

**THE STATE OF SOUTH CAROLINA
In the Supreme Court**

APPEAL FROM CHARLESTON COUNTY
Court of Common Pleas
B. Hicks Harwell, Jr., Circuit Court Judge

Case No. 2002-CP-10-4390

Auto-Owners Insurance Co., Inc.,

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S.C. SUPREME COURT

Appellant,

v.

Virginia T. Newman and Trinity Construction, Inc.,

Respondents.

**BRIEF OF AMICUS CURIAE
COMPLEX INSURANCE CLAIMS LITIGATION ASSOCIATION
IN SUPPORT OF APPELLANT**

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INTRODUCTION

The Complex Insurance Claims Litigation Association (“CICLA”) respectfully submits this brief as amicus curiae in support of appellant Auto-Owners Insurance Company. CICLA represents property and casualty insurance companies that write property and casualty insurance policies around the country, and specifically in South Carolina. CICLA asks this Court to reverse the judgment of the trial court.

To decide whether coverage exists under a liability policy, the policy language requires a determination of (1) whether there has been an occurrence that (2) causes property damage, and (3) whether the resulting loss is otherwise excluded. Under this Court’s prior precedent, it is clear under the terms of the insurance policy that no coverage is provided for the repair or replacement of defective work by a policyholder. In this case, there is no allegation of damage to a third party that has no contractual relationship with the policyholder.

There is no coverage for repair of a policyholder’s defective work because there has been no occurrence. An occurrence requires a fortuitous event, and, in the context of a home builder, defective work is simply a breach of contract. A breach of contract is inherently foreseeable and non-fortuitous.

If the Court were to decide that the policyholder’s own faulty workmanship somehow did constitute an occurrence, it would then have to be determined whether there was resulting property damage. However, property damage is limited to physical injury to property. The damages resulting from a breach of contract are economic losses because they relate entirely to the failure to perform and the cost to

replace or remedy the faulty workmanship. Further, something that was never constructed properly in the first place cannot properly be deemed “damaged.”

Finally, an exclusion to an insurance policy cannot be read to provide coverage that is not otherwise within the initial grant of the policy. In this case, various amici curiae for the policyholder argue that an exception to an exclusion grants the policyholder coverage. This argument ignores the fact that there has been no occurrence causing property damage. Exclusions only limit the coverage that has been initially granted. For example, the “your work” exclusion, exclusion *l*, is not implicated unless there has been damage to a third party that has no contractual relationship to the insured. Because the exclusion has not been implicated, the exception to the exclusion cannot restore coverage.

STATEMENT OF INTEREST

CICLA is a trade association of major property and casualty insurance companies. This brief is filed on behalf of the following CICLA members: AIG Insurance Companies; Arrowpoint Capital Corp. (formerly Royal & SunAlliance); Chubb & Son, a Division of Federal Insurance Company; Liberty Mutual Insurance Company; The Riverstone Group, Inc.; St. Paul Fire and Marine Insurance Company; and Travelers Casualty & Surety Company.

CICLA members provide a substantial percentage of the liability coverage written in South Carolina. CICLA, or its predecessor Insurance Environmental Litigation Association (“IELA”), has participated in numerous cases throughout the country, including several cases before this Court or the Court of Appeals.¹ As a

¹See, e.g., Helena Chem. Co. v. Allianz Underwriters Ins. Co., 357 S.C. 631, 594 S.E.2d 455 (S.C. 2004); Century Indem. Co. v. Golden Hills Builders Inc., 348 S.C.

trade association with a broad outlook on the contract interpretation and public policy considerations before the Court, CICLA is uniquely positioned to address the policyholder's attempts to extend coverage for breaches of contract.

STATEMENT OF ISSUES ON APPEAL

CICLA respectfully adopts the statement of issues on appeal as stated in the Final Brief of Appellant.

STATEMENT OF THE CASE

CICLA respectfully adopts the statement of the case as stated in the Final Brief of Appellant.

STATEMENT OF FACTS

Defendant Virginia T. Newman ("Newman") hired Defendant Trinity Construction, Inc. ("Trinity Construction") to construct a house in Mt. Pleasant, South Carolina. The two parties entered into a contract that stated that Trinity Construction, among other things, would construct the house in a workmanlike manner and according to state and local regulations. The contract allowed the construction company to use subcontractors but also made clear that the construction company would be responsible for delivering the house according to specifications. After a certificate of occupancy was issued for the house on May 28, 1999, Newman hired Robert G. Sisroy, P.E., to inspect the construction of the house and its apparent deficiencies. The Sisroy Report, entitled "Construction Deficiencies Investigation" and dated September 2, 1999, detailed numerous construction defects with the house.

559, 561 S.E.2d 355 (2002); Greenville County v. Ins. Reserve Fund, 131 S.C. 546, 443 S.E.2d 552 (1994); and Harleysville Mut. Ins. Co. v. R.W. Harp & Sons, Inc., 305 S.C. 492, 409 S.E.2d 418 (Ct. App. 1991)

Specifically, the Sisroy report pointed out that the stucco siding on the house was improperly installed by a subcontractor hired by Trinity Construction. This report led Newman to file a complaint against Trinity Construction alleging defective construction of the house, primarily relating to the improperly installed stucco siding. In the complaint, Newman alleged breach of contract, breach of warranty, and negligence against Trinity Construction. The complaint did not allege any damage to property other than the deficiencies in the house itself. Trinity Construction submitted a claim under a general liability policy issued by Auto-Owners Insurance Company. Auto-Owners sent Trinity Construction a reservation of rights letter in regards to coverage and provided counsel to defend Trinity Construction.

Newman and Trinity Construction referred the action to binding arbitration. The arbitrator issued an award in favor of Newman, awarding specified damages per an itemized estimate prepared by an expert hired by Newman. Auto-Owners subsequently filed a declaratory judgment action asking the trial court to declare that the damages awarded to Newman against Trinity Construction were not covered by the Policy. The Honorable B. Hicks Harwell, Jr., after a non-jury trial on October 31, 2005, found that the damages came within the Policy's coverage. This appeal followed.

ARGUMENT

I. COURTS IN SOUTH CAROLINA AND ELSEWHERE AGREE THAT COMMERCIAL GENERAL LIABILITY POLICIES ARE NOT DESIGNED TO PROVIDE COVERAGE FOR DAMAGES ARISING FROM A POLICYHOLDER'S BREACH OF CONTRACT

A. General Liability Policies Are Meant To Cover Tort Liability, Not Breach Of Contract Claims

The basic insuring provision contained in the insurance contract at issue – as in most commercial general liability insurance contracts – provides that an insurer agrees to pay sums which a policyholder becomes “legally obligated to pay as damages because of bodily injury or property damage caused by an occurrence.” This language provides coverage for tort liability, not for damages for breach of contract. See 7a Lee R. Russ & Thomas F. Segalla, Couch on Ins. § 103:19 (3d ed. 1997 & Supp. 2003) (“As policies of liability insurance are designed to cover an insured’s tort liability . . . liability based upon contract is generally excluded from coverage.”).

This fundamental tenet that general liability coverage is for third-party tort, not contract, liability reflects a recognized danger of allowing policyholders to charge the costs of their own contractual breaches to general liability insurers. If courts forced insurers to provide coverage for breach of contract under commercial general liability policies, policyholders would be permitted to breach contracts with impunity, because the breaching party would not bear the cost of its breach. Allowing indemnification for losses arising from breach of contract would externalize the cost of such a breach onto the liability insurer, decreasing the policyholder’s incentive to avoid breaching a contract.

B. This Court's Prior Precedent Establishes That General Liability Policies Do Not Cover Breach Of Contract Claims

South Carolina courts repeatedly have held that breach of contract claims are not covered by commercial general liability policies because breach of contract claims are not "occurrences" within the meaning of a liability policy. See L-J, Inc. v. Bituminous Fire & Marine Ins. Co., 366 S.C. 117, 124, 621 S.E.2d 33, 36 (2005) (stating that the "insurance policy will not stand to cover liability for the [policyholder's] contract liability for a claim that was for money damages to compensate for the defective work"); see also Century Indem. Co. v. Golden Hills Builders, Inc., 348 S.C. 559, 566, 561 S.E.2d 355, 358 (2002) (holding that general liability insurance "is not intended to insure business risks, *i.e.*, risks that are normal, frequent, or predictable consequences of doing business, and which business management can and should control or manage") (citing Rowland H. Long, The Law of Liab. Ins., § 10.01[1] (2001)); Isle of Palms Pest Control Co. v. Monticello Ins. Co., 319 S.C. 12, 16, 459 S.E.2d 318, 320 (Ct. App. 1995) (stating that a "general liability insurance policy typically does not cover claims of faulty workmanship, but instead covers claims of faulty workmanship that causes an accident"), aff'd 321 S.C. 310, 468 S.E.2d 304 (1996); C.D. Walters Constr. Co. v. Fireman's Ins. Co., 281 S.C. 593, 596-97, 316 S.E.2d 703, 712 (Ct. App. 1984) (holding that a general liability policy is not intended to cover business risks, such as faulty workmanship).

In L-J, this Court's most recent decision interpreting a general liability policy and construction defects, the policyholder was hired to build roads for a subdivision. The policyholder then hired subcontractors to do much of the actual construction on the roads. When the roads subsequently deteriorated due to the subcontractors faulty

workmanship, the developer of the subdivision brought suit against the contractor for breach of contract, breach of warranty, and negligence. Id. at 121, 621 S.E.2d at 35. In addressing whether such faulty workmanship constituted an occurrence under a general liability policy, this Court stated that “any liability that is incurred because of faulty workmanship is part of the insured’s contractual liability, not an insurable event under a CGL policy.” Id. at 122, 621 S.E.2d at 35. L-J then further ruled that “because faulty workmanship is not something that is typically caused by an accident or by exposure to the same general harmful conditions, we hold that the damage in this case did not constitute an occurrence.” Id. at 123, 621 S.E.2d at 36.

This Court’s holding in L-J is particularly dispositive here where the facts are strikingly similar. In L-J, the general contractor was contractually responsible for its subcontractors’ work. When the road deteriorated because of the faulty workmanship of the subcontractor, the general contractor breached its contract. This case involves the same situation. The subcontractor allegedly failed to construct the stucco siding of the house competently. Because of the subcontractor’s failure, the general contractor breached its contract. In both cases, there is no third party property damage. The only “damage” incurred is to the general contractor’s overall work product, *i.e.*, the road and the house, respectively.

The policyholder’s reliance on High Country Associates v. New Hampshire Insurance Co., 648 A.2d 474 (N.H. 1994), which this Court cited and distinguished in L-J, is meritless. In High Country Assocs., the New Hampshire Supreme Court held that faulty workmanship in constructing a condominium complex constituted an occurrence where the faulty workmanship led to property damage beyond the

policyholder's work product. Id. at 477. In L-J, this Court recognized the factual distinction in High Country Assocs. where the complaint "alleged negligent construction that resulted in property damage," 648 A.2d at 477, as opposed to L-J where there was "merely negligent construction damaging only the work product itself." L-J, 366 S.C. at 123, 621 S.E.2d at 36. As noted in L-J, the general liability policy may "provide coverage in cases where faulty workmanship causes a third party bodily injury or damage to other property, not in cases where faulty workmanship damages the work product alone." Id. at 123, n.4, 621 S.E.2d at 36, n.4.

In the case at issue here, the policyholder, Trinity Construction, breached its contract to construct a house pursuant to state and local building code by improperly installing the stucco siding. That faulty workmanship damaged the work product alone – namely the house. The general contractor was entirely responsible for the proper building of the house. The underlying complaint does not allege any third party damage. Therefore, there is no accident under which the faulty workmanship could be considered an occurrence.² The policyholder simply breached the construction contract, for which there is no coverage under the general liability policy.

C. Other Courts Have Held that General Liability Policies Do Not Cover The Costs Of Doing Business, Which Includes The Foreseeable Costs Of A Breach Of Contract

Other courts, likewise, agree that a breach of contract alone cannot constitute an occurrence. As this court noted in L-J: "Several different approaches are used in

² In this case, if the improperly installed stucco siding had fallen off the house and injured a person or an object nearby, there could possibly be coverage barring any applicable exclusions.

analyzing the issue, but a majority of the states reach the same conclusion – a CGL policy does not cover faulty workmanship.” Id. at 121 n.3, 621 S.E.2d at 36 n.3. The Court cited to decisions in Florida, Illinois, Louisiana, Maine, Maryland, Michigan, Missouri, New Jersey, and North Carolina. Courts in Colorado, Hawaii, Iowa, Kentucky, Mississippi, Missouri, New York, Ohio, Oregon, Pennsylvania, and Wyoming likewise agree.³ For example, in Kvaerner Metals Division v. Commercial Union Insurance Co., 908 A.2d 888 (Pa. 2006), the Pennsylvania Supreme Court

³ Union Ins. Co. v. Hottenstein, 83 P.3d 1196, 1202 (Colo. Ct. App. 2003) (“We similarly conclude that poor workmanship constituting a breach of contract is not a covered occurrence here and that the policy’s exception to the contract exclusion does not apply.”); Norwalk Ready Mixed Concrete, Inc. v. Travelers Ins. Cos., 246 F.3d 1132, 1137 (8th Cir. 2001) (quoting Central Bearings Co. v. Wolverine Ins. Co., 179 N.W.2d 443, 448 (Iowa 1970)) (“[A] claim characterized essentially as one for a contractor’s defective workmanship in the construction of a foundation, ‘resulting in damages only to the work product itself,’ was not caused by an ‘occurrence’ under Iowa law”); Lenning v. Commercial Union Ins. Co., 260 F.3d 574, 583 (6th Cir. 2001) (applying Kentucky law) (“The majority of courts to consider the issue have concluded that policies do not provide coverage where the damages claimed are the cost of correcting the work itself, even in the context of the broad protections offered by comprehensive general liability (“CGL”) policies.”); ACS Constr. Co. v. CGU, 332 F.3d 885, 891 (5th Cir. 2003) (applying Mississippi law) (“The faulty workmanship of [subcontractors] unfortunately amounts to negligence. Hiring subcontractors and installing the waterproofing membranes were not accidents under the terms of the policy.”); Am. States Ins. Co. v. Mathis, 974 S.W.2d 647, 650 (Mo. Ct. App. 1998). (“Such a breach of a defined contractual duty cannot fall within the term ‘accident.’ Performance of its contract according to the terms specified therein was within [sub-subcontractor’s] control and management and its failure to perform cannot be described as an undesigned or unexpected event.”); Hartford Accident & Indem. Co. v. A.P. Reale & Sons, Inc., 644 N.Y.S.2d 442, 443 (N.Y. App. Div. 1998) (holding that general liability policies do not provide coverage for contractual obligations); Royal Plastics, Inc. v. State Auto. Mut. Ins. Co., 650 N.E.2d 180, 183 (Ohio Ct. App. 1994) (ruling that the damage claimed was damage to the subject of the contract based on improper manufacture and this could not be construed to be an accident which would constitute an occurrence); Oak Crest Constr. Co. v. Austin Mut. Ins. Co., 998 P.2d 1254, 1257 (Or. 2000) (“This court has indicated that there can be no ‘accident,’ within the meaning of a commercial liability policy, when the resulting damage is merely a breach of contract.”) (citing Kisle v. St. Paul Fire & Marine Ins., 495 P.2d 1198 (Or. 1972)).

recently held that faulty workmanship is not considered an accident and, therefore, is not an occurrence. In Kvaerner, the policyholder breached its contract of constructing a coke battery oven for use in metal work by constructing the coke battery oven outside the specifications of the contract, causing damage to parts of the oven the policyholder built. In reaching the conclusion that there was no occurrence where the policyholder breached its contract, the court stated that claims of faulty workmanship “do not present the degree of fortuity contemplated by the ordinary definition of ‘accident’ or its common judicial construction in this context.” Id. at 899.

Another case holding that a breach of contract is not an occurrence is Action Ads, Inc. v. Great American Insurance Co., 685 P.2d 42 (Wyo. 1984), in which the Wyoming Supreme Court held that third-party liability coverage provisions refer “to liability sounding in tort, not in contract.” Id. at 43-44. In that case, the employer was contractually obligated to obtain medical insurance for the plaintiff but failed to do so. In failing to do so, the court held that this was not a liability risk within the policy, but rather a risk that the employer chose “to assume pursuant to contract.” Id. at 45.

The United States Court of Appeals for the Ninth Circuit, applying Hawaii law, held that claims arising out of a contract to build a house do not constitute occurrences. Burlington Ins. Co. v. Oceanic Design & Constr., 383 F.3d 940 (9th Cir. 2004). In that case, the homeowner brought suit against the general contractor, alleging “(1) breach of contract; (2) breach of express and implied warranties; (3) deceptive trade practices; (4) negligent and/or intentional infliction of emotional distress upon homeowner Han; and (5) punitive damages.” Id. at 943. The court

applied Hawaii's interpretation of occurrence, which holds there is no duty to defend or indemnify if "the injury. . . [is] the expected or reasonably foreseeable result of the insured's own intentional acts or omissions." Id. at 947 (quoting Hawaiian Holiday Macadamia Nut Co. v. Indus. Indem. Co., 872 P.2d 230, 234 (Haw. 1994)). The court concluded that there was no occurrence because a breach of contract is a reasonably foreseeable result:

If Oceanic breached its contractual duty by constructing a substandard home, then facing a lawsuit for that breach is a reasonably foreseeable result. . . . Allowing recovery for disputes between parties in a contractual relationship over the quality of work performed would convert this CGL policy into a professional liability policy or a performance bond.

Id. at 948-49 (citation omitted).

Another recent decision, this one by an appellate court of Illinois, also concludes that a construction defect does not constitute an occurrence. Viking Constr. Mgmt., Inc. v. Liberty Mut. Ins. Co., 831 N.E.2d 1 (Ill. App. Ct. 2005). In that case, the policyholder was responsible for constructing a school, and defects in its construction caused a portion of the building to collapse. Id. at 3. The court noted that "there is no 'occurrence when a subcontractor's defective workmanship necessitates removing and repairing work.'" Id. at 6 (quoting R. Franco, Ins. Coverage for Faulty Workmanship Claims Under Commercial Gen. Liab. Policies, 30 Tort & Insurance L.J. 785, 789 (Spring 1995)). The court further stated that a breach of contract cannot be the basis of an occurrence because "it does not result from a fortuitous event." Id. at 7 (citation omitted). The court also noted that, in using shoddy materials or performing a construction contract negligently, the policyholder "takes a calculated business risk that no damage will take place. . . . [and] [t]here can

be no coverage for such damage.” Id. at 7 (quoting J. Yang, No Accident: The Scope of Coverage for Construction Defect Claims, 690 PLI/Lit 7, 36-37 (April 2003)). As succinctly stated by the court, construction defects only constitute an occurrence to the extent there is third party damage: “CGL policies do not cover an occurrence of alleged negligent manufacture; [they] cover [] negligent manufacture that results in an occurrence.” Id. at 12 (citation omitted) (internal quotation marks omitted).

This Court should continue to follow L-J and the decisions of courts in other states. Trinity Construction breached its construction contract for the Newman house by failing to abide by the provisions of the contract that states Trinity Construction must follow applicable building code that will ensure the house was weather resistant. See App.’s Br. 12. When Trinity Construction breached its construction contract by defectively building the Newman house, the claim for the faulty workmanship became one of a breach of contract, not a tort, as the failure to follow the applicable code per the construction contract eliminated the subsequent claim as fortuitous. When a party breaches a contract, fortuity is lacking. Therefore, there was no occurrence here because this faulty workmanship sounds under contract and, hence, is a breach of breach of contract issue.

II. A CONSTRUCTION DEFECT CLAIM CONCERNS ECONOMIC LOSS, NOT PROPERTY DAMAGE

Liability policies provide coverage for the policyholder’s liability arising out of third-party property damage, but not for economic loss. A defective product or defective construction claim which does not allege damage to third-party property is a claim for economic loss. In addition, for something to be “damaged,” it must have

had an undamaged state. In the case of defective construction, there is no undamaged state because the home never was constructed properly in the first place.

South Carolina courts have held that economic loss is not covered by liability policies as property damage. If this Court were to decide there is an occurrence, it would still be necessary to conclude that defective work somehow constitutes property damage in order to invoke coverage under the policy. In the context of claims to repair and replace defective construction, there is no property damage within the terms of the policy.

A. A Construction Defect Claim Without Third-Party Damage Constitutes Economic Loss, Not Property Damage

South Carolina case law consistently has held that economic losses do not constitute property damage. In L-J, this court stated that a general liability policy “is not intended to cover economic loss resulting from faulty workmanship.” 366 S.C. at 121-22, 621 S.E.2d at 35. Similarly, in Isle of Palms, the South Carolina Court of Appeals noted that a “general liability policy is intended to provide coverage for tort liability for physical damage to the property of others; it is not intended to provide coverage for the insured’s contractual liability which causes economic losses.” 319 S.C. at 16, 459 S.E.2d at 320 (while ultimately finding coverage where a termite inspector negligently conducted its inspection leading to property damage, the court commented that had the house had “preexisting termite damage, but no active termite infestation, the [] claim against [the policyholder] would have been one for faulty workmanship resulting in only economic losses,” for which “[t]here would be no possibility of coverage”). Id.

The same doctrine has been applied by many courts in cases where policyholders have sought coverage for construction defects. For example, in Sapp v. State Farm Fire & Casualty Co., 486 S.E.2d 71 (Ga. Ct. App. 1997), the Georgia intermediate appellate court held that the “coverage applicable under the CGL policy is for tort liability for injury to persons and damage to other property[,] and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.” Id. at 75 (quoting Glen Falls Ins. Co. v. Donmac Golf Shaping Co., 417 S.E.2d 197, 201 (Ga. Ct. App. 1992); see also Hartford Accident & Indem. Co. v. A.P. Reale & Sons Inc., 644 N.Y.S.2d 442, 443 (N.Y. App. Div. 1996) (noting that a suit where “the product or completed work is not what the damaged person bargained for” represents a claim for “economic loss” and so is not covered by a liability policy).

The California Court of Appeal also held that a construction defect was not property damage. F&H Constr. v. ITT Hartford Ins. Co., 12 Cal. Rptr. 3d 896 (Cal. Ct. App. 2004). In that case, a subcontractor used poor grade materials, forcing the contractor to reinforce the work of the subcontractor. Id. at 897. The contractor then sought reimbursement for its costs against the subcontractor’s insurer. The court noted that the poor grade materials were inadequate for their purpose, but did not damage any other work performed by the subcontractor. Id. at 898. The court cited, as the “prevailing view” that in order for a construction defect to constitute property damage it must cause damage to “some other part of the system” that was not the subcontractor’s work. Id. at 901 (citation omitted). Because the only damage was the need to reinforce the work of the subcontractor, there was no insured property

damage. See also Viking Constr., 831 N.E.2d at 16-17 (“[W]here the underlying complaint alleges only damages in the nature of repair and replacement of the defective product or construction, such damages constitute economic losses and do not constitute ‘property damage.’”).

Respondent here is not entitled to coverage when the only “damage” it can identify is the defective work for which it is responsible. The water seepage caused by the improperly installed stucco siding has not damaged anything inside the house or, more simply, anything other than the house itself. Thus, the house may be less valuable because a subsequent owner will have to repair that siding – just as a house may be less valuable if a central air conditioning unit has broken down. Both cases involve diminution in value of the house. Neither case involves third-party property damage implicating a liability policy.

B. A Defect In The Policyholder’s Construction Does Not Constitute “Property Damage”

As an independent basis for finding that no coverage exists, this Court also should conclude that there was no property damage precisely because the house was defectively built. A defect cannot constitute property damage because the very idea of damage to third-party property requires that there was third-party property in an undamaged state. Otherwise, the property is merely in the state that it always has been in and cannot be considered damaged.

The Court of Appeals of North Carolina, for instance, has recognized this as a prerequisite to coverage. In a case involving a claim for damages relating to the deficient construction of rubber oven feed lines, that court ruled: “The term ‘property damage’ in an insurance policy has been interpreted to mean damage to property that

was previously undamaged, and not the expense of repairing property or completing a project that was not done correctly or according to contract in the first instance.” Prod. Sys., Inc. v. Amerisure Ins. Co., 605 S.E.2d 663, 666 (N.C. Ct. App. 2004) (emphasis in original); see also Wm. C. Vick Constr. Co. v. Pa. Nat’l Mut., 52 F. Supp. 2d 569, 582 (E.D.N.C. 1999), aff’d sub nom Wm. C. Vick Constr. Co. v. Great Am. Ins. Co., 213 F.3d 634 (4th Cir. 2000).

A claim for repair or replacement because of such a defect is merely a claim that one is not satisfied with the product received, not that it has been damaged. Here, Respondent cannot claim there has been property damage because it never constructed the house in a workmanlike, acceptable manner in the first place.

III. POLICYHOLDERS CANNOT USE EXCLUSIONS TO EXPAND COVERAGE

This Court, and courts around the country, have stated that a policyholder cannot rely on an exclusion to create coverage where none otherwise exists. Simply put, exclusions exclude coverage and do not create coverage. Amici for the policyholder, however, rely upon exclusions, such as exclusion *l*, in an attempt to create coverage that was not otherwise included. This argument has been rejected repeatedly and consistently by courts nationwide, including this one.

In L-J, this Court reversed the lower court’s decision granting coverage in light of exclusion *l* in ruling that there was no coverage under the general liability policy. Id. at 120-22, 621 S.E.2d at 34-35. Specifically, once this Court found that the “occurrence” definition had not been met, it ruled for the insurer: “Because we find that the faulty workmanship does not constitute an ‘occurrence,’ we do not address [the other issues presented, including exclusion *l*] to determine whether the

policy exclusions apply.” *Id.* at 125, 621 S.E.2d at 37. Contrary to the arguments made in the amici’s briefs, the exclusions are not relevant in the absence of an “occurrence.”

A large number of courts across the country have joined with South Carolina and reasoned persuasively that “occurrence” does not include construction defects and construction defects do not constitute “property damage,” even in the face of exclusion *l*. An Oregon Supreme Court case, Oak Crest Construction Co. v. Austin Mutual Insurance Co., 998 P.2d 1254 (Or. 2000), is just one example of many cases that also refused to extend coverage in light of exclusion *l*. The plaintiff in this case was a general contractor that had to remove and replace its subcontractor’s defective painting work. When its commercial liability insurer refused to provide reimbursement costs, the general contractor filed a coverage action, arguing that defective painting work constituted damage arising from an “occurrence,” which the policy defined in part as an “accident.” The insurer countered by asserting that the remediation costs resulted from the subcontractor’s failure to fulfill the terms of a contract, not from an accident. The court ruled in favor of the insurer, noting that the term “‘accident’ has a tortious connotation,” meaning that there must be a breach of a duty of due care. *Id.* at 1257 (internal citation omitted). Absent such a breach, there cannot be an accident.

In addition, the United States Court of Appeals for the Fourth Circuit, applying Virginia law, has recently ruled that exclusion *l* cannot create coverage. Travelers Indem. Co. v. Miller Bldg. Corp., 142 Fed. Appx. 147 (4th Cir. 2005). There, a subcontractor was hired to perform site development and selected defective

fill material. Id. at 148. Virginia law holds that breaches of contract and construction defects do not constitute occurrences. Id. at 149. The policyholder nonetheless contended that exclusion *l* somehow created coverage. The court rebuffed this argument: “Because the damage to the Wal-Mart store was not unexpected and, therefore, not an ‘occurrence,’ and because an exception to an exclusion does not grant or extend coverage, Travelers is not required under this policy to indemnify Miller for Wal-Mart’s damages.” Id. at 150.

The Indiana courts similarly have addressed the subcontractor exception to exclusion *l* and held that, in the case of defective work, there simply is no occurrence and, therefore, no coverage. In R.N. Thompson & Assocs., Inc. v. Monroe Guar. Ins. Co., 686 N.E.2d 160 (Ind. Ct. App. 1997), for example, the damages were the cost to replace and repair defectively designed condominium units. Id. at 161. The Indiana appellate court cited an Indiana Supreme Court decision for the proposition that the business expense of complying with contractual obligations does not constitute property damage. Id. at 162 (citing Ind. Ins. Co. v. DeZutti, 408 N.E.2d 1275, 1279 (Ind. 1980)). The court, therefore, ruled that there was no coverage despite the existence of exclusion *l*. Courts applying the law of Mississippi, Iowa, Illinois, and West Virginia agree.⁴

⁴ ACS Constr. Co., 332 F.3d at 892 (5th Cir. 2003) (applying Mississippi law) (“The exclusionary language in the contract cannot be used to create coverage where none exists.”); Norwalk Ready Mixed Concrete, Inc., 246 F.3d at 1137-38 (applying Iowa law) (ruling that defective construction did not constitute an occurrence, the court finds it unnecessary to address the applicability or inapplicability of the business risk exclusions); Viking Constr., 831 N.E.2d at 3 (holding that there was neither an occurrence nor property damage and noting that exclusion *l* was inapplicable to the current dispute); Erie Ins. Prop. & Cas. Co. v. Pioneer Home Improvement, Inc., 526 S.E.2d 28, 33 (W.Va. 1999) (refusing to apply the “completed operations hazard”

IV. A GENERAL LIABILITY POLICY SHOULD NOT BE TREATED AS A SURETY BOND

This Court, as well as courts in other jurisdictions, has recognized the inappropriateness of providing coverage for claims seeking the repair or replacement of work. L-J, 366 S.C. at 124, 621 S.E.2d at 36 (holding that faulty workmanship is not an occurrence, as “to hold otherwise, [would make] the CGL policy . . . more like a performance bond, which guarantees the work, rather than like an insurance policy”). Public policy does not support treating liability policies as surety arrangements, which is exactly what trial court has done in this case. Such an arrangement would encourage poor work and breaches of contract. This fear of encouraging breaches of contract has prompted some courts to recognize that obligations stemming from contractual relations are not and cannot be insured under third-party liability policies. WDC Venture v. Hartford Accident & Indem. Co., 938 F. Supp. 671, 679 (D. Haw. 1996); see also George A. Fuller Co. v. U.S. Fid. & Guar. Co., 613 N.Y.S.2d 152, 155 (N.Y. App. Div. 1994) (“To interpret the policy as did the IAS court would transform USF & G into a surety for the performance of Fuller’s work. USF & G’s liability policy was never intended to insure Fuller’s work product or Fuller’s compliance, as a general contractor or construction manager, with its contractual obligations.”).

Under a performance bond, in contrast to an insurance policy, the carrier simply serves as a quasi-surety for the faithful performance of the contract. The carrier typically retains the right to seek reimbursement from its bond principal, the

when the policyholder had failed to show that there was an occurrence based on its faulty workmanship).

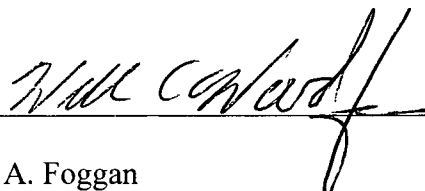
insured. Thus, a performance bond carrier called upon to complete or redo a project has the right to sue its principal for payment of all of the completion expenses incurred by the bond carrier, the insurer. Even a well-known policyholder advocate acknowledges that: “Most construction projects are bonded. The typical surety arrangement in the construction industry requires the contractor – the principal on the surety bond – to indemnify the surety for any losses it pays out by virtue of issuing the particular bond.” Patrick J. Wielinski, Insurance for Defective Construction, Beyond Broad Form Property Damage Coverage, 103 (2000). A liability policy should not be transformed into a performance bond without the personal guarantee that goes with it.

As all of these courts recognize, policy rationales reinforce what the plain language of the contracts require: that defective construction constituting a breach of contract does not constitute an “occurrence” or insured third-party “property damage.”

CONCLUSION

For the foregoing reasons, Complex Insurance Claims Litigation Association urges the Court to conclude that defective construction constituting a breach of contract is not “property damage” caused by an “occurrence” and reverse the decision of the trial court.

Respectfully Submitted,

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THE STATE OF SOUTH CAROLINA
In the Supreme Court

APPEAL FROM CHARLESTON COUNTY
Court of Common Pleas
B. Hicks Harwell, Jr., Circuit Court Judge

Case No. 2002-CP-10-4390

Auto-Owners Insurance Co., Inc.,

Appellant,

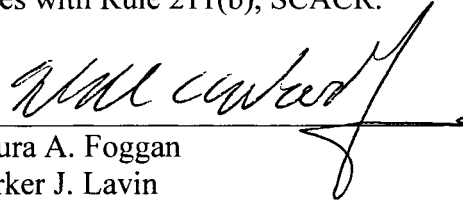
v.

Virginia T. Newman and Trinity Construction, Inc.,

Respondents.

CERTIFICATE OF COUNSEL

The undersigned certifies that this Amicus Curiae Brief of the Complex Insurance Claims Litigation Association complies with Rule 211(b), SCACR.



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CERTIFICATE OF SERVICE

I, Jennifer Lee, an employee of the law firm of Nelson Mullins, do hereby certify that I served one copy of Amicus Curiae Complex Insurance Claims Litigation Association's Brief this the 18th day of January, 2008, upon all counsel of record by depositing same in the U.S. Mail, postage prepaid and addressed as follows:

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