

Nos. A04-1442 and A04-1612

State of Minnesota
In Supreme Court

Wooddale Builders, Inc.,

Appellant,

vs.

Maryland Casualty Company, d/b/a Zurich North America,

Appellant,

vs.

American Family Insurance, and
Western National Insurance Group,

Appellants,

and

West Bend Mutual Insurance Company, and
American Economy Insurance Co. (SafeCo),

Respondents.

**BRIEF OF AMICUS CURIAE DEFECTIVE
CONSTRUCTION HOMEOWNERS OF MINNESOTA**

Erik F. Hansen (#303410)
J. Robert Keena (#258817)
HELLMUTH & JOHNSON, PLLC
10400 Viking Drive, Suite 500
Eden Prairie, MN 55344
(952) 941-4005

*Attorneys for Defective
Construction Homeowners of Minnesota*

(Additional Counsel Listed on following page)

James T. Martin (#68044)
GISLASON, MARTIN
& VARPNESS, P.A.
7600 Parklawn Avenue South
Suite 444
Edina, MN 55435
(952) 831-5793

*Attorney for Appellant Western National
Insurance Group*

Ted E. Sullivan (#122452)
William L. Davidson (#201777)
LIND, JENSEN, SULLIVAN
& PETERSON, P.A.
150 South Fifth Street, Suite 1700
Minneapolis, MN 55402
(612) 333-3637

*Attorneys for Respondent American Economy
Insurance Company (Safeco)*

Andrea E. Reisbord (#22411X)
Peter G. Van Bergen (#112033)
Minard M. Halverson, II
COUSINEAU, McGUIRE &
ANDERSON, CHARTERED
600 Travelers Express Tower
1550 Utica Avenue South
Minneapolis, MN 55416
(952) 546-8400

*Attorneys for Appellant Maryland Casualty
Company d/b/a Zurich North America*

Ernest F. Peake (#212453)
Chad A. Kelsch (#0300794)
LEONARD, O'BRIEN, SPENCER,
GALE & SAYRE, LTD.
100 South Fifth Street
Suite 2500
Minneapolis, MN 55402-1216
(612) 332-1030

Attorneys for Appellant Wooddale Builders, Inc.

David Oskie (#144265)
James M. Hamilton (#167526)
OSKIE, REUTER, HAMILTON,
SOFIO & ZENTNER, P.A.
970 Raymond Avenue
Suite 202
St. Paul, MN 55114
(651) 644-8037

*Attorneys for Appellant American
Family Insurance Group*

Gregory J. Johnson (#202678)
JOHNSON & PROVO-PETERSON, LLP
First National Bank Building
332 Minnesota Street, Suite W-975
St. Paul, MN 55101
(651) 227-2534

Attorneys for Respondent West Bend Mutual Insurance Co.

Jocelyn Knoll (#02298X)
Katie Pfeifer (#0309709)
DORSEY & WHITNEY LLP
50 South Sixth Street, Suite 1500
Minneapolis, MN 55402-1498

*Attorneys for Builders Association of Minnesota, as
Umbrella Organization for Builders Association of the
Twin Cities and Minnesota Out State Builders
Association*

Thomas H. Boyd (#200517)
Christianna L. Finnern (#310724)
WINTHROP & WEINSTINE, P.A.
225 South Sixth Street, Suite 3500
Minneapolis, MN 55402

Attorneys for the Minnesota Chamber of Commerce

Alan C. Williams (#117328)
Assistant Attorney General
Office of the Attorney General, State of Minnesota
900 Bremer Tower
445 Minnesota Street
St. Paul, MN 55101

*Attorneys for the Office of the Minnesota Attorney
General*

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STATEMENT OF ISSUES

I. Whether the Appropriate End Date for Allocation Pursuant to a “Pro Rata By Time on the Risk” Allocation Plan Should be the Date of Discovery of Damage or the Date of Remediation of the Damage.

The trial court held that the appropriate end date for allocation is the date of discovery. The Minnesota Court of Appeals revised the trial court and set the end date as the date of remediation.

Wooddale Builders, Inc. v. Maryland Cas. Co., 695 N.W.2d 399 (Minn. Ct. App. 2005)

Northern States Power v. Fidelity & Cas. Co. of New York, 523 N.W.2d 657 (Minn.1994)

In Re Silicone Implant Ins. Coverage Litig., 667 N.W.2d 405 (Minn. 2003)

II. Whether the Court Should Adopt an Allocation Plan that Protects Insureds and Claimants from Uninsured Periods.

The trial court and Minnesota Court of Appeals did not address alternative allocation plans.

Armstrong World Industries, Inc. v. Aetna Cas. & Surety Co., 45 Cal.App. 4th 1, 52 Cal. Rptr.2d 690 (Cal. Ct. App. 1996)

III. Whether the Court Should Reject the Application of Pro Rata by Time on the Risk to Moisture Intrusion Cases.

The trial court and Minnesota Court of Appeals did address the decision to apply a pro rata by time on the risk allocation plan to the facts of this case.

In Re Silicone Implant Ins. Coverage Litig., 667 N.W.2d 405 (Minn. 2003)

SCSC Corp v. Allied Maf. Ins. Co., 536 N.W.2d 305, (Minn. 1995)

Domtar, Inc. v. Niagara Fire Ins. Co., 563 N.W.2d 724 (Minn. 1997)

STATEMENT OF THE CASE

Defective Construction Homeowners of Minnesota, a Minnesota non-profit corporation, submits the following amicus curiae brief urging that the decision of the Minnesota Court of Appeals be overturned.¹

Procedurally, this case arose as a declaratory judgment action instituted by a builder of residential homes, Wooddale Builders, Inc., against one of its insurers, Maryland Casualty Company seeking coverage for a number of construction defect claims brought against Wooddale. Maryland, in turn, brought claims for contribution and indemnification against other insurers who provided coverage to Wooddale from 1990 until 2002. Those insurers are American Family Insurance, West Bend Mutual Insurance Company, American Economy Insurance Company (SafeCo), and Western National Insurance Group.

The parties agreed that liability for the claims should be allocated among the insurers pursuant to a “pro rata by time on the risk” allocation plan. The parties agreed that the allocation period should begin with the date of closing on each home; however, the parties did not agree on the end date for the allocation period. The district court accepted the parties’ stipulation, stating:

Since the damage sustained to these homes was not the result of a discrete and identifiable event, but rather so continuous and indivisible as to make it impossible to identify one such event, the appropriate method of allocating damages to the Insurers in this case is pro rata by time on the risk. The pro rata by time on the risk allocation method is consistent with the actual

¹ Pursuant to Minn. R. Civ. App. P. 129.03, Defective Construction Homeowners of Minnesota states that no other party made a monetary contribution to the preparation or submission of this brief.

injury rule and is appropriate here because the damages sustained by these homes is so continuous and indivisible that the Court must conclude that some damage occurred continuously from the point of first damage until discovery or repair.

Order and Memorandum, dated June 15, 2004, pg. 4.

On the disputed issue of the appropriate end date for the allocation period, the district court set the end date as the date that the insured, Wooddale, was notified that a homeowner was making a claim for damages. *Id.* Finally, the district court was asked to address the issue of the allocation of defense costs among the insurers. The district court held that defense costs should be borne equally by the insurers.

On appeal, the Minnesota Court of Appeals did not question the appropriateness of the district court's acceptance of the "pro rata by time on the risk" allocation, nor, predictably, did the insurers challenge the applicability of "pro rata by time on the risk."

The court of appeals did address the end date for allocation. The court of appeals reversed the district court, holding that the appropriate end date is the date of remediation. The court of appeals also reversed the district court's division of the cost of defense, instead holding that the cost of defense should also be allocated on a "pro rata by time on the risk" basis identical to the liability allocation.

Defective Construction Homeowners urges reversal of the Minnesota Court of Appeals decision regarding the appropriate end date for allocation and takes no position as to the proper allocation of defense costs. Defective Construction Homeowners further urges adoption of a modified "pro rata by time on the risk" allocation that covers uninsured periods and protects homeowners. In the alternative, Defective Construction

Homeowners urges the Court to reject the application of “pro rata by time on the risk” allocation for all moisture intrusion cases as the completion of the home constitutes a discrete originating event sufficient to trigger insurance coverage.

INTRODUCTION

Defective Construction Homeowners of Minnesota was created to represent the interests of Minnesota homeowners who own homes that have sustained structural damage due to defects in their construction that allow moisture to penetrate the home. Due to the nature of construction defect cases, all of the parties, with the notable exception of homeowners, have large, well-funded trade groups. Two of those groups, the Builders Association of Minnesota and the Minnesota Chamber of Commerce, have been granted amicus status in the present matter.

By contrast, homeowners who find themselves in defectively constructed homes experiencing moisture intrusion desire little more than to repair their homes as quickly and cheaply as possible so they can put the matter behind them. As a result, the class of people most affected by defective construction has very little interest in continuing to pay the regular costs required to sustain an effective advocacy group. Defective Construction Homeowners of Minnesota was created to give those homeowners a voice in important decisions, such as this one, about risk allocation and responsibility for construction defects.

The present case is important not only for its broad impact on current and future homeowners experiencing moisture intrusion damage but also because, up to this point, homeowners have had no voice in these proceedings. Despite the lack of representation

of affected homeowners, this case has significant and far reaching implications for homeowners, especially for those who face claims of an uninsured loss.

ARGUMENT

I. The Appropriate End Date for Allocation Pursuant to a Pro Rata By Time on the Risk Allocation Plan Should be the Date of Discovery of Damage.

In evaluating the Court of Appeals decision in this matter, it is helpful to review the state of Minnesota law prior to the current decision regarding allocation of insurance coverage in cases with continuous, indivisible damage occurring over the course of multiple policies. Typically, these cases have arisen in environmental contamination cases.

Minnesota applies an “actual injury” trigger rule when determining what insurance policies are triggered by an occurrence causing damage. *Northern States Power Co. v. Fidelity & Cas. Co. of New York*, 523 N.W.2d 657, 661 (Minn. 1994). “The essence of the actual injury trigger theory is that each insurer is held liable for only those damages which occurred during its policy period; no insurer is held liable for damages outside its policy period.” *Id.*

In applying the “actual injury” trigger theory to cases involving continuous damage occurring over multiple policy periods where no discrete originating event can be identified, Minnesota applies a “pro rata by time on the risk” allocation method. *Id.* at 663-664.

In reaching this holding, the Court in *Northern States Power Co. v. Fidelity & Cas. Co. of New York* (“NSP”) rejected a “pro rata by limits” allocation model whereby

each triggered policy is liable to its policy limits. The *NSP* Court concluded that a “pro rata by limits” allocation violated the spirit of the “actual injury” trigger theory because it “effectively makes those insurers with higher limits liable for damages incurred outside their policy periods.” *Id.* at 662.

The *NSP* Court also considered an “as proven” allocation plan wherein insurers would be liable only for damages that can be proven to have occurred during the policy period. The Court rejected the “as proven” method because, in complex cases like environmental cases, it is often scientifically impossible to prove when the harm occurred. Furthermore, even when the date of the harm can be proven, it is often prohibitively expensive to do so. *Id.* at 663.

After considering and rejecting other allocation methods, the *NSP* Court adopted “pro rata by time on the risk” allocation. The “pro rata by time on the risk” scheme assumes that damage is evenly distributed from the first date of damage until discovery or remediation. *Id.* The allocation scheme calculates the proportion of each individual policy period versus the total time period of damages. Thus, if damage occurred over a ten-year period and an insurer provided coverage for one of those ten years, that insurer would be responsible for 10% of the total loss.

The *NSP* Court stated that the time period of damages ran from the first date of damage until discovery or remediation. The Court did not decide the appropriate end date for allocation.

The present case addresses the selection of an appropriate end date for allocation purpose. The Minnesota Court of Appeals held that the appropriate end date for

calculating allocation is the date that the property is remediated. This holding fails to consider several practical realities common to many moisture intrusion cases and, if upheld, would significantly impair the ability of homeowners to recover damages for defective construction.

A. Uninsured Periods of Risk Fall on Homeowners.

First, the court of appeals fails to consider the impact of its ruling in cases where a builder is no longer insured. Unfortunately, a lapse in insurance coverage is not uncommon and frequently occurs when a builder has ceased doing business and has allowed its insurance to lapse. When apportioning liability via a “pro rata by time on the risk” allocation plan, the period of time since the lapse of coverage is uninsured. The responsibility for this uninsured period falls on the out-of-business builder. Typically, the result is that this uninsured period is simply unrecoverable by the injured homeowner and ultimately must come out of the homeowner’s own pocket.

The court of appeals decision effectively extends this uninsured period. By setting the end date for allocation calculations at the date of remediation rather than the date of discovery, the court of appeals decision incentivizes insurers to delay remediation, thereby retaining their contributions as long as possible, while simultaneously reducing the total dollar amount allocated to the insurers as the allocation attributed to the uninsured period grows. Furthermore, the continued growth of the uninsured period serves as a powerful bargaining chip for insurers. Homeowners can either accept a reduced settlement to resolve the case early or take the matter to trial in the hope that the costs and continued reallocation of responsibility does not exceed the initial discounted

offer. Therefore, the court of appeals decision will likely, albeit unintentionally, prejudice homeowners by delaying the resolution of litigation and the repair of homes.

B. Homeowners Lack the Financial Resources to Remediate Their Homes.

Second, this dynamic is compounded by the fact that typical repair costs for moisture intrusion cases are in the tens of thousands to hundreds of thousand of dollars. Most homeowners lack the financial resources to undertake such costly repairs on their own. Instead, homeowners are held hostage to obtaining payments from the insurers to fund the cost of repair. With homeowners at the mercy of the insurers for payment to fund remediation, under the court of appeal's decision, homeowners are faced with the poor choice of leaving the home unrepaired and simply eating a larger portion of the total repair cost or borrowing funds to perform the repairs and then pursuing the cost of repair in litigation.

This result may be ameliorated slightly by application to the Contractor's Recovery Fund, pursuant to Minn. Stat. § 326.975. The Fund provides a limited recourse to homeowners who have obtained judgments against builders who defectively constructed homes and have subsequently gone out of business. However, recovery from the fund is limited to \$50,000.00 per claimant and there is a cap on recovery against any one licensee of \$75,000.00. Given the typically high cost to repair moisture intrusion damage, the Fund serves as a potential remedy for no more than a handful of affected homeowners. All subsequent homeowners must bear the full uninsured loss themselves.

Most importantly, the structure for recovering money from the Fund requires the homeowner to go through the litigation process before obtaining any funds to apply

towards remediation. Thus, while some homeowners may ultimately recover a portion of the uninsured loss, they will not recover any of the resources necessary to remediate their homes and stop the clock from running until they have completed both litigation and application to the Contractor's Recovery Fund.

C. Insurers Have an Incentive to Delay Remediation.

Finally, the Minnesota Court of Appeals waived aside concerns that insurers had an incentive to delay by stating that "these arguments fail to consider the nature of the claims at issue: any delay in commencing repair efforts will result in additional decay and additional expense for the insured and the insurer on the risk." *Wooddale Builders, Inc. v. Maryland Cas. Co.*, 695 N.W2d 399 (Minn. Ct. App. 2005). While it is true that additional decay results from delay, the court of appeals fails to understand the nature of the claims at issue.

The majority of moisture intrusion cases involve stucco applications on one or more sides of a home. Due to a variety of defects such as failure to properly install windows, failure to install weep screed, improper flashing and other causes, water penetrates behind the stucco where it becomes trapped between the stucco and the home's vapor barrier. This trapped moisture begins decaying the sheathing and, ultimately, the structural supports of the home.

Remediation of a moisture damaged home requires several stages. First, the stucco (or other siding) must be removed to obtain access to the decayed materials inside the walls. The decayed material is then removed and replaced. Finally, a new exterior

(whether stucco or some alternate siding) is reinstalled and the openings that previously allowed moisture to penetrate into the home are sealed.

The vast majority of the cost for remediation of a moisture damaged home stems from the removal and replacement of the home's exterior. By comparison, the cost of replacing decayed material inside the walls is minimal. Thus, the court of appeals assumption that delays in remediation will result in increased cost is flawed. By the time the insurer becomes aware of moisture intrusion damage, the primary cost (the removal and replacement of the exterior) is fixed. Whether the insurer moves quickly or slowly from this point forward will have little bearing on the total cost of repair. Accordingly, the insurer has a substantial incentive to delay remediation. The insurer gets to keep its money and can reduce its total responsibility by allowing the passage of time to shift growing percentages of loss to other insurers or to uninsured periods.

The court of appeals holding that the end date of allocation is the date of remediation is highly detrimental to the recovery of homeowners. Setting the end date for allocation at the date of discovery limits the harm to homeowners and removes the strong incentive for insurers to delay paying for repair costs.

II. The Court Should Adopt an Allocation Plan that Protects Insureds and Claimants from Uninsured Periods.

While "pro rata by time on the risk" allocation plans may represent an equitable mechanism for dividing responsibility for indivisible damage occurring over lengthy periods of time that cannot be traced to a single causal event or time, it is not a good mechanism for allocating risk in the context of moisture intrusion cases.

Unlike the dispute in *Northern States Power Co. v. Fidelity & Cas. Co. of New York*, 523 N.W.2d 657, 662 (Minn. 1994) moisture intrusion cases typically involve parties with vastly disparate financial resources. Homeowners are innocent third parties who, while not the direct beneficiaries of the commercial general liability (CGL) insurance policies, are the ultimate recipients of the coverage. By contrast, the insurers are large, frequently multi-national corporations, who are more financially solvent and most importantly, in the business of risk allocation. This dynamic must be taken into account when considering the public policy consideration of allocation. “As with all insurance contract-related issues, courts must consider many factors when deciding this issue, including the policy language, parties’ intent or reasonable expectations, canons of construction and **public policy.**” *Northern States Power Co. v. Fidelity & Cas. Co. of New York*, 523 N.W.2d 657, 661 (Minn. 1994) (emphasis added).

In previous cases addressing “pro rata by time on the risk” allocation, the Court has not addressed the public policy considerations implicated by allowing uninsured losses to fall on innocent third-parties. Rather, the Court’s focus has been on allocation among insurers and large corporation that engage in polluting activities. As the Court explained the *NSP* holding in *Domtar, Inc. v. Niagara Fire Ins. Co.*, 563 N.W.2d 724 (Minn. 1997) the holding was limited to allocation among insurers. “[W]e recommend a fair method for allocating losses *among CGL insurers* who are consecutively liable for continuing property damage, in the absence of applicable policy language – pro rata by time on the risk.” *Domtar, Inc. v. Niagara Fire Ins. Co.*, 563 N.W.2d 724, 732 (Minn. 1997) (emphasis added).

Absolving the insurer of responsibility for periods outside of their policy period is not the only approach of allocating responsibility for a loss. Other jurisdictions have adopted alternative allocation schemes that allow for allocation among implicated CGL policies yet still protect policy holders, and ultimately claimants, from uninsured losses. In *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, 45 Cal.App. 4th 1, 52 Cal. Rptr.2d 690 (Cal. Ct. App. 1996), the California Court of Appeals held that uninsured portions of a loss are covered, up to the policy limits, by any triggered CGL policies. *Id.* at 57, 711.

The California court held that apportionment between successive insurers on a pro rata basis was appropriate. However, as between the insurer and the insured a different analysis applied. The court interpreted the language of successive insurance policies to mean “that once coverage is triggered, the insurer’s obligation to the policyholder is to cover the policyholder’s liability ‘in full’ up to the policy limits.” *Id.* The consequence of this reasoning is that uninsured periods are covered by the triggered policies even though part of the loss falls outside the time period of the policy. The court’s reasoning for this outcome is both the express language of the policies and the policy considerations that are implicated. *Id.* at 56, 710.

Policy considerations in moisture intrusion cases warrant application of a similar rule in the present case. As noted previously, that party that most commonly bears the burden of uninsured losses is the innocent homeowner. It is the homeowner who must pay for repairs of faulty construction and it is the homeowner who is least financially capable to finance the high cost of remediation and repairs. Furthermore, under the court

of appeals decision in this action, it is the homeowner who bears the cost of any delays in remediation.

By adopting a rule similar to that of *Armstrong*, the Court would prevent or at least ameliorate the harsh consequences of an uninsured loss falling on innocent homeowners. Furthermore, such a rule would protect builders and Minnesota's Contractor Recovery Fund from bearing costs when insurers have already been paid to assume the risk of claims that accrued during their policy periods. As such, the Court should adopt a modified version of "pro rata by time on the risk" allocation for moisture intrusion cases and protect claimants from uninsured losses.

III. The Court Should Reject the Application of Pro Rata by Time on the Risk to Moisture Intrusion Cases.

As an alternative to setting the allocation date as the date of discovery or applying an *Armstrong* type rule to uninsured periods, the Court should reject the application of "pro rata by time on the risk" allocation to moisture intrusion cases. As most moisture intrusion cases have readily identifiable dates for the occurrence of damage (the closing date for the home), the insurer at the time of closing should be responsible for the full cost of any moisture intrusion damage. This holding would be simpler to apply and would result in full coverage for losses incurred by innocent homeowners.

The insurers in this action stipulated to allocating liability through a "pro rata by time on the risk" allocation plan and that stipulation was accepted without discussion by the district court and the court of appeals. While the homeowners who were the victims of Wooddale's defective construction are protected because there is no uninsured period,

the stipulation that was agreed to here represents a real threat for homeowners facing a partially uninsured loss.²

In this case, the insurers stipulated that the twelve years of coverage would be divided among the respective insurers via a “pro rata by time on the risk” allocation. As a consequence, American Family’s allocation was based on the first five years of the twelve year period, West Bend had the sixth year, SafeCo had the seventh year, Maryland had the eighth, ninth, and tenth years, and Western National had the final two years. This stipulation ignores previous guidance from the Court that “pro rata by time on the risk” allocation is disfavored.

The Court should make clear that “pro rata by time on the risk” allocation is the exception rather than the rule for moisture intrusion cases. In this Court’s decision of *In Re Silicone Implant Ins. Coverage Litig.*, 667 N.W.2d 405 (Minn. 2003), the Court emphasized that the “pro rata by time on the risk” allocation plan utilized in *NSP* should be employed only in those rare cases where no originating event can be determined and the harm is truly indivisible. This point was reiterated in *SCSC Corp v. Allied Mut. Ins. Co.*, 536 N.W.2d 305, 318 (Minn. 1995) when the Court rejected a vertical triggering approach to allocation used by the trial court and also rejected application of “pro rata by time on the risk” allocation. The Court held that the damage was attributable to a single occurrence and thus not appropriate for “pro rata by time on the risk” allocation.

² In its brief, Wooddale contends that there may in fact be an uninsured or self-insured period due to the application of the “known loss” rule and the inability to purchase CGL policies that provide coverage for moisture intrusion since the expiration of the Western National policy.

Similarly, in *Domtar, Inc. v. Niagara Fire Ins. Co.*, 563 N.W2d 724 (Minn. 1997) the Court noted “[W]hen environmental contamination arises from discrete and identifiable events, then the actual-injury trigger theory allows those policies on the risk at the point of initial contamination to pay for all property damage that follows. *Id.* at 733.

The Court should reiterate its holding that “[i]f we can identify a discrete originating event that allows us to avoid allocation, we should do so.” *In Re Silicone Implant Ins. Coverage Litig.*, 667 N.W.2d 405, 421-422 (Minn. 2003).

In moisture intrusion cases, like those implicated in the present action, a discreet originating event is readily identifiable; the completion of construction of the homes. In the present case, the district court erroneously focused on the instances of water intrusion, principally dates of rainfall, to conclude that no direct originating event occurred. At the time that a home is completed, the defects that allow moisture to infiltrate the building and ultimately cause damage exist. While it may take multiple incursions of water for structural damage to the home to manifest, the creation of the defects themselves constitutes a discrete originating event sufficient to trigger coverage. As such, in the typical moisture intrusion case, there is no need to employ a “pro rata by time on the risk” allocation plan.

There *may* be some cases in which a “pro rata by time on the risk” allocation plan may be appropriate for moisture intrusion cases. For example, a home where defects can be traced to both original and subsequent construction may require a “pro rata by time on the risk” allocation plan. If the evidence established that defects in both the original

construction and subsequent construction resulted in damage to the structure and that the damage was indivisible and could not be attributed with any certainty to the new or subsequent construction, it would be appropriate to allocate the damage among any CGL policies that existed from the time of the original construction to the time of the subsequent construction. “Pro rata by time on the risk” allocation in such circumstances comports with the Court’s guidance that such an application “offers a practical solution in the face of uncertainty.” *Domtar, Inc. v. Niagara Fire Ins. Co.*, 563 N.W2d 733, 734 (Minn. 1997).

In those rare cases where “pro rata by time on the risk” allocation is necessary, the Court should still set the allocation end date as the date of discovery and should apply an *Armstrong* rule to protect homeowners from uninsured periods. However, the Court should make clear in its holding that these cases are limited exceptions where application of “pro rata by time on the risk” allocation is appropriate, rather than making this sort of allocation the general rule in moisture intrusion cases.

By reiterating that “pro rata by time on the risk” allocation plans are typically not necessary for moisture intrusion case, the Court would be providing parties and lower courts with important guidance for handling these cases. More importantly, the Court would avoid application of a “pro rata by time on the risk” allocation plan and the resulting shifting of uninsured losses to innocent homeowners. Such a decision would effectuate public policy by protecting innocent homeowners and provided much needed clarity to moisture intrusion cases.

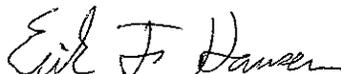
CONCLUSION

The decision of the Minnesota Court of Appeals extending the end date for “pro rata by time on the risk” allocation significantly harms Minnesota homeowners. The Minnesota Supreme Court should reverse the decision of the court of appeals and restore the date of discovery as the appropriate end date for allocation calculations. Furthermore, Defective Construction Homeowners of Minnesota urges the Court to adopt a rule similar to that advanced in *Armstrong World Industries, Inc. v. Aetna Cas. & Surety Co.*, protecting Minnesota homeowners from uninsured losses in moisture intrusion cases. Finally, the Court should reiterate its holding in *In Re Silicone Breast Implant Ins. Litig.* that “pro rata by time on the risk” allocation is inappropriate for the majority of moisture intrusion cases as the completion of construction of a defective home constitutes a discrete originating event sufficient to trigger insurance coverage.

Respectfully submitted,

HELLMUTH & JOHNSON, PLLC

Dated: August 25, 2005

By: 
Erik F. Hansen, ID No. 0303410
J. Robert Keena, ID No. 258817
Barton C. Gernander, ID No. 26779X
10400 Viking Drive, Suite 500
Eden Prairie, MN 55344
952-941-4005

Attorneys for Defective Construction
Homeowners of Minnesota

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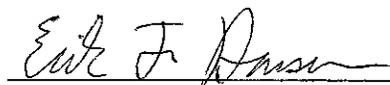
Respondents.

CERTIFICATION OF BRIEF LENGTH

I hereby certify that this brief conforms to the requirements of Minn. R. Civ. App. P. 132.01, suds, 1 and 3, for a brief produced with a proportional font. The length of this brief is 4,253 words. This brief was prepared using Microsoft Word 2002.

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Erik F. Hansen, ID No. 0303410
J. Robert Keena, ID No. 258817
Hellmuth & Johnson, PLLC
10400 Viking Drive, Suite 500
Eden Prairie, MN 55344
952-941-4005



Erik F. Hansen