

## Workshop L

*Wednesday, November 9, 9:00 a.m.–noon*

# ***BUSINESS IN THE TWENTY-FIRST CENTURY: DEFECTIVE CONSTRUCTION AS “OCCURRENCE” AND “PROPERTY DAMAGE”***

Presented by

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For the past several years, contractors have seen their coverage for construction defects change dramatically. These changes have been fueled both by the insurers that write the coverage and the courts that interpret it. Insurers have slowly chipped away at contractors' coverage by adding numerous policy exclusions and placing other restrictions on coverage. The courts have compounded the problem with inconsistent interpretations of coverage, which reduce contractors' confidence in the coverage they believe they have. This two-part session will provide an overview of how both the insurance market and the legal system are responding to the issue of construction defects. See how recent court decisions—including four major state supreme court decisions—come to radically different conclusions with respect to issues such as the definition of “occurrence,” the “your work” exclusion, and the business risk doctrine in defective construction cases. Attendees will leave with a better understanding of where the insurance market is on this issue and how to argue for coverage in the event of a coverage dispute.

# Risky?

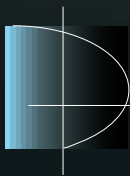
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Mr. Wielinski is one of the presenters for Workshop L, "Coverage for Construction Defects: An Oxymoron in 2005?" on Wednesday morning. He is a principal in the Dallas-Fort Worth office of Cokinos, Bosien & Young.

Mr. Wielinski practices in the areas of construction, insurance coverage, and risk management. As a result, Mr. Wielinski has advised clients, and litigated and appealed insurance coverage claims involving defective workmanship for nearly 25 years. He is admitted to practice before the courts of the states of Texas and Minnesota, the U.S. Supreme Court, U.S. Fifth Circuit Court of Appeals, and other state and federal courts.

Mr. Wielinski is the Immediate Past Chair of the Insurance Law Section of the State Bar of Texas. He serves as the Chair of the Construction Insurance Subcommittee of the Construction Law Committee of Defense Research Institute and also on the Risk Management Committee of the Associated General Contractors of America. He is a member of the ABA Forum Committee on the Construction Industry and the Insurance Coverage and Construction Committees of the ABA Litigation Section. He received his B.A. degree from St. John's University and his law degree from the University of Minnesota.

Mr. Wielinski regularly lectures to construction, insurance, and legal groups on insurance coverage and risk management issues. He is the author of *Insurance for Defective Construction: Beyond Broad Form Property Damage Coverage*, published by IRMI, as well as numerous other publications for insurance, construction, and legal organizations. He is also the coauthor of *Broad Form Property Damage Coverage*, Third Edition, and *Contractual Risk Transfer: Strategies for Contractual Indemnity and Insurance Provisions*, which are also published by IRMI.

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# ***BUSINESS RISK IN THE TWENTY-FIRST CENTURY: DEFECTIVE CONSTRUCTION AS "OCCURRENCE" AND "PROPERTY DAMAGE"***

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***Patrick J. Wielinski  
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As any general contractor, subcontractor, and particularly any residential contractor will tell you, insurance coverage for defective construction has been constricting steadily over the past several years. Two sources of constriction of coverage are the subject of this paper. The first limitation is the result of efforts by the insurance industry to amend the policy to eliminate or limit coverage for risks that are perceived to be difficult or impossible to underwrite. The second type of limitation is imposed through interpretation of the policy language by the courts.

## **Introduction**

Recent years have seen new and largely unforeseen developments in liabilities being faced by the construction industry. These liabilities are particularly centered in the residential construction sector, including subdivision-wide construction defect lawsuits in single-family units, and condominium construction defect suits filed by homeowners associations in the commercial residential context. In addition, mold and EIFS claims increased, and terrorism emerged as a legitimate underwriting concern, all during the hard market portion of the normal insurance cycle during which prices are higher and coverage more difficult to obtain. Unfortunately, all of these factors have affected the availability of coverage under commercial general liability (CGL) insurance policies for many other construction contractors, even those not typically involved in residential construction, much the same that the residential mold scare resulted in absolute exclusions being attached to commercial contractors-policies.

The result of the convergence of these factors is a reduction in the coverage available for construction exposures, a reduction that is accomplished through the amendment of the language of standard policies, usually through the attachments of endorsements to the policy. The last couple of years have seen the issuance of numerous such endorsements. For example, a standard endorsement is now available to eliminate the "subcontractor" exception as to coverage for defective work under the CGL policy and habitational exclusions are frequently added to policies to eliminate coverage for residential exposures.

Policy amendments to limit coverage are not the only issue facing the construction industry particularly as to coverage for defective construction. That coverage is the subject of a continuous effort by the insurance industry to limit coverage through insurance coverage litigation. As detailed below, the uninsured "business risks" for contractors under their CGL policies are carefully circumscribed under the policy, particularly in the property damage exclusions, which, when read and applied together with the insuring agreement and the definitions, often provide coverage for portions of this exposure. Unfortunately, certain insurers have experienced some success in diverting courts-attention from the entire policy and limiting the focus to artificial distinctions based upon breach of contract versus negligence and economic loss versus property damage, artificial distinctions without basis in the policy language, or the better-reasoned case law.

As a result, courts continue to grapple with the issue of whether defective construction by an insured contractor constitutes an “occurrence” of “property damage” as defined in the CGL policy. Despite standardized policy language, courts around the United States have, at best, produced a confusing and mixed bag of results in applying those terms to defective construction. While mixed bags often defy categorization, a general trend is discernable in this case law. Those courts that forsake the language of the policy for an amalgam of “breach of contract-economic loss” analysis tend to find no occurrence or property damage, and in turn, no coverage for the insured contractor. Those courts never reach the exclusion provisions of the policy that often extend coverage. In contrast, those courts that employ a more traditional analysis, that is, whether the physical injury to tangible property caused by the defect was neither expected or intended from the standpoint of the insured, tend to find a covered occurrence. Part and parcel of this analysis is a determination of whether the claim involves damage to property other than the insured’s own work.

These limitations only exacerbate one of the major problems facing the construction industry today, that is, the disconnect between the tiers on a construction project as to the fair and practical allocation of risk. This disconnect is particularly apparent in the onerous and impossible insurance requirements imposed by many owners upon general contractors, or the even more onerous and impossible requirements imposed by a lender. Of course, general contractors are quick to rely on the “flow down,” the argument that they are only passing on to their subcontractors the requirements they have assumed from the owner. Of course, this approach ignores the fact that insurers are usually more likely to provide broader coverage to larger general contractors than smaller risks such as specialty subcontractors. Thus, the risk is not effectively transferred when all is said and done.

The limitations on coverage under standard CGL and related policies make it extremely difficult for the construction industry to meet its most significant risk management challenge--to try to match available and affordable insurance coverage with contractual requirements, both insurance specifications and other contractual risk transfer provisions, such as broad indemnity. One of the questions that needs to be answered is whether contract requirements drive the availability of insurance, or whether availability of insurance should drive the contract provisions. The answer is undoubtedly somewhere in between, although the limits being placed on an insured contractor’s coverage would seem to indicate that neither may be the case, as the gulf between contract specifications and available coverage continues to widen.<sup>1</sup>

### **Coverage Litigation over Defective Construction Claims**

Particularly since 1986 when the standard form CGL insurance policy form was revised into arguably a more “plain language” format, courts have generally upheld the intent to provide coverage to an insured contractor for property damage arising out of the work of subcontractors. This coverage extended to defective work of those subcontractors. The coverage available for property damage attributable to subcontractor work has assumed increasing importance due to the

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<sup>1</sup> These materials are an adaptation from the author’s book, *Insurance for Defective Construction*, the second edition of which was recently published by IRMI.

escalation of construction defect litigation, particularly residential subdivision and condominium lawsuits. Completed operations coverage for subcontractor defects has taken center stage to provide coverage for settlements in these cases. While not of the same magnitude as asbestos or mold, this exposure is proving to be much greater than underwritten, and like asbestos, can trigger coverage under policies that were issued years ago.

Because many of these policies have been issued years ago, other arguments have been raised to support the denial of coverage for defective work claims. These arguments have evolved into an attempt to eliminate coverage without the necessity of applying the exclusions in the policy. In fact, many of them represent a studied attempt to ignore the language of the policy itself, language that had been previously recognized as providing coverage. These attempts involve reliance on the definition of occurrence, to argue that property damage caused by defective work in breach of contract is natural and probable and not an occurrence. Another argument is based upon the definition of property damage, applying the economic loss rule to conclude that property damage from construction defects constitutes economic loss that is not covered under the CGL definition. The occurrence and economic loss arguments have been the subject of considerable recent litigation and are the focus of this paper. Other related arguments are based upon the “legally obligated” requirement in the insuring agreement<sup>2</sup> and non-policy based “defenses” such as the “conversion of the CGL policy into a performance bond.”<sup>3</sup>

The primary target of these attacks on coverage is the exception to Exclusion (1), the Your Work Exclusion, often referred to as the “subcontractor exception.” That exclusion denies coverage for property damage to the named insured-s work arising out of it and included in the products-completed operations hazard. However, the exclusion specifically states that, “This exclusion does not apply if the damage to work or the work out of which the damage arises was performed on your

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<sup>2</sup> This argument is most often made against the backdrop of the language in the CGL insuring agreement to the effect that the insurer shall pay all sums that the insured becomes “legally obligated” to pay. Some insurers argue that this language limits coverage to only tort-based damages and not damages for breach of contract. Of course, this argument is frequently encountered in the defective construction context due to the fact that most construction work is performed pursuant to contract, of which defective construction work may be a breach. This argument met with some initial success, but was later rejected by the California Supreme Court in *Vandenberg v. Centennial Ins. Co.*, 982 P.2d 229 (Cal. 1999). More recently, other courts have held that damages incurred to repair a defective product pursuant to a contractual requirement constitute damages that the insured is “legally obligated” to pay under a liability policy. *Venture Encoding, Inc. v. Atlantic Mutual Ins. Co.*, 107 S.W.3d 729 (Tex.App.--Fort Worth 2003, pet. denied). See also, *Wanzek v. Employers Ins. Co. of Wausau*, 667 N.W.2d 473 (Minn.App. 2003), *aff'd on other grounds*, 679 N.W.2d 322 (Minn.2004)(costs of repairing pool due to defective coping stone provided by insured’s subcontractor involved property damage and a contractual obligation to repair, thus constituting a covered legal obligation of the insured).

<sup>3</sup> This argument, though easier to state than to justify, ignores the fact that a performance bond is a financial guarantee posted by the contractor in favor of the owner that the project will be constructed as set out in the contract documents. It also ignores the fact that the surety has a right of contractual indemnity against the contractor for any amounts paid out pursuant to the bond. Some claims, particularly claims that involve defective workmanship that cause damage to the project, can trigger both the CGL policy and the performance bond. In that instance, the CGL policy should respond first, particularly in light of the contractor’s indemnity obligations to the surety. Because of the contractor’s indemnity obligation, upon payment of a performance bond claim involving defective workmanship, the insured contractor’s rights under its CGL policy are frequently assigned to the surety for pursuit of subrogation.

behalf by a subcontractor.” The construction industry, the insurance industry, and the courts have regarded the subcontractor exception as an enhancement to the CGL coverage provided to a general contractor or any other entity that uses subcontractors in its operations. As a result, general contractors have been able to tap a considerable amount of completed operations coverage under appropriate circumstances in reliance on that exception.<sup>4</sup>

While this paper focuses on the effect of these arguments on Exclusion (l), the Your Work Exclusion, the analysis applies with equal force to the other property exclusions, also referred to as the “business risk” exclusions, all of which, as explained below, circumscribe and limit the doctrine that states that defective work is an uninsurable business risk that the insured contractor should be able to control in its everyday operations. These exclusions are Exclusion (j.5), ongoing operations; (j.6), faulty workmanship; (k), your product; (m), impaired property; and (n), products recall.

**Traditional Coverage Approach: Circumscribing “Business Risk”**

A review of the importance of the “Business Risk Doctrine” and its relationship to the property damage exclusions in the CGL policy is useful to understand the seriousness of the issues facing insured contractors. There has always been a historical tension between CGL coverage for defective construction work and what insurers have traditionally referred to as an uninsurable “business risk.” This tension gained momentum with the 1973 revisions to the ISO CGL form when the exclusion for property damage arising out of work performed by the named insured was split from the exclusion for property damage arising out of the named insured-s product. At the same time, ISO promulgated the Broad Form Property Damage Endorsement (“BFPDE”) to the standard policy form. That endorsement expanded the coverage under the 1973 form by modifying the “work performed” exclusion so as to provide an insured coverage for property damage arising out of the defective work of its subcontractors. It also narrowed the exclusion, in the operations context, to property damage to “that particular part” of the work upon which operations are being performed, out of which the property damage arises or that must be repaired or replaced because the insured’s workmanship was faulty.

Nevertheless, the argument persisted that, despite the attachment of a BFPD to an insured contractor’s CGL policy, all property damage arising from defective workmanship, including property damage arising from a subcontractor’s defective work, constituted an uninsurable business risk. This argument was supported by frequent reference to an early case, *Weedo v. Stone B E Brick, Inc.*, 405 A.2d 788 (N.J. 1979), that employed an analysis based upon CGL coverage unmodified, i.e., unexpanded, by the BFPDE. Therefore, these seminal authorities and the numerous cases that followed them reached the erroneous conclusion that defective workmanship is a business risk that is

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<sup>4</sup> Insurance Services Office (ISO) promulgated a standard endorsement in December 2001, intended to eliminate the subcontractor exception from the policies to which it was attached. That endorsement is Endorsement No. CG 22 94. Nevertheless, the endorsement, for obvious reasons, is not used throughout the industry on a blanket basis. Moreover, most defective construction insurance litigation involves past policies not so endorsed.

uninsurable *per se*, even though those cases involved policies that were modified by the BFPDE to provide expanded coverage and to limit the business risk concept, particularly as to subcontractor work.

Through the 1986 revisions to the CGL form, ISO sought to clarify the limitations on the business risk concept by the revised exclusions of the BFPDE as applied to CGL coverage for defective work. Major clarifications such as the “subcontractor exception” (Exclusion I) and the “particular part” limitation on the operations in progress and the faulty workmanship exclusions (Exclusions j(5) and (6)) were incorporated into the standard forms. Most courts, with some exceptions, such as Florida, upheld the circumscription and limitation of the business risk doctrine by the 1986 revisions to the CGL policy form.

### “New Approach” Occurrence Cases

Despite the standardized language of the CGL policy, including the subcontractor exception, some courts have exhibited a tendency not to apply it. Recent cases sidestep the coverage preserved through the subcontractor exception by applying the definition of occurrence to deny coverage for claims involving the defective work of subcontractors. These “new” approach cases call into question the need to include provisions in a policy excluding coverage for defective work and to include a subcontractor exception as a means to preserve the coverage available for defective workmanship. For if property damage arising out of defective work cannot constitute an occurrence, **by definition**, there is no need to reach and apply the exclusions in the policy. Of course, the fact that ISO saw a need for the promulgation of an endorsement to eliminate the subcontractor exception may indicate that the insurance industry does not truly believe that defective workmanship cannot *per se* satisfy the definition of occurrence so that the policy exclusions can be ignored.

One recent case to wrestled with this issue is *L-J, Inc. vs. Bituminous Fire & Marine Ins. Co.*, 2004 WL 1775571 (S.C. April 21, 2004). In that case, L-J, the insured site development contractor, faced claims against it arising out of an inadequately compacted road base, which resulted in the deterioration of pavement in a subdivision several years after completion. Subcontractors performed all of the defective site compaction work. As a result, the developers sued L-J for breach of contract, breach of warranty, and negligence. L-J was insured by various insurance companies over the period of 1989 through 1996, three of whom contributed to a \$750,000 settlement. Bituminous refused to participate in the settlement, and the other three insurers and L-J filed a declaratory judgment action seeking contribution from Bituminous for the settlement amount, coupled with indemnification for all defense costs. The trial court upheld coverage, and was affirmed by the South Carolina Court of Appeals in *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 567 S.E.2d 489 (S.C. App. 2002).

Before the Court of Appeals, Bituminous argued that faulty workmanship can never constitute an occurrence under a CGL policy. The court rejected this argument, and in a footnote, acknowledged the proposition that an automatic denial of coverage, on the basis that defective work cannot be an occurrence, constitutes a “rehash” of the business risk doctrine, and depends entirely on the court ignoring the terms of the CGL policy. Rather, the Court of Appeals held that while faulty

workmanship, standing alone, may not constitute an accident, when the damage due to the faulty site compaction extended beyond the cost of repairing the compaction, there was an accident that was neither expected nor intended from the standpoint of the insured. There was damage beyond the faulty site compaction because the failure to properly compact the roadbed led to the failure of the road surfaces. All of this work was part of the insured's work under its contract. Finally, the Court of Appeals went on to uphold coverage and to apply the "subcontractor exception" to the Your Work Exclusion. Therefore, even though the entire road construction project fell within the definition of "your [L-J's] work" within the Your Work Exclusion, the subcontractor exception preserved coverage where the damage to L-J's work arose out of the work of a subcontractor. In other words, the Court of Appeals applied the plain and unambiguous language of the policy in its 2002 opinion.

Bituminous appealed that result to the South Carolina Supreme Court, and more than two years later, that court did a rapid about-face, reversing the Court of Appeals, and in the process, forsaking the policy language and intent. Inexplicably, the Supreme Court held that even though there were numerous acts of negligence on the part of L-J, no occurrence had taken place. The court stated as follows:

While the alligator cracking may have constituted property damage, we find that no 'occurrence' took place as defined by the CGL contract. According to the deposition testimony, the only 'occurrences' were various negligent acts by the Contractor during road design, preparation, and construction that led to the premature deterioration of the roads. Those negligent acts included: (1) A failure to prepare the subgrade by both failing to remove the tree stumps and failing to remove or compact the white clay in the subgrade; (2) An improperly designed drainage system; (3) A thin road course, ill-prepared to handle heavy wheel loads; and (4) an improperly designed curve edge detail. We find that all of these contributing factors are examples of faulty workmanship causing damage to the roadway system only, which does not fall within the contractual definition of 'occurrence' under Bituminous's CGL policy.

The Bituminous policy contained the standard definition of occurrence, meaning "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Thus, while the court recognized the negligent conduct of L-J, it determined that that negligent conduct did not constitute an occurrence simply because the property damage arising from it was to L-J's work under its contract. The court's holding is not supported by the language of the definition itself which contains no requirement of third party property damage to constitute an occurrence. The court's holding fails to take into account the fact that it is the property damage exclusions, including the Your Work Exclusion, that differentiate between covered and non-covered property damage once there has been an occurrence.

In addition, the South Carolina Supreme Court supported its holding by quoting from a frequently cited law review article, Henderson, *Insurance Protection for Products Liability and*

*Completed Operations-What Every Lawyer Should Know*, 50 NEB. L. REV. 415 (1971). That article is cited for the proposition that the CGL policy covers only tort liability for physical damage to others and not contractual liability of the insured for economic loss because its product or completed work was not that for which the damaged person bargained. However, the Henderson law review article addressed the 1966 revisions to the CGL policy, revisions that did not include the subcontractor exception that was a standard provision in the 1986 policy form, the form that was before the *L-J* court. Finally, the court illustrated its ruling with the following hypothetical:

We agree that the CGL policy may provide coverage in cases where faulty workmanship causes bodily injury or property damage to another. For instance, if a bicyclist rode through Dunes West [the development], caught his front wheel in an alligator crack, and suffered an injury, the damages resulting from his successful negligence cause of action would likely be covered under a CGL policy. In our view, this example represents the type of insurable loss contemplated by a CGL policy definition of ‘occurrence’ because it was an accident causing bodily injury and property damage to another, rather than damage to the road itself.

The hypothetical begs the question since it involves bodily injury, and bodily injury is not subject to property damage exclusions that apply to defective work claims. As such, it does little to advance the analysis and in the process, misdirects the focus from the property damage exclusions where coverage for property damage is determined under the CGL policy form, to the definition of occurrence that makes no differentiation between bodily injury or property damage to the named insured’s own work and the property of third parties.

Because of its reliance on the definition of occurrence, the South Carolina Supreme Court declined to address whether the damage fell within the subcontractor exception to the Your Work Exclusion. Nevertheless, the court corrected the Court of Appeals for the proposition that the subcontractor exception restored coverage as contrary to existing law, which states that an exclusion does not provide coverage. Other courts have reached a contrary result. For example, in *American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004), only six months before *L-J v. Bituminous*, the Wisconsin Supreme Court held that the subcontractor exception does not create coverage where none existed before since the coverage is within the insuring agreement’s initial grant of coverage. The Your Work Exclusion would exclude coverage except that the subcontractor exception applies, operating to preserve the coverage.

On February 3, 2005, the Supreme Court of South Carolina, in a 5-0 unanimous vote, granted the petition for review filed by the insured after a firestorm of comment from the construction industry and legal groups and argument were held in mid-April. The unanimous decision to grant the petition for rehearing was regarded as a relatively certain sign that a new opinion will be issued. Oral arguments were heard on rehearing in April, 2005 and the case is currently pending before court.

Since the Court of Appeals' opinion in *L-J* was issued in April of 2002, and the Supreme Court opinion was not handed down until well over two years later in August of 2004, in the interim, other courts have relied upon the analysis of the court of appeals. One of the most recent of those cases is *Auto-Owners Ins. Co. v. Home Pride Cos., Inc.*, 684 N.W.2d 571 (Neb. 2004). That opinion was issued by the Nebraska Supreme Court on August 6, 2004, only three days before the lower court opinion in *L-J* was reversed by the South Carolina Supreme Court. In upholding coverage for an insured roofer for property damage to roof structures in a building damaged by its faulty installation of shingles, the Nebraska Supreme Court relied upon the lower *L-J* opinion for the proposition that while faulty workmanship, standing alone, does not constitute an accident and cannot therefore be an occurrence, faulty workmanship that causes an accident is covered under a standard CGL policy.

Another recent case relying upon the occurrence requirement to bypass coverage for a general contractor for property damage arising out of defective work of subcontractors is *Groves v. Erie Ins. Co.*, 333 F.Supp.2d 568 (N.D.W.Va. 2004). In that case, Bland, the insured homebuilder, sued Groves, the party with whom Bland had contracted to construct a home, seeking recovery of the balance owed on the contract. Groves counterclaimed, recovering damages for the costs of completion and the cost to repair construction defects in the home. Groves subsequently filed suit as judgment creditor against Erie, Bland's CGL insurer, to recover the repair costs.

Faced with the coverage dispute, the court framed the issue as "whether the policy covers property damage arising out of negligent workmanship by Bland or his subcontractors." In resolving the dispute, the court addressed the issue of whether faulty workmanship constitutes an occurrence. Initially, the court felt compelled to determine whether negligence can be an "occurrence." Under the standard definition in the CGL policy, i.e., "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The court noted that although an occurrence can include a continuous or repeated exposure to the same general harmful conditions, it must nevertheless be an accident, going on to apply the following reasoning:

An 'accident' generally means an unusual, unexpected and unforeseen event. An accident is never present when a deliberate act is performed unless some additional unexpected, independent and unforeseen happening occurs which produces the damage. To be an accident, both the means and the result must be unforeseen, involuntary, unexpected and unusual.

The court then concluded that in order to support a cause of action on behalf of the plaintiff, negligence must be reasonably expected to produce an injury. In contrast, the cause and result of an accident are unforeseen, involuntary, unexpected, or unusual. Therefore, the court reached the somewhat novel conclusion that "the unambiguous definition of 'accident' does not encompass negligent acts. Accordingly, the negligent workmanship by Bland or his subcontractors is not an 'occurrence' and receives no coverage under the Policy." Of course, in reaching this conclusion, the court appears to have ignored the traditional formulation of occurrence, that is, an accident, resulting in property damage that is neither expected nor intended from the standpoint of the insured. Moreover, its formulation of "occurrence" runs counter to the notion that one of the basic purposes

of the CGL policy is to provide coverage for the negligence of the insured. Only where the property damage is expected or intended should the definition of occurrence not be satisfied.

In addition, the *Groves v. Erie* case contains a truncated treatment of the subcontractor exception, addressing it in a single sentence, “[T]he parties argue that whether a certain exclusion in the Policy that is inapplicable to subcontractors consequently creates coverage for subcontractors for their negligent work.” However, the court never addresses that issue, even though the opinion appears to make a point of describing the property damage as having been caused by subcontractors. The failure to address the subcontractor exception is not particularly astounding in light of the court’s occurrence analysis and result. In fact, it is a characteristic of many of the “defective work as no occurrence” cases that the court stops short of considering the effect of the subcontractor exception.

Another case to take this approach is *Hartrick v. Great American Lloyds Ins. Co.*, 62 S.W.3d 270 (Tex. App.--Houston [1st District] 2000, no pet.). In that case, the insured homebuilder was out of business, so the insurer controlled the defense of the underlying lawsuit, including the submission of the case to the jury. The jury specifically found that neither the builder nor its subcontractors were negligent, but that the builder had breached its implied warranties of good and workmanlike construction and habitability. The *Hartrick* court concluded that lack of compliance with an implied warranty is not accidental, but results from not doing what one must do. By not doing what it had to do, the builder could reasonably anticipate injury to the homeowner. Of course, because of this peculiar procedural twist alone, the *Hartrick* case is distinguishable from most construction claims.

The *Hartrick* court ignored the fact that a cause of action for breach of an implied warranty involves strict liability. *Centex Homes v. Buecher*, 95 S.W.3d 266 (Tex. 2002). There is no foreseeability requirement necessary to establish strict liability. Obviously, under traditional notions of occurrence, a homebuilder can find itself in breach of an implied warranty without having expected or intended the property damage arising from that breach. Moreover, a homebuilder can find itself in breach of warranty without ever having to have committed an intentional act. The property damage arising out of an unintended breach is an “occurrence.”

The *Hartrick* court reached its conclusion despite the fact that a subcontractor performed the defective site work that caused the damage to the home. The court never explicitly ruled on the subcontractor exception, embarking only upon a truncated analysis of coverage under the policy that did not necessarily track prior case law on construction-related occurrences.

Another such case is *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F.Supp.2d 706 (N.D. Tex. 2003). Although the court ultimately held that there was no occurrence, one should note the unique facts before the court. That case did not involve a completed operations claim, i.e. property damage that was discovered subsequent to completion; accordingly, the subcontractor exception was not in play. Rather, the home was never completed because the insured contractor walked the job based upon a payment dispute with the homeowners. Moreover, during construction, problems as to defective work were actually brought to the insured’s attention by the homeowner, and they were led to believe that the problems were corrected, only later to discover that they were not properly corrected. There were also allegations in the arbitration that representations made by

the insured builder that the piers and foundation of the home would be designed and inspected by a registered engineer were false and that no such inspection occurred. The causes of action alleged included breach of contract, violation of the DTPA, fraud based on false representation regarding the design and construction of the home, and negligence.

Since the insured contractor walked the job, and failed and refused to correct defective work brought to its attention, the court's scepticism as to the negligence claim asserted against the builder was warranted. Moreover, the court's characterization of the issue as more akin to a performance bond than a CGL policy is also somewhat understandable in light of the fact that facts before him involved a default and termination of the contractor, a classic scenario that may invoke the obligations of a surety under a performance bond. Due to the disparity in the facts, the analogy to a performance bond in *Jim Johnson* should not carry over to most defective construction claims.

### **The Traditional Occurrence Approach**

At the same time, other courts continue to uphold coverage for these types of claims. One of these cases is *American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004). In that case, the insured general contractor, Renschler, contracted with Pleasant (now known as American Girl) to design and construct a distribution warehouse. The soils engineering subcontractor, Lawson, gave Renschler faulty site preparation advice. As a result, there was excessive settlement of the soil under the building, causing it to sink by as much as eight inches on one end. The structure buckled and cracked. Ultimately, the warehouse was found unsafe due to structural steel over-stress and had to be torn down. American Family, the CGL insurer of Renschler, denied the claim, but the Wisconsin Supreme Court upheld coverage for Renschler for the property damage attributable to the actions of Lawson, its subcontractor. The court noted that the Your Work Exclusion would operate to exclude coverage under the circumstances of the case before it, but for the subcontractor exception that specifically restored coverage for the property damage that arose out of the work performed by the subcontractor. In that connection, the court set out the history of the exception as follows:

This subcontractor exception dates to the 1986 revision of the standard CGL policy form. Prior to 1986 the CGL business risk exclusions operated collectively to preclude coverage for damage to construction projects caused by subcontractors. Many contractors were unhappy with this state of affairs, since more and more projects were being completed with the help of subcontractors. In response to this changing reality, insurers began to offer coverage for damage caused by subcontractors through an endorsement to the CGL known as the Broad Form Property Damage Endorsement, or BFPD. Introduced in 1976, the BFPD deleted several portions from the business risk exclusions and replaced them with more specific exclusions that effectively broadened coverage. Among other changes, the BFPD extended coverage to property damage caused by the work of subcontractors. In 1986 the insurance industry

incorporated this aspect of the BFPD directly into the CGL itself by inserting the subcontractor exception to the “your work” exclusion.

The Wisconsin Supreme Court also relied upon the subcontractor exception in rejecting American Family’s argument that the installation of defective work by Renschler did not constitute an occurrence under the CGL policy. The court stated:

If, as American Family argues, losses actionable in contract are never CGL “occurrences” for purposes of the initial coverage grant, then the business risk exclusions are entirely unnecessary. The business risk exclusions eliminate coverage for liability for property damage to the insured’s own work or product--liability that is typically actionable between the parties pursuant to the terms of their contract, not in tort. If the insuring agreement never confers coverage for this type of liability as an original definitional matter, then there is no need to specifically exclude it. Why would the insurance industry exclude damage to the insured’s own work or product if the damage could never be considered to have arisen from a covered “occurrence” in the first place?

Thus, the coverage provided by virtue of the subcontractor exception to the Your Work Exclusion preserves coverage not only for a subcontractor’s defective work, but also serves as the cornerstone for the argument that in light of the presence of such restrictions on the property damage exclusions in the CGL policy, the policy does in fact extend coverage to certain elements of an insured’s defective work.

In *Kvaerner Metals v. Commercial Union Ins. Co.*, 825 A.2d 641 (Pa.Super. 2003), *appeal pending*, 848 A.2d 925 (Pa. 2004), Kvaerner, the insured contractor, sought coverage from its CGL insurer after the coke battery it constructed was damaged in heavy rains. As a result, the owner made a claim against Kvaerner for those damages. Premature grouting of the battery during construction resulted in a lack of expansion space during heat up, which, in combination with the heavy rains, caused deformation of the joints in the roof. The court held that there was no requirement in the policy that a civil complaint be filed against Kvaerner in order to trigger coverage, that the battery deformities were caused by an occurrence, and that they resulted in property damage. The court then considered the effect of the property damage exclusions, primarily the subcontractor exception, and remanded the case to the trial court to determine what part, if any, of the work on the battery was performed by subcontractors.

The insurer petitioned for appeal to the Pennsylvania Supreme Court, and the issue to be addressed is the “appropriate test or inquiry in ascertaining whether an underlying claim sounds in contract or tort for purposes of insurance coverage.” The appeal of *Kvaerner* should be interesting based upon the fact that the lower court placed primarily reliance on the court of appeals opinion in *L-J, Inc. v. Bituminous Fire & Marine*, a case that has, in the interim, been reversed by the South Carolina Supreme Court as discussed above.

On January 24, 2005, the Fourth Circuit, applying Pennsylvania law, followed *Kvaerner Metals v. Commercial Union*, in *Limbach Co., L.L.C. v. Zurich Am. Ins. Co.*, 2005 WL 127335 (4th Cir. January 24, 2005), holding that costs of replacement of a leaky steam pipe fell within the subcontractor exception. The court also held that the supplier of the leaky steam pipe was a subcontractor, relying on several cases, including *Wanzek Construction v. Employers Insurance of Wausau*, immediately below.

Despite the contrary Texas precedent represented by *Hartrick v. Great American Lloyds above*, see *Gehan Homes v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App.--Dallas 2004, pet. filed). There, the court held that a complaint against the insured homebuilder for negligent construction of a defective foundation that resulted in unexpected and unforeseen property damage to a home alleged an “occurrence” under a standard CGL policy. Reversing the lower court’s grant of summary judgment in favor of the insurer, the *Gehan* court began its analysis with the policies’ language, which defined the term “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions,” a definition identical to the one before this Court. The policies left the term “accident” undefined, so the court reviewed Texas Supreme Court precedent, *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185 (Tex. 2002). stating that an injury is accidental if the injury is not the natural and probable consequence of the action which caused the occurrence. Nevertheless, the *Gehan* court acknowledged the proper inquiry as to the existence of an “occurrence” under a CGL policy is whether the injury was expected or intended from the standpoint of the insured. Under *King*, Dallas Court of Appeals noted that limiting the definition of “occurrence” to only unintentional acts renders the policy exclusion for intended injury surplusage. The *Gehan* court further explained that there is an accident when the action is intentionally taken but is performed negligently and the effect is not what would have been intended or expected had the deliberate action been performed non-negligently. Accordingly, although the claim involved damage to the house, which was the subject matter of the contract, there was still an occurrence, and, therefore, a covered claim. Another Texas Court of Appeals reached a similar result in the context of coverage for water damage caused by EIFS in *Lennar Corp. v. Great American Ins. Co.*, 2005 WL 1324833 (Tex.App. -- Houston [14th Dist.] June 2, 2005).

The subcontractor exception has also received broad treatment as to the type of entity that constitutes a “subcontractor” for purposes of application of the exception. One of the very recent cases to engage in such an interpretation is *Wanzek Construction, Inc. v. Employers Insurance of Wausau*, 679 N.W.2d 322 (Minn. 2004). Although the opinion does not directly address the “occurrence” issue, it nevertheless is useful to illustrate the breadth of coverage available to general contractors by virtue of the subcontractor exception. In that case, Wanzek, the general contractor, entered into a contract to construct a city aquatic center, including a pool. The contract called for Wanzek to install custom fabricated coping stone at the perimeter of the pool. That coping stone was provided by Aquatic. As part of its obligation to supply the coping stone, Aquatic also provided training to Wanzek personnel as to installation of the stone. After completion, occupancy, and use of the pool, the stones failed. Wanzek replaced the stones pursuant to its obligations under the contract, seeking coverage for the cost of repair from Wausau, its CGL insurer.

Wausau raised several defenses to the claim, first arguing that the coping stone constituted Wanzek's product, so that the "your product" exclusion applied, in that the entire construction project constitutes a general contractor's project. The court rejected this argument based upon the definition of "your product" contained in the standard CGL policy form that contains an exception for "real property."

Wausau's main argument was that the subcontractor exception to the Your Work Exclusion did not apply to the supplier of materials so that the exclusion denied coverage for property damage arising out of Wanzek's work. In support of that argument, Wausau relied upon state sales tax cases, while on the other hand, Wanzek relied upon payment bond cases for its position that a supplier should be treated the same as a subcontractor. The court found neither of these lines of cases controlling because that precedent did not deal with the language of the "Your Work Exclusion" in Wausau's policy. The court stated as follows:

The policy language governs. If the policy language is ambiguous, it must be interpreted in favor of finding coverage. Because there is no statutory or regulatory definition of subcontractor that is incorporated into the "your work" exclusion, and the policy does not define the term, we hold that the term "subcontractor" in the exception to the "your work" exclusion of the CGL insurance policy is ambiguous and we will construe it liberally in favor of coverage.

Wausau also argued that even if the supplier met the definition of a subcontractor, the Your Work Exclusion nevertheless applied because the supplier did not perform its work on behalf of Wanzek, but had supplied materials manufactured to the specification of the owner. The court was not persuaded by this argument, observing that Aquatic had no agreement with the city for providing the coping stone. Instead, it contracted directly with Wanzek and that contract obligated Aquatic to furnish and pay for supervision, labor, materials, tools, equipment, services, and all other items necessary to design and fabricate the stones. The court held that since Aquatic's performance of its obligations to Wanzek contributed to the performance by Wanzek of its obligation to the city to furnish and install the coping stones, Aquatic had performed its work as a subcontractor on behalf of Wanzek.<sup>5</sup>

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<sup>5</sup> Perhaps one of the most fascinating aspects of the *Wanzek* case was not briefed and argued before the Minnesota Supreme Court. However, it was discussed by the lower Court of Appeals in its opinion, *Wanzek Construction, Inc. v. Employers Insurance of Wausau*, 667 N.W.2d 473 (2003). There, the court addressed Wausau's argument that since Wanzek had repaired the defective work per the requirements of its contract so that no lawsuit had been filed against Wanzek, it could not be "legally obligated" to pay damages within the meaning of the insuring agreement of the standard CGL policy. The court rejected that argument stating that the insuring agreement was broad and general enough to pertain to Wanzek's claim which involved property damage and an apparent contractual obligation on Wanzek's part to repair or pay for the property damage. Nothing in the provision suggested a lawsuit was necessary to trigger coverage. Finally, the court concluded that to construe the language of the provision to require a lawsuit to trigger coverage would not serve the public policy goal of encouraging the resolution of disputes without litigation.

These “traditional” cases apply the intent behind the subcontractor exception to uphold coverage for insured general contractors for property damage arising out of the defective work of their subcontractors. In the process, the courts gave effect to all provisions in the entire policy, harmonizing them to determine the policy intent. In other words, they did not stop short at the definition of occurrence and ignored the property damage exclusions, particularly the subcontractor exception.

### **Economic Loss versus “Property Damage”**

Another argument that is frequently heard is that defective construction gives rise to mere economic loss and does not constitute “property damage” as defined in the CGL policy. This position is frequently framed in terms of economic loss. In other words, the contention is often made that the cost of repairing or replacing defective work is an economic loss that is not covered under the policy. Under many circumstances, such costs may not be in fact covered. Take, for example, the costs of repairing or replacing work that is known to be defective, but that has not yet failed. See *Travelers Insurance Co. v. Eljer Manufacturing, Inc.*, 757 N.E. 2d 481 (Ill. 2001), discussed later in this paper.

A problem is created, however, when an economic loss argument is used to divert attention away from the exclusions in the policy, or even away from the definition of “property damage” in connection with reviewing coverage for defective work claims under a CGL policy. In other words, initially approaching coverage for defective work claims from the perspective that economic loss is *per se* not covered is, in reality, backward. Somehow, the existence of “property damage” is avoided if it is called something else: “economic loss.” Rather, the inquiry should focus on whether the claim involves “property damage,” as defined in the policy, i.e., physical injury to tangible property or loss of use of tangible property. If the definition of property damage is not satisfied, then the claim may in fact involve mere economic loss, but not because economic loss is not covered, but rather, because there is no “property damage.” If in fact there is “property damage,” then the exclusions must be applied before a definitive coverage determination can be made.

Recently, the assertion that defective work claims involve mere economic losses has often been combined with a companion assertion that this result is in accord with the “Economic Loss Rule.” Of course, references to neither “economic loss” nor the “economic loss rule,” can be found within the CGL policy itself. Thus, this analysis is another effort to misdirect the attention of the insured and the courts away from the policy itself toward vague and largely irrelevant concepts.

### **Economic Loss and Defective Work Claim:**

As previously stated, in order to be covered under the policy, a claim, including a defective work claim, must meet the definition of “property damage,” that is, it must involve “physical injury to tangible property, including all resulting loss of use of that property,” or “loss of use of tangible property that is not physically injured.” Then the claim is evaluated in light of the property damage exclusions, an exercise that will eventually confirm or eliminate coverage. Nevertheless, the steppingstone to the exclusions is the definition of property damage.

One of the most recent cases to engage in an in-depth analysis of property damage versus economic loss in the context of CGL coverage for defective work is *Travelers Insurance Co. v. Eljer Manufacturing, Inc.*, 757 N.E. 2d 481 (Ill. 2001). In that case, the insured manufacturer of the Qest polybutylene plumbing system sought coverage for the costs of replacing leaky plumbing systems, including plumbing systems installed in homes where the systems were replaced prior to the development of an actual leak. The damages sought against the insured manufacturer were the costs of replacing the system and diminution in value of the homes.

The court determined that “tangible property suffers a ‘physical injury’ when the property is altered in appearance, shape, color or another material dimension,” and went on to state as follows:

Conversely, to the average mind, tangible property does not experience ‘physical injury’ if that property suffers intangible damage, such as diminution in value as a result of a failure of a component, such as the Qest System to function as promised.

Based upon the upon the standard CGL definition of “physical injury,” the Illinois Supreme Court concluded that the mere installation of the Qest plumbing system, without some physical injury to the home itself, did not constitute an “alteration in appearance, shape, color or other material dimension” and, thus, did not constitute property damage.

The *Eljer* court also concluded that economic losses do not involve property damage, holding that coverage is not triggered by purely economic losses. Absent physical injury to tangible property, economic losses such as damages for inadequate value, costs of repair or replacement, and diminution in value that result from a product’s inferior quality or its failure to perform for the general purposes for which it was manufactured and sold are not covered.

### **The Economic Loss Rule**

Obviously, cases that address mere economic loss are of limited utility as applied to claims involving occurrences of physical injury to tangible property, as is the case with many defective work claims. As a result, an argument has emerged that seeks to meld concepts from economic loss cases with an additional argument in order to deny coverage for claims involving physical injury to tangible property without the necessity of resorting to the policy exclusions and in the process risk a finding of coverage. This argument borrows from an unlikely source B the Economic Loss Rule.

The economic loss rule provides that a cause of action for negligence is not available when the only loss or damage is to the subject matter of the contract. In that case, the plaintiff’s action is ordinarily limited to one in contract. In other words, in determining whether to apply the rule, the court determines whether the cause of action is in contract or tort, and when the loss is to only subject matter of the contract itself, the action stands in contract alone. However, an exception to the economic loss rule exists where the conduct of the wrongdoer causes damage to property other than the subject matter of the work itself.

While the economic loss rule developed as an offshoot of products liability law, its utility in the construction context is obvious. Construction work is performed pursuant to contracts, and construction claims involving construction failures, including defective workmanship, are prosecuted under various theories, including breach of contract, breach of warranty, and negligence. Again, where the defective construction involves the work contracted for under the construction contract, the possibility of an economic loss defense exists, particularly where no damage in third party property has occurred. In construction litigation, motions for summary judgment based upon the economic loss rule are commonplace, and are sometimes granted, thus eliminating the negligence cause of action, a tort cause of action perhaps giving rise to more remote damages that are not recoverable under a breach of contract theory.

### **The Economic Loss Rule and Insurance Coverage**

It must be kept in mind that the economic loss rule is a *liability* defense; it is not necessarily dispositive of insurance coverage. Nevertheless, insurers will frequently state the position that once the economic loss rule has eliminated the negligence cause of action, it no longer owes a duty to defend and indemnify an insured contractor as to the remaining breach of contract cause of action.<sup>6</sup>

Moreover, of late, the economic loss rule has been offered up in support of the argument that damage to a project arising out of the insured contractor's defective work is an economic loss due to the applicability of the economic loss rule.

Particularly, in the case of a general contractor or homebuilder, the entire project or home may constitute the "subject matter" of the contract with the owner. Taken to its illogical extreme, application of the economic loss rule dictates that since damage to the subject matter of the contract is economic loss, *ergo*, it cannot be property damage covered under the CGL policy. Once again, this argument ignores the remainder of the policy, including the property damage exclusions which carve out coverage for elements of the work which is the subject matter of the contract, particularly after the application of Exclusions (j) and (l). Of course, it goes without saying that the CGL policy makes no reference to the economic loss rule and the applicability of that rule to insurance coverage ignores the definition of property damage, i.e. physical injury to tangible property, or loss of use of tangible property that has not been physically injured.

Obviously, "physical injury to tangible property" can occur to a construction project, the subject matter of the contract between the insured contractor and the owner. For example, consider a project that is subject to water infiltration due to defective installation of the windows and exterior cladding. Water infiltrates the building and causes damage to interior finishes, rotting of the wooden

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<sup>6</sup> This position is sometimes based upon the questionable notion that a CGL policy provides coverage only for tort damages, and not breach of contract. Coverage does not necessarily depend upon the assertion of a cause of action for negligence versus breach of contract, but rather, whether the claim involves an occurrence of property damage, as those terms are defined in the policy.

structural members, and causes mold. Obviously, there has been “physical injury to tangible property,” the building, but at the same time, that building is the subject matter of the contract between the contractor and the owner. At that point, there has clearly been an “occurrence” of “property damage” as those terms are defined in the policy, and resort must be had to the property damage exclusions to determine the scope of coverage. If the contractor constructed the project using subcontractors, there is likely a considerable amount of insurance coverage available.

The economic loss rule analysis has been steadily creeping into coverage litigation over defective construction. For example, in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 335 F.Supp.2d 754 (W.D.Tex. 2004), *appeal pending*, the insurer relied upon an economic loss rule analysis to support its contention that its policy did not provide coverage to a homebuilder for allegations of defective construction of a home resulting in foundation failure and associated damages to the structure and finishes. The court stated that though the acts of a party may breach duties simultaneously in tort and contract, the nature of the injury determines which duty is breached. Where the injury is only the economic loss to the subject of the contract itself, the action sounds in contract alone. Economic loss encompasses damage based on the “loss of bargain,” the difference between the value of what is received and its value as represented. Direct economic loss also may be measured by costs of replacement and repair.

As to insurance coverage for that economic loss, the court went on to hold that something other than pure economic damage must be sought by the underlying claimant in order to trigger obligations under a commercial general liability insurance policy. The court reached this conclusion with no consideration whatsoever of the exclusions in the policy, including the Your Work Exclusion or the Impaired Property Exclusion, the exclusions that are necessary to determine whether particular property damage is covered. In *Lamar Homes*, the contractor neither expected nor intended that its subcontractors would cause the defects in the foundation, and those defects caused physical injury to tangible property, i.e. the home. The true coverage issue was the applicability of the subcontractor exception. The exception should have been applied to preserve coverage. The *Lamar Homes v. Mid-Continent* case is currently on appeal to the Fifth Circuit and has generated several *amicus* briefs by construction industry groups.

As expected, other courts that have carefully considered this issue have rejected the notion that a liability defense such as the economic loss rule can control insurance coverage in the absence of express policy language to that effect. A similar argument was made in *American Family Mutual v. American Girl, supra*, and the Wisconsin Supreme Court resoundingly rejected it. In the process, the court called into question the sinking, buckling, and cracking of a foundation as the result of soil settlement was subject to the economic loss rule, and was not “physical injury to tangible property.” The Wisconsin Supreme Court stated that even though the economic loss doctrine restricted the owner’s recovery to specific warranties in the construction contract, there was no basis for the insurer’s argument that a loss giving rise to a breach of contract or warranty claim could never categorically constitute “property damage” within the meaning of the CGL policy’s coverage grant. The court determined that, under the circumstances of an occurrence of physical injury to tangible

property, the CGL insuring agreement provided coverage for the claim, a claim for “property damage” within the meaning of the policy. The court stated:

The economic loss doctrine operates to restrict contracting parties to contract rather than tort remedies for recovery of economic losses associated with the special contract relationship. The economic loss doctrine is a remedies principle. It determines how a loss can be recovered B in tort or in contract/warranty law. It does not determine whether an insurance policy covers a claim, which depends instead upon the policy language.

The economic loss doctrine may indeed preclude tort recovery here (the underlying claim is in arbitration not before us); regardless, everyone agrees that the loss remains actionable in contract, pursuant to specific warranties in the construction agreement between Pleasant [the owner] and Renschler [the insured contractor]. To the extent that American Family [the insurer] is arguing categorically that a loss giving rise to a breach of contract or warranty claim can *never* constitute ‘property damage’ within the meaning of the CGL’s coverage grant, we disagree.

Thus, the theory of recovery against the insured is not dispositive of whether there has been an “occurrence” of “property damage” as defined in the policy.

Another example is *Commercial Union Ins. Co. v. Roxborough Village Joint Venture*, 944 F.Supp. 827 (D.Colo. 1996), in which the court also rejected the economic loss analysis. In that case, Pulte, the homebuilder, sued Roxborough, the developer, due to its negligent installation and maintenance of utilities and misrepresentation and concealment of conditions making the land unsuitable for construction. Roxborough raised the economic loss rule as a defense to Pulte’s claim.

In refusing to apply the economic loss rule, the court held that while the rule prevents recovery in tort where the duty breached is a contractual duty and the harm incurred is the failure of the purpose of the contract, the rule is not absolute, and its application is limited to cases involving economic loss only. As to the allegations of Pulte against Roxborough, the court held that the claims involved allegations of intentional misconduct on the part of Roxborough and breaches of duties of care independent of contractual obligations. Therefore, the economic loss rule did not apply.

As far as the reliance by Commercial Union, the insurer, upon the economic loss rule, the court stated as follows:

I find the use of the rule in the insurance context troublesome generally and specifically question its applicability in this case. As an initial matter, Commercial Union’s argument that it owed Roxborough no indemnification duty under the Policies because Pulte’s claims Roxborough settled sounded in contract, rather than tort, is a novel one.

Commercial Union cites no case in which an insurer invoked the rule in this manner and I find no reasoned basis for doing so.

The court added the following:

In essence, Commercial Union argues application of the economic loss rule to ‘protect’ the contractual relationship between Pulte and Roxborough. Citing *Adventura*, Commercial Union argues that a characterization of Pulte’s claims in the Underlying Case as sounding in tort will ‘undermine’ the Pulte-Roxborough relationship and ‘frustrate’ the ability of commercial entities like them to allocate the risk of pecuniary loss. [Citation to Pulte’s brief omitted.] Commercial Union’s use of the economic loss rule in this manner is strained and self-serving.

As the Roxborough court observed, the applicability of an economic loss rule analysis to coverage under a CGL policy for defective work impermissibly mixes liability and coverage concepts. Quite predictably, this “strained and self-serving analysis” invites the parties, and the courts, to ignore the remainder of the policy, that is, the property damage exclusions, where the complete coverage analysis is intended to be played out. That analysis may result in coverage for property damage to and arising out of defective work.

### Conclusion

At first blush, the disparate results between cases such as *Gehan Homes*, *American Girl* and *Wanzek*, as opposed to *Jim Johnson*, *Lamar Homes*, *L-J* and *Groves*, is surprising, possibly disturbing. After all, these courts are all considering and applying CGL policies on standard forms promulgated by ISO. Such cases span the full gamut of construction defect claims, from single family homes to subdivision-wide residential to large scale commercial office, retail, and industrial to road construction projects. Despite similar fact patterns, results are so divergent that they are impossible to reconcile, and even an explanation is difficult to achieve. However, the single thread that winds throughout many of them is the diversion of the court’s attention from the policy as a whole, overemphasizing the definition of occurrence and economic loss over the property damage exclusions that serve to limit the business risk doctrine. That failure to consider the entire policy cannot be squared with either the intent of the drafters or the rules of insurance policy interpretation applied by the courts. As such, this truncated analysis is misguided.

If this occurrence and economic loss analysis is followed, truncating the coverage and cutting the policy off at the knees, there is no need for the restrictive endorsements recently promulgated by ISO to eliminate the coverage preserved by the subcontractor exception. No defective work will constitute an occurrence or property damage and the insuring agreement of the CGL policy will not be satisfied, eliminating the need to consider the property damage exclusions and their limitations on the business risk doctrine.

## ***Notes***

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