CONSTRUCTION DEFECT CLAIMS: IS THERE PROPERTY DAMAGE WITHIN THE MEANING OF THE POLICY?

By Linda B. Foster[1]

Coverage analysis of a construction defect claim requires a determination whether there has been property damage within the meaning of the policy. In the absence of an allegation of property damage within the meaning of the policy, there is no duty to defend. Even in a case where the allegations create a duty to defend, if the actual damages are not paid because of property damage within the meaning of the policy, there can be no obligation to indemnify for those damages.[2]

This paper first will address what information coverage counsel must have to evaluate whether the claim presents damages because of property damage within the meaning of the policy. Then, the paper will highlight some of the key cases on the property damage coverage issue in construction defect claims.

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[2] Of course, the property damage must arise from an occurrence and must occur during the policy period. However, other papers and presentations at this seminar will address those issues.

Information Counsel Needs to Analyze Construction Defect Claims

To analyze properly whether a construction defect claim seeks damages because of property damage within the meaning of the policy, counsel must know several things about the case. First, counsel must know the language in the policy or policies at issue. While there are ISO coverage forms that are commonly used, there are many variations and not every carrier uses the same language. Forms can be changed by endorsement. The actual words used can make all the difference in the outcome of a claim. Get a copy of the policy and read it. Be aware that if there are several policies at issue, the pertinent language may have changed over the years.

Second, counsel must know the underlying case. If the issue is whether there is a duty to defend, counsel must know and analyze the complaint. If the issue is what, if any, actual damages must be indemnified, knowing and understanding the nature of those damages is critical to the analysis. This often will require review of the expert reports and the discovery responses in the case to understand the scope of the damages sought by the plaintiffs and the alleged causes of the claims.

Counsel also must know who the insured is in the chain of the construction. Depending on what state's law will apply, counsel's conclusion about coverage for a claim where the damages are water damage to interior drywall may differ dramatically if the insured is the subcontractor installing the EIFS on the structure or if the insured is the general contractor. Similarly, counsel's conclusion will differ in a claim where a window

Equally important is to know what language the courts addressed in the cases upon which counsel will rely.

has leaked if the insured is the window manufacturer, the window installer or the supplier of a component part of the window.

Third, counsel must know how the courts that might interpret the policy have ruled in the past. to accomplish this task, counsel must assess what state's law is likely to apply. Sometimes, this is no easy analysis. A site in one state, claimants in another and a policy delivered in a third state spell interesting research project. In that case, a review of the law in each of those states is advisable.

Likewise, an understanding of the choice of law analysis of each of those jurisdictions is critical. For example, you might have a policyholder subcontractor in North Carolina and a general contractor direct claimant in North Carolina with a project and underlying lawsuit in South Carolina. Since North Carolina is traditionally *a lex loci contractu* state, if a declaratory judgment action is filed in North Carolina, it is highly likely that North Carolina law will be applied to the interpretation of the policy. However, if the declaratory judgment action is filed in South Carolina, more than likely the South Carolina court will apply South Carolina law because of an insurance specific choice of law statute that has been interpreted to mean that if the risk to be insured (in a construction defect case, the project) is in that state, that state's law will apply no matter where the policy was delivered.[4] Similarly, Georgia has some unusual case law that often results in the application of Georgia law in a suit pending in Georgia even if the policy was delivered elsewhere or the project is located elsewhere.[5]

[4]SC Code Ann. 38-61-10 (1976); North Carolina has a similar statute, N.C.Gen.Stat. 58-3-1(2002), but see the recent case of NAS Surety Group v. Precision Wood Products, Inc., 271 F.Supp.2d 776 (M.D.N.C. 2003).

[5]Avnet, Inc. v. Wyle Laboratories, Inc., 263 Ga. 615, 621, 437 S.E.2d 302, 306 (1993); Frank Briscoe Company, Inc. v. Georgia Sprinkler Company, Inc., 713 F.2d 1500, 1503

What Does Counsel Do With That Information

Once counsel marshals the information outlined above, analysis of the construction defect claim can begin. Coverage analysis should always start by asking what damages are sought and determining whether they are damages because of property damage or bodily injury within the meaning of the policy. From there a determination must be made as to whether those damages arise from an occurrence, whether they occurred within the policy period and whether they are otherwise excluded.

For years, either through laziness or lack of necessity, counsel (and courts) have leaped directly to analysis of the application of the exclusions in the policies, bypassing the critical issue of whether the claim falls within the insuring agreement. Policyholders almost universally carry the burden to prove that a claim comes within the insuring agreement. So, if a carrier counsel skips the insuring agreement analysis, he is conceding a large part of the battle. Likewise, policyholder counsel should expect that he will have to carry that burden of proof.

As noted above, the insuring agreement varies from policy to policy and should be checked in every instance. However, this language or language very similar is seen commonly in recent policies:

(11th Cir. 1983); Kirkpatrick v. J.C. Bradford & Co., 827 F.2d 718, f. n.6 (11th Cir.1987); Raintree Trucking Co., Inc. v. First American Ins. Co., 245 Ga.App. 305, 534 S.E.2d 459 (2000); Leavell v. Bank of Commerce, 169 Ga. App. 626(2), 314 S.E.2d 678 (1984). 6

For collection of cases, see 2 Insurance Claims and Disputes 4th 9:1.

While it is not unheard of to have to address older policies in construction defect claims, they are less common than in the pollution claims that used to occupy the coverage bar. Most construction defect claims are constrained by statutes of limitation and/or statutes of repose (granted, in South Carolina, there is a 13 year statute of repose); whereas, the pullutioa claims arising from CERCLA were unaffected by those types of limitations.

> We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages. We may at our discretion investigate any "occurrence" and settle any claim or "suit" that may result.
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> This insurance applies to "bodily injury" and "property damage" only if (1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory", and (2) The "bodily injury" or "property damage" occurs during the policy period.

This definition of "property damage" also is seen frequently in recent policies:

> "Property damage" means:
>
> A. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it;
> B. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

Since the coverage analysis of a construction defect claim should always start with a review of the damages sought, a sampling of some of the types of damages frequently seen in construction detect claims would be helpful. It is not uncommon to see a claim for damages because the general contractor insured allegedly permitted the structure to be built in violation of the building code. Specifically, we frequently see allegations that the risers on the stairs are not at code specified height; that the firewalls are not properly built or placed; or that the proper number of sprinklers was not installed. A common claim in those cases is that there will also be "loss of use" damages for the time period in which the corrections are made. It is also common to see claims that a condition in the structure is not "built to specs." This allegation is usually coupled with a

claim that the failure to build to specs has resulted in some sort of damage, but sometimes

the allegation is that it might result in damage in the future and should be repaired now. For example, concrete floor slabs are not of the density required by the specs. They have shown no deterioration to date, but they may as the building ages. They need to be replaced, repaired or remediated. Similarly, we frequently see allegations that the existence of defects in a building has caused a loss of financing or other financial hardship on the claimant.

Are these types of claims and others like them claims for damages because of property damage within the meaning of the policy? While the author certainly has personal opinions about the answer to that question based on the plain language of the policy, the author's opinions will not prevail over case law. So, let's review some of the key cases on these issues.

What Do the Courts Say on the Property Damage Issue?

Can Defective Work Ever Be Property Damage?

Some courts find that there cannot be property damage where the work or product was defective in the first place. In Vick Construction Co. v. Pennsylvania National Mutual Casualty Insurance Company," Vick contracted with North Carolina Farm Bureau Federation for the construction of an addition to the Farm Bureau's office building. Great American Insurance Company was one of Vick's insurers.

Vick subcontracted with Chamberlin to do a portion of the roofing work that involved the installation of a waterproofing system. The installation of the system was faulty—it was later discovered that the membrane was installed upside down. The

"52 F.Supp.2d 569 (W.D.N.C. 1999) (unpublished), *affd.* 213 F.3d 634 (4th Cir. 2000).

membrane leaked from the first test. Over time the roof leaked in several places. Farm Bureau demanded that Vick remedy the problem. Farm Bureau and Vick met multiple times and much investigative work was done, but to no avail. Farm Bureau instituted arbitration proceedings against Vick. In the arbitration, 1 arm Bureau stated that it sought damages for the cost of repair of the defective waterproofing membrane and sought to recover the cost to repair cracks in a stucco wall.

Vick sued its carriers for a declaration that they were obligated to defend and indemnify it for the arbitration claim. The carriers filed comprehensive motions for summary judgment. In a lengthy decision addressing multiple issues, the court considered the insurers' argument that there was no property damage within the meaning of the policies. After reviewing several well-established principles under North Carolina law, the court found that the damages sought in the arbitration claims were not because of property damage.

The coup stated:

> Under the clear language of the policies, property damage requires either (1) a "physical injury to" or "destruction ot" tangible property, or (2) "loss of use of tangible property which has no been physically injured or destroyed[.]" These requirements, in this court's opinion, infer that the property allegedly damaged has to have been undamaged or uninjured at some previous point in time. This is inconsistent with the allegations that the subject property was never constructed properly in the first place. As noted *supra,* Farm Bureau's arbitration claims against Plaintiff sought recovery for repairs for allegedly unworkmanlike construction. Moreover, Farm Bureau's theories of recovery were premised solely [sic] allegations that Plaintiff never brought the quality of its work on the Construction Project up to the standard bargained for. 9

52 F.Supp.2d 569, 583 (W.D.N.C. 1999) (unpublished), *affd.* 213 F.3d 634 (4a' Cir. 2000).

Because Farm Bureau's entire basis of recovery against Plaintiff was for repair costs necessitated by the poor workmanship, the court granted the insurer's summary judgment motion on the ground that there was no property damage within the meaning of the policies. The Fourth Circuit afhrmed.[10]

Just this year, another order from the United States District Court bench in North Carolina reached the same conclusion. In Travelers Indemnity Company of America v. Miller Building Corporation," Travelers insured Miller Building, which had contracted to build the Holiday Inn Sunspree Resort in Wrightsville Beach, North Carolina for PVC, Inc. Miller sued PVC to recover money due under the construction contract and PVC counterclaimed seeking damages for the cost of remedying defective construction and for damages caused by Miller's failure to complete the hotel on time. Allegedly, the post-tensioning cable system, which reinforces the concrete structure of the building, was tensioned improperly. As a result, the concrete floor slabs fractured and cracked throughout the hotel and, without repair, many of the slabs and beams allegedly might collapse. Allegedly, the building's exterior wall finish was designed and installed defectively, resulting in water leaking into guest rooms and support spaces, so there was significant water damage to the building. The windows and sliding glass doors also leaked, resulting in additional waster damage to guest rooms such as damaged interior walls, floors and carpeting. [12]

[10] 213 F.3d 634 (4th Cir. 2000)

[11] 2003 WL 21357206 (E.D.N.C. 2003).

[12] 2003 WL 21357206 (E.D.N.C. 2003) (citations omitted).

After determining that none of the damages arose from an occurrence such that Travelers was entitled to summary judgment on that ground, the court also addressed the issue of whether the damages sought were because of property damage within the meaning of the policies.

> State succinctly, under North Carolina law, "damages based solely on shoddy workmanship (i.e. damages seeking repair costs and/or completion costs) are not 'property damage" within the meaning of a standard form CGL policy....In the present case, the Hotel, was never in an undamaged condition. The post-tensioning cable system was never properly tensioned, the exterior wall finish was never properly applied, and the doors and windows were never in proper working order. Therefore, the Underlying Claims do not constitute claims for property damage, rather, they are claims for defective construction. The Policies issued by Travelers do not extend to cover defective construction. To construe the Policies to cover defects would essentially convert them from general liability policies into performance bonds. Yet, the plain language of the Policies shows they are not performance bonds. They do not cover the Hotel because it was never undamaged in the first place. [13]

Are the Damages Sought "Economic" Damages?

Some courts call repair and replacement costs "economic damages" and refuse to permit recovery under the policies on that basis. In United States Fire Insurance Company v. Milton Company, [14] the insurers filed a declaratory judgment action seeking a declaration that they had no obligation to indemnify for the $7 million judgment held by the owners of condos developed by the developer and builder insureds. In deciding the motions for summary judgment, the court concluded that the record created questions of fact. IIowever, the court reviewed Maryland law on both the occurrence issue and the property damage issue. As to property damage, the court observed that Maryland law holds that the standard definition of "property damage" excludes the replacement of "

2003 WL 21357206 (E.D.N.C. 2003).

° 35 F. Supp.2d 83 (D.C.D.C. 1998).

substandard materials and repair of inferior workmanship. The court cited from the Maryland Court of Appeals decision in Sheets v. Brethren Mutual Insurance Company: "The Sheetses concede that the money spent to fix the system was economic loss and thus not covered under the policy as property damage."[15] In ruling on the damages in the case before the court, the court stated that the damages awarded in the underlying litigation for the replacement of inferior or omitted materials and the correction of substandard workmanship were not covered. Likewise, the court stated that other damages apparently awarded to compensate the unit owners for losses they suffered as a result of the use of inferior materials and substandard workmanship also were not covered.

An appellate court in Illinois reached a similar conclusion in State Farm Fire and Casualty Company v. Tillerson.[16] The insured had contracted with the plaintiff to construct a new room addition and convert a carport into a garage. The plaintiff homeowners alleged that the insured built over a cistern and failed to take the necessary precautions to prevent uneven settling of the soil beneath the room addition. The court first held that under Illinois law, these allegations did not allege an occurrence. "Where the defect is no more than the natural and ordinary consequence of faulty workmanship, it is not caused by an accident."[17] The court then addressed whether there was any property damage within the meaning of the policy. Citing the Illinois Supreme Court's decision of

[15] 342 Md. 634, 645, 679 A.2d 540, 545 (1996).

[16] 334 Ill.App.3d 404, 777 N.E.2d 986, 268 Ill.Dec. 63 (2002).

[17] 334 Ill.App.3d 404, 409, 777 N.E.2d 986, 991, 269 Ill.Dec. 63, 68 (2002).

Travelers Insurance Co. v. Eljer Manufacturing, Inc., [18] the court held that the plaintiffs merely sought either the repair of the replacement of defective work or the diminishing value of their home. They sought recovery for economic loss, not physical injury to tangible property, so there was no property damage within the meaning of the policy and no coverage under the policy.

What if there is a Claim for Diminution in Value?

Many courts have also addressed the issue of whether there is coverage where the claim is that the product or structure has suffered diminution in value by virtue of incorporation of defective work. [19] Many have concluded what has been described as the majority view [20] that the definition of property definition set out *supra* requires that there [78]

197 I11.2d 278, 757 N.E.2d 481, 258 Ill.Dec.792 (2001).

[19] Travelers Insurance Co. v. Eller Manufacturing, Inc., 197 I112d 278, 757 N.E.2d 481, 258 Il1.Dec.792 (2001) (some physical injury to tangible property must be shown in order to trigger coverage"); Esicorp, Inc. v. Liberty Mut. Ins. Co., 266 F.3d 859, 862-63 (8[1]. Cir. 2001) (the costs of repairing defective welds not covered "damages because of property damage"); New Hampshire Insurance Co. v. Vieira, 930 F.2d 696, 701-702 (9[1h] Cir. 1991)("ifthe harm—Vieira's defective work—is not covered as measured by the diminished value [of the end product], it is not covered as measured by the cost of repair."); Aetna Life & Cas. v. Patrick Industries, Inc. 645 N.E.2d 656, 661-62 (Ind.Ct.App. 1995) (must have physical injury to tangible property, so diminution in value does not create coverage); Wyoming Sawmills, Inc. v. Transportation Ins. Co. 282 Or. 401, 578 P.2d 1253, 1256 (1978); Columbia National Ins. v. Pacesetter Homes, 248 Neb. 1, 532 N.W.2d 1, 8 (1995) ("diminution in value or loss of enjoyment... is not a los of use covered under the policy"); Shade Foods, Inc. v. Innovative Prods. Sales & Mktg, Inc., 78 Cal.App.4[1h] 847, 93 Cal. Rptr. 2d 364, 376 (2000); Aetna Cas. & Sur. Co. v. Ply Gem Indus. Inc., 343 N.J.Super. 430, 778 A.2d 1132, 1137 (2001); Eljer Mfg. Inc., v. Liberty Mut. Ins. Co., 972 F.2d 805 (7[1h] Cir. 1992); National Union Fire Insurance Company of Pittsburgh, P.A. v. Terra Industries, Inc., 216 F.Supp.2d 899 (N.D. Iowa 2002)

[70] Esicorp, Inc. v. Liberty Mut. Ins. Co., 266 F.3d 859, 862 (8[1h] Cir. 2001)

be a physical injury such that mere diminution in value by virtue of incorporation of a defective part is not property damage within the meaning of the policy. [21]

In 2001, the Illinois Supreme Court surprised some counsel when it issued Travelers Insurance Co. v. Eljer Manufacturing Inc.[22] In addressing the issues in that case, the Illinois Supreme Court was faced with the Seventh Circuit Court of Appeals' decision in Elier Mfg Inc., v. Liberty Mut. Ins. Co.,[23] which appeared to decide the issue under Illinois law—unfavorably to the insurer. However, the Illinois Supreme Court rightfully observed that they were not bound by the Seventh Circuit and concluded that there must be a harmful change in appearance, shape, composition or some other physical dimension to the claimants' property for there to be damages because of property damage. In a very lengthy opinion, the court explained the basis for its ruling contrary to the Seventh Circuit's decision. The Court concluded by saying:

> In sum, this court now finds that, under its plain an ordinary meaning, the term "physical injury" unambiguously connotes damage to tangible property causing an alteration in appearance, shape, color or in other material dimension... Me also conclude that under its plain and ordinary meaning, the phrase "physical injury" does not include intangible damage to property, such as economic loss. We agree with the ruling of our appellate court ... that the diminution in value of a whole, resulting from the failure of a component to perform as promised, does not constitute a physical injury. [24]

[21] See, footnote 19.

[22] 197 I11.2d 278, 757 N.E.2d 481, 258 Ill.Dec.792 (2001).

[23] 972 F.2d 805 (7th Cir. 1992).

[24] 197 I11.2d 278, 312, 757 N.E.2d 481, 502, 258 III.Dec.792, 813 (2001).

In Vogel v. Russo, [25] the Wisconsin Supreme Court addressed whether a general liability policy provides coverage for diminution in value of a home that resulted from a subcontractor's faulty masonry work. The insured was the general contractor for the home. At the trial of the underlying case, the jury found for the homeowners and awarded damages, measured under two alternate theories: cost of repair and diminution in value. The trial court adopted the diminution in value measure of damages. On the coverage issues, the trial court concluded that the general contractor's general liability policy provided coverage for diminution in value damages. The court of appeals affirmed. The Wisconsin Supreme Court reversed.

These problems plagued the house: water spots on interior walls, efflorescence around the perimeter of the basement, water stains elsewhere, chimney caps crumbled, non-working fire places, incorrect size wall ties that threatened the stability of the exterior walls, incompletely filled brick head joints, no weep holes in the brick and extensive water intrusion. At trial, the court ruled that the house was essentially a "tear down," repair or replacement would constitute economic waste and concluded that there was covered property damage within in the meaning of the policy. The Court of Appeals affirmed the ruling, focusing on the circuit court's choice of diminution in value as the appropriate measure of damages and concluding that because the entire home was worthless, "property damage" within the meaning of the policy had occurred.

The Wisconsin Supreme Court noted that had the damages been awarded based on cost of repair, there would be no coverage. [16] The court then held that the election of

"236 Wis.2d 504, 613 N.W.2d 177 (Wis. 2000). =[6]236 Wis.2d 504, 613 N.W.2d 177, 183 (Wis. 2000).

the alternate measure of damages—diminution in value—could not convert otherwise uncovered damages into covered ones. Moreover, the court held that the damages did not constitute 'loss of use" within the meaning of property damage in the policy.

> Where is no evidence that the Vogels ever lost the use of their home, and the jury was not asked to and did not award any loss of use damages. Diminution in value—even to the point of worthlessness—is not the same as "loss of use" under the insurance policy, which by its plain language contemplates some sort of loss of use in fact, not a reduction in value. In any event, as we have noted above, the diminution in value award in this case was simply an alternate measure of the cost of repair damages, and did not fundamentally recharacterize the nature of the harm in such a way as to trigger coverage under West Bend's CGL policy. "Diminution in value and cost of repair are not two separate covered harms—they are two different ways of measuring the same harm. If the harm... is not covered as measured by diminished value, it is not covered as measured by cost of repair.... The opposite is true as well.[27]

Another example is Amtrol, Inc. v. Tudor Insurance Company. [28] The court cited Eller[29] and stated that.

> The physical injury requirement in standard CGL policies exists to prevent recovery of mere economic loss. ...In other words, CGL policies are intended to protect the insured from liability for injury or damage to the persons or property of others; they are not intended to pay the costs associated with repairing or replacing the insured's defective work and products, with are purely economic losses. Finding coverage for the cost of replacing or repairing defective work would transform the policy into something akin to a performance bond. [30]
>
> [31]

[27] 236 Wis.2d 504, 517-518; 613 N.W.2d 177, 184-185 (Wis. 2000). (citation omitted) [28]

2002 WL 31194863 (D.C.Mass.).

[29] 197 I112d 278, 757 N.E.2d 481, 258 Ill.Dec.792 (2001).

[30] *2002* WL 31194863 (D.C.Mass.).

31 This court also dealt with the frequently heard argument that the repair and replacement work was being undertaken to prevent future property damage, so it should be considered to be sums they were legally obligated to pay because of property damage within the meaning of the policy. The court ultimately rejected this argument concluding that to embrace this argument the court would have to ignore the requirement of the policy that there be property damage. The policyholder argued that in environmental

What About Damages Caused by the Repair and/or Replacement?

Another argument frequently made is that the damage done during the repair and replacement of the defective work is property damage within the meaning of the policy and converts the repair/replacement cost into covered damages. Some courts that have been asked to address this argument—sometimes referred to as the "rip and tear" argument--have outright rejected it.[32]

In NAS Surety Group v. Precision Wood Products, Inc.,[33] the court declined to rule based on the direct issue of whether the damages were because of property damage within the meaning of the policy, but did address one aspect of what is commonly referred to the "rip and tear" issue: is the damage that is done when defective work is repaired or replaced covered? In NAS, the Almance Regional Medical Center (ARMC) hired Rodgers Builders, Inc. to serve as general contractor for an extensive renovation and expansion of the Center. Rodgers hired Fowler Jones Construction Company to serve as the prime contractor. Fowler hired PWP as a subcontractor to provide cabinets

cases court frequently ruled that remediation costs were covered even though their purpose was to prevent future contamination. The court observed that property damage in the form of contamination was present in those cases from the beginning, unlike in the construction defect case before it.

32 One way that the argument should be subject to defeat is that the insurance market has products available to address this very type of claim. Referred to as "rip and tear" or "rework" endorsements, coverage can be bought to pay for costs associated with replacing faulty work or products.

33 271 F.Supp.2d 776 (M.D.N.C. 2003).

and millwork on the project. PWP obtained a performance bond from NAS Surety and purchased a general liability policy from Lumber Insurance Company.

PWP supplied the cabinetry and millwork to Fowler and subcontracted the installation to Laboratory Services. After AKMC took possession of the work, extensive defects were discovered in the cabinetry and millwork provided by PWP. The problems included delamination of the countertops and inadequate construction of the drawers and doors.

ARMC demanded that Rodgers and Fowler correct the cabinetry and millwork problems. Fowler made demand on PWP and NAS, as PWP's surety. Fowler, claiming rights as an additional insured, PWP and NAS all tendered the ARMC claim to Lumber at various times. Lumber issued reservation of rights letters to each, noting that there was no duty to defend because there was no lawsuit.

The claim was settled by a payment by NAS as surety for PWP and by the CGL carrier for Fowler. NAS was assigned the rights of Fowler and its CGL carrier. NAS then sued Lumber.

Lumber moved for summary judgment, which was granted. The order addressed several coverage issues, including the lack of an occurrence under South Carolina or North Carolina law where the claim is for damages for repair or replacement of faulty or defective workmanship standing alone. In particular, the court addressed whether ARMC experienced other damages as a result of PWP's defective cabinetry that would trigger coverage under the CGL policy.

The settlement agreement in the case included a provision that PWP's defective cabinetry and millwork would cause "significant damage to other portions of the Project

in the hospital, including but not limited to sheet rock, painting, wallpaper, floor covering, plumbing and fixtures, and wiring and electrical work" and "would result in a disruption of its business, thereby causing it substantial economic loss." [34] NAS counsel argued that this anticipatory damage should be the focus of the analysis.

Lumber was able to obtain from the executive vice president of ARMC an affidavit that ARMC did not experience any "collateral property damage" during the repair and replacement of PWP's defective work. Apparently, Lumber counsel conceded at argument that ARMC incurred some minor damages for repair of drywall, repainting of walls and removal and reinstallation of sinks incident to the replacement of the cabinetry and millwork. However, Lumber argued that such damages were not "collateral damages," but rather a foreseeable consequence of the repair and replacement effort. Thus, those damages did not arise from an occurrence, so would not be covered. The court agreed.

The court concluded that the potential for anticipatory damages outlined in the settlement agreement were defeated by the affidavit of the ARMC vice president who said that the damages were not incurred.

Another case that has addressed these issues is Woodfin Equities Corp. v. Harford Mutual Insurance Comoany,[35] the court also addressed the so-called "rip and tear" issue, finding that the ripping out of the subject hotel's walls, molding and carpeting to replace failed HVAC units was not "property damage" within the meaning of the policy. The reader will note when it reviews the case that it is red flagged in the [34]271 F.Supp.2d 776, 783 (M.D.N.C. 2003).

[35] 110 Md.App. 616, 678 A.2d 116 (1996), *overruled on procedural grounds* 344 Md. 399, 687 A.2d 652 (1997)

computer research systems. On appeal from the Court of Special Appeals to the Court of Appeals, the Court of Appeals ruled that the failure of the circuit court to file written declaration with regard to the disputed insurance coverage disputes was reversible error and the Court of Special Appeals should not have reached the merits of the dispute in absence of such declaration.[36] In effect, the Court of Appeals did not reject the analysis, but rather ruled that it should not have been addressed. Other courts have noted that the case was overruled on "procedural" grounds and have cited the case anyway.[37] Other courts and commentators have just cited the case as "affirmed in part and reversed in part.'

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In Woodfin, Woodfin developed a hotel in Rockville, Maryland. Woodfin hired HCC to serve as general contractor. HCC subcontracted with Deerfield Engineering, Inc., to perform the mechanical work for the project, specifically the HVAC system. Deerfield was insured by Harford Mutual Insurance Company.

Allegedly, the hotel opened on 2/23/88 and in March 1988, the hotel began to experience problems with the HVAC system. By June 1989, 130 of the HVAC units had failed at least once. Woodfin sued Deerfield and the suppliers for the HVAC units. Woodfin asserted that they incurred considerable losses and expenses, including the loss of income from the unavailability of guest rooms, costs associated with the repair and replacement of pumps in the HVAC systems, consultant fees for conducting tests and

"Hanford Mutual Insurance Company v. Woodfin Equities Corp., 344 Md. 399, 687 A.2d 652 (1997)

[37] Lords Landing Village Condominium Council of Unit Owners v. Continental Insurance Company, 191 F.3d 448 (4th Cir. 1999). (unpublished)

[38] United States Fire Insurance Company v. Milton Company, 35 F.Supp.2d 83 (D.C.D.C. 1998); 4 Bruner & O'Connor Construction Law 11:35.

providing opinions as to the reasons for the HVAC failures, management time expended with respect to customer relations and correcting the problems, increased energy costs, loss of goodwill, and attorneys fees and costs related to the lawsuit.

Deerf eld's insurer tiled a declaratory judgment action. The case went to trial and the developers put on evidence that that the failure of the system resulted form a number of acts that were performed by Deerfield including rupturing or fracturing capillary tubes in the units during installation and placing the temperature-sensing bulb in the wrong position. As the units failed, they were replaced. The witness testified that replacement caused damage to the walls and carpeting of the hotel and testified that there damages for loss of room occupancies, replacement of the HVAC units, consultant fees, management time and loss of goodwill.

In reviewing the trial court's determination that none of the damages were covered, the appellate court started with the basic premise in Maryland that "CGL policy coverage compensates for physical damage to the property of others, and not for an insured's contractual liability because the product of completed work supplied by the insured is not that for which the damaged third party bargained.[i39] The appellate court concluded that the trial court was correct in part and incorrect in part.

Looking at the issue of whether there was property damage within the meaning of the policy, the appellate court ruled that the evidence demonstrated physical injury to tangible property in the form of the broken capillary tubes, burnt out compressors, damaged pipes and contaminated HVAC system. However, the court explained that the

" 110 Md.App. 616, 642, 678 A.2d 116, 127 (1996), *overruled on procedural grounds* 344 Md. 399, 687 A.2d 652 (Md. 1997)

insured would have to show also that the property damage resulted from an occurrence. The court held that it could not do so when the property damage is confined to the insured's own work product. Interestingly, then, the court went on to hold that the policy also would not cover the costs associated with tearing out walls, molding, and carpeting in order to repair and remove the HVAC units, nor would the policy cover the economic costs of paying consultants or the economic costs associated with loss of management time—all because these damages were not caused by an occurrence.

In a footnote, the court further explained its reasoning:

> We reject appellants' suggestion that there was 'property damage' to the walls, molding, and carpeting in the suites. Simply stated, no such evidence was presented—not during the hearing below and not during the Trane default judgment damages hearing. For example, appellants produced no evidence that fluids leaked out of the HVAC system and ruined walls or carpeting in the hotel. Voluntarily pulling up carpeting or breaking through dry-wall to access the HVAC units is not property damage; it is the cost incurred in replacing and repairing the HVAC systems. Even if it could be considered "property damage,' we would hold that it was not caused by an 'occurrence, " because the so-called damage was not accidental. To be sure, these are damages under the CGL policy that have resulted from "property damage' to the HVAC system, but they are not, in and of themselves, 'property damage." In this regard, appellants have tailed to appreciate the critical difference under the CGL policy between "damages" on the one hand, and "property damage," on the other hand. As we have demonstrated, the CGL policy defines the term "property damage." The term "damages,' however, is not defined in the CGL policy. In Bausch & Lomb--where the term 'damages' also was not defined in the general coverage provision of a CGL policy –the Court of Appeals determined that 'damages' should be interpreted according to its ordinary dictionary meaning .... The Court, therefore, held that "damages' means the money estimated for reparation for an injury sustained or the money paid to make good on an insurance loss. [4]

[40] 110 Md.App. 616, 649, fn 8, 678 A.2d 116, 131 (1996), *overruled on procedural groundv* 344 Md. 399, 687 A.2d 652 (1997) (citations omitted).

Just last year, a court in Florida weighed in on the issue. In Auto Owners Insurance Company v. Travelers Casualty & Surety Company, [41] the court addressed several coverage issues arising from this dispute in which the surety argued that the contractor's general liability carrier was obligated to reimburse the surety for its payments. The court framed the rip and tear issue as follows:

> The costs to repair the leaking pipe at Wellcraft would necessarily include the costs to dig up the facility and replace the floor once the pipe was repaired or replaced—part of the original construction. Therefore, this court finds that the liability Reliance alleges it was paying pursuant to the performance bond—the cost to dig up the facility, repair or replace the pipe and once the pipe is replaced or repaired, re-construct the floors—is liability to correct the defect (the leaking pipe) and not liability for damages as a result of the defect. Reliance argues that the costs to dig up the pipe and re-construct the lay up facility after replacing the pipe are "damage" to other property and should be covered by the CGL carrier.. . .Interpreting a CGL policy to cover replacement and repair of defective construction would "enable a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from his insurance company to repair or correct the deficiencies in his work.[42]

Conclusion

As many of the cases discussed have demonstrated, it is important to remember that there are many coverage issues in construction defect claims. Even if one or more of the damages are because of property damage within the meaning of the policy, they may not be caused by an occurrence. Likewise, one or more of the exclusions commonly found in the general liability policies may apply.

[41]227 F.Supp.2d 1248 (M.D.Fla. 2002).

"227 F.Supp.2d 1248, 1270-71 (M.D.Fla. 2002)

Analyze all the coverage issues in a construction defect claim. Start with the insuring agreement. Be sure that the insured can prove that the sums they claim to be legally obligated to pay as damages are because of property damage within the meaning of the policy, that the property damage happened during the policy period and that they were caused by an occurrence within the meaning of the policy. Then and only then should the exclusions come into play.