

Construction Defect Litigation and Emerging Coverage Issues: Diminution in Value Claims



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The heart of the recent construction litigation boom is the water intrusion claim. As the 'boom' evolves, new claims may begin like this: a homeowner finds out his neighbor is having some sort of water problem, and decides to get his or her home tested. In the alternative, mass-mailings by inspections companies mean whole neighborhoods may bring claims around the same time. Unsurprisingly, the inspector manages to find evidence of water intrusion, and suggests the homeowner contact a lawyer.

Construction defect lawsuits are based on damage to the home caused by some defect in the way it was built or the materials used in construction. Where the defective work or materials have caused damage to the home, such as rotting sheathing, studs, or other damage, an insurance policy clearly covers the contractor responsible. The coverage issue arises if it turns out there is no evidence of property damage at all.

Virtually every home has some water staining present. This is normal, and can happen due to several benign causes. Damage means deteriorated sheathing or rotting wood, all things that could affect the integrity of the structure. But even when there is no evidence of damage, there is usually a technical code violation or two that may diminish the value of the home.

Claims based almost entirely on these technical violations are becoming more common. In particular, the issue of building paper under stucco almost always comes up. The building code has required two layers of Grade D paper under stucco since 1983. However, according to many stucco subcontractors, Grade D paper was not available in Minnesota for nearly a decade. Because of this, nearly every stucco home built during that time was built with a technical violation.

We are now seeing more claims where there is no real physical damage to the property. This presents problems for builders, insurers, and plaintiff homeowners alike, because it raises questions whether a CGL insurance policy provides coverage. Thus, homeowners must not assume they will be paid by the insurer, contractors have to be concerned of the liability falling on their shoulders, and insurers must consider all of the above in valuing cases for settlement.

Property Damage

In typical current CGL insurance policies, property damage is defined as:

- physical injury to or destruction of tangible property . . . , including the loss of use thereof . . . ; or
- loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period.

An 'occurrence' is defined as:

[A]n accident, including continuous or repeated exposure to conditions, which results in . . . property damage neither expected nor intended from the standpoint of the insured.

In sum, the insurance policy provides the insurer "will pay all sums which the insured shall become legally obligated to pay as damages because of . . . property damage."

Under the law currently, a plaintiff can recover either the diminution in value or the cost to repair, but not both. They can recover the lesser of the two amounts, because either is presumed to make the plaintiff 'whole' and justly compensate them for their damages.

To inflate damages numbers, we have seen homeowners attempt to include 'stigma damages' in their claims due to the fact they will have to admit their house is a 'leaker' to future buyers. Under current law, stigma appears to be a component of diminution in value (*see, e.g., Russell v. Carroll* , 2004 WL 2093555, Minn. Ct. App., Sep 21, 2004).

If diminution in value becomes larger than the cost to repair, the cost to repair becomes the measure of damages. Because of this, plaintiffs' attorneys are now trying to add diminution in value to the cost to repair, as well, claiming cost to repair will not alone make the plaintiff whole. Of course, if there is no real damage, there is nothing to repair, so plaintiffs allege stigma to make up the difference in the two measures of damages.

In either case, diminution in value alone is not property damage under a CGL policy, as the Minnesota Supreme Court pointed out in *Federated Mutual Ins. Co. v. Concrete Units, Inc.* , 363 N.W.2d 751 (1985).

Diminution in Value Coverage

If diminution in value is not property damage, when will a CGL insurance policy cover diminution in value? The answer is deceptively simple: when there is a diminution in value *because of* property damage.

In a case where the only basis for the claim is noncompliance with the building code's requirement of two layers of Grade D paper under stucco, for example, the answer would be simple: there is no coverage. Of course, lawsuits are rarely so simple.

For example, a plaintiff will more commonly allege they have stains on their windowsills or sheathing that indicate water intrusion. If the sheathing is deteriorated as well, there is damage, which triggers coverage. If there is only staining, there may still be no coverage obligation.

As an example of where property damage *does* lead to coverage, in *Concrete Units*, damage to reinforcing rods not provided by the concrete supplier and the cost of re-leveling the contractor's slip forms, both caused by the poor quality of the concrete supplied, were sufficient property damage to trigger coverage for causally-related diminution in value. In *Concrete Units*, the causally-related diminution in value was the cost of delays, including losses from piled-up corn, but not potential lost profits.

The Minnesota U.S. District Court, Judge Erickson, recently used *Concrete Units* to find coverage where water intrusion and consequent damage at a townhome-style rental complex led to diminution in value in the form of, among other things, lowered and lost rents and a reduced sale price if the jury found causation. See *Westfield Ins. Co. v. Weis Builders, Inc.*, 2004 WL 1630871.

The Crux of the Problem

The problem all parties to a diminution in value claim must take into consideration is the cost of coverage litigation subsequent to a verdict at trial. There is the consequent possibility the insured will not have the money to pay the verdict out of its own pocket.

While plaintiffs typically use cost to repair and an insurance policy's limits to gauge their potential recovery, they may have to temper their expectation to reflect the possibility of the non-existence of coverage in a case founded on technical code violations without real property damage.

Making this more difficult for plaintiffs is the fact a claim based on code violations *without* real property damage may give rise to the same or similar costs to repair as a full-blown water intrusion lawsuit *with* real property damage. On a stucco-sided house, the main difference in the cost to repair is that sheathing and insulation need not be replaced, but the stucco still does. The resulting repair bill is still very steep in most cases.

And just like a homeowner with a full-blown water intrusion case with real property damage, the plaintiff in this case has to cope with the fact they may have to disclose the 'water intrusion' to a future buyer, whose home inspector will no doubt bring up the 'risk' of water intrusion. The plaintiff sees financial losses besetting him from all sides, and still has his attorney's bill to consider.

Conclusion: Settling Diminution in Value Claims

If all the parties are brought to a realistic understanding of the different forces and risks at play in a claim based solely on technical code violations, mediation may still work to the advantage of them all.

As mentioned above, most plaintiffs will find a way to allege property damage, even if there is a chance they will lose on that issue. Taking this into account, the insurer cannot assume it can safely deny coverage. However, the possibility means it can discount the value of the lawsuit.

The contractor or subcontractor itself may want to consider the possibility it will lose coverage through subsequent litigation, and contribute to a settlement as a precautionary measure.

The plaintiffs, however, have to accept the possibility coverage will not lie and lower their expectations accordingly. Further, if there really is no water damage due to the technical code violation, their disadvantage on sale can be minimized by smart bargaining methods and buyer education. Of course, plaintiffs may believe they really do have water intrusion and property damage.

Plaintiffs must also take into account the added expense and uncertainty of a resulting declaratory action to determine coverage. If the insurance company prevails, the plaintiff may have to go to additional expense and trouble attempting to enforce the judgment against the builder. The additional uncertainty of a diminution in value claim should be primarily to the detriment of the plaintiffs, who stand to lose the most.

In conclusion, insurers and attorneys should be on the lookout for claims based on diminution in value alone, and account for the different risks accordingly when valuing the claim. As always, the uncertainty of trial is a strong incentive to settle; where diminution in value forms the core of the claim, there is greater uncertainty. The incentive to settle may, consequently, be that much greater.

If you have any questions about this topic, please contact [John Veith](#) or [Mark Pryor](#).

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