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UNDER CONSTRUCTION

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Arizona Supreme Court Rules in Favor of Developer on Claim Against CGL Insurer for Cost of Repairing Defective Construction

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In May 2011, the Arizona Supreme Court affirmed the Arizona Court of Appeals' August 2010 decision affirming a jury trial verdict and subsequent judgment in favor of a developer who had sued its commercial general liability (CGL) insurer to recover the cost of repairing 50 homes in a master-planned community. *Desert Mountain Properties Limited Partnership v. Liberty Mutual Fire Insurance Company*, 2011 Ariz. LEXIS 25, 250 P.3d 196 (May 12, 2011).

While the Court of Appeals had ruled on many issues raised by both the developer and the insurer on cross appeals, the Supreme Court evaluated just the following three issues: (1) whether a CGL policy covers an insured's contractual liability for damage that caused only economic loss, (2) whether the CGL policy's contractual liability exclusion applies only when an insured has "assumed" another's liability by agreeing to indemnify or hold another harmless and (3) whether an insured's voluntary expenditures to repair property damage caused by construction defects resulted from a "legal obligation" to pay "damages." The Supreme Court affirmed the Court of Appeals' rulings on these three issues. The Supreme Court's decision should be very helpful to developers, contractors and subcontractors attempting to obtain CGL insurance coverage in Arizona when the insurer raises any of these arguments.

Background

The developer of an upscale north Scottsdale, Arizona master planned community learned that soil settlement had caused cracks and other damage to 50 new homes. Prompted by complaints from homeowners, the developer paid an average of $200,000 per home to have the soil issues corrected and the damage repaired. The developer sought reimbursement from its CGL insurer, who denied coverage on a number of bases. The contractor sued the insurer for breach of contract and bad faith, and, following a jury trial, the trial court entered judgment in favor of the contractor. The Court of Appeals affirmed the trial court on all issues.

Supreme Court Review

Issue (1): Whether a CGL Policy Covers Contractual Liability for Solely Economic Losses

The Supreme Court first reviewed the insurer's issue regarding whether the CGL policy covered the developer's contractual liability to the homeowners for damages that were purely economic in nature, i.e., the cost of repair of the homes versus personal injury or personal property loss. The Supreme Court affirmed the Court of Appeals' earlier analysis. The Court of Appeals recognized that, based upon the Arizona Supreme Court ruling in *Flagstaff Affordable Housing Limited Partnership v. Design Alliance, Inc.*, 223 Ariz. 320, 223 P.3d 664 (2010), the developer's liability to the homeowners for the damage to the homes was in contract, not in tort. The insurer argued that CGL coverage extended only to damages arising from accidents that result in tort claims, not damages arising from breach of contract.

The Supreme Court affirmed the Court of Appeals' analysis that "[w]hile there is some appeal to the notion that a breach of contract is not the sort of accidental risk to which liability insurance is designed to apply, we are reluctant to read such a limitation into a CGL policy when the parties have not chosen to write it for themselves. The policies at issue here included various express limitations or exclusions that may apply to certain contractual liabilities. … The fact that those express provisions do not flatly bar coverage of all contract claims supports our decision to decline to imply into the policies the broad principle that coverage is not afforded to damages arising from contract." Instead, the proper inquiry is whether an occurrence has caused property damage, not whether the ultimate remedy for that claim lies in contract or in tort. This was a very helpful holding to Arizona developers, contractors and subcontractors in light of the Arizona Supreme Court decision in *Flagstaff Affordable Housing* that limits remedies to contract remedies when a contract exists between the parties and the damages are economic damages.

Issue (2): Whether the CGL Policy Contractual Liability Exclusion Applies Only When the Insured Has Assumed Another's Liability

The Supreme Court next reviewed whether the CGL policy contractual liability exclusion applies only when the insured has assumed the liability of another by agreeing to indemnify or hold another harmless. Again, the Supreme Court affirmed the Court of Appeals' earlier analysis. In the policy at issue, an endorsement excluded "property damages" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages (1) that the insured would have in the absence of the contract or agreement; or (2) assumed in a contract or agreement that is an "insured contract" provided the . . . "property damage" occurs subsequent to the execution of the contract or agreement."

The question decided was whether the developer's obligations to its homeowner customers gave rise to "damages by reason of the assumption of liability in a contract or agreement" within the meaning of the exclusion, or, put differently, whether the sales contracts the developer entered into with its homeowner customers constituted "assumption of liability in a contract or agreement" within the meaning of the policy. The Supreme Court affirmed that the contractual liability exclusion did not apply to bar the developer's recovery from the insurer because the sales contracts did not amount to the assumption of the homeowner customers' liability or an agreement to indemnify the homeowner customers.

Issue (3): Whether the Developer's Voluntary Expenditures to Repair Property Damage Resulted From a Legal Obligation to Pay Damages

The third and final issue was whether the expenditures by the developer to repair property damage resulting from defective construction in the absence of a lawsuit by the homeowners fell within the coverage language of "damages" that the insured was "legally obligated to pay." The Supreme Court affirmed that an insurance policy is to be interpreted according to its plain and ordinary meaning, examining it from the viewpoint of an individual untrained in law or business. Reading the policies in that manner, a "legal obligation to pay" means any obligation enforceable by law, including, for example, an obligation created by statute, contract or the common law. Once created, the obligation exists prior to and even in the absence of a suit to enforce it or a court order compelling performance. In short, although a court may *enforce* a legal obligation, in the usual case, no court action is required to *create* a legal obligation. For that reason, the Supreme Court affirmed that the better-reasoned rule is that coverage for sums an insured becomes "legally obligated to pay as damages" may be triggered even in the absence of a civil lawsuit against the insured or a court order requiring the insured to make payment. This holding should be helpful to those who choose to resolve matters with their contractual clients earlier in the process and even before a lawsuit is filed.

Summary

Based upon the Arizona Supreme Court's decision, developers, contractors, subcontractors and their CGL insurers should now be aware that, assuming insurance coverage otherwise exists, under Arizona law, (1) a CGL policy may, unless the policy contains an express exclusion of such liability, cover the insured's contractual liability for solely economic losses; (2) a contract between a developer or contractor and the homeowner that obligates the developer or contractor to remedy or pay for property damage resulting from defective construction is not construed as an agreement to indemnify or hold the homeowner harmless for purposes of applying the CGL contractual liability exclusion; and (3) the voluntary expenditures of an insured to repair property damage caused by construction defects for which the insured is contractually obligated to the homeowner results from a "legal obligation" to pay "damages" for purposes of CGL coverage analysis.

As a closing note, the Court of Appeals recited in its opinion the factual history of the case, including the developer's communications with the CGL insurer during the course of the developer's investigation and repairs and the insurer's conduct in response. To be clear, in the event of a complaint and/or damage for which an insured may believe that coverage applies, it is a strongly recommended practice, and is often required under the policy, that the insured promptly notify the insurer and take no steps to assume any obligation or incur expense without the insurer's consent. That said, in this fact scenario in which the insurer was determined to be nonresponsive, the developer, acting in what it believed to be a reasonable manner and to protect its customers' goodwill, stepped up and made repairs even in the absence of aid or commitment from the insurer, and was not penalized for doing what it believed to be the right thing by remedying the damages.

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