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INSURANCE LAW BLOG

December 29, 2023

Illinois Supreme Court Holds that Constructions Defects May Constitute "Property Damage" Caused By An "Occurrence" Under Standard CGL Policy, Overruling Prior Appellate Court Precedent

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On November 30, 2023, the Illinois Supreme Court issued an opinion that overturned precedent in Illinois regarding whether faulty workmanship that only caused damage to the insured's own work constituted "property damage" caused by an "occurrence" under Illinois law. In *Acuity v. M/I Homes of Chicago, LLC*, 2023 IL 129087, the Illinois Supreme Court considered whether Acuity, a mutual insurance company, had a duty to defend its additional insured, M/I Homes of Chicago, LLC (M/I Homes), under a subcontractor's commercial general liability (CGL) policy in connection with an underlying lawsuit brought by a townhome owners' association for breach of contract and breach of an implied warranty of habitability. The Cook County Circuit Court granted summary judgment in favor of Acuity finding no duty to defend because the underlying complaint did not allege "property damage" caused by an "occurrence" under the initial grant of coverage of the insurance policy. The appellate court reversed and remanded, finding that Acuity owed M/I Homes a duty to defend. The Illinois Supreme Court affirmed, in part, holding construction defects to the general contractor's own work may constitute "property damage" caused by an "occurrence" under the standard CGL Policy. This is significant as it overrules prior Illinois precedent finding that repair or replacement of the insured's defective work does not satisfy the initial grant of coverage of a CGL Policy.

By way of background, the underlying litigation stems from alleged construction defects in a residential townhome development in the village of Hanover Park, Illinois. The townhome owners' association, through its board of directors (the Association) subsequently filed an action on behalf of the townhome owners for breach of contract and breach of the implied warranty of habitability against M/I Homes as the general contractor and successor developer/seller of the townhomes. The Association alleged that M/I Homes' subcontractors caused construction defects by using defective materials, conducting faulty workmanship, and failing to comply with applicable building codes. As a result, "[t]he [d]efects caused physical injury to the [t]ownhomes (*i.e.* altered the exterior's appearance, shape, color or other material dimension) after construction of the [t]ownhome[ ] was completed from repeated exposure to substantially the same general conditions." The defects included "leakage and/or uncontrolled water and/or moisture in locations in the buildings where it was not intended or expected." The Association alleged that the "[d]efects have caused substantial damage to the [t]ownhomes and damage to other property."

M/I Homes demanded a defense from Acuity as the additional insured on a CGL policy that Acuity issued to one of its subcontractors, H&R Exteriors, Inc. (H&R). Acuity denied coverage and initiated a complaint for declaratory judgment arguing the underlying complaint failed to allege any "property damage" caused by an "occurrence" as those terms are defined by the Acuity policy and interpreted by Illinois law. Indeed, Illinois law (as it then existed) generally held that there could be no "property damage" caused by an "occurrence" unless the underlying complaint alleged property damage to something beyond the insured's own work, or in this case, beyond the entire townhome construction project itself. The appellate court, and the Illinois Supreme Court, however, reasoned that this understanding of Illinois law "was not directly tied to the language of the insurance policy but, rather, [] derived from appellate court case law interpreting CGL policies."

After examining Illinois law, case law from other jurisdictions, and the "general components of the CGL Policy," the Illinois Supreme Court concluded that the underlying allegations of resulting water damage to the interior of the completed units plainly constitutes physical injury to tangible property, i.e. "property damage" under the policy. Next, the Court held that that the term "occurrence" (i.e., an "accident") in the policies reasonably encompassed the unintended and unexpected harm caused by negligent conduct. Because neither the cause of the harm—the construction defects—nor the harm itself—resulting water damage to the walls of the interior of the units—was intended, anticipated, or expected by the insured or its subcontractors, an "occurrence" was alleged.

Notably, the Illinois Supreme Court's analysis replaces prior Illinois appellate court precedent that had held that repair or replacement of the insured's own defective work (whatever the scope of that work was) did not satisfy the initial Insuring Agreement or grant of coverage in a standard CGL policy. The Illinois Supreme Court acknowledged Acuity's argument that ultimately the intent of CGL coverage is not to insure the cost to repair or replace defective work or to recover damages within the named insured's own scope of work. Nevertheless, the Court reasoned that these notions of "business risk" articulated by the insurer are specifically expressed in the *exclusions section* of the policy; they are not found in the language of the initial grant of coverage. According to the Court:

> To hold that all construction defects that result in property damage to the completed project are always excluded would mean that the exclusions in the policy related to business risk become meaningless….[T]he business risk exclusions contemplate that some construction defects that result in property damage are covered and some are not, depending on various factors written into the policy. To the extent that inadvertent construction defects that result in property damage are not covered, those limitations are effectuated by operation of the exclusions section of the policy.
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> Furthermore, we hold that the parties' premise—that there could be no "property damage" caused by an "occurrence" under the policy unless the underlying complaint alleged property damage to something beyond the townhome construction project—is erroneous; it is not grounded in the language of the initial grant of coverage in the insuring agreement. To the extent that prior appellate court cases relied upon considerations outside the scope of the insuring agreement's express language, that analysis, which is not tied to the language of the policy, should no longer be relied upon.

The Illinois Supreme Court affirmed the appellate court's ruling in favor of M/I Homes, in part, and remanded the case back to the Circuit Court to consider whether the exclusions in the CGL policy bar coverage.