The Uninsured Risks Of Development

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Don't assume that just because the architect and contractor have insurance that they will have coverage.

ACCIDENTS HAPPEN and insurance is generally available to protect against the consequences of accidents. Development projects involve risks and insurance is an integral part of all development projects. The risks of bodily injury and death resulting from accidents are generally insured against. The risks of damage to other property resulting from accidents and mistakes are generally insured against. However, defective design or construction are deemed by the courts to result from mistakes and not accidents and are generally uninsured risks.

The law equates defective design or construction of a building to defective design or manufacture of an automobile or other product and the insurance industry generally does not provide insurance coverage for such defects, unless bodily injury or death is involved. If the only result of the defective design or construction or manufacture is injury to the structure constructed or product manufactured, the economic costs of repair or reconstruction are generally uninsured costs. These are the uninsured risks of development.

The fact that these are uninsured costs may not be obvious or understood by contractors, architects, developers, and their respective transactional attorneys. The

participants in development projects have often litigated these matters and often there will be coverage litigation with the insurers who provided insurance of one type or another for the development project. The courts in every jurisdiction have addressed whether there is coverage for the various risks of development and there is a huge body of case law that can be studied and sometimes understood.

In some jurisdictions, there is a judicial doctrine or court-created doctrine called the "economic loss doctrine" or "economic loss rule" that shields the negligent party from any liability for purely economic losses. The cost of redesign or repair, or reconstruction of faulty structures or resulting damage to the structure itself along with other consequential damages, are often deemed to be purely economic losses for which there will be a shield of no liability if the injured party sues only in negligence. Along with not having any liability in negligence, the architect and the contractor may have no insurance for such economic losses. Having been paid once for the design and for the construction, the architect and the contractor will not be paid again from insurance proceeds to rectify their errors — and often even if they are contractually obligated to do so.

Attorneys involved in construction litigation and attorneys involved in insurance coverage litigation are familiar with the complexities of insurance policies, the economic loss rule, and the limitations of insurance coverage for economic losses. The attorneys who regularly litigate construction defect claims are adept at including allegations in their complaints that will trigger an insurer's duty to defend and possibly an insurer's willingness to participate in settlement payments in situations in which the insurer may have no duty to indemnify its insured. On the other hand, transactional attorneys and their developer clients and some of their contractor or architect clients may not be as knowledgeable about the limitations in their insurance policies. Yet, transactional attorneys will often negotiate construction contracts, architect's contracts, and insurance requirements, and their clients may sign contracts with (possibly) a false sense of security that they have allocated risks and transferred risks to insurers. Without a full understanding of the economic loss rule and the limitations and exclusions of the insurance policies, clients may be disappointed to discover that they have failed to transfer these risks to the insurance companies. They may also be disappointed to learn of the uninsured risks of development.

The focus of this article is on economic losses due to defective design and defective construction. As will be discussed, insurance is generally not available to insure that an architect or a contractor will meet the contractual expectations of the owner or developer. The provisions in the architect's contract or the construction contract that promise or agree to quality standards (or warrant or guarantee them) will be obligations of the architect or the contractor; there will be no insurance in the event of failure to live up to them. As a general rule, insurance is not available to insure purely economic losses resulting from the architect's errors and omissions. Similarly, insurance is not available to insure purely economic losses resulting from the contractor's faulty construction. There are, however, exceptions that will be discussed later in the article. But let's start with the basics.

RELEVANT INSURANCE POLICIES • The relevant insurance for the architect with respect to the architect's negligence or malpractice is the Architect's Errors and Omissions (E&O) or professional liability policy. The relevant insurance for the contractor with respect to the contractor's negligent construction is the commercial general liability policy (CGL). The architect's CGL excludes coverage for professional services, leaving the architect to rely on its E&O policy, and the contractor's builder's risk policy ends when construction is completed, leaving the contractor to rely on its

CGL policy for completed operations. It is possible that the performance bond that the contractor posts will apply to these risks. The courts have been just as conflicted on the surety's obligations for construction defects under the performance bond as they have with respect to the insurer's obligations under the CGL and this article focuses only on the CGL and the architect's E&O policy.

There are significant limitations on the coverage provided by the architect's E&O policy with respect to purely economic losses that result from the architect's negligent services. Likewise, there are significant limitations on the coverage provided by the contractor's CGL with respect to purely economic losses that result from the contractor's negligent construction.

The standard form CGL policies have evolved over time, at times contracting and at times expanding coverage. The relevant case law may be based on differing forms of the CGL policy. As with all insurance coverage questions, the first inquiry focuses on the coverage agreement or the insuring agreement as stated in the policy. The economic loss rule may actually negate the coverage agreement. After all, if there is no liability, there is no need for liability insurance.

This article focuses on the economic loss rule as it has been adopted in Hawaii (several states have taken a similar approach, other states have not, and others have adopted the rule in different forms). In examining whether a CGL policy will provide coverage for repairs necessitated by defective construction or other resulting economic losses, the following must be considered:

- The insuring provisions of the policy;
- The exclusions to the policy;
- The exceptions to the exclusions;
- The provisions of endorsements;
- Whether the poor workmanship was performed by a subcontractor;
- Whether the work is continuing;
- Whether the work is completed;
- Court decisions construing the terms of the policy;
- The form of CGL policy involved;
- The economic loss rule in the jurisdiction.

ECONOMIC LOSSES • Generally, "economic losses" are the costs and expenses of losses or damage to or defects in the structure itself that was designed or constructed. In Hawaii, purely economic losses include the following:

- The cost of remedying the alleged building defects;
- The difference between the value of the building as designed and the value it would have had if it had been properly designed;
- Lost rent. *City Express, Inc. v. Express Partners,* 959 P.2d 836, 839 (Haw. 1998) (discussing the three foregoing items);
- Damage to the structure;
- Loss in value;
- Cost of experts;
- Increase in maintenance costs;
- Cost to remedy the defects;
- Other consequential damages. *Association of Apt. Owners of Newtown Meadows v. Venture 15, Inc.,* 167 P.3d 225, 238, 287 (Haw. 2007) (discussing the six foregoing items).

From these, it would appear that the following are also purely economic losses:

- Cost of redesign of the required repairs to the subject property;
- Cost of repair or rebuilding of a defectively constructed structure;
- Difference between the value of the building as constructed and the value it would have had if it had been properly constructed;
- Loss of profits.

In construction litigation, liability attaches under either a tort theory or a breach of contract theory. If the architect or the contractor performed their respective contracts negligently, the complaint against them will allege both the tort of negligence and breach of contract. If only economic losses were suffered, the negligence count could be dismissed in summary judgment. The limitations on insurance coverage for these economic losses correspond with the limitations on the liability of the architect and contractor for these losses. As a result of the economic loss rule, both the architect and contractor have no liability under Hawaii case law for purely economic losses resulting from their negligence in the performance of their contractual obligations. They may have liability for breach of contract but they may have no insurance coverage for that contractual liability.

The Economic Loss Doctrine

The economic loss doctrine or economic loss rule in Hawaii was explained by the Hawaii Supreme Court in the context of construction litigation in *City Express*. There the architect designed a building in which a forklift could be used on the second floor. One of the architect's blueprints showed a ramp with an indication that it was for "forklift use." After the building was built, it was discovered that the second floor of the building could not carry the weight of a forklift, and structural damage resulted. After other claims were settled, the sole issue in the case "was the alleged professional negligence of" the architect. *City Express,* supra, 959 P.2d at 838.

The case went to trial and the trial court ruled that the architect was not liable for economic losses resulting from the architect's negligence under a tort theory of recovery. The Hawaii Intermediate Court of Appeals overruled the trial court and allowed additional costs, lost rent, and either the cost of remedying the alleged building defects or the difference between the value of the building as designed, and the value it would have had if it had been properly designed. However, the Hawaii Supreme Court reversed the decision of the Intermediate Court of Appeals and ruled that these costs were purely economic and "[t]he economic loss rule bars recovery in tort for purely economic loss." *Id.* at 839.

Note that in a very recent case, the Supreme Court of Nevada, after reviewing case law in many other jurisdictions, held that the economic loss doctrine applied to preclude negligence-based claims against design professionals, such as engineers and architects, who provided professional services in the commercial property development or improvement process, when the plaintiffs sought to recover purely economic losses. *Terracon Consultants W., Inc. v. Mandalay Resort Group,* 206 P.3d 81, 89-90 (Nev. 2009).

In *Newtown Meadows,* the Hawaii Supreme Court applied the economic loss rule in an action against a contractor. The Association of Apartment Owners in that case sued the masonry subcontractor (referred to as "Contractor" for purposes of this case) and others on numerous theories for damages and other remedies because of cracks in buildings and foundations that resulted from settlement and defective floor slabs in their condominium project. The Association alleged that the Contractor was negligent based on violations of contract specifications and the court ruled that the economic loss rule would bar the negligence claim, because damage to the units, loss in value, costs of experts, increase in maintenance costs, cost to remedy the defects, and other consequential damages "consist of purely economic losses." *Newtown Meadows,* supra, 167 P.3d at 231, 237-38, 287-88 (citing *City Express,* supra, 959 P.2d at 839).

The rule is rooted in products liability law. In extending the rule to construction liability, the courts have applied the concept that there is no remedy under tort law for a product that only injures itself. "When a product injures only itself[,] the rea-

sons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong …. Damage to a product itself is most naturally understood as a warranty claim. Such damage means simply that the product has not met the customer's expectations, or, in other words, that the customer has received 'insufficient product value.'" *Id.* at 278 (alteration in original) (quoting *State by Bronster v. U.S. Steel Corp.,* 919 P.2d 294, 302 (Haw. 1996)).

As a result of these cases, the architect and the contractor are shielded from liability from negligence claims that allege purely economic losses. However, they are not shielded from breach of contract claims that allege economic losses. They may have insurance coverage only for the negligence claims for which they are shielded by case law and no insurance coverage for the breach of contract claims because of their respective insurance policies, the exclusions contained in them, and other case law.

Section 15.1.6, of the American Institute of Architects (AIA) Document A201 - 2007, General Conditions of the Contract for Construction (AIA A201 Form), includes a mutual waiver of consequential damages. The waiver expressly includes a waiver of some of the owner's economic losses, such as lost profits, lost rent, and loss of use claims, but it does not waive the cost of repair or replacement of defective work, which would be a part of direct damages. Therefore, with these types of contracts, the contractor's contractual liability with respect to defective construction would be limited to the cost of repair and replacement. However, this would be a breach of contract liability for which the contractor may have no insurance.

The Requirement For Privity

Certain jurisdictions will apply the economic loss rule only when there is privity of contract between the claimant and the defendant on the basis that the law will require the parties to address the risk of economic loss in their contract. However, an injured party without privity of contract is unable to allocate such risks by contract. Nonetheless, the majority rule appears not to require privity of contract in applying the rule. The Court of Appeals of Arizona has stated that the rule bars recovery of economic damages in tort even without privity of contract because such damages are just not cognizable in tort absent actual injury. *See Carstens v. City of Phoenix,* 75 P.3d 1081, 1085 (Ariz. Ct. App. 2003). In a similar ruling, a Utah court noted that condominium buyers could have bargained for a warranty, but having failed to do so, they cannot recover in tort for strictly economic losses. *See Snow Flower Homeowners Ass'n v. Snow Flower, Ltd.,* 31 P.3d 576, 583 n.5 (Utah Ct. App. 2001). Federal law in the Seventh Circuit is similar, and Judge Posner stated that "[p]rivity of contract is not an element of the economic loss doctrine." *Miller v. U.S. Steel Corp.,* 902 F.2d 573, 575 (7th Cir. 1990).

The Colorado courts uphold the minority position and require privity before applying the rule. In a case in which unit owners and the homeowner association had no opportunity to allocate economic loss by contract with the subcontractors, the Colorado court refused to apply the rule against the association in its lawsuit against the subcontractors with whom the association had no privity of contract. *See Yacht Club II Homeowners Ass'n v. A.C. Excavating,* 94 P.3d 1177, 1180-82 (Colo. Ct. App. 2003), *aff'd,* 114 P.3d 862 (Colo. 2005). Since the court in *Yacht Club* mentions the same freedom of contract rationale for the rule as stated by the Hawaii Supreme Court in *City Express,* given the right case, it was thought that the Hawaii Supreme Court might rule the same way. *See Yacht Club,* supra, 94 P.3d at 1180-82; *City Express,* supra, 959 P.2d 839-40. Otherwise, condominium buyers have no recourse against a contractor or subcontractor with whom they have no contract or assigned warranty for defects in the constructed project, unless an exception to the rule is applicable.

In *Newtown Meadows,* the Hawaii Supreme Court reviewed cases in other jurisdictions regarding whether privity was required and decided to follow those jurisdictions that do not require privity before applying the economic loss rule. Therefore, even though there was no contractual relationship between the Association of Apartment Owners and the Contractor, the negligence claims based on violations of contract specifications by the apartment owners for economic losses were barred by the economic loss rule. *Newtown Meadows,* supra, 167 P.3d at 265, 280-288.

Exceptions To The Rule

The Hawaii Supreme Court has upheld exceptions to the economic loss rule in two distinct cases. In *Bronster*, the court held that a claim of negligent misrepresentation based on the *Restatement (Second) of Torts* section 552 (1977) was not barred by the economic loss rule because it is "founded on the breach of a duty separate and distinct from the duty abolished by the economic loss rule." *Bronster,* supra, 919 P.2d at 302-07. Similarly in *Newtown Meadows,* the claims of negligence based on violations of the Uniform Building Code were not barred by the economic loss rule. The Hawaii Supreme Court also stated that it believed that the approach of the South Carolina Supreme Court in *Kennedy v. Columbia Lumber and Manufacturing Co.,* 384 S.E.2d 730 (S.C. 1989), was sound. There, the South Carolina Supreme Court found that "'a violation of a building code violates a legal duty for which a builder can be held liable in tort for proximately caused losses.'" *Newtown Meadows,* supra, 167 P.3d at 288 (quoting *Kennedy,* supra, 384 S.E.2d at 737).

In Hawaii, it is clear that the economic loss rule will be applied even when there is no privity. It is unclear, however, whether the Hawaii-recognized exceptions to the economic loss rule require that the parties to the lawsuit are parties who are not in privity of contract. In *Bronster,* the State of Hawaii without privity of contract was allowed the benefit of the exception. *Bronster,* supra, 919 P.2d at 302-07, 314-15. And in *Newtown Meadows,* the Association of Apartment Owners without privity of contract was allowed the benefit of the exception. *Newtown Meadows,* supra, 167 P.3d at 285, 288. There was also no privity in the South Carolina case relied upon by *Newtown Meadows. See Kennedy,* supra, 384 S.E.2d at 736.

In *City Express,* the Hawaii Supreme Court stated that, "[i]n *United States Steel* (*Bronster*), the issue of whether contractual privity would prevent the application of section 552 was not presented. No contract existed between the steel manufacturer and the State of Hawaii." *City Express,* supra, 959 P.2d at 839 (parenthetical added). Similarly in *Newtown Meadows,* supra, the issue of whether contractual privity would prevent the application of the duty to comply with the building code was not presented. In *City Express,* the Hawaii Supreme Court also stated that the exception for negligent misrepresentation upheld in *Bronster* would not be available in construction litigation involving an architect when there is privity of contract. *City Express,* supra, 959 P.2d at 840.

In *Newtown Meadows,* the court applied the rule to bar the negligence claim based on negligent performance of contract specifications but found liability under the exception for negligent failure to comply with the Uniform Building Code in a case without privity. *Newtown Meadows,* supra,167 P.3d at 285, 288. In this case, there was no privity between the Association of Apartment Owners and the Contractor, although there was a contract (with contract specifications) and therefore privity between the Contractor and another party. See *id.* at 232, 285. While the court does not discuss it, it would be safe to assume that the Contractor was required by contract as well as by the Uniform Building Code to construct the building slabs to specifications. It appears that, in a case without privity, since the contractual duties did not stem from a contract between the Contractor and the Association, because

the Contractor violated a duty independent of the Contractor's contractual duties, the court upheld the exception to the economic loss rule.

The South Carolina court stated that it would apply the economic loss rule when duties are created solely by contract. *Kennedy,* supra, 384 S.E.2d at 737. The *Newtown Meadows* court said that this approach was sound. *Newtown Meadows,* supra, 167 P.3d at 288. Yet in *City Express,* the Hawaii Supreme Court also stated that a tort action for negligent misrepresentation, even though arising out of *Restatement (Second) of Torts* section 552 (1977), "alleging damages based purely on economic loss is not available to a party in privity of contract with a design professional." The court also stated, "In the context of construction litigation involving design professionals, sound policy reasons counsel against providing open-ended tort recovery to parties who have negotiated a contractual relationship." *City Express,* supra, 959 P.2d at 839-840. It is difficult to understand how contractors who negotiate a contractual relationship are to be treated any differently, unless the duty to conform to the Building Code is a higher duty because there are public safety considerations involved, whereas the duty to avoid negligent misrepresentation does not have the same public policy considerations.

Assuming that the *Newtown Meadows* exception to the economic loss rule will apply even when there is a contract between the parties, will there be insurance coverage if the damages alleged are purely economic damages? Since there is tort liability, the insuring agreement will be applicable, but there are also exclusions and the requirement for an "occurrence" in the CGL policy. The *Newtown Meadows* exception to the economic loss rule presents squarely and highlights the problem that the contractor could have liability in tort for negligent construction that causes only economic losses and yet there might be no insurance coverage under the CGL policy despite this exception. In *Newtown Meadows,* the court held that "a homeowner may pursue a negligence claim against a builder where it is alleged that the builder has violated an applicable building code, despite the fact that the homeowner suffered only economic losses." *Newtown Meadows,* supra, 167 P.3d at 288. There is no Hawaii case law addressing whether a CGL policy will provide insurance coverage for this exception to the economic loss rule.

INSURANCE AND THE ECONOMIC LOSS RULE • There is no Hawaii case law addressing insurance and the economic loss rule. But there are cases construing insurance policies. Insurance contracts are contracts of adhesion and the courts tend to construe them liberally in favor of the insured. *See Sturla, Inc. v. Fireman's Fund Ins. Co.*, 684 P.2d 960, 964 (Haw. 1984). As a result, these questions have been litigated with varying results. Despite the intent to construe insurance contracts in favor of the insured, there is significant case authority for the proposition that there is no coverage.

Owners who contract with contractors may be surprised to find that the liability insurance will only protect against claims for damage to property other than the property constructed. The lack of coverage under the CGL stems primarily from the application of one or more of the "business exclusions" or on how the court in the jurisdiction will construe the meaning of the words "occurrence" and "property damage."

The first inquiry is whether the claim satisfies the insuring agreement or the coverage provisions of the CGL policy. In practice, the contractors will obtain a standard ISO CGL policy, such as CG 00 01 12 07 (2006) (Standard CGL Policy), which provides:

I. - COVERAGES

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1. Insuring Agreement
   a. 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.

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b. This insurance applies … only if … caused by an **"occurrence"** ….

(Bold emphasis added).

As this article focuses on economic loss, we will examine only the definitions of "property damage" and "occurrence" in the Standard CGL Policy:

V. - DEFINITIONS

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13. "Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

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17. "Property damage" means:
    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.

Addressing the I.a. requirement for legal obligation to pay first, if the complaint or claim is faulty construction based on negligence, the courts in Hawaii will rule that the contractor is not legally obligated to pay for purely economic losses resulting from ordinary negligence. *See generally, Newtown Meadows,* supra, 167 P.3d at 288 (holding that the economic loss rule bars negligence claims based on violations of contract specifications for purely economic losses). Under the insuring agreement of the policy, there is no coverage for economic damages under a negligence theory because the contractor has no liability for economic damages under a negligence theory.

In *Newtown Meadows,* an exception to the economic loss rule could result in the contractor becoming legally obligated to pay and so the next inquiry would be to review the exclusions in the policy and whether there has been an "occurrence." In general, if the courts will rule that the negligence claims are really contractual claims or claims based on contract, the courts will then rule that a breach of contract cannot be an "occurrence." As for the exclusions, the CGL policy provides that the insurance does not apply to property damage to "your work" arising out of it or any part of it and included in the products completed operations hazard. As a result, courts have had to judicially interpret the policy provisions and definitions and, in particular, the meaning of "property damage," and whether it pertains to the contractor's work and whether defects in the work are damage to the work, and the meaning of "tangible property." Consequently, while the issue has been the subject of much litigation, it is very possible that only damage to property other than the contractor's work is covered by the CGL.

There is a parallel between the CGL policy's coverage of damage only with respect to other property and the exception to the economic loss rule for damage to other property. The CGL policy will provide insurance protection when the contractor's negligent work causes damage to other property. Similarly excluded from the economic loss rule are damages to property "other than the building itself." *City Express,* supra, 959 P.2d at 839.

In determining whether the defective product or defective work injured only itself or other property, the *Newtown Meadows* court, citing various rulings in other jurisdictions, adopted the test of looking to what the purchaser purchased rather than what the defendant sold. *Newtown Meadows,* supra,167 P.3d at 287. As a result, the court rejected the arguments by the Association of Apartment Owners concern-

ing damage to "other property" and ruled that in addition to the allegedly defective floor slabs, the cracked floor tiles, demising walls, skewed door jambs and windows, and even damage caused by termites entering through the cracked floors, were not damage to "other property" and all of the alleged damages were subject to the economic loss rule. *Id.* at 286-88.

Business Risk Exclusions In The CGL Policy

A New Jersey court paved the way in applying the business risk exclusions in finding that damage to the contractor's own work was not covered by the CGL policy. *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979). Although this case interpreted an older version of the CGL policy, the courts have followed its rulings to often find that the CGL policy is not intended to insure the quality of the contractor's work. Since then, there has been a growing recognition that there are business risks and there are insured risks, and the two are different.

While there are other exclusions which the courts have used to find exclusions from coverage, such as the "damage to property," "damage to your product," and the "impaired property" exclusions, for this article the relevant Standard CGL Policy exclusion reads as follows:

I. - COVERAGES
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2. Exclusions
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l. Damage To Your Work
"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

The relevant Standard CGL Policy goes on to define "your work" as:

V. - DEFINITIONS
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22. "Your work":
a. Means:
(1) Work or operations performed by you or on your behalf; and
(2) Materials, parts or equipment furnished in connection with such work or operations.

Therefore, damage to the contractor's work is excluded. It must be remembered that the CGL applies only after construction of the work has been completed and the completed operations coverage comes into play. It is the intent of this exclusion to exclude any insurance coverage for the contractor's liability for defective construction that damages the contractor's work.

The Subcontractor Exception To The Exclusion

In many CGL policies, there is an exception to the "your work" exclusion for work performed on the contractor's behalf by a subcontractor. This exception provides insurance coverage under the CGL for defects in the work if it is caused by a subcontractor's faulty workmanship. If the contractor used its own forces to perform the work, and defects in the performance of that work injures that work, the damages falls within the exclusion from coverage. But if a subcontractor performed the work, and defects in the subcontractor's performance of the work damages the subcontractor's work or other parts of the construction project, the damage is covered by the CGL policy. The subcontractor exception to the exclusion is significant and could provide insurance coverage to all work performed by all subcontractors and the general contractor itself if damaged by work or defective work produced by a subcontractor. In many construction projects, the work of subcontractors may far exceed work done by the general contractor with its own forces.

Potential Insurance Products For Economic Losses

A Home Builder's Protective Insurance Policy is available (through a single carrier) to a home builder, including an owner, developer, or contractor, that provides a purchaser of the home with a specific warranty. This policy appears to provide insurance coverage for economic losses that are "repair costs." Economic losses in the nature of consequential damages or economic losses other than repair costs do not appear to be covered. This policy is available if the home builder provides a specific prescribed warranty agreement in which the home buyer agrees to mediate and arbitrate disputes and which specifically defines a "construction occurrence" (with respect to repair costs only) without using the word "accident" in the definition.

Owner Controlled or Contractor Controlled Insurance Policies (OCIP or CCIP) may also provide coverage for economic losses depending on how the courts will respond to these products. Contractors may find it difficult to obtain liability coverage in multi-family residential construction projects. A potential cost effective alternative is a "wrap-up" policy or an OCIP or CCIP. With these policies, the owner or the contractor will wrap up and procure liability and workers compensation insurance for the owner, the contractor, construction manager, and the subcontractors participating in the construction project. Different states such as Hawaii require high dollar amount projects before authorizing the issuance of these policies. There are potential economic benefits to the developer who procures this policy and these policies can include endorsements that eliminate some of the business risk exclusions. It will then depend on whether the insurer will deny coverage for economic losses and how the courts will determine whether the elimination of the business exclusions will permit recovery of insurance proceeds for purely economic losses. One issue is whether the courts will then interpret the word "occurrence" differently because of the elimination of the business risk exclusions. The insured needs to carefully review which of the business risk exclusions are eliminated.

Breach Of Contract

As discussed above, the contractor may not have liability under a negligence claim for economic losses but could have liability for the same losses under a breach of contract claim. The insuring agreement of the CGL policy does not distinguish between tort or contract liability and would cover contractual liability. In Section 3.5, of the AIA A201 Form, the contractor warrants that materials and equipment furnished will be of good quality and that the contractor's work will be free from defects and will conform to the Contract Documents. Thus if the work is defective due to the contractor's negligence, the contractor has exposure not only to a claim of negligence but also to a breach of warranty or breach of contract claim. The negligence count could be subject to dismissal if only economic losses are claimed. The breach of contract claim could result in the contractor's liability. Then, the contractual liability exclusion in the CGL policy has to be considered. The Standard CGL Policy provides:

I. - COVERAGES

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2. Exclusions

   This insurance does not apply to:

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   b. Contractual Liability

      … "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement.

This would appear to exclude the breach of warranty or breach of contract claim from coverage under the CGL policy. Then there are two excep-

tions to this contractual liability exclusion, stated in said subsection of the Standard CGL Policy as follows:

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 … an "insured contract" ….

Taking the second exception for "insured contract" first, construction contracts do not fit within the policy definition of "insured contract." Such contracts have more to do with agreements to assume a third party's tort liability. The first exception for liability that the insured would have in the absence of the contract or agreement refers to tort or negligence liability. This exception is intended to preserve and does preserve the insurance protection for bodily injury, death, and damage to other property, but due to the operation of the economic loss rule, it fails to preserve insurance protection for purely economic losses. The intent of the exception is to prevent the contractual liability exclusion from excluding insurance coverage for negligence resulting in claims not barred by the economic loss rule. In other words, if the contractor acted negligently, the contractor would be liable for both breach of contract and negligence. If, as a result, the negligence caused bodily injury, or death, or damage to other property, there would still be insurance coverage under the insuring agreement and this exception to the exclusion for contractual liability.

However, if only economic losses are the proximate result of the contractor's negligent construction, there is no liability under a negligence theory because of the economic loss rule. As a result, there is no liability for damages that the insured would have in the absence of the contract and the first exception to the exclusion for contractual liability would not be applicable. Since neither of the two exceptions apply, the contractor has no insurance coverage under the CGL for contractual liability for causing economic losses.

Occurrence

Next, let us review the word "occurrence," which is also a requirement before there can be coverage. Subsection I – 1.b of the Standard CGL Policy provides that "[t]his insurance applies to … 'property damage' only if … [t]he … 'property damage' is caused by an 'occurrence.'" Over the years, the insuring provisions have changed from providing coverage only for damages "caused by an accident" to include coverage caused by an "occurrence," which is defined as "an accident, including continuous or related exposure to substantially the same general harmful conditions." The term "occurrence" has been the subject of coverage litigation. When a contractor uses defective materials or defective means of construction, or simply constructs in a manner that is defective, has there been an accident, and, therefore, has there been an occurrence? In general, the courts have ruled that such acts are intentional rather than accidental and therefore are not "occurrences," and as a result, there being no occurrence, the CGL does not apply.

In *Hawaiian Holiday Macadamia Nut Co. v. Industrial Indemnity Co.,* 872 P.2d 230, 234 (Haw. 1994), the Hawaii Supreme Court stated, "[I]n order for the insurer to owe a duty to defend or indemnify, the injury cannot be the expected or reasonably foreseeable result of the insured's own intentional acts or omissions." So, extending this principle to construction projects, while a contractor does not intend to build in a defective manner, the contractor's acts of building defectively could be deemed to be intentional and the resulting defects in what he built would not be accidental.

While federal court decisions are not binding on the Hawaii state courts, a federal insurance and construction case could influence Hawaii state court

decisions. The United States Court of Appeals for the Ninth Circuit, in *Burlington Insurance Co. v. Oceanic Design & Constr., Inc.,* 383 F.3d 940, 948 (9th Cir. 2004), held that a CGL policy did not cover disputes between parties in a contractual relationship over the quality of the work performed. In reaching this decision, the court reviewed related Hawaii Supreme Court decisions and concluded that the Hawaii courts would not recognize claims for "a negligent breach of contract." *Id.* at 946-53. The Ninth Circuit court cited a Hawaii Supreme Court case holding that Hawaii law would not allow tort recovery unless there is conduct that is a violation of a duty that is independently recognized under tort law and transcends the breach of the contract. *Id.* at 948 (citing *Francis v. Lee Enters., Inc.,* 971 P.2d 707, 717 (Haw. 1999)). The court also stated, "Likewise, our holding is consistent with the line of cases from the District of Hawaii that hold that contract and contract-based tort claims are not within the scope of CGL policies under Hawaii law." *Id.* at 949. The court ruled that by building a residence substantially inferior to the standard of care and quality that had been agreed upon, the contractor's breach of that contractual duty consisted of the contractor's intentional acts or omissions, and the reasonably foreseeable results of such intentional acts or omissions cannot qualify as an "occurrence" under the CGL policy. *See id.* at 948. Similarly, the Ninth Circuit court agreed with the trial court's finding that but for the contractual relationship, the homeowners would not have a claim for negligent infliction of emotional distress and therefore such claim cannot be an "occurrence" under the CGL policy. *Id.* at 955. The Ninth Circuit court made a similar ruling with respect to the homeowners' claim of negligent recommendation. *Id.* at 955-56.

The Ninth Circuit court reached its decision in Oceanic with a focus on the requirement for an "occurrence" under the CGL policy. A lawsuit for breach of contract based on negligent performance of the contract will not constitute an "occurrence" under these cases because the breach is considered an intentional act or omission and the lawsuit is a reasonably foreseeable result of such breach.

The insuring agreement of the CGL policy does not discriminate on the basis of whether the contractor is liable under tort or contract. The insuring agreement would cover tort liability as well as contractual liability. However, the economic loss rule applies only to tort liability and not to contractual liability. While a contract-based claim of negligence will be subject to the economic loss rule and would also not qualify as an "occurrence" under the policy, the claim could also be excluded from coverage because of the contractual liability exclusion.

In another Burlington Insurance Company case, *Burlington Insurance Co. v. Steve's AG Services, Ltd.,* 259 Fed.Appx. 45 (9th Cir. 2007), the Ninth Circuit court also ruled that under Hawaii law, claims for breach of contract are not covered by insurance policies that require an "occurrence" "because a breach of contract claim precludes accidental conduct." *Id.* at 47 (citing *Oceanic,* supra, 383 F.3d at 946). It also noted that the negligence claim in the case did not state a basis for an independent duty outside of the duties created by contract. *Id.* at 48. It remains to be seen whether a negligence claim that is based on the violation of an independent duty separate and apart from the duties imposed by the contract, such as the duty of the Contractor in *Newtown Meadows,* to conform to the Uniform Building Code, could be sufficient to overcome the limitations of the CGL policy.

In *Newtown Meadows,* the Contractor (a subcontractor) had a contractual duty to construct the foundations properly and had a duty under the Uniform Building Code to construct the foundations in accordance with that code. Therefore, the Contractor had a duty separate and apart from its contractual duties that could, according to the Hawaii Supreme Court, support a negligence claim. *See Newtown Meadows,* supra, 167 P.3d at 288. In

Oceanic, the Ninth Circuit court said there was no independent duty to support a negligence claim. Therefore, left unanswered is the question whether the independent duty to comply with the building code and the insured's intentional acts or omissions in violating that duty could result in a claim constituting an "occurrence" for purposes of the CGL. *Oceanic,* supra, 383 F.3d at 948.

Is the violation of the building code a contract-based claim? But for the contract between the subcontractor and the contractor, and but for the contract between the contractor and the developer, there would have been no construction and no violation of the building code. Once again, does this exception to the economic loss rule apply because there was no contract between the aggrieved claimant and the subcontractor and therefore the claim is not a contract-based claim? In applying the rule to the ordinary negligence claim based on contract specifications, the *Newtown Meadows* court emphasized how there had been contractual arrangements between the contractor and subcontractor, and even though the claimant was not a party to those arrangements, imposing tort liability on the subcontractor would upset the contractual allocations made by the parties to those contractual arrangements. *Newtown Meadows,* supra, 167 P.3d at 285.

The Subcontractor Exception Again

But *Oceanic* was not a case that construed the subcontractor exclusion nor was it a case that addressed the Newtown Meadows' breach of the separate duty to construct in accordance with the building code. The court stated in *Oceanic,* "Other than a breach of that contractual duty, the facts in this case do not reflect a breach of an independent duty that would otherwise support a negligence claim." *Oceanic,* supra, 383 F.3d at 948. It also stated, "In Hawaii, an occurrence 'cannot be the expected or reasonably foreseeable result of the insured's own intentional acts or omissions.'" *Id.* (citing *Hawaiian Holiday,* supra, 872 P.2d at 234). The acts of a subcontractor would not be the "insured's own intentional acts or omissions" and, therefore, the "occurrence" requirement could be satisfied if the defective work was the actions or neglect of a subcontractor.

The Supreme Court of Florida addressed this issue in *U.S. Fire Insurance Co. v. J.S.U.B., Inc.,* 979 So. 2d 871 (Fla. 2007). The question before the court was "whether a post-1986 standard form commercial general liability (CGL) policy with products-completed operations hazard coverage, issued to a general contractor, provides coverage when a claim is made against the contractor for damage to the completed project caused by a subcontractor's defective work." *Id.* at 877. The court stated that, in resolving this issue, it had to determine whether under the CGL policy a subcontractor's faulty workmanship can constitute an "occurrence" under the policy. *Id.* The court reviewed the subcontractor exception to the "your work exclusion" and stated that the exception "becomes important only if there is coverage under the initial insuring provision." *Id.* at 879-80. Since the initial insuring provision requires an "occurrence," the court had to first rule that "a subcontractor's defective work that results in damage to the completed project can constitute an 'occurrence.'" *See id.* at 880, 887. For the Florida court, "faulty workmanship that is neither intended nor expected from the standpoint of the contractor can constitute an 'accident' and, thus, an 'occurrence.'" *Id.* at 888. The court also construed the CGL's term, "property damage" to include damage to either the contractor's own work or damage to other property. *See id.* at 889. The court concluded:

"We conclude that faulty workmanship that is neither intended nor expected from the standpoint of the contractor can constitute an 'accident' and thus an 'occurrence' under a post-1986 standard form CGL policy. We further conclude that physi-

cal injury to the completed project that occurs as a result of the defective work can constitute 'property damage' as defined in a CGL policy. Accordingly, we hold that a post-1986 standard form commercial general liability policy with products completed-operations hazard coverage, issued to a general contractor, provides coverage for a claim made against the contractor for damage to the completed project caused by a subcontractor's defective work provided that there is no specific exclusion that otherwise excludes coverage."

Id. at 891.

Unfortunately, as a result of widespread construction defect litigation, especially in the multi-family residential product area, the insurance industry has begun to eliminate the subcontractor exception to the "your work" exclusion. (*See* the ISO CG 22-94 form or the ISO CG 22-95 form.) The result is that, once again, there is no insurance coverage for defective work that creates economic losses.

The contractor typically agrees in the construction contract to provide insurance. The CGL, if anything, is where the contractor must look for coverage for completed operations. However, a CGL is not intended to insure quality of the insured contractor's work. The agreements that the contractor makes regarding the contractor's required insurance pursuant to the AIA A201 Form appear to recognize the limitations in the CGL with respect to purely economic losses. However, this may not be evident to the contracting parties. Section 11.1 of the AIA A201 Form provides in part:

§ 11.1.1 The Contractor shall purchase from and maintain … such insurance as will protect the Contractor from claims set forth below which may arise out of or result from the Contractor's operations and completed operations under the Contract and for which the Contractor may be legally liable, whether such operations be by the Contractor or by a Subcontractor or by anyone directly or indirectly employed by any of them, or by anyone for whose acts any of them may be liable:

***

.7 Claims for bodily injury or property damage arising out of completed operations; and

.8 Claims involving contractual liability insurance applicable to the Contractor's obligations under Section 3.18.

***

§ 11.1.4 The Contractor shall cause the commercial liability coverage required by the Contract Documents to include (1) the Owner, the Architect and the Architect's Consultants as additional insureds for claims caused in whole or in part by the Contractor's negligent acts or omissions during the Contractor's operations; and (2) the Owner as an additional insured for claims caused in whole or in part by the Contractor's negligent acts or omissions during the Contractor's completed operations.

Both the contractor and the owner who executes these contracts may be under the impression that these provisions require the contractor to provide insurance that will protect the contractor against claims for purely economic losses. However, note that the contractor's obligation under Section 11.1.1.8 with respect to maintaining contractual liability insurance is for the obligations under Section 3.18. Under Section 3.18, the contractor contractually obligates itself to indemnify the Owner and the Architect and their agents and employees from and against claims, damages, losses, and expenses arising or resulting from performance of the work including injury to or destruction of tangible property other than the work itself. So there is no requirement to insure the contractor's contractual liability with respect to economic damage or economic losses to the work itself.

The contractor's CGL will probably also be in compliance with the tort liability for economic losses to the work itself because the agreement is to maintain insurance to protect the contractor from claims "for which the Contractor may be legally liable." In jurisdictions that apply the economic loss rule, a negligence claim for purely economic losses will not be a claim for which the contractor may be liable.

The interplay between the economic loss rule and the insuring agreement, exclusions and exceptions to the exclusions, and the requirement of an occurrence under the CGL, creates a complex web of uncertainty that generates litigation as the parties seek to discover whether the risks of economic loss have been shifted to the insurer. It would appear that the quest to find insurance coverage for purely economic losses is not a promising quest. Let us now turn to the architect.

The Architect

With respect to the architect, we are focused on a different insurance policy (the professional liability policy) and not the CGL. Yet, the interplay between the economic loss rule and the insuring agreement of the policy and the exclusions and exceptions to the exclusions also operate to create a complex situation that could generate litigation resulting in a denial of coverage.

The architect's CGL excludes liability resulting from the architect's professional services. The architect's E&O policy is intended to provide insurance protection for the architect's negligence in providing architectural services or, in other words, for the architect's malpractice. Perhaps many owners who contract with architects believe that the E&O policy will provide insurance with which the architect can respond to claims of economic losses that the owners suffer from the architect's faulty design or errors in design. However, the E&O policy will provide insurance for bodily injury, death, and resulting damage to other property or property other than the structure designed by the architect.

It appears that the contractor's CGL is not intended to insure the quality of the contractor's work if only economic losses are at issue. On the other hand, it appears that the architect's E&O policy may have been intended to insure the architect's malpractice even where only economic losses are at issue and actually fulfills that intention in jurisdictions that do not adopt the economic loss rule. As a result of the economic loss rule and the contract exclusions in the E&O policy, the intention to provide coverage fails. Under *City Express,* the architect cannot be held liable under a negligence claim for economic losses suffered by the owner with whom the architect contracts. *City Express,* supra, 959 P.2d at 836. And under *Newtown Meadows,* the architect cannot be held liable for economic losses suffered by third parties who sue the architect for negligence in the performance of the architect's design contract. *Newtown Meadows,* supra, 167 P.3d 225. Hence, the architect may not need insurance to cover economic losses resulting from the architect's negligence. The architect needs insurance for causing economic losses if the developer sues the architect for breach of contract. Without modifying the E&O policy, the architect may not have insurance to cover that liability.

Architect's E&O Policy

Let us now turn to a typical Architect's E&O policy, which provides in part:

I. COVERAGE AGREEMENTS

A. We will pay all amounts … that you become **legally obligated to pay** as a result of:

1. a wrongful act …

***

III. DEFINITIONS

***

T. Wrongful act means an error, omission, or other act that causes liability in the performance of professional services ….

(Bold emphasis added) (original emphasis omitted).

This is the insuring agreement in the policy. The policy requires an error, omission, or other act that causes liability in the performance of professional services that results in the architect becoming legally obligated to pay.

If the developer sues the architect in tort and alleges that the error or omission constituted negligence on the part of the architect, the courts in Hawaii, as explained above, unless an exception to the economic loss rule is found, will rule that the architect is not legally obligated to pay for purely economic losses based on a tort or negligence theory of recovery. Therefore, under the insuring agreement of the policy, there may be no coverage for economic damages under a negligence theory because the architect is likely to have no liability for economic damages under a negligence theory.

Design Claim Conciliation Panel

Chapter 672B of the Hawaii Revised Statutes (HRS), in effect as of January 1, 2008, created a Design Claim Conciliation panel to render findings and advisory opinions on liability and damages in tort claims against architects. As a result of the economic loss rule, the mandate of this panel would appear to be limited to bodily injury and collateral damage to property other than the one designed. Economic losses due to design defects and negligence, such as additional costs incurred, costs of repair, lost rent, and the diminished value of the designed building, are usually not recoverable under tort claims. Section 672B-5 of the HRS requires a claim that a tort has been committed by an architect. Section 672B-7 of the HRS requires every claim of a tort against an architect shall be heard by this panel. 672B-9 of the HRS requires the panel, if it makes a finding of liability, to allocate the damages and determine which of the damages are attributable to the architect, including economic losses and noneconomic losses. Litigation may then follow.

If the tort claim is one of negligent design based on negligent performance of the design contract, the economic loss rule will preclude liability for economic losses. If the product did not meet expectations, and the plaintiff received insufficient product value, the remedy is limited to contract; there are no tort remedies. Therefore, the liability for negligent design under such a tort theory is only for bodily injury and for collateral damage to other property. This panel has nothing to do with the architect's contractual liability for causing economic losses by breaching an agreement in the contract.

A developer who has suffered only economic damages due to an architect's malpractice will consider suing strictly for contract damages without alleging any tort action. By avoiding pleading negligence or tort, the developer might be able to avoid the necessity of having the matter reviewed by this panel. If the injuries are strictly economic losses, and frustration of business expectations, it could be inefficient, and a waste of time and money, to fall under the jurisdiction of this panel. Alternatively, if the facts involved will allow the developer to allege resulting damage or damage to other property, pleading negligence may trigger the insurer's duty to defend and possibly encourage the insurer to provide settlement funds. In such case, the Design Claim Conciliation Panel would have jurisdiction.

Architect's Breach Of Contract

Depending on the contract, the architect could be liable to pay for these economic losses by reason of breach of contract, warranty, or guaranty. Section 1.2 of the AIA Document B102 – 2007, Standard Form of Agreement Between Owner and Architect (AIA B102 Form), includes an agreement

by the architect that the architect's services will be performed consistent with the professional skill and care ordinarily provided by architects practicing in a similar locality under similar circumstances, and as expeditiously as is consistent with such professional skill and care. If the architect failed to perform the services consistent with professional skill and care, the architect will have breached the contract and could be liable for the resulting economic losses that the developer sustains. Once again, the architect may find comfort in thinking that his E&O policy will insure him against this liability. As stated above, the insuring agreement of the policy requires a wrongful act in the performance of services that results in the architect becoming legally obligated to pay. The architect could become legally obligated to pay for these economic losses by virtue of having failed to live up to the architect's agreement to perform his services consistent with professional skill and care. However, as with the contractor's CGL, we need to examine the express exclusions that are found in the architect's E&O policy. One exclusion provides:

IV. EXCLUSIONS

We will not defend or pay … for any claim … :

***

B. arising out of:

1. your alleged liability under any … written contract or agreement, including but not limited to express warranties or guarantees …

(Original emphasis omitted.)

As with the CGL there is an exception to this exclusion that requires the architect's liability to exist in the absence of such contract or agreement. However, arguably as with the contractor's CGL, this exception to the contract exclusion does not exist because of the economic loss rule.

Therefore, the architect will find that his E&O policy expressly excludes coverage for his liability for economic losses due to his breach of his contractual obligation to perform his services consistent with professional skill and care. Since the economic loss doctrine requires that remedies for economic losses be addressed in contracts, in jurisdictions that apply the economic loss rule, contractual liability for economic losses is the only way the architect can be held liable for economic losses resulting from the architect's malpractice. Yet the architect's E&O policy expressly excludes from insurance coverage such liability.

It is essential that either the architect or the developer negotiate with the carrier for an endorsement to modify the exclusion for contractual liability. Such an endorsement may be available for an additional premium and will provide insurance coverage for scheduled contractual agreements, which allows separate underwriting for the separate exposure involved and can name the developer as an indemnitee. As with all insurance contracts, the precise wording of the endorsement will be critical.

What about the architect's general liability policy? These typically provide that coverage is not extended to an architect's contractual assumption of liability in connection with his professional services. As a result, the architect, who unfortunately may have made a serious mistake in his design, may have no insurance coverage whatsoever for damage to the property he designed or for other purely economic losses.

Architect's Liability To The Owner And To Third Parties

If an architect negligently performs its services under a design contract and the negligence results in purely economic losses, the developer or owner cannot recover such losses by bringing a lawsuit alleging negligence. See *City Express,* supra, 959 P.2d at 839. If an architect negligently performs its ser-

vices under a design contract and the negligence results in purely economic losses to third parties who did not contract with the architect, the third party suffering purely economic losses cannot recover against the architect by bringing a lawsuit that alleges negligence. *See Newtown Meadows,* supra, 167 P.3d at 285-86 (holding that the economic loss rule barred the Association of Apartment Owners' negligence claim based on violations of contract specifications against a subcontractor for purely economic losses). Since the third party has no contract with the architect, the third party is unable to seek a remedy under a breach of contract theory unless the third party can establish that it was an intended third-party beneficiary. If the third party can establish this and impose liability, the exclusion for contractual liability in the policy could preclude coverage. Note that the AIA B102 Form includes a clause, Section 7.5, that states that nothing in the agreement shall create a contractual relationship with or a cause of action in favor of a third party. So, such third parties would be left to seeking remedies under tort theories and would need to find an exception to the economic loss doctrine if they seek damages for economic losses.

An architect probably has an independent duty to design in accordance with the Building Code and could have liability for failure to design in accordance with the Building Code under the *Newtown Meadows* ruling. However, since a building permit has to first issue, the possibility of finding that an architect failed to design in accordance with code may be remote.

Therefore, the architect is exposed to liability for economic losses suffered by the developer but probably not by the association of apartment owners with whom the architect did not contract. Architects report that their insurers strongly discourage their accepting condominium projects on the basis that residential multi-family buildings generate most of the litigation against the architects. It should be noted that this advice should also be given along with the advice that under the architect's E&O policy, there is only coverage if there is tort liability for negligent design as contrasted with contractual liability, and that in certain jurisdictions that adopt the economic loss rule, the liability for which there could be E&O insurance coverage probably does not exist anyway. After *Newtown Meadows,* architects have practically no liability to condominium purchasers with whom the architects have not contracted and the underwriting of the policy needs to be reexamined by the insurance underwriters. Perhaps the real reason for being cautious about accepting multi-family residential projects is the fact that while the economic loss rule will shield against liability from negligence, the fact that there is no insurance coverage also means that the insurers may not agree to bear the defense costs.

Due to the combination of the economic loss rule and the exclusion in the architect's E&O policy for contractual liability, the developer who has sued the architect for breach of the architect's contractual obligation to perform services in accordance with professional skill and care and the architect who has unfortunately breached this duty will find that the architect is not covered by insurance to pay for these economic losses. If the architect is unable to pay, the architect may decide to discharge the obligation by filing bankruptcy.

Architect Agreements

In negotiating architect agreements, the architects, allegedly upon advice of their insurers, have insisted on reducing their liability risks. Generally, the architect's argument is that their fees do not justify the risks that they are assuming. In jurisdictions that have adopted the economic loss rule, the risks assumed by the architect do not include the risk of their negligence causing purely economic losses. The architect, at times, will ask the developer to include the architect as an additional insured on CGL policies. It should be noted that the typical CGL policy will have exclusions for professional

services. The architect may ask the developer to provide indemnifications for damages resulting other than from the architect's negligence or willful misconduct.

The architect may also ask for a limitation of liability, first to the amount of his or her fees, and when the developer resists this, then the architect will ask to limit liability to the amount of his or her insurance coverage. The developer will then look at the insurance limit in the policy and decide to fund additional premiums for extended professional liability coverage with an increase in the liability limits specifically for the project. Since E&O policies are usually of the claims-made variety, developers typically agree to fund a professional liability project policy with an extended period.

This additional project cost should be incurred by the developer with the understanding that this project-specific insurance will protect the architect (and vicariously the developer) only for bodily injury and secondary property damage claims. This additional cost will not provide coverage for purely economic losses, cost of remedying defective design, repairs to the designed building, loss of profits, diminution in value, and other consequential economic losses. In other words, this additional cost should not be incurred unless an endorsement for scheduled contractual obligations could also be obtained or the additional cost may not be justified.

The architect's E&O policy provides practically no coverage for the architect's liability for causing purely economic losses. If the architect intends to obtain insurance protection against liability for economic losses resulting from the architect's negligence, and if it is the intent of the insurance industry to provide such insurance, the exclusion in the architect's E&O policy for contractual liability should be deleted in order to provide the architect with the protection it needs. The architect may have no liability for economic losses under tort theories but could be held liable under breach of contract theories, and without deleting the exclusion, or modifying the exclusion by endorsement, the architect may have no insurance coverage for causing economic losses.

It should be noted that the duty of the insurer to defend is broader than the duty of the insurer to indemnify. Often, the plaintiff's counsel will allege a myriad of facts and claims so as to trigger the possibility of insurance coverage. These might include a claim for collateral or resulting damage to other property or the potential of injury. Therefore, the insurer will often agree to bear the defense costs in the litigation against the architect. However, the insurer will usually agree to defend with a reservation of rights, and if the final resolution is that the plaintiff has only suffered economic losses, the insurer, having reserved its rights, may then seek reimbursement of the defense costs from the architect.

As a result of a tremendous increase in defective construction and completed operations claims, especially in residential construction, it has become more and more difficult for a contractor to obtain a CGL policy that does not also include endorsements that eliminate the subcontractor exception to the exclusion. With these endorsements, the contractor will have no insurance for economic loss or damages resulting from a subcontractor's defective work. There is no insurance product to insure quality of the contractor's work when only economic losses are at issue.

So, for the architect E&O, it is critical to purchase a policy with the endorsement that provides coverage for contractual obligations, and for the contractor's CGL, it is critical to at least preserve the subcontractor exception to the "your work" exclusion by avoiding the endorsement that eliminates the subcontractor exception to the "your work" exclusion.

CONCLUSION • In summary, in jurisdictions that apply the economic loss rule, contractors and architects may have no liability for economic

losses caused by their negligence but could have liability for economic losses caused by their negligence if their negligence also results in a breach of their contracts. In these jurisdictions, the architect's E&O policy with respect to purely economic losses resulting from the architect's mistakes is not really needed. What is needed is insurance to protect the architect when its mistakes cause economic losses and a breach of contract. Likewise, in these jurisdictions, the contractor's CGL with respect to purely economic losses resulting from the contractor's mistakes is not really needed. What is needed is insurance to protect the contractor when its mistakes cause economic losses and a breach of contract. Either the policies need to be changed by endorsement or otherwise, or new policies need to be developed.

There is a movement toward sustainability and green buildings but the risk landscape for green buildings is evolving and largely untested. The insurance industry is examining this movement and is developing green endorsements to different types of policies. By and large, these are property policies as the insurance industry has adopted a wait and see posture for liability policies. Green buildings introduce additional economic losses such as costs of certification, documentation costs, loss of tax credits, and so on. Insuring the uninsured risks of development in the near future appears unlikely. In all likelihood, until the industry has more experience with green buildings, architects and contractors, unless compensated for it, will not guarantee or warrant the achievement of LEED Certification, the attainment of tax benefits, the reduction of carbon emissions, or other such goals, and there will be no contractual obligations in this area. As a result, owners will be limited to their remedies for failure to meet professional standards under tort law, and with respect to purely economic losses, the owner will actually have no remedy and there will be no insurance coverage. If an owner pays a premium to obtain a warranty in the area of LEED or other green certifications, the owner should inquire into whether there will be insurance coverage for this contractual obligation.