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Construction Defects And 'The Space Between'

Law360, New York (May 31, 2014, 10:23 PM ET) -- As the economy continues its convalescence, construction activity is on the rise, and is projected to remain on that trajectory throughout 2014, all of which portends an increase in construction-related loss and an inevitable uptick in construction litigation. Although few consequences are certain, both surety bonds and commercial general liability coverage will likely be implicated simultaneously by many of the same claims.

Consider, for example, this common fact pattern:

A state decides to build a new convention center, selects a general contractor and requires contractor to procure performance and payment surety bonds. The contractor also obtains commercial general liability cover. Contractor later builds the convention center and receives payment for its work. Six years later, the state discovers significant leaks in the roof, due to latent defects in the roofing material used by contractor and defective work performed by contractor's roofing subcontractor. The state sues the contractor and its surety for the costs of repairing the roof, damages to other portions of the convention center and its contents caused by the leaks, as well as its costs associated with the conventions and other events it was forced to cancel during repairs. In an attempt to bring deeper pockets to the table, the state also sues the contractor for negligence, seeking to trigger contractor's CGL coverage. The contractor, in turn, tenders the claim to its CGL carrier.

Under this scenario, the surety's obligations may not be triggered at all and, even if they are, the surety might not be required to pay if the contractor remains solvent. Any obligation of the CGL carrier to defend or indemnify will, of course, depend on the facts of the case and state's law.

However, if the contractor becomes insolvent, the multimillion dollar question is "who pays" for the damage and loss occasioned by the referenced construction defect — the surety, CGL carrier, both or neither? Notwithstanding the seemingly expansive coverage provided by each product, it is possible that neither the surety nor the CGL carrier will cover the subject loss. The following analysis identifies some of the risks that may reside in the "space between" a performance bond and CGL cover in these circumstances.

Background

Surety bonds are used by the construction industry to shift the risk of contractor default and nonpayment for labor and materials by the contractor from the owner of a project to the surety. The type of bond discussed in this article, a performance bond, typically protects the project owner from a contractor's failure, inability or refusal to complete the work required by the construction contract. Performance bonds are optional for private construction projects, but are required by federal or state statutes in the context of most government construction projects.

Owners and contractors also generally obtain CGL cover to protect themselves against unexpected loss and liability arising from their construction activities. Common CGL wording, as outlined in the CGL policy form issued by the Insurance Services Office — an industry organization whose standard policy forms are frequently utilized by insurers — provides that the insurer will pay those sums that the insured becomes "legally obligated to pay" as damages because of "bodily injury" or "property damage" caused by an "occurrence," and will defend the insured against any suit seeking such damages.

There are several key differences between surety bonds and CGL policies:

- CGL carriers have a duty to defend the insured contractor against suits seeking damages emanating from property damage, whereas sureties have the right to tender their defense to the solvent contractor and demand to be held harmless.

- Performance bonds are designed to protect the owner against the risk of the contractor's failure to perform its contractual obligations, while insurance contracts are designed to protect the contractor, in the event of an accidental loss unknown at policy inception.

- Sureties do not expect to incur loss and do not price their product to accommodate reserves in the event that loss occurs, whereas insurers do calculate premiums to create a pool of reserves available to address the inevitability of loss.

- Sureties arguably have a broader array of defenses at their disposal when a claim is made against the bond, whereas the insurer's rights and defenses are generally limited by its contract. For example, the insurer cannot seek indemnification from its own policyholder.

What is "the Space Between?"

When both a performance bond and a CGL policy are in play, many owners may believe they have ample coverage in the event of a construction defect, but more coverage does not necessarily mean sufficient and appropriate protection. As in the loss scenario described above, one of the most commonly litigated construction disputes arises from the discovery of latent defects many years after a project is completed. The surety and the CGL carrier may each invoke several potentially viable defenses to latent defect claims.

Surety defenses include:

- Scope of performance bond: Because the surety only guarantees the principal's contract obligations, the substantial completion of the bonded contract by the contractor may relieve the surety of liability on the bond. Whether a surety may successfully assert this defense remains largely untested, and it is not yet settled as a matter of U.S. law.

- Contractual limitations period: The contractual limitations period in a performance bond may contain an express limitation period circumscribing the temporal window in which an owner may sue. However, while contractual limitation periods generally have been enforced by U.S. courts, other courts have held that — if the limitation period in the bond conflicts with a state statute of limitations — the bond limitation period is void.

- Statutes of limitation and repose: A surety's exposure may also be limited by a state statute of limitations. Some courts have held that a limitations period begins on the date of project completion, whereas in other jurisdictions, it does not begin to run until discovery of a latent defect.

Unlike a limitations period, a repose period begins to run at a statutorily defined event. Statutes of repose provide a valuable, temporal outer-limitation to a surety's liability, but only following the passage of a protracted term of time during which a defect remains hidden or innocuous. The application of statutes of repose likewise varies by jurisdiction.

CGL carriers also possess a wide array of defenses to construction defect claims:

- Latent defects as a covered occurrence: The most fundamental defense, perhaps, is the contention that defective work resulting in a (latent) construction defect does not constitute an "occurrence." Whether latent defects constitute an occurrence eligible for coverage depends on the law of the relevant jurisdiction and, more specifically, whether its jurisprudence considers faulty work to be an "accident," or merely a happening devoid of the degree of fortuity needed to support an insurable "occurrence."

- Business risk exclusions: Exclusions (j) through (n) in the standard form CGL policy generally preclude cover for damage to the insured's work and are often called "business risk" exclusions. The most common business risk exclusion for construction defect claims is Exclusion (l) — the "Your Work" exclusion — which is aimed at eliminating coverage for latent defects arising out of the insured's work that cause property damage to the insured's work.

An exception to this exclusion reinstates cover if the damaged or damage-causing work was performed by a subcontractor. However, this exception can, in some cases, swallow the bargained-for exclusion owing to the extensive use of subcontractors in major construction projects. In response, the ISO has issued an endorsement, which eliminates the subcontractor exception. With the endorsement in place, a CGL carrier has a persuasive argument that coverage for latent defects is barred by Exclusion (l), regardless of whose hands perform the allegedly defective work.

- Definition of property damage: An insurer is liable only for those sums the insured becomes legally obligated to pay as damages because of "property damage," and CGL carriers have argued successfully that faulty work is not "property damage," as defined by the CGL form.

- Policy period: The carrier agrees to pay only for "property damage" that occurs during the policy period, not defects that may give rise to property damage after the policy expires.

- Consolidated insurance programs: In the context of large projects, contractors and subcontractors may be insured through a "wrap-up" program that provides consolidated insurance to the parties involved. These programs may leave gaps in coverage if they: (1) cease to respond once a project reaches substantial completion or a scheduled completion date; (2) contain a "your work" exclusion; or (3) include a waiver of the right to sue another insured participating in the program.

Overlapping Coverage: A Space No More?

Although there are occasions where neither a performance bond nor a CGL policy provides cover for construction defects, in some cases, both products may be triggered and facially available to cover a latent defect claim. Consider, for example, faulty work that arguably causes property damage under a CGL policy and also constitutes a breach of a bonded construction contract which the surety may be obligated to remedy. In jurisdictions where faulty work may be considered an "occurrence," where none of the business risk exclusions applies, and where the terms of the performance bond and state limitation periods do not preclude coverage, there may, in fact, be overlapping cover for a particular construction defect.

Although this state of affairs may seem ideal from an owner's perspective, the potential overlap may have the reverse effect, causing the surety and the CGL carrier each to defer its own coverage decision, in light of the coverage arguably available from the other one. In these cases, an owner may, again, find itself in the uncertain "space between" — where gridlock induced by carriers pointing to each other's coverages temporarily nullifies each one — at least until costly and protracted litigation resolves the conflict.

So, who pays for the damage and loss occasioned by contractor's faulty work? The surety, the CGL insurer, both or neither? In the most general terms, the answer is "it depends" — on the terms of the bond; the CGL wording; and the applicable law, which varies by jurisdiction.

The state convention center in our hypothetical may help to illuminate a few more refined responses. Experience teaches that the state's claims against both the surety and the CGL carrier will both find traction in the text of the policy and bond, and simultaneously be undermined as antithetical to the purpose of each product.

CGL coverage does not guaranty contract performance, even if the dispute is clad in the idiom of a tort claim (i.e., “negligence” on these facts); and, performance bonds do not indemnify for the kind of property damage sustained here. Among other significant impediments to coverage, the state will likely be forced to contend with the surety’s objections predicated on substantial completion of the convention center; a contractual limitation period in light of the six years elapsed between completion and the discovery of leaks, particularly if the cessation of work or payment to the contractor is the triggering event for limitations purposes; and the state’s statute of repose. Likewise, the state’s attempts to trigger the contractor’s CGL cover may be impeded by the absence of an “occurrence;” one of five “business risk” exclusions; or an inability to prove property damage during the CGL policy period.

Conclusion

Although many commentators have focused on the expansive cover provided by performance bonds and CGL policies alike, few have considered the prospect of a space between them — where an owner may be left without coverage based on the purpose and/or performance of both products. That space will not necessarily be filled by a particular bond or CGL policy.

As a result, all parties should closely analyze whether the performance bond and insurance policy they propose to activate each provides adequate cover in the event of a construction defect likely to present itself in the context of a particular project — or, in the case of CGL covers, a type of business activity — or whether, taken together, they arguably leave a “space between” wide enough to engulf a risk likely to come to fruition.

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