The Times They Are A Changin':

Legal And Market Trends In The Insurance Industry

By WILLIAM D. BRITT JR. and JOHN W. DAVIDSON

Whether you represent a client that is above or below the "v." in a construction-related lawsuit, ultimately one of the biggest questions that must be answered is whether there is insurance coverage for the claims. Until recently it was generally accepted, although widely litigated, that if a contractor subbed out his work, and that work was proven defective and resulted in damage to the building, then a standard commercial general liability insurance policy would be available to pay for some or all of the contractor's liability. Then, the South Carolina Supreme Court issued its opinion in *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 366 S.C. 117, 621 S.E.2d 33 (2005), and from clarity came confusion (see Aug. 16, 2004 Lawyers Weekly). This article examines the status of the law in South Carolina regarding liability insurance coverage for faulty workmanship claims and what one may do to improve his odds of finding coverage, as well as observed trends within the insurance industry itself, including attempts by insurance carriers to limit or eliminate their exposure.

Life After *L-J, Inc. v. Bituminous*

A typical CGL policy provides coverage for sums the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage." The "bodily injury" or "property damage" must be caused by an "occurrence," which is defined in the policy as an accident, including continuous or repeated exposure to substantially the same general harmful conditions. A CGL policy excludes coverage for, among other things, property damage to "your work." "Your work" includes work or operations performed by the insured or on the insured's behalf. However, the "your work" exclusion does not apply if the damaged work or the work out of which the damage arises was performed on the insured's behalf by a subcontractor.

Prior to *L-J, Inc.*, South Carolina courts consistently held that general liability insurance policies typically do not cover claims solely of faulty workmanship, but instead cover claims of faulty workmanship that causes an accident. Using that logic, construction litigators, developers, contractors, and even, for the most part, insurance carriers, operated under the assumption that if a general contractor subbed out work to a subcontractor, and that subcontractor's work was defective and caused, for example, water intrusion into the building damaging other people's work, a CGL policy would provide coverage to the general contractor. That assumption was turned on its head following *L-J, Inc.*

In *L-J, Inc.*, a case involving faulty road construction, the Supreme Court determined that no "occurrence" had taken place after roads began to deteriorate, resulting in "alligator cracking." Insufficient road subgrade preparation, an insufficiently thick road course, improper drainage, and excessive traffic caused the cracking. Interestingly, in the opinion overruled by the Supreme Court, the Court of Appeals also found that the deteriorating roads were also caused by surface water and moisture seeping into the road base as a result of the defective work.

John W. Davidson is a member in the Columbia office of Nexsen Pruet, LLC and practices in the firm's construction practice group. Will Britt is an associate in the Columbia office of Nexsen Pruet, LLC and also practices in the firm's construction practice group.

Although the general contractor hired subcontractors to perform all of the work, the Supreme Court never reached an analysis under the "your work" exclusion. Rather, the court determined that the damage to the roadbed caused by the faulty workmanship of the general contractor was not an "occurrence," and so its analysis stopped there. The court went on to explain that the underlying complaint did not allege property damage beyond the improper performance of the task itself. As a result, and despite allegations of negligence and breach of warranty, the court concluded that the insurance policy will not stand to cover liability for the contractor's contract liability for a claim that was for money damages to compensate for the defective work.

Had the Supreme Court ended its analysis there, it may have ended CGL coverage for faulty workmanship under any scenario. However, the court cited specifically to a New Hampshire Supreme Court opinion as being "helpful in distinguishing between a claim for faulty workmanship versus a claim for damage to the work product caused by the negligence of a third party."

The case cited by the Supreme Court was *High County Assocs. v. New Hampshire Ins. Co.*, 648 A.2d 474 (1994), involving allegations of faulty workmanship in the construction of condominiums. High County Associates was the builder and seller of condominiums, which brought suit against its insurance carrier for coverage in an underlying construction defects matter involving the condominiums. The construction defects case included allegations that the general contractor's faulty work resulted in substantial moisture seepage into the buildings, causing mildew and rotting of the walls, and loss of structural integrity. Finding that the damage caused by faulty workmanship constituted an "occurrence," the New Hampshire Supreme Court stated that the "plaintiff in the underlying suit alleged negligent construction that resulted in property damage, rather than merely negligent construction." As a result, the case involved allegations of "negligent construction that resulted in an occurrence, rather than an occurrence of alleged negligent construction."

Because of the citation by the South Carolina Supreme Court to *High Country*, plaintiff insurance coverage practitioners opined that one need only match his pleadings to those in the New Hampshire case in order to prevail on coverage. As it turns out, we did not have to wait very long to find out that they were right. On Jan. 13, 2006, the District Court for the State of South Carolina issued an opinion in *Okatie Hotel Group, LLC v. Amerisure Ins. Co.*, 2006 WL 91577 (D.S.C. Jan. 13, 2006) (see Jan. 30, 2006 Lawyers Weekly). There, a general contractor hired subcontractors to construct a hotel. The subcontractors improperly performed their work, causing extensive moisture damage to the hotel. The hotel then brought suit against the general contractor's insurance carrier for its failure to satisfy the hotel's judgment against the general contractor. In finding that the damage to the hotel constituted an "occurrence," the district court relied heavily upon the distinction between *L-J, Inc.* and *High County*. According to the court, the distinction between the two cases results from the allegations in the pleadings. *L-J, Inc.* did not involve allegations beyond the improper performance of the task itself, while *High Country* involved allegations of continuous exposure to water, resulting in damaged walls. Agreeing that damage to the work product alone, caused by faulty workmanship, does not constitute an occurrence, the court concluded that the property damage to the plaintiff's hotel, caused by exposure to the harmful condition of leaks and moisture, did constitute an occurrence.

All three cases involve faulty workmanship of subcontractors, causing water intrusion and resulting damage, yet *L-J, Inc.* reaches a far different conclusion than either *High Country* or *Okatie*. What does that mean for the legal practitioner, and what do these cases say about the future of insurance coverage in South Carolina? First, *Okatie*, in analyzing *L-J, Inc.* and *High Country*, makes it fairly clear that insurance coverage cases may turn on the language of the pleadings. Thus, plaintiff's attorneys, not only in coverage cases, but in underlying construction matters, must plead their cases carefully and model their allegations of faulty workmanship and resulting damage after the language used in *Okatie* and *High Country*. Even though South Carolina is a notice pleading state, attorneys must avoid the trap of simple claims of negligence and go further in describing how the faulty workmanship caused a condition that harmed something other than the work itself.

Secondly, *Okatie* may signal the shift from a reliance on *L-J, Inc.* to a focus on the law and facts of *High Country*. Consequently, South Carolina may find itself circling back to the days when faulty workmanship alone does not constitute an occurrence, but faulty workmanship that causes an accident does. *L-J, Inc.* then becomes an opinion that has little implication outside the specific facts and circumstances involved in the case itself. In other words, because of the Supreme Court's citation to *High Country*, something old is new again.

Market Trends: The Carriers' Return Serve

What seems to be lost in all of the discussion of *L-J, Inc.*, *High Country* and *Okatie* is the fact that insurance coverage involves a written contract. Like all contracts, they are to be analyzed according to the general rules of contract construction, giving policy language its plain, ordinary and popular meaning. When faced with an ambiguity, courts must adopt the interpretation most favorable to the insured.

Time and time again, in analyzing these standard CGL policies and construing them against the carriers and in favor of the insureds, courts have found coverage. Instead of simply modifying the insurance contracts to provide, or not provide, the type of coverage carriers insisted they intended all along, carriers have asked courts to read into policies such high sounding concepts as the business risk doctrine. These arguments have met with varying degrees of success.

In response, as early as 10 years ago, carriers began to add endorsements to CGL policies in an effort to limit or eliminate certain coverage, i.e., EIFS and mold exclusions. While these endorsements did limit coverage, particularly to such groups as EIFS subcontractors, they appeared to be aimed at very specific issues in the construction industry. Now, new endorsements are appearing that are much more generalized and stand to affect the construction industry as a whole, including the wholesale elimination of the very coverage people believe they have purchased.

A real life example involved a residential builder from the Lowcountry who had renewed a standard CGL policy for approximately 10 years. In year 11, however, without any decrease in his premium, the insurance company added an endorsement to the builder's policy entitled the "prior work" exclusion. Under its terms, the builder's insurance no longer applied to "property damage" arising out of "your work" *completed prior to the inception date of the policy*. Giving the exclusion its plain and ordinary meaning, the builder would enjoy coverage only for houses he built within that policy year, unlike before, when subsequent policies would cover "property damage" arising out of "your work" from prior policy years.

Under the standard CGL policy, the builder enjoyed coverage on each home constructed for at least eight *years* — the current statute of repose. Under the new "prior work" exclusion, the builder would enjoy 364 *days* of coverage at a maximum — assuming he completed the house on the first day of the one-year policy and the lawsuit commenced in that same year. In a worst case scenario, and the more likely in light of latent defects, the builder would have no coverage at all. Which begs the question — what is the builder paying for?

The builder only realized the change in coverage after he had been sued and his carrier denied coverage. When confronted with the issue, his insurance agent indicated that he believed so long as the builder renewed the policy with the same carrier each year that coverage for prior years' work would be covered. The carrier obviously disagreed.

Other trends observed in the market include project-specific policies in commercial building. In the past developers and contractors purchased a standard CGL policy and any work performed on any project would be protected under the one policy. Now, some carriers are requiring developers and contractors to purchase one policy for each project performed. These mirror the standard CGL, but cover only risks involved with that one particular project. Further, the policy is not renewable and lasts for a period equal to the statute of repose and no longer. While not substantially different in terms of coverage, the cost of the policies are significant, particularly in light of the fact that the coverage purchased on day one could be taken away on day two through decisions such as *L-J, Inc.* In the case of renewable one-year policies, a change in law could be corrected in the next year's policy. With an eight-year, nonrenewable policy, a change in law could leave a contractor or developer completely exposed having already paid a significant premium.

The above examples are not intended as indictments of insurance carriers. To the contrary, carriers should tailor their contracts to afford the coverage they intended. Likewise, it is certainly the responsibility of the insured to review the policy each year, including any changes, before it is renewed and weigh the risk involved with the purchase. The reality of the situation, though, is that the average developer, contractor or subcontractor in South Carolina, much like the average homeowner or average automobile driver, does not take time to read the fine print in his insurance contract. And even if he did, there is a substantial likelihood that he would not understand the scope of his coverage or the risk involved. Thus, attorneys have an opportunity, and in many cases a responsibility, to make their clients aware that changes in CGL policies are entering the market and these changes could operate to completely eliminate the coverage the client believed he purchased.