

STATE OF SOUTH CAROLINA)
)
COUNTY OF HORRY)
)
HARLEYSVILLE GROUP INSURANCE,)
A PENNSYLVANIA CORPORATION)

Plaintiff,)

VS.)

HERITAGE COMMUNITIES, INC, A)
SOUTH CAROLINA CORPORATION;)
HERITAGE MAGNOLIA NORTH, INC.)
A SOUTH CAROLINACORPORATION;)
BUILDSTAR CORPORATION, A)
SOUTH CAROLINA CORPORATION,)
MAGNOLIA NORTH HORIZONTAL)
PROPERTY REGIME, MAGNOLIA)
NORTH PROPERTY OWNERS)
ASSOCIATION, INC. A SOUTH)
CAROLINA CORPORATION and)
NATIONAL SURETY CORP.)

Defendants)

IN THE COURT OF COMMON PLEAS
FIFTEENTH JUDICIAL CIRCUIT
CASE NO. 2009-CP-26-11862

HORRY COUNTY
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HELEN HIGGINS - WARD
CLERK OF COURT

ORDER

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SC Court of Appeals

This is a declaratory judgment action to determine coverage under Commercial General Liability ("CGL") policies issued by the Plaintiff, Harleysville Group Insurance, a Pennsylvania Corporation ("Harleysville"). This case arises out of a construction defect action ("underlying action") which was tried to a jury verdict. Because of the common parties, issues and policies, this case was consolidated with the *Riverwalk at Arrowhead Country Club Property Owners' Assoc., Inc. vs. Heritage Communities, Inc. et al* and the *Tony L. Pope, et al vs. Heritage Communities, Inc., et al* cases for which a separate order will be issued. This case was referred to me as Special Referee by the Honorable Larry B. Hyman, Jr., Presiding Judge, Fifteenth



Circuit by Order dated October 21, 2010. The Order directs that I take testimony and evidence and issue an Order disposing of this action, with finality, with all rights to appeal reserved.

Although the judgment in the underlying case is under appeal and has not finally concluded, there is a justifiable controversy and this case is ripe. Owners v. Rhodes, 385 S.C. 83, 682 S.E.2d 857 (Ct. App. 2009); Owners Ins. Co. v. Clayton, 364 S.C. 555, 557, 614 S.E.2d 611, 612-13 (2005). The Court would note that the “judgment holder” in this action stands in the shoes of the Harleysville insureds. Lee v. Gulf Ins. Co., 248 S.C. 296, 149 S.E.2d 639 (1966)(“an injured party who brings suit against a liability carrier in order to collect on a judgment previously acquired against an insured is possessed of all rights of the insured and subject to all defenses that exist as between the insured and the insurance carrier”).

Harleysville is represented by Robert C. Calamari, Esquire, formerly of the firm of McAngus, Goudelock & Courie, LLC, now of Nelson Mullins Riley and Scarborough; the “judgment holder”, Magnolia North Property Owners Association, Inc. is represented by John P. Henry, Esquire, and Philip C. Thompson, Esquire, of the firm of Thompson & Henry, P.A. National Surety Corporation is represented by Laura Johnson Evans of the firm of Smith, Moore, Leatherwood, LLP and Karin McCarthy of the firm of Rivkin Redler, Attorneys at Law of New York. Issues relating to this party are being addressed in a separate Order. “Harleysville’s insureds”, Heritage Communities, Inc., Heritage Magnolia North, Inc., and Buildstar Corporation did not answer or otherwise appear in this declaratory judgment action, although properly served. The Plaintiff in the underlying cases have stepped into the shoes of the insureds and while the default of the insureds prohibits them, individually, from relitigating any issues involved in these cases, the same does not affect the rights of the Plaintiff’s judgment holders.



THE "UNDERLYING ACTION"

The underlying action is styled Magnolia North Property Owners Association, Inc. v. Heritage Communities, Inc., Heritage Magnolia North, Inc. and Buildstar Corporation (C/A No. 2003-CP-26-3203) ("Magnolia North POA action") and was originally filed on May 28, 2003. After trial by jury on May 20, 2009, the jury returned a general verdict against Heritage Communities, Inc., Heritage Magnolia North and Buildstar Corporation on negligence, breach of warranty and breach of fiduciary duty and awarded \$6,500,000.00 in actual damages and \$2,000,000.00 in punitive damages. (Rec. Ex. 27).¹

The Plaintiff in the underlying action alleged and sought damages for faulty construction and consequential damages from water intrusion arising out of the construction and development of the condominiums. (Rec. Ex. 9).

Prior to the jury trial the underlying Plaintiff settled with numerous subcontractors. It is not contested that all of the work on the project was done by subcontractors. Buildstar, the general contractor, oversaw the construction by the subcontractors on the project.

THE PROJECT

The Magnolia North condominium project is located near Myrtle Beach, South Carolina and is composed of 21 three-story buildings containing 12, 13 or 15 units per building. The Magnolia North buildings were constructed beginning in 1997 and completed in late 2000. Heritage Communities, Inc. was the overall developer; Heritage Magnolia North, Inc. was the site specific developer that owned the land and conveyed the condominium units; and Buildstar Corporation was the general contractor.

¹ A set-off of \$1,531,063.15 from the total verdict of \$8,500,000.00 was granted by the trial judge in his post trial motion order making the total verdict \$6,968,936.85 as of November 16, 2009.

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THE HARLEYSVILLE POLICIES

Harleysville issued numerous CGL primary policies and excess policies to the Harleysville insureds and a list of those policies with policy periods, policy amounts and the remaining amounts left on the policies has been marked as Rec. Ex. 17. Although there were numerous policies, all of the policies were standard "ISO" Insurance Service Organization and Commercial General Liability ("CGL") policies with the same pertinent language in each policy. (Rec. Ex. 12).


The primary policies issued by Harleysville to its insureds contain the standard ISO insuring agreement as follows:

1. "Insuring Agreement

a. We will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. However, we will have no duty to defend the insured against any 'suit' seeking damages for 'bodily injury' or 'property damage' to which this insurance does not apply. We may at our discretion, investigate any 'occurrence' and settle any claim or "suit" that may result. But:

- (1) The amount we will pay for damages is limited as described in LIMITS OF INSURANCE (SECTION III); and
- (2) Our right and duty to defend ends when we have used up the applicable limit of insurance in the payment of judgments or settlements under Coverages A or B or medical expenses under Coverage C.

No other obligation or liability to pay sums or perform acts or services is covered unless explicitly provided for under SUPPLEMENTARY PAYMENTS - COVERAGES AND B.

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b. This insurance applies to 'bodily injury' and 'property damage' only if:

- (1) The 'bodily injury' or 'property damage' is caused by an "occurrence" that takes place in the "coverage territory"; and
- (2) The 'bodily injury' or 'property damage' occurs during the policy period."

All of the policies define "occurrence" as an accident, including continuous or repeated exposure to substantially the same general harmful conditions. Both the primary and excess policies provided completed operations coverage.

Harleysville also issued Commercial Umbrella Liability policies with substantially the same insuring agreement as the primary policy:

1. "INSURING AGREEMENT

We will pay on behalf of the insured the 'ultimate net loss' in excess of the 'applicable underlying limit' which the insured becomes legally obligated to pay as damages because of:

- a. 'Bodily injury' or 'property damage' covered by this policy and caused by an 'occurrence' which occurs during the policy period: or
- b. 'personal injury' or 'advertising injury' covered by this policy and caused by an 'offense' committed during the policy period.

This insurance applies anywhere in the world."

All of the excess policies also define "occurrence" as an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

The Exclusions in each of the Harleysville policies are the same.

FINDINGS OF FACTS²


Based on the record before the Court, the Court makes the following findings of facts applicable to the underlying action:

² References to the Record are not intended to be all inclusive.

1. Magnolia North Property Owners Association, Inc. is a South Carolina Corporation which governs the Magnolia North condominiums in accordance with the South Carolina Horizontal Property Act.
2. The Harleysville insureds who were defendants in the Magnolia North POA action were Heritage Communities, Inc., Heritage Magnolia North, Inc., and Buildstar Corporation. Heritage Communities, Inc. was the overall developer. Heritage Magnolia North, Inc. was the site specific developer and owned the land upon which the Magnolia North condominiums were constructed and conveyed the condominium units to the individual owners. Buildstar Corporation was the general contractor which oversaw the subcontractors. (Rec. Hardister, pp. 13644-45). The trial court amalgamated the Harleysville insureds.
3. The Plaintiffs in the underlying action sought compensation for faulty workmanship and for negligent construction resulting from damage to other property (building components) from continuous and repeated water intrusion. (Rec. Ex. 9).
4. Buildstar Corporation did not provide any construction. The construction was all performed by subcontractors. (Rec. Hardister, pp. 13585-86).
5. The buildings at Magnolia North were composed of 21 multi-story buildings containing 12, 13, or 15 units per building.
6. Complete copies of all the policies issued by Harleysville to the Harleysville insureds are included in Rec. Ex. 12. A listing of the policies with the

policy periods, face amount of the policies and amounts of available coverage remaining on each of the policies is set forth on Rec. Ex. 17.

7. The Harleysville CGL policies were basically the same policies for both primary and excess coverage and prototype forms are included in Lee Wright's deposition. (Rec. Ex.19)
8. The Harleysville policies listed on Rec. Ex. 17 provide sufficient coverage to indemnify the Harleysville insureds for the judgments rendered in the underlying action should the Court find coverage and, thus, the National Surety Corp. policies would not be triggered.
9. There are no endorsements in any of the Harleysville policies that would adversely affect coverage issues in this action. (Rec. Ex. 11, p. 12243).
10. In the Magnolia North project the first building permit was issued April 16, 1997 and the last Certificate of Occupancy was issued in late 2000. (Rec. Ex. 10, Buric Report).
11. For each building at Magnolia North, the construction began shortly after the building permit was issued and the buildings were completed at or about the time the Certificates of Occupancy were issued.
12. Harleysville insureds expected their subcontractors to be reliable and skilled in their trade and did not expect their subcontractors to perform negligently. (Rec. Hardister, pp. 13639-13640).
13. Harleysville Insureds relied on the skill of their subcontractors and expected and intended them to perform their work in a competent manner. (Rec. Hardister, p. 13638).

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14. Heritage intended their buildings to be quality condominiums. (Rec. Hardister, 13640-41).
15. There were numerous deficiencies in the subcontractor's work including but not limited to: 1) inappropriate installation of flashing or omission of flashing; 2) inappropriate application of sealants or omission of sealants; 3) installation of defective windows some of which leaked; 4) installation of a trim product that turned out to be defective allowing water intrusion; 5) inappropriate attachment of handrails in that the screws attaching the handrails accidentally penetrated the waterproofing on the decks at some locations allowing water intrusion and damage. All of these deficiencies allowed for continuous moisture intrusion resulting in substantial water damage to the condominiums exterior framing and sheathing which was previously undamaged. (Rec. Ex. 10).
16. The continuous moisture intrusion from the faulty workmanship also damaged the interior of the units including sheetrock, drapes and carpeting. (Rec. Hearing 12/9/11, pp. 13966-67).
17. The county inspected the buildings' components including the sheathing and issued a Certificate of Occupancy which required all the building components to meet code.
18. There is no evidence that sheathing, framing, insulation and interior finishes were defective when they were damaged by water seeping into the buildings and units.
19. The repair of the damage from water intrusion will require the removal and replacement of defective and non-defective building components.




20. Progressive damages from water intrusion began to occur at each building thirty (30) days from the time the Certificate of Occupancy was issued and continued thereafter.
21. Some of the deficiencies were latent defects. (Rec. Buric Report, Ex. 10).
22. Not all buildings had the same defects or quantities of defects.
23. There is no evidence in the record to indicate the Harleysville insureds realized that the Louisiana Pacific trim was a defective product. (Rec. Hardister, p. 13641). The defective and improperly installed trim allowed water intrusion which caused damage to other building components. (Rec. Buric Report, pp. 13640-41).
24. The Harleysville insureds neither expected nor intended that the work of the subcontractors be performed negligently nor did they expect or intend water intrusion or damage would result from the negligent construction.
25. The Harleysville insureds did not expect or intend that a defective product be installed on the buildings such as the Louisiana Pacific trim and did not expect or intend there to be water intrusion and damage from the defective product. (Rec. Hardister, pp. 13640-41).
26. The Harleysville insureds did not expect or intend the subcontractors to install defective windows in the buildings. Harleysville insureds intended its subcontractors to install non-defective windows and changed window manufacturers in an attempt to accomplish this. (Rec. Buric Report, Ex. 10; Rec. Ex. 24; Rec. Hearing 12/13/10, Lee Wright, p. 12841-42).

27. The Harleysville insureds did not expect or intend that the walkway railings would be installed by its subcontractors so as to cause a breach of the waterproofing membrane exposing the framing, sheathing and units to continuous and repeated exposure to water intrusion and rot. (Rec. Ex. 6, pp. 6036-37).
28. The Harleysville insureds did not expect or intend the continuous and repeated water intrusion and deterioration of the buildings due to the negligent construction or the application of defective windows and Louisiana Pacific Trim installed by the subcontractors.
29. Some of the construction defects were latent defects and the record does not provide any evidence that the Harleysville insureds were even aware of some of the defects or that some of the defects were exposing the buildings to continuous and repeated water intrusion causing rot and deterioration of the buildings. (Rec. Buric Report, Ex. 10).
30. The Harleysville insureds did not expect or intend the negligent installation of or omission of building components by its subcontractors or expect or intend the buildings would be exposed to repeated and continuous moisture intrusion causing property damage.
31. Viewing the evidence from the standpoint of the insureds, the continuous moisture intrusion into the condominium buildings and resulting damage was an unexpected happening or event not intended by the Harleysville insureds, in other words an "accident" involving continuous or repeated exposure to the same general harmful conditions.

32. Harleysville issued reservation of rights letters to some of its insureds. (Rec. Ex. 15).
33. Harleysville evidently inadvertently omitted issuing a reservation of rights letter to Buildstar Corporation in the underlying action and, thus, such letter was not a part of Ex. 15. (Rec. Hearing 12/13/10, p. 13828).
34. Harleysville employed defense counsel for the Harleysville insureds and controlled the defense of the insureds in the underlying action. (Rec. Hearing 12/13/10, pp. 13833-34).
35. Harleysville's Reservation of Rights letters were general in nature and set out the provisions of the policies Harleysville thought may affect coverage. Coverage was questioned but not denied. (Rec. Ex. 15).
36. The Reservation of Rights letters did not advise Harleysville's insureds of the conflict of interest or the need for an allocated verdict. (Rec. Ex. 15).
37. Harleysville orally advised the insureds that there was no coverage because the claims did not meet the definition of "occurrence" as opposed to coverage being excluded by one of the policy exclusions. (Rec. Hearing 12/13/10, p. 13829-30).
38. After the reservation of rights letters were sent, Harleysville never modified them but continued advising their insureds there appeared to be no coverage because there was no "occurrence" (Rec. Hearing 12/13/10, pp. 13828-29).
39. Harleysville advised its insureds that if Harleysville intervened it would "create" a conflict of interest so they would wait until after the verdict to litigate coverage. (Rec. Hearing 12/13/10, p. 13829).

40. Harleysville did not detail to its insureds which exclusion if any would preclude coverage because Harleysville did not believe there was an "occurrence" so there was no need to discuss exclusions. (Rec. Hearing 12/13/10, pp. 13830-31).
41. Harleysville advised the insureds personal counsel that there was not likely going to be coverage for a "grand majority" of these damages. (Rec. Hearing 12/13/10, p. 13758).
42. Harleysville advised its insureds that the decision on coverage would be made after the verdict. (Rec. Hearing 12/13/10, p. 13832).
43. Harleysville's representatives including Harleysville's personal counsel attended the trial of the underlying action and discussed the progress of the case with defense counsel. (Rec. Hearing 12/13/10, p. 13836).
44. Harleysville was aware of the coverage issues but based on its understanding of the law and the fact, chose not to discuss the need for an allocated verdict with its insureds and the consequences that an unallocated verdict may cause. (Rec. Hearing 12/13/10, p. 13835).
45. Harleysville made a conscious decision not to intervene in the underlying action and took no action to seek an allocated verdict by informing the trial Court of the need for an allocated verdict or by submitting special interrogatories for the Court's consideration for submission to the jury. (Rec. Hearing 12/13/10, pp. 13835, 13856).



LEGAL ISSUES TO BE RESOLVED

In this declaratory judgment action the court has before it for resolution the following issues:

1. The threshold question to be resolved is: was there an “occurrence(s)” with resulting “property damage” that occurred during the policy period and triggered coverage under the Harleysville policies?
2. If there was an “occurrence(s)” causing “property damage” that triggered coverage, do any of the exclusions advanced by Harleysville preclude indemnification of the Harleysville insureds?
3. In the underlying action the jury reached general verdicts after submission to them of more than one cause of action and numerous claims. If the Court determines that covered claims and non-covered claims were submitted to the jury, can the Court look behind the general verdicts and allocate the damages between covered and non-covered claims?
4. Is the award of punitive damages in the underlying action covered and not excluded by the Harleysville policies?
5. Did Harleysville reserve its rights to contest coverage?
6. Is it possible for the Court to perform a “time on the risk” analysis or do the general verdicts preclude such an analysis?

DISCUSSIONS AND FINDINGS OF LAW

OCCURRENCE.

Harleysville argues that the judgment in the underlying action is not covered by the CGL policy. Specifically, Harleysville argues that the subcontractor’s negligent application of

building components did not cause an “accident” constituting an “occurrence” subject to coverage under their policies. As in Newman, infra, and Crossmann, infra, the Harleysville policies are standard CGL Insurance Services Office (ISO) policies used since 1996. (Rec. Ex. 6). These policies provide that Harleysville will “pay those sums which the insured becomes legally obligated to pay as damages because of ‘bodily injury’ or ‘property damage’ to which this insurance applies”. The policy also requires that the “bodily injury” or “property damage” be caused by an “occurrence”. It defines “occurrence” as an “accident” “including continuous or repeated exposure to substantially the same general harmful conditions.” “Property damage” is defined as “physical injury to tangible property including all resulting loss of use of that property.” The policy does not define “accident”.

The pleadings below alleged both negligent construction and use of defective products and alleged damage to parts of the buildings caused by water seeping into the buildings as the result of the negligent construction. (Rec. Ex. 4). The complaint was not simply a claim for faulty workmanship seeking damages for the repair and replacement of defective construction itself, but rather was also a claim for “property damage” resulting from the negligent construction. The Court finds that the underlying Complaint properly alleged negligent construction that resulted in an “occurrence” rather than an occurrence of alleged negligent construction. Here, the record reveals there was “property damage” beyond that of the work product itself caused by a subcontractor and therefore I find that the homeowners’ claims are not merely for faulty workmanship typically excluded under a CGL policy.³

The two recent cases of Auto Owners v. Newman, 385 S.C. 187, 684 S.E.2d 541 (2009), “Newman”, and Crossmann Communities of North Carolina, Inc., v. Beazer Homes Investment

³ According to the testimony of the experts hired by the POA and Harleysville insureds, the subcontractors’ application of flashing, sealants, windows and decks did not meet code or industry standards and resulted in water seeping into the buildings causing rot and deterioration of building components.

Corp., et al., 395 S.C. 40, 717 S.E.2d 589 (2011), "Crossmann", resolved the long standing and much litigated issue of what constitutes an "occurrence" that would trigger coverage in the context of construction defect litigation under the 1996 ISO CGL policy. The Court in Crossmann held that the expanded definition of "occurrence" to include "continuous or repeated exposure to substantially the same general harmful conditions" leaves the Court with an ambiguity which must be construed against the insurer and in favor of the insured. As in Crossmann, this Court finds that there were allegations of negligent construction causing continuous and repeated exposure to moisture intrusion resulting in "property damage" as defined by the Harleysville policy. Although the subcontractors' negligence in installing the various components of the building does not on its own constitute an "occurrence", the Court finds that the continuous moisture intrusion resulting from the subcontractors' negligence is an "occurrence" and is "property damage" as those terms are defined by the Harleysville policies.⁴ As the Court will discuss below, I find that the continuous moisture intrusion into the condominium buildings was an "unexpected happening or event" not intended by the Harleysville insureds, in other words "an accident" – involving "continuous or repeated exposure to substantially the same general harmful conditions." Accordingly, I find that the subcontractors' negligence resulted in an "occurrence" falling within the Harleysville policies' initial grant of coverage for the resulting "property damage" to the non-defective sheathing, insulation, framing, interior finishes and other non-defective building components of the condominiums, unless excluded as discussed below. Newman, Crossmann.

The Court in Crossmann analyzed the coverage issue not only from the "occurrence" standpoint as it did in Newman, but also from the standpoint of "property damage" as that term is

⁴ High Country Associates v. Hampshire Ins. Co., 139 N. H. 39, 648 A.2d (474 (1994))("Occurrence' has a broader meaning than 'accident' because occurrence includes an injurious exposure to continuing conditions as well as a discreet event." Citation Omitted). *Id.* at p. 44

defined in the policy. The Court said that the term “property damage” required “physical injury” which suggests that the property was not defective at the outset. Therefore, the Crossmann Court held that a claim for the costs of repairing or removing defective work, which is not a claim for “property damage” is not covered by the CGL policy while a claim for the costs of repairing damage caused by the defective work is a claim for “property damage” which may be covered by the CGL policy, unless excluded.⁵

Harleysville contends that because of the numerous and repeated defects in this project, there was no “accident” and coverage is precluded. Harleysville does not define “accident” in its policy. Our Court has, however, defined “accident” as “[a]n unexpected happening or event which occurs by chance, and usually suddenly with harmful results, not intended or designed by the person suffering the harm or hurt.” Newman, Id. at p. 192. [*Emphasis supplied*]. Our Courts have made it clear that an accident does not require a sudden happening. Boggs v. Aetna Cas. & Surety Co., 272 S.C. 460, 252 S.E.2d 565 (1979)(“The phrase “injurious exposure to conditions” incorporated in the policy definition of “occurrence” indicates that an occurrence need not be sudden but may be produced over a period of time”).

From the evidence presented, the Court finds that the continuous moisture intrusion into the Magnolia North buildings was an unexpected happening or event causing “property damage”, in other words an “accident”- involving “continuous or repeated exposure to substantially the same harmful conditions” which triggered coverage under the Harleysville policies.

Based on the record, I find that the non-defective building components damaged by the continuous and repeated water intrusion constitutes “property damage” which was caused by an

⁵ The Court in Crossmann did not discuss exclusions since the parties stipulated that policy exclusions would not be raised.

“occurrence” and falls within the initial grant of coverage under the Harleysville policies. I further find that the negligently installed building components themselves would fall outside the grant of coverage by the Harleysville policies. Also, I find that the costs to remove defective building components to access the water damage would not be covered under the Harleysville policies. However, as discussed below, since there were covered claims and non-covered claims submitted to the jury and a general verdict was rendered, Harleysville must indemnify its insureds for the full amount of the final judgment, (reduced by “time –on-the-risk” analysis as discussed, *infra.*) unless the court finds that the covered claims are excluded.

EXCLUSIONS

Insurance policy exclusions are construed most strongly against the insurance company, which also has the burden of establishing the exclusion’s applicability. Owners Insurance Co., v. Clayton, 364 SC 555, 614 S.E.2d 611 (2005). Since the jury in the underlying action returned a general verdict, a finding that a claim submitted to the jury is covered and not excluded answers the coverage question, *ie.*, the entire verdict is covered. Owners, supra. (Discussed *infra.*)

Harleysville through its answers to interrogatories (Rec. Ex. 14), its pre-trial brief, and through the testimony of Lee Wright, Harleysville’s construction litigation specialist, advances a number of policy exclusions it contends apply to exclude coverage. The following are exclusions advanced by Harleysville which will be discussed below:⁶

Exclusion “a” Expected or Intended Injury;

Exclusion “J-1” Property Damage to Property You Own Rent or Occupy;

Exclusion “J-5” Performing Operations;

Exclusion “J-6” Your Work Incorrectly Performed;

Exclusion “k” Damage to Your Product;

⁶ The numbering or lettering of the exclusions may vary among the various policies.

Exclusion "m" Impaired Property.

A. **Exclusion "a"- Expected or Intended Injury**

"Bodily injury" or "property damage" expected or intended from the standpoint of the insured.⁷ This exclusion does not apply to the "bodily injury" resulting from the use of reasonable force to protect persons or property.

As noted above, the Harleysville insureds did not perform any of the construction. Their function was to oversee the subcontractors that were performing the construction. In Newman, the homeowner sued the contractor ("Trinity") alleging that the application of stucco to their home violated the building code and industry standards and these anomalies caused water to seep into the home and damage the home's exterior sheathing and framing. The stucco work was done by a subcontractor and the alleged defects were similar or identical to the defective work alleged in the underlying case here. Auto Owners claimed that the "expected or intended" exclusion precluded coverage because "a construction professional would expect substantial moisture intrusion from defective stucco to result in these type damages." *Id.* at p. 197. In rejecting this contention, the court stated:

"In our opinion, and in the absence of any evidence otherwise, it is unreasonable to believe that Trinity expected or intended its subcontractor to perform negligently. Therefore Trinity could not have expected or intended the resulting property damage. CF. Lamar Homes v. Mid-Continent Cas. Co., 242 SW 3d 1, 8 (Tx. 2007)('But a deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly') *Id.* at p. 197.

⁷ Note that the exclusion expressly provides that it is the injury or damage which must not be intended.

The Court then must examine the record to determine if the Harleysville insureds “expected or intended” its subcontractors to act negligently and expected or intended the resulting property damage.

South Carolina applies a two pronged subjective test in determining the applicability of this exclusion. First, the act causing the damage must be expected or intended by the insured and second, the resulting damage must be expected or intended from the standpoint of the insured. Vermont Mutual Insurance Co., v. Singleton By and Through Singleton, 316 S.C. 5, 446 S.E.2d 417 (1994); Manufacturers and Merchants Mutual Inc. Co. v. Harvey, 330 S.C., 152 498 S.E.2d 222 (S.C. 1998). In South Carolina Farm Bureau Mut. Ins. Co. v. Dawsey, 371 S.C. 353 638 S.E.2d 103 (S.C. App. 2006)(Certiorari Denied), the Court pointed out that the terms “intend” and “expect” are often defined synonymously.

The question then before the Court is did Harleysville’s insureds not only expect or intend their subcontractor to perform negligently which caused the damage complained of, but did they also expect or intend the resulting damages to the condominiums? Harleysville’s construction litigation manager, Lee Wright explained the proof he believed necessary for exclusion “a” to be applicable:

“On the, on, on the exclusion, you have to prove that – well, intent is, is, difficult to prove in any, in any sense. It’s a more subjective argument, that you’d have to climb inside somebody’s head and prove that, you know, that there is a reason to believe that they either expected or intended or intended this.”⁸
(Rec. p. 1372, 11 6-19).

Mr. Wright also testified that he had no evidence that the insureds “consciously intended to create a situation that water damage would occur, I don’t have that.” (Rec. p. 13839). The record is replete with numerous deficiencies that were repeated but this is tempered by the fact

⁸ This is clearly in accord with South Carolina law.



that there were 21 buildings containing 12, 13 or 15 units per building. However, for exclusion "a" to apply there must be evidence viewed from the standpoint of the insured that the insured subjectively intended its subcontractors to perform negligently and subjectively intended the resulting damages. The evidence in this record does not support such a finding. In neither the underlying action nor this action was Roger Van Wie called as a witness. Mr. Van Wie, a principal in all the insureds, was intimately involved in the construction. However, officers of the Harleysville insureds were called to testify in the underlying action.

Gwyn Hardister, Chief Operating Officer of Heritage Communities, Inc., the overall developer, testified. He testified that Heritage hired subcontractors thought to be skilled in their trade. (Rec. Video, Tr. pp.13640-41). He also testified that they were not knowingly using products that were defective. (Rec. Video, pp. 13640-41). Mr. Hardister testified that Heritage had no intent to harm the homeowners; that Heritage rectified the construction deficiencies. (Rec. video p. 13643); and that Heritage attempted to lean to the side of the homeowners. (Rec. Video, p. 13643).

Harleysville emphasizes the leaking window issues as negating the existence of an accident. During construction the Harleysville insureds claimed the Betterbilt windows were defective and leaked. Betterbilt claimed the method of installation caused the leaks. James Graham, a Betterbilt representative, testified by deposition (Rec. Ex. 24) that he warned Heritage the windows were being installed in a defective manner. The subcontractor continued installing the windows the same way because the Harleysville insureds were convinced that the windows were defective and the source of the leaks and changed to another manufacturer. This was clearly a dispute between the builder and the manufacturer as to the source of the problem. Post construction tests revealed that leaks occurred both from defective windows and the



method of installation. City of Johnstown N.Y. v. Bankers Standard Ins. Co., 877 Fd.2d. 1146, 1150, 1151 (2nd Cir. N.Y. 1989)(It is not enough that an insured was warned that damages might ensue from its actions or insured decided to take a calculated risk. It is only when the insured knew that damages would flow from his acts that coverage is precluded because the damages are not accidental). It is clear from the record that Heritage was attempting to find the source of the leaks and stop them.

The record reveals defects and installation of a defective product with no proof showing that the Heritage insureds were even aware of, such as the defective Louisiana Pacific trim which caused extensive damages to the buildings.⁹ The fact that there were numerous defects is not determinative. It is the intent, not the foreseeability that determines the application of exclusion "a". Continental Western Ins. Co. v. Toal, 309 Minn. 169, 244 N.W.2d 121 (Minn. 1976)(defining expected injury as a foreseeable injury would have the effect of unduly limiting coverage because foreseeability is an essential element of negligence and therefore would exclude injuries even from simple negligence). This "foreseeability" test was rejected in Newman and the Court will not apply it here.

Harleysville contends that the award of punitive damages is strong evidence that their insureds intended to cause damages. This same position was advanced by the insurance company in Pennsylvania Thresherman & Farmer's Mutual Casualty Ins. Co. v. Thornton, 244 F.2d 823 (C.A. 4 1957).¹⁰ Applying South Carolina law, the court rejected the carrier's position holding that:

"Negligent conduct may be so gross so as to merit characterization as willful and wanton in the sense of the rule for punitive damages, yet fall far short of an assault and battery which would distinguish it from an

⁹ Acceptance Ins. Co. v. American Safety Risk Retention Group, Inc., 2011 WL 3475305 (S.D. Cal. 2011)(In determining what knowledge of insured was, construction defects must be analyzed separately).

¹⁰ This case is cited in Carroway v. Johnson, *supra*.

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accidental event and withdraw it from the coverage of the policy...to allow the appellant's argument would lead to the illogical and indefensible result that...the more extreme the recklessness the more likely the insurer would be to escape liability." *Id.* at p. 827.

The Court went on to hold that no matter how reckless the respondent's conduct, there was nothing in the record to establish the insured intended to injure the plaintiff. Likewise in the case at bar there is nothing in the record that indicates the insureds intended to injure the plaintiffs or intended its subcontractors to perform negligently.

In addition, two causes of action were submitted to the jury, negligence and breach of fiduciary duty, both of which would support punitive damages. Unfortunately, Harleysville chose not to attempt to intervene and special interrogatories were not submitted to determine the basis upon which the jury awarded exemplary damages. The Court cannot now speculate. The Court would also note that a finding of intent to harm is not required for an award of punitive damages. Anderson v. Atlantic Coast Line R. Co., 179 S.C. 367, 184 S.E. 164 (1936)(to authorize recovery of punitive damages, an intentional act with a purpose to do wrong to a person is not necessary; reckless disregard of the rights of others is sufficient to authorize such damages. It is not necessary for punitive damages that the Defendant had a specific intent to injure Plaintiff); Hicks v. McCandlish, 221 S.C. 410, 70 S.E.2d 629 (1952)(punitive damages allowed when wrongdoer does not actually realize that he is invading the rights of another). The Court finds this argument unpersuasive. ¹¹

This Court finds as a matter of law that there is insufficient evidence to conclude that the Harleysville insureds expected or intended their subcontractors to perform negligently and

¹¹ American Family Mutual Inc. Co. v. Pacchetti, 808 SW2d. 369 (Mo. 1991)(Finding that insured acted recklessly does not compel a finding that injury was intentional. If coverage were to turn on jury's finding whether insured acted negligently or recklessly, insurance would be of scant value); Koch Engineering Co, Inc. Gilbralter Cas. Co, Inc., 78 F. 3rd 1291 (C.A. 8 Mo. 1996)(Finding recklessness is not the equivalent of a finding that insured intended the conduct. This case involved a failure to properly design a filtration system).

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expected or intended the property damage that resulted from the negligent construction. The Court finds as a matter of law Harleysville did not meet its burden of proof that exclusion “a” precludes coverage.

B. Exclusion “J-1” – Property You Own Rent or Occupy

This exclusion is intended to carve out coverage that would normally be afforded under a property policy. Bruner & O’Connor Construction Law 11:96 (2010); C.O. Falter, Inc. v. Crum and Forster Ins. Companies, 79 Misc. 2d 981, 361 N.Y.S. 2d 968 (N.Y. Sup. 1974)(this exclusion did not preclude coverage where insured contractor relinquished key to building upon completion of work); Mid-Continent Cas. Co. v. JPH Development, Inc., 557 F.3d. 207 (5th Cir. Tex. 2009). (Exclusion “J” does not apply to damage that occurs after construction is completed).

In a 1979 publication by the Insurance Services Office (ISO), the drafter of exclusion “j”, the ISO explained its intent for this exclusion as follows:

“It is intended that property manufactured or purchased by the insureds and constructed or installed at premises not owned by the insured shall be considered property owned by the insured until the construction or installation is accepted by the owner. (Insurance Services Office, Inc., Circular No. General Liability GL 79-12, (Broad form property damage coverage explained) January 29, 1979).
[Emphasis Supplied].

Although it is apparent that some damage from water intrusion (although unspecified) may have begun while construction was being performed, it is also clear damages were occurring after the units were completed and sold. There is no quantification of these damages in the record, nor can there be since there was a general verdict and Harleysville did not seek an allocation of damages. The Court finds as a matter of law that the evidence does not support

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the application of this exclusion “J(1)” and even if it did, the exclusion would be a partial exclusion and thus would not aid Harleysville because of the general verdict. Owners, supra.

C. Exclusion “J(5)”

That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations if the “property damage” arises out of those operations;

This exclusion, known as the “Performing Operations Exclusion” only applies to the work that is being actively worked on at the instant the property damage occurs. Assurance Co. of America v. Admiral Ins. Co., 2011 WL 1897589, (S.D. Ala. 2011)(Exclusion “J(5)” applies only to the property damage that occurs while the contractor and/or subcontractor is performing work); Thomas v. Nautilus Ins. Co., 2011 WL 4369519 (D. Mon. 2011)(This “J(5)” exclusion only applies to bar coverage to property on which the insured or any subcontractors “are performing operations”).

Again, there is no quantification of damages occurring during the time Buildstar’s subcontractors were performing work (“Operations”) at the projects. Even if there were such proof it would exclude only a portion, if any, of the damages which would not aid Harleysville because of the general verdict. I find as a matter of law, that Harleysville has not discharged its burden of proof that exclusion “J(5)” applies to exclude coverage of the judgment in the underlying action.

D. Exclusion “J(6)”

That particular part of any property that must be restored, repaired or replaced because of “your work” was incorrectly performed on it.

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Paragraph (6) of this exclusion does not apply to the “property damage” included in the products completed operations hazard.

This exclusion is one of the “business risk” exclusions and may apply to exclude Plaintiff’s claims except for the last paragraph providing that “J(6)” does not apply to property included in the products completed operations hazard.¹²

The Harleysville policies provide completed operations hazard coverage. Since the Harleysville Insureds had completed operations hazard coverage, exclusion “(J)(6)” cannot apply to damage occurring after the insureds work is completed. Century Indemnity Co. v. Golden Hills Builders, Inc., 348 S.C. 559, 561 S.E.2d 355 (2002); Exclusion “J6” applies to damages that occur during construction due to faulty workmanship. Mid-Continent Cas. Co. v. JPH Development, Inc., *supra*.

Harleysville has failed to discharge its burden of proof as to this exclusion’s applicability and I find as a matter of law Exclusion “J(6)” does not apply.

E. Exclusion “k” - Damage to Your Product

“Property damage to “your product” arising out of it or any part of it”.

This exclusion cannot apply because the policy defines “your product” as “a. any goods or products other than real property manufactured, sold and/or distributed or disposed of by you...” Since “your product” does not include real property, the exclusion cannot apply to the condominiums at Magnolia North. In addition, “goods or products” do not include services, such as the work of contractors and developers. Fireguard Sprinkler Systems, Inc. v. Scottsdale Ins. Co., 864 F.2d 648, 654 (9th Cir. Or. 1988); Scottsdale Ins. Co., v. Tri-State Ins. Co. of MN, 302 F. Supp 2d. 1100 (D.N.D 2004)(“Real Property” was deleted from the definition of

¹² The policies define “Products-Completed Operations Hazard” “a. Includes all...property damage occurring away from the premises you own or rent and arising out of...’your work’ except;...(2) work that has not been completed or abandoned.



“Product” in the 1996 CGL policy “clarifying that work on homes, buildings, or other structures is not considered to be the insureds “product”) [citation omitted]. The Court concludes as a matter of law that exclusion “k” does not apply.

F. Exclusion “m” - Damage to Impaired Property or Property not Physically Injured

“Property Damage” to “impaired property” or property that has not been physically injured arising out of:

- (1) a defect, deficiency, inadequacy 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 a sudden and accidental physical injury to “your product” or “your work” after it has been put to its intended use.

“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:
 - a. The repair, replacement, adjustment or removal of “your product” or your work; or
 - b. Your fulfilling the terms of the contract or agreement.

[Emphasis Supplied.]

This exclusion is commonly called the “impaired property” exclusion. Our courts have not addressed the impaired property exclusion under the facts and circumstances present in this action. The exclusion contains numerous terms that are defined in the CGL policies and the policy definitions must be applied when determining the applicability of exclusion “m”. The



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exclusion is complex and difficult to understand. It has been found to be ambiguous. Serigne v. Wildey, 612 So.2d 155 (La. App. 5th Cir. 1992).

If the loss involves damage by work performed by the insured or its subcontractors (and thus falls outside of the definition of “impaired property”) or involves physical injury to tangible property, the exclusion will often be found not to apply...” *Bruner & O’Connor Construction Law*, Sec. 11:106, p. 4. The definition of “impaired property” requires that the tangible property whose use has been lost cannot be “your product” or “your work”. Thus damage to “your product” or “your work” cannot qualify. *Insurance Coverage of Construction Disputes*, 2nd Edition, Sec. 26:7.

In these cases, the condominiums are not “impaired property” because they are the work of the Harleysville insureds and are therefore “your work” which falls outside of the policy definition of “impaired property”. Therefore, exclusion “m” cannot apply. C.J.S.U.B., Inc. v. U.S. Fire Ins. Co., 906 So.2d 303, 311 (Fla. App. 2 Dist. 2005)(“impaired property” exclusion does not apply because defective homes are undeniably the builder’s work as “your work” is defined in the C.G.L policy.”)(Decision approved 979 So.2d 871 (Fla. 2007); Auto Owners Ins. Co. v. NewMech Companies, Inc., 678 N.W.2d 477 (Minn. App. 2004)(work was performed on behalf of the developer and is thus “your work” which does not come within the definition of “impaired property”). Durbrow v. Mike Check Builders, Inc., 442 F. Supp. 2d. 676, 684 (E.D. Wis. 2006)(the only damage at issue is damage caused by the insured’s builder’s work, which does not come within the definition of “impaired property” since it is the builder’s work). Accordingly, “m(1)” of the impaired property exclusion does not apply.

The second part of exclusion “m” includes failure to perform a contract in accordance with its terms. This exclusion by its terms excludes contract claims. In this case, the allegations



and proof were in tort in that the insureds violated applicable building codes and industry standards. Kennedy v. Columbia Lumber and Mfg. Co., Inc., 299 S.C. 335, 384 S.E.2d 730 (1989)(violation of a building code violates a legal duty for which a builder can be held liable in tort).

The Court finds as a matter of law that exclusion "m" does not exclude coverage for the final underlying judgment.

As a result of the Court's findings that there was an "occurrence(s)" causing "property damage", and none of the exclusions advanced by Harleysville excluded all coverage, the Court finds as a matter of law that there were covered claims submitted to the jury and since there was a general verdict, that answers the coverage question, *ie*, Harleysville must indemnify the Harleysville Insureds for the entire final judgments rendered in the underlying action. Owners, supra.

GENERAL VERDICT

The Court has determined as discussed above that both covered claims and non-covered claims and various causes of action were submitted to the jury in the underlying action which reached a general verdict. Harleysville offered evidence in an attempt to allocate the general verdict between covered and non-covered claims. The judgment holders objected on two grounds:

1. Since there was a general verdict any attempt at allocation would be speculative and;
2. The testimony would be irrelevant under Rules 401 & 402, *SCRE*.

Although I sustained the objection, I allowed Harleysville to proffer the testimony. Harleysville offered F.E. Baiden, a general contractor, to proffer evidence of an estimate that he performed



to completely repair the Magnolia North buildings. He then segregated that portion of his estimate which constituted cost to repair damage from water intrusion which under Newman and Crossmann would constitute "covered damages". He then took the percentage of the covered damages contained in his estimate and multiplied it times the jury's verdict to arrive at an amount representing damages from water intrusion. Mr. Baiden admitted that his estimate does not correlate or correspond with the underlying jury award (Rec. Tr. p. 13909). His estimate was based on labor rates and material costs current in 2010. (Rec. Tr. p. 13901). Plaintiff's estimate submitted at trial was based upon an investigation and scope of work prepared much earlier. Mr. Baiden's testimony would be irrelevant and speculative under Rule 401 & 402 *SCRE*, and therefore inadmissible even if the Court allowed Harleysville to attempt an allocation of the general verdict. This attempt at a re-litigation of damages was addressed in Newman.

Newman was a declaratory judgment action to determine if an arbitration award was covered under a CGL policy. Both covered claims and non-covered claims had been submitted to the arbitrator. The arbitrator issued a general award and did not allocate damages between covered and non-covered claims. The Court held that because the arbitrator did not allocate damages, Auto Owners would be liable for the entire award. Strikingly, the Court had this to say:

Nevertheless, it is not possible from the record before this Court to determine what portion of the arbitrator's itemized list of damages may be attributed to the removal and replacement of the defective stucco, and it is not the purpose of this declaratory judgment action to relitigate the issue of damages. Auto-Owners had an opportunity to raise this matter [allocation of damages between covered and non-covered damages] when the issue of damages was litigated before the arbitrator, who issued a final, binding award on the merits. FN5 (citation omitted).

Id. at p. 198.



FN5. Auto-Owners represented Trinity in binding arbitration, made mandatory by the terms of the insurance contract. Auto-Owners did so with a reservation of rights and an understanding that the coverage issue would be reserved for judicial consideration in a separate proceeding. When the arbitrator determined damages, Auto-Owners did not seek review of or otherwise contest the damages award.

Id. at p. 198.

The Court refused to allow Auto Owners to re-litigate damages as have other courts.¹³ This Court likewise will not allow Harleysville to re-litigate the damages for to do so would be a clear invasion of the province of the jury. Lorick S. Lowrance, Inc. v. Julius H. Walsh, Co., 153 S.C. 309, 319, 150 S.E. 789 792(1929)(“The law rather forbids this Court assuming to take upon itself the powers, duties, rights and privileges of a jury”). Anderson v. Aetna Cas. Sur. Co., 175 S.C. 254, 282, 178 S.E.819, 829 (1934)(“Obviously, the absolute power to change or modify the findings of the jury upon an issue of fact properly submitted to them would when exercised, amount to the substitution of the trial judge’s findings for the verdict of the jury and to the abrogation in such cases of the right of trial by jury”. *Id.* at p. 283). As the Court said in S.C. State Hwy. Dept. v. Miller, 237 S.C. 386, 117 S.E.2d 561 (1960). “A verdict is the product of the minds of twelve men, and to a certain extent...frequently represents a result which no individual member of the panel would have reached in the first instance if free to follow his own judgment.” *Id.* at p. 395.

In the underlying action, Harleysville undertook the defense of its insureds and hired attorneys to defend its insureds as it was required to do under the terms of its policies. Harleysville represented some of the insureds under a reservation of rights with an

¹³ Herrera v. American Standard Ins. Co., 203 Neb. 477, 279 N.W.2d 140 (1979)(Where numerous types of damages were submitted and defendant did not request an allocated verdict, the defendant at this late date will not be allowed to relitigate damages).



understanding that coverage issues would be reserved for judicial consideration in a separate proceeding. (Rec. Tr. pp. 13832, 13835-36). Harleysville's representatives and its legal counsel attended the trial (Rec. Tr. p. 13836) and were in contact both pre-trial and at trial with the trial counsel Harleysville employed to represent its insureds. (Rec. Tr. pp. 13833-34). Harleysville made the decision not file a motion to intervene or otherwise seek an allocated verdict as it could have done under Rules 24 and 49, *SCRPC*. (Rec. Tr. p. 13835). Harleysville never explained to its insureds the need for an allocated verdict and the potentially devastating consequences of an unallocated verdict. (Rec. Tr. 13835-36). Nor did Harleysville explain to its insureds the divergence of interest (conflict) between it and its insureds. (Rec. Tr. 13839). Harleysville's representative conceded at trial that it is now impossible to determine how the jury allocated damages. (Rec. Ex. 11, p. 12245, Wright Depo); The Court will not engage in speculation.¹⁴

Harleysville contends, in part, that it made the decision not to intervene because at the time of the trial the law on CGL coverage was in a state of flux and an intervention would have

¹⁴ Jenkins v. Few, 391 S.C. 209, 705 S.E.2d 457 (S.C. App. 2010)(Defendant contributed to drafting general verdict form and general verdict makes it impossible to determine how the jury allocated damages. The Court will not speculate on how the jury allocated damages.);

Moore v. Moore, 360 S.C. 241, 599 S.E.2d 467 (S.C. App. 2004)("since the jury returned a general verdict and appellant did not request the trial court to submit a special verdict form to determine the type of damages rendered by the jury, the Court cannot speculate as to what portion of the award the jury attributed to lost profits as opposed to other tort damages");

Armstrong v. Collins, 366 S.C. 204, 621 S.E.2d 368 (S.C. App. 2005)(the jury's verdict was declared a general verdict by the trial Court and because the verdict was a general verdict we cannot now speculate as to how the jury allocated damages");

Pearson v. Bridges, 344 S.C. 366, 544 S.E.2d 617 (2001)(since the jury returned a general verdict and the Defendant never requested a special verdict form separating the elements of damage, there is no way of knowing now how the jury allocated damages);

Harry L. Hussmann Refrigerator & Supply Co. v. Cash & Carry Grocer, 134 S.C. 191, 132 S.E.173 (1926)(since the Defendant's counsel made no attempt to find out what the jury intended, the Court cannot now clarify the jury's verdict).

Owners Ins. Co., v. Clayton, 364 SC 555, 614 S.E.2d 611 (2005)(Where covered claims were submitted to the jury which reached a general verdict, a finding that any of the three claims submitted to the jury is not excluded answers the coverage question, i.e., the carrier must pay the entire general verdict).

put Harleysville in a direct conflict with its insureds. Harleysville had advised its insureds that the claims in the underlying action may not be covered because the cases said there was no "occurrence". (Rec. Tr. pp. 13829-30). Harleysville relied on its assessment and sat silent when the forms of the verdict were being drafted and submitted to the jury. Harleysville cannot now use its own miscalculation to prejudice the rights of the insureds. Tadlock Painting Co. v. Maryland Casualty Co., 322 S.C. 498, 473 S.E.2d 52 (1996)("There is an implied covenant of good faith and fair dealing that neither party, insurer or insured, will do anything to impair the other's rights to receive benefits under the contract"). Our Courts have long recognized that when the insurer undertakes to represent its insured, it must subordinate its interests to those of its insureds. Tyger River Pine Co. v. Maryland Cas. Co., 170 S.C. 286, 170 S.E. 346 (1933) is apposite. In Tyger River, *supra*, the Court rejected the Kentucky rule that an insurance company in processing a claim may look to its own interest as well as interests of the insured stating that:

We especially dissent from the language of the [Kentucky] opinion which we have italicized. The very thing which the appellant in the case which we have before us for determination undertook to do was to hold the respondent harmless in the disposition of Chesser's claim. If, in the effort to do this, its own interest conflicted with those of respondent, it was bound, under its contract of indemnity, and in good faith, *to sacrifice its interest in favor of those of the respondent*. If the Kentucky rule is the law, then a policy of indemnity such as is before us becomes a delusion and a snare. In the nature of things when there is a conflict of interests – as is inevitably the case in all such matters-the company will give the preference to its own. [*Emphasis by the Court*].

For the protection of its interests the casualty company especially reserved the right to control and direct the matter of negotiations for settlement and compromise, and of the defense of the action if litigation ensued. The plaintiff was directly deprived of a voice or part in such negotiations and defense. If the rule of the Kentucky case shall prevail, the indemnity companies may well felicitate themselves, for they are in a position to say to the insured, 'Heads I win, tails you lose.'"

Id. at p. 348.



As the Court said in Newman, it is the insurer's responsibility, who is in control of the litigation, to make sure there is an allocated verdict. Harleysville must sacrifice its interests in favor of the insureds. Courts throughout the country have determined likewise.

The following, taken from the case of Magnum Foods, Inc. v. Continental Cas. Co., 36 F.3d 1491 (10th Cir. Oak. 1994), is worth quoting:

As an initial matter, we note that an insurer who undertakes the defense of a suit against its insured must meet a high standard of conduct. Duke v. Hoch, 468 F.2d 973, 978, (5th Cir. 1972); Gay & Taylor, Inc. v. St. Paul Fire & Marine Ins. Co., 550 F. Supp. 710, 714-16 (W.D.Okla.1981). The right to control the litigation carries with it certain duties. Traders & Gen. Ins. Co. v. Rudco Oil & Gas Co., 129 F.2d 621, 627 (10th Cir.1942). One of these is the duty not to prejudice the insured's rights by failing to request special interrogatories or a special verdict in order to clarify coverage of damages. See Gay & Taylor, 550 F.Supp. at 716. The reason for this is that when grounds of liability are asserted, some of which are covered by insurance and some of which are not, a conflict of interest arises between the insurer and the insured. If the burden of apportioning damages between covered and non-covered were to rest on the insured, who is not in control of the defense, the insurer could obtain for itself an escape from responsibility merely by failing to request a special verdict or special interrogatories. Duke, 468 F.2d at 979. The insurer is in the best position to see to it that the damages are allocated; therefore, it should be given the incentive to do so. *Id.* at pp. 1498-1499.

Harleysville's failure to attempt to intervene or otherwise seek an allocated verdict cannot now be used to prejudice the rights of its insureds or the rights of the claimants who step into the shoes of the insureds. As the court said in Buckley v. Orem, 112 Idaho 117, 123, 730 P.2d 1037 (Idaho App. 1986):

"...when the insurer sought to limit its liability to the coverage provided by the contract, the insurer was required to show that it had faithfully and fully performed its responsibilities to its insured by disclosing the need for an allocated verdict. The application of this principle has consequences in the secondary action where the



injured party was directly pursuing insurance proceeds through garnishment or other post-trial litigation involving the insurer. This carry over effect occurred because at this secondary stage of the litigation the injured party stands in the shoes of the insured party. Accordingly, the injured party would be able to assert rights the insured would have had against the insurer and the insurer would be able to rely on any defenses which it could have asserted against its insured." *Id.* at p. 124 [*Emphasis Supplied*].

Harleysville relies on Duke v. Hoch, 468 F.2d 973 (C.A.5 1973) for the proposition that the Court should allow it to estimate what part of the unallocated verdicts constitute non-covered claims. In Duke, because the Court directed a verdict on one issue, the insurance carrier was able to carry its burden of showing that the jury allocated damages to a non-covered claim. Duke clearly holds that a post verdict allocation of damages in the coverage context should not even be considered unless and until the insurer meets its burden of showing that the general verdict includes damages for non-covered acts. In the case at bar, that is simply not possible. Here, the Court has no basis upon which to make a logical assessment of the jury's purpose when it awarded the general verdict, and the Court will not engage in unguided speculation with respect to this issue, particularly when the dilemma now confronting Harleysville is of its own making.¹⁵

The Court concludes as a matter of law that because there were covered claims submitted to the jury which were not excluded and the jury rendered a general verdict, Harleysville is precluded from now re-litigating damages. Harleysville must indemnify its insureds for the entire amount of the final judgment in the underlying case.

¹⁵ McCloud v. Roy Riegels Chemicals, 20 Cal. App. 3rd 928, 97 Cal. Repr. 910 (Cal. App. 3d Dist. 1971) (parties should have one chance (by request for special verdict forms) to have the jury's verdict pinpointed. They should not be permitted to drag out litigation by turning their backs on the safeguards provided by the legislature. Where a general verdict was rendered where a special verdict could have been used, it puts the courts in a guessing game as to how the jury traveled to reach its verdict).

PUNITIVE DAMAGES

Harleysville denies that its CGL policies provide coverage for punitive damages "because they are uninsurable as damages under the policies". (Ex. 3 Complaint, p. 7 paragraph "P"). The Court disagrees. Our Courts have long held that a builder who is grossly negligent in the construction of a building is subject to punitive damages. Kennedy v. Columbia Lumber and Mfg. Co., Inc., 299 S.C. 335, 384 S.E.2d 730 (1989).

Some Courts have found that the "all sums" and "damages" language in the CGL policy is ambiguous which requires the ambiguity to be construed against the insurer and in favor of coverage. United Services Auto Ass'n. v. Webb, 235 Va. 655, 369 S.E.2d 196 (1988). Other Courts such as South Carolina have found punitive damages recoverable under the plain language of the CGL policy. Carroway v. Johnson, 245 S.C. 200, 205, 139 S.E.2d 908, 910 (1965)(stated by the Court to be the majority rule); S.C. State Budget & Control Board Division of General Services v. Prince, 304 S.C. 241, 403 S.E.2d 643 (1991)(the term "all sums" requires the construction of the policy to include coverage for punitive damages).

In Carroway v. Johnson, *supra*, the Court was faced with the coverage of punitive damages under the identical language contained in the Harleysville policies. The insuring agreement in the Carroway policy provided the carrier agreed:

"to pay on behalf of the insured **all sums** which the insured shall become legally obligated to pay as damages because of"
Id. at p. 202.

The Court held that the average insured would contemplate punitive damages would be covered under the CGL policy, stating: "with this view the majority of Courts have agreed, and have imposed liability upon the insurer even though the recovery was based upon willful or wanton

conduct...” *Id* at p. 205. The Court concluded the language in the policy was broad enough to include liability for punitive damages.¹⁶

The Supreme Court examined this same issue in South Carolina State Budget and Control Board v. Prince, *supra*, wherein the court was once again faced with the identical language contained in the Harleysville policies:

“The fund will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages.”
[*Emphasis supplied*]. *Id.* at p. 648. (citing Carroway, *supra.*)

The Court pointed out that the policy does not define “damages” and does not limit recovery to “actual damages”. The Court held that this broad language must be interpreted to include punitive damages.¹⁷

Harleysville agreed to indemnify its insureds for “all sums” its insureds become legally obligated to pay. Punitive damages are not excluded by the language of the policy. If insurers intend to preclude coverage of an item, it is incumbent upon them to include clear language accomplishing that result. Crossmann, *supra*. Harleysville could have simply added the word “compensatory” before the word “damages” if it had intended to exclude punitive damages. United Services Automobile Assn. v. Webb, *Id.* at p. 204. (“The insurance carrier could have inserted the word ‘compensatory’ before the word ‘damages’, or specifically excluded liability for punitive damages elsewhere in the policy, and resolved the ambiguity but it did not. Therefore we construe the ambiguity, against the insurance company and in favor of coverage”).

¹⁶ Harleysville’s representative, Lee Wright testified that if the claim met the requirements of the insuring agreement there is nothing in the policy that says Harleysville will not pay punitive damages. “There is not a punitive damages exclusion in the policy” (Rec. Ex. 11, Lee Wright depo. p. 12245).

¹⁷ Fluke Corp. v. Hartford Acc. & Indemnity Co., 102 Wash. App. 237, 7 P.3d. 825 (2000)(Trial Court was in error in interpreting the policy to include only “compensatory damages”. We elect to follow the majority rule that the terms of the policy “all sums that the insured becomes legally obligated to pay as damages” will be interpreted to provide coverage for punitive damages).[Citing among other cases South Carolina State Budget and Control Board v. Prince., *supra.*]



Harleysville advances the position that the jury's award of punitive damages is tantamount to a finding of intentional conduct which would exclude coverage for punitive damages. This same position was advanced by the insurance company in Pennsylvania Thresherman & Farmer's Mutual Casualty Ins. Co. v. Thornton, 244 F.2d 823 (C.A. 4 1957).¹⁸

Applying South Carolina law, the court rejected the carrier's position holding that:

"Negligent conduct may be so gross so as to merit characterization as willful and wanton in the sense of the rule for punitive damages, yet fall far short of an assault and battery which would distinguish it from an accidental event and withdraw it from the coverage of the policy...to allow the appellant's argument would lead to the illogical and indefensible result that...the more extreme the recklessness the more likely the insurer would be to escape liability." *Id.* at p. 827.

The Court went on to hold that no matter how reckless the respondent's conduct, there was nothing in the record that the insured intended to injure the plaintiff.

Likewise in the case at bar there is nothing in the record that the insureds intended to injure the plaintiff.

Despite the contrary arguments by Harleysville, the Court concludes that punitive damages are covered under the Harleysville policies and Harleysville must indemnify its insureds for any punitive damages in the final judgment.

RESERVATION OF RIGHTS

Magnolia North POA contends that Harleysville did not issue a reservation of rights letter ("R/R/L") to Buildstar, the general contractor. Magnolia North POA also contends that the R/R/Ls issued to Heritage Communities, Inc. and Heritage Magnolia North, Inc. were insufficient to reserve its rights to contest coverage. This issue was raised by the parties in both the pleadings and discovery and was thoroughly explored in the testimony at trial.

¹⁸ This case is cited in Carroway v. Johnson, *supra*.

A. FAILURE TO ISSUE R/R/L TO BUILDSTAR.

Lee Wright, construction Litigation Specialist for Harleysville, testified that he believed a R/R/L was sent to Buildstar but could not find one. (Rec. Tr. p. 13745). Harleysville produced no copy of the letter or other proof that one had been sent. While it may have been an inadvertent oversight, the Court concludes that Harleysville never sent a letter reserving its rights as to Buildstar.

Harleysville, however contends that its discussions with principals of its insureds were sufficient to reserve its rights because the same principals were in all three of its insureds and Harleysville's representatives had conversations with the principals and their attorney about coverage issues, ergo., their insureds including Buildstar understood and agreed that coverage issues would be reserved post litigation. The Court disagrees.

As noted in the findings of facts, Harleysville issued general reservation of rights letters to Heritage Communities and Heritage Magnolia North and never supplemented them to advise their insureds of their specific policy defenses even though Harleysville recognized that facts arise during litigation that may or may not affect coverage. (Rec. Tr. p. 12234). In fact, although Harleysville set forth practically all of its policy exclusions, Harleysville advised its insureds that it was relying on Harleysville's interpretation of the law that there was no "occurrence" as that term is defined under the policy and therefore there was no need to even consider exclusions. (Rec. Tr. pp. 13829-31). Now that there is a judgment against its insureds, Harleysville has decided that there are four exclusions that may be applicable. (See Harleysville's Amended Answers to Interrogatories dated Oct. 15, 2010, interrogatory No. 37.). There is no South Carolina law that details what a properly written R/R/L must contain.



However, several commentators have discussed the purpose of a R/R/L and the minimum such a letter should contain.

PURPOSE

1. “[t]he purpose of reservation of rights letters is to enable insureds to make informed decisions as to whether they should because of the existence of conflicts of interest between themselves and their insurers, take some action in order to protect their interests.” Allan D. Windt, *Insurance Claims & Disputes: Representation of Insurance Companies & Insureds* § 2.14 (5th ed.2007).

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2. “The insurer must avoid ambiguity, since any ambiguity in the reservation of rights will be resolved against the insurer.” Goodman & Jacobs § 8.9. To avoid ambiguity, certain elements should be included in a reservation of rights letter, including (i) specific identification of the policy at issue; (ii) a description of the claims or allegations in the complaint, including details of the facts known at that time (iii) citation and quotation of each policy provision forming the basis of the insurer’s coverage defenses, including an explanation of why each provision could cause denial of coverage; (iv) a specific reservation of the insurer’s right to change its coverage position and to assert defenses based on any of the policy provisions, even if not specifically set forth in the letter; (v) a detailed explanation of the claim investigation that will be undertaken to determine the insurer’s ultimate coverage decision and when that decision should be expected; and (vi) an advisement of any issues that actually or potentially give rise to a conflict of interest between the insurer and insured. See Peter Kalis, et al., *Policyholder’s Guide to the Law of Insurance Coverage* § 24.04 (1998 & Supp.2007); Jerold Oshinsky & Theodore A. Howard, *Practitioner’s Guide to the Law of Insurance Coverage* § 205 (2ⁿ ed.1198 & Supp.2007); Goodman & Jacobs § 8.9.

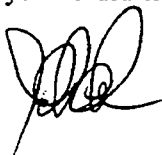
As to the timing of a reservation of rights letter, once the insurer determines that it has a duty to defend, it should send the letter “prior to assuming the insured’s defense, or within a reasonable time thereafter.” Windt § 2.14; see Oshinsky &



Howard § 205 (“there are two basic requirements for reservations of rights and disclaimers of coverage: (1) they must be given in a timely fashion; and (2) they must be made with specificity”). Sometimes an insurer may need additional time to analyze the existence of coverage and thus it may send a general reservation of rights letter; however, the insurer must then supplement the reservation of rights letter as soon as it learns of its specific defenses, Windt § 2.14.

The Harleysville R/R/Ls fall far short of these requirements. The R/R/L does not explain why each provision or exclusion would cause a denial of coverage; does not contain a detailed explanation of the claim investigation that will be undertaken to determine the insurer’s ultimate coverage decision and when that decision could be expected; and does not set forth issues that actually or potentially could give rise to a conflict of interest. Harleysville’s R/R/Ls fail in specificity and Harleysville never supplemented its letters to detail their specific defenses and importantly, Harleysville never advised its insureds of the need for an allocated verdict and the devastating consequences a general verdict may cause.

Although the Court could find no legal precedent in South Carolina for an oral reservation of rights, it is generally frowned upon because it can lend itself to ambiguity and is at odds with the very purpose behind a R/R/L – that is, to inform the insured in a timely manner specifically what the policy defenses are so that the insureds can take appropriate action to protect their own interest due to a conflict of interest with the insurer. Oshinsky & Howard § 205; Windt § 2.14; Goodman & Jacobs § 8.9. An oral reservation is likely to generate a dispute as to what was said and lead to exactly the kind of expensive and protracted litigation Magnolia North is now experiencing. Even if an oral reservation is allowed under South Carolina jurisprudence, when viewing the facts in the light most favorable to Harleysville, the oral communications by Lee Wright fall short of the specificity and are ambiguous at best. On the one hand he was advising the insureds Harleysville did not believe anything was covered



(Rec. Tr. p. 13827), and on the other hand he was advising them that the "grand majority" of the claims were not covered. This exemplifies the need for a written and specific reservation of rights.

Providing timely and specific policy defenses and disclosing actual or potential conflicts are important fiduciary duties of the insurer especially when, as here, Harleysville is controlling the defense of its insured.

The Court concludes as a matter of law that Harleysville failed to properly reserve its rights to dispute coverage not only as to Buildstar, but also as to Heritage Communities, Inc and Heritage Magnolia North, Inc. The Court further finds that this action clearly prejudiced the Harleysville insureds and can be raised by Magnolia North. *Lee, supra*. The Court further finds that Harleysville's actions constitute an implied waiver of Harleysville's right to contest coverage in this action. *Lyles v. MBI, Inc.*, 292 S.C 153, 355 S.E.2d 282 (S.C. App. 1987) (Implied waiver results from acts and conduct of party against whom doctrine is invoked from which an intentional relinquishment of right is reasonably inferable).

Although the Court has already concluded that Harleysville has a duty to indemnify the insureds, this issue was fully litigated and the Court felt it appropriate to address the issue.

TIME ON THE RISK

Harleysville has asked this Court to apply a time-on-the risk analysis to the damages if the Court finds that there are damages covered by the Harleysville policies. As noted above, I have determined that the judgment rendered in the underlying action is covered by the Harleysville policies. However, I find as a matter of law that the "time-on-the-risk" analysis recently adopted by the Supreme Court in *Crossmann, supra*, should be applied to the actual damages awarded of \$4,968,937.02 (verdict with set-off and less the \$2,000,000 punitive



damages). I find that the "time-on-the-risk" analysis should not be applied to the punitive damages.

In the recent Crossmann, *supra*, case the court had before it the question of how to equitably allocate damages among successive insurance policies when the damages were "progressive" damages that occurred over several policy periods or uninsured periods. The parties stipulated that the damages resulted from water intrusion (and were all progressive damages) and the time the damages began and progressed. The parties in Crossmann, *supra*, also stipulated that either "time-on-the-risk" analysis or "joint-and-several" analysis would apply to those progressive damages. The Supreme Court adopted a time-on-the-risk analysis. The Court instructed that in cases where progressive damages have occurred over a number of successive policy periods so that it is impossible both scientifically and administratively to determine the amount of damages occurring in each policy period, a default method is to be employed. The default method would require the total amount of progressive damage to be divided by the number of policy periods to determine the approximate amount of damages in each policy period. If there were periods in which the insured did not provide insurance the insured would absorb the amount of damages occurring during the uninsured periods. I find that it is appropriate for the Court to apply a time-on-the-risk analysis to the general verdict pursuant to Crossmann, *supra*. In order to accomplish this I must determine when damages began to occur and an ending date of those damages for the purpose of this analysis.

Drew Brown, expert for the underlying Plaintiffs testified that damages began 30 days following the Certificate of Occupancy. The first Certificate of Occupancy was issued December 10, 1998 so the damages began on January 10, 1999. The last time that anyone went out to look at that property in connection with the Buric Report was May 5, 2004. I find that the



damages were advanced enough that they needed repair and/or replacement and that the passage of additional time, while it may have made something even less sound, it did not change the point in time that they needed repair and/or replacement. Accordingly, I find that there were 1,943 days in which these damages occurred and had reached a point where all of the repairs and/or replacements would have needed to be made. The Court is not going to attempt to compute damages using a per building Certificate of Occupancy date. The verdict rendered in this case was a general verdict and, thus, made no award based on damages for a particular building, but awarded damages as to the whole project. Using a per building Certificate of Occupancy would, in essence, require the Court to allocate damages and would be speculative, at best. The Court concludes that in applying "Time-on-the-Risk" to these facts, the most equitable way to proceed is by comparing the total number of days in which damage occurred to the entire project to the total number of days of coverage under the Harleysville policies.

Harleysville had coverage on January 10, 1999 when the damage began and I find that this coverage for Magnolia North continued until November 30, 2000 which are the dates of coverage put into evidence in the 2010 hearing and in the 2011 hearing. I find that Harleysville, therefore, had coverage for Magnolia North for a period of 691 days. In using the numerator and denominator in the Crossmann case, this creates a multiplier of .3556 which is used to multiply the general verdict. Using this multiplier, Harleysville will be responsible for only a part of the general verdict as follows:

MAGNOLIA NORTH PROPERTY OWNERS ASSOCIATION

\$4,968,937.02	actual damages after set-off and less punitive damages
x .3556	multiplier as determined above
\$ 1,766,954	actual damages after applying "time-on-the-risk"



\$ 2,000,000 punitive damages added back
\$ 2,766,954 amount covered by Harleysville policies

CONCLUSION

IT IS HEREBY ORDERED AS FOLLOWS:

- A. I find and conclude that there were "occurrences" with resulting "property damage" which occurred during the policy period and which triggered coverage for the Association's claim for actual and punitive damages;
- B. I find and conclude that the exclusions advanced by Harleysville do not exclude coverage for the claims made in the underlying action by the Association;
- C. I find and conclude that the general verdict rendered in the underlying action preclude the Court from looking behind the general verdict in an attempt to allocate damages between covered and non-covered damages. I further find and conclude that covered claims and non-covered claims were submitted to the jury and since there was a general verdict, the entire amounts awarded by the jury in the underlying actions are covered by the Harleysville policies;
- D. I find and conclude that it is appropriate to perform a time-on-the-risk analysis to the actual damages in the underlying action but that it would not be appropriate to apply the time-on-the-risk analysis to the punitive damages awarded to the association. Applying the time-on-the-risk analysis to the actual damages awarded to the Association, Harleysville would have coverage for actual damages awarded the Association in the amount of One Million Seven Hundred Sixty-Six Thousand Nine Hundred Fifty-Four and 00/100



(~~\$~~ 1,766,954.00) Dollars as calculated on page forty-three (43) above.

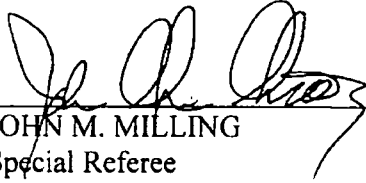
Harleysville would also have coverage for punitive damages awarded the Association in the amount of Two Million and 00/100 (\$ 2,000,000.00) Dollars.

- E. I find and conclude that punitive damages are not excluded from the Harleysville policies and are covered under the terms of the Harleysville policies;
- F. I find and conclude that Harleysville did not properly reserve its right to contest coverage for the claims made by the Association;
- G. I find and conclude that the Association is entitled to judgment against Harleysville for actual damages in the amount of One Million Seven Hundred Sixty-Six Thousand Nine Hundred Fifty-Four and 00/100 (\$ 1,766,954.00) Dollars and punitive damages in the amount of Two Million and 00/100 (\$ 2,000,000.00) Dollars;
- H. I find and conclude that Harleysville's policies here under consideration specifically provide coverage for post-judgment interest and the Association is entitled to judgment for statutory post-judgment interest on the amounts found covered from the date of the order for judgment in the underlying actions;
- I. The Motion by Harleysville to amend or reopen the record is denied;
- J. As noted above, the underlying actions are under appeal. The provisions of this Order are subject to modification if warranted by the final judgment in the underlying actions and this order is without prejudice to the parties to move



pursuant to Rule 60, SCRPC, for the correction of the amount to be indemnified.

AND IT IS SO ORDERED.



JOHN M. MILLING
Special Referee

Darlington, South Carolina.
February 28, 2013.

