Anderson Kill & Olick, P.C.
REAL ESTATE & CONSTRUCTION ADVISOR
Volume 3 Number 2 www.andersonkill.com Summer 2004

Securing Insurance Coverage For Construction Defect Claims

By Cathleen Cinella Tylis and Dennis J. Artese

Commercial and residential builders often are faced with several common hurdles when attempting to obtain insurance coverage under their commercial general liability ("CGL") policies for construction defects claims. This article provides builders with practical information regarding what preliminary steps they should take to maximize their insurance recovery and also suggests certain legal strategies for sidestepping some of the common exclusions and other grounds insurance companies rely on when denying coverage for such claims.

Consider the following hypothetical: Owner hires General Contractor ("GC") to build a commercial office building in Manhattan. GC enters into a subcontractor agreement with Subcontractor ("Sub") to install all the windows for the project. The agreement requires Sub to name GC as an "Additional Insured" under Sub's CGL policies covering the project. After the project is completed and the tenants move in, torrential rains occur and water enters the building through the window joints damaging both the windows and the tenants' computer equipment. Owner sues GC in negligence and breach of contract alleging that the windows were installed improperly (the "Action"). The Action seeks to recover from the GC the costs of repairing the windows and replacing the tenants' computer equipment. What should GC do?

I. Give Notice of Claim as Soon as Possible

GC's first reflex upon learning of the loss is to provide notice under all potentially applicable policies. This includes GC's own policies as well as any policies sold to Sub, listing GC as an "Additional Insured." In many cases, Additional Insureds do not receive the actual policy endorsement, but are notified by way of certificate of insurance. GC should carefully review Sub's records for any certificates of insurance. Because late notice can result in forfeiture in some jurisdictions, it is imperative that GC provide its insurance companies with timely notice.

II. Do Not Accept "No" for an Answer

After GC has given timely notice of the Action, it will likely receive a tersely worded letter from the insurance company "reserving its rights" or denying the claim outright. If GC does

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Notice to Lenders: File Your Notice of Lending

By Thomas A. Neufeld

A recent decision by New York State's highest court demonstrates the importance of strict compliance with New York Lien Law provisions. A lending institution that failed to file a "notice of lending" breached its fiduciary duty to subcontractors and was liable for damages of $1.9 million. *Aspro Mechanical Contracting, Inc. v. Fleet Bank, N. A.*, 1 NY3d 324.

Real Property Improvement Project

In 1989 Berry Street Corporation entered into a contract with the New York City Housing Authority whereby Berry Street would acquire title to three parcels of land in Brooklyn, construct residential buildings on the parcels, and convey title to the improved property to the Housing Authority. The contract required the Housing Authority to make payments to Berry Street as the improvements were completed. In connection with the project, Norstar Bank, the predecessor of the defendant Fleet Bank, N.A., made a construction loan to Berry Street in 1992. The building loan agreement and the mortgages were recorded. The mortgages contained a covenant that the mortgages were subject to the trust provisions of Lien Law section 13. As

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additional security for the loan, Berry Street assigned to the lender its contract with the Housing Authority, which agreed to make payments directly to the lender until the loans were paid in full. The mortgages refer to Berry Street's assignment of its contract to the lender, although the specific rights and responsibilities assigned were not disclosed. The assignment itself was not filed.

Subcontractors Not Paid

When the project was finished, the Housing Authority paid the proceeds of the sale directly to the lender, which applied the proceeds to the repayment of its building loan to Berry Street. Aspro Mechanical Contracting, Inc. and other subcontractors, who provided labor, services and materials for the project, were not paid for their work. They sued Fleet Bank, alleging that Fleet Bank became a statutory trustee as the result of the assignment of the contract with Berry Street, and that Fleet Bank improperly diverted trust funds by paying itself prior to paying the subcontractors' claims. The plaintiffs asserted that the failure to file a notice of lending pursuant to the Lien Law precluded the lender from maintaining a defense that the lender was entitled to repay the advances made to Berry Street pursuant to the building loan agreement and mortgages. The court agreed in an unanimous decision (6-0).

Trust Funds and Notice of Lending

The Lien Law creates trust funds out of certain construction payments to assure payment of contractors, subcontractors, suppliers, architects, engineers, surveyors, and laborers. The trust fund provisions were enacted to protect the suppliers of labor and material on projects for the improvement of real property because frequently those suppliers were not paid. Funds received by an owner under a building loan agreement and building loan mortgages are trust assets. Once a trust is created, its assets may not be used for non-trust purposes. The owner-trustee must apply the trust for the payment of the cost of improvement, which includes

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not challenge the denial of coverage, the matter will end there. There is no downside, however, if GC challenges the denial of coverage. GC should make sure the insurance company has clearly spelled out the bases for its denial. Moreover, GC should read its policy to verify whether it says what the insurance company is claiming it says; and then read it again to see if any other provisions alter the insurance company's interpretation. Keep in mind that any ambiguity in the policy is construed strictly against the insurance company. The difference between coverage and non-coverage directly reflects the determination and persistence of the individual policyholder.

III. Overcoming Common Coverage Obstacles

To secure coverage for the Action, GC may have to file a declaratory judgment action against the insurance company. Some of the common coverage arguments the insurance company may raise include: (1) there is no "occurrence" (2) certain "business risk" exclusions preclude coverage, and (3) contractually liability is explicitly excluded under the policy. Although the law on these issues varies from state to state, GC should be aware of the potential arguments set forth below.

A. Construction Disputes Allege An Occurrence

Construction disputes almost always allege an occurrence. An occurrence is typically defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions," which is neither expected or intended from the viewpoint of the policyholder. The better reasoned cases have expressly recognized that construction defects represent "accidents" and therefore qualify as an "occurrence" under a CGL policy. In our hypothetical, the water damage to the Owner's building and the third-party property damage to the tenants' computers clearly constitutes an "occurrence" because it was neither expected nor intended by the GC.

B. The So-Called "Business Risk" Exclusions Do Not Preclude Coverage

The standard CGL policy contains a number of exclusions sometimes referred to as "business risk" or "work product" exclusions. One of the principal business risk exclusions is the "your work" exclusion. Insurance companies often raise this exclusion in connection with claims against builders for defective work. The insurance companies argue that the CGL policy is not intended to serve as a warranty against a policyholder's own defective workmanship and that builders are expected to assume this responsibility as a "business risk."

It is well-established, however, that the "your work"

exclusion does not apply where the defective component has damaged other parts of the building, causing independent third-party property damage. Thus, in our hypothetical, GC should be covered for the third-party property damage caused to the tenants' computer equipment. The insurance companies will undoubtedly argue that the costs incurred to repair the windows are not covered because the windows constitute GC's own work. GC's ability to recover these costs is strengthened if the policy at issue contains a "subcontractor exception" to the "your work" exclusion.

The "subcontractor exception" to the "your work" exclusion states that: "This exclusion does not apply if the damaged work or the work out of which the damages arises was performed on your behalf by the subcontractor." This provision clearly acknowledges that builders are afforded coverage for property damage that either arises out of or is the work of a subcontractor. Here, GC may argue that the defective windows do not qualify as its "work," but rather the Sub's "work," and therefore are covered under the policy. GC should review its policies carefully for this language because recent policy forms have removed the "subcontractor exception" from certain CGL policies.

A similar "business risk" exclusion often raised by insurance companies is the "your product" exclusion. "Your product" is typically defined as "any goods or products, *other than real property*." Thus, this exclusion should not apply to a construction defect claim where the damage is to real property. Finally, the insurance company will raise the "impaired property" exclusion, which purports to exclude coverage for the loss of use of tangible property that has not been physically injured or destroyed. Application of this exclusion is avoided in our hypothetical, and in most construction defect cases, by demonstrating physical injury to tangible third-party property.

C. The "Contractual Liability" Exclusion Is Inapplicable

Many CGL policies purport to exclude coverage for damages arising out of liabilities assumed by the policyholder under a contract or agreement. The purpose of the exclusion is to confine the coverage of the policy to the policyholder's tort liability. Where a legal duty arises independent of an insured's contractual obligations, however, the contractual liability exclusion will not apply.

In our hypothetical, although the parties' relationship initially is formed by contract, the Action alleges that the contract was performed negligently. Moreover, professionals, such as GC, may be subject to tort liability for failure to exercise reasonable care, irrespective of their contractual duties. Thus, it will likely be found that GC had an independent duty to exercise reasonable care when rendering its professional contracting services and

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not only the claims of the suppliers of labor and material, but also sums paid to discharge building loan mortgages. The trustee must alert the beneficiaries to the distribution of trust assets to repay advances made by a lender. That can be accomplished by the lender filing a "notice of lending" in the county clerk's office. By doing so there would be public notice of any transaction by the owner, or in this case the lender, that may lead to depletion of the funds available for future trust claims. The notice of lending would eliminate any taint of self-dealing by the lender, who was both a trustee as the recipient of funds and a trust beneficiary as a claimant for repayment of its loan.

The funds that the Housing Authority owed Berry Street under the contract were trust assets subject to the rights of the subcontractors as trust beneficiaries. Absent the assignment of contract, the sale proceeds would have been paid to Berry Street and would have been subject to the trust provisions of the Lien Law. Fleet Bank's rights, as the assignee of the contract, were no greater than the rights of Berry Street. Fleet Bank, as the assignee of the contract, was a statutory owner-trustee, who was required to administer the trust solely in the interest of the beneficiaries. Fleet Bank must act, not as a mere entrepreneur, but as a fiduciary manager of the trust funds.

Breach of Fiduciary Duty

Fleet Bank's application of the trust assets to repay its loans to Berry Street, without acknowledging the lender's status as a trustee and without providing notice to the trust beneficiaries, constituted a breach of the lender's fiduciary duty. Although Fleet Bank's building loan mortgages may have had priority over subsequently filed mechanics' liens, the loans did not have priority over the claims of the subcontractors because there was no notice to the beneficiaries that Fleet Bank planned to use the trust assets to repay itself. The filing by Fleet Bank of a notice of lending would have satisfied Fleet Bank's fiduciary duty. ■

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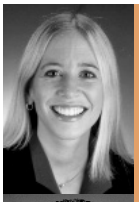
thus the "contractual liability" exclusion is inapplicable.

IV. Conclusion

There are certain steps a policyholder must take to ensure that it does nothing to negate coverage by failing to comply with certain technical requirements under its policy. As indicated above, many of the exclusions and other obstacles to coverage can be avoided. The key is not to give up the fight. ■



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