

# BAD HOUSE CASES: LIABILITY AND INSURANCE COVERAGE ISSUES

## I. Overview

For the last decade or more, there has been a significant increase in the number of claims and lawsuits brought by homeowners against contractors and home builders. Sometimes colloquially referred to as “bad house” cases or “broke house” cases, among other endearing terms, these refer to claims by homeowners against construction professionals for defects or deficiencies arising out of residential construction projects. The primary theories of recovery are express and implied warranty, breach of contract, and negligence. Sometimes other theories, such as misrepresentation, suppression, and/or wantonness are included. These claims typically present insurance coverage issues, in addition to the usual concerns with liability, causation, and damages.

### a. Breach of Contract/Breach of Warranty

An action for breach of warranty is a subset of a breach of contract action. *Turner v. Westhampton Court, LLC*, 903 So. 2d 82 (Ala. 2004). Depending upon the circumstances, actions for construction defects and/or deficiencies may give rise to a claim for express warranty (*Desouza v. Lauderdale*, 928 So. 2d 1035 (Ala. Civ. App. 2005)), breach of implied warranty of habitability (*Cochran v. Keeton*, 252 So. 2d 307 (Ala. Civ. App. 1970)), or breach of implied warranty of workmanship (*Stephens v. Creel*, 429 So. 2d 278 (Ala. 1983)).

In *Cochran v. Keeton*, 252 So. 2d 313 (Ala. 1971) the Alabama Supreme Court, overruling prior precedent<sup>1</sup>, the Court held

"The decision in *Druid* would be overruled, insofar as it adopts the rule of caveat emptor in the sale by a builder-vendor of a newly constructed home and that the principle of an implied warranty of fitness and habitability for the purpose purchased would be recognized."

Which implied warranty would be applicable to a particular case would depend upon the nature of the transaction. On the one hand, there are occasions where a builder may construct a new house with the intention of selling it (sometimes referred to as a “spec house”), and in that situation, the applicable warranty would likely be an implied warranty of habitability. The elements of an implied warranty of habitability are:

1. That plaintiff purchased a new residence from defendant;

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<sup>1</sup> *Druid Homes, Inc. v. Cooper* 131 So. 2d 884 (Ala. 1961) held that the rule of caveat emptor applied to the sale of houses.

2. That defendant built the residence or had it built for sale to the public;
3. That the residence had not been lived in by anyone else before plaintiff purchased it;
4. That the residence was sold in a defective condition which impaired the intended use of the residence;
5. That the plaintiff was not aware of the defective condition; and,
6. That plaintiff was harmed by the defective condition.

1 Ala. Pattern Jury Instr. Civ. 10.15 (3d ed.)

On the other hand, builders often contract, in advance, for the construction of a new house for a particular individual (often called a “pre-sale” or “custom” house). In that situation, there would not necessarily be a “sale” so most likely the remedy would be an action for an implied warranty of workmanship.

In either of the above situations, there may also be an express warranty which may provide rights for the purchaser/homeowner. The elements of such a claim would be consistent with the law applicable to express warranty claims in other contexts.

Of course, what one hand taketh, the other hand may taketh away. An express warranty may also serve to limit the rights of the would be Plaintiff, and indeed, the most common provision seen in new home contracts would be described as a “Limited New Home Warranty”. Typically the provision will afford a warranty against defects in workmanship and materials for a limited period of time (often one year) and also subject to restrictions and limitations (somewhat akin to the Limited New Car Warranty automobile manufacturers may provide).

This Limited Warranty can have important implications. Alabama Courts have held that the parties may contract to limit their liabilities and/or disclaim certain warranties or obligations, based upon the inherent freedom of contract. An important decision in this regard is *Turner v. Westhampton Court, LLC*, 903 So. 2d 82 (Ala. 2004), wherein the Alabama Supreme Court stated:

“In *Ex parte Miller*, 693 So. 2d 1372, 1376 (Ala. 1997), a case decided under Alabama’s version of the Uniform Commercial Code, we held that a company can limit its warranty coverage. In *Southern Energy Homes v. Washington*, 774 So. 2d 505, 511 (Ala. 2000), we held that a warranty can require a certain method by which the warranty holder notifies the party giving the warranty of a defect covered by the warranty. See also *Copenhagen Reinsurance Co. v. Champion Home Builders Co.*, 872 So. 2d 848 (Ala. Civ. App. 2003). If a purchaser were to attempt to hold the seller liable when the purchase had not notified the seller pursuant to the method set out in the warranty, the seller would not be liable. While these cases are based upon Alabama’s Commercial Code, we see no reason to limit the rule to cases concerning ‘goods.’ Rather,

we are led by the principle of freedom of contract. Therefore, we hold that companies selling houses are similarly capable of limiting warranty coverage”.

In *Stewart v. Bradley*, 15 So. 3d 533 (Ala. Civ. App. 2008), the Court determined that a valid limited warranty may waive and bar claims for consequential and indirect damages including emotional distress damages. The Alabama Court of Civil Appeals stated “we hold that the Bradleys [Plaintiff homeowners] waived their claims alleging breach of implied warranties of habitability and workmanship, their claims of general negligence, and their right to seek damages for mental anguish.”

**b. Breach of Contract:**

The same decision held that the homeowners did not, however, waive their right to pursue a breach of contract claim against the builder based upon the limited warranty agreement. In that decision, the Court emphasized that the typical issues and defenses applicable to breach of contract actions would be available in such cases. These include defenses such as notice and waiver.

**c. Negligence:**

Historically, as noted above, the rule of caveat emptor applied to negligence and warranty claims against a builder-vendor of a newly constructed house (as well as a used house, of course). In *Cochran, supra*, the Alabama Supreme Court overruled their earlier decision but did not set out, specifically, the elements of a negligence claim nor directly discuss the tort implications. The abrogation of caveat emptor in the sale of houses applies only to new construction; used houses are still subject to the caveat emptor rule.

While subsequent appellate cases have referenced an action for negligent construction (in this context), none, to my knowledge, have articulated the elements or principles for such a claim. In my experience, Courts have treated these claims as traditional common-law type negligence claims (i.e. requiring proof of duty, breach, proximate causation, and damages).

**d. Other theories:**

In such cases, Plaintiffs also often allege claims for wantonness (recklessness), misrepresentation, and/or suppression. Exhaustive discussion of those claims beyond the scope here, but generally the same elements and considerations would be applicable to “house cases” under those theories as in claims of other underlying natures.

**e. Damages:**

The most commonly sought damages in new home construction cases are before and after value, repair costs, mental anguish, and in appropriate cases, attorney fees and punitive damages. Obviously, punitive damages would be recoverable only for certain species of

fraud and/or intentional or reckless misconduct. Attorney fees would not be recoverable, absent an express contractual provision permitting such a recovery.

The most common items of damage in such cases would be before and after value and mental anguish. Under Alabama law, the measure of damages in such cases would typically be as set out below:

The measure of damage is the difference between the reasonable market value of the land immediately before the harm and the reasonable market value immediately after the harm.

1 Ala. Pattern Jury Instr. Civ. 11.38 (3d ed.)

Evidence of cost of repair would be admissible but not conclusive.

Generally, under Alabama law, mental anguish and emotional distress recovery is not permitted in a breach of contract/property damage claim. However, exceptions do exist and probably the most litigated exception is new home construction. Alabama law recognizes that claims for mental anguish and emotional distress may be recovered in cases involving new home construction. (See *Baldwin v. Panetta*, 4 So. 3d 555, 567 (Ala. Civ. App. 2008))<sup>2</sup>

## **II. Insurance Coverage for “Bad House Cases”.**

Often an important consideration in this type of litigation is the potential for insurance coverage in the event of a recovery. This has implications for the practitioner whether

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<sup>2</sup> Under Alabama law, ‘[d]amages for mental anguish can be recovered ... where the contractual duty or obligation is so coupled with matters of mental concern or solicitude, or with the feelings of the party to whom the duty is owed, that a breach of that duty will necessarily or reasonably result in mental anguish or suffering.’ *Liberty Homes, Inc. v. Epperson*, 581 So.2d 449, 454 (Ala.1991) (quoting *F. Becker Asphaltum Roofing Co. v. Murphy*, 224 Ala. 655, 141 So. 630, 631 (1932)). “.... The majority of the cases in which a plaintiff has been allowed to recover damages for mental anguish involved actions on ‘contracts for the repair or construction of a house or dwelling or the delivery of utilities thereto, where the breach affected habitability.’ See, e.g., *Epperson*, 581 So.2d at 454; *Orkin Exterminating Co. v. Donovan*, 519 So.2d 1330 (Ala.1988); *Lawler Mobile Homes, Inc. v. Tarver*, 492 So.2d 297 (Ala.1986); *Alabama Power Co. v. Harmon*, 483 So.2d 386 (Ala.1986). Because a person's home is said to be his ‘castle’ and the ‘largest single individual investment the average American family will make,’ these contracts are ‘so coupled with matters of mental concern or solicitude or with the feelings of the party to whom the duty is owed, that a breach of that duty will necessarily or reasonably result in mental anguish or suffering.’ *B & M Homes, Inc. v. Hogan*, 376 So.2d 667, 671-72 (Ala.1979). Where such a contractual duty [is] breached, the Alabama Supreme Court has said that ‘it is just that damages therefor be taken into consideration and awarded.’ *Id.* at 671.

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“The Alabama Supreme Court has made very clear, however, that all these cases represent an exception to the general rule prohibiting mental anguish damages for breach of contract. These cases deserve special treatment because it is highly foreseeable that egregious breaches of certain contracts-involving one's home ..., for example-will result in significant emotional distress. See *Sexton v. St. Clair Federal Sav. Bank*, 653 So.2d 959, 962 (Ala.1995).” *Ruiz de Molina*, 207 F.3d at 1359-60.

pursuing the claim or representing a builder/contractor, and has assumed even greater significance in light of the current economic difficulties confronting contractors.

Generally, in order to obtain a license in this community, a contractor and/or homebuilder must have liability insurance coverage. However, the coverage available to contractors is typically a general liability policy, rather than an errors and omissions type of policy. Limited coverage is provided under these policies. Most often these are “occurrence” rather than “claims made” policies. The following language is typical:

**“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. We will have the right and duty to defend the insured against any “suit” seeking those damages. However we will have no duty to defend the insured against any “suit” seeking damages for “bodily injury” or “property damage” to which this insurance does not apply. We may, at our discretion, investigate any “occurrence” and settle any claim or “suit” that may result...”

Such liability insurance policy typically defines terms including the following:

“Bodily injury” means “bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time.”

“Property damage”:

“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.

An “occurrence” is defined as:

“an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”

The policies typically also contain exclusion including exclusions to the property damage coverage for “that particular part of any property that must be restored, repaired or replaced because “your work” was incorrectly performed on it. The policy excludes “your work”.

These are common provisions but the language in some of the policies will vary and should be reviewed carefully. From the forgoing, there are implications for several considerations.

First, the insuring agreement not only provides coverage for damages that the insured becomes legally obligated to pay but also provides a duty to defend the insured. There are many Alabama cases addressing the duty to defend an insured in a situation where some of the claims may not be covered. The duty to defend the insured is greater than the duty to ultimately indemnify (see *Tanner v. State Farm Fire & Casualty*, 874 So. 2d 1058 (Ala. 2003)). Further, the general rule in Alabama is that contracts of insurance must be construed liberally in favor of the insured and exclusions are to be interpreted as narrowly as possible, *Alliance Insurance Company v. Reynolds*, 494 So. 2d 609 (Ala. 1986).

Therefore, under many circumstances, a general liability insurance carrier may provide a defense to its insured, typically under a Reservation of Rights, even though it may contend that some or all of the claims would not be covered under the liability insurance policy. In insurance terms, they might owe a duty to defend but would not necessarily owe a duty to indemnify.

Put most simply (at the risk of over-simplification), as the cases below will illustrate, typical general liability insurance policies may provide some coverage (indemnification) for some property claims and for mental distress claims. The latter is relatively unique in Alabama. Unlike most states, Alabama has construed the definition of “bodily injury” as including mental anguish and emotional distress even when unaccompanied by physical injury. In *Morrison Assurance Co. v. North American Reinsurance Corp.*, 588 F.Supp 1324 (N.D. Ala. 1984), the Northern District Court, applying Alabama law, found that although the words “mental anguish” were not articulated specifically in the definition of “bodily injury” in that particular policy, the terms “sickness” and “disease” necessarily encompassed mental anguish. See also *American Economy Insurance Co. v. Fort Deposit Bank*, 890 F.Supp 1011 (M.D. Ala. 1995); *American States Insurance Co. v. Cooper*, 518 So. 2d 708 (Ala. 1987). As noted above, Alabama law has recognized mental anguish as compensable in a contract case involving a new house and, interestingly, a misrepresentation causing mental anguish has also been identified as an occurrence resulting in bodily injury. *State Farm Fire & Casualty v. Gwin*, 658 So. 2d 426 (Ala. 1995).

If, as indicated above, mental anguish may constitute a “bodily injury” for purposes of liability insurance coverage, what coverage is afforded in these cases under “property damage”. Typically, the definition of property damage will indicate that only direct loss to “tangible property” falls within the definition. The Alabama Supreme Court has defined “tangible property” as follows:

“Tangible property is that which may be felt or touched; such property may be seen, weighed, measured, and estimated by the physical senses; that which is visible and corporeal; having substance and body as contrasted with incorporeal property rights...

In this context, tangible property (like real estate) is property that is capable of being handled, touched, or physically possessed. Purely economic losses are not included in this definition. *Oxford Lumber Company v. Lumberman's Mutual Insurance Company*, 472 So. 2d 973 (Ala. 1985)(employee's claim for insured's failure to provide medical benefits not covered). *See also Keeting v. National Union Fire Insurance Company of Pittsburg*, 995 F. 2d 154 (9<sup>th</sup> Circuit 1993) (economic losses not damage or injury to tangible property covered by a comprehensive general liability policy); *Allstate Insurance Company v. Russo*, 829 F. Supp. 24 (D. R. I. 1993)(lost investments and lost deposits not tangible property)."

*American States Ins. Co. v. Martin*, 662 So. 2d 245 (Ala. 1995); *See Prince v. Higgins*, 572 So. 2d 1217 (Ala. 1990).

Tangible property does not include purely economic loss. Unlike an economic interest, tangible property is generally subject to physical damage or destruction. Thus, under a policy covering property damage to only "tangible property," purely economic losses are not covered. *Martin*, 662 So. 2d at 249.

For many years, Alabama Courts have grappled with the definition of "property damage" as well as the "your work exclusions" and the interplay between the two. This can have significance because, as a general principle of insurance law, the burden of proving coverage is upon the party seeking coverage while the duty of proving an exclusion rests with the insurer.<sup>3</sup>

Alabama Courts have held that where the work or product of an insured damages other property there is "property damage". There are, however, allegations that there was physical

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<sup>3</sup> See, e.g., *Am. Safety Indem. Co. v. T.H. Taylor, Inc.*, 513 F. App'x 807, 813-14 (11th Cir. 2013); *Twin City Fire Ins. Co. v. Alfa Mut. Ins. Co.*, 817 So.2d 687, 697 (Ala.2001) (declaratory judgment action by insurer: "Twin City [the insurer] has the burden of proof in asserting that a claim is excluded under its policy of insurance"); *Acceptance Ins. Co. v. Brown*, 832 So.2d 1, 12 (Ala.2001) (bad faith breach of duty to defend action brought by insureds: "In general, the insurer bears the burden of proving the applicability of any policy exclusion."); *State Farm Fire and Cas. Co. v. Shady Grove Baptist Church*, 838 So.2d 1039, 1043 (Ala.2002) (an action for coverage by insured for collapse of a roof in which the insurance company moved for judgment as a matter of law that the roof collapse was not covered under the policy. The court noted that the insured had the burden of presenting substantial evidence showing that the collapse fell within the coverage definition of "collapse" contained in the policy.); *Colonial Life & Accident Ins. Co. v. Collins*, 280 Ala. 373, 194 So.2d 532, 535 (1967) (beneficiary brought suit for coverage in a life insurance policy: "The burden was on the plaintiff to prove that the insured's death resulted from injuries sustained in such a manner as to bring him within the coverage of the policy.").

damage to the residence caused by the improper construction work. Alabama courts have held that where the work or product of an insured damages other property there is “property damage.” *U.S.F. & G. v. Bonitz Roofing, supra*; *U.S.F. & G. v. Andalusia Ready-Mix*, 436 So. 2d 868 (Ala. 1983)(where defective grout caused damage to piping system); *Fitness Equipment Co. v. Pennsylvania General Insurance Co.*, 493 So. 2d 1337 (Ala. 1985)(where defective motors installed in exercise equipment caused the control units of the exercise equipment to be damaged); *Liberty Mut. Ins. Co. v. Wheelwright Trucking Co., Inc.*, 851 So. 2d 466 (Ala. 2002)(cracking of trailer beds caused “property damage” to tractor-trucks); *See also Lamar Homes, Inc. v. Mid Continent Cas. Co.*, 2007 WL 2459193 (Tex. 2007)(holding that cracks in stone veneer and sheet rock caused by a defective foundation were “property damage”). In this context, there are two very important relatively recent Alabama Appellate Court decisions:

In *Town & Country Property, LLC v. Amerisure Insurance Company*, 111 So. 3d 699 (Ala. 2011), opinion on return to remand. In that decision, Jones-Williams contracted with Town & Country Property to construct an automobile sales and service center. Jones-Williams entered into contracts with various subcontractors to construct the facility. Thereafter, Town & Country discovered various defects in the facility and notified Jones-Williams to correct them. Town & Country sued Jones-Williams asserting various tort and contract claims stemming from the alleged faulty construction of the facility. Jones-Williams notified its insurer, Amerisure, to provide a defense. Town & Country’s claims against Jones-Williams were tried and the jury returned a verdict against Jones-Williams. Amerisure indicated that it would not indemnify Jones-Williams for the judgment entered against it. Town & Country initiated an action against Amerisure, which Amerisure filed a counterclaim seeking a declaratory judgment that there had been no occurrence triggering coverage under the Amerisure policy. The trial court entered Summary Judgment on behalf of Amerisure, holding that “faulty construction” was not an occurrence under a CGL policy. Town & Country appealed.

The Court looked to the holdings of *United States Fid. & Guar. Co. v. Warwick Dev. Co.*, 446 So. 2d 1021 (Ala. 1984) and *Moss v. Champion Ins. Co.*, 442 So. 2d 26 (Ala. 1983) for guidance with regard to whether damages alleged to be the result of faulty workmanship are covered under a CGL policy. In each of these two cases, the decision hinged on the nature of the damages caused by the faulty workmanship. In *United States Fid. & Guar. Co. v. Warwick Dev. Co.*, 446 So. 2d 1021 (Ala. 1984), the purchasers of a newly built house sued the builder, stating claims of faulty construction and misrepresentation, after taking possession of the house and discovering extensive defects in its construction. The builder then alleged a third-party claim against its insurer after it sought coverage for the purchasers’ claims pursuant to a CGL policy, and its request for coverage was denied. The Court held that there was no occurrence within the policy definition, where the alleged damage was confined to the residence itself. In *Moss v. Champion Ins. Co.*, 442 So. 2d 26 (Ala. 1983), a homeowner sued a contractor she had hired to re-roof her house in order “to recover for damage she allegedly incurred due to rain which fell into her attic and ceilings because, as she claimed, the roof was uncovered much of the time that the re-roofing job

was being performed.” The Court held that there had been an occurrence for CGL policy purposes when the contractor’s poor workmanship resulted in not merely a poorly constructed roof but damage to the Plaintiff’s attic, interior ceilings, and at least some furnishings.

Reading *Warwick* and *Moss* together, the *Town & Country* Court held that that faulty workmanship itself is not an occurrence but that faulty workmanship may lead to an occurrence if it subjects personal property or other parts of the structure to “continuous or repeated exposure” to some other “general harmful condition” (e.g., the rain in *Moss*) and, as a result of that exposure, personal property or other parts of the structure are damaged. The Court held that Amerisure was not required to indemnify Jones–Williams for the judgment entered against it insofar as the damages represented the costs of repairing or replacing the faulty work.

While the *Town & Country Property, LLC* case did not deal with a new residential property, those principles will likely be applicable to “bad house” cases. In addition, the Appellate Court apparently undertook to review the record, in detail, and segregated out the damages which were caused by “faulty work” as opposed to those which were “resulting damage”. Previously, it had not been clear whether a Court could “go behind a general verdict”.

In *Owners Insurance Co. v. Jim Carr Homebuilders, LLC*, 2013 WL 5298575 (Ala. September 20, 2013), an action was brought seeking a declaration, under the policy of a homebuilder, regarding the existence of coverage under a CGL policy for building defects. The homeowners contracted with JCH, a licensed homebuilder, for construction of a new residence. After taking possession, the homeowners noted several problems in the house related to water leaking through the roof, walls, and floors, resulting in water damage to those and other areas of the residence. The homeowners sued JCH, who subsequently filed a claim with Owners requesting defense and indemnification. Owners sought a declaratory judgment action. The underlying action proceeded to arbitration with an award against JCH based upon various defects and mental anguish. All parties moved for Summary Judgment in the declaratory judgment action, and the trial court ultimately held that the entire arbitration award was covered by the Owners policy. Owners appealed.

The Court looked to the holding in *Town & Country Property, LLC v. Amerisure Insurance Company*, 111 So. 3d 699 (Ala. 2011), finding that it was clear that faulty workmanship performed as part of a construction or repair project may lead to an occurrence if that faulty workmanship subjects personal property or other parts of the structure *outside the scope of that construction or repair project* “to ‘continuous or repeated exposure’ to some other ‘general harmful condition’ ” and if, as a result of that exposure, that personal property or other *unrelated* parts of the structure are damaged. Hence, there was no occurrence in *Warwick* where the builder’s poor workmanship resulted in just a poor final product (the house itself), but there was an occurrence in *Moss* because the contractor’s poor workmanship resulted not just in a poor final product (the new roof), but also in damage to

the homeowner's personal property and other parts of the house outside the scope of the contractor's project—the attic and interior ceilings. *See also United States Fidelity & Guaranty Co. v. Bonitz Insulation Co. of Alabama*, 424 So. 2d 569 (Ala. 1982), (“If damage to the roof itself were the only damage claimed by the [Plaintiff], the exclusions would work to deny [the roofing contractor] any coverage under the [CGL] policy. The [Plaintiff], however, also claims damage to ceilings, walls, carpets, and the gym floor. We think there can be no doubt that, if the occurrence or accident causes damage to some *other* property than the insured's product, the insured's liability for such damage becomes the liability of the insurer under the policy.”). The Court held that the facts were substantially identical to those in *Warwick* in which the Court held that an insurer was not required to indemnify its insured homebuilder for damages stemming from an action alleging that a new house had been poorly constructed, because “there was no ‘occurrence’ within the definition of ‘occurrence’ found in the pertinent policy provisions.” The Court indicated that the homeowners contracted with JCH to build them a house, and any damage that resulted from poor workmanship was damage to JCH's own product. As such, there was no occurrence and the trial court erred in granting Summary Judgment on behalf of the homeowners and JCH holding that Owners was required to indemnify JCH for the judgment against it.

It should be noted that the insurance policy in *Owners* did have a somewhat different provision within the property damage coverage and work exclusion. A typical liability policy has a subcontractor exception to the “*your work*” exclusion. The *Owners*' policy did not have such an exclusion and essentially provided that in the construction of a new house, the entire house, even work performed by a subcontractor, would be considered “the work” of the builder.

### **III. Conclusions**

Since it appears that these cases will continue to proliferate, at least for the foreseeable future, and since the Appellate Courts appear to be reviewing these issues somewhat more constrictively, both in terms of insurance coverage and underlying contractual (and tort) liability, it is important to review and become familiar with the most recent cases, including those cited herein. In addition to the obvious importance to a lawyer representing a homeowner or defending a builder, these considerations will also be important to lawyers with a general or business practice particularly if you have contractor clients. The principles contained in these cases should be considered in drafting construction and sales contracts, as well as in advising clients on such matters.