INSURANCE COVERAGE FOR CONSTRUCTION DEFECTS

Kvaerner Metals v. Comm. Union, PA Supreme Court

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In a highly anticipated decision, the Pennsylvania Supreme Court recently provided an important clarification of insurance law in the Commonwealth when it overturned the Superior Court's decision in *Kvaerner Metals v. Commercial Union Ins.Co.* In *Kvaerner*, the Supreme Court held that the Superior Court erred by looking to information not contained in the underlying complaint in resolving an insurance coverage dispute. Also, since the underlying suit alleged only property damage from faulty workmanship, such a claim did not constitute an occurrence under the policies. This decision may effectively preclude coverage pursuant to a comprehensive general liability policy, in any claim by a customer against its contractor for allegedly poor workmanship which results in damages.

The *Kvaerner* case arose following claims asserted by Bethlehem Steel against Kvaerner for breach of contract and breach of warranty for defects in a coke oven battery built for Bethlehem by Kvaerner.

Commercial Insurance Company, Lexington Insurance Company, and National Union Fire Insurance Company of Pittsburgh, PA, had each issued insurance policies to Kvaerner under which Kvaerner sought coverage for the Bethlehem Steel claims.[2]

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[2]Commercial Union and Lexington Insurance Company settled with Kvaerner and were not involved in the appeals.

Bethlehem initially filed suit in the Court of Common Pleas of Northampton County, PA against Kvaerner, and its subcontractor, to recover damages for injuries allegedly sustained by Bethlehem's Burns Harbor No. 2 Coke Oven Battery which had been the subject of a design build contract between Kvaerner and Bethlehem Steel.

Kvaerner subsequently filed a declaratory judgment action against its insurers which had denied coverage for the Bethlehem Steel claim. Eventually, National Union, which had issued two very similar commercial general liability ("CGL") insurance policies to Kvaerner during the period of the contract, filed a motion for summary judgment. In its motion, National Union primarily contended that the claims asserted against Kvaerner by Bethlehem Steel were purely contractual claims and, therefore, were not within the coverages provided to Kvaerner by the CGL policies.

The trial court granted summary judgment to National Union, based upon its conclusion that the claims asserted against Kvaerner by Bethlehem Steel were not within the coverages afforded by the CGL policies because there had been no "occurrence" but only a breach of its contractual responsibility. In reaching it conclusion, the trial court substantially relied upon *Redevelopment Authority of Cambria County v. International Ins. Co.*, 454 Pa. Super. 374, 685 A.2d 581 (Pa. Super. 1996) (en banc), appeal denied, 548 Pa. 649, 695 A.2d 787 (1997), which held generally that comprehensive general liability policies do not cover claims by a customer against a contractor for breach of a contract. Because it found no occurrence which would trigger the insuring agreement in the National Union policies, the trial court did not reach the issue of the applicability of certain "business risk/work product" exclusions relied upon by National Union in the alternative.

In its decision, the Superior Court first rejected the argument that a determination of coverage should only be made by an examination of the allegations of the underlying complaint. The Superior Court found that it could look outside of Bethlehem's Complaint in the underlying case because there was "no requirement in the [Policies] that a civil complaint be filed to trigger coverage . . . "

The Superior Court also quoted the Supreme Court's decision in *Mutual Beneficial Ins. Co. v. Haver*, 555 Pa. 534, 725 A.2d 743 (1999) which provides that "to allow the manner in which the complainant frames the request for redress to control in a case such as this one would encourage litigation through the use of artful pleadings designed to avoid exclusions in liability insurance policies."

On the basis of this authority, the Superior Court apparently relied upon expert reports prepared prior to and during the Bethlehem Steel litigation in reaching its decision. Some of those reports attributed at least a portion of the damage to the battery to heavy rains during the construction which may have washed out brick mortar.

The Superior Court concluded that:

> the damage at issue is not the absence of the grout or the size of the grout spaces but the deformation and deflection of the brick work, tie rods and roof of the battery which occurred after the battery was placed in use. Whether that damage was caused in whole or in part by the torrential rains of October 31st and November 1st, or by some other event during the heatup of the battery, we are not hesitant to conclude that the physical damage to the battery constituted an occurrence for which the policies provide coverage UNLESS otherwise precluded by one of the exclusions set forth in the policy.[3]

The Superior Court recognized that the business risk/work product exclusions typically exclude coverage for "property damage to your product arising out of it or any part of it and

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[3]825 A.2d at 654.

included in the products-completed operations hazard." Since "your work" is defined to include work "performed by you or on your behalf," the Court noted that these provisions appear to exclude coverage for damage to the Bethlehem coke battery. However, Endorsement 16 to the National Union policies changed the definition of "your work" under the "products-completed operations hazard" clause so as to exclude work performed by a subcontractor. Since the Superior Court concluded that it could not resolve the questions of which part of the work on the battery was performed by subcontractors and which work was defective, it held that the case should be remanded to the trial court for its application of Endorsement 16 to the facts.

In its opinion issued on October 25, 2006, the Supreme Court reversed the order of the Superior Court and held that National Union had no duty to defend or indemnify Kvaerner for the Bethlehem Steel's coke oven battery claims.

The Supreme Court first held that the Superior Court had erred by relying on evidence outside the complaint filed by Bethlehem Steel against Kvaerner, i.e., the litigation and pre-litigation expert reports. The Supreme Court rejected the Superior Court's use of evidence outside the complaint for the following reasons:

> The Superior Court erred in looking beyond the allegations raised in Bethlehem's Complaint to determine whether National Union had a duty to defend Kvaerner and in finding that the Battery's damages may have been the result of an "occurrence." In doing so, it departed from the well-established precedent of this Court requiring that an insurer's duty to defend and indemnify be determined solely from the language of the complaint against the insured. We find no reason to expand upon the well-reasoned and long-standing rule that an insurer's duty to defend is triggered, if at all, by the factual averments contained in the complaint itself.[4]

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[4]2006 Pa. LEXIS 2064 at 18-19. (Citations omitted).

The Supreme Court next turned to the language of the National Union policies to determine what coverage was provided. The Court also found it necessary to review the Bethlehem Steel complaint to determine whether the allegations triggered coverage under the policies.

While recognizing that the underlying suit alleged property damage only to Kvaerner's own work product from its faulty workmanship, the Supreme Court held that "definition of 'accident' required to establish an 'occurrence' under the [National Union] policies cannot be satisfied by claims based upon faulty workmanship [such as those in the Bethlehem Steel complaint].[5] The Court was concerned that to do so would convert the policies into "performance bonds" which the parties obviously did not intend.[6]

It was clear to the Supreme Court that the Bethlehem Steel complaint alleged property damage from poor workmanship only to the work product itself, i.e., the coke oven battery. This conclusion was apparent from the complaint which alleged, *inter alia*, that the battery "did not meet the contract specifications and warranties, or the applicable industry standards for construction, and accordingly was in breach of the Contract and its warranties." However, since it held that the Complaint's basis in faulty workmanship did not allege an "occurrence," the Court did not reach the questions raised either by the potential application of the business risk/work product exclusions or by its own grant of appeal to address the "gist of the action" doctrine

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[5]2006 Pa. LEXIS 2064 at 27.

[6]The Court noted that Kvaerner had recovered under both a Builder's Risk Policy, providing coverage for property constructed by it under the contract, and a Professional Liability Policy, covering alleged negligent acts, errors, or omissions by Kvaerner or its subcontractors.

regarding whether the essence of a claim lies in an uninsured breach of contract or potentially insured negligence.

The Pennsylvania Supreme Court's decision in *Kvaerner* appears to be in line with the minority rule regarding insurance coverage for construction defects. In a recent article in the Tort Trial & Insurance Practice Law Journal,[7] the authors divided the cases from various jurisdictions across the country which have dealt with the issue of whether there was an occurrence in construction defect claims into three categories:

1. The "majority rule" that coverage is limited to damage to other property, i.e., construction defects satisfy the occurrence definition only if they cause damage to property other than the insured's own work or product;

2. The "foreseeability" rule (a pro-insurer minority rule consistent with the Pa. Supreme Court's specific no-occurrence holding), i.e., there is no coverage even for damage to other property because defective work actively performed by the insured is not an occurrence even where there is damage to other property because any damage to other property is a foreseeable result of faulty workmanship; and

3. The pro-insured minority rule, i.e., all damage is a covered occurrence since the term "accident" is not defined, therefore a broad definition will be applied which typically results in coverage.

A recent opinion from the U.S. Court of Appeals for the First Circuit in *Am. Home Assur. Co. V. AGM Marine Contractors, Inc.* discussed the majority rule but noted that some courts have held faulty workmanship by an insured that results in only damage to its product is not an

[7] 41 Tort Trial & Ins. Prac. L.J. 1079 (2006).

occurrence, other courts have held that faulty workmanship does not constitute property damage while yet a third line of reasoning focuses solely on the business risk exclusions.[8] The First Circuit, however, declined to rule based on an interpretation of the "occurrence" term, since there was no defining state law which provided definitive guidance. Rather, the Court noted that in "all events, one of the exclusions in this case bars coverage even if we assume *arguendo* that there was an occurrence and property damage within the meaning of the policy." Therefore, the Court ruled against coverage in that case based on the application of the various business risk exclusions.

A review of Justice Cappy's unanimous Opinion in *Kvaerner* indicates that Pennsylvania aligns itself with those jurisdictions which hold that claims for faulty workmanship are not covered because the insuring agreement of the policy is not triggered.

Many cases involving construction defect claim have some elements of damages that involve repair or replacement of the insured's own work product as well as repair or replacement of the work of other contractors or subcontractors. In *dicta* in *Kvaerner*, the Supreme Court discussed several such cases from both within and outside Pennsylvania as part of its discussion. One of the cases reviewed was the decision of the Supreme Court of South Carolina, in *L-J, Inc. v. Bituminous Ins. Co.*, 621 S.E.2d 33 (S.C. 2005).

The holding in *L-J, Inc. v. Bituminous* is consistent with *Kvaerner* in that it holds that faulty workmanship does not constitute an occurrence, however, the court in *L-J, Inc.* appears limited to a denial of coverage respecting claims for damages only to the insured's own work

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[8] *Am. Home Assur. Co. V. AGM Marine Contractors, Inc.*, No. 05-2310 (1st Cir., November 8, 2006).

product. In its discussion of that opinion, the Pennsylvania Supreme Court noted "[t]he Court stated that a CGL policy may provide coverage where faulty workmanship caused bodily injury or property damage to another property, but not in cases where faulty workmanship damages the work product alone."[9] In light of this apparently limiting language, one may fairly question whether the holding in *Kvaerner* is also limited. If so, a CGL policy will only cover a claim against a contractor for repair or replacement of the work or property -of others, but not for those claims which contend that the contractor's shoddy work required the repair or replacement of the contractor's own work product.

However, the holding of *Kvaerner* appears to leave no room for dispute. Note that the Supreme Court follows its discussion of similar cases by clearly announcing its holding - without restricting the application of the case only to damage to the insured's work. In the operative portion of this unanimous Opinion, Chief Justice Cappy writes:

> We hold that the definition of "accident" required to establish an "occurrence" under the policies cannot be satisfied by claims based upon faulty workmanship. Such claims simply do not present the degree of fortuity contemplated by the ordinary definition of "accident" or its common judicial construction in this context. To hold otherwise would be to convert a policy for insurance into a performance bond. We are unwilling to do so, especially since such protections are already readily available for the protection of contractors.[10]

While our Supreme Court clearly discussed several supporting opinions, one of which is limited in a way which may be relevant to the questions presented in this case, its decision is clear and apparently fully dispositive of any and all claims made by a customer against its contractor arising from allegedly poor or shoddy workmanship. That the Supreme Court did not limit its

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[9]2006 Pa. LEXIS 2064 at 15.

[10]2006 Pa. LEXIS 2064 at 16-17.

holding to the work product of the insured is made clearer by the concluding paragraph of the Opinion. After concluding that "faulty workmanship does not constitute an 'accident' as required to set forth an occurrence under the CGL policies,"[11] the Court went on to explain, "[g]iven this conclusion, it is not necessary for us to consider whether the business risk/work product exclusions also preclude coverage here."[12] Since there was no occurrence, the Supreme Court found that the Insuring Agreement in the policies was not triggered. Further, no where in the opinion does the Court indicate any intent to limit its holding regarding coverage for damage to the insured own work or product.

If you have any questions regarding this case or would like a copy of the opinion, do not hesitate to contact the author at 412-355-4975 or tgebler@margolisedelstein.com.

[11]2006 Pa. LEXIS 2064 at 17.

[12]2006 Pa. LEXIS 2064 at 17.