

September 2008 Vol. 15

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Seventh Circuit Holds that Breach of Construction Contract is not Property Damage Caused by an Occurrence

The United States Court of Appeals for the Seventh Circuit applied Illinois law and held that there was no coverage for a contractor's alleged breach of a contract to construct a home because there were no allegations of property damage caused by an occurrence. *Lyle Lyerla d/b/a Wildewood Construction v. AMCO Ins. Co.*, No. 07-3104 (7th Cir. Aug. 4, 2008).

Factual and Procedural Background

Lyle Lyerla d/b/a Wildewood Construction (Lyerla) was hired to construct a home. The property owners filed a breach of contract action against Lyerla, alleging failure to construct the building in a good and workmanlike manner; failing to correct all defects; failing to meet the building plans and specifications; and failing to pay liquidated damages.

Lyerla was insured under a commercial general liability contract issued by AMCO Insurance Company (AMCO). AMCO denied a defense and indemnity for the homeowners' lawsuit.

In the declaratory judgment action that followed, a United States District Court for the Southern District of Illinois granted summary judgment to AMCO. The federal district court held that the lawsuit did not allege an occurrence or property damage as those terms are defined under the AMCO policy. Lyerla appealed.

Holding

The Seventh Circuit agreed with the federal district court that there was neither an occurrence nor property damage.

Defective Construction Is Not Property Damage Caused by an Occurrence

The AMCO contract defined an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." It defined property damage, in part, as "physical injury to tangible property" and "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."

The court began by addressing whether there was an occurrence. Although "accident" was not defined in the AMCO policy, the court explained that Illinois courts "have defined 'accident' as 'an unforeseen occurrence, usually of an untoward or disastrous character or an undesigned, sudden, or unexpected event of an inflictive or unfortunate character,'" and have "reasoned that damage to a construction project resulting from construction defects is not an 'accident' or 'occurrence' because it represents the natural and ordinary consequence of faulty construction." (citations omitted).

The court analyzed Illinois case law on the issue of whether defective construction was an occurrence or an accident. In *Monticello*

Ins. Co. v. Wil-Freds Constr., Inc., 661 N.E.2d 451 (Ill. App. Ct. 1996), an Illinois intermediate appellate court held that defects “[were] the natural and ordinary consequences of the improper construction techniques . . . and, thus, [did] not constitute an occurrence.” Similarly, in *Viking Construction Management, Inc. v. Liberty Mutual Insurance Co.*, 831 N.E.2d 1, 6 (Ill. App. Ct. 2005), an Illinois intermediate appellate court concluded that an insurer had no duty to defend because “the damages claimed by [the claimant] were the natural and ordinary consequences of defective workmanship and, accordingly, did not constitute an ‘occurrence.’” *Id.* at 16. In summary, the court stated that “[p]recedent . . . strongly supports the district court’s conclusion that the Owners’ allegations of defective work do not constitute an ‘accident’ or ‘occurrence.’”

The court noted that despite this Illinois precedent, there is “some support for the position that negligently performed work or defective work can give rise to an occurrence. . . .” Negligent construction may constitute an occurrence if “the person performing the acts leading to the result intended or expected the result. If the person did not intend or expect the result, then the result was the product of an accident.” (quoting *Country Mut. Ins. Co. v. Carr*, 867 N.E.2d 1157 (Ill. App. Ct. 2007)). In other words, work that is performed negligently may constitute an occurrence if it

causes damage to something other than the work itself. Under this analysis, the definitions of occurrence and property damage are conflated—whether there is an occurrence appears to hinge on whether there is property damage.

In the case before it, the court found that the underlying complaint alleged that the insured’s work did not satisfy contractual obligations and made no allegations of property damage caused by an occurrence. The court explained that the complaint did not allege physical injury to tangible property because no property was allegedly “altered in appearance, shape, color, or in other material dimension.” The court stated that the complaint alleged that “the work called for under the contract was performed improperly or incompletely.” In other words, “it alleged faulty workmanship, not faulty workmanship that damaged property.” The court concluded that the costs of repairing defective work is not property damage.

Loss Of Use Is Not Property Damage

In an attempt to establish that there was property damage, Lyerla next argued that the liquidated damages and storage fees fell within the “loss of use” definition of property damage. The court rejected Lyerla’s argument. The court reasoned that the liquidated damages were not for the loss of use of tangible property but rather were costs imposed on Lyerla pursuant to the contract. As for the stor-

age fees, the court found that the policy required that any loss of use must take place at the time of the occurrence that caused it. Because Lyerla’s failure to complete the home on time was not an occurrence, the court found there was no loss of use.

Subcontractor’s Defective Work Is Not Property Damage Caused by an Occurrence

The court also rejected Lyerla’s argument that defective work resulting from a subcontractor’s work—even if Lyerla did not foresee the defective work—was property damage caused an occurrence. The court stated that “whether [the insured] expected his subcontractors to perform their work properly is irrelevant where the complaint clearly does not allege any property damage.”

Implications

In the nationwide debate regarding whether defective construction is an occurrence, Illinois remains among those jurisdictions that have found commercial general liability contracts do not cover faulty construction. This decision confirms that defective construction that is limited to the work itself and does not damage other property is neither an occurrence nor property damage. It also rejects attempts to characterize liquidated damages and storage fees as property damage.

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