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CT Supreme Court Capstone Decision Limits Scope of Insurers' Liability

Earlier this week, the Connecticut Supreme Court decided several questions of first impression on important insurance coverage issues. In *Capstone Building Corp. & Capstone Dev. Corp. v. Am. Motorists Ins. Co.*, SC 18886, 2013 Conn. LEXIS 187 (2013), the Connecticut Supreme Court addressed three certified questions arising out of an underlying action in which breach of contract and bad-faith claims had been brought against an insurer. Day Pitney served as amicus curiae counsel for the American Insurance Association with respect to the second and third certified questions. In summary, the court held:

- The cost of repairing faulty workmanship is not covered under a commercial general liability policy, but allegations of unintended defective construction work by a subcontractor may constitute an "occurrence" resulting in "property damage" in limited circumstances.
- An insured cannot maintain a bad faith cause of action based solely on an insurer's failure to conduct a discretionary investigation of a claim.
- Where an insured settles a dispute involving mixed covered and noncovered claims against which an insurer wrongfully refused to defend, the insured is entitled to recover from the insurer only that portion of the settlement that the insured can prove should be reasonably allocated to those claims against which the insurer had a duty to defend.

Background

In spring 2000, the plaintiffs, Capstone Building Corp. and Capstone Development Corp. (together, "Capstone"), entered into a contract with the University of Connecticut ("UConn") under which Capstone agreed to serve as the general contractor and project developer for the construction of a student-resident housing complex on UConn's Storrs campus. Capstone completed the project in August 2001. In 2004, UConn discovered that the construction for which Capstone was responsible was defective. Among other things, UConn alleged Capstone's faulty construction would require UConn to take remedial steps to correct elevated carbon monoxide levels resulting from inadequate venting, improperly sized flues, "[p]oor workmanship and quality control," as well as "[v]iolations of numerous code requirements." *Capstone*, 2013 Conn. LEXIS 187, at *33 n.20.

UConn's claims against Capstone were mediated. Capstone demanded that American Motorists Insurance Company ("AMICO") participate in the mediation, claiming a policy AMICO issued covered the damages UConn sought. AMICO declined to participate in the mediation. UConn and Capstone eventually negotiated a settlement agreement. Thereafter, Capstone sued AMICO in Alabama. The U.S. Court for the District of Northern Alabama concluded that the insurance policy at issue was governed by Connecticut law. The court identified three issues of first impression relating to the policy. Those issues were submitted as certified questions to the Connecticut Supreme Court.

The Connecticut Supreme Court's Decision

The first certified question was whether damage to a construction project caused by construction defects and faulty workmanship may constitute "property damage" resulting from an "occurrence," triggering coverage under a commercial general liability policy. *Id.* at *21-22. The court concluded that defective workmanship can give rise to an occurrence under a commercial general liability policy. *Id.* at *22. The court noted that whether such an occurrence has caused covered property damage will depend on the specific facts of each case. *Id.* at *33. The court held, however, that a loss would constitute

property damage only if it involved physical injury to or loss of use of "*nondefective* property." *Id.* at *45 (emphasis added). The court then explained that "project components defective prior to delivery, or those defectively installed," do not constitute "physical injury within the meaning of the policy's terms." *Id.* Thus, property damage occurs only when faulty workmanship has damaged the otherwise nondefective completed project. *Id.* at *48. Lastly, the court determined that the policy's "your work" exclusion meant that such coverage was further limited to property damage caused by the work of a subcontractor and not by the insured. *Id.* at *58.

The second certified question was whether an insurer's conduct in investigating an insurance claim provides an independent basis for a cause of action for bad faith, even in the absence of coverage. *Id.* at *64. Agreeing with the majority of jurisdictions, the court held that Connecticut does not recognize a cause of action based solely on an insurer's failure to investigate a claim. *Id.* at *75, 79. Relying on long-established contract principles, the court explained that bad faith (a claim for breach of the covenant of good faith and fair dealing) requires a plaintiff to demonstrate that the allegedly wrongful conduct deprived it of some benefit of the parties' agreement. The court explained, "Unless the alleged failure to investigate led to the denial of a contractually *mandated benefit*...[a plaintiff cannot] raise[] a viable bad faith claim." *Id.* at *68 (emphasis added). Under the express terms of the policy at issue, AMICO had sole discretion to decide whether to investigate Capstone's claims, and any failure or deficiency by AMICO in investigating the claim did not deprive Capstone of any bargained-for benefit. *Id.* at *69.

The final certified question was whether, under *Alderman v. Hanover Ins. Group*, 169 Conn. 603 (1975), an insured is entitled to recover the full amount of a pre-suit settlement involving both covered and noncovered claims after an insurer wrongfully disclaims coverage. *Id.* at *83-84. The court noted that the premise of the certified question did not fall squarely within either *Alderman* or *Missionaries of Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 155 Conn. 104 (1967), because in both those cases the policy provided coverage for *all* the claims at issue, whereas the policy in *Capstone* covered only some of the underlying claims. *Id.* at *97. The court reaffirmed the rule that an insurer forfeits its policy defenses against indemnity coverage when the insurer breaches the duty to defend. *Id.* at *89. The court also reaffirmed that the breaching insurer must pay the amount the insured paid to settle with the claimant, to the extent the settlement was reasonable, as well as the costs incurred in effectuating the settlement but only "up to the limits of the policy." *Id.* at *92. In cases involving settlements of both covered and noncovered claims, however, the insurer would be liable, up to its policy limit, only for that part of the settlement the insured could demonstrate should properly be apportioned to the claims that triggered the insurer's duty to defend. *Id.* at *106. The court reasoned that to hold otherwise would create coverage by estoppel. *Id.* The court also held that the insured bears the burden of demonstrating the proper allocation to covered claims. *Id.* at *106-107. Significantly, the court did not limit its holding to pre-suit settlements and acknowledged that this new rule represents an erosion of some of the insured's advantages under *Missionaries*. *Id.* at *108-109.

Consequences for Insurance Companies

The *Capstone* decision is an important ruling for insurance companies conducting business in Connecticut. It limits the scope of coverage for construction defect claims. It also imposes reasonable requirements on an insured to allocate a settlement between covered and noncovered claims. Perhaps more important, *Capstone* should end insureds' claims for bad faith in the absence of coverage.