

# DECONSTRUCTING CONSTRUCTION DEFECT CLAIMS

A White Paper for Construction Contractors

## OVERVIEW

**CONSTRUCTION DEFECTS HAVE OCCURRED THROUGHOUT HISTORY.** Perhaps the most notable is the Leaning Tower of Pisa. Construction began on the 8-story building in 1173 and took 200 years to complete. The website [towerofpisa.info](http://towerofpisa.info) states the white marble building with 207 columns “looks like a massive wedding cake knocked precariously askew by a clumsy giant guest.” Today, the Tower of Pisa would be considered a construction defect rather than a tourist destination: Builders did not anticipate the soil conditions.

Construction defects arise from deficiencies in how something is designed, built, operated or maintained. Allegations of construction defect happen on jobs of all sizes and types; they impact everyone associated with the project, from architects to general contractors, electricians and roofers. In today’s litigious society, construction defect claims are likely to increase in frequency. The associated costs can be staggering, taking a toll not only on a company’s finances, but also its reputation.

This white paper discusses the primary categories of construction defects, the concept of construction defects as an “occurrence,” general liability coverage for construction defects and risk management solutions. It’s based on the Assurex Global Construction Practice Group meeting hosted by member company Oswald Companies in Cleveland in October 2015.



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### Section 1:

A Primer on Construction Defects

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### Section 2:

CGL Insurance and Construction Defects

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### Section 3:

Risk Management Solutions

## Section 1:

# A PRIMER ON CONSTRUCTION DEFECTS

The International Risk Management Institute (IRMI) offers this generally accepted definition of construction defect:

“*A deficiency in the design or construction of a building or structure resulting from a failure to design or construct in a reasonably workmanlike manner, and/or in accordance with a buyer’s reasonable expectation.*”

The IRMI adds that construction defects typically fall into two basic types – dangerous defects and passive defects. Dangerous defects have the potential to fail, causing physical injury or damage to both people and property. Conversely, passive defects don’t present an increased risk of injury or damage to people or property. “Nevertheless [these defects] cause harm to the property owner in the form of loss of use, diminution in value and extra expenses incurred while defects are corrected,” according to the IRMI.

## Four Categories of Construction Defect

During a webinar held in June 2015 for the Assurex Global Construction Practice Group, insurance company Travelers shared insight on construction defects. Simply put, a construction defect is a failure of any building component, system or adjoining property. Sometimes damages are immediately obvious, such as when a water pipe bursts. Those are generally covered under general liability insurance because a specific date and cause can be easily determined. Other damage appears over time, like a slowly shifting foundation from soil movement. These defects—in which the damage occurs over time with no known date of loss—are considered construction defects.



### **Most construction defects fall into one of four categories:**

- Design deficiencies
- Product or material insufficiencies
- Construction process failures
- Operation and maintenance issues

## Design Deficiencies

Architects and engineers may design buildings and structures that don't function as anticipated or in the manner intended by an owner. Oftentimes, design deficiencies can be attributed to building outside of the specified code. Some questions asked around design deficiency include the following: How clear is the design? Is it unduly vague? What's the experience level of the architect?

Sometimes issues arise when designers work for an owner of a franchise, building cookie cutter locations from Maine to California. The same design may not work everywhere. For instance, you would expect to design a building envelope for a restaurant in Florida much differently than for one in Minnesota. In short, design can play a role in how a structure is built and how it performs down the road.

### **Recommended Solution:**

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A professional liability policy for architects, engineers and contractors, which protects professionals against liability incurred as a result of errors and omissions in performing their services.

## Product or Material Insufficiencies

A building is simply a group of products brought together to form a structure. Many materials go into a building project, from steel frames and drywall to lights and carpet. Sometimes these materials are defective or damaged. This can lead to failure despite proper design and construction. In other cases, inferior products may not function as anticipated. In addition, how all these products interact with each other is key: Are they compatible?

### **Recommended Solutions:**

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Some options include documented quality assurance/quality control standards, contractual risk transfer to pass along what would otherwise be your own risks of loss, and proper certificates and warranties from manufacturers.

## Construction Process Failures

Subpar or faulty workmanship on building projects can lead to a host of defects, including water infiltration, mold and pest infestation, cracks in foundations or walls, dry rotting of wood and electrical or mechanical issues. Construction deficiencies also can stem from soil issues: The soil may have been improperly compacted, or a structure may have been built on expansive soil. In the latter case, the soil expands when it's exposed to moisture, causing it to heave and the structure to move or deflect.

### Recommended Solutions:

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You may consider quality assurance/quality control standards, contractual risk transfer with subcontractors, and errors and omission insurance to protect against liability for committing an error or omission during the course of a project.

## Operation and Maintenance Issues

Operation and maintenance problems may not inherently be a construction defect. However, if owners don't take care of the structure and run into problems several years down the road, guess who they are likely to blame? The contractors.

Once a construction project is finished and turned over to the owner, it's critical that the building be properly maintained. For instance, exterior sealants may be designed to last only five years depending on the environment. Without maintenance, the sealants may fail and cause water intrusion issues.

### Recommended Solutions:

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There's no simple solution for this category, but the best preventative step may be to educate owners on the importance of maintaining their properties. If an issue occurs, notify the appropriate team members such as legal counsel and your insurance carrier before resolving it. They can make recommendations on how to proceed.

## Who Is Affected by Construction Defect Claims?

Construction defect claims can impact a broad range of companies involved in projects, including the following:

- Architects
- Construction Management Companies
- Design-Build Contractors
- Developers
- Engineers
- Engineering, Procurement and Construction Contractors
- General Contractors
- Lenders
- Manufacturers & Suppliers
- Owners
- Trade Contractors
- Surety & Insurance Companies

## Section 2:

# CGL INSURANCE AND CONSTRUCTION DEFECTS

### **WHILE THE DEFINITION AND CATEGORIES OF CONSTRUCTION DEFECTS MAY**

seem clear cut, insurance coverage for those defects is decidedly not. Commercial general liability (CGL) insurance is designed to protect companies against liability exposures from bodily injury and property damage associated with their premises, operations, products and completed operations. But because CGL policies are designed for a wide array of risks across multiple industries, they don't meet all the nuances of the construction industry. Whether or not—and to what extent—CGL policies cover claims alleging construction defects is up for debate among insurance companies and in the courts.

At the heart of the debate is the concept of “occurrence.” CGL policies cover occurrences, which are typically defined as accidents, including continuous or repeated exposure to conditions resulting in bodily injury or property damage that was not expected or intended by the insured company. Unfortunately, when it comes to construction defects, the notion of occurrence is hazy. Language within CGL policies has been interpreted differently by courts deciding construction defect claims, which has led to inconsistencies in coverage for policyholders.

The case law varies from state to state concerning CGL coverage for construction defects, but courts generally render an opinion that falls into one of four categories:

**1 Defective construction is an occurrence.** Courts in nearly half the states have found that any property damage as the result of defective construction is considered an occurrence. Four states have passed statutes defining construction defect claims as occurrences—Arkansas, Colorado, Hawaii and South Carolina. [Case example: K & L Holmes, Inc. v. American Family Mutual Insurance Co., North Dakota, 2013]

**2 Damage to other work is an occurrence.** This stance says that property damage from faulty workmanship is not an occurrence. However, damage to other property, including the insured company's own work, is considered an occurrence. [Case example: Owners Insurance Co. v. Jim Carr Homebuilder LLC, Alabama, 2014]

**3 Damage to third-party property is an occurrence.** This principle limits the extent of an occurrence, claiming that only property damage to third-party property is covered by a CGL policy. [Case example: Oak Creek Apartments LLC v. Garcia, Michigan, 2013]

**4 Construction defect is not an occurrence.** Courts in at least six states have denied coverage under a CGL policy, rejecting the notion that defective construction is an occurrence. These include Iowa, Kentucky, Ohio, Oregon, Montana and Pennsylvania. [Case example: Westfield Insurance Co. v. Custom Agri Systems Inc., Ohio, 2012]

## / A Closer Look at CGL Exclusions

While you may think you are sufficiently covered under a CGL policy, there are provisions that restrict coverage. The standard CGL policy, introduced in 1986, includes limitations on coverage in 17 areas as wide ranging as pollution, electronic data and war. Restrictions that are most likely to affect construction contractors are related to damage to your property, product, work or impaired property.

- **Damage to your property.** The section of this exclusion most worth noting is “that particular part of any property that must be restored, repaired or replaced because ‘your work’ was incorrectly performed on it.” The policy defines “your work” as any work or operations performed by you or on your behalf and materials, parts or equipment furnished in connection with such work or operations.
- **Damage to product.** A clause in the CGL states that “property damage to your product arising out of it or any part of it” is excluded.
- **Damage to your work.** The CGL policy doesn’t apply to “property damage to your work arising out of it or any part of it and included in the products-completed operations hazard.” This exclusion features a subcontractor exception: It doesn’t apply “if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.”
- **Damage to impaired property or property not physically injured.** This excludes damage arising out of “a defect, deficiency, inadequacy or dangerous condition in your product or work; or a delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.”

The standard CGL coverage form is 16 pages, and while it strives to be comprehensive, it often gets muddled when construction defect claims are filed. Consider a couple scenarios: In the first, a self-performing contractor installs a roof on a hospital, which subsequently comes off during a windstorm. The hospital is reimbursed for damages through its property insurance, but more than a year later the insurance company says the general contractor owes money for the roof it paid to repair. The general contractor argues that the problem is the responsibility of the self-performing contractor, while the insurance company says the roof is part of “your work” in the CGL policy.

In a second case, owners of a hotel discover mold behind wallpaper in the guest rooms. They opt to tear down the walls and rebuild the rooms. The owners suspect water intrusion from the exterior windows and air conditioners, so they hire window professionals to investigate. A more expansive investigation conducted by investigators for an insurance company get to the heart of the problem: The hotel’s HVAC system was



not maintained properly. The owners had unnecessarily demolished walls between rooms. Furthermore, if those walls are rebuilt without addressing the real issue—maintenance of the HVAC system—then mold buildup will occur again. But who foots the bill for the room demolition and rebuild? Is the HVAC company responsible for damages or the hotel owners, who didn't maintain the system?

Each day in courts across the country, attorneys vigorously prosecute—and defend—construction defect claims. One of the best ways to mitigate losses from such lawsuits is to work with your insurance provider on risk management solutions.

## The Most Common Construction Defects

Some construction defects happen infrequently, such as the parapet that fell off a 10-story building in Cleveland necessitating a \$350,000 fix. Others are commonplace. The most common construction defects fall into one of three primary areas—envelope performance, environmental performance, and grading and drainage. The overarching culprit in many of the failures: water.



### Envelope Performance

- Incorrectly installed windows
- Leaky wall penetrations
- Failed curtain walls
- Leaking roofs

### Environmental Performance

- Ventilation (twisted, blocked or leaking ductwork)
- Acoustics (improper sound insulation)
- Odors (improper routing or balancing of HVAC systems)

### Grading and Drainage

- Slopes
- Splash back

## Section 3:

# RISK MANAGEMENT SOLUTIONS

**THERE ARE STEPS YOU CAN TAKE TO REDUCE YOUR RISK** and help ensure you are properly covered. Your insurance broker can help select the best option. Here are four potential risk management solutions:

**1 CGL modifications.** There are two potential endorsements you can use—an occurrence endorsement or a choice of law endorsement. In general, endorsement policies change or add provisions to the CGL or other policies. They can do things such as broaden the scope of coverage, limit scope of coverage, clarify the application of coverage for a specific loss exposure and add other companies as insured parties.

**2 Surety bonds.** This third-party agreement binds a principal seeking the bond, the company that requires the bond and a surety company that sells the bond. The bond guarantees that the principal will perform the work set forth in the contract. If they fail to do so, then the bond covers any resulting losses or damages. Most surety bonds are limited to work during the course of construction and for one year afterward.

**3 Subcontractor default insurance.** Used as an alternative to surety bonds, default insurance compensates the insured company if a covered subcontractor neglects to fulfill its contractual obligations. Some agreements specify coverage for the costs of correcting defective or nonconforming work or materials. This option is best for large general contractors who subcontract a lot of work (\$500,000 to \$1 million) and can invest in thorough subcontractor prequalifications.

**4 Contractor's errors and omission policy.** This insurance protects the insured against liability for committing a negligent act, error or omission. The policies may spell out what those acts, errors and omissions include, such as the design of a company's work, workmanship or defective materials and products that result in property damage.

Your insurance broker or a risk management firm may also advise you to institute quality assurance and quality control measures.





## Construction Defect Claim Case Study:

### A CAUTIONARY TALE

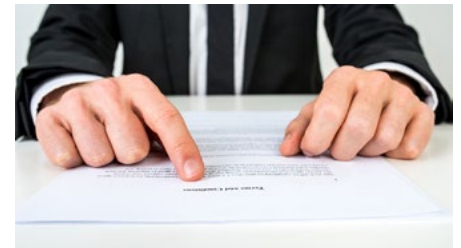
A case currently working its way through the legal system highlights the complicated and murky nature of construction defect claims. In 2009, a retirement community was built in the Midwest that included a community center, assisted living facility and six independent living buildings. Each apartment had concrete decks on first-floor units and wooden ones on upper floors. The property owner called the construction management company two years after construction was completed saying there was leaking around some of the porches.

The construction management company agreed to look into the problem. The owner hired another contractor to tear the finishes off of two of the elevated porches to investigate the causes of the water intrusion. Everything under the finishes—including wood timber and plywood plank—was saturated, as was the drywall and insulation on walls near the decks. There was significant deterioration. Repairs cost \$70,000 per porch, and there were 80 total porches, creating a \$5.6 million problem.

The failure was caused by incorrect flashing and minimal deck sloping. But sorting out who was responsible was less clear. The porches were built by three entities—a wood framing contractor, a roofing contractor and a company that was hired by the roofing contractor to handle the EPDM roofing membrane. The construction management company has agreed to replace all the porches to keep its reputation intact, but it's currently trying to recoup costs from the insurance company. So far, the construction company has been unsuccessful.

The insurance company has provided several reasons why the damage will not be covered. First, it said there's no claim for property damage because the porches were improperly constructed rather than damaged over time. The insurance company also denied the construction company's environmental liability claim, despite the fact that mold was present. In addition, it took the position that the construction company was acting as a general contractor, rather than a construction manager on the project, and the policy doesn't cover general contractors.

The case remains tied up in court. But one of the big lessons is that it's critical to review the language of your CGL policies and consider alternative coverage to ensure you are protected.



Repairs cost \$70,000

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80 total porches

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**\$5.6M**

## In Summary

**CONSTRUCTION DEFECT CLAIMS ARE HANDLED DIFFERENTLY** from state to state. Companies operating in states where construction defects are not considered an occurrence are most vulnerable. But with new cases being tried in courts daily across the U.S., and courts reversing decisions on what should and should not be covered, all construction companies are susceptible to losses, from large general contractors to small trade contractors. The industry faces a huge exposure, so it's more important than ever to maintain a close relationship with your insurance broker, carefully select subcontractors, implement sound quality control standards and consider alternative risk management solutions.



The Assurex Global Construction Practice Group is an alliance of insurance industry leaders and experts who collaborate to provide products and services that better serve the coverage needs of construction clients across the United States and around the world.