The Uninsured Risks Of Development (Part 2)

Raymond S. Iwamoto,
a member of the firm of Schlack Ito, in Honolulu, practices as a transactional lawyer, handling complex real estate and business transactions, and has developed significant experience in resort, residential, and commercial developments, acquisitions, sales, and real estate financing. His real property expertise was recognized by his selection for membership in the prestigious American College of Real Estate Lawyers. He is also listed in the ***International Who's Who of Real Estate Lawyers, The Best Lawyers in America*** and in ***Chambers USA America's Leading Lawyers for Business.*** He represents developers, land owners, financial institutions and individuals from Hawaii and from the Continental United States, Australia, Hong Kong, and Japan. He can be reached at riwamoto@schlackito.com.

Raymond S. Iwamoto

Case law and time haven't made the situation any clearer.

PART 1 of this article, which appeared in the January 2010 issue of *The Practical Real Estate Lawyer*, focused on issues related to coverage for construction defects resulting from design and construction. This article focuses on construction defects as a result of poor or defective construction of a building (herein referred to as the "Building") and on the economic consequences of such construction defects and whether such consequences are insured or uninsured. This article discusses the court-created economic loss doctrine or rule, another court doctrine involving contract-based claims which for convenience I have called the contract-based negligence doctrine, and the liability insurance policy in light of the first reported Hawaii case on construction defects and insurance. This article also examines the economic loss doctrine in the context of certain opinions that proclaim that the doctrine does not encompass coverage questions.

BACKGROUND • Damage to property other than the Building, such as neighboring structures, caused by the construction defect in the Building is sometimes called "collateral damage." Construction defects and damage to the Building will involve the following (hereinafter called "purely economic losses"):

- Economic costs of repair and/or replacement of the defect;
- (Possibly) other resulting damage to the Building; and
- Loss of revenue and/or value.

Part 1 of this article included a listing of economic losses addressed in Hawaii court opinions. Part 1 focused on the fact that the risks of purely economic losses resulting from construction defects are often uninsured risks; and that if there were any chance of insurance coverage, it would be under liability policies. (The standard liability policy is the commercial general liability (CGL) insurance policy issued by the Insurance Services Office (ISO) such as CG 00 01 12 07 (2006)).

The Insurance Contract

The complexity of insurance contracts and the resulting difficulty that courts have in dealing with them make it difficult to advise clients whether certain risks have been shifted to the insurers or whether the risks are insured or uninsured. Insurers appear to intend to provide coverage, but when the courts stumble in interpreting that intent, some insurers seize the opportunity to deny coverage even if they intended to provide it in the first place. In Hawaii, this is seen in the after-effect of the first Hawaii case on construction defects and insurance coverage (discussed below). Unfortunately, despite revisiting Part 1 in light of this case, reviewing insurance coverage case law from Hawaii and elsewhere, and providing a more detailed discussion of the economic loss doctrine as it relates to insurance coverage, the matter remains as complex as ever.

The Other Contracts

Development projects almost always involve contractual arrangements. There is usually a contract between the owner or developer and the general contractor, as well as several subcontracts between the general contractor, the subcontractors, and material suppliers. If the project is to be marketed, there will be sales contracts between the developer and the buyers. (This is the typical scenario in the development of a high-rise residential condominium development project.) The presence of contracts and contractual arrangements has a significant effect on how the courts interpret negligent construction and whether the risks are insured or uninsured.

Owner Controlled Insurance Programs (OCIPs)

In Hawaii, insurers are reluctant to provide subcontractors working on residential high-rise projects with CGL insurance coverage. Many are unable to procure such policies in connection with residential projects. As a result, large high-rise residential condominium projects are usually insured through an Owner Controlled Insurance Program (OCIP) sometimes referred to as a "Wrap" or "Wrap Up." The developer/owner, the general contractor, and the subcontractors are all named insureds in the OCIP policy. The insurance industry in Hawaii markets the OCIP as providing liability insurance coverage for construction defects and emphasizes how the OCIP is a product with a 10-year tail, meaning coverage lasts for 10 years because the Hawaii construction statute of limitations/statute of repose is for 10 years. However, the main marketing emphasis is on the fact that since all of the participants in the construction are insured, the OCIP eliminates the usual finger pointing that results when there are claims based on construction defects.

OCIPs And Economic Losses

It is not clear from a review of the brochures and marketing materials whether the OCIP is touted (in writing anyway) as an insurance program that covers not only claims of collateral damage and personal injury and death from construction defects but one that also covers purely economic

losses resulting from construction defects. The standard form of CGL insurance is used in the OCIP and while there is no case law in Hawaii construing the OCIP, a Hawaii Intermediate Court of Appeals case interpreted the CGL insurance policy with respect to construction defects and purely economic losses. *Group Builders, Inc. v. Admiral Ins. Co.,* 231 P.3d 67 (Haw. Ct. App. 2010).

As insurers market OCIPs on the basis that construction defects are intended to be covered, one purpose of this article is to explore how the OCIP should and can be viewed by the courts in Hawaii as an insurance product that will insure purely economic losses resulting from a construction defect. There are considerable obstacles in the way including Group Builders. Before discussing *Group Builders,* a review of general principles is in order.

CGL Policies And Contract-Based Negligence

As stated above, a development project involves contracts. As a general principle, the CGL policy provides no insurance coverage for breaching a contract. In other words, usually, there is no insurance for contractual liability. But, as will be discussed below, this may be too broad a generalization and one that does not cover all situations. However, the exclusion for coverage for contractual liability is so fundamental that usually the courts will say that the CGL policy does not provide insurance coverage for claims of purely economic losses as a result of negligence that occurs in the performance of a contract.

While substandard construction of a Building below the industry standard of care resulting in construction defects and purely economic losses may constitute negligence, if the negligent acts or omissions were done pursuant to a contract, the negligence is considered to be contract-based negligence. The United States Court of Appeals for the Ninth Circuit, in *Burlington Insurance Co. v. Oceanic Design & Constr., Inc.,* 383 F.3d 940 (9th Cir. 2004), concluded that the Hawaii courts would not recognize a tort claim for contract-based negligence, and cited a Hawaii Supreme Court case providing that unless there is conduct that violates an independently recognized duty under tort law and transcends the breach of the contract, Hawaii law will not allow recovery in tort. *See id.* at 946-953 (citing *Francis v. Lee Enters., Inc.*, 971 P.2d 707, 717 (Haw. 1999)). The Ninth Circuit court also found, in evaluating a breach of contract claim for contract-based negligence, that a CGL policy does not cover disputes between parties in a contractual relationship over the quality of the work performed. *Id.* at 948-49.

It is important to note that the Ninth Circuit court reached this result through an interpretation of when there is an "occurrence," which is a required element in the insuring clause of the CGL policy. In ruling that there was no coverage, the court in effect held that where there is contract-based negligence, there is no "occurrence." *See id.* at 948. The court stated that by building a residence substantially inferior to the standard of care and quality that had been agreed upon, the contractor's breach of that contractual duty *consisted of the contractor's intentional acts or omissions, and the reasonably foreseeable results of such intentional acts or omissions cannot qualify as an "occurrence" under the CGL policy. See id.* In *Hawaiian Holiday Macadamia Nut Co. v. Industrial Indemnity Co.,* 872 P.2d 230 (Haw. 1994), the Hawaii Supreme Court similarly ruled that to have an occurrence that triggers coverage under a CGL policy, "'the injury cannot be the expected or reasonably foreseeable result of the **insured's own intentional acts or omissions**.'" *Id.* at 233-34 (bold emphasis added) (quoting *AIG Hawaii Insurance Co. v. Estate of Caraang,* 851 P.2d 321, 329 (Haw. 1993)). In Hawaii, creating a construction defect whether through negligence or not is the result of intentional acts or omissions.

THE GROUP BUILDERS DECISION • On May 19, 2010, the Hawaii Intermediate Court of Appeals (the ICA) decided the first reported Hawaii State case on insurance and construction defects, *Group Builders, Inc. v. Admiral Ins. Co.,* 231 P.3d 67 (Haw. Ct. App. 2010).

Group Builders, Inc. (GBI) was a subcontractor hired by the general contractor constructing a high rise hotel tower in Waikiki, to install an exterior insulation finishing system and sealant, fireproofing, building insulation, and metal framing. After the hotel rooms were opened to the public, extensive mold growth was discovered and the guest rooms were closed. A multi-party law suit (herein referred to as the "Hotel Lawsuit") followed with many participants settling. As Admiral Insurance Company (Admiral) refused to defend, indemnify, or otherwise provide insurance coverage to its insured, GBI, under a CGL, GBI assigned its claims against Admiral, as well as the right to sue in GBI's name, to one of its insurers that participated in the settlement, Tradewind Insurance Company, Ltd., and they brought suit against Admiral and others. Admiral filed a Motion for Partial Summary Judgment Re: No Duty to Indemnify at the trial level, which was granted under a decree that there was no genuine issue of material fact that any **property damage** as a result of an **occurrence** took place. *Group Builders,* 231 P.3d at 69-70. The ICA dismissed other appeal/cross-appeals, and only considered plaintiff's appeal of the order granting Admiral's motion for partial summary judgment and argument that the trial court "erroneously concluded that there was no evidence of property damage caused by an occurrence during [Admiral's] Policy Period and dismissed the indemnity claim." *Id.* at 69-70 (bracketed language in original).

The alleged causes of action in the Hotel Lawsuit included breach of contract and tort causes of action such as negligence. Relying on cases such as *Burlington*, the ICA held that "breach of contract claims based on allegations of shoddy performance are not covered under CGL policies." *Id.* at 71, 73. While we cannot fault this ruling because GBI could not reasonably expect that its own CGL policy would protect GBI against its own shoddy work, unfortunately the ICA also said, "We hold that under Hawai`i law, construction defect claims do not constitute an 'occurrence' under a CGL policy." *Id.* at 73. This overly broad statement reaches beyond what was necessary to resolve the case and has caused repercussions in Hawaii. Insurers are sending letters to their insureds citing *Group Builders* to deny their duty to defend and their duty to indemnify in construction defect cases regardless of differing facts and circumstances and regardless of the CGL policy provisions involved.

Of particular concern is that certain insurers are sending these denial of coverage letters in connection with OCIPs in situations where the CGL policies were arguably intended to provide insurance coverage for construction defects. The second result of this ruling is that insurance brokers are now scrambling to work with insurers to include policy endorsements that attempt to overcome the statement that construction defect claims can never constitute an occurrence. The results so far are not encouraging. The potential repercussions of this case have been recognized as so severe that the Hawaii State legislature passed and on May 6, 2011 sent to the Governor for signature a law that requires in construction cases the term "occurrence" in a CGL to be construed in accordance with the law as it existed at the time the insurance policy was issued. House Bill 924 HD2 SD2 Hawaii State Legislature 2011 Regular Session.

CONSTRUCTION DEFECTS AND PROPERTY DAMAGE • In Part I, we discussed the CGL policy definition of "property damage" to mean physical injury to tangible property including resulting loss of use of that property. A construction defect alone without any resulting injury would not constitute "property damage." Collateral damage

would be "property damage," as there would be injury to the other property. A construction defect standing alone without injury to property would not constitute "property damage" and there would be no coverage because of this element without any necessity of exploring whether there had been an "occurrence." A difficulty arises in deciding when the construction defect has caused collateral damage or merely damage to the work being constructed. In Part I we stated, "Consequently, while the issue has been the subject of much litigation, it is very possible that only damage to property other than the contractor's work is covered by the CGL."

For cases that hold that inferior materials or workmanship standing alone (without physical injury or loss of use) do not constitute "property damage" under the CGL policy, see *Md. Cas. Co. v. Reeder,* 270 Cal. Rptr. 719, 723 (Cal. Ct. App. 1990). *See also Travelers Indem. Co. v. Miller Bldg. Corp.,* 221 F.App'x. 265, 269 (4th Cir. 2007).

But interestingly, *Group Builders* held that the mold growth and resulting loss of use satisfied the requirement for "property damage" in the CGL. To the ICA, since the defects in design and construction caused or contributed to the mold growth and the loss of revenue from the closing of the hotel, the "property damage" requirement of the policy was satisfied even if the "occurrence" requirement was not. In the next section we will discuss how other courts analyze whether there is property damage beyond the defective work in determining whether there is an "occurrence." We should also note that in the next section in discussing the business risk exclusions, the term "property damage" is not consistently used but the term, "damaged work" is used instead. Perhaps the growth of mold and the resulting economic losses are to be considered collateral damage and not property damage insured under the CGL. But this may depend on who is the insured as discussed below. The defective work of the insured in *Group Builders* caused damage to more than just the work of the insured.

CONSTRUCTION DEFECTS AND OCCURRENCES • The ICA in *Group Builders* chose to deny coverage by ruling that there was no "occurrence." The insurers themselves intend that construction defects are "occurrences" under a CGL policy when collateral damage is involved or when, as a result of the construction defect, someone is injured or dies. If a construction defect causes collateral damage and if the construction defect is not an occurrence under the CGL policy, the contractor could have no insurance protection against the claims. If a construction defect results in someone's death, will insurers deny coverage under a CGL policy because the acts that resulted in the construction defect are not an "occurrence"? As discussed below, the insurers themselves also intend that construction defects are occurrences under a general contractor's CGL policy when the party responsible for the construction defect is a subcontractor.

Put The Focus Where It Belongs: On The Acts Of The Insured

The case law in Hawaii focuses on the acts of the insured, *see Hawaiian Holiday,* supra, 872 P.2d at 234, and the ICA should have limited its ruling in *Group Builders* to the case before it by holding, "The alleged faulty construction work was the work of the **insured** and in connection with contractual claims arising from such faulty work, under the **insured's** CGL policy, an occurrence cannot be the expected or reasonably foreseeable result of the **insured's** own intentional acts or omissions."

Such a limited holding would preserve insurance protection against construction defects, as intended by the insurers when they issue CGL policies with a subcontractor exception to the business risk exclusions (discussed below). A contractor typically understands that he has to be responsible for his own actions and he does not expect to purchase insurance that will provide him with insurance money with which to rectify his own mistakes in construction. Absent personal injuries and absent collater-

al damage, he knows and does not expect that he has purchased insurance to protect him against his shoddy workmanship or if he provides defective materials. He understands that these are his business risks. His insurance advisers will inform him that there are business risk exclusions in his CGL policies.

What About The Acts Of Others?

However, the contractor probably has a different understanding about, and he intends and thinks that he has purchased insurance coverage against, claims of all types resulting from acts that he cannot control, such as the acts of third persons. He usually expects that if someone else was responsible for the shoddy workmanship and he was sued, his insurance would protect him whether the claim was for economic losses or for repair obligations. A careful review of the CGL contract reveals that the insurers also intend and understand that the CGL policy will provide the contractor with the insurance protection he intends and expects to purchase.

The Hawaii precedents relied on by *Group Builders* involved the acts or omissions of the insured. Neither *Burlington* nor *Group Builders* addressed the question as to whether there could be an "occurrence" under a CGL policy if the intentional acts or omissions were those of a third party or someone other than the insured or when there are multiple insureds as under an OCIP.

Group Builders was a case in which the insured claimed coverage for its own shoddy performance under its own CGL policy. *Group Builders* should not apply to a general contractor seeking insurance defense and indemnity under its own CGL policy when the facts reveal that the shoddy performance was actually performed by a subcontractor. It should also not apply to an "Owner" and all of the participating contractors and subcontractors named as insureds under an OCIP policy. In these different situations, whether there is or there is not insurance coverage for construction defects should be a matter of interpretation of the provisions of the insurance contract. "Every insurance contract shall be construed according to the **entirety** of its terms and conditions as set forth in the policy" pursuant to section 431:10-237 of the Hawaii Revised Statutes (bold emphasis added).

Business Risk Exclusions: Evidence That Construction Defects Could Be Occurrences

The very fact that CGL policies have numerous detailed and lengthy business risk exclusions would indicate that the insurers themselves interpret the CGL policy as providing that construction defects could in certain circumstances, not involving the "business risks" or pursuant to policy exceptions, be an "occurrence" for purposes of coverage. There would be absolutely no need for these lengthy and precise business risk exclusions if the insurers intended as the ICA stated that construction defect claims do not constitute an occurrence under a CGL policy. A Wisconsin court asked, "Why would the insurance industry exclude damage to the insured's own work or product if the damage could never be considered to have arisen from a covered 'occurrence' in the first place?" *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65, 78 (Wis. 2004).

The CGL policy includes 16 separate exclusions lettered "a" through "p" of Subsection I.A.2 of the CGL policy under the phrase, "This insurance does not apply to." Exclusion b is labeled "Contractual Liability," which excludes contractually assumed liabilities (discussed below). Exclusions j though l are the "business risk exclusions," which cover property damage to the insured's own work. Exclusion k excludes damage to "your product," but "your product" is defined to exclude real property in Subsection V.21.a.(1) of the CGL policy. Exclusion j.(6) excludes property damage to that part of any property that must be restored, repaired, or replaced because "your work" was incorrectly performed on it. This is followed by a specific exception for "prop-

erty damage" included in the "products-completed operations hazard," which applies following completion of construction.

So business risk exclusion j.(6) excludes property damage that must be restored or repaired but not if included in the "products-completed operations hazard." However, there is another exclusion having to do with the "products-completed operations hazard." Exclusion l, "Damage To Your Work," excludes from coverage "property damage" to "your work" arising out of it and included in the "products-completed operations hazard." So, in convoluted fashion, the business risk exclusions exclude, then include, then exclude coverage. But the policy does not end there. This is followed by a significant exception, the subcontractor exception. The exception reads, "This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor."

Combining the "Products-Completed Operations Hazard" with the "Your Work Exclusion" and the subcontractor exception to the "Your Work Exclusion," the CGL policy provides post-completion insurance against claims for property damage if the damaged work or the work out of which the damage arises was performed by a subcontractor. Note that the plain meaning of "damaged work" should encompass defective construction. Insurance policies are subject to the general rules of contract construction; the terms of the policy should be interpreted according to their plain, ordinary, and accepted sense in common speech unless it appears from the policy that a different meaning is intended.

Learning From *Lamar Homes*

In *Group Builders,* the ICA mentions a Texas case, *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007), as representing the "minority position" as to whether construction defects could be an occurrence under a CGL policy. *See Group Builders,* supra, 231 P.3d at 73. Interestingly, *Lamar Homes* was a subcontractor exception case. In *Lamar Homes,* the United States Court of Appeals for the Fifth Circuit certified questions to the Texas Supreme Court involving an insurer's duty to defend under a CGL where a subcontractor's defective construction of the foundation caused damage to sheetrock and veneer of the home. *See Lamar Homes,* supra, 242 S.W.3d at 4-5, 10-11.

Judging from the answers by the Texas Supreme Court in a detailed and well-reasoned opinion and from the list of the organizations that submitted amicus briefs, the issues were extensively briefed. Organizations submitting briefs included Property Casualty Insurers Association of America, Complex Insurance Claims Litigation Association, Associated General Contractors of America, National Association of Home Builders, Greater Houston Builders Association, Texas Association of Builders, and two insurance companies.

The Texas Supreme Court first resolves the question as to whether there was an "occurrence" under the CGL. *Id.* at 7. The court notes that other courts might first look to see if there was damage to other property or only damage to the property constructed in deciding whether there was an occurrence. *See id.* at 5-7, 9. But applying contract interpretation principles, the court notes that the CGL policy does not define "occurrence" in terms of the ownership or character of the property damaged. *Id.* at 9. The test instead is whether the injury was an accident and for the Texas Supreme Court this means whether the injury was intended or fortuitous. *Id.* In doing so, it quoted from an Ohio case:

"The logical basis for the distinction between damage to the work itself (not caused by an occurrence) and damage to collateral property (caused by an occurrence) is less than clear. Both types of property damage are caused by the same thing — negligent or defective work. One type of damage is no more accidental than the other. Rather,…the basis for the distinction is not found in the definition of an oc-

currence but by application of the standard "work performed" and "work product" exclusions found in a CGL policy."

Id. (quoting *Erie Ins. Exch. v. Colony Dev. Corp.,* 736 N.E.2d 950, 952 n.1 (Ohio Ct. App. 2000)).

The Texas court states that the determination as to whether the faulty workmanship was intended or accidental is dependent on the facts and circumstances of the particular case. *Id.* For purposes of the duty to defend, the facts and circumstances must be gleaned from the allegations in the complaint. *See Id.* In *Lamar,* the complaint alleged negligent construction and the court wrote, "No one alleges that Lamar intended or expected its work or its subcontractors' work to damage the DiMares' home." *Id.* The court further determined that "when a general contractor becomes liable for damage to work performed by a subcontractor — or for damage to the general contractor's own work arising out of a subcontractor's work — the subcontractor exception preserves coverage that the 'your-work' exclusion would otherwise negate." *Id.* at 11.

The Subcontractor Exception

This subcontractor exception did not exist before 1986 but was added in 1986 by the ISO to specifically provide the coverage. *See id.* at 11 n.8. If construction defects of a subcontractor and the damage to the property caused thereby cannot be an "occurrence," then there would be no reason for the ISO to add this exception in 1986. The Supreme Court of Florida addressed this issue in *U.S. Fire Insurance Co. v. J.S.U.B., Inc.,* 979 So.2d 871 (Fla. 2007). The question before the court was "whether a post-1986 standard form commercial general liability (CGL) policy with products-completed operations hazard coverage, issued to a general contractor, provides coverage when a claim is made against the contractor for damage to the completed project caused by a subcontractor's defective work." *Id.* at 877. The court stated that, in resolving this issue, it had to determine whether under the CGL policy a subcontractor's faulty workmanship can constitute an "occurrence" under the policy. *Id.* The court reviewed the subcontractor exception to the "your work exclusion" and stated that the exception "becomes important only if there is coverage under the initial insuring provision." *Id.* at 879-80. Since the initial insuring provision requires an "occurrence," the court had to first rule that "a subcontractor's defective work that results in damage to the completed project can constitute an 'occurrence.'" *See id.* at 880, 887. For the Florida court, "faulty workmanship that is neither intended nor expected from the standpoint of the contractor can constitute an 'accident' and, thus, an 'occurrence.'" *Id.* at 888. The court also construed the CGL's term, "property damage" to include damage to either the contractor's own work or damage to other property. *See id.* at 889. The court stated:

"We conclude that faulty workmanship that is neither intended nor expected from the standpoint of the contractor can constitute an "accident" and thus an "occurrence" under a post-1986 standard form CGL policy. We further conclude that physical injury to the completed project that occurs as a result of the defective work can constitute "property damage" as defined in a CGL policy. Accordingly, we hold that a post-1986 standard form commercial general liability policy with products completed-operations hazard coverage, issued to a general contractor, provides coverage for a claim made against the contractor for damage to the completed project caused by a subcontractor's defective work provided that there is no specific exclusion that otherwise excludes coverage."

Id. at 891.

The holding of the Florida court is in line with the following Hawaii Supreme Court precedent. In

Hawaiian Holiday, 872 P.2d at 234, the Hawaii Supreme Court stated, "[I]n order for the insurer to owe a duty to defend or indemnify, the injury cannot be the expected or reasonably foreseeable result of the insured's own intentional acts or omissions." Where a subcontractor creates the construction defects, the insurer should owe a duty to defend or indemnify the general contractor because the injury is not the expected or reasonably foreseeable result of the insured general contractor's own intentional acts or omissions.

Unfortunately, as a result of widespread construction defect litigation, especially in the multi-family residential product area, the insurance industry has begun to eliminate the subcontractor exception to the "your work" exclusion. *See, e.g.,* the ISO CG 22-94 form or the ISO CG 22-95 form. If the CGL includes one of these endorsements, the "your work" exclusion will mean that the contractor did not purchase insurance in the event construction defects are the result of a subcontractor's actions.

OCIP • Let us now turn to whether construction defects and purely economic loss claims, notwithstanding *Group Builders,* should be covered under an OCIP as the insurers arguably intend. In Part I, we discussed another Hawaii construction defect case, *Association of Apartment Owners of Newtown Meadows v. Venture 15, Inc.*, 167 P.3d 225 (Haw. 2007), in which the Hawaii Supreme Court decided to apply the economic loss doctrine even in the absence of privity of contract. In Part 1, we raised the question as to whether this doctrine could be used in interpreting insurance coverage questions. The case law discussed below suggests that the economic loss rule should not be used to determine coverage questions.

Economic Loss Doctrine And The OCIP

In *Newtown Meadows,* the Association of Apartment Owners of Newtown Meadows sued several entities involved in the development and construction of Newtown Meadows, including the developer, the site development general contractor, the soils compaction subcontractor, the soils engineer, and the masonry subcontractor. The case involved claims of breach of contract, negligence, and others and was not an insurance coverage case. But the circumstances of the case would be typical of those with OCIP coverage. In these cases, any construction defect will almost never be due to the intentional acts or omissions of all of the insureds and so Hawaii court holdings that an occurrence cannot be the expected or reasonably foreseeable result of the **insured's** own intentional acts or omissions should not be applicable.

Newtown Meadows also recognized an exception if the acts or omissions violated a duty separate and apart from the duty abolished by the economic loss rule. *See id.* at 288. A Colorado court found an exception to the economic loss rule by examining a Colorado statute and finding that the legislative enactments recognized that subcontractors have an independent duty to act without negligence in the construction of homes. *A.C. Excavating v. Yacht Club II Homeowners Ass'n,* 114 P.3d 862, 869 (Colo. 2005). Since the subcontractors therefore owed "homeowners a duty of care, independent of any contractual obligations, to act without negligence in the construction of homes," the economic loss rule did not apply. *Id.* at 870. Unfortunately, while the recodification of the Hawaii condominium statute addressed the *Newtown Meadows* ruling with respect to the Association's lack of standing to bring statutory unfair or deceptive acts or practices claims, *see* Haw. Rev. Stat. Ann. §514B-104(a)(4) (2011), it did not go as far as the Colorado statute which enables home owner associations to represent homeowners in such matters as construction defect claims, *see A.C. Excavating,* supra, 114 P.3d at 869 (citation omitted). Perhaps, one day, our legislature may do the same.

Until then, the risk is that a Hawaii court may rule that even under an OCIP, since the negligent

construction was a result of performing contractual duties, such negligence cannot be an occurrence under the OCIP notwithstanding that the negligence was not the acts or omissions of the insured. After all, to the Hawaii Supreme Court in *Newtown Meadows,* the opportunity to allocate the risks of construction defects in a contract where the aggrieved party was not even a party was not as significant as much as whether there was a contract where such risks were allocated by agreement. In applying the economic loss rule to the ordinary negligence claim based on contract specifications, the *Newtown Meadows* court emphasized how there had been contractual arrangements between the contractor and subcontractor, and even though the claimant was not a party to those arrangements, imposing tort liability on the subcontractor would upset the contractual allocations made by the parties to those contractual arrangements. *Newtown Meadows,* supra, 167 P.3d at 285. While the economic loss doctrine and the contract-based negligence doctrine are two different doctrines, there are common or related elements and the courts' reluctance to meddle with contracts even where there is no privity may also influence the courts to find that all the tort claims are contract-based negligence claims and therefore not covered by the CGL policy.

ECONOMIC LOSS DOCTRINE IS NOT A COVERAGE DOCTRINE • The case law from other jurisdictions points out that a careful reading of the CGL policy terms would lead to the conclusion that the economic loss rule is not intended to be used to determine coverage questions. The economic loss doctrine determines how a loss can be recovered, in tort or contract; it does not determine whether an insurance policy covers a claim, which depends instead on the language of the policy. *See Vogel v. Russo,* 613 N.W.2d 177, 181-82 (Wis. 2000).

In *Vandenberg v. Superior Court,* 982 P.2d 229 (Cal. 1999), the California court ruled that CGL coverage depends not on the origins of the alleged liability in either tort or contract, but rather on the nature of the damage and the risk involved. *See Vandenburg,* 982 P.2d at 243-44. The court said a reasonable layperson would certainly understand "legally obligated to pay" as a reference to "any obligation which is binding and enforceable under the law, whether pursuant to contract or tort liability." *Id.* at 245.

In *American Family,* supra, the Wisconsin court recognized that the economic loss doctrine could preclude tort recovery while the construction defect claim remained actionable in contract pursuant to contractual warranties. *See id.* 673 N.W.2d at 75. The court cited the *Vogel* case in stating that the economic loss rule does not determine whether an insurance policy covers a claim "which depends instead upon the policy language." *American Family, Id.* at 75. The court then assumed that by operation of the economic loss doctrine, the owner of the damaged property was confined to a contract rather than a tort remedy and asked whether the CGL policy covered the loss. *Id.* at 75 n.4. The court then goes on to rule that losses actionable only in contract can be an "occurrence" under the CGL policy and that by virtue of the subcontractor exception to the business risk exclusions, the losses were covered under the CGL policy. *See id.* at 76-84.

Common Situation: Both Contract And Tort Claims

If a subcontractor negligently causes a defect in construction, such actions will give rise to a breach of the subcontract between the general contractor and the subcontractor. The negligent acts or omissions of the subcontractor will be contract-based and subject to the contract-based negligence doctrine. If a buyer of an apartment or if an association of apartment owners (for purposes of this discussion, the "Association") sues the developer and the general contractor and the subcontractors, seeking repair and replacement cost damages, the allegations will include tort and contract claims.

As for contract claims, the Association probably has no contractual privity with any of the parties. The members of the Association who purchased from the developer may have a sales contract for the purchase of the apartment. Neither the Association nor any buyer will be parties to the construction contract with the general contractor and will not be parties to any of the subcontracts. At most, the developer might have agreed in the sales contracts to assign warranties given by the contractor in the construction contract.

Without express intended third-party beneficiary provisions, the Association will not have the benefit of any third-party beneficiary standing to bring breach of contract actions against any defendant other than the developer. *See Newtown Meadows*, supra, 167 P.3d at 265. As a result, the Association has to allege negligence theories against all of these defendants. Typically, these assertions are not explained but the negligence allegations could involve the following: that the developer negligently selected the general contractor who in turn negligently selected the negligent subcontractor(s) and that the general contractor and the subcontractor(s) constructed negligently, meaning that they failed to live up to the industry standard of care for construction.

As discussed above, under Hawaii case law, there is no coverage under a CGL policy for contract-based negligence. Hawaii courts have approached coverage questions with respect to construction defects by asking whether the negligence claims are derivative of the various contracts or whether they transcend those contracts and do they manifest allegations of conduct that violates a duty that is independently recognized by principles of tort law. *See generally Francis v. Lee Enterprises, Inc.*, 971 P.2d 707 (Haw. 1999). As stated above, the court in *Newtown Meadows* for purposes of the economic loss rule essentially aggregated the different contracts by deciding that privity was not required for that doctrine. Unless an exception is present, the courts, for purposes of deciding coverage questions, may again aggregate the contracts and apply the contract-based negligence doctrine as an impediment to finding that an OCIP does not provide coverage for construction defects.

Coverage Should Be Available

However, a court reviewing all of the facts and circumstances, the entire OCIP policy, the multiple-named insureds, and the subcontractor exception to the business risk exclusions could find that the claims by the Association against the developer and the general contractor should not be subject to the contract-based negligence claims exclusion from coverage. A Hawaii case involving more than one covered person albeit in connection with an automobile insurance policy is instructive as to how a Hawaii court might view all of the covered persons under an OCIP. In *AIG Hawaii Insurance Co. v. Estate of Caraang*, 851 P.2d 321 (Haw. 1993), a passenger in a truck shot and killed a person in another vehicle and the court ruled that the driver was a covered person, and that from the perspective of the driver of the truck, the intentional shooting death was an accident under the automobile policy and while the insurer had no duty to defend and indemnify the shooter, it did have a duty to defend and indemnify the driver.

AIG Hawaii was not a case in which tort and contract overlapped, as was the case in *Newtown Meadows*. But it must be kept in mind that the contract-based negligence doctrine is based on the actions of the insured, which is the basis for courts finding that intentional acts or omissions in performance of contracts cannot satisfy the requirement for an "occurrence" under the CGL policy. Since there are multiple insureds under OCIPs, the contract-based negligence doctrine cannot be applied against all insureds.

CONTRACTUAL LIABILITY EXCLUSION • There is still another policy exclusion to discuss. The CGL policy has a "contractual liability exclusion."

Subsection I.A.2 of the CGL policy provides in part, "This insurance does not apply to…'property damage' for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement."

While it is convenient for the courts to say that the CGL is not intended to insure *liability* for breach of contract, the fact is that breaches of contract are not covered in the first place. The insuring agreement under Subsection I.A.1 of the CGL policy insures "sums that the insured becomes legally obligated to pay as damages because of…'property damage' to which this insurance applies." The Subsection goes on to state that the property damage must be caused by an occurrence. If there is no property damage to which this insurance applies, there is no insurance coverage regardless of whether there is liability under tort or breach of contract. If there is property damage to which this insurance would otherwise apply (such as possibly construction defects), then the next inquiry is whether the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.

The Reach Of The Contractual Liability Exclusion

The contractual liability exclusion has also divided the courts. The exclusion reads in effect that the insurance does not apply to property damage for which the insured is obligated to pay damages by reason of the **assumption of liability** in a contract or agreement. Clearly, this provision is not equivalent to "by reason of the breach of an obligation in a contract or agreement" but should it be interpreted to be equivalent? Do parties to contracts assume liability simply by making agreements or promises? There are courts that have interpreted the exclusion to exclude any contractual liability. *See American Family*, supra, 673 N.W.2d at 79-80 (citing *Nelson v. Motor Tech, Inc.*, 462 N.W.2d 903 (Wis. Ct. App. 1990)). Others have interpreted it to exclude only agreements to indemnify. *See American Family*, supra, 673 N.W.2d at 80 (citing *Dreis & Krump Mfg Co. v. Phoenix Ins. Co.*, 548 F.2d 681 (7th Cir. 1977). Under this interpretation, the exclusion for assumption of liability has to be the assumption of a third party's liability. The court in *American Family* stated:

"We agree that CGL policies generally do not cover contract claims arising out of the insured's defective work or product, but this is by operation of the CGL's business risk exclusions, not because a loss actionable only in contract can never be the result of an 'occurrence' within the meaning of the CGL's initial grant of coverage. This distinction is sometimes overlooked, and has resulted in some regrettably overbroad generalizations about CGL policies in our case law."

American Family, supra, 673 N.W.2d at 76.

The court recognizes that the focus should not be on contract claims versus tort claims but on property damage to which this insurance applies provided there is an occurrence. *Id.* at 70, 76-78. The court then uses the subcontractor exception to a business risk exclusion coupled with the court's view that the economic loss rule does not operate to deny coverage under the insuring agreement's initial coverage grant and holds that whereas coverage would otherwise be denied by the business risk exclusion, the subcontractor exception operates to restore the otherwise excluded coverage. *See id.* at 75, 81-82. *American Family* found that the contractual liability exclusion did not prevent coverage and so *American Family* did not and had no reason to address an exception to the contractual liability exclusion.

The "Insured Contract" Exception

As is the pattern of the CGL policy, there is an exception to the contractual liability exclusion called the "insured contract" exception. The CGL policy, under Subsection I.A.2, simply states in effect this exclusion does not apply to liability for damages as-

sumed in an "insured contract." Insured contract is defined to include several types of contracts but the relevant definition is in Subsection V.9.f of the CGL policy, which reads in pertinent part, "That part of any other contract or agreement pertaining to your business…under which you assume the tort liability of another party to pay for…"property damage" to a third person…."

Note that under the definition of "insured contract," Subsection V.9.f, the indemnity provisions of a construction contract or subcontract would be an "insured contract" but only if such indemnity clauses or hold harmless clauses effectively transfers or assumes the "tort liability" of another party. It is insurance for indemnifying or assuming another party's tort liability. *See VBF, Inc. v. Chubb Group of Ins. Cos.,* 263 F.3d 1226, 1232 (10th Cir. 2001); *Va. Sur. Co. v. N. Ins. Co. of New York,* 866 N.E.2d 149, 161 (Ill. 2007). Usually there are indemnity clauses in all of the project construction contracts. Each of these could be an "insured contract" under an OCIP. If a subcontractor creates the construction defect and has agreed to indemnify the general contractor against the resulting claims, some of those claims will include tort as well as contract claims. At times, the negligent construction will be the joint fault of several subcontractors and the general contractor as well.

Exclusion For Damage To "Work"

The general contractor in the construction contract typically agrees to indemnify and hold the developer harmless against claims resulting from construction defects. However, under the standard construction contract, there is an express exclusion for damage to the "Work" itself. AIA Document A201 - 2007 General Conditions of the Contract for Construction (A201) section 318.1 provides:

"To the fullest extent permitted by law the Contractor shall indemnify and hold harmless the Owner, Architect, Architect's consultants, and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (**other than the Work itself**), but only to the extent caused by the negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Section 3.18."

Available at www.aia.org/aiaucmp/groups/aia/documents/pdf/aias076835.pdf (bold emphasis added).

Owners will typically negotiate changes to this indemnification clause whereby the Contractor agrees to indemnify the Owner against damages arising from injury to the Work itself.

In Article 11 of the A201, the Contractor agrees to provide liability insurance for claims "for damages, other than to the Work itself" but including "property damage arising out of completed operations" and "[c]laims involving contractual liability insurance applicable to the Contractor's obligations under Section 3.18."

As stated above, often Section 3.18 is amended to include damage to the Work itself within the scope of the agreement to indemnify and this agreement would constitute an "insured contract." The Association's lawsuit against the developer would be based on this damage to the Work itself and on property damage arising out of completed operations as well. Therefore, the intent and agree-

ment of the contractor is to provide liability insurance that will insure against property damage arising out of completed operations and to insure the contractual liability under the indemnity provisions of Section 3.18. Since the contractor would have contractual liability for having agreed to assume liability for the owner's tort liability to the purchasers, this "insured contract" would be an exception to the exclusion that the insurance does not apply to contractual liability.

If the general contractor in its construction contract with the developer agrees to cover the liability of the developer to the purchasers of units because of property damage sustained by such purchasers, the OCIP should cover the developer's liability pursuant to the **insured contract exception** to the exclusion. Contractually assumed liability in insured contracts is one of the risks that the CGL policy promises to pay under the clause, "sums that the insured becomes legally obligated to pay" provided that the liability is assumed in an "insured contract."

In addition, the tort liability of the developer that the contractor agrees to assume is not contract-based negligence liability. While from the vantage point of the contractor and the subcontractors the construction defect could conceivably be subject to contract-based negligence liability, the same cannot be said of the developer's tort liability. The contractor's and subcontractor's tort liability could be considered contract-based negligence liability because the actions or omissions occurred while performing the contracts for construction. However, the tort liability of the developer to the purchasers of the condominium apartments would in all likelihood not be based on any actions or omissions that occurred while performing the developer's obligations under the sales contracts and, therefore, the court could find that the claims are not contract-based negligence claims.

There is no separate OCIP policy. Instead the OCIP is made up of the following standard insurance coverage: CGL and Worker's Compensation, and sometimes Builder's Risk and occasionally professional liability, policies. The coverage becomes an OCIP through endorsements to these standard policies. The CGL policy with all its exclusions from coverage and the exceptions from the exclusions is still the relevant policy. The coverage could be changed as in all CGL policies by endorsements to the CGL policy. Therefore coverage questions for construction defect economic and other losses will still include issues such as whether the claim involves an "occurrence," "property damage," etc.

However there is a significant difference. In an OCIP, there are multiple insureds under the one policy. While the different policies may differ (some using named insured endorsements) the following is how one policy defines who is an insured: "All contractors with whom owner contractually agreed to provide insurance and all tiers of subcontractors of such contractors."

The OCIP/CGL Separation of Insured condition (except for certain specified exceptions) requires that the insurance will apply as if each named insured were the only named insured and separately to each insured against whom claim is made or suit is brought. Therefore the exclusions for property damage to property "you own," "your product," or "your work" should not apply to all of the insureds under an OCIP.

Analysis When There Are Multiple Named Insureds

The coverage analysis has to recognize this. If a third-party claim for construction defects names multiple insureds, a separate coverage analysis will be required for each of these several insureds. Thus while under the standard CGL policy there may or may not be coverage for construction defect economic losses depending on the policy in question and the application of the business risk exclusions, there could be coverage for one or more of the insureds under the OCIP and no coverage for

another insured. The coverage determination will need to analyze the exclusions and exceptions to the exclusions on an insured by insured basis and the result could be that there is no coverage for the insured that created the defect and coverage for the insureds that did not. Since there will be indemnity agreements in the various contracts among the insureds, the analysis of the "insured contract" exception may also play an important role.

OCIPs thus provide multiple avenues for a court in Hawaii to find that the construction defects and the claims of purely economic losses resulting therefrom are covered claims. The construction defect would probably not be the intentional acts or omissions of all of the insureds; there is the subcontractor exception to the business risk exclusions and there is the insured contract exception to the contractual liability exclusion.

It's Not Enough To Stop At "Occurrence"

If a court, as did the ICA, concludes its exploration of the insurance policy at the word "occurrence," the court does not properly interpret the insurance contract. The Hawaii Supreme Court has ruled that agreements must be construed as a whole. *Kaiser Haw. Kai Dev. Co. v. Murray,* 412 P.2d 925, 932 (Haw. 1966). The courts often state that in interpreting contracts, the court will look to the four corners of the agreement. *See Williams v. Aona,* 210 P.3d 501, 515 (Haw. 2009); *Stanford Carr Dev. Corp. v. Unity House, Inc.,* 141 P.3d 459, 471 (Haw. 2006).

A proper case brought to the Hawaii Supreme Court could result in a reversal of the unintended reach of the *Group Builders* case. The Hawaii Supreme Court has stated, "This court does not, however, apply a mechanistic reading of **insurance contracts**; it has instead adhered to the proposition that, because **insurance** policies are **contracts of adhesion** and are premised on standard forms prepared by the insurer's attorneys,… they must be construed liberally in favor of the insured and any ambiguities must be resolved against the insurer. In other words, the rule is that policies are to be construed in accord with the reasonable expectations of a layperson." *Guajardo v. AIG Haw. Ins. Co.,* 187 P.3d 580, 587 (Haw. 2008) (bold emphasis added) (brackets removed) (original emphasis and citations and related internal quotation marks and parentheticals omitted). The reasonable expectations of the lay person contractor is that he will be responsible for his own actions but his CGL policies protect him against the actions of third parties such as a subcontractor.

The insurance world is one in which overly broad rulings can have a lot of unintended consequences. How would the *Group Builders* ruling affect a Landlord who is an "Additional Insured" under a tenant's CGL policy? Clearly in such situations, a construction defect is not the reasonably foreseeable result of the additional insured's own intentional acts or omissions. There are issues of indemnification, contribution, and other complex legal issues that could be implicated and for these reasons, besides good judicial policy, the courts should strive to limit their holdings to what is necessary to resolve the dispute in light of the facts and circumstances facing the court.

In a recent opinion, the South Carolina Supreme Court, in *Crossmann Communities of N.C., Inc. v. Harleysville Mut. Ins. Co.,* 2011 S.C. LEXIS 2 (S.C. Jan. 7, 2011) (as of the date of this writing, this decision was not final, owing to the grant of a petition for rehearing on March 9, 2011), gives a thoughtful description of how the CGL policy has given courts throughout the United States a difficult time and even cites *Group Builders*. The court stated, "Courts across the country have struggled with CGL policies, in particular the 'subcontractor exception' to the 'your work' exclusion. In analyzing difficult and complex issues which arise in these cases, courts have taken differing approaches. The result is an intellectual mess." *Id.* at *7-8. The court then proves its own statement by reversing a decision in a case it decided only about a year earlier. *Id.* at *28. If

the insurers intend to modify their OCIP policies to counter the effect of *Group Builders* and the difficulties the courts have with the CGL policy, they will need to do much more than simply provide that construction defects are "occurrences."

CONCLUSION • There must be a way to more clearly write a policy than one that provides insurance coverage for property damage arising from an occurrence, excluding property damage if your work was incorrectly performed unless included in the products completed operations hazard, but even if included, excluding property damage to your work except if performed on your behalf by a subcontractor. The insurance industry and the ISO should share responsibility with the courts for this intellectual mess in the case law regarding the CGL policy and construction defects and should endeavor to write a completely new CGL policy that better serves the customers of the insurance industry and their reasonable expectations in return for the premiums that they pay.