Case Alert

Iowa Court Holds Defective Construction Is A Covered Occurrence

Making a bold move in favor of policy holders, the Iowa Supreme Court extended the coverage of CGL policies to include defective workmanship. In *National Surety Corp. v. Westlake Investments, LLC*, the Court held that a general contractor's excess CGL policy provided coverage for the settlement proceeds in lawsuits arising out of a doomed apartment-complex construction project.

Background

Westlake Investments purchased the apartment complex in 2003, while it was still under construction. That summer, the complex's developers and general contractor purchased a primary CGL policy from Arch Insurance Group and an excess CGL policy from National Surety Corporation (NSC). Problems arose throughout the complex over the next few years, particularly water seepage that caused widespread damages.

Westlake sued the developer and the general contractor under tort and contract theories in February of 2008. The developer and general contractor then sued the subcontractors, architect, and other third-party defendants. All but one of the subcontractors settled, and a consent judgment for $15.6 M entered in favor of Westlake in February of 2012. Arch Insurance contributed its policy limit of $1,000,000, and the third-party defendants contributed $1,737,500 out of their own pockets. The developer and general contractor then assigned their claims against NSC to Westlake, and Westlake tried to force NSC to pay out the unsatisfied portion of consent judgment. But NSC argued that damage caused by defective workmanship does not constitute an occurrence.

Holding

The typical post-1986 standard-form CGL policy will only provide coverage for property damage caused by an "occurrence." In the policy at issue in this case, "occurrence" was defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." But neither the primary nor the excess policy defined the term "accident." NSC argued that defective work performed by an insured's subcontractor did not amount to an accident and therefore could not be an occurrence.

But the Court's majority refused to interpret the policy in fragments. Undefined policy terms must be construed in light of the entire policy, including exclusions. The policy here contained both an exclusion for property damage "expected or intended from the standpoint of the insured" and an exception to an exclusion that allowed coverage for certain damages "arising out of sudden and accidental physical injury." Working within this context, the majority concluded that "the term 'accident' meant 'an unexpected and unintended event.'" And so, the defective work of a subcontractor, insofar as it was "[a]n intentional act resulting in property damage the insured did not expect or intend," was an *accident* and therefore amounted to an occurrence within the framework of the policy.

Two elements of *Westlake Investments* should particularly interest policyholders. First, the majority relied on basic contractual principles to reach its conclusions. It took care to note that the scope of risk covered by a CGL policy was something negotiated between the insurer and the policyholder, and it refused to disturb that agreement by imposing its own view of whether business-risk coverage was, in the abstract, appropriate. "Insurers," the majority concluded, "know how to modify the allocation of risk in CGL policies should they wish to do so."

Second, the majority paid special attention to the standard-form CGL policy's history. By the 1970s, the insurance industry was enjoying the benefits of higher premiums paid by policyholders wanting to add an endorsement that extended their CGL coverage to damage

arising out of the work of their subcontractors. In 1986, this endorsement was added directly to the body of the standard-form CGL policy, leading one court to conclude that the 1986 revision "was specifically designed to provide general contractors with at least some insurance coverage for damage caused by the faulty workmanship of their subcontractors." *Greystone Constr. v. Nat'l Fire & Marine Ins. Co.,* 661 F.3d 1271, 1287 (10th Cir. 2011).

The dissenting opinion illustrates, with particular clarity, what was at stake in this case. Iowa precedent had previously defined "accident" as "a *sudden* and unexpected event." Under the "sudden" analysis, defective workmanship could only lead to a covered "occurrence" "*if and when* there is a sudden and unexpected event resulting in damage to a third party, rather than to the poorly constructed building itself." And so, the gradual water seepage at issue for the policyholder here would not have been covered. But this reasoning would lead to a troubling state of affairs for policyholders concerned about managing their risk, as the following example (offered by the dissent) illustrates:

> If a defectively installed balcony collapses and injures a passerby who sues the building, that strikes me as a covered occurrence under a liability policy. But a property owner who sues the building to replace a sagging balcony before it collapses does not allege an occurrence covered under the builder's CGL policy.

The majority's holding, therefore, by rejecting the former definition of "accident," affords protection to policyholders for defective workmanship *before* those defects cause potentially catastrophic damage to third parties.

Final Thoughts

It is difficult to overstate this case's significance. First, it allows coverage for defective workmanship when the result is damage to the property itself. This in and of itself is a significant development for policyholders. But, second, it expands the definition of "accident" from "a *sudden*, unexpected event" to "an unexpected and unintended event." CGL policies subject to Iowa law now cover both "sudden" occurrences (e.g., fires caused by faulty wiring or explosions caused by improperly installed gas lines) and for more gradual damages that obtain over time (e.g., leaks, crumbling masonry, and shifting foundations) and are caused by defective workmanship.

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