CHAPTER 1.4

CONSTRUCTION RISK MANAGEMENT THROUGH INSURANCE

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§ 1.4.1 Introduction

One of the most important services construction lawyers can provide their clients is counseling in the area of risk management. Their experience within the construction industry has made them generally aware of the risks that regularly confront their clients. In addition, lawyers who routinely practice in this area have observed the expansion of existing risk and the emergence of new risk through recent appellate court and legislative authority. When construction lawyers couple these advantages with a working knowledge of the available insurance products that specifically address these existing and emerging construction risks, they are capable of making a significant contribution to the risk management programs of their clients.

§ 1.4.2 Common Construction Insurance Coverages

It is not enough for construction lawyers to be aware of the various risks in the construction industry. They must also assist their clients in making proper arrangements to assure that when a potentially devastating loss does occur it will be covered by insurance and/or transferred to another party through contractual indemnification.

The most common insurance coverages available in the marketplace today are more thoroughly described below.

§ 1.4.2.1 Commercial General Liability (CGL)

The Commercial General Liability policy provides third-party liability coverage for property damage and personal injury. The standard CGL policy form is promulgated by the Insurance Services Office, Inc. (ISO). Both insurers and insureds are free to deviate from the standard versions. It is therefore necessary that the specific language of individual policies be closely examined. CGL policies are more closely examined later in this chapter.

Most construction clients will at the very least maintain commercial general liability (CGL) insurance. In a CGL policy, the insurance company typically agrees to pay those sums that the policyholder becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which the insurance applies.[1] "Bodily Injury" is defined as bodily injury, sickness or disease sustained by a person, including death.[2] "Property Damage" is defined as physical injury to tangible property, including all resulting loss of use of that property.[3]

Additionally, the CGL policy requires the insurance company to defend the insured against any "suit" seeking the aforementioned damages.[4] Suit is defined as any civil proceeding in which damages because of bodily injury or property damage to which the insurance applies are alleged including arbitration proceedings or other alternative dispute resolution proceedings.[5]

Many construction companies fall outside the guidelines for a standard CGL policy thereby requiring a policy written by an Excess & Surplus Lines insurance carrier ("E/S"). E/S insurance carriers offer insurance coverage for policy holders with unique risk factors such as new residential construction, heavy highway or extreme danger construction. Risk factors also include poor loss history or the need to obtain coverage without the standard CGL exclusions that are discussed in detail later in this chapter.

§ 1.4.2.2 Builder's Risk

Builder's Risk insurance protects a contractor from damage to his own materials and equipment at the job site and to the buildings under construction. Such risks are not usually covered by standard insurance.

Builder's Risk policies cover the loss of, or damage to, covered property caused by or resulting from covered causes of loss. The damage must be "fortuitous" in nature. Most courts apply a subjective test to determine whether a loss is fortuitous, looking to what the insured actually knew or believed as to the probability of loss. Most policies contain a "faulty workmanship" exclusion, which excludes losses arising from faulty or inadequate work.

An Installation Floater policy, which is typically purchased by a subcontractor, is very similar to Builder's Risk insurance. An Installation Floater provides coverage for materials, equipment, and personal property while in transit, while being installed, and until coverage terminates according to the terms of the floater. Installation Floaters are generally required when expensive equipment or materials, such as generators, compressors, etc., are involved in the project. While a builder's risk policy is generally

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[1] Insurance Services Organization (ISO) CGL FORM, § 1.A.

[2] ISO CGL FORM, § V.2 (2007).

[3] ISO CGL FORM, § V.13 (2007).

[4] ISO CGL FORM, § I.A (2007).

[5] ISO CGL FORM, § V.14 (2007).

site specific, many installation floaters cover not only at site construction but also while the property to be installed is in transit. Thus, in some cases, the installation floater may cover a gap that otherwise exists in the builder's risk policy.

§ 1.4.2.3 Owner's and Contractor's Project Management Protective Liability

Owner's and Contractor's Project Management Protective Liability Insurance (OCP) is intended to protect certain owners and contractors but only for operations performed for the named insured by the contractor listed in the Policy as the "Designated Contractor". An OCP is a protective liability policy—usually purchased by a contractor for the sole benefit of another person. Generally, an OCP provides an owner with coverage in only two circumstances: (1) if the owner is held vicariously liable for acts or omissions of the general contractor, or (2) if the project owner is held directly liable for its acts or omissions in the general supervision of the operations of the general contractor. Additionally, an OCP generally excludes coverage for bodily injury or property damage if such injury takes place after the earlier of when the operation has been completed or put to its intended use (i.e., completed operations).

Due to the limited coverage afforded in an OCP, an owner should not solely rely on it for liability protection. In other words, an OCP generally works in unison with and not as a substitute to a commercial general liability policy. Further, it may be a viable alternative to adding the owner or contractor as an additional insured on the CGL policy of a general or subcontractor. As an additional insured, limits are shared with any and all other insureds for the same occurrence and aggregate limits are also shared. The OCP limits, on the other hand, are exclusive to the named insured.

§ 1.4.2.4 "Wrap Up Policies"

An Owner Controlled Insurance Policy (OCIP) or Contractor Controlled Insurance Policy (CCIP) commonly referred to as a "Wrap" is a policy wherein the owner or contractor obtains insurance protecting the owner, the prime contractor and all subcontractors on a specific construction project. The Wrap generally encompasses CGL coverage, builder's risk coverage, worker's compensation coverage, design errors and omissions as well as excess, umbrella and other special coverages.

Historically, an owner accepts the economic risk of a project but seeks insulation of the construction risk through contractual indemnity provisions that shift the risk to the design professionals and contractors. In contrast, in an OCIP, the owner becomes responsible for insuring the project and for administering loss prevention programs and becomes exposed to construction risk.

A Wrap can provide significant cost savings for projects exceeding $50 million. Additionally, Wraps are being used in condominium and other multi-residential construction projects as contractors and subcontractors find it increasingly difficult to obtain affordable coverage for these types of projects.

Wrap coverage for large projects should not be renewed until the statute of repose has expired. Wraps frequently end upon completion of the project and coverage is generally limited to activities at the project site. As such, the existence of a Wrap does

not eliminate the need to provide for contractual indemnity by the contractor. An owner should include a broad indemnity clause in the construction contract as a second basis of risk protection.

§ 1.4.2.5 Contractor's Design Liability

The standard CGL policy excludes coverage for design liability. The ISO has promulgated an endorsement to the CGL that negates this exclusion. Contractors can also procure their own design liability insurance separate from the CGL. Such professional liability coverage typically will have multiple and varying exclusions. Design liability can arise from either breach of contract (under the agreement with the owner) or tort (negligence in failing to exercise a reasonable degree of care and skill in carrying out professional duties).

§ 1.4.2.6 Workers' Compensation

The Arizona Workers' Compensation system is statutory and is intended by the legislature to assure speedy, reasonable compensation to all injured workmen, and to protect the contractor from liability in tort for accidents on the work site. The standard of proof for recovery is less than that in civil litigation. Workers' compensation insurance is mandatory.

The ISO's CGL policy expressly excludes coverage for workers' compensation claims.

§ 1.4.2.7 Automobile Coverage

Automobile insurance is necessary to fill a gap in the CGL policy. The ISO issues a standard business automobile policy form that covers "autos". Its definition of "auto" is broad enough to encompass some devices that may be used on a construction job site, including trailers and self-propelled vehicles to which cherry pickers or air compressors are attached. Automobile insurance provides both liability and physical damage coverage. The language of the standard policy is similar to that of a CGL policy, with similar exclusions for intended or expected damages.

§ 1.4.2.8 "Umbrella" Coverage

"Umbrella" and Excess Insurance provides coverage upon the exhaustion of the limits of other policies. An umbrella policy provides additional coverage over multiple primary policies. The schedule of underlying insurance on the umbrella policy's declaration page will dictate the umbrella policy's coverage scope. An excess insurance policy differs from an umbrella as it is generally additional coverage for just one primary policy – usually a CGL.

Excess and Umbrella insurer's obligations are triggered only upon the exhaustion of a certain level of the primary insurance. Only actual settlement or payment of judgment constitutes "exhaustion" that invokes excess insurance.

§ 1.4.2.9 Contractor's Equipment Insurance

Equipment floaters cover loss from physical damage to equipment used by the contractor in the construction process. In order to be eligible for an equipment floater, the equipment must be mobile in nature. Equipment typically insured under an equipment floater includes cranes, bulldozers, earth movers, tractors, air compressors, office and storage trailers, welding units, hand tools, and scaffolding. With a few exceptions, e.g., watercraft and aircraft, virtually any item of portable equipment used by a contractor can be insured under an equipment floater, provided that the equipment is normally used on the job and any storage of the equipment on the contractor's actual premises is incidental to its normal use. An equipment floater can be obtained on either a named peril or all risk bases. Named peril coverage provides insurance only for those losses that result from perils specifically named in the policy. All risk coverage insures against all losses except those caused by perils specifically excluded in the policy.

§ 1.4.2.10 Property Insurance

Property Insurance is designed to insure against physical damage to buildings and their contents caused by perils such as fire, windstorm, and hail. Coverage can also be arranged to insure against indirect losses arising as a result of direct damage to property. Property Insurance policies should be purchased to insure against damage to the contractor's real and personal property (e.g., office building and contents). Property Insurance does not cover construction projects.

§ 1.4.3 Insurance Coverage Fundamentals

Insurance is the most common form of risk avoidance. Through insurance, the contractor is able to shift the financial burden of many standard and extraordinary business risks to an insurance company. Typically, depending on when the insurance coverage is triggered, the insurance company has the duty to defend its policyholder and may ultimately have the duty to indemnify.

§ 1.4.3.1 Contract Interpretation

Interpretation of an insurance contract is a question of law.[6] The courts will construe provisions in insurance contracts according to their plain and ordinary meaning.[7] "[A]mbiguity in an insurance policy will be construed against the insurer"; however, this rule applies only to provisions that are "actually ambiguous."[8] Before construing an ambiguous clause against the insurer, the court will attempt to interpret it by looking to legislative goals, social policy, and the transaction as a whole.[9]

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[6] *Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 199 Ariz. 43, 13 P.3d 785 (2000), citing *Benevides v. Ariz. Prop. & Cas. Ins. Guar. Fund*, 184 Ariz. 610, 613, 911 P.2d 616, 619 (Ct. App.1995).

[7] *Id.*; citing *Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 534, 647 P.2d 1127, 1132 (1982).

[8] *Thomas v. Liberty Mut. Ins. Co.*, 173 Ariz. 322, 325, 842 P.2d 1335, 1338 (Ct. App.1992).

[9] *First Am. Title Ins. Co. v. Action Acquisitions, LLC*, 218 Ariz. 394, 397, 187 P.3d 1107, 1110 (2008).

Generally, the insured bears the burden to establish coverage under an insuring clause.[10]

§ 1.4.3.1.1 Reasonable Expectations Doctrine

The reasonable expectations doctrine may provide coverage to a policyholder even when an unambiguous provision found in a standardized insurance contract clearly restricts coverage. In *Darner Motor Sales, Inc. v. Universal Underwriters Insurance Co.*, the Arizona Supreme Court prohibited courts from enforcing even unambiguous contractual terms in limited circumstances, including where some activity reasonably attributable to the insurer has induced a policyholder reasonably to believe that it has coverage, although such coverage is expressly and unambiguously denied by the policy.[11]

§ 1.4.3.2 Deductible vs. Self-Insured Retention

Policy holders can reduce costs by selecting different deductible amounts or electing a self-insured retention option. A deductible does not become due until after a claim is closed and paid by the insurance company. A self-insured retention on the other hand becomes due at the time the claim is first reported.

§ 1.4.3.3 Insurance Certificates

Insurance certificates are widely accepted as proof of insurance in the construction industry. The certificate should provide the accurate name of the company performing work, specifically requested coverages, limits of insurance, policy expiration dates, name of insurance company and producer. The certificate should also provide the names of any applicable additional insured under the policy, whether the additional insured has waived its rights of subrogation (waiver of the right to take action against a third party for a loss suffered by the insured), and whether the policy listed in the certificate is the primary policy. Owners and contractors will often rely on an ACORD[12] certificate of insurance as proof of its subcontractor's insurance as well as its additional insured status. However, owners and general contractors alike need to review more than just an ACORD certificate as the certificate is not an insurance policy and does not serve to provide, endorse, amend, extend or alter the actual policy terms[13]. Further, reference to a contract between the client and a third party in an ACORD certificate does not provide coverage.

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[10] *Pac. Indem. Co. v. Kohlhase*, 9 Ariz. App. 595, 597, 455 P.2d 277, 279 (1969).

[11] *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 140 Ariz. 383, 682 P.2d 388 (1984); *Gordinier v. Aetna Cas. & Sur.Co.*, 144 Ariz. 266, 272-73, 742 P.2d 277, 283-84 (1987).

[12] The Association for Cooperative Operations Research and Development (ACORD) is a nonprofit standards development organization serving the insurance industry. The ACORD certificate of insurance forms is used throughout the insurance industry.

[13] "http://www.acord.org/standards/forms/documents/acordcertificatesfaq_201004.pdf".

§ 1.4.3.4 Triggering of Coverage

§ 1.4.3.4.1 Claims-Made vs. Per Occurrence

Insurance coverage is triggered depending on the type of coverage purchased. In a Claims-Made policy, coverage extends to incidents arising on or after the policy's retroactive date and which are reported during the term of the policy. Incidents that have not been reported during the policy term will not be covered unless there is tail coverage or an extended reporting date.

In an Occurrence policy, coverage applies to incidents arising from the coverage period regardless of when those claims are reported. No tail coverage is necessary because incidents that occurred during the policy period are covered regardless of the date the claim is actually reported.

Claims-Made policies are not as common as Occurrence policies in the construction industry because of the threat of a construction defect long after the policy has expired. Often, a claim will not be made until years after a construction project is completed. As such, this chapter focuses primarily on occurrence coverage although the definitions and terms are generally very similar.

§ 1.4.3.4.2 Occurrence

An "occurrence" is defined by the standard CGL policy as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."[14]

The term "accident," has been defined by Arizona courts as a "sudden and unexpected event, usually of an afflictive or unfortunate character, and often accompanied by a manifestation of force."[15]

Generally, the policy requires the policyholder to notify its insurance carrier of an "occurrence" as soon as possible.[16] Also, if a claim or suit is brought, the policyholder is supposed to notify its insurer as soon as practicable.[17] Policies also generally provide that the policyholder may not make a voluntary payment, assume an obligation or incur any expense without its insurer's consent.[18]

Arizona law holds that "faulty workmanship, standing alone, cannot constitute an occurrence as defined in [a CGL] policy, nor would the cost of repairing the defect

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[14] COMMERCIAL GENERAL LIABILITY COVERAGE FORM, Insurance Services Office, Inc. § I.A.1a (2007) (hereinafter ISO CGL).

[15] *W. Cas. & Sur. Co. v. Hays*, 162 Ariz. 61, 781 P.2d 38 (Ct. App. 1989); *Century Mut. Ins. Co. v. S. Air Aviation, Inc.*, 8 Ariz. App. 384, 446 P.2d 490 (1968).

[16] ISO CGL FORM, § IV.2(a) (2007).

[17] ISO CGL FORM, § IV.2(b) (2007).

[18] ISO CGL FORM, § IV.2 (d) (2007).

constitute property damages."[19] Coverage is precluded only if the policyholder expected or intended to do the act and to cause some kind of injury or damage. However, when "accidental" property damage results from continued exposure to faulty construction, that property damage is an "occurrence" as defined by the plain terms of the policy.[20]

In *Advance Roofing*, a roofing company performed faulty work for a homeowners' association.[21] The association filed suit alleging that "[t]he work ... performed ... was not completed in accordance with the contract requirements and was not performed in a good and workmanlike manner."[22] There was no allegation that the faulty work caused other property damage. The court held that faulty workmanship did not constitute an occurrence within coverage of a CGL policy.[23]

In contrast, the plaintiffs in the underlying construction defect case in *Lennar* alleged damage resulting at least in part from faulty workmanship, including cracks in the walls, baseboard separation, and floor tile grout cracks and separation.[24] These allegations contained in the plaintiffs' original complaint and in subsequent disclosure statements detailing the property damage were sufficient to allege an occurrence under the applicable policies.[25]

Even if a subcontractor acted intentionally and intended the work to be faulty (i.e. – not accidental) the intent of the subcontractor will not be imputed to a general contractor or owner who is an additionally named insured.[26]

Occurrence policies only provide coverage for property damage that occurs during the policy period.[27] There can be no "occurrence" within the meaning of an insurance

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[19] *U.S. Fid. & Guar. Corp. v. Advance Roofing & Supply Co.*, 163 Ariz. 476, 482, 788 P.2d 1227, 1233 (Ct. App. 1989).

[20] *Lennar Corp. v. Auto-Owners Ins. Co.*, 214 Ariz. 255, 263, 151 P.3d 538, 546 (Ct. App. 2007).

[21] *Advance Roofing & Supply Co.*, 163 Ariz. at 477, 788 P.2d at 1238-39.

[22] *Id.* at 478, 788 P.2d at 1229.

[23] *Id.* at 482, P.2d at 1233.

[24] *Lennar Corp.*, 214 Ariz. at 262, 151 P.3d at 545.

[25] *Id.*

[26] *Id.* (whether an event is accidental is evaluated from the perspective of the insured.) *See, e.g., Butler v. Farmers Ins. Co. of Ariz.*, 126 Ariz. 371, 373, 616 P.2d 46, 48 (1980) (when stolen automobile was recovered by true owner, the loss to the insured, who was a bona fide purchaser of the stolen automobile, was "accidental," entitling him to coverage); *see also* 16 HOLMES APPLEMAN ON INSURANCE 2D § 117.3(B) at 241 (2000) ("[A]n accident is anything that happens or is the result of that which is unanticipated and takes place without the insured's foresight or expectation or intention.").

[27] *Lennar Corp.*, 214 Ariz. at 265 ¶ 35, 151 P.3d at 548; *see also Thoracic Cardiovascular Assocs., Ltd. v. St. Paul Fire & Marine Ins. Co.*, 181 Ariz. 449, 452, 891 P.2d 916, 919 (Ct. App.1994) (occurrence policies cover occurrences "within the policy period, regardless of the date of discovery or the date the claim is made or asserted").

policy until a plaintiff sustains actual damage.[28] This rule applies even if the property damage occurring during the policy period is incremental.[29] Thus, insurers must provide coverage for ongoing property damage that occurs during the policy period even if other similar damage preceded that damage.

Whether the policy is Claims-Made or Per Occurrence, the triggering of coverage creates two express and distinct duties of the insurance company; the duty to defend and the duty to indemnify.[30] These concepts are discussed more fully below.

§ 1.4.3.5 The Duty to Defend

The duty to defend arises at the earliest stages of litigation and generally exists regardless of whether the insured is ultimately found liable.[31] The insurer would have the duty to defend a suit alleging facts that, if true, would give rise to coverage, even though there would ultimately be no obligation to indemnify if the facts giving rise to coverage were not established.[32] Indeed, the duty to defend extends to claims potentially covered by the policy including those that are groundless, false or fraudulent.[33]

If any claim alleged in the complaint is within the policy's coverage, the insurer has a duty to defend the entire suit because it is impossible to determine the basis upon which the plaintiff will recover (if any) until the action is completed.[34]

§ 1.4.3.6 The Duty to Indemnify

In Arizona, an insurer's indemnity duty may be triggered even in the absence of a legal proceeding or a court order requiring the insurer to make payment.[35] A "legal obligation to pay" means any obligation by law, including an obligation created by

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[28] *Lennar Corp.*, 214 Ariz. at 265, ¶ 37, 151 P.3d at 548; citing *State v. Glens Falls Ins. Co.*, 125 Ariz. 328, 330-31, 609 P.2d 598, 600-01 (Ct. App.1980).

[29] *Id.;* citing *Associated Aviation Underwriters v. Wood,* 209 Ariz. 137, 158, ¶ 167, 98 P.3d 572, 602 (Ct. App.2004).

[30] A liability insurer in Arizona owes two express duties and one implied duty to its insured. The express duties are the duty to defend the insured and the duty to indemnify the insured. *Mora v. Phoenix Indem. Ins. Co.*, 196 Ariz. 315, 319, 996 P.2d 116, 120 (Ct. App.1999). The implied duty is commonly referred to as the duty of good faith and fair dealing. The implied duty of good faith and fair dealing will not be discussed in this chapter but see *Rawlings v. Apodaca,* 151 Ariz. 149, 726 P.2d 565 (1986).

[31] *INA Ins. Co. of N. Am. v. Valley Forge Ins. Co.*, 150 Ariz. 248, 255, 722 P.2d 975, 982 (Ct. App.1986).

[32] *Lennar Corp.*, 214 Ariz. at 261, 151 P.3d at 544.

[33] *United Servs. Auto. Ass'n v. Morris*, 154 Ariz. 113, 117, 741 P.2d 246, 250 (1987).

[34] *Regal Homes, Inc. v. CNA Ins.*, 217 Ariz. 159, 169, 171 P.3d 610, 620 (Ct. App. 2007); citing *W. Cas. & Sur. Co. v. Int'l Spas of Ariz. Inc.*, 130 Ariz. 76, 634 P.2d 3 (Ct. App. 1981).

[35] *Desert Mountain Prop. Ltd. P'ship v. Liberty Mut. Fire Ins. Co.*, 225 Ariz. 194, 201, 236 P.3d 421, 428 (Ct. App. 2010); *affirmed by* Arizona Supreme Ct. CV-10-0339 (2011).

statute, contract or the common law.[36] The duty to indemnify includes voluntary costs incurred prior to notice, provided the insured's actions did not have an actual and substantial adverse effect on the insurer's right to defend, settle or adjust the claim.[37]

Although providing prompt notice to the insurer is critically important, it will not bar coverage if the policyholder's actions did not have an actual and substantial adverse effect on the insurer's right to defend, settle or adjust the claim.[38]

§ 1.4.4 Commercial General Liability Coverage

Most construction clients will at the very least maintain commercial general liability (CGL) insurance. In a CGL policy, the insurance company typically agrees to pay those sums that the policyholder becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which the insurance applies.[39] "Bodily Injury" is defined as bodily injury, sickness or disease sustained by a person, including death.[40] "Property Damage" is defined as physical injury to tangible property, including all resulting loss of use of that property.[41]

Additionally, the CGL policy requires the insurance company to defend the insured against any "suit" seeking the aforementioned damages.[42] Suit is defined as any civil proceeding in which damages because of bodily injury or property damage to which the insurance applies are alleged including arbitration proceedings or other alternative dispute resolution proceedings.[43]

Generally, the policy requires the policyholder to notify its insurance carrier of an "occurrence" as soon as possible.[44] Also, if a claim or suit is brought, the policyholder is supposed to notify its insurer as soon as practicable.[45] Policies also generally provide that the policyholder may not make a voluntary payment, assume an obligation or incur any expense without its insurer's consent.[46]

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[36] *Id.* at 201, 236 P.3d at 428, quoting *Megannell v. United Servs. Auto. Ass'n*, 796 A.2d 758, 765-66 (Md. 2002).

[37] *Id.* at 207, 236 P.3d at 434; *see also Ariz. Prop. & Cas. Guar. Fund v. Helme*, 153 Ariz. 129, 136, 735 P.2d 451, 458 (1987).

[38] *Desert Mountain Prop. Ltd. P'ship*, 225 Ariz. at 207, 236 P.3d at 434; *see also Helme*, 153 Ariz. at 136, 735 P.2d at 458.

[39] Insurance Services Organization (ISO) CGL FORM, § 1.A.

[40] ISO CGL FORM, § V.2 (2007).

[41] ISO CGL FORM, § V.13 (2007).

[42] ISO CGL FORM, § I.A (2007).

[43] ISO CGL FORM, § V.14 (2007).

[44] ISO CGL FORM, § IV.2(a) (2007).

[45] ISO CGL FORM, § IV.2(b) (2007).

[46] ISO CGL FORM, § IV.2 (d) (2007).

Although providing prompt notice to the insurer is critically important, it will not bar coverage if the policyholder's actions did not have an actual and substantial adverse effect on the insurer's right to defend, settle or adjust the claim.[47]

§ 1.4.5 Common Insurance Coverage Exclusions

Insurance policies limit coverage through the use of exclusions written into the policy. The insurer bears the burden to establish the applicability of any exclusion.[48]

§ 1.4.5.1 Expected or Intended Injury

Exclusion (a) in the standard CGL policy excludes any injury or damage that is "expected or intended from the standpoint of the insured."[49] This form of intent relates to the insured's state of mind with respect to the consequences of the act, the resulting harm, and should not be confused with the test for "occurrence," which focuses on the intent to commit the act itself.

The language "from the standpoint of the insured" indicates that Exclusion (a) imposes a subjective test. The focus is on what the insured actually expected or intended, rather than an objective test that would charge the insured with some level of foresight or intent. Additionally, Exclusion (a) looks to whether the injury or damage resulting from an act was expected or intended, not merely whether the act itself was intentional in nature.

In Arizona, this policy exclusion applies only if an act was intentional and there was either a subjective desire to cause some specific harm (intent) or substantial certainty (expectation) some significant harm would occur.[50]

§ 1.4.5.2 Contractual Liability

Exclusion (b) of the ISO CGL policy excludes coverage for:

> "Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:
>
> (1) That the insured would have in the absence of the contract or agreement; or
>
> (2) Assumed in a contract or agreement that is an "insured contract," provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement.[51]

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[47] *Desert Mountain Prop. Ltd. P'ship*, 225 Ariz. at 207, 236 P.3d at 434; *see also Ariz. Prop. & Cas. Guar. Fund v. Helme*, 153 Ariz. 129, 136, 735 P.2d 451, 458.

[48] *Pac. Indem. Co. v. Kohlhase*, 9 Ariz. App. 595, 597, 455 P.2d 277, 279 (1969).

[49] ISO CGL FORM, § 1.A.2 (a) (2007).

[50] *Ohio Cas. Ins. Co. v. Henderson*, 189 Ariz. 184, 939 P.2d 1337 (1997).

[51] ISO CGL FORM, § 1.A.2 (B) (2007).

The CGL Policy defines "insured contract" as follows:

"Insured Contract" means

> (f) That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for "bodily injury" or "property damage" to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement. Paragraph f does not include that part of any contract or agreement: ***
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> (2) That indemnifies an architect, engineer or surveyor for
>
> (a) Preparing, approving or failing to prepare or approve maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; or
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> (b) Giving directions or instructions, or failing to give them, if that is the primary cause of the injury or damage; or
>
> (3) Under which the insured, if an architect, engineer or surveyor, assumes liability for an injury or damage arising out of the insured's rendering or failure to render professional services, including those listed in (2) above and supervisory, inspection, architectural or engineering activities.[52]

Exclusion (b) relieves the insurer of liability under the policy in situations where the insured would not be liable to a third party except for the fact that the insured "assumed" the liabilities in question under a hold harmless or indemnity agreement. However, the exclusion will not apply, even in the face of a contractually assumed liability, where there is a legal basis for such liability separate from the contractual assumption, e.g., where the insured would also be liable to the indemnitee under principles of tort law, implied indemnity, or contribution. Therefore, where the insured specifically assumes liability under a contract with a third party, such exclusion relieves the insurer of liability, otherwise existing under the policy, only in situations where the insured would not be liable to a third party except where the insured's liability would not exist except for the express contract.

§ 1.4.5.3 Damage to Property

Two portions of Exclusion (j) may apply to a claim arising out of construction activities. Exclusion (j)(5) excludes from coverage "property damage" to:

> (5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are

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[52] ISO CGL FORM, § V. (9) (2007).

> performing operations, if the "property damage" arises out of those operations;[53]

The use of the term "particular part" limits the exclusion's application to damages to the work on which the insured is actually working at the time of the occurrence. The property damage to be excluded must arise out of the work of the insured, its contractors, or its subcontractors in the process of "performing operations." Therefore, exclusion (j)(5) applies only to property damage that result from ongoing work.

> Exclusion (j)(6) excludes from coverage repairs to defective construction before the entire project is completed. It excludes "property damage" to:
>
> (6) That particular part of any property that must be restored repaired or replaced because "your work" was incorrectly performed on it.
>
> Paragraph (6) of this exclusion does not apply to "property damage" included in the products-completed operations hazard.

Exclusion (j)(6) excludes coverage for property damage sustained to "that particular part" of any property requiring repair due to "your work." Under the CGL policy, "your work" means "work or operations performed by you or on your behalf' and "materials, parts or equipment furnished in connection with such work or operations."[54] Exclusion (j)(6) excludes coverage for damage to property on which the insured performed work where the property itself must be restored, repaired or replaced. Like Exclusion (j) (5), Exclusion (j) (6) requires a "particular part" test, which may serve to limit the reach of this exclusion.

Exclusion (j)(6) only pertains to repair or replacement of defective work while construction is ongoing; the policy excludes from the exclusion property damage included in the "products-completed operations hazard," which covers damage arising out of the insured's work that does not occur until after the work has been completed or abandoned.[55] Work is completed when "that part of the work done at the jobsite has been put to its intended use by any persons or organizations other than another contractor or subcontractor working on the same project"-- in essence, when the project as a whole has reached final completion. Furthermore, work that needs correction or repair but is otherwise complete will be treated as completed.[56] Thus, the fact that warranty work is required does not mean that the work is not completed.

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[53] ISO CGL FORM, § I.A.2 (j)(5) (2007).

[54] ISO CGL FORM, § I.A.2 (j)(6) (2007).

[55] ISO CGL FORM, § V.16(a)(2)(c) (2007).

[56] *Id.*

§ 1.4.5.4 Insured's Product

Exclusion (k) provides that CGL coverage does not apply to "property damage" to "your product" arising out of it or any part of it.[57]

The CGL policy defines "your product" as:

> (a) Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by:
>
> (1) You;
>
> (2) Others trading under your name; or
>
> (3) A person or organization whose business or assets you have acquired; and
>
> (b) Containers (other than vehicles), materials, parts or equipment furnished in connection with such goods or products.
>
> "Your product" includes:
>
> (a) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your product;" and
>
> (b) The providing of or failure to provide warnings or instructions.[58]

This exclusion is intended to deny coverage for damages arising out of items manufactured or fabricated by the insured contractor, breach of warranty thereon, or failure to warn. To exclude coverage under this exclusion, the insurer must show that (1) the damage was done to the insured's product, and (2) the damage arose out of the insured's product.[59] A question often arises whether a building itself constitutes a general contractor's "product." While a few jurisdictions consider a building constructed by the insured to be a "product" of the insured,[60] the majority do not.[61] Property damage caused by the insured's product to other parts of the construction project is not affected by this exclusion.[62]

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[57] ISO CGL FORM, § I.A.2 (k) (2007).

[58] *Id.*

[59] *Fireguard Sprinkler Sys. Co. v. Scottsdale Ins. Co.*, 864 F.2d 648, 654 (9th Cir. 1988).

[60] *Indiana Ins. Co. v. DeZutti*, 408 N.E.2d 1275, 1280 (Ind. 1980); *Swarts v. Woodlawn, Inc.* 610 So. 2d 888 (La. Ct. App. 1992); *Federated Serv. Ins. Co. v. R.E.W., Inc.*, 770 P.2d 654, 656 (Wash. Ct.App. 1989).

[61] *Maryland Cas. Co. v. Reeder.* 270 Cal. Rptr. 719 (Ct. App. 1990); *Stratton & Co., Inc. v. Argonaut Ins. Co.*, 469 S.E.2d 545, 547 (Ga. Ct. App. 1996); *Mid-United Contractors, Inc. v. Providence Lloyd's Ins. Co.*, 754 S.W.2d 824, 826 (Tex. App. Forth Worth 1988).

[62] *Pittsburgh Plate Glass Co. v. Fidelity & Cas. Co.*, 281 F.2d 538, 541 (3d Cir. 1960); *Aetna Cas. & Sur. Co. v. Monsanto Co.*, 487 So. 2d 398, 400 (Fla. Dist. Ct. App. 1986).

§ 1.4.5.5 Insured's Work and the Subcontractor Exception

Exclusion (l) states:

> This insurance does not apply to: "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.[63]

Exclusion (1) generally excludes coverage for damage to completed work; however, the 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. Thus, if the work that causes the damage or the work that is damaged is subcontractor work, coverage exists.

The F.C.&S. Bulletin illustrates this exclusion as follows:

> [A]ssume the named insured, a general contractor, constructs a building that is accepted by its owner. Sometime later the building is damaged by fire as the result of a faulty heating system installed by the insured. The insured is not covered for the damage to the completed work-the heating system and any other work performed by the insured--but is covered for damage to work performed by subcontractors. Or, suppose the cause of damage—faulty heating system—was the work of a subcontractor. Any subsequent damage to the building—whether the work of the insured (general contractor) or of subcontractors—is covered.[64]

In other words, the insured contractor's CGL will respond to all of the following:

1. Damage to the insured contractor's work that arises out of the work of a subcontractor.
2. Damage to a subcontractor's work that arises from that subcontractor's work.
3. Damage to a subcontractor's work arising out of the insured contractor's work.
4. Damage to a subcontractor's work arising out of another contractor's or subcontractor's work.

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[63] ISO CGL FORM, § I.A.2 (l) (2007).

[64] F.C. & S. Bulletins, Epb-8 (1982); *but see Van Builders, Inc. v. U.S. Fid. & Guar. Co.*, 523 A.2d 549 (Del. Super. Ct. 1986); *Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 396 N.W.2d 229 (Minn. 1986); *Bar-Son Bldg. Corp. v. Employers Commercial Union Ins. Co.*, 323 N.W.2d 58 (Minn. 1982). In each of these cases, the completed operations exclusion was arguably misapplied.

§ 1.4.5.6 Impaired Property

Exclusion (m) excludes coverage for loss of use of certain property not physically damaged. It states:

> This insurance does not apply to:
>
> (m) "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
>
> (1) A defect, deficiency or dangerous condition in "your product" or "your work"; or
>
> (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.[65]

The CGL policy defines "impaired property" as follows:

> "Impaired property" means tangible property, other than "your product" or "your work", that cannot be used or is less useful because:
>
> (a) It incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous, or
>
> (b) You have failed to fulfill the terms of a contract or agreement;
>
> If such property can be restored to use by the repair, replacement, adjustment or removal of "your product" or "your work" or your fulfilling the terms of the contract or agreement.[66]

The impaired property exclusion has been held to preclude coverage for economic losses caused by the insured's failure to live up to a contractual obligation[67]. However,

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[65] ISO CGL FORM, § I.A.2 (m) (2007).

[66] ISO CGL FORM, § V.8 (2007).

[67] *Corn Plus Co-op. v. Cont'l Cas. Co.* 444 F. Supp.\2d 981, 990 (D. Minn. 2006) (Impaired property exclusion precluded coverage for loss of use of ethanol plant including decreased ethanol production that was result of defective welding excluded from coverage); *Bethke v. Assurance Co. of Am.*, 2002 WL 31655357, No. C9-02-751, 2 (Minn. Ct. App. 2002) (Impaired property exclusion precluded coverage for loss of use of home when claims were causally connected with insured's failure to fulfill contractual obligations); *Std. Fire Ins. Co. v. Chester O'Donley & Assocs., Inc.*, 972 S.W.2d 1, 9-10 (Tenn. Ct. App. 1998) (Noting textbook illustration of impaired property exclusion is that coverage would be precluded for loss of use of a building that incorporates defective heating and ventilation system).

the impaired property exclusion does not apply if there is damage to property other than the insured's own work.[68]

§ 1.4.6 Endorsements Typically Used in Construction Industry

Very often insurance policies include endorsements that materially alter the scope of coverage; especially in residential and multi-use construction. When blindsided by an endorsement excluding coverage, all is not lost. These endorsements may be subject to attack due to ambiguity if terms are undefined or overly broad. If a clause appears ambiguous, Arizona courts will interpret it by looking to legislative goals, social policy, and the transaction as a whole.[69] If an ambiguity remains after considering these interpretive guides, the courts will construe the clause against the insurer.[70]

Although each insurer's endorsement language will differ, you should keep your eye out for endorsements which alter coverage as follows:

§ 1.4.6.1 Additional Insured Endorsement

Construction contracts frequently require contractors to add other parties (i.e., the owner or other contractors) as additional insureds on their liability policies. Generally speaking, the additional insured wants broad protection for any claim it might face with respect to the construction activity. In reality, their coverage may be much narrower than they expected.

The two key issues with regard to an additional insured's coverage are whether coverage applies to completed operations, and whether there is coverage with respect to losses caused by the additional insured's own negligence.

In 1993, the standard additional insured endorsements were modified to extend coverage to additional insureds only with respect to the contractor's "ongoing"

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[68] *See, e.g., Auto-Owners Ins. Co. v. Home Pride Cos., Inc.*, 684 N.W.2d 571, 580 (Neb. 2004) ("[B]ecause damage to the roof structures and buildings cannot be repaired or restored by simply reshingling the apartment roofs, they are not 'impaired property.' "); *Std. Fire Ins.* Co., 972 S.W.2d at 9 (Impaired property exclusion "does not apply if there is damage to property other than the insured's work"); *Action Auto Stores, Inc. v. United Capitol Ins. Co.*, 845 F. Supp. 417 (W.D. Mich.1993) (Impaired property exclusion inapplicable when pollution to property surrounding defective containment system could not be remedied by repair or replacement of insured's work); *Glens Falls Ins. Co. v. Donmac Golf Shaping Co., Inc.*, 417 S.E.2d 197, 201 (Ga. Ct. App.1992) (Exclusion inapplicable when damages sought for construction of golf course on federally protected wetlands were not directly related to cost of repair and replacement of work but rather encompassed tort damages beyond scope of contract); *cf. Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 193 F.3d 966, 970 n. 2 (8th Cir.1999) (Impaired property exclusion not applicable because defective welds could not be restored by further testing).

[69] *Employers Mut. Cas. Co. v. DGG & CAR, Inc.*, 218 Ariz. 262, 264 ¶ 9, 183 P.3d 513, 515 (2008).

[70] *First Am. Title Ins. Co. v. Action Acquisitions, LLC*, 218 Ariz. 394, 397, ¶ 8, 187 P.3d 1107, 1110 (2008).

operations for the additional insured, thus attempting to eliminate completed operations coverage for the additional insured. Insurers have also drafted their own additional insured endorsements that not only attempt to remove completed operations coverage, but also narrow the scope of coverage for claims that can be tied to the additional insured's own negligence. Careful review of an additional insured endorsement is critical.[71]

§ 1.4.6.2 Known Loss Provisions

Construction defects often produce property damage that takes place over a period of time. For example, faulty installation of roofing, windows or flashing may cause water leakage leading to deterioration of wood and other materials. It is possible, therefore, for a contractor to be aware of defects that are likely to give rise to claims well before the claims actually surface.

In *Montrose Chemical Corp. v Admiral Insurance Co.*,[72] the California Supreme Court ruled that prior to the determination of an insured's actual liability for the injury or damage, the loss is neither certain nor fully "known." Consequently, knowledge of a potential claim at the time the policy becomes effective does not negate coverage (at least in that jurisdiction) as long as there is uncertainty regarding the insured's actual degree of liability.

To counter the impact of the *Montrose* decision, many insurers developed "known injury or damage" endorsements that specifically exclude coverage for losses or potential losses of which the insured was aware prior to the policy period.

§ 1.4.6.3 Exterior Insulation and Finish Systems (EIFS) Exclusions

Exterior insulation and finish systems (EIFS) are multilayered exterior wall systems that are designed to provide high energy efficiency. EIFS have been at the core of a significant amount of construction defect litigation. Typically these claims allege faulty installation or some other product defect that allowed water to penetrate the walls, where it became trapped; resulting in mold or wood and drywall damage.

§ 1.4.6.4 Mold Exclusions

In recent years, the construction and insurance industries have seen a dramatic increase in the number of claims alleging bodily injury and property damage caused by mold. Most insurers have attached mold exclusions to a broad cross section of contractors' liability policies. Some insurers attach mold exclusions to all contractors' policies, regardless of the risk assessment. The standard ISO "fungi or bacteria exclusion" endorsement is very broad, removing coverage for all injury or damage that would not have occurred "but for" exposure to any fungi (e.g., mold) or bacteria, as well as any costs incurred in cleaning up the fungi or bacteria.

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[71] For additional analysis on additional insured endorsements and contractual indemnity, please refer to Chapter 3.6.

[72] 42 Cal. Rptr. 2d 234, 913 P2d 878 (1995).

§ 1.4.6.5 Earth Movement Exclusion

Contractors whose work involves the foundation of a building, or any form of moving, grading, or compaction of land or dirt on the construction site may see an "earth movement" or "subsidence" exclusion on their general and umbrella liability policies. (Where the term "subsidence" is used, it is typically defined to include virtually any form of earth movement, including landslide, mudflow, collapse, or movement of fill, earthquake, and virtually any form of earth rising, sinking, setting, eroding, tilting, or settling.)

§ 1.4.6.6 Residential Construction Exclusion

As discussed previously, construction defect litigation profoundly impacted contractor's ability to secure affordable coverage. This is especially true for the residential construction industry. Some insurers have withdrawn from residential construction markets altogether, or in certain problem regions. Other insurers have included residential construction exclusions. The scope of the exclusions can vary significantly but in one form or another set out to exclude coverage for certain types of projects, including tract homes, condominiums, apartments, townhomes, and/or projects in excess of 25 units in a 12 month period. The inclusion of residential construction exclusion on a subcontractor's liability policy would also eliminate any coverage the contractor may have had as an additional insured on that policy.

§ 1.4.6.7 Subcontractor Exclusion Endorsements

The CGL policy's "Damage to Your Work" exclusion, frequently referred to as the "workmanship" exclusion, eliminates coverage for damage to the insured contractor's completed work that arises out of the contractor's work. This prevents the CGL policy from acting as a warranty on the insured's work. Although the definition of "your work" includes work performed by subcontractors, by exception, the exclusion does not apply to damage to a subcontractors' work nor to damage caused by a subcontractor's work. However, in 2001, ISO introduced optional endorsements that remove the coverage that the subcontractor exception left intact. One of these endorsements eliminates all coverage for damage to "your work" that is, or is caused by, a subcontractors' work.

§ 1.4.6.8 Contractors' Limitation Endorsements

With respect to construction defect exposures, most umbrella insurers have chosen to combine various industry-specific exclusions into one endorsement commonly referred to as a contractor's limitation endorsement. In recent years, many umbrella insurers have added a number of construction defect-related exclusions to their contractor's limitation endorsements. For the most part, these exclusions mirror their CGL counterparts. Mold, EIFS, subsidence, and residential construction are all potential exclusions on the contractor's limitation endorsement.

§ 1.4.7 Conclusion

The construction law lawyer should have a working knowledge of the basic principles and application of contractual indemnification. To that end, the lawyer must be familiar with the insurance products available in the construction industry and the

prerequisites for coverage, the most troublesome of which are "property damage" and "occurrence."

PRACTICE POINTER

The allegations contained in a complaint arising from a dispute concerning construction may well trigger coverage under a contractor's CGL policy or under the project's builder's risk policy. A construction law lawyer, when presented with a complaint, should carefully consider whether the allegations could possibly evoke coverage. If such allegations are found, the complaint should immediately be tendered to the insured's insurance broker with the invitation that the insurer defend and indemnify. It would be most embarrassing for a construction law lawyer, who for many months had undertaken the defense of his or her client at considerable expense to the client, later to realize that certain allegations in the complaint evoked insurance coverage, such that the entire action would have been defended at the expense of the client's insurer.