KENTUCKY SUPREME COURT
NO. 2008-SC-000293

CINCINNATI INSURANCE COMPANY — **APPELLANT**

v. **ON REVIEW FROM COURT OF APPEALS**

NO. 2007-CA-000818

JEFFERSON CIRCUIT COURT NO. 01-CI-05857

MOTORISTS MUTUAL INSURANCE COMPANY — **APPELLEE**

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APPELLANT'S REPLY BRIEF

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CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing Appellant's Reply Brief was served by first class mail, postage prepaid, upon Hon. Mary M. Shaw, Division Five, Jefferson Circuit Court, 600 West Jefferson Street, Louisville, KY 40202, and William P. Swain, Esq., Paul J. Bishop, Esq., D. Sean Ragland, Esq., Phillips Parker Orberson & Moore, 716 West Main Street, Suite 300, Louisville, Kentucky 40202, on this 24th day of July, 2009. It is further certified that the record on appeal was not withdrawn by the appellant.

Michael D. Risley
Michael D. Risley

STATEMENT OF POINTS & AUTHORITIES

Cincinnati Insurance Company ("CIC") submits this reply brief to address certain points raised in the response brief of appellee, Motorists Mutual Insurance Company. Nothing in Motorists Mutual's Response Brief takes away from CIC's showing that this Court should reverse the Court of Appeals and reinstate the summary judgment granted to CIC by the trial court.

ARGUMENT

I. THE MINTMANS' CLAIMS AGAINST ELITE HOMES WERE NOT FOR "PROPERTY DAMAGE" AS DEFINED IN THE COMMERCIAL GENERAL LIABILITY POLICY.

In discussing the property damage issue, Motorists Mutual's response strays from analysis of the CIC policy language. The CIC policy covers Elite Homes for "those sums that the insured becomes legally obligated to pay as damages because of [...] 'property damage.'" Elite Homes became legally obligated to pay damages due to breaching its obligations to properly construct a home, not due to "property damage," which the policy defines as "physical injury to tangible property" or "[l]oss of use of tangible property that [was] not physically injured."

Motorists Mutual suggests that the presence of any physical deterioration in Elite Homes' work triggers coverage. (Response, p. 10) This suggestion confuses the analysis. 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). Instead, the analysis properly turns on the underlying cause giving rise to Elite Homes' legal obligation, which was the Mintmans' claim that Elite Homes had improperly constructed their home. Id. Thus, Elite Homes became legally obligated to pay damages due to breaching its

obligations to the Mintmans by performing shoddy work, not because the shoddy work caused property damage to some other thing. Motorists Mutual's argument glosses over this important distinction.

This distinction is important because the position Motorists Mutual urges this Court to adopt ignores the purpose of modern liability insurance, which is to spread the risk of unexpected losses substantially outside of the policyholder's control, not to act as a performance bond to cover obligations arising directly from the failure to perform adequate work. Motorists Mutual's position would convert an insurance policy into a performance guarantee, which it was never meant to be, and it would create a disincentive for proper management controls by the policyholder. (See CIC's Brief, § I (C)-(D), discussing authorities) Various courts, including courts applying Kentucky law, have reached similar conclusions. (Id.)

Courts consistently recognize that commercial general liability policies are not intended to provide coverage for economic loss caused by an insured's failure to construct a building according to the standards expected by the purchaser. See, e.g., Parrott v. Hoosier State Construction, Inc., No. 3:02CV-499-MO, 2006 U.S. Dist. LEXIS 14062, *11 (W.D. Ky. 2006) (General liability policies "are not intended to cover all risks" and "are not intended to act as a guarantee of an insured's work itself...."); Fuller v. U.S. Fidelity & Guar. Co., 200 A.D. 2d 255 (N.Y. App. 1994) (General liability policy was "never intended to provide contractual indemnification for economic loss to a contracting party because the work product contracted for is defectively produced"). Yet that is the result of the Court of Appeals decision. After moving into the house built by Elite Homes, the Mintmans noticed minor cracks developing, windows and doors were

sticking, floors were sagging, etc. Complaint, ¶ 24. Under the rationale expressed by the Court of Appeals, a homeowners' claims against the builder to correct such problems come within the grant of coverage contained in a general liability policy. As recognized in the many cases cited in CIC's earlier brief, that should not be the law of Kentucky.

II. FAULTY WORKMANSHIP IS NOT AN "OCCURRENCE" UNDER THE COMMERCIAL GENERAL LIABILITY POLICY.

The CIC policy defines "occurrence" as an "accident." The occurrence issue turns on whether shoddy workmanship is an accident. Whether shoddy workmanship is an accident turns on whether it is fortuitous. Motorists Mutual asserts that a "substantial part" of CIC's argument suggests that the terms "accidental" and "fortuitous" are somehow different. (Response, p. 16) This is absolutely false. Instead, CIC argues the opposite. As explained in CIC's brief, accident incorporates the principle of fortuity, but both the Court of Appeals in this case and other Kentucky courts attempting to define "accident," have failed to recognize the breadth of the fortuity principle. (Brief, § II(E)) This has caused confusion and oversimplification in analysis of construction-related CGL cases such as this one. (Id.) In fact, as outlined in CIC's brief, no Kentucky court has squarely addressed the principle of fortuity. (Id.)

Motorists Mutual concedes that "accident" and "fortuity" are synonymous (Response, pp. 16, 20), and, therefore, it must also concede that shoddy workmanship is not an occurrence under CIC's policy. The principle of fortuity, which is the most fundamental principal of insurance and insurance law, recognizes that the risk of loss must be, to a substantial extent, beyond the control of either party to the insurance contract. (Brief, § II(E)) Elite Homes' faulty construction was substantially within its control. It was not accidental.

That faulty workmanship is not an occurrence under CGL policies is the majority view. Citing a 2007 source, Motorists Mutual suggests that at least one commentator may not necessarily agree with that proposition. (Response, p. 11) Regardless of whatever doubt may have existed in the mind of that one commentator in 2007, both the Supreme Court of Arkansas and the Colorado Court of Appeals have recently confirmed, and added their voices to, the existing majority view holding that faulty workmanship is not an occurrence for purposes of a commercial general liability policy. See Essex Ins. Co. v. Holder, 261 S.W.3d 456, 459-460 (Ark. 2008) (noting majority view and collecting cases); General Security Indem. Co. of Ariz. v. Mountain States Mut. Cas. Co., 205 P.3d 529, 535 (Colo. App. 2009) (noting majority and minority views and collecting cases and sources).

In General Security, the court held that claims of defective workmanship, standing alone, do not constitute an "occurrence" under CGL policies. Id. at 531. The policy at issue defined "occurrence" as an accident. Id. at 533. In reaching its decision, the court was "persuaded by the majority rule because it is consistent with [Colorado law] and relies on the necessary element of fortuity inherent in the ordinary meaning of the term 'accident.'" Id. at 535 (emphasis added). It further noted that "courts adopting the minority rule and applying a broad definition of 'accident' do not address the reasoning of courts following the majority rule that an accident must be fortuitous." Id. at 536.

Other than citing the cases adopting the minority rule, Motorists Mutual's response fails to address the reasoning which has convinced the majority of courts to conclude faulty workmanship is not an occurrence under the CIC policy because it was not an accident. The minority rule, adopted by the Court of Appeals in this case, means

that any time a floor sags, a crack develops in a wall, or a window or door sticks, the builder's liability insurer is on the hook to correct the problems and to bring the house up to the standards expected by the purchaser. A liability policy was never intended to be a guarantee of a builder's performance, and this Court should not so hold.

III. NEITHER BITUMINOUS NOR BROWN FOUNDATION JUSTIFY COVERAGE.

Motorists Mutual characterizes CIC's argument as calling for this Court to overrule Bituminous Cas. Corp. v. Kenway Contracting, Inc., 240 S.W.3d 633 (Ky. 2007) and James Graham Brown Foundation, Inc. v. St. Paul Fire & Marine Ins. Co., 814 S.W.2d 273 (Ky. 1991). (Response, p. 24). This is false. CIC argues that neither case supports upholding the decision of the Court of Appeals, not that this Court should overrule them.

Although decisions from other courts applying Kentucky law have agreed with the position CIC urges this Court to adopt, no decision from this Court has addressed the issues now before it. Bituminous dealt with whether coverage existed for a contractor who demolished the wrong structure. It did not decide the issue of whether faulty workmanship causing damage to the work itself was "property damage" caused by an "occurrence." The Court of Appeals' conclusion that the issues raised in this case had been resolved in Bituminous was erroneous.

The Brown Foundation decision contains a sweeping statement about the purpose of "all risks" policies, which is based on virtually no legal authority and is improper as it applies to CIC's policy and construction-defect cases. (Brief, § III) CIC does not call for overruling the Brown Foundation decision but instead explains why this Court should recognize the limitations of the decision and not use it as justification to create coverage

under CIC's policy where none actually exists. (Id.) In fact, the courts considering the issues now before this Court under Kentucky law since this Court's decision in Brown Foundation have concluded that coverage does not exist under a general liability policy for claims of faulty construction. See, e.g., Parrott v. Hoosier State Construction, Inc., No. 3:02CV-499-MO, 2006 U.S. Dist. LEXIS 14062 (W.D. Ky. 2006); Standard Fire Ins. Co. v. Chester-O'Donley & Associates, Inc., 972 S.W.2d 1 (Tenn. App. 1998). Thus, Brown Foundation does not need to be overruled, only properly understood and applied.

IV. THE "PROPERTY DAMAGE" AND "OCCURRENCE" ISSUES ARE THE ONLY ISSUES BEFORE THIS COURT.

This Court granted discretionary review to address two discrete legal issues – whether a claim of faulty workmanship constitutes a claim for "property damage" and whether such a claim constitutes an "occurrence" for purposes of a commercial general liability insurance policy. In its response, Motorists Mutual suggests that a 2002 letter from CIC somehow waived CIC's right to contest coverage or created an ambiguity in the policy language itself. (Response, p. 17, 22) Such suggestions are false, and the language contained in the policy itself will resolve the issues before this Court.

Furthermore, Motorists Mutual urges this Court to rule that, if it affirms the Court of Appeals on the issues actually before this Court, this Court should also be the first to consider the potential application of the policy's exclusions. The trial court never considered the policy's exclusions because it properly concluded that the claims did not come within the policy's grant of coverage. Because the trial court did not consider their potential application, the Court of Appeals remanded the case so that the trial court could consider the potential application of the policy's exclusions.

Motorists Mutual did not file a cross motion for discretionary review on the Court of Appeals remanding the case for consideration of the policy's exclusions. Thus, whether the Court of Appeals was correct in remanding the case for consideration of the policy's exclusions is not before this Court.

The same is true with Motorists Mutual's newly offered argument that CIC had a duty to defend even if no coverage is found to exist. Motorists Mutual did not raise that issue before either the trial court or the Court of Appeals, and the issues upon which this Court granted discretionary review do not include that issue. Motorists Mutual cannot wait until it files its brief with this Court to raise an issue not considered by either the trial court or the Court of Appeals.

In any event, this Court recognized again in Aetna Casualty & Surety Co. v. Commonwealth, 179 S.W.3d 830, 841 (Ky. 2005), that an insurer who believes there is no coverage may elect not to defend the insured. While the insurer may be liable for defense costs "should coverage be found," id., that possibility does not impinge upon the right of an insurer who believes there is no coverage to elect to not provide a defense.

CONCLUSION

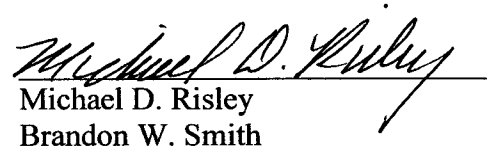
Elite Homes' faulty workmanship was not an "occurrence" under CIC's policy, and did not cause "property damage" for purposes of the policy. The majority of the courts addressing this issue agree with CIC on those issues, and the Court of Appeals conclusion that it was compelled to adopt the minority rule based on prior decisions of this Court was erroneous.

Although amusing, Motorists Mutual's concluding image of the Tower of Pisa collapsing on a passing chariot underscores the logic of the majority of courts around the

nation.[1] In modern times, were a building to collapse due to poor workmanship, a performance bond, not a CGL policy, would cover the damage to the building, and the contractor would have every incentive to institute proper management controls preventing such loss.

For the foregoing reasons and the arguments contained in CIC's original brief, 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 the Court affirms the Court of Appeals, the affirmance should include the Court of Appeals' remand to the trial court for resolution of any factual issues which may determine whether coverage ever existed under the CIC Commercial General Liability insurance policy issued to Elite Homes, including the potential application of the policy's exclusions.

Respectfully submitted,



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[1] The image is further amusing because of its anachronism. The Tower of Pisa was constructed from 1172 – 1372 A.D. The chariot was a late Bronze-Age device which ceased to have military importance in the 4th century B.C. and whose use in chariot races ended in the 6th Century A.D., 500 years before construction on the Tower of Pisa began. Like the chariot, CIC urges that the minority view be relegated to the dustbin of history.