2024 Surety Bonding and Construction Risk Management Conference

Case Law Research Questions

Impacting the Construction

AGC 2024 Surety Bonding and Construction Risk Management Conference

Paper Title: Survey of Construction-Insurance Case Law: Recent Court Opinions Impacting the Construction-Risk Field

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The main body of the policy contained a faulty-workmanship exclusion, but by endorsement, that exclusion was deleted and replaced by a "LEG 3 Defect Extension" ("LEG3 clause") that provided:

> This policy shall not pay for loss, damage or expense caused directly or indirectly by any of the following.
> * * * * *
> (C) All costs rendered necessary by defects of material workmanship, design, plan, or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property containing any of the said defects, the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.
>
> For the purpose of this policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship, design, plan, or specification.
>
> All other terms and conditions of the policy remain the same.

Id. at *2.

The court in *South Capitol Bridgebuilders* granted the contractor's motion and denied the insurer's motion. (The parties agreed that Illinois law governed the policy and, thus, that is the substantive law the court applied. *Id.* at *4.) In so doing, it found that the damage to the bridge fell within the policy's insuring agreement, which insured against "all risks of direct physical loss of or damage to insured property"

> and bordering incomprehensible. SCB's statement that the Extension is "convoluted" is an understatement.

Id. The court also said that it "rejects Lexington's invitation to ignore the unclear and error-riddled language of the Extension, which Lexington drafted, signed, and now seeks to rely on to deny coverage." *Id.*

The *South Capitol Bridgebuilders* court further explained that while the LEG3 clause purported to exclude replacement or rectification costs incurred to "improve" the original workmanship, what it meant to "improve" the original workmanship was ambiguous. It found that it was not clear from the

water and/or moisture . . . where it was not intended or expected," thus causing "physical injury to the [t]ownhomes . . . ." *Acuity*, 2023 WL 8266295, at *1.

The contractor/developer tendered its defense of the construction-defect action as an additional insured under a CGL policy issued to a subcontractor hired to perform exterior work on the project. *Id.* at *2. The insurer denied coverage and filed a declaratory relief action against the contractor/developer, asserting that the underlying complaint did not allege "property damage" caused by an "occurrence." *Id.* The contractor/developer counterclaimed and the parties filed cross-motions for summary judgment. *Id.* The trial court granted the insurer's motion and denied the contractor/developer's motion, but the appellate court reversed, finding that there was a potential for coverage and that the broad allegations in the underlying litigation, thus, triggered the insurer's duty to defend. *Id.* at *2-3.

The Illinois Supreme Court allowed the insurer's petition for leave to appeal, affirmed the appellate court's reversal of summary judgment for the insurer, and reversed the part of the appellate court's order directing the trial court to enter summary judgment for the contractor/developer. *Id.* at *3, 9. The *Acuity* court then remanded the case to the trial court "[t]o ultimately resolve whether Acuity has a duty to defend." *Id.* at *9.

The *Acuity* court first analyzed whether the underlying complaint alleged that there was "property damage," and easily found that "the resulting water damage to the interior of the completed units plainly constitutes physical damage to tangible property." *Id.* at *6. It then analyzed whether the property damage was caused by an "occurrence" (defined as "an accident . . ."), and concluded that "the term 'accident' in the policies at issue reasonably encompasses the unintended and unexpected harm caused by negligent conduct." *Id.* at *7. It thus held that "property damage that results from inadvertent faulty work can be caused by an 'accident' and therefore constitute an 'occurrence' for purposes of the initial grant of coverage under the insuring agreement." *Id.* at *8.

The court also explained that under Illinois law, there is no requirement of an allegation of damage to "other" property for an insurer to have a duty to defend:

> Furthermore, we hold that the parties' premise—that there could be no "property damage" caused by an "occurrence" under the policy unless the underlying complaint alleged property damage to something beyond the townhome construction project—is erroneous; it is not grounded in the language of the initial grant of coverage in the insuring agreement. To the extent that prior appellate court cases relied upon considerations outside the scope of the insuring agreement's express language, that analysis, which is not

tied to the language of the policy, should no longer be relied upon.

2. "Reimbursement erodes the duty to defend." As the court explained: "Hawai'i's duty to defend is determined up front, at the start. Not the end. . . . Reimbursement for defense expenses undercuts the duty to defend." *Id.* at *2-3.

3. "[T]he insured is not unjustly enriched." The court noted that "contracts benefit both sides. Though it owes a duty to defend, the insurer benefits. It retains the premiums. It directs litigation. It runs the case, decision-making-wise." It went on to observe: "If we allowed reimbursement, the unjustly enriched party may very well be the insurer. When the insured pays back defense costs to the insurer, it pays for the insurer to protect itself." *Id.* at *1, 3-4.

Thus, in Hawaii, it seems that insurers must have an express reimbursement provision in their