COMMONWEALTH OF KENTUCKY
KENTUCKY SUPREME COURT
NO. 2008-SC-293

CINCINNATI INSURANCE COMPANY — APPELLANT

v.

# BRIEF OF APPELLANT CINCINNATI INSURANCE COMPANY

MOTORISTS MUTUAL INSURANCE COMPANY — APPELLEE

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ON DISCRETIONARY REVIEW FROM THE
COURT OF APPEALS
No. 2007-CA-818

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## CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true copy of this Brief has been served by first class mail, postage prepaid, upon Hon. Mary M. Shaw, Judge, Division Five, Jefferson Circuit Court, 600 West Jefferson Street, Louisville, KY 40202; William P. Swain, Esq., Paul J. Bishop, Esq., D. Sean Ragland, Esq., Philips Parker Orberson & Moore, 716 West Main Street, Suite 300, Louisville, KY 40202; and Clerk, Kentucky Court of Appeals, 360 Democrat Drive, Frankfort, Kentucky 40601 on this 13th day of April, 2009. It is further certified that no part of the record on appeal has been withdrawn from the clerk of the trial court.

Michael D. Risley

Michael D. Risley

## INTRODUCTION

The issue before this Court is whether claims of defective construction against a homebuilder are claims for "property damage" caused by an "occurrence" for purposes of a commercial general liability insurance policy. Despite the trial court concluding that they are not and the Court of Appeals finding the insurer's arguments on the issue "compelling," the Court of Appeals reversed the trial court and held that claims of defective construction against the homebuilder constituted claims for "property damage" caused by an "occurrence" for purposes of the commercial general liability insurance policy issued by Cincinnati Insurance Company.

## STATEMENT CONCERNING ORAL ARGUMENT

Cincinnati Insurance Company requests that the Court hear oral argument in this case. The opportunity to address any issues or questions the Court may have will be of value to both the Court and the parties.

## STATEMENT OF POINTS AND AUTHORITIES

## STATEMENT OF THE CASE

This action concerns whether claims of faulty workmanship against an insured constitute claims for "property damage" caused by an "occurrence" for purposes of a commercial general liability insurance policy. The Jefferson Circuit Court held they did not, and entered summary judgment in favor of the insurer. The Court of Appeals reversed, and remanded the case to the Jefferson Circuit Court for consideration of whether the policy's exclusions would apply to defeat the possibility of coverage. Thus, the issue before this Court is whether a claim of faulty workmanship constitutes a claim for "property damage" caused by an "occurrence" for purposes of a commercial general liability insurance policy.

### A. The CIC Policy

Cincinnati Insurance Company ("CIC") issued a commercial general liability policy to Elite Homes, policy number CPP 0673193C, insuring against "bodily injury" and "property damage" claims arising out of certain insured activities. See Exhibit A. The policy was effective July 1, 1996. See Third-party complaint, ¶ 8. The Policy contains the following grant of coverage:

> 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 any "suit" seeking those damages. We may at our discretion investigate any "occurrence" and settle any claim or "suit" that may result.
>
> * * * * *
>
> 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.

Exhibit A, form GA 101 01 95, at page 1 of 13. Under this grant of coverage, claims which do not arise from "bodily injury" or "property damage," or which are not caused by an "occurrence," are not covered under the terms of the policy.

"Occurrence" is defined in the policy as an "accident, including continuous or repeated exposure to substantially the same general harmful conditions." Id., form GA 101 01 95, at page 11 of 13. "Bodily injury" is defined as bodily injury, sickness or disease sustained by a person, including death. Id., form GA 101 01 95, at page 9 of 13. "Property damage" is defined as:

> a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
>
> b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

Id., form GA 101 01 95, at page 11 of 13.

The policy also includes several exclusions to the coverage provided by the policy. Because it concluded that the claims asserted against the CIC insured did not come within the coverage provided by the policy, the trial court never reviewed or considered the potential application of the policy's exclusions. The Court of Appeals likewise did not review or consider the application of the policy's exclusions.[1] Because

[1] In reversing the trial court, the Court of Appeals remanded the case to the trial court for consideration of the policy's exclusions.

the potential application of the exclusions is not before this Court, the exclusions are not addressed here.

### B. The Mintmans' Claims Against Elite Homes

The claims at issue were asserted by Warren S. and Jennifer Mintman against Elite Homes, Inc. in the original complaint filed herein (a copy of which is attached as Exhibit B). In that complaint, the Mintmans alleged that they entered into a construction and purchase agreement with Elite Homes dated November 14, 1994. Complaint, ¶ 7. That agreement related to the construction of a residence in Shelby County, and was for a total price of $282,600. Complaint, ¶¶ 8-9. It was further alleged that Joseph Pusateri, President of Elite Homes, represented that Elite Homes' contract provided for a ten-year warranty against major structural defects in the homes it constructs. Complaint, ¶ 13.

The Mintmans alleged that Elite Homes substantially completed construction of the residence on or about June 1, 1995. Complaint, ¶ 19. Elite Homes was paid in full by the plaintiffs at that time. Complaint, ¶ 20. That was long before the CIC coverage provided to Elite Homes came into effect (in July 1996).

The Mintmans alleged that the residence "suffered from serious latent structural defects as a result of its substandard construction by Elite and/or one or more of its various subcontractors." Complaint, ¶ 23. Minor cracks and other defects appeared, which were brought to the attention of Elite Homes and its President who made various cosmetic repairs. Complaint, ¶ 24.

In addition to those problems, the Mintmans alleged that cracks in the drywall and in the brick exterior walls of the residence, along with other problems such as stuck windows and doors, sagging floors, brick veneer separating from exterior walls, and leaning walls, continued to develop and become more prominent. Complaint, ¶ 25. A

structural engineer was retained, who advised that there were major structural issues with the home involving the foundation, the framing, and the retaining wall. Complaint, ¶ 28.

At that time, the matter was turned over to Motorists Mutual. Complaint, ¶ 29. Apparently, Motorists Mutual retained an additional structural engineer who indicated that the home's condition was the result of several causes, including framing inadequacies; instability of garage knee-wall; improper construction over fill material; concentrated loads over small, shallow, foundation footings causing the rotation of the garage in relation to the house; haphazard roof framing; and improper construction of retaining walls. Complaint, ¶ 39. Another structural engineer provided a similar opinion. Complaint, ¶ 44. The complaint then outlines a series of contacts between the Mintmans and Motorists Mutual relating to a potential settlement of the Mintmans' claim.

In addition to asserting a claim for misrepresentation against Joseph Pusateri and a claim against Motorists Mutual for how it handled the claim, the Mintmans alleged that Elite Homes was liable to the plaintiffs because the subject home was not constructed in a workmanlike manner by Elite Homes and/or its subcontractors; Elite Homes negligently and improperly modified the plans to the home, thereby weakening the structure's integrity; and Elite Homes failed to properly coordinate and supervise the work of its subcontractors. Complaint, ¶¶ 50-52. It was alleged that Elite Homes was liable to the plaintiffs as a result of the "deficient construction of the residence including, but not limited to Elite's faulty design, planning, supervision, inspection, and/or construction with respect to the subject residence." Complaint, ¶ 48.

### C. Motorists Mutual's Claim Against CIC

Motorists Mutual settled the claim which had been asserted by the Mintmans against Elite Homes and filed a third-party complaint against CIC seeking to recover

some portion of the settlement. In its third-party complaint, Motorists Mutual alleged that it had issued polices of insurance to Elite Homes and that Elite Homes had been sued by the Mintmans. Third-party complaint, ¶ ¶ 4, 9. Motorists Mutual alleged that the claims made against Elite Homes were covered under the provisions of the insurance policy issued by Cincinnati Insurance Company to Elite Homes. Third-party complaint, ¶ 10. CIC denied that allegation. Answer to third-party complaint, ¶ 10.

### D. The Trial Court's Grant of Summary Judgment

Both parties moved for summary judgment. In an Opinion and Order entered on March 22, 2007, the trial court granted CIC's motion for summary judgment, holding that:

> After review, the Court agrees with CIC that the plain language of the policy regarding coverage does not include the Mintmans' intangible economic loss arising from claims of faulty construction of their house by Elite. The Court is persuaded by the numerous cases cited by CIC from other jurisdictions which have addressed this issue and found that "property damage" and/or "occurrence" under CGL policies do not extend coverage to protect an insured from liability for faulty workmanship in the work product itself. Instead, the CGL policy extends coverage to the situation where the faulty workmanship causes bodily injury or property damage to something other than the work product. In other words, the policy does not cover an insured from liability for its building flaws or deficiencies but covers the insured from liability for injury incurred by a third party or for damage to property other than the work product, which is caused by such flaws and deficiencies.

Opinion and Order (attached as Exhibit C), at 4-5.

### E. Reversal by the Court of Appeals

The Court of Appeals rendered its Opinion on March 21, 2008, vacating and remanding the trial court's Opinion and Order granting summary judgment to CIC. While the Court of Appeals acknowledged that CIC's argument was "compelling," the

Court of Appeals concluded that "since comprehensive general liability policies are designed to cover broad risks, Motorists has the better argument." Court of Appeals Opinion, attached as Exhibit D, at 7. In reaching that conclusion, the Court of Appeals stated that it was "guided" by this Court's decision in Bituminous Cas. Corp. v. Kenway Contracting, Inc., 240 S.W.3d 633, 638 (Ky. 2007). The Court of Appeals remanded the case to the trial court to consider the potential application of the policy's exclusions to the claims asserted by the Mintmans against Elite Homes.

## ARGUMENT

### I. THE TRIAL COURT CORRECTLY ENTERED SUMMARY JUDGMENT IN FAVOR OF CIC BECAUSE THE MINTMANS' CLAIMS AGAINST ELITE HOMES WERE NOT FOR "PROPERTY DAMAGE" AS DEFINED IN THE COMMERCIAL GENERAL LIABILITY POLICY.

The trial court properly granted summary judgment in favor of CIC because the Mintmans' claims for economic loss due to poor workmanship fall outside the definition of "property damage" in CIC's commercial general liability insurance policy. In the absence of property damage, the CGL policy affords no coverage.

#### A. The CIC policy insures against specific property damage risks.

The CIC policy provides coverage for a specific set of risks. It covers "those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies." See Exhibit A, GA 101 01 95, p.1 of 13.[2] Thus, for coverage to exist for the claims asserted by the Mintmans against Elite Homes, any claims for damage must be a result of "property damage" as defined in the policy, and Elite Homes must be "legally obligated" to pay them. Id. The

[2] Bodily injury is not at issue in this litigation.

policy defines "property damage" to include either "[p]hysical injury to tangible property" or "[l]oss of use of tangible property that is not physically injured." Id.

### B. The trial court correctly concluded that the Mintmans' claims did not constitute property damage under the policy.

In the underlying complaint, the Mintmans alleged that Elite Home was liable to them as a result of the "deficient construction of the residence including, but not limited to Elite's faulty design, planning, supervision, inspection, and/or construction with respect to the subject residence." Complaint, ¶ 48. Thus, the claim asserted against the CIC insured was for economic loss due to a job poorly done. As a result, "those sums" that Elite Home became legally obligated to pay were damages resulting from poor workmanship and not "damages because of 'property damage'" under the policy language. As recognized by the trial court, Elite Homes' legal obligations arose from breaching its obligations to the Mintmans and not from causing "[p]hysical injury to tangible property" or "[l]oss of use of tangible property that is not physically injury." As explained by the trial court, the CGL policy extends coverage to the situation where the faulty workmanship causes property damage to something other than the work product, and it is not intended "to protect an insured from liability for faulty workmanship in the work product itself." Opinion and Order, at 4.

The fact that property damage may have been "lurking somewhere in the underlying case" is inconsequential. Nabholz Construction Co. v. St. Paul Fire and Marine Ins. Co., 354 F. Supp. 2d 917, 921 (E.D. Ark. 2005). The analysis properly turns on the underlying cause giving rise to Elite's legal obligation. Id. In Elite Homes' instance, that cause was breaching its obligation to the Mintmans by deficient

construction of their residence, not from causing property damage to something other than the product created by the insured.

### C. The trial court's decision is consistent with other decisions rendered under Kentucky law finding that poor workmanship is not property damage.

While published Kentucky appellate decisions have not directly addressed whether poor workmanship in the product itself constitutes "property damage" under a CGL policy, the trial court's decision finding that no coverage existed is consistent with numerous other courts which have found that such poor workmanship falls outside the definition of "property damage" under Kentucky law.

In Assurance Company of America v. Dusel Builders, Inc., 78 F. Supp. 2d 607 (W.D. Ky. 1999), the Western District of Kentucky, interpreting language identical to the language contained in CIC's policy, granted summary judgment in favor of an insurer, holding that its insured was not entitled to a defense or indemnity under a CGL policy for claims arising from a contract dispute alleging "faulty workmanship in the product itself" during the construction of a house. Id. at 609. The court held that such claims fell outside the policy's definition of "property damage." Id. In reaching its decision, the court discussed cases from other jurisdictions that limited "the types of claims and damages recoverable under such language." Id. (citing Fuller v. U.S. Fidelity & Guar. Co., 200 A.D.2d 255 (N.Y. App. 1994) (CGL policy "never intended to provide contractual indemnification for economic loss to a contracting party because the work product contracted for is defectively produced"); Ryan Homes, Inc. v. Home Indem. Co., 647 A.2d 939, 942 (Pa. Super. 1994) ("Such policies are intended to protect against limited risks and are not intended to act as performance bonds ... The insured, therefore, must assume the risk of the quality of its product and its work"); Yegge v. Integrity Mut.

Ins. Co., 534 N.W.2d 100 (Iowa 1995) (homeowner's claims failed to qualify as property damage within the policy's definition)).

In Parrott v. Hoosier State Construction, Inc., No. 3:02CV-499-MO, 2006 U.S. Dist. LEXIS 14062 (W.D. Ky. March 28, 2006), the court granted summary judgment in favor of an insurer for poor workmanship claims involving the construction of a commercial building, stating that:

> The claims alleged by the plaintiffs are not claims of personal injury or damage to property other than their own. They are claims of faulty workmanship. As the majority of courts have held, the purpose of a commercial general liability policy is not to cover faulty workmanship .... As the court noted in its prior opinion, it would be economically inefficient for an insurance policy to protect against risks that appropriate business management could and should control.

2006 U.S. Dist. LEXIS 14062, *7-8.

In Standard Fire Ins. Co. v. Chester-O'Donley & Associates, Inc., 972 S.W.2d 1 (Tenn. App. 1998), the court concluded that Kentucky law applied to a dispute concerning coverage available under a mechanical subcontractor's commercial general liability insurance policy. While recognizing that "Kentucky law provides little substantive guidance in this area," the court concluded that "we can apply Kentucky's canons for construing insurance policies, and we may also inform our judgment by reviewing decisions from other jurisdictions construing similar policy provisions." Id. at 5.

The Standard Fire court explained that "general liability policies are not intended to cover the insured's contractual liability for economic loss because its work was not that for which the damaged person bargained." Id. at 7. In concluding that the policy did not provide coverage for the claims before it under Kentucky law, the court found that

additional construction expenses, lost profits, or diminution in value of the project caused by the insured's defective work are the sort of economic losses that do not fit within the definition of "property damage." Id. at 10.

These cases, all decided under Kentucky law, are consistent with the conclusion reached by the trial court. A commercial general liability policy is not intended to guarantee the work performed by the insured, yet that is what it becomes under the Court of Appeals' decision in this case. As in these cases decided under Kentucky law, this Court should not allow a liability policy to be turned into a performance guarantee.

### D. Courts in other jurisdictions also have recognized that poor workmanship is not property damage.

Decisions from other jurisdictions also have found that poor workmanship falls outside the definition of property damage under a CGL policy. For example, in Nabholz Construction Corp. v. St. Paul Fire and Marine Ins. Co., 354 F. Supp. 2d 917, 921 (E.D. Ark. 2005), the court, applying the Arkansas Supreme Court's opinion in Unigard Security Ins. Co. v. Murphy Oil, 962 S.W.2d 735 (Ark. 1998), to a construction defect case, explained that the proper analysis of "property damage" focuses on the underlying cause of damage legally obligating the insured to pay damages, such as breach of lease (in the case of Unigard) or breach of contract. The fact that "property damage" of some type was "merely lurking somewhere in the underlying case" was not enough to find coverage under a CGL policy. 354 F. Supp.2d at 921. The court held that coverage did not exist for "'economic damages' incurred in connection with [the] subcontractor's construction of a faulty roof because [the faulty construction of the roof] resulted in a

foreseeable breach of contract." Id., at 923.[3]

In another construction defect case, the U.S. District Court for the Southern District of Indiana denied coverage under a liability policy for a poorly-constructed roof, explaining that insureds purchasing CGL policies did not bargain for insurance coverage for poor workmanship as property damage. See Selective Ins. Co. v. Cagnoni Dev., LLC, No. 1:06-CV-0760-DFH-TAB, 2008 U.S. Dist. LEXIS 2162, *26-28 (S.D. Ind. Jan. 10, 2008). It explained:

> Indiana courts have made it clear that the 'coverage is for tort liability for physical damages to others, and not for contractual liability of the insured for economic loss suffered because the completed work is not what the damaged person bargained for.' Otherwise, the court would 'effectively convert the policy into a performance bond or guarantee of contractual performance ... .'

Id. at *27 (quoting R.N. Thompson & Assoc., Inc. v. Monroe Guaranty Ins. Co., 686 N.E.2d 160, 162 (Ind. App. 1997); Indiana Ins. Co. v. DeZutti, 408 N.E.2d 1275, 1279 (Ind. 1980)). The court further explained that CGL policies cover accidental injury and not poor workmanship business risks because:

> Unlike business risks ... where the tradesman commonly absorbs the cost attendant upon the repair of his faulty work, the accidental injury to property or persons substantially caused by his unworkmanlike performance exposes the contractor to almost limitless liabilities.

Id. at *26-27 (quoting Weedo v. Stone-E-Brick, Inc., 405 A.2d 788, 791 (N.J. 1979)). Importantly, the court also noted that, while other decisions have cited this analysis of business risks in reference to the application of exclusions, the same reasoning applies to

[3] It also found no occurrence under the policy and noted the distinctions between CGL policies and performance bonds.

the term "property damage" in the insuring clause itself. Id. at *27 n.3 (citing R.N. Thompson, 686 N.E.2d at 163 n.4).

In Nationwide Prop. & Cas. v. Comer, 595 F. Supp. 2d 685, 691 n.1 (S.D. W. Va. 2008), the court recognized that coverage did not exist for numerous claims involving damages that were "pecuniary in nature and [did] not constitute property damage or bodily injury," including a claim for "negligent" home construction. The court followed the lead of the Supreme Court of West Virginia, which held that claims for negligent repair "simply do not fall within the scope of the policy" and further noted no distinction between negligent repair and negligent construction. Id. at 692 (quoting Aluise v. Nationwide Mut. Fire Ins. Co., 625 S.E.2d 260, 270 (W. Va. 2005)). Importantly, Nationwide shows that courts applying similar reasoning have found that poor workmanship is not property damage regardless of the whether the underlying claim sounds in tort or contract.

### E. The Court of Appeals never actually analyzed whether the Mintmans' claim was for "property damage."

The Court of Appeals simply glossed over the issue of whether the Mintmans' claims against Elite Homes constituted "property damage" for purposes of the CIC general liability policy. After citing this Court's decision in Bituminous Cas. Corp. v. Kenway Contracting, Inc., 240 S.W.3d 633 (Ky. 2007), which the Court of Appeals said "guided" its decision in this case, the Court of Appeals stated in a very conclusory fashion that the damage to the Mintmans' house "was clearly property damage . . . ." Opinion, at 7. The Court of Appeals engaged in no other analysis of the issue.

Of course, the differences between the facts of Bituminous and this case are significant. In Bituminous, the insured tore down a structure it was not supposed to

touch. The destruction of a structure the insured is not supposed to touch certainly is an example of property damage.

Here, Elite Homes allegedly was negligent in the construction of a residence. Because that is fundamentally different from the destruction of an already existing structure, the Court of Appeals' reliance on Bituminous to conclude that this case involved sufficient allegations of property damage was misplaced.

Instead, the Court of Appeals should have undertaken the analysis reflected in the many cases discussed above in which the courts have concluded that negligently building a house does not constitute property damage. That being the case, this Court should reverse the Court of Appeals and reinstate the summary judgment granted to Cincinnati Insurance Company.

## II. THE TRIAL COURT PROPERLY ENTERED SUMMARY JUDGMENT IN CIC'S FAVOR FOR THE ADDITIONAL REASON THAT THE MINTMANS' CLAIMS DID NOT ARISE FROM AN "OCCURRENCE" AS DEFINED IN CIC'S COMMERCIAL GENERAL LIABILITY POLICY.

The trial court properly granted CIC summary judgment for the additional reason that Elite Homes' allegedly negligent construction of the Mintmans' home did not result from an "occurrence" as required by the policy.

### A. The CIC policy requires that covered losses be caused by an "occurrence."

Not only does the CIC policy limit the types of risk covered in its policy through the definition of "property damage," it further specifies that coverage exists only if the "'property damage' is caused by an 'occurrence' taking place during the policy period." See Exhibit A, form GA 101 01 95, p. 1 of 13. The policy defines "occurrence" as "an

accident, including continuous or repeated exposure to substantially the same general harmful condition." Id. at p. 11 of 13.

### B. The trial court correctly concluded that the Mintmans' claims of faulty workmanship did not satisfy the policy's occurrence requirement.

Here, the Mintmans claimed damage to their home as a result of Elite's deficient construction of the home. The trial court correctly recognized that such claims do not arise from an "occurrence" under a CGL policy. The purpose of CGL policies is "to protect an insured from bearing financial responsibility for unexpected and accidental damage to people or property," not to serve as a performance bond for shoddy work. Because the Mintmans' claims fell outside the definition of "occurrence," the trial court correctly held that the CGL's occurrence requirement was not satisfied.

### C. The trial court's decision is consistent with the majority of other courts which have held that poor workmanship damaging the work itself is not an occurrence.

A majority of courts around the nation have held that poor workmanship damaging the work itself is not an accidental occurrence. Essex Ins. Co. v. Holder, 261 S.W.3d 456, 459-460 (Ark. 2008) (collecting cases). See, e.g., Pursell Constr., Inc. v. Hawkeye-Security Ins. Co., 596 N.W.2d 67, 71 (Iowa 1999) ("We agree with the majority rule and now join those jurisdictions that hold that defective workmanship standing alone, that is, resulting in damages only to the work product itself, is not an occurrence under a CGL policy"); Amerisure, Inc. v. Wurster Constr. Co., Inc., 818 N.E.2d 998, 1004 (Ind. App. 2004) (holding that faulty workmanship is not an accident and therefore not an occurrence); Heile v. Herrmann, 736 N.E.2d 566, 568 (Ohio App. 1999) (holding that faulty workmanship does not constitute an occurrence when the damage is to the work product only); Monticello Ins. Co. v. Wil-Fred's Constr., Inc., 661

N.E.2d 451, 456 (Ill. 1996) (finding that improper construction by a contractor and its subcontractors does not constitute occurrence when the improper construction leads to defects); ACUITY v. Burd & Smith Const., Inc., 721 N.W.2d 33, 39 (N.D. 2006) ("We conclude property damage caused by faulty workmanship is a covered occurrence to the extent the faulty workmanship causes bodily injury or property damage to property other than the insured's work product."); Corder v. William W. Smith Excavating Co., 556 S.E.2d 77, 83 (W. Va. 2001) ("Poor workmanship, standing alone, cannot constitute an 'occurrence' under the standard policy definition of this term as an 'accident including continuous or repeated exposure to substantially the same general harmful conditions."); Auto-Owners Ins. Co. v. Home Pride Cos., Inc., 684 N.W.2d 571, 576-79 (Neb. 2004) (CGL policy does not provide coverage for faulty workmanship that damages only the insured's work product); Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co., 908 A.2d 888, 889 (Pa. 2006) ("We hold that the definition of 'accident' required to establish an 'occurrence' under the policies cannot be satisfied by claims based on faulty workmanship."); Commerce Ins. Co. v. Betty Caplette Builders, Inc., 647 N.E.2d 1211, 1213-14 (Mass. 1995) (no coverage is provided under a CGL policy for damages suffered by the homeowners in the underlying actions due to faulty construction or workmanship); McAllister v. Peerless Ins. Co., 474 A.2d 1033, 1036-37 (N.H. 1984) (claimed damages were for cost of correcting defective landscaping work with no claim that defects had caused damage to property other than the work product).

A central theme in the majority opinions is that "the fortuity implied by reference to accident or exposure is not what is commonly meant by a failure of workmanship." Essex, 261 S.W.3d at 1036. See also Kvaerner, 908 A.2d at 899; Pursell Const., 596

N.W.2d at 70. In Kvaerner, the Supreme Court of Pennsylvania recognized that a claim for poor workmanship did not meet the degree of fortuity in the ordinary meaning of the word "accident." 908 A.2d at 898. It criticized courts holding that poor workmanship damaging the work itself is accidental if the insured did not intend for the damage to occur. See 908 A.2d at 899 n. 9. Siding with the majority of courts which have addressed the issue, the Kvaerner court reasoned that holding otherwise "converted a policy for insurance into a performance bond." Id. at 899. It explained:

> We believe that this is an overly broad interpretation of accident, as the situation is rare indeed in which a contractor intends that the work product suffer injury. Because we believe that CGL policies are not the proper means to protect against such risks, we concur with the majority of Courts and decline to apply coverage in such cases.

Id. at 899 n.9 (also noting the existence of Builder's Risk Policy and Professional Liability Policy available to the insured).

The Kvaerner court further explained:

> Such claims simply do not present the degree of fortuity contemplated by the ordinary definition of "accident" or its common judicial construction in this context. To hold otherwise would be to convert a policy for insurance into a performance bond. We are unwilling to do so, especially since such protections are already readily available for the protection of contractors.

Id. at 899.

The Supreme Court of Arkansas in Essex likewise found that claims for faulty workmanship against a contractor, including "delays, employment of incompetent subcontractors, and defective or incomplete construction" did not constitute an occurrence under a CGL policy. See 261 S.W.3d at 456. In explaining the difference between commercial general liability policies and performance bonds, the court wrote:

> The purpose of a CGL policy is to protect an insured from bearing financial responsibility for unexpected and accidental damage to people or property. It is not intended to substitute for a contractor's performance bond, the purpose of which is to insure the contractor against claims for the cost of repair or replacement of faulty work. [Contractor] might have elected to purchase a performance bond to protect it from a known business risk that its subcontractor would not perform its contractual duties. That [the contractor] has no remedy for its subcontractor's default under its CGL policy is neither troublesome nor unexpected given the nature of the risk involved.

Id. at 459 (quoting Nabholz, 354 F. Supp. 2d. at 923). As noted above, the courts in Assurance and Parrott, applying Kentucky law, also recognized that CGL policies are not intended to be performance bonds and should not be so interpreted. See supra.

Some insureds have argued that the 1986 revisions to the standard CGL policy express an intent to cover poor workmanship performed by a subcontractors via an exception to the policy's "your work" exclusion. See Amerisure, Inc. v. Wurster Construction Co., 818 N.E.2d 998, 1005 (Ind. App. 2004); Exhibit A, form GA 101 01 95, pp. 3-4. Recognizing that coverage only arises from the policy's insuring clause and that exceptions to exclusions do not grant coverage, the Amerisure court explained:

> An exception to an exclusion cannot create coverage where none exists. Exclusion clauses do not grant or enlarge coverage; rather, they are limitations. In simplistic terms, the process is such: if the insuring clause does not extend coverage, one need look no further. If coverage exists, exclusions must then be considered. If an exclusion excludes coverage, an exception may re-grant coverage. However, the entire process must begin with an initial grant of coverage via the insuring clause; otherwise, no further consideration is necessary. Therefore, in the present case, we do not address any arguments regarding exclusions or exceptions to exclusions because here there is no initial coverage due to the lack of "property damage" and an "occurrence."

Amerisure, 818 N.E.2d at 1005 (citation omitted).

### D. Prior Kentucky decisions, including this Court's Bituminous Casualty decision, do not call for a different result.

This Court has not previously addressed the "occurrence" issue in a construction defect case, and there is nothing in prior decisions which conflicts with the trial court's decision in this case. Indeed, the courts previously addressing the issue under Kentucky law (discussed above) have reached the same conclusion as the trial court reached in this case. The earlier decisions from this Court likewise do not call for the result the Court of Appeals felt compelled to reach. For example, while Kentucky courts have long defined "occurrence" broadly in favor of extending coverage, James Graham Brown Foundation, Inc. v. St. Paul Fire & Marine Ins. Co., 814 S.W.2d 273, 278 (Ky. 1991), Kentucky courts also have recognized that liability coverage does not extend to claims which do not arise from an "occurrence." See, e.g., Goldsmith v. Physicians Ins. Co. of Ohio, 890 S.W.2d 644 (Ky. 1994); Thompson v. West American Ins. Co., 839 S.W.2d 579 (Ky. App. 1992). The issue of whether alleged faulty workmanship constitutes an occurrence has not been resolved previously by this Court.[4]

The Court of Appeals indicated that it was "guided" by this Court's decision in Bituminous Cas. Corp. v. Kenway Contracting, Inc., 240 S.W.3d 633 (Ky. 2007). Indeed, the Court of Appeals acted as if the issues raised in this case had been resolved in Bituminous. However, that is not the case.

Bituminous dealt with a contractor who was hired to tear down a carport who instead tore down the house to which the carport was attached. While the insured's acts were intentional in Bituminous, they were accidently directed at the wrong structure.

[4] A recent decision from the Court of Appeals suggests that a breach of contract claim relating to alleged faulty construction of a home does not arise from an occurrence. See Kentucky Farm Bureau Mut. Ins. Co. v. Blevins, 268 S.W.3d 368, 374 (Ky. App. 2008).

This Court in Bituminous held that such claims arose from an occurrence for purposes of a general liability insurance policy.

The Court of Appeals was mistaken in its belief that Bituminous was determinative of the issues presented in this case for two reasons. First, this Court in Bituminous comes nowhere close to addressing whether a claim such as the one asserted by the Mintmans against Elite Homes involves property damage. In Bituminous, there clearly was property damage to the house, as it was torn down. Here, the alleged damage was to the very structure that the insured created. Prior to Elite Homes starting work, there was no structure and no property to damage. Elite Homes created the structure, with the Mintmans then claiming that Elite Homes did a bad job in creating the structure.

That is a significant difference. While the Court of Appeals felt that it was guided by this Court's decision in Bituminous, there is nothing in Bituminous to guide the Court of Appeals or any other Kentucky court on this very important issue on which the majority of other states have reached a result diametrically opposed to the result reached by the Court of Appeals in this case.

Second, the issue addressed in Bituminous is far different from whether an insured's allegedly poor workmanship leading to cracks in the walls and a sagging floor in the very structure it was retained to build constitutes an occurrence. The issue in Bituminous was whether a contractor tearing down the wrong structure constituted an occurrence. The issue herein is whether a contractor's poor workmanship constitutes an occurrence which is a far different issue.

Thus, the Court of Appeals' reliance on Bituminous for the conclusion that the Mintmans' claims were for property damage caused by an occurrence was misplaced.

The Court of Appeals should have conducted the analysis undertaken by the trial court, which leads to the conclusion that claims such as those asserted by the Mintmans against Elite Homes do not arise from an occurrence.

### E. Declaring claims of faulty workmanship to be caused by an occurrence would be an improper application of the concept of fortuity.

The Court of Appeals decision, adopting the minority view, reflects a basic misapplication of the concept of fortuity as it relates to a general liability policy's occurrence requirement. In a line of cases originating with Fryman v. Pilot Life Ins. Co., 704 S.W.2d 205, 206 (Ky. 1986), Kentucky courts have described the accident element of "occurrence" as a consequence which, from the subjective standpoint of the insured, was the result of the insured's "plan, design or intent."[5] As highlighted in Bituminous and other decisions, however, this line of cases has created confusion in how the principle of fortuity applies in construction-related CGL cases such as this one.

#### 1. Fortuity incorporates "control" as well as "intent."

Fortuity "is perhaps the most fundamental principal of insurance and insurance law" and "is central to understanding what constitutes insurance." 16 Appleman on Insurance Law and Practice 2d, § 116.1[B] (Matthew Bender & Co., Inc. 2008). Fortuitous events are those "**substantially beyond the control** of either the insured or insurer." Id. (discussing ideas popularized in insurance law by Edwin W. Patterson, Essentials of Insurance Law (1935) (emphasis added)). The principle of fortuity creates an implied exception to coverage that "serves to guard against the hazard of loss

[5] See Bituminous, 240 S.W.3d at 639; Aetna Cas. & Surety Co. v. Commonwealth of Kentucky, 179 S.W.3d 830, 836 (Ky. 2005); Brown Foundation, supra, 814 S.W.2d at 278-79; Stone v. Kentucky Farm Bureau Mut. Ins. Co., 34 S.W.3d 809, 812-13 (Ky. App. 2000).

intentionally caused by the insured, or arising out of the insured's carelessness or lack of concern." Id. (emphasis added).

Fortuity "primarily concerns intent" and often is expressed via the intentional acts exclusion found in most liability insurance policies. Id. See also Aetna, supra, 179 S.W.3d at 836 ("We agree [...] that the requirement that the loss be fortuitous, *i.e.* not intended, is a concept inherent in all liability policies.")[6] The principle of fortuity, however, encompasses more than "intent," and courts err when they fail to recognize that the root of fortuity is that the risk of loss must be, to a substantial extent, beyond the control of either party to the insurance contract. See Appleman, supra, § 116.1[B].

**2. Prior decisions have failed to adequately address the fortuity principle or the element of control.**

Prior Kentucky decisions have failed to recognize the breadth of the fortuity principle, causing confusion and oversimplification in analysis of construction-related CGL cases. In Fryman, supra, the Court addressed whether an insured's death constituted an "accident" under a life insurance policy where the insured crashed his motorcycle while intoxicated. Without citation to authority for the language used or analysis of the fortuity principle, the Court stated that "a consequence which is a result of plan, design or intent is commonly understood as not accidental." 704 S.W.2d at 705.

In Brown Foundation, supra, this Court addressed whether damages caused by environmental pollution giving rise to CERCLA claims constituted an occurrence under a CGL policy. See 814 S.W.2d at 278-79. Unlike CIC's policy, the policy in Brown Foundation defined "occurrence" as "[a]n accident, including continuous or repeated

[6] It is also expressed in some CGL definitions of "occurrence," that, unlike CIC's language, incorporate "expected or intended" language. See Brown Foundation, supra, 814 S.W.2d at 275 (citing policy language).

exposure to conditions, which results in bodily injury or property damage, neither expected nor intended from the standpoint of the insured." Id. at 275 (emphasis added). The Brown Foundation opinion makes no mention of the fortuity principle. Id. at 278-79. Instead, it focuses on the "neither expected nor intended" language in the definition of occurrence. Id. The Brown Foundation case has come to stand for the proposition that "if injury was not actually and subjectively intended or expected by the insured, coverage is provided even though the action giving rise to the injury itself was intentional and the injury foreseeable." Id. at 278.

This analysis introduced confusion, as seen in Aetna, supra, another environmental pollution case, because the Court in Aetna assumed that Brown Foundation had addressed fortuity and that fortuity was synonymous with the degree of intent. See Aetna, supra, 179 S.W.3d at 836 (stating that "[i]n Brown Foundation, this Court addressed the issue of fortuity regarding a claim for insurance coverage" and equating fortuitous with "not intended"). In fact, as explained above, the Brown Foundation decision fails to squarely address fortuity.

More recently, in Bituminous, this Court sought to apply "the fortuity requirement in the definition of accident" in deciding whether a contractor's mistaken demolition of the wrong structure constituted an occurrence under a CGL policy. 240 S.W.3d at 639. This Court in Bituminous cited Brown Foundation for the proposition that intentional acts causing unexpected or unintended results from the insured's standpoint are accidents. Id. Citing Fryman, this Court then stated that because the damage to the property was "unexpected and unintended" by the insured, "[i]t was not the plan, design, or intent of

the insured" and thus it met the "fortuity requirement" in the definition of accident. Id. at 639-40.

As explained above, however, the holding in Brown Foundation was based on the "neither intended nor expected language" in the definition of accident, and this language does not appear in CIC's policy. Because the Brown Foundation Court's holding was not based on an analysis of the fortuity principle, neither Fryman nor Brown Foundation, the two cases cited in conjunction with fortuity in Bituminous, actually address the principle of fortuity, and neither case explained how fortuity applies to a modern policy like CIC's policy where the "intent" element appears in the exclusions and not in the definition of occurrence. Thus, this Court has never squarely addressed the principle of fortuity, and failing to do so confuses the analysis of occurrence in construction defect cases.

### 3. The element of control differentiates construction defect cases from prior cases.

This case involves a claim for deficient construction of a house resulting in damage to the house itself. Under the principle of fortuity, fortuitous events are those substantially beyond the control of the insurer or insured. "Plan, design or intent" captures an important aspect of this concept, but it does not encompass the entire principle. In certain instances, as where an insured deficiently constructs a house in a manner that damages the house itself, the insured has so much control that a fortuitous event could not have occurred even when the insured may not have planned, designed, or intended the damage it caused to its own construction.

In deciding this question of first impression, this Court should recognize the element of substantial control inherent in the principle of fortuity and apply the control analysis to construction defect cases, as has been done by the majority of courts who have

addressed the issue. In CIC's case, Elite Homes substantially controlled the allegedly defective construction, and thus damage to the Mintmans' house arising from the construction itself was not a fortuitous event that meets the definition of occurrence in the CGL policy.

## III. THIS COURT'S BROWN FOUNDATION DECISION DOES NOT CALL FOR A FINDING OF COVERAGE.

In its decision reversing the trial court, the Court of Appeals recognized that CIC's argument was "compelling." Opinion, p. 7. The Court of Appeals concluded, however, that Motorists Mutual had the better argument because "comprehensive general liability policies are designed to cover broad risks." Id. The Court of Appeals based its reasoning on the statement in Brown Foundation that the purpose of a comprehensive general liability policy is to cover all risks not expressly excluded. See 814 S.W.2d at 278. The fatal flaw with the Court of Appeals' analysis is that commercial general liability policies like the one issued by CIC to Elite Homes are not designed to cover "all risks," and reliance on this portion of the Brown Foundation decision is improper as it applies to CIC's policy and construction-defect cases.

Reliance on the broad-sweeping statements concerning "comprehensive" and "all risks" policies in Brown Foundation is no longer appropriate, particularly where, as in the case of poor workmanship damaging the insured's work itself, the claims fail to satisfy either the definition of "property damage" or "occurrence" under the policy. As seen in the Court of Appeals Opinion in this case, the Brown Foundation Court's sweeping statement confuses the issues and arguably provides authority for Kentucky courts to unjustifiably discount "compelling" arguments that directly address the insurance coverage issues in a particular case.

A good example of the problems created by the lingering effects of the Brown Foundation decision is Parrott v. Hoosier State Construction Co., No. 3:02CV-499-MO, 2006 U.S. LEXIS 14062 (W.D. Ky. March 28, 2006), which addressed the issue now before this Court. When the insurer therein first moved for summary judgment, the Court denied the motion based on its perception that the Brown Foundation decision made it likely that the courts of Kentucky "at a minimum would find that Erie has a duty to defend Hoosier State Construction and might very well find that Erie also has a duty to provide coverage for some, if not all of the claims." Parrott v. Hoosier State Construction, Inc., No. 3:02CV-499-MO, 2004 U.S. Dist. LEXIS 2776, *11 (W.D. Ky. March 29, 2004). The court added, however, that it disagreed with that result, and believed that the reasoning of the majority line of cases was correct:

> General liability policies are not designed to cover all risks, and are premised on the notion that general liability policies do not and are not intended to act as a guarantee of an insured's work itself, but to generally insure consequential risks that stem from the insured's work. The New Jersey Supreme Court perhaps has best described the purpose of commercial general liability policies: they do "not cover the accident of faulty workmanship but rather faulty workmanship which causes an accident." Weedo v. Stone-E-Brick, Inc., 405 A.2d 788, 796, 81 N.J. 233 (1979). It would be economically inefficient for an insurance policy to protect against risks that appropriate business management could and should control.

Slip op., at *8.

Two years later, however, the same court in the same case concluded that this Court would agree with the majority of the courts which have decided that coverage does not exist under a general liability policy for claims of faulty construction:

> Kentucky commercial law has continued to evolve since James Graham Brown was decided, however. First and foremost, the makeup of the Kentucky Supreme Court has

> materially changed, and this Court can no longer say with certainty that the current Justices would take an "expansive approach" to the interpretation of CGL policies. Were the James Graham Brown case directly on point factually and legally, this Court might not be inclined to rethink its prior ruling. That case, however, merely shows that the Kentucky Supreme Court was previously inclined to be rather expansive in its approach to coverage issues. It did not definitely rule that it would be expansive if presented with the same facts at issue in this case.
>
> Because Kentucky's precedent is not directly on point, and the general approach to coverage issues articulated in that case may no longer be the mindset of the majority of the sitting Justices, and because the majority of courts in this country have held that coverage under a CGL policy is not appropriate for the types of claims alleged by the plaintiffs, this Court can no longer say, in good faith, that Erie is not entitled to judgment as a matter of law. Accordingly, the court finds that, as a matter law, it is appropriate to grant Erie's motion.

Parrott v. Hoosier State Construction, Inc., No. 3:02CV-499-MO, 2006 U.S. Dist. LEXIS 14062, at *9-10.

The problem highlighted in Parrott is created by the breadth of the statements made in Brown Foundation concerning insurance policies. The Brown Foundation court stated:

> [T]he primary purpose of a comprehensive general liability policy is to provide broad comprehensive insurance. Obviously the very name of the policy suggests the expectations of maximum coverage. Consequently the comprehensive policy had been one of the most preferred by business and governmental entities over the years because that policy has provided the broadest coverage available. All risks not expressly excluded are covered, including those not contemplated by either party. See The Applicability of General Liability Insurance to Hazardous Waste Disposal, 57 S. Cal. Law Review 745 (1984).

Id. at 278. The source cited in Brown is a law journal note (not article) discussing the application of pre-1986 "comprehensive" general liability polices to environmental

claims involving hazardous waste disposal. See Note, The Applicability of General Liability Insurance to Hazardous Waste Disposal, 57 S. Cal. Law Review 745 (1984). This note fails to discuss the purpose of CGL coverage in detail, and the only reference in the Note supporting the broad statement made by the Brown Foundation court reads:

> Generally, the insurance company adopts all known and unknown risks of injury or damages that occur during the policy period. This broad liability is limited only by policy provisions explicitly excluding coverage for certain specific events. Other than these exclusions, the insurer adopts all risks, regardless of the intent of the parties. n.33

Id. at p. 749. The footnote to that paragraph reads: "See Comment, Liability Insurance for Insidious Disease: Who Picks Up the Tab?, 32 Fordham L. Rev. 657, 679 (1980) (language of policy strictly construed against insurer and for coverage unless unambiguous)" (explanatory parenthetical in original).

This journal comment, divulged by the author's own parenthetical, does not justify the overly broad conclusions stated in Brown Foundation. Tracing the legal research demonstrates that the statements in Brown Foundation are based on scant, if any, legal authority.

In the absence of actual legal authority, the only reasoning allegedly supporting the Brown Foundation court's "all risks" conclusion is that "the very name of the policy suggests the expectation of maximum coverage." Brown Foundation, 814 S.W.2d at 278. Although the word "comprehensive" may or may not suggest an expectation of maximum coverage, CIC's policy is a post-1986 "commercial general liability policy" employing different language than the 1973-era policy at issue in Brown Foundation. See Exhibit A, form GA 101 01 95, p. 1 of 13 (covering "those sums" the insured becomes legally obligated to pay as damages due to "property damage" caused by an

"occurrence" within the policy period versus the "all sums" language found in the comprehensive general liability policy at issue in Brown Foundation.) Nothing, then, remains to support the reasoning in Brown Foundation.

These significant differences have previously been recognized. For example, while deciding a construction defect case under Kentucky law, the court in Standard Fire, Supra, recognized that CGL policies do not cover "all risks." 972 S.W.2d at 6-7. It explained:

> General liability policies are not "all-risk" policies. They provide an insured with indemnification for damages up to policy limits for which the insured becomes liable as a result of tort liability to a third party. The risk insured by these policies is the possibility that the insured's product or work will cause bodily injury or damage to property other than the work itself for which the insured may be found liable.

Id. (citations omitted).

In addition, writing in dissent in an environmental damages case, Justice Cooper, previously of this Court, also noted the difference between CGL policies, which are designed to cover losses to third parties, and:

> First-party polices, sometimes referred to as "Differences in Conditions" (DIC), "All Risks," or Casualty Insurance policies, [which] are conceptually similar to collision coverage in a standard automobile police or fire coverage in a standard homeowner's policy.

Aetna, supra, 179 S.W.3d at 844-45 (J. Cooper, dissenting) (citations omitted).

Thus, the reasoning behind the "all risks" statement in Brown Foundation is suspect, and it fails to justify finding coverage where, as in the case of poor workmanship damaging the insured's work itself, the claims fail to satisfy either the definition of "property damage" or "occurrence" under the policy. This Court should

recognize the limitations of the Brown Foundation decision and not use it as justification to create coverage under CIC's policy where none would otherwise exist.

## CONCLUSION

The trial court correctly concluded that no coverage exists under CIC's policy because the Mintmans' claims for defective construction of their house fail to meet the definitions of "property damage" and "occurrence" under CIC's policy. The Mintmans claimed that Elite's poor workmanship in constructing their home caused damage to the home itself, which at its core is an economic loss claim for allegedly shoddy work. This is not the type of damage insured against under the policy. Since the Mintmans' claims are not "property damage," they fall outside the grant of coverage in CIC's commercial general liability policy. This alone justifies a complete denial of coverage.

In addition, defective construction of a home resulting in damage to nothing other than the home itself is not an accident and thus is not caused by an "occurrence" because it is not the type of fortuitous event insured against under the policy. Regardless of whether the damage arose from Elite's design, plan, or intent, the damage was substantially within Elite's control. In construction defect cases where damage occurs only to the work itself, holding that such claims are caused by an occurrence would run contrary to the purpose of the policy and convert CIC's commercial general liability policy into a performance bond. Independent of this Court's ruling on the "property damage" issue, the lack of an "occurrence" under CIC's policy also supports the trial court's grant of summary judgment in favor of CIC.

For the foregoing reasons, this Court should reverse the Court of Appeals and reinstate the summary judgment granted by the trial court finding that CIC owes no duty

to defend or indemnify Elite Homes. If instead this Court affirms the Court of Appeals, it should remand this case to the trial court for resolution of any factual issues which may determine whether coverage ever existed under the Cincinnati Insurance Company Commercial General Liability insurance policy issued to Elite Homes, including the potential application of any exclusions.

Respectfully submitted,

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