.App.4th 364, 373.

Two recent cases underscore this vital point.

WRONG SEISMIC HOOKS

In *Regional Steel Corp. v. Liberty Surplus Ins. Corp.*, 226 Cal.App.4th 1377 (2014), the court found no coverage for construction defects involving the installation of the wrong type of seismic tie hooks in rebar structures on which cement had been poured.

The Florentine Apartments were to be a 14-story mixed use development with ground

floor retail space, four stories of parking and residential units on the upper floors. JSM Florentine was the owner, and JSM was the general contractor. Regional Steel subcontracted to provide reinforcing steel, while Webcor Construction, LP contracted to supply and pour concrete which encased the rebar structures built by Regional.

Regional prepared shop drawings, which were approved by JSM, using both 90-degree and 135-degree seismic tie hooks in shear walls. Regional began construction in October 2004 using both types of tie hooks. Webcor began pouring concrete on the reinforced steel structures.

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In January 2005, a City of Los Angeles building inspector issued a correction notice requiring exclusive use of 135-degree seismic tie hooks. In April 2005, JSM became aware of this and stopped pouring concrete until this issue could be resolved. In June 2005, the City notified JSM that the garage had defective tie hooks and needed repair.

JSM asserted that Regional had failed to comply with the subcontract and building code when it installed 90-degree seismic hooks. Consequently, JSM alleged it was forced to open up numerous locations in the concrete walls, weld reinforcements to the steel and otherwise strengthen the installation. JSM alleged delayed completion resulting in loss of use, loss of rental income and other damages.

Liberty Surplus Insurance issued a claims-made commercial liability policy to JSM, modified by a wrap endorsement, and Liberty added Regional as an additional insured effective October 2005. The policy covered “property damage” caused by an “occurrence” on or after the retroactive date of August 5, 2005, and excluded damage to impaired property or property that has not been physically injured. That exclusion precluded coverage of damage to “impaired property” or property that has not been physically injured arising out of a defect, deficiency, inadequacy or dangerous condition of “your work” or “your product.” “Impaired property” meant tangible property (other than the insured’s work) known or thought to be defective, deficient, inadequate or dangerous, if that tangible property could be restored to use by repair, replacement, adjustment or removal of the insured’s work, or the insured fulfilling the terms of its contract.

There is a conflict in the case law on whether construction defects that are incorporated into a whole property constitute property damage. One line of cases finds no property damage where defective work is incorporated into, but does not damage, other property. *F & H Construction v. ITT Hartford Ins. Co.*, 118 Cal.App.4th 364 (2004) (insured subcontractor provided inadequate steel pile caps to contractor; this did not cause the contractor a loss of use of tangible property, and was not covered as property damage; the only damages were the costs of modifying the pile caps to conform

to the contractual specifications and a lost early completion bonus); *St. Paul Fire & Marine Ins. Co. v. Coss*, 80 Cal.App.3d 888 (1978) (insured contractor’s defective materials and workmanship in constructing a dwelling were not property damage, and were excluded by insured’s work and other “business risk” exclusions).

Another line of cases holds that incorporation of a defective part into other product or property constitutes property damage. *Eljer Mfg v. Liberty Mut. Ins. Co.* (7th Cir.1992) 972 F.2d 805 (the court held that property damage occurred when toilets prone to leaking were incorporated into the construction) (note that in *Travelers Ins. Co v. Eljer Mfg., Inc.*, 197 Ill. 2d 278, 303 (2001), the Illinois Supreme Court held that *Eljer v. Liberty Mutual* was incorrectly decided under Illinois law); *Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co.*, 45 Cal.App.4th 1 (1996) (the court found property damage based on the incorporation of asbestos tiles and insulation into a building because the potentially hazardous material was physically linked to the building); *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal.App.4th 847 (2000) (a roaster supplied roasted diced almonds which contained wooden splinters; the almonds were processed into nut clusters, that were incorporated into breakfast cereal; the court held that the splinters in the almonds caused property damage to the “nut clusters” and to the cereal into which they were incorporated).

The court found that the *Regional Steel v. Liberty Surplus* case is like those involving defective materials or work incorporated into a construction project, and not like cases involving hazardous material incorporated into a whole. The court adopted the prevailing view that unless and until the defective component causes physical injury to tangible property or to some other part of the system, that mere defects or mere failure to perform are not property damage. Under that view, there was no coverage for Regional’s use of defective tie hooks.

CRACKING TILES

In a more recent case decided last year, a federal court, relying on California law, ruled that

there was no “property damage” and hence no coverage, when floor tiles were defectively installed in a luxury hotel and condominium project in Los Angeles. *American Home Assurance Co. v. SMG Stone Co., Inc.* (N.D. Cal. 2015) 119 F.Supp.3d 1053. The court observed that the tiles themselves were not defective. Rather, it was the subcontractors’ installation of those tiles that was flawed—and the subcontractor’s defective installation caused the tiles to crack. Even so, the court still did not find property damage as defined by the policy, as the tile cracking did not cause physical damage to any other part of the project. See 119 F.Supp.3d at 1061.

READ THE POLICY, KNOW THE CASES

As these cases illustrate, it is crucial to review the precise policy language. It is also vital in construction cases to appreciate that normal liability policies do not cover defective workmanship unless there is physical damage to other parts of the structure.

Otherwise, courts will likely conclude that the owner has suffered economic loss and not physical property damage.

“In California, ‘the prevailing view is that the incorporation of a defective component or product into a larger structure does not constitute property damage unless and until the defective component causes physical injury to tangible property in at least some other part of the system.’ As a result, property damage is not established by the mere failure of a defective product to perform as intended, [n]or is it established by economic losses such as the diminution in value of the structure or the cost to repair a defective product or structure. California cases consistently hold that coverage does not exist where the only property ‘damage’ is the defective construction, and damage to other property has not occurred.” See *American Home Assurance*, 119 F.Supp.3d at 1060 (citations and internal quotations omitted).

Forewarned is forearmed. When there are legal disputes arising out of a construction project, don’t just call a lawyer. Find counsel who has experience dealing with these issues, including the sometimes arcane insurance controversies that accompany them.