

CGL ISSUES AND DEVELOPMENTS SEMINAR***IMPAIRED PROPERTY EXCLUSION***

Presented by

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IMPAIRED PROPERTY EXCLUSION

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Computer Corner v. Fireman's Fund

New Mexico Court of Appeals (2002):

“We conclude that this exclusion is unintelligible from the standpoint of a hypothetical reasonable insured . . . Too vague and indefinite to be enforceable.”

Computer Corner, Inc. v. Fireman's Fund Ins. Co. (N.M. App. 2002)
46 P.3d 1264, 1270.

BUSINESS RISK

The risk that the insured's work or products will be:

- High or low quality
- Demanded or rejected in the market
- Economic gain or loss

BUSINESS RISK EXCLUSIONS

- 'Your work'
- 'Your product'
- 'Sistership'
- 'Impaired property'

THE PROBLEM

We need clear lines between:

Insured's Work / Other Property

Physical Injury / Economic loss

DEVELOPMENT OF IDEAS

1. Simple idea of 'injury'
2. Divided into two:
'physical' / 'non-physical'
3. Then became three:
'physical' / 'non-physical' and 'impaired property'

HAUENSTEIN CASE (1954)

- Insured supplied defective plaster
- Plaster shrank and cracked
- Damage to plaster itself (insured's product) was excluded
- But the entire house was reduced in value
- That “injury” was covered “property damage”

Hauenstein v. St. Paul-Mercury Indemnity Co. (Minn. 1954) 65 N.W.2d 122.

GEDDES CASE (1959)

- Insured supplied aluminum doors
- Doors failed shortly after installation
- Houses were less secure, less valuable due to doors
- Court found houses suffered “property damage” to the extent of the cost to remove the doors

PRE-1973 “PROPERTY DAMAGE”

“. . . Injury to or destruction of property, including the loss of use thereof, caused by accident.”

1973 DEFINITION

“(1) physical injury to or destruction of tangible property . . . , including the loss of use thereof . . . , or

“(2) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence”

FOCUS ON THE PHYSICAL

- “(1) **physical** injury to or destruction of **tangible** property . . ., including the loss of use thereof at any time resulting therefrom, or
- “(2) loss of use of **tangible** property which has not been **physically** injured or destroyed”

1973 EXCLUSION

- (m) To loss of use of tangible property which has not been physically injured or destroyed resulting from
 - (1) a delay in or lack of performance . . . of any contract or agreement, or
 - (2) the failure of the named insured’s products or work

THREE KINDS OF DAMAGE

- Damage to insured's work or product
- Physical injury to other property
- Nonphysical injury to other property
 - Loss of use
 - Loss of value?
 - Loss caused by repairs??

EXAMPLE 1

- Insured electrical contractor installs wiring in office building
- After the building is occupied, a defect in the wiring causes a small fire, causing minor damage
- Investigation reveals that all the wiring is defective and must be replaced

EXAMPLE 1

The three kinds of damage are:

- Damage to the insured's work: the cost to repair the wiring;
- Physical injury to other property: the cost to repair what burned;
- Non-physical injury to other property: loss of use of the building, partly due to fire, but mostly due to the presence of defective wiring

1973 INTENDED RESULT

- Damage to insured's work: excluded
- Physical injury to other property: covered
- Nonphysical injury to other property:
Excluded if caused by insured's poor workmanship

SOCIETY OF ARTS CASE (1984)

- Spalling bricks on exterior wall
- Court decides the 1973 wording makes a difference
- No coverage for loss of value of whole structure
- Economic loss not covered after 1973

THE EMPIRE STRIKES BACK

- Real estate boom brings in marginal contractors
- Rapid escalation of costs makes past insurance inadequate
- More money needed to settle construction defect litigation
- Pressure to avoid “bad faith” claims

“TEAR OUT” ARGUMENT

- To repair insured's work, other property must be torn out
- Property torn out is physically injured
- Therefore, there is physical injury to other property
- Physical injury to other property is covered

“TEAR OUT” ARGUMENT

The Key: Defines type of damage in terms of the repair method, rather than the initial occurrence

RETURN OF EXCLUSION (m)

1973: “loss of use of property which has not been physically injured or destroyed”

1986: “**impaired property** or property that has not been physically injured”

CATEGORIES OF DAMAGE

- Damage to “your work” or “your product”
- Physical injury to other property
- Non-physical injury
- Damage to “Impaired property”

NEW EXCLUSION (m)

“Property damage” to “impaired property” or property that has not been physically injured, arising out of:

- (1) A defect . . . in “your product” or “your work”; or
- (2) A delay in or failure . . . to perform a contract.

‘IMPAIRED PROPERTY’

- Tangible property other than “your work” or “your product”
- Incorporating “your work” or “your product” that is allegedly defective
- If such property can be restored to value or use by repair or replacement of insured’s work, or by insured’s fulfillment of the contract

EXAMPLE 2

- Insured supplied structural steel for roller coaster
- Corrosion-resistant alloy specified, but wrong alloy is shipped
- Steel is rusting at accelerated pace
- Replacing steel will require entire structure to be dismantled

EXAMPLE 2

- Roller coaster is less useful because it incorporates the defective steel
- Can be restored to full value by replacing the defective steel
- Therefore, damage is excluded:
 - Damage to steel is excluded as 'your product'
 - Damage to rest of structure is excluded as 'impaired property'

“SUDDEN AND ACCIDENTAL”

“. . . This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to ‘your product’ or ‘your work’, after it has been put to its intended use.”

“SUDDEN AND ACCIDENTAL”

Four requirements for exception:

- Loss of use of other property
- Physical injury to work or product
- Physical injury is “sudden and accidental”
- After work or product put to intended use

EXAMPLE 3

- Acme is GC building HQ for Chicken Little Ltd.
- Roof supported by glu-lam beams, supplied by Beamco
- Acme is add'l insured under Beamco policy
- Some beams delaminate, are discovered to be cracking, though none has failed yet
- Alarmed, Chicken Little moves out, sues

EXAMPLE 3

- Beamco: not covered unless the delaminations are “sudden and accidental”
- Acme not covered as AI, unless “sudden”
- Acme, however, is covered under its own policy, because the whole building is ‘your work’ under Acme’s policy

PROPERTY THAT CANNOT BE RESTORED

Examples:

- Contents that have escaped;
- Contamination of other property;
- Physical damage to other property;
- Where repair not economically feasible??

EXAMPLE 4

- Insured supplies chip to hearing aid mfr.
- Chips are soldered into circuit boards
- Boards cost \$40 w/o chips
- Chips are found to be defective
- To remove / replace chips costs \$50ea.
- Are the hearing aids “capable of being restored to full value”??

EXAMPLE 4

- Arguably the doctrine of mitigation of damages would require the mfr to destroy the boards and recover \$40 each
- Does it make any sense to say something “can” be restored to value when doing so is contrary to public policy?

REMAINING ISSUES

- Meaning of “sudden and accidental”?
- When is property not ‘capable of being repaired or restored’?
- When is work “incorporated” into other property?

IMPACT

Subcontractors:

- Theoretically, less coverage available for defects
- Limits effectiveness of risk transfer methods

IMPACT

Owners/General Contractors:

- Less direct impact, most of the project is 'your work'
- Limitation on risk transfer to subcontractors

IMPACT

Additional Insureds:

- Exclusion stated in terms of named insured's work, 'your work'
- So exclusion applies equally to named and additional insureds

MANAGING THE NEW RISK

Consider:

- Errors & Omissions Coverage
- Performance Bonds
- Financial condition of subs and vendors
- Emphasis on quality control
- Buy back the coverage??

Action Auto v. United Capitol

- Named Insured installed gasoline storage tanks at three Action Auto locations
- Gasoline leaked out due to alleged defects
- Contamination to surrounding property
- Held: exclusion (m) does not apply
 - contamination cannot be repaired by repair or removal of the defective tanks

Action Auto Stores, Inc. v. United Capitol Ins. Co. (W.D.Mich 1993)
845 F.Supp. 417.

United Steel Fabricators

- Named insured subcontracted to install modular expansion joints in a bridge
- After bridge opened, some welds cracked
- GC repaired the cracked welds and brought suit
- Held: cracks were “sudden and accidental”, so exclusion (m) not applicable

United Steel Fabricators, Inc. v. Fidelity & Guaranty Ins. Underwriters, Inc.
(Ohio App. 1993) 1993 WL 69258.

St. Paul v. Geo Pipe Co.

- Insured supplied chrome tubing for an offshore oil & gas well
- Gradual corrosion resulted in pressure problems due to holes in the tubing
- Held: the gradual corrosion over a six-month period not ‘sudden and accidental’

St. Paul Surplus Lines Ins. Co. v. Geo Pipe Co. (Tex. App. 2000) 25 S.W.2d 900.

SHADE FOODS

- Insured supplied diced almonds to be made into nut clusters for breakfast cereal
- Nuts contaminated with wood splinters
- Cereal destroyed, but some nut clusters salvaged by grinding into almond paste
- Held: salvage of part of product did not show product was “capable of repair”

Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc. (Cal.App. 2000) 78 Cal.App.4th 847, 93 Cal.Rptr.2d 364.

DCB CONST. v. TRAVELERS

- Insured built airport hotels according to architect's plans
- Walls failed to meet contract specs for sound transmission
- Owner demanded insured tear down and reconstruct the walls
- Held: excluded. No physical injury to walls

DCB Construction Co., Inc. v. Travelers Indemnity Co. of America
(D.Colo. 2002) 2002 WL 31163855.

IMPAIRED PROPERTY EXCLUSION

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I. *Hauenstein Case*

- A. Insured sold defective plaster, used to plaster a house
- B. The plaster shrank and cracked
 - 1. Injury to plaster (insured's work) excluded
- C. Presence of defective plaster reduced value of house—and constituted property damage

II. *Geddes Case*

- A. Insured sold aluminum doors to builder
- B. Doors failed shortly after installation in houses
 - 1. Damage to doors (insured's product) excluded
- C. Houses were less valuable, less usable
- D. Court found the houses suffered property damage to the extent of the cost to remove defective doors

III. Pre-1973 Definition of "Property Damage"

- A. "... Injury to or destruction of property, including the loss of use thereof, caused by accident."

IV. 1973 Definition of "Property Damage"

- A. "(1) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom or
- B. "(2) 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"

V. 1973 CGL Performance Exclusion (m)

- (m) to loss of use of tangible property which has not been physically injured or destroyed resulting from
 - (1) a delay in or lack of performance by or on behalf of the named insured of any contract or agreement, or
 - (2) the failure of the named insured's products or works performed by or on behalf of the named insured to meet the level of performance, quality, fitness or durability warranted or represented by the named insured ...

VI. Three Kinds of Damage (1973 Form)

- A. Damage to insured's work or product
- B. Physical injury to other property
- C. Nonphysical injury to other property
 - 1. Loss of use
 - 2. Diminution in value?
 - 3. Loss due to repair method?

VII. The "Tear Out" Argument

- A. Other property must be torn out in order to repair the insured's work
 - 1. Alternate repairs?
 - 2. View as "loss of use" instead?
- B. "Tear out" would be physical injury to the other property
 - 1. When?
 - 2. By accident?
- C. Therefore, there is physical injury to property other than the insured's work

VIII. Modification to 1973 CGL Performance Exclusion

- A. Old:
 - (m) To loss of use of tangible property which has not been physically injured or destroyed ...
- B. New:
 - (m) To "impaired property" or property that has not been physically injured ...

IX. Three Kinds of Damage (After 1986)

- A. Damage to "your work" or "your product";
- B. Physical injury to other property;
- C. Damage to "impaired property" or nonphysical injury

X. New Impaired Property Exclusion

- A. This insurance does not apply to:
 - 1. "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
 - (1) A defect ... in "your product" or "your work", or
 - (2) A delay or failure by you or anyone acting on your behalf to perform a contract...

XI. Definition of Impaired Property

- A. Tangible property other than "your work" or "your product"
- B. Incorporating "your work" or "your product" which allegedly is defective or in breach of contract
- C. If such property can be restored by repair or replacement of "your work" or "your product", or by your fulfillment of the contract

XII. Sudden and Accidental Exception

- A. ... This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

XIII. Property That Cannot Be Restored

- A. Contents that have leaked out of containers
- B. Where repair will cause other permanent defects
- C. Where repair not economically feasible?

XIV. Your Work

- A. Work or operations performed by or on behalf of the named insured
- B. Materials, parts and equipment furnished with the work
- C. Includes warranties or representations about fitness or quality of the work
- D. Includes failure to warn or give instructions

XV. Your Product

- A. Goods or products other than real property
- B. Manufactured, sold, handled, distributed or disposed of by the named insured
- C. Includes containers;
- D. Includes warranties and representations
- E. Includes failure to warn or give instructions
- F. Does not include vending machines not sold to others

XVI. 1990 CGL Exclusion (I)

This insurance does not apply to

"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor

XVII.Hypothetical No. 1

- A. General Contractor hired to construct a resort, including a manmade lake
- B. Subcontractor hired to line bottom of lake
- C. Sub makes GC an additional insured
- D. Lake lining fails, so that water leaks out continually
- E. Owner sues for cost to repair lining and refill lake
- F. Coverage under GC's policy?
- G. Coverage under Sub's policy?

XVIII.Hypothetical No. 2

- A. General Contractor hired to build housing tract
- B. Subcontractor installs copper plumbing
- C. Homeowners complain toxic solder used by plumber is leaching into water; seek cost to replace pipes
- D. Repair of plumbing would require tearing out wallboard and floors
- E. Coverage under plumber's policy?

XIX.Hypothetical No. 3

- A. Owner hires Builder to design and construct a home—Builder's work
- B. Owner sues alleging plumbing and electrical code violations and improperly installed doors, windows
- C. Since the home is Builder's work, is it covered because excepted from the definition of "impaired property"?
 - 1. Property, other than "your work"
- D. Exclusion (m) also includes property "not physically injured"

XX. Hypothetical No. 4

- A. Insured supplies microchips to manufacturer of hearing aids; to be soldered into circuit board in each unit.
- B. Circuit boards cost \$40 before chips installed
- C. One shipment of chips is discovered after assembly, to be defective
- D. Repair program with trained personnel would cost \$50 each
- E. Are hearing aids "capable of being restored to value"?

THE CGL "IMPAIRED PROPERTY" EXCLUSION

Liability insurers always have tried to limit coverage to events beyond the control of the insured, with imperfect results. By adding Exclusion (m) in the 1986 revision of the commercial general liability (CGL) policy, insurers have attempted to avoid liability for one risk within the control (more or less) of the insured: the quality of the insured's products and work. It has proven surprisingly difficult for insurers to draw, and courts to recognize, a bright line between the uncovered cost of replacing or repairing the insured's defective product or work and a covered, consequential loss to other property.

Types of Harm Resulting from Defective Products/Work

The CGL policy addresses three types of harm due to defective products or work.

- \$ Damage to the insured's own work or product
- \$ Physical injury to other property
- \$ Nonphysical injury to other property

An example will help illustrate these kinds of harm. Assume the insured manufactures roofing materials, applied by someone else over plywood sheathing on the roof of an apartment building. Due to a defect in the insured's product, the roofing material breaks down rapidly in sunlight and begins to leak. Rain water leaks through the roofing material and rots the plywood underneath. The three types of resulting harm are the: (1) physical breakdown of the insured's product, which must be repaired or replaced; (2) physical injury to someone else's product or work, the plywood, which must also be repaired or replaced; and (3) a loss of value of the building as a whole, due to having a leaky roof.

Speaking generally, CGL insurers intend to cover only item (2), physical injury to something other than the insured's own work or product. Item (1) is considered to be the insured's "business risk"—the uncovered cost of quality control. Item (3) is, in this simple case, duplicative of (1) since the repair or replacement of the insured's product would presumably restore the building to full value.

In more complicated, and realistic, cases, insureds have argued that the lines between physical and nonphysical injury, and between the insured's work or product and other property, were blurry in the 1973 CGL form. Courts, especially trial courts, where most lawsuits are resolved, have often agreed. As a result, insurers found themselves paying more in cases of allegedly defective work or products than they apparently intended to cover. The 1986 CGL policy employs a brand new concept, "impaired property," to assist in defining the nonphysical loss of value to property of which the insured's work or product forms a part—item (3) in our first example—which they do not intend to insure.

The Problem with Component Parts

The intended neat division of harm into three categories became difficult to apply in cases where the insured's work could not be repaired without removing some otherwise undamaged parts of the property. For example, assume a microchip manufactured by the insured is supplied to another company which uses the chip in hand-held calculators. When the chips prove defective, the calculators must be dismantled to allow replacement of the chip. Replacement cost of the chip clearly is not covered, because it is damage to the insured's own product ("your product"). But does the required dismantling constitute "physical" injury to the rest of each calculator? This issue has been raised in many cases prior to the 1986 revisions.

Drafting History

The risk that manufacturers, sellers, or contractors will need to repair or replace their defective products or redo their faulty or negligently performed workmanship is often referred to as their business

risk. The intention of insurance underwriters always has been to leave the cost of such business risks to the insured, but to insure the risk that their defective products or faulty work will cause damage to other property for which the insured is liable. Despite the insurance industry's efforts, however, courts interpreting these exclusions have consistently endeavored to create new theories in order to find coverage for business risks. The ongoing struggle is illustrated by the insurance industry's 1973 and 1986 efforts to redraft business risk exclusions to prevent such judicial interpretations.

Pre-1973 CGL Policies

As an attempt to draft policy language that would provide adequate coverage for accidentally caused damage to property other than the insured's work but would exclude claims arising from business risks, the insurance industry's pre-1973 policies often were construed narrowly by courts in sympathetic judicial attempts to provide coverage for insured contractors and developers. Other courts labeled such exclusions a "ambiguous," construing them against insurers in order to reach similar coverage determinations. Such judicial devices contributed to the resulting payment by the insurance industry for business risks of insureds that were not previously contemplated.

For example, consider the landmark case of *Hauenstein v. ST. Paul-Mercury, Indemnity Co.*, [65 NW2d 122 (1954)], which involved the interpretation of a pre-1973 policy exclusion for property damage due to the insured's business risk. The *Hauenstein* case involved plaster that shrank and cracked after its application to walls and ceilings in several buildings. No property other than the plaster was damaged. The insurer, who viewed the insured seller's claim as an excluded business risk, denied coverage. The court, however, theorized that the buildings themselves had sustained property damage because the defective plaster caused diminution to their market value. Such diminution, according to the court, constituted covered property damage.

The *Hauenstein* case illustrates how the pre-1973 exclusions proved ineffective as a basis on which insurers could deny coverage for various nonphysical damages claims such a loss of use, lost profits, and diminution in value. Such losses, as viewed by the insurance industry, were basically the insureds' business risks and not within the intended scope of general liability coverage. More effective preclusion of these types of nonphysical damage claims was among the goals contemplated by the Insurance Service Office, Inc. (ISO), in its 1973 policy revisions.

The 1973 CGL Policy

_____ The 1973 ISO revised the standard general liability policies with definitions and exclusions specifically drafted to prevent coverage decisions similar to *Hauenstein*. The exclusions contained within the 1973 form that are most relevant to claims arising from faulty workmanship are exclusions (m), (n), and (o), which were intended to preclude coverage for business risk losses. (See Figure 1, below.)

_____ Exclusion (m) of the 1973 CGL form is sometimes referred to as the "failure to perform" exclusion. Exclusions (n) and (o) are often used to prevent an insurer from becoming a guarantor of the quality of the insured's product or work, and often are misleadingly referred to as

"The work-product exclusion." Exclusion (n) only applies to damage to the actual product of the insured and has no application to damage that affects property other than the product itself. The application of exclusion (o), however, is broader than exclusion (n) in that it excludes not only the insured's own work, but also work done by others "on behalf of" the insured.

Exclusion (p) of the 1973 CGL, the "sistership exclusion," encompasses the situation in which an insured's product has been found to be defective. While coverage may exist for property damage caused by the product that failed, the exclusion precludes coverage for the recall of similar or additional products that the manufacturer must withdraw from the marketplace in order to prevent other failures.

FIGURE 1
1973 CGL EXCLUSION FOR BUSINESS RISK LOSSES

This insurance does not apply:

(m) to loss of use of tangible property which has not been physically injured or destroyed resulting from:

1. a delay in or lack of performance by or on behalf of the named insured of any contract or agreement, or
2. the failure of the named insured's products or work performed by or on behalf of the named insured to meet the level of performance, quality, fitness or durability warranted or represented by the named insured;

but this exclusion does not apply to loss of use of other tangible property resulting from the sudden and accidental physical injury to or destruction of the named insured's products or work performed by or on behalf of then named insured after such products or work have been put to use by any person or organization other than an insured;

(n) to property damage to the named insured's products arising out of such products or any part of such products;

(o) to property damage to work performed by or on behalf of the named insured arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith;

(p) to damages claimed for the withdrawal, inspection, repair, replacement, or loss of use of the named insured's products or work competed by or for the named insured or of any property of which such products or work form a part, if such products, work or property are withdrawn from the market or from use because of any known or suspected defect or deficiency therein.

"Property Damage" Definition

(1) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom, or (2) 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.

The exclusions contained in the 1973 form, as well as the specific inclusion of "physical injury" in the definition of covered property damage, were only partially successful in precluding coverage for business risks. Insurers still found themselves paying for nonphysical damage caused by their insured's defective products or workmanship. While some courts reasoned that the inclusion of the word "physical" negated any possibility that the 1973 form was intended to include intangible damage such as diminution in value or loss of profits, other courts simply created new theories to get around the "physical" injury requirement. For example, some courts reasoned that the plain meaning of physical injury embraces any injury due to physical forces—including the physical contact, installation, and tangible presence of a product that causes harm. Under this reasoning, even though no real physical damage has occurred (other than to the insured's own product or work), courts have found that the entire structure or entity has been physically injured.

Other courts have reasoned that "physical injury" has occurred where a defective product has become so integrated into a larger structure that it loses its separate identity. Under this reasoning, the insured's defective product or work has caused physical injury to the integrated structure.

Use of legal theories similar to those mentioned above resulted in incentives to revise the 1973 policy wording to prevent such judicial devising. In an effort to prevent further erosion of the 1973 exclusions, ISO again endeavored to redraft the policy wording to preclude coverage for nonphysical damage

to property due to the insured's faulty products or work. These and other efforts resulted in what is referred to as the 1986 commercial general liability policy.

The 1986 CGL Policy Revisions

_____The 1986 and later commercial general liability (CGL) forms differ substantially from the terms and conditions used in the 1973 form. The 1986 policy, like the 1973 form, contains several exclusions that potentially apply to preclude coverage for the insured's business risk. These are exclusions (k), (l), (m), and (n), which may significantly restrict coverage in the construction and real estate development context. These exclusions are shown in Figure 2.

Exclusion (k) corresponds to the 1973 form's exclusion (n), the injury to products exclusion, and precludes coverage for "property damage" to the insured's product arising out of it or any part of it. The definition of "property damage" in the 1986 form is substantially the same as in the 1973 form. The 1986 policy makes it clear that the term "your product" does not include "real property."

FIGURE 2 POST-1986 CGL EXCLUSIONS FOR BUSINESS RISK LOSSES

This insurance does not apply:

- (k) "Property damage" to "your product" arising out of it or any part of it.
- (l) "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."
- (m) "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
 - 1. A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work;" or
 - 2. A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

- (n) Damages claimed for any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal, or disposal of:
 - 1. "Your product;"
 - 2. "Your work;" or
 - 3. "Impaired property;"

if such product, work or property is withdrawn or recalled from the market or from use by any person or organization because of a known or suspected defect, deficiency, inadequacy or dangerous condition in it.

Exclusions c. through n. do not apply to damage by fire to premises rented to you. A separate limit of insurance applies to this coverage as described in SECTION III - LIMITS OF INSURANCE.

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Exclusion (l) corresponds to the broad form property damage exclusion of damage to work performed by the named insured arising out of such work. This exclusion does not apply if the work out of which the damage arises was performed on the insured's behalf by a subcontractor. The definition of "your work" means (a) work or operation performed by the insured or on its behalf, and (b) materials, parts, or equipment furnished in connection with such work or operations. "Your work" is also defined to include "warranties or representations made at any time with respect to the fitness, quality, durability or performance" of the insured's work.

Exclusions (m) and (n) of the 1986 form incorporate the concept of "impaired property." This new term represents ISO's main strategy to preclude coverage for nonphysical damage arising from the insured's business risk. The definition of "impaired property" is given in Figure 3.

FIGURE 3
1986 CGL "IMPAIRED PROPERTY" DEFINITION

5. "Impaired property" means tangible property, other than "your product" or "your work," that cannot be used or is less useful because:
- (a) It incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous; or
 - (b) You have failed to fulfill the terms of a contract or agreement;
- if such property can be restored to use by:
- (a) The repair, replacement, adjustment or removal of "your product" or "your work;" or
 - (b) Your fulfilling the terms of the contract or agreement.

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The concept of impaired property is twofold. Not only must the usefulness of the tangible property be lessened or nullified, but the property also must be capable of being repaired or restored to use. Both parts of the definition must be satisfied in order for the term to apply. If, for example, the first part of the definition is satisfied, but the damaged property is incapable of being repaired or replaced, it is not impaired property, and the exclusion does not apply.

Exclusion (m) of the 1986 CGL form is a substantially revised version of exclusion (m) of the 1973 wording, which excluded "property damage" to property "which has not been physically injured," the 1986 form extends the exclusion to preclude coverage for "property damage" to "impaired property" or property that has not been physically injured, arising out of: (1) a defect, deficiency, inadequacy or dangerous condition in the insured's product; or (2) a delay or failure by the insured or anyone acting on its behalf to perform a contract or agreement. Thus, even where it may be argued that a whole project or assembly is physically harmed by incorporation of the insured's work or product, that damage will be excluded if the whole project or assembly constitutes "impaired property."

Exclusion (m) also continues to apply to "property that has not been physically injured." This wording clarified the insurance industry's intention that the exclusion encompass claims for damages, such as diminution in value, loss of use, and loss of profits, which are unrelated to actual physical injury to property. The "impaired property" concept is intended to thwart judicial attempts to find "physical injuries" to the entity or structure as a whole, where none otherwise exist.

By its express terms, exclusion (m) also precludes coverage for damage arising from the "work" of the insured, including the work of subcontractors. Exclusion (m) thus contemplates situations where there is damage to property that is not the work of the contractor or its subcontractors. Such property, for example, might include preexisting work or adjacent property. Exclusion (m) generally will not apply to property that is physically damaged because such property typically cannot be "restored to use" solely by the "repair, replacement, adjustment or removal" of the insured's work. Where physical repairs are required to make other damaged property useful, exclusion (m) does not apply. Nor will the exclusion apply to "the loss of use of other property arising out of sudden and accidental physical injury to the insured's product or work after it has been put to its intended use."

Application of the New Wording

Working through a typical situation will demonstrate the effect of the new wording. Assume Scrooge & Marley is a general contractor, builder of a tract of individual family homes. Plumbing was installed under a subcontract by Humbug Plumbing. Two years after the homes are completed, owners complain of numerous plumbing leaks caused by corrosion and bring suit against Scrooge & Marley, alleging the pipe is defective. Scrooge & Marley, in turn, cross-complain against Humbug seeking indemnity for any defects in the plumbing.

Under the 1973 CGL form, Humbug's insurer would face the argument that the existence of defective plumbing damages each entire house, making the house less valuable or useful, and the only way to repair the damage to the house is to tear out the walls and floors that cover the plumbing. Thus, it would be argued, the walls and floors, which are not Humbug's work, are physically damaged. Insurers are frequently contributing to settlements on just that argument. In that situation, Scrooge & Marley, or their insurers, may transfer the cost of settlement to Humbug's insurers.

Under the 1986 CGL form, however, the loss of use and diminution of value of the house due to the existence of defective plumbing is clearly excluded. "Impaired property" includes the house "that cannot be used or is less useful" because it incorporates the insured's allegedly defective work or product. As a result, the general contractor cannot look to the plumbing contractor's insurers for the cost of repairing the plumbing.

Scrooge & Marley still would be covered under their own policy. However, the inability to transfer risk to the subcontractor's insurer will likely make insurance scarcer and more expensive for general contractors.

Treatment of Exclusion (m) By the Courts

We now have more than a decade of experience with the new "impaired property" concept. Yet, relatively few disputes about the interpretation or application of the exclusion have been decided by the appellate courts, and the results are quite uneven. Some have applied the new wording as intended; some have been puzzled by it and some have even ignored it. Following are some illustrative decisions.

General Issues With The Exclusion

The New Mexico Court of Appeal, in *Computer Corner, Inc. v. Fireman's Fund Ins. Co.* [43 P.2d 1264 (N.M.App. 2002)], recently held that the impaired property exclusion was too complicated to be understood by a reasonable layperson, and refused to apply it.

In *Standard Fire Ins. Co. v. Chester O'Donley & Assoc.* [972 S.W.2d 1 (Tenn.App. 1998)], the court interpreted the exclusion as not applying to damage to anything other than the insured's own work. The insured installed an HVAC system, which allegedly did not perform and had to be replaced. During the removal of the system, some incidental damage was done to walls and ceilings. The court held such damage may be covered. Actually, "impaired property" includes the whole structure into which the insured's work is incorporated, as long as the repair or replacement of the insured's work can fix it. Damage to the insured's own work is already excluded in Exclusion (l), so the court effectively nullifies the impaired property exclusion.

On the other hand, the Seventh Circuit seems to have understood the exclusion. In Hamlin, Inc. v. Hartford Acc. & Indem. Co. [86 F.3d 93 (7th Cir. 1996)], the insured manufactured liquid crystal displays which were sold to a tractor manufacturer and incorporated into the instrument panels of its tractors. Some of the displays were allegedly defective, reducing the value of the tractors. The court held that damages for replacement displays and diminution of value of the tractors fell within the exclusion.

The “Sudden and Accidental” Exception

The exclusion does not apply to “loss of use of other property arising out of sudden and accidental physical injury to “your product” or “your work” after it has been put to its intended use.” It is reasonable to assume that courts will construe the term “sudden and accidental” as they have in connection with the pollution exclusion. In fact, that does appear to be the trend. For example, in *St. Paul Fire & Marine Ins. Co. v. Futura Coatings, Inc.* [993 F.Supp. 1258 (D. Minn. 1998)], the gradual peeling of a coating supplied by the insured, which eventually had to be scraped off and replaced, was held not to be “sudden and accidental”. Therefore, the cost of removing and replacing the coating was excluded by exclusion (m). In *Hartzell Industries, Inc., v. Federal Ins. Co.* [168 F.Supp.2d 789 (S.D. Ohio 2001)], the court held the “sudden and accidental” exception did apply to loss of use of a building where the blades on a ceiling ventilation fan supplied by the insured suddenly broke.

Damage That Cannot Be Remedied By Repair or Replacement of the Insured’s Work

In the long run, the most interesting issue raised by the exclusion may be trying to define when it becomes either impossible, or sufficiently impractical, to replace or repair the insured’s work. The definition of “impaired property” (Fig. 3) requires that the property “can be restored to use by ... repair, replacement, adjustment or removal of” the insured’s work or product. If the repair or removal of the insured’s work would be absurdly expensive, would it be reasonable to deny coverage because it, nevertheless, “can be” done? In *Shade foods, Inc. v. Innovative Products Sales & Marketing, Inc.* [93 Cal.Rptr.2d 364 (Cal.App. 2000)], the court held that the burden of proving the property can be restored to use is on the insurer. There, the insured supplied nut clusters to a breakfast cereal manufacturer. Due to a defect in equipment at the processor’s plant, the diced almonds were contaminated with wood splinters. The court rejected application of the impaired property exclusion, saying “it is fanciful to suppose that the nut clusters composed of congealed syrups and diced nuts ... could be somehow deconstructed to remove the injurious splinters and then recombined for their original use.” This appears to assume that where the only possible repair requires herculean efforts and unreasonable expense, the exclusion will not apply.

Conclusion: Managing the “Impaired Property” Risk

The intended effect of Exclusion (m) is to avoid payment for repair or replacement of the insured’s work or product—even where the contemplated repair or replacement involves removing other nondefective parts of the property. This will reduce the amount of insurance money available to subcontractors and suppliers of component parts in product defect suits. Therefore, general contractors and manufacturers of assembled goods should consider alternative methods to transfer the risk of defective parts to others. Some alternative are: performance bonds, and investigation of the long-term financial responsibility of subcontractors and suppliers. Each of these options has its limitations.

Performance bonds commonly have suit limitation clauses, restricting their effect to cases where suit is brought against the principal within a certain period after completion of the contract work. These limitation periods range from 6 months to 4 years. Unfortunately, the statutes of limitation on tort claims arising from defects in products or completed work vary widely and may be much longer. In cases where the alleged defect was “latent,” not reasonably apparent to a consumer, the statute of limitation may not begin to run at all until the defect causes an injury many years after the work or product is put to its intended use. Bond premiums also may impact the price of components and subcontracts, especially important in competitive bidding situations.

Maintenance of long-term relationships with proven and financially responsible suppliers and subcontractors may be the most effective method to avoid increased exposure to defect suits.

Written evidence of financial status could be requested of subcontractors and suppliers in the same way that certificates of insurance now are commonly required. Unfortunately, the financial standing of small firms—especially the sole proprietorships often found in the construction trades—is subject to sudden change. Many sole proprietorships close their doors when the founder retires.

Errors and omissions (E&O) insurance is available to professionals, such as architects and engineers. Similar “design/build” coverage is available to protect builders against professional liability for the design of a project. Such policies generally exclude faulty workmanship by or on behalf of the named insured, so the cost of replacing subcontractors’ work will not be covered except to the extent required to correct design errors. However, in many cases solvent subcontractors will stand the cost of replacing their defective work, and only the part of the loss attributable to design errors will fall to the general contractor or construction manager. Another feature of E&O policies to consider is that they typically are written on a claims-made form. Therefore, they must be continually renewed to protect against claims arising from latent defects.