

CONSTRUCTION DEFECT COVERAGE ISSUES: ASSESSING BEACHHEAD DEFENSES

The initial issues analyzed in any defective construction coverage question applying commercial general liability (CGL) policies written on standard Insurance Services Organization (ISO) forms¹ for about the last twenty years are whether the claim is one for:

- 1) physical injury to tangible property (one of the “property damage” components)² and
- 2) involves an “occurrence.”

If so, there may well be coverage unless a particular exclusion applies to bar the granted coverage (subject to many caveats beyond the scope of these materials).

The following pages provide a brief overview of these two seemingly simple concepts and how they have been applied to construction coverage questions in various jurisdictions. The discussion is by no means an exhaustive analysis of these issues. Instead, these materials intend to highlight some of the beachhead defenses practitioners may utilize in this area.

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The relevant ISO CGL policy language generally addressed in caselaw is as follows:

SECTION I – COVERAGES COVERAGE A BODILY INJURY AND PROPERTY DAMAGE LIABILITY

1. Insuring Agreement

¹ See Hartford Fire Ins. Co. v. California, 509 U.S. 764, 772, 113 S.Ct. 2891, 125 L.Ed.2d 612 (1993) (“ISO develops standard policy forms and files or lodges them with each State’s insurance regulators; most CGL insurance written in the United States is written on these forms.”). The first standard form comprehensive general liability insurance policy was drafted by the insurance industry in 1940. See 21 Eric Mills Holmes, *Holmes’ Appleman on Insurance 2d*, § 129.1, at 7 (2002).

² These materials do not address the issues raised by the “loss of use” components of the “property damage” definition.

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

* * *

- b. This insurance applies to * * * "property damage" only if:
 - (1) The * * * "**property damage**" is **caused by an "occurrence"**"

* * *

SECTION V – DEFINITIONS

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- 13. "Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

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- 17. "Property damage" means (in relevant part for these materials):

- a. Physical injury to tangible property

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OCCURRENCE: Minnesota caselaw interpreting pre-1986 ISO forms analyzed the existence of an occurrence as follows:

- (1) Was there an accident (including continuous or repeated exposure to conditions)?
- (2) Did the event result in property damage? and
- (3) Was the property damage was neither expected nor intended by the insured.

See e.g., Johnson v. AID Ins. Co. of Des Moines, Iowa, 287 N.W.2d 663, 664 (Minn. 1980).³ This test was developed from the pre-1986 “occurrence” definition itself:

“an accident, including continuous or repeated exposure to conditions, which results in * * * property damage neither expected nor intended from the standpoint of the insured.”

The second and third prongs of this definition were removed when the standard ISO form was revised in 1986. The Minnesota Supreme Court emphasizes policy interpretation must be based on *current* policy language. See e.g., Thommes v. Milwaukee Ins. Co., 641 N.W.2d 877 (Minn.2002); Federated Mut. Ins. Co. v. Concrete Units, Inc., 363 N.W.2d 751 (Minn.1985); O’Shaughnessy v. Smuckler Corp., 543 N.W.2d 99 (Minn. App. 1996), review denied (Minn. March 28, 1996). Therefore, the key to the “occurrence” analysis today is whether an “accident” is at issue.

Over 50 years ago, the Minnesota Supreme Court defined “accident” in the seminal construction defect case of Hauenstein v. St. Paul Mercury Indemn. Co.:

“Accident, as a source and cause of damage to property, within the terms of an accident policy, is an unexpected, unforeseen, or undesigned happening or consequence from either a known or an unknown cause.”

242 Minn. 354, 65 N.W.2d 122, 126 (1954). This basic “accident” concept was incorporated into the occurrence analysis when occurrence policies came on the market in the mid-1960s, and remains an applicable rule today. See American Fam. Mut. Ins. Co. v. Walser, 628 N.W.2d 605, 609 (Minn. 2001). The Walser decision compresses this definition by saying an “accident” is an “unexpected, unforeseen, or undesigned happening or consequence.” Id. at 611-12.

³ The Johnson policyholder was a general contractor who built a house for the underlying claimants. The Complaint alleged:

“Johnson had not met his obligations under the construction contract” and catalog[ued] ‘numerous and flagrant deficiencies’ in the construction of [the plaintiffs’] home, for which they sought reimbursement. The complaint charged that the house was marred by ‘major structural defects,’ ‘major departures from the design requirements,’ and ‘poor quality’ of workmanship and that, despite numerous complaints from the Smiths, Johnson ‘failed and neglected’ to ‘complete the said construction or to correct the defects’ in the work he had already completed.”

Id. at 664.

Caselaw beginning in the 1970s addressed whether, in the first instance, an occurrence was involved when faulty construction work was at issue. In Bituminous Casualty Corp. v. Bartlett, the Minnesota Supreme Court considered how the occurrence definition is impacted by the policyholder's control of the risks being insured:

“A construction contractor's liability policy is designed to protect him from fortuitous losses occurring in connection with his work. If property damage occurs because of mistake or carelessness on the part of the contractor or his employees, he reasonably expects that damage to be covered. On the other hand, the insurer is in the business of distributing losses due to such property damage among a large number of policyholders. It is able to properly set premiums and supply coverage only if those losses are uncertain from the standpoint of any single policyholder. If the single insured is allowed through intentional or reckless acts to consciously control the risks covered by the policy, a central concept of insurance is violated. * * * A contractor who knowingly violates contract specifications is consciously controlling his risk of loss and has not suffered an occurrence.”

307 Minn. 72, 78, 240 N.W.2d 310, 313 (1976) (emphasis added),⁴ overruled in part on other grounds, Prahm v. Rupp Constr. Co., 277 N.W.2d 389 (Minn. 1979). Both Bartlett and Johnson involved general contractors who performed deficient work on construction projects which violated the project's contract specifications. However, these cases involved more than simple failure to perform the construction pursuant to the contracts. Evidence in both of these cases established the deficiencies at issue were brought to the policyholder's attention during construction, but the contractors chose not to correct the faulty/poor workmanship. Under these

⁴ The Bartlett insured was a masonry subcontractor working on new construction. The allegations against the insured were that:

“(1) Some of the bricks in the exterior walls of the building were chipped. [The building owner] testified that there were about 20 chipped bricks per square (100 square feet); that the chips were ‘big’; and that he had complained about them to Bartlett during the course of construction. (2) Certain of the exterior walls of the building were not built entirely straight and perpendicular, or ‘plumb,’ to the ground. [The building owner] testified that this alleged defect was also brought to Bartlett's attention during construction. Bartlett informed [the building owner] then and maintains now that it was necessary to run the walls out of plumb because precast concrete columns, which were placed by another contractor and for which he was not responsible, pushed a steel beam out of place. Both the chipped bricks and the out-of-plumb walls were contrary to standards of workmanship in the contract between Bartlett and [the building owner].”

307 Minn. at 74-75, 240 N.W.2d at 311.

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facts, the Minnesota Supreme Court ruled that results of obvious violations of contract standards of workmanship are not “unexpected,” and an “occurrence” therefore did not exist for the purposes of a prima facie coverage analysis.

The Johnson court contrasted a known violation of contract specifications during construction with a fact pattern which did not involve such obvious failures of workmanship existing and known by the contractor at the time of the construction:

“In Ohio Casualty Ins. Co. v. Terrace Enterprises, Inc., 260 N.W.2d 450 (Minn.1977),⁵ we distinguished [Bartlett], and held that the settling of an apartment building resulting from faulty construction that was ‘perhaps negligent, but not reckless or intentional’ did constitute an ‘occurrence.’ In [Terrace Enterprises], the insured building contractor was warned by an engineer subcontractor that the soil at the building site needed added protection from freezing. The insured contractor ‘made efforts to protect the soil and concrete from the climate,’ but those efforts proved inadequate. Noting that some precautions had been taken, we found an ‘occurrence’ within the policy terms. A contractor’s mistake or carelessness is covered; but an insured will not be allowed through intentional or reckless acts to consciously control the risks covered by the policy. 260 N.W.2d at 452.”

Johnson, 287 N.W.2d at 665 (footnotes omitted). Thus, it might be argued that Terrace Enterprises stand for the proposition that, if the contractor genuinely attempts to properly perform its work and takes what appears to be proper precautions, the failures in these activities will constitute an “occurrence.” Stated another way, an “occurrence” may exist if the insured did not engage in conscious wrongdoing. W. Nat’l Mut. Ins. Co. v. Frost Paint & Oil Corp., 1998 WL 27247 at *1 (Minn. App. 1998). Cf. Reinsurance Ass’n. of Minnesota v. Timmer, 641

⁵ The Terrace Enterprises policyholder was the general contractor for the construction of two apartment buildings, and was the contractor who actually laid the buildings’ footings and foundation. However, this work was done over the objection of engineers who:

“recommended the project be stopped or slowed until the soil conditions improved for laying the footings and the foundation, and specifically warned of the need to protect the soil and concrete from freezing and of the danger of back filling over frozen soil.”

260 N.W.2d at 451-52. The insured tried to protect the soil and concrete from the climate, but was unsuccessful. The building ultimately settled and threatened collapse because of the failure to protect the work from the elements and to back fill adequately. Id. The opinion does not state if any of the various subcontractors’ work performed on the building may have been damaged by the settling. The remedy was to jack up the building and replace the foundation.

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N.W.2d 302 (Minn. App. 2002) (negligent misrepresentation caused an “accident” of accepting diseased cows which thereafter infected a health heard), review denied (Minn. May 14, 2002).

Perhaps there is another way to reconcile these cases. In Terrace Enterprises, there is no doubt there was physical injury to the building due to the defective work. In Bartlett and Johnson, it seems there was no physical injury to tangible property (“property damage”) in that the defects were just that – defects in the construction. At best, there may have been some economic loss measured by some diminution in the structure’s value, but there simply does not seem to be property damage.

Compare this analysis of these historic Minnesota cases with how courts around the country analyze the “occurrence” issue today. It seems most cases which hold that defective construction is not an occurrence turn, not on the presence or absence of physical injury to the defectively constructed portion of the building, but on whether another part of the structure has been physically injured by the defective work or product. See, e.g., Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co., 908 A.2d 888, 897-98 (Pa. 2006) (defectively constructed coke battery for a steel mill which physically deteriorated after construction does not present a fortuitous or unexpected claim, and therefore is not an occurrence); L-J, Inc. v. Bituminous Fire & Marine Ins. Co., 621 S.E.2d 33, 36 (S.C. 2005) (asphalt cracking due to faulty site preparation and construction workmanship by the policyholder was not an occurrence); Auto-Owners Ins. Co. v. Home Pride Cos., Inc., 684 N.W.2d 571, 577 (Neb. 2004) (faulty workmanship that damages the resulting work product, standing alone, is not an occurrence); Pursell Constr., Inc. v. Hawkeye-Security Ins. Co., 596 N.W.2d 67, 71 (Iowa 1999) (failure to construct houses at correct elevation as required by contract does not constitute an occurrence); Heile v. Herrmann, 736 N.E.2d 566, 568 (Ohio 1999) (faulty workmanship does not constitute an occurrence when the damage is to the work product only); McAllister v. Peerless Ins. Co., 474 A.2d 1033 (N.H. 1984) (defective work, standing alone, did not result from an occurrence); Amerisure, Inc. v. Wurster Constr. Co., Inc., 818 N.E.2d 998, 1004 (Ind. App.2004) (sheathing and insulation system failures caused by faulty subcontractor workmanship is a natural and ordinary act not constituting an accident and therefore is not an occurrence (citing Weedo v. Stone-E-Brick, Inc., 81 N.J. 233, 405 A.2d 788, 791 (1979).)); Monticello Ins. Co. v. Wilfred's Constr., 661 N.E.2d 451, 456 (Ill. App. 1996) (improper construction by a contractor and its subcontractors does not constitute an occurrence when the improper construction leads to defects); Indiana Ins. Co. v. Hydra Corp., 615 N.E.2d 70 (Ill. App. 1993) (cracks in floor and loose paint were natural and ordinary consequences of installing defective concrete flooring and applying wrong type of paint and did not constitute an accident); Hawkeye-Security Ins. Co. v. Vector Constr. Co., 185 Mich. App. 369, 460 N.W.2d 329 (Mich. App. 1990) (defective workmanship was not the result of an occurrence); Adair Group, Inc. v. St. Paul Fire and Marine Ins. Co., 477 F.3d 1186 (10th Cir. 2007) (where consequential or resultant damages do not flow from poor workmanship, construction deficiencies alone are not an “event”); United States Fidelity & Guar. Corp. v. Advance Roofing & Supply Co., Inc., 788 P.2d 1227, 1233 (Ariz. App.1989) (failure to replace roof and faulty work on replaced roofs not an occurrence); OneBeacon Ins. Co. v. Metro Ready-Mix, Inc., 242 Fed. Appx. 936, 940 (4th Cir. 2007) (no

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occurrence when defectively supplied product does not damage other parts of the structure, even when the other parts of the structure are damaged to remove the defective product); French v. Assurance Co. of America, 448 F.3d 693, 703 (6th Cir. 2006) (damages allocable to costs to replace faulty workmanship itself are economic losses and therefore do not constitute an occurrence triggering indemnification); Norwalk Ready Mixed Concrete v. Travelers Ins. Cos., 246 F.3d 1132, 1137 (8th Cir.2001) (Iowa law) (defective workmanship cannot be characterized as an accident); J.Z.G. Resources, Inc. v. King, 987 F.2d 98 (2d Cir.1993) (New York law) (failure to construct roads at contracted for elevations not an occurrence); Hotel Roanoke Conf. Center Comm. v. Cincinnati Ins. Co., 303 F.Supp.2d. 784, 788 (W.D.Va.2004), (“‘accident’ as used in the definition of occurrence involves a degree of fortuity not present when the insured’s defective performance of a contract causes injury to the insured’s own work or product.”). Cf. ACUITY v. Burd & Smith Constr., Inc., 721 N.W.2d 33, 39 (N.D. 2006) (in stating an “occurrence” exists if the property damaged was not the insured’s work product, the opinion impliedly stands for the proposition damage to the defective work itself is not an “occurrence.”).

Auto-Owners Ins. Co. v. Home Pride Cos., Inc. discusses the reasons why these courts so hold:

“Although it is clear that faulty workmanship, standing alone, is not covered under a standard CGL policy, it is important to realize that there are two different justifications for this rule. On the one hand, the rule has been justified on public policy grounds, primarily on the long founded notion that the cost to repair and replace the damages caused by faulty workmanship is a business risk not covered under a CGL policy. * * * Today, the business risk rule is part of standard CGL policies in the form of ‘your work’ exceptions to coverage. Therefore, the business risk rule does not serve as an initial bar to coverage, but, rather, as a potential exclusion, via the ‘your work’ exclusions, if an initial grant of coverage is found. * * *

“On the other hand, rather than relying on the business risk rule, a majority of courts have determined that faulty workmanship, standing alone, is not covered under a CGL policy because, as a matter of policy interpretation, ‘[t]he fortuity implied by reference to accident or exposure is not what is commonly meant by a failure of workmanship.’ * * * Because the majority rule is based on an actual interpretation of policy language, as opposed to a mere exposition of policy, and comports with our prior definitions of the term ‘accident,’ we believe that it represents the better rule. * * * Consequently, we conclude that faulty workmanship, standing alone, is not covered under a standard CGL policy because it is not a fortuitous event.”

684 N.W.2d at 577 (citations omitted). This rationale is consistent with the reasons why the Bartlett and Johnson cases held there were no occurrences involved in those fact patterns. When fortuity is no longer a factor, there is no occurrence.

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Conversely, if there is physical injury to something other than the defective work or product, most cases seem to agree with Terrace Enterprises that an occurrence exists under a CGL policy. See e.g., Auto-Owners Ins. Co., Inc. v. Newman, 2008 WL 648546 (S.C. 2008) (subcontractor's defectively installed stucco resulted in an occurrence of water infiltration under the general contractor's policy when parts of the house not constructed by the subcontractor were physically injured; "negligence of a third party" is fortuitous and therefore an occurrence);⁶ Auto-Owners Ins. Co. v. Pozzi Window Co., 984 So.2d 1241, 1248 (Fla. 2008) (subcontractor's defective installation of windows which themselves are not defective constitutes an occurrence under the general contractor's policy); United States Fire Ins. Co. v. J.S.U.B., Inc., 979 So.2d 871, (Fla. 2007) (coverage available for damage to insured contractor's work not performed by negligent subcontractor because of faulty work performed by that subcontractor); Travelers Indemn. Co. of Am. v. Moore & Assoc., Inc., 216 S.W.3d 302 (Tenn. 2007) (damages unforeseeable and therefore an occurrence when defective window installation by a subcontractor causes water intrusion damages to other parts of the building); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 137 P.3d 486 (Kan. 2006) (subcontractor's defective work can constitute an occurrence); ACQUITY v. Burd & Smith Constr., Inc., 721 N.W.2d 33 (N.D. 2006) (faulty workmanship causing damage to property other than the work product is an accidental occurrence for purposes of a CGL policy); American Fam. Mut. Ins. Co. v. American Girl, Inc., 673 N.W.2d 65 (Wis. 2004) (settling damage to a building caused by professional insured's improper soil preparation an occurrence); Auto-Owners Ins. Co. v. Home Pride Cos., Inc., 684 N.W.2d 571, 577-78 (Neb. 2004) (negligently installed shingles on existing buildings caused physical injury to other parts of the buildings); Erie Ins. Exchange v. Colony Development Corp., 736 N.E.2d 941 (Ohio 1999); High Country Assocs. v. New Hampshire Ins. Co., 648 A.2d 474 (N.H. 1994) (allegations of faulty workmanship resulting in water infiltration damaging walls which were not faulty constituted an occurrence); Lennar Corp. v. Auto Owners Ins. Co., 214 Ariz. 255, 151 P.3d 538 (Ariz. App. 2007); Broadmoor Anderson v. Nat'l Union Fire Ins. Co. of La., 912 So.2d 400 (La. App. 2 Cir. 2005), cert. denied, 925 So.2d 1239 (La. 2006) (breach of contract for faulty workmanship can constitute an occurrence as CGL policy does not distinguish between tort and breach of contract liability); Joe Banks Drywall v. Transcontinental Ins. Co., 753 So.2d 980 (La. App.2000); French v. Assurance Co. of America, 448 F.3d 693, 703-705 (6th Cir. 2006) (moisture intrusion into non-defective areas of project an occurrence when defective work performed by a subcontractor of the insured); Okatie Hotel Group v. Amerisure Ins. Co., 2006 WL 91577 (D.S.C. 2006) (water intrusion damage to building from defective work of another is an occurrence); Fidelity & Deposit of Maryland v. Hartford Cas., 189 F.Supp.2d 1212 (D.Kan.2002).

Several of these cases involve claims where the general contractor seeks coverage from its CGL policy for damages to its "work" (the entire structure) based on defective work or products of

⁶ L-J, Inc. v. Bituminous Fire & Marine Ins. Co., 621 S.E.2d 33, 36 (S.C. 2005) is difficult to reconcile with the same Court's later Newman decision. In L-J, one subcontractor's defective work on a roadbed resulted in damage to another subcontractor's work – the road asphalt. The general contractor's coverage was at issue in both cases.

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one subcontractor damaging another part of the constructed building. See e.g., Auto-Owners Ins. Co., Inc. v. Newman, 2008 WL 648546 (S.C. 2008); Travelers Indemn. Co. of Am. v. Moore & Assoc., Inc., 216 S.W.3d 302 (Tenn. 2007); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 137 P.3d 486 (Kan. 2006); American Fam. Mut. Ins. Co. v. American Girl, Inc., 673 N.W.2d 65 (Wis. 2004). In these cases, the entire project is the general contractor's "work." Therefore, if the historic distinction in determining if an "occurrence" has happened is whether the insured's "work" or "product" is the only item physically injured by the defect, how can a general contractor obtain coverage when it is the general contractor's work which is damaged? These cases have evolved the "occurrence" concept to include consideration of whether it is unforeseeable that the subcontractor will perform its work in a defective manner. Therefore, if the work of another is defective, it is fortuitous, and therefore an occurrence.

This concept, however, has been taken one step further recently in Texas. In Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1 (Tex. 2007), the Texas Supreme Court ruled that a general contractor's own faulty workmanship performed on a house it constructed is an "occurrence," even if its negligence physically injured only its own work. In Lamar Homes, the insured constructed a house for the underlying claimants. Several years later, the homeowners sued the contractor for problems which were allegedly attributed to foundation defects. These defects manifested in cracks in the house's sheetrock and stone veneer. The court observed there is no language in the standard CGL policy which distinguishes an "occurrence" between damage to the work itself (not caused by an occurrence) with damage to collateral property (caused by an occurrence). Id. at 9 (citing Erie Ins. Exch. v. Colony Dev. Corp., 736 N.E.2d 950, 952 (Ohio App. 2000)). Therefore, there is no policy language reason to differentiate an occurrence base on whether or not other property is or is not physically injured.

The question ultimately becomes, how do all these cases influence the application of the occurrence definition to construction defect coverage cases interpreting Minnesota law? In Aten v. Scottsdale Ins. Co., 511 F.3d 818 (8th Cir. 2008), the Eighth Circuit ruled that cracked and uneven basement floors which caused water damage to the project constituted an "occurrence" for the purposes of CGL coverage. However, in so ruling, the court provided little guidance as to why it reached this holding. One of the few cases the Aten court cited, O'Shaughnessy v. Smuckler Corp., 543 N.W.2d 99 (Minn. App.1996), abrogated on other grounds by Gordon v. Microsoft Corp., 645 N.W.2d 393 (Minn.2002), does not even contain a discussion of what constitutes an occurrence under a CGL policy.

The Aten Court also ignored cases cited by the trial court which hold that faulty workmanship which only physically injures the work itself did not constitute an "occurrence" under the CGL policy. It is likely the appellate court, however, ignored these cases as they discuss the "Business Risk" Doctrine as interpreted in two Minnesota Supreme Court cases from the 1980s: Bor-Son Building Corp. v. Employers Commercial Union Ins. Co. of Am., 323 N.W.2d 58 (Minn.1982) and Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co., 396 N.W.2d 229 (Minn.1986). Bor-Son and Knutson favorably discussed and endorsed the Business Risk Doctrine and how it should shape a court's coverage analysis in construction defect cases.

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However, the Business Risk Doctrine has lost its authority as a basis on which coverage can be determined when later cases such as O’Shaughnessy and Thommes expressly rejected the Doctrine as an independent basis on which to interpret policies. Instead, policy interpretation is to be principally determined by the policy’s language. See also, Wanzek Constr. Co. v. Employers Ins. of Wausau, 679 N.W.2d 322 (Minn. 2004) (subsequent change in policy language in 1986 governs coverage determination, citing O’Shaughnessy).

There is no clear answer on where Minnesota may go in the national debate on what constitutes an “occurrence” in construction coverage cases. Recent “occurrence” cases in other coverage areas may provide some guidance. However, when these cases are closely analyzed, they seem to blur the distinction between an “occurrence”, and the result of the “occurrence” (“property damage”). This is because the Hauenstein definition of an “accident” includes not only an unforeseen “happening,” but also an unforeseen “consequence.”

This concern is underscored by the court’s “occurrence” discussion in the Walser decision. American Fam. Mut. Ins. Co. v. Walser, 628 N.W.2d 605, (Minn. 2001). The Walser analysis focuses on the “consequence” term in the old Hauenstein definition to seemingly expand the “occurrence” definition into something vastly more broad than what is reasonable. Walser, technically addressing an intent to injure fact pattern, holds that:

“[W]here there is no intent to injure, the incident is an accident, even if the conduct itself was intentional.”

Id. at 612. In so ruling, the Walser court implicitly rejected a line of court of appeals decisions which focused on the conduct at issue and not the result. These prior court of appeals decisions implicitly held that a working understanding of “accident” centered on whether the act itself was intentional, regardless of whether the outcome (“consequence”) was intentional. See e.g., Sage Co. v. INA, 480 N.W.2d 695, 697 (Minn. App. 1992) (firing an employee was not an accident); Milbank Ins. Co. v. B.L.G., 484 N.W.2d 52, 58 (Minn. App.), review denied (Minn. July 16, 1992) (act resulting in transmission of herpes was not an “accident”); Gilman v. State Farm Fire & Cas. Co., 526 N.W.2d 378, 383 (Minn. App. 1995) (an intentional tackle was not an accident).

In rejecting these court of appeals rulings, the Walser court essentially defined an “accident” as being something which is substantively identical to the application of the standard Insurance Services Organization’s “Expected or Intended” Exclusion. The Walser court tried to soften this position by stating it:

“do[es] not conclude or suggest that the scope of coverage for accidents will always coincide with the scope of an exclusion for intentional acts. Rather, we conclude that in analyzing whether there was an accident for purposes of coverage, lack of specific intent to injure will be determinative, just as it is in an intentional act exclusion analysis.”

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Walser, 628 N.W.2d at 612.

The concern with Walser is that a Minnesota court may now say that, since defective construction is an unexpected result, defective construction will always be an “occurrence,” just as it apparently now is under Lamar Homes. See e.g., Web Constr., Inc. v. Cincinnati Ins. Co., No. 06-5061 (RHK/AJB) (D. Minn. November 29, 2007) at pp. 13-14 (concrete floor defects constituted an accident). See also State Farm Fire & Cas. Co. v. CTC Dev. Corp., 720 So.2d 1072, 1076 (Fla.1998) (“accident” in construction coverage analysis not only involves accidental events, but injuries or damages neither expected or intended from the standpoint of the insured).

The “Rip-Tear” Issue: In Bright Wood Corp. v. Bankers Standard Ins. Co., 655 N.W.2d 544 (Minn. App. 2003), review denied (Minn. September 24, 2003), the court addressed whether coverage existed for the damage to an insured’s product which was required to remove a defective component incorporated into that product. The court noted the key factor in determining whether coverage exists for materials damaged in order to reach the defective item to be repaired or replaced was whether the materials removed to reach the specific item were damaged before the repair efforts were commenced. Since these items were not physically injured before these efforts, damage inflicted as part of the defective component replacement process could not be an “accidental occurrence.” Id. at 549. In other words, despite the fact the thrust of the case focused on application of policy exclusions, the exclusions were not the reason why the incidental damage happening during the repair process was not covered. Instead, it is the application of the prima facie coverage language which determined the issue. See also OneBeacon Ins. Co. v. Metro Ready-Mix, Inc., 242 Fed. Appx. 936, 940 (4th Cir. 2007) (no occurrence when defectively supplied product does not damage other parts of the structure, even when the other parts of the structure are damaged to remove the defective product).

The “Tail Wagging the Dog” Issue: In Acceptance Ins. Co. v. Ross Contractors, Inc., 2005 WL 1870688 (Minn. App. 2005), appeal after remand, 2008 WL 2796593 (Minn. App. 2008), an insured sought coverage for an adverse damages award following defective installation of a roof over an existing roof. The underlying verdict awarded the building owner: (1) \$13,365.58 for damages related to leaks through the old roof during construction; (2) \$119,707.79 for amounts the building owner spent in an effort to salvage the new roof and mitigate damages; (3) \$800,000 for the costs of repair or replacement of the roof; and (4) \$174,619.34 for the building owner’s lost profits.

The appeals addressed application of a variety of exclusions to the fact pattern. However, due to the appeals’ procedural posture, both appellate courts declined to consider whether an occurrence was at issue (as found by the first trial court judge handling the case) and, if so, the impact of the occurrence on the coverage analysis. Based on the characterization of the damages award, it seems the \$13,365.58 may have been for either clean-up of leaks, or possibly physical injury to other parts of the building or personal property. However, what also seems clear is that the bulk of the damages were awarded to simply replace the defectively-installed roof, and that there was no physical injury to the defectively-installed roof.

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Because the fact pattern involved a contractor's work on an existing building, the case was best postured to claim the defective work itself (the defective roof installation) conducted on an existing building took the case outside of the troublesome line of occurrence cases involving new construction where one subcontractor's defective work damaged another part of the insured general contractor's work (other parts of the new construction). However, instead of applying the logic as seen in the various cases outlined above, the court appears to have applied an "in for a penny, in for a pound" approach to let a relatively small amount of damage to other property create coverage for the repair and replacement of the insured's defective work.

One approach to counter this type of reasoning is to assess whether the defective work actually is "damaged". If not, even if an occurrence has caused some physical injury at other locations, there would not be coverage for the repair or replacement of the defective work itself because it is not "physically injured."

* * * * *

PROPERTY DAMAGE: As recited in the beginning of these materials, "property damage" is defined for the purposes of the analysis presented as "physical injury to tangible property." The intellectual question presented in a construction defect coverage analysis is whether defective construction, in and of itself, is "physical injury to tangible property." Stated another way, is there physical injury because a wall is out of plumb, or because the contractor did not properly install crown molding? More significantly, how are the costs incurred to remedy the defective construction analyzed under a CGL policy?

Even if "defective construction" is an occurrence, the question in a prima facie coverage analysis then becomes: is defective construction, in and of itself, physical injury to tangible property? Several courts hold the answer to the question is "no."

"[T]here is a difference between a claim for the costs of repairing or removing defective work, which is not a claim for 'property damage,' and a claim for the costs of repairing damage caused by the defective work, which is a claim for 'property damage.'"

United States Fire Ins. Co. v. J.S.U.B., Inc., 979 So.2d 871, 889 (Fla. 2007). See also Auto-Owners Ins. Co. v. Pozzi Window Co., 984 So.2d 1241, 1248-49 (Fla. 2008) (defective installation of defective windows is not itself "physical injury to tangible property"); Travelers Indemn. Co. of Am. v. Moore & Assoc., Inc., 216 S.W.3d 302 (Tenn. 2007) (mere inclusion of a defective component does not allege property damage); Pursell Constr. Inc. v. Hawkeye Security Ins. Co., 596 N.W.2d 67, 70 (Iowa 1999); Lennar Corp. v. Great Am. Ins. Co., 200 S.W.3d 651, 679-80 (Tex. App. 2006) (distinguishing between costs to remove and replace defective stucco as a preventative measure, which were not "damages because of ... property damage," and the costs to repair water damage that resulted from the application of the defective stucco, which

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were "damages because of ... property damage"); West Orange Lumber Co. v. Indiana Lumbermens Mut. Ins. Co., 898 So.2d 1147, 1148 (Fla. 5th DCA 2005) (costs of removing and replacing wrong grade of cedar siding are not because of physical injury to the construction; mere inclusion of a defective component does not constitute property damage absent physical injury to some other tangible property); Amerisure, Inc. v. Wurster Constr. Co., Inc., 818 N.E.2d 998, 1004 (Ind. App.2004) (sheathing and insulation system failures caused by faulty workmanship did not constitute "property damage"); French v. Assurance Co. of America, 448 F.3d 693, 703 (6th Cir. 2006) (damages allocable to costs to replace faulty workmanship itself are economic losses and therefore do not trigger indemnification); Cincinnati Ins. Co. v. Venetian Terrazzo, Inc., 198 F.Supp.2d 1074, 1079 n. 1 (E.D. Mo. 2001) (costs of repair and replacement of an improperly installed floor was not covered "property damage").

There is remarkably little caselaw interpreting Minnesota law as to whether mere defective construction, without more, constitutes "property damage." The persuasive cases are more intuitive in their analysis. For example, in Federated Mut. Ins. Co. v. Concrete Units, Inc., 363 N.W.2d 751 (Minn. 1985) a concrete grain elevator owner and the contractor constructing the elevator sued the concrete supplier for providing defective concrete to the project. Some of the costs sought included costs to replace the defective concrete itself. The Minnesota Supreme Court's analysis really does not address whether this category of replacement costs, in and of themselves, were awarded. Id. at 757. While there was damage to property other than the defective concrete, it can be argued the case implies the defective concrete replacement costs are not a claim for "property damage." Id.

At least one Minnesota Court of Appeals supports this position. Thermex Corp. v. Fireman's Fund Ins. Cos., 393 N.W.2d 15, 17 (Minn. App. 1986) (costs incurred to replace defectively installed heating and ventilation system are not "physical injury to or destruction of tangible property"). Another can be interpreted as also supporting this position. Sphere Drake Ins. Co. v. Tremco, Inc., 513 N.W.2d 473, 481 (Minn. App. 1994) (reciting numerous examples of physical injuries to tangible property, but none of which were the defects). In addition, balanced and well-respected insurance treatises confirm this conceptual approach to the issue. See e.g., Patin, *Construction Insurance*, in Bjorkman, et al., *LAW AND PRACTICE OF INSURANCE COVERAGE*, Ch. 145.6 (discussing post 1966 versions of the property damage definition requiring physical damage, and noting that repair or replacement of faulty work or products is not physical damage).

This logic is not unlike that seen in Travelers Ins. Co. v. Eljer Mfg., Inc., 757 N.E.2d 481 (Ill. 2001). Eljer addressed whether the mere presence of defective piping in houses constituted "property damage" (defined as "physical injury to tangible property"):

"We conclude that, to the average, ordinary person, tangible property suffers a "physical" injury when the property is altered in appearance, shape, color or in other material dimension. Conversely, to the average mind, tangible property does not experience "physical" injury if that property suffers intangible damage,

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such as diminution in value as a result from the failure of a component, such as the Qest system, to function as promised.”

Eljer, 757 N.E.2d at 496. See also, Fireman’s Fund Ins. Co. v. Hartford Fire Ins. Co., 73 F.3d 811, 815 (8th Cir. 1996) (repair costs incurred merely to prevent unknown future damage are outside of the analogous “property damage” definition under Minnesota law).

What if the Defective Construction is Physically Injured? The question becomes muddled if not downright unfavorable if the question is whether there is “property damage” because the defective construction itself is physically injured. Some courts have held that, while injury to the insured’s work is an occurrence, it is not “property damage.” ACUITY v. Burd & Smith, 721 N.W.2d 33, 39 (N.D. 2006); Auto Owners Ins. Co. v. Home Pride Cos., 268 Neb. 528, 684 N.W.2d 571, 577 (2004). Holdings such as those in Burd & Smith and Home Pride have prompted carriers to make the following argument, which most times a court will reject, as the J.S.U.B. Florida Supreme Court did:

“The CGL policies define ‘property damage’ as ‘[p]hysical injury to tangible property, including all resulting loss of use of that property.’ U.S. Fire and the amici that argue in favor of its position assert that faulty workmanship that injures only the work product itself does not result in ‘property damage.’ However, just like the definition of the term ‘occurrence,’ the definition of ‘property damage’ in the CGL policies does not differentiate between damage to the contractor’s work and damage to other property.”

United States Fire Ins. Co. v. J.S.U.B., Inc., 979 So.2d 871, 888-89 (Fla. 2007). Other courts similarly hold that property damage exists, even if it is the insured’s work which is damaged. In Lamar Homes v. Mid-Continent Cas. Co., the court observed:

“[The insured’s] defective workmanship caused the home’s sheetrock and stone veneer to crack. These allegations of cracking sheetrock and stone veneer are allegations of ‘physical injury’ to ‘tangible property’”

242 S.W.3d at 10. The court also observed the “property damage” definition similarly does not eliminate the insured’s work from the definition. Id. at p. 10.

In Aten, the recent 8th Circuit decision interpreting Minnesota coverage law, the court noted the underlying lawsuit against the insured contractor determined that the damages at issue in the underlying action consisted of:

“trim missing, exposed sheetrock screws, damaged pieces of sheetrock installed, interior walls that were not plumb, floors that were uneven, gaps between the flooring and the wall/trim, doors off center, door jambs improperly installed,

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uneven and cracked floors in the garage and basement, with the basement floor not graded properly towards the drain causing water damage.”

511 F.3d at 819 (Emphasis in original). It was the italicized items on which the court appeared to be focused to implicitly find “property damage,” even though it appeared the areas damaged were the contractor’s work. See also, Web Construction, No. 06-5061 (RHK/AJB) (D. Minn. November 29, 2007) at p. 14 (popouts in the concrete floor constitute “property damage” under the policy because such defects caused “physical injury” to the floor).

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CONCLUSION: Clearly the discussions in this paper are just some of the beachhead considerations for the “occurrence” and “property damage” issues when assessing construction coverage issues. As coverage positions are formulated, defenses beyond the granting language are naturally considered, but in so doing, it is easy to lose sight of these initial coverage considerations. See e.g., Wanzek Constr. Co. v. Employers Ins. of Wausau, 679 N.W.2d 322 (Minn. 2004); O’Shaughnessy v. Smuckler Corp., 543 N.W.2d 99 (Minn. App.1996), abrogated on other grounds by Gordon v. Microsoft Corp., 645 N.W.2d 393 (Minn.2002). The result is that a court is tempted to let the policy exclusions drive the prima facie coverage discussion. As one judge recently discussed, such an analysis implies that exclusions define the initial scope of coverage, and is an analysis which ultimately begs the prima facie coverage question itself.

“COVERAGE DETERMINATIONS SHOULD NOT BE MADE BASED UPON POLICY EXCLUSIONS.

“The policy-interpretation linguistic gymnastics that tend to occur in some jurisdictions across the country in CGL cases, which involve the so-called subcontractor exception to the your-work exclusion, walk a very thin line of falling into violations of the rule that ‘exclusionary clauses cannot be relied upon to create coverage.’ See, e.g., [State Farm Fire & Cas. Co. v. CTC Dev. Corp., 720 So.2d 1072, 1074 (Fla.1998)]. However, *the insurance industry itself* created the language which has necessitated much of this at times thin and often thought-provoking interpretation by drafting CGL forms in a fashion that has pushed insureds and courts to rely on language in the exclusions to give meaning to all the words in the policy and to decipher the coverage grants. See, e.g., Am. Family Mut. Ins. Co. v. Am. Girl, Inc., 268 Wis.2d 16, 673 N.W.2d 65, 73 (2004) (adopting a three-part approach to interpreting a CGL policy: (1) examine the initial coverage grant to determine if “property damage” or ‘bodily injury’ has resulted from an ‘occurrence’; (2) if ‘property damage’ or ‘bodily injury’ has occurred, examine the policy exclusions to see if the CGL policy's otherwise broad coverage is thereby narrowed to exclude the claim; and finally (3) determine if any exceptions to applicable exclusions restore otherwise excluded coverage); Elmer W. Sawyer, *Comprehensive Liability Insurance* 11 (1943)

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(‘[I]nstead of insuring against only enumerated hazards, we now insure against all hazards not excluded.’ (emphasis supplied)). Furthermore, the ‘Business-Risk Doctrine’ or the ‘Historical Model’ concept--the weapons upon which the insurance industry has generally relied to deny claims for faulty subcontractor work--simply do not appear anywhere in these post-1986 standard-form CGL policies, as demonstrated by the policy involved in J.S.U.B. See, e.g., ISO Policy Form Number CG 00 01 07 98, <http://www.lexis.com>; see also James Duffy O’Connor, *What Every Construction Lawyer Should Know About CGL Coverage for Defective Construction*, *Constr. Law.*, Winter 2001, at 15, 15-16 (explaining that the Business-Risk Doctrine or Historical Model cannot be used to rewrite the actual language of the policy); 4 Philip L. Bruner & Patrick J. O’Connor, Jr., *Bruner & O’Connor on Construction Law* § 11:28 (2002 & Supp.2007) (substantially similar). These concepts should not be used to preclude coverage that the drafters of the policy intended and that insureds relied upon to justify paying additional premiums. Courts should not use the ‘concepts’ of the Business-Risk Doctrine and Historic Model to simply bar coverage, in lieu of examining the policies *as written*. See Wanzek Constr., Inc. v. Employers Ins. of Wausau, 679 N.W.2d 322, 325-27 (Minn.2004) (avoiding this interpretive problem by modifying Minnesota’s view of the Business-Risk Doctrine in light of the changed policy language present in post-1986 standard-form CGL policies).

“It has become clear that if the insurance industry seeks to avoid further and expansive interpretations of its CGL policies, it must do a better job of more narrowly describing coverage and defining the type of ‘property damage,’ ‘bodily injury,’ and ‘occurrences’ that it may intend these types of policies to cover, rather than adopting linguistic forms that tend to force courts to swim against the interpretive current by looking into the policy exclusions for answers to coverage questions to give meaning and life to all words utilized. Thus, while I am hesitant to place as much emphasis on the policies’ exclusions and exceptions as does the majority, I certainly recognize that courts should not rely on ephemeral policy justifications when the actual language of the policy at issue and the parties’ admitted intent do not include or reflect these justifications.”

J.S.U.B., 979 So.2d at 892-93 (Lewis, J., concurring)..

In the end, it is always best to not ignore the fact the insured is initially obligated to establish prima facie coverage under the policy. Boedigheimer v. Taylor, 287 Minn. 323, 329, 178 N.W.2d 610, 614 (1970). A careful and critical analysis of whether there is an “occurrence” or what it is, and whether “physical injury to tangible property” actually exists with regard to each component of the damages sought, will properly base the entire coverage analysis, and likely provide better reasoned determinations of construction defect coverage claims.

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