

Workshop T4

Tuesday, October 10, 1:30-3:00 p.m. and 3:30-5:00 p.m.

DEFECTIVE WORK AND THE CGL POLICY

"Application of the Business Risk Exclusions: A Survey of Recent Case Law"

Presented by



**Linda B. Foster
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Over the past 2 decades, the incidence of construction defect claims has soared. Litigation between contractors and their CGL insurers over coverage for these claims has also spiked, sometimes resulting in dramatically different interpretations of policy language. While contractors bemoan the attachment of various exclusionary endorsements, the more heated issues arise over interpretations of language in the basic CGL policy. This session reviews the history of construction defect coverage and the positions being taken on both sides of the controversy.

- Presents trends in construction defect coverage, claims, and litigation.
- Demonstrates the radically different conclusions courts have reached on standard CGL policy language.
- Outlines arguments for and against coverage over issues such as the definition of "occurrence" and the business risk doctrine.

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Ms. Foster is cospeaker for Workshop T4, "Defective Work and the CGL Policy," on Tuesday. She is a shareholder with Weissman, Nowack, Curry & Wilco, P.C., in Atlanta, where she focuses her practice on insurance coverage, extra-contractual liability, and agent and broker liability. She is a frequent author and speaker on her areas of practice and is a member of the American Bar Association, the Georgia State Bar, and Defense Research Institute. Ms. Foster is co-chair of the Insurance Coverage Litigation Committee of the Section of Litigation of the ABA and was co-chair for the Midyear Meeting in March 2004. Ms. Foster received her B.S. *summa cum laude* from Ball State University and her J.D. *cum laude* from Indiana University School of Law, Bloomington.

Notes

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DEFECTIVE WORK AND THE CGL POLICY

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For the past several years, contractors have seen their coverage for damage arising out of construction defects eroding due to changes in the policy language and changes in the way courts are interpreting the language. While contractors bemoan the loss of coverage from exclusionary endorsements, the more heated issues arise over the interpretations of language in the basic CGL policy. This session reviews the history of this coverage and the positions being taken on both sides of this controversial coverage issue.

- Presents trends in construction defect coverage, claims, and litigation.
- Demonstrates the radically different conclusions courts have reached on standard CGL policy language.
- Outlines arguments for and against coverage over issues such as the definition of occurrence and the business risk doctrine.

I. Overview of Broad Form Property Damage Coverage

- A. Purpose and intent behind the coverage
- B. Evolution of the coverage from the 1973 ISO forms to the present

II. The “Occurrence” Definition

- A. Is defective construction an “occurrence”?
- B. Comparison of recent cases reaching differing results
- C. Necessity of property damage beyond the work?

III. The Economic Loss Doctrine and the Definition of “Property Damage”

- A. Property damage as economic loss argument
- B. Liability defense versus coverage defense

IV. The Incorporation Doctrine and the Definition of “Property Damage”

- A. Does incorporation of a defective component result in “property damage” to the larger structure?
- B. Comparison of recent cases reaching differing results

V. Exclusion L: Damage to “Your Work”

- A. Does Exclusion L restore coverage in construction defect claims where the work was performed by a subcontractor?
- B. Comparison of recent cases reaching different results
- C. The Business Risk Doctrine

APPLICATION OF THE BUSINESS RISK EXCLUSIONS: A SURVEY OF RECENT CASE LAW*

**Linda B. Foster
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Introduction

Many people, especially those who do not work with insurance policies everyday (e.g. many judges, policyholders and lawyers), have two misconceptions about general liability policies. First, they incorrectly believe that the insuring agreement of a general liability policy is all encompassing in its scope. Second, they incorrectly believe that if a risk is mentioned in an exclusion that means it was covered by the insuring agreement in the first place.

Neither premise is correct. First, the insuring agreements of most general liability policies are similar and by their very terms are not all encompassing. The insuring agreements typically require that an insured (not just anyone) be legally obligated to pay (not just feel like paying money to maintain good will with other parties) sums as damages (not injunctive relief) because of property damage (not just something that was not done right in the first place) or bodily injury (not just I would like to have medical monitoring because I might develop an illness someday) during the policy period (not just speculation or assumption that there might have been property damage or bodily injury during the policy period) because of an occurrence which is defined as an accident (not faulty workmanship). A wide range of claims is not included within that insuring agreement including, in the judgment of the majority of jurisdictions, claims to repair, replace or redo the work a contractor put into the stream of commerce. If the insured was a framing contractor, claims to repair, replace or redo the framing work, which is what that insured put into the stream of commerce, would not fall within the insuring agreement. Likewise, if the insured was a general contractor, claims to repair, replace or redo the building the general contractor put into the stream of commerce would not fall within the insuring agreement.

The second premise is equally incorrect, but widely held. One of the best examples of the error in the premise is the expected or intended exclusion. Those claims are not covered by the insuring agreement in the first place, but many courts failed to enforce the insuring agreement as written. So, the exclusion seeks to make clear the intent of the scope of the insuring agreement. As another example, consider the auto exclusion. Most would assume that the insuring agreement applies to every claim involving an auto or the exclusion would not be in the policy. However,

*This article is coauthored with Ms. Foster by Steven D. Caley, also of Weissman, Nowack, Curry & Wilco, P.C.

consider a claim asserting that the insured terrorized a claimant by threatening to run over the claimant with his car while revving the engine. Assuming that the policy did not define bodily injury to include mental anguish, that claim would not come within the insuring agreement for a variety of reasons, including that there was no bodily injury within the meaning of the policy and because there was no “occurrence”—no accident—he intended to terrorize the claimant. More than likely, the claim handler, the lawyer addressing the coverage issue and the judge would immediately go to the auto exclusion to deny coverage. However, the claim was not covered in the first place.

These misconceptions about the general liability policy, in combination with general laziness in policy analysis, led to many of the old coverage cases that address construction defect claims skipping over the insuring agreement analysis and referencing the so-called business risk exclusions. Only more recently have courts been encouraged to examine the insuring agreement when addressing these claims, many finding that the claims do not fall within the insuring agreement of the policies. The fact that the earlier courts skipped the first step does not weaken the significance of those decisions finding that general liability policies are not designed to address claims to repair, replace or redo what the insured put into the stream of commerce.

Claims people and insurer counsel will be well-served to free themselves of these misconceptions and to strive to explain the errors in the misconceptions to others. Analysis of every claim should start with whether the claim comes within the insuring agreement. The existence of an applicable exclusion does not excuse the failure to consider whether the claim is covered at all.

The exclusions, however, do have their place. First, there are some jurisdictions that have concluded that general liability policies are performance bonds, so resort to exclusions is required. Secondly, there are instances where a claim will fall within the insuring agreement and all or parts of it are barred by one or more of the exclusions. So, this paper will survey some of the most recent caselaw addressing the so-called business risk exclusions.

Your Work Exclusion

Many courts continue to find that the “your work” exclusion does not preclude coverage for defective construction claims against general contractors who have the work performed by subcontractors due to the subcontractor exception contained in the exclusion. The exception provides that the exclusion does not apply if the work was performed on behalf of the general contractor by a subcontractor. At least one case decided last year, however, applied the “your work” exclusion to exclude coverage.

In *C & I Steel, Inc. v. Zurich N.A.*, 2005 WL 1367814 (Mass. Super. 2005), C & I Steel was awarded a contract to perform structural steel work at an elementary school. C & I

subcontracted the steel erection and welding work to New England Ornamental Metals (“Ornamental”). After the work was allegedly completed, an independent inspector found Ornamental’s work to be defective. When Ornamental refused to correct the defective work, C & I hired a replacement steel erector to make the repairs and then sent a notice of claim to Ornamental’s carriers. C & I also based its claim on its status as an additional insured on the insurance policies issued to Ornamental. When the carriers denied coverage, C & I brought suit for reimbursement for all funds it incurred to make the necessary repairs for Ornamental’s defective work which included repairs to correct “faulty welding of moment connections.”

The court found that it was undisputed that there was physical injury to many of the moment connections which was directly caused by Ornamental’s faulty welding work. Based upon this evidence, the court found that the C & I claim “fits squarely” within the “damage to your work” exclusion. Summary judgment was therefore granted to C & I. It is unclear from the opinion whether the exclusion at issue in the case contained the subcontractor exception that is generally included in the “your work” exclusion.

Another recent case which applied the “your work” exclusion to exclude coverage where the exclusion did contain the subcontractor exception is *Afcon, Inc. v. Ellis-Don Michigan, Inc.*, 2005 WL 415671 (Mich. App. 2005). In that case, Ellis-Don was the general contractor for the construction of a sewer overflow detention basin and treatment facility that was to be constructed on the bank of the Rouge River. To safely perform the required excavation, retaining walls had to be constructed to protect the workers and project from the collapse of surrounding earth. Ellis-Don hired Afcon to build the walls. After the excavation reached a depth of 16 feet, the wall moved. As a result, two dirt berms perpendicular to the wall had to be installed to prop up the wall. In order to gain access to the work area, Ellis-Don had to constantly move the berms until the facility structure was strong enough to allow removal of the retaining wall. Ellis-Don thereby incurred considerable extra expense and also incurred damages resulting from the movement of the wall. Ellis-Don sought recovery from Afcon who then tendered defense of the action to its carrier. Afcon’s carrier denied the tender based, in part, on the “your work” and “your product” exclusions. Ellis-Don subsequently obtained a default judgment and filed a writ of garnishment on Afcon’s carrier. Ellis-Don argued that the business risk exclusions did not apply because the claimed damages were to Ellis-Don’s work area, not to Afcon’s wall.

In analyzing the applicability of the “your work” and “your product” exclusions, the Michigan Court of Appeals found that “[t]he core of the present dispute is whether Ellis-Don’s ‘damages’ constituted ‘property damage’ or whether its ‘damages’ were merely additional costs expended to remedy Afcon’s defective wall. They are the latter.” *Id.* at *3. In finding that Ellis-Don’s damages did not constitute property damage, the court relied on undisputed testimony that the damage was to Ellis-Don’s worksite in having to move the berm that was propping up the wall rather than damage to the wall itself. Although Ellis-Don attempted to save its case by arguing that a crack in the soil constituted “property damage,” the court found that the crack in the soil

was merely a natural consequence that happened as a result of the wall movement and that there was no indication that the value or usefulness of the soil was reduced. The court concluded by stating that the “business risk” exclusions bar coverage under the policy because Ellis-Don’s “damages” were not “property damage” but additional costs associated with rectifying Afcon’s faulty work product. *Id.*

In *Bosak v. H&R Mason Contractors, Inc.*, 2005 WL 3475817 (Ohio App. 2005), Bosak hired H&R Mason to perform masonry work for the foundation and basement of his new house. H&R Mason allegedly failed to install support footers and foundation walls to the specifications of the contract, and Bosak filed suit against both H&R Mason and its insurer. Bosak later dismissed the complaint against the insurer. Bosak then entered into a consent judgment with H&R Mason and subsequently filed a supplemental complaint against the insurer, arguing that the insurer was obligated to indemnify H&R Mason for the consent judgment, alleging that the insurer was obligated to provide indemnification for damages resulting from H&R Mason’s “negligence and/or failure to perform in a workmanlike manner.” The Ohio Court of Appeals held that “your work” exclusion applied. According to the court, “[the insurers] policy was never intended to insure the integrity or quality of H&R Mason’s work.” *Id.* at *6. The Ohio Court of Appeals did note the “subcontractor exception” to the “your work” exclusion; however the court noted that Bosak did not allege that subcontractors perform work on behalf of H&R Mason.

Additionally, in the past year, courts have continued to reject the notion that the subcontractor exception to the “your work” exclusion creates or “restores” coverage that does not otherwise exist under a CGL policy. For example, in *American Home Assurance Co. v. AGM Marine Contractors, Inc.*, 379 F.Supp.2d. 134 (D. Mass. 2005), AGM brought a declaratory judgment action seeking coverage for claims relating to physical damage to concrete floating docks installed by AGM. Before addressing the “your work” exclusion, the court analyzed whether the claim alleged an occurrence under the liability policy at issue. The court found that it was undisputed that only the floating docks themselves sustained property damage and that this damage resulted from faulty workmanship. The court then noted that “[m]ost policies of commercial general liability insurance exclude the insured’s faulty workmanship from coverage. The rationale for such exclusions is that faulty workmanship is not an insurable ‘fortuitous event,’ but a business risk to be borne by the insured. [citations omitted] Massachusetts courts have adopted this rationale and held that faulty workmanship fails to constitute an accidental occurrence in a commercial general liability policy.” *Id.* at 136. The court then went on to hold that “...faulty workmanship...does not constitute an occurrence and, therefore, there is no coverage under the policy.”

Next, the court addressed the insured’s argument that the subcontractor exception to the “your work” exclusion created coverage. In rejecting this argument, the court held as follows: “Even if the Court were to accept respondent’s argument that the faulty workmanship was performed by a subcontractor, this argument would prove, at most, that the ‘Assured’s work’

exclusion is inapplicable. The subcontractor exception to the ‘Assured’s work’ exclusion cannot create coverage where—because of the absence of an ‘occurrence’—none exists.” *Id.* at 137-38.

To similar effect is a recent decision from the United States District Court for the Eastern District of Arkansas, *Nabholz Constr. Corp. v. St. Paul Fire & Marine Ins. Co.*, 354 F.Supp.2d 917 (E.D. Ark. 2005). In that case, a general contractor, Century Builders, contracted for the construction of a new worship facility and subcontracted with CONARK (Nabholz d/b/a CONARK) to construct the facility’s metal building. In turn, CONARK entered into a subcontract with Global to provide all labor and equipment for the erection of the metal building, which was pre-engineered including a standing seam roof. After the project was completed, the roof began to leak. The owner demanded that Century replace the roof, and Century advised CONARK of this claim. After CONARK reported the claim to St. Paul, St. Paul retained an engineering firm who advised that the roof was incorrectly installed. After CONARK settled the claim with Century, it sought coverage from its carrier.

The St. Paul policy provided coverage for an “event” similar to occurrence-based policies. The engineering firm that inspected the roof and found that it was improperly installed found no damage to other parts of the building other than some stained ceiling tiles, and possible damage from water leaking into the perimeter wall cavities and/or behind the EIFS. St. Paul did not dispute coverage for the minimal damage of stained ceiling tiles and possible damage caused by water leaking into the perimeter wall cavities or behind the EIFS but denied coverage for the replacement of the roof. In rejecting CONARK’s coverage claim, the federal court held that “...a contractor’s obligation to repair or replace its subcontractor’s defective workmanship should not be deemed ‘unexpected’ on the part of the contractor, and therefore, fails to constitute an ‘event’ for which coverage exists.” *Id.* at 921. The court went on to state as follows:

This Court predicts that the Arkansas Supreme Court would elect to join the ‘majority of courts in jurisdictions throughout the country which have concluded that defective workmanship does not constitute an ‘occurrence’ on policies such as the one here.’”
[citations omitted]

Id. at 922.

In finding that defective workmanship does not constitute an occurrence or an “event,” the court noted the distinction between a CGL policy and performance bonds as follows:

The Court is further persuaded by the distinctions between CGL policies and performance bonds. The purpose of a CGL policy is to protect an insured from bearing financial responsibility for unexpected and accidental damage to people or property. It is not

intended to substitute for a contractor's performance bond, the purpose of which is to insure the contractor against claims for the cost of repair or replacement of faulty work. CONARK might have elected to purchase a performance bond to protect it from the known business risk that its subcontractor would not perform its contractual duties. That CONARK has no remedy for its subcontractor's default under its CGL Policy is neither troublesome nor unexpected given the nature of the risks involved.

Id.

After finding that defective workmanship does not constitute an occurrence or an "event," the court rejected CONARK's argument that coverage exists based upon the subcontractor exception to the "your work" exclusion. In rejecting this argument, the court held as follows:

Because the Court's finding is based upon its conclusion that coverage is lacking under the basic insuring clause, it is unnecessary to consider this exclusion. An exception to an exclusion cannot create or extend coverage where none exists under the terms of the policy's basic insuring agreement.

Id. at 923. Several other courts also have reached this conclusion. See *ACS Constr. Co., Inc. of Mississippi v. CGU*, 332 F.3d 885 (5th Cir. 2003); *Auto Owners Ins. Co. v. Travelers Cas. and Sur. Co.*, 227 F.Supp.2d 1248 (M.D. Fla. 2002); *Homeowners Warranty Corp. v. Hanover Ins. Co.*, 683 So.2d 527 (Fla. 3d D.C.A. 1996); *Lassister Constr. Co. v. American States Ins. Co.*, 699 So.2d 768 (Fla. 4th D.C.A. 1997); *Hawkeye Security Ins. Co. v. Davis*, 6 S.W.3d 419 (Mo. App. 1999); *R.N. Thompson & Assoc., Inc. v. Monroe Guar. Ins. Co.*, 686 N.E.2d 160 (Ind. App. 1997); see also *Nationwide Ins. Co. v. Phelps*, No. 03 CO 23 (Ohio App. 2004).

Your Product and Your Work Exclusions

The "your product" exclusion was addressed in *McMath Constr. Co., Inc. v. Dupuy*, 897 So.2d 677 (La. App. 1st Cir. 2004), *writ denied*, 896 So.2d 40 (2005). In that case, McMath was the general contractor on a condominium complex and hired Dupuy to install the stucco EIFS system. After Dupuy completed his work, the building leaked around the doors and windows allegedly because Dupuy's workers failed to apply backer rods to 90 percent of the openings around the windows and doors before caulking and finishing them with stucco. After Dupuy attempted and failed to fix the leaks, McMath hired another company who completed the necessary repairs. When McMath realized initially that the building was not waterproofed, he held off on finishing the interiors so that there was no damage to the condominium units as a result of the leaks.

In analyzing the “your product” and “your work” exclusions, the court found that “[t]hese exclusions reflect the intent of the insurance industry to avoid the possibility that coverage under a commercial general liability policy will be used to repair and replace the insured’s defective products and faulty workmanship.” [citations omitted] Consistent jurisprudence interpreting commercial general liability policies holds that these exceptions unambiguously exclude coverage for damage to the work or product itself or for repair or replacement of the insured’s defective work or product. This is based on the principle that the general liability policies are not intended to serve as performance bonds. [citations omitted] The jurisprudence has further interpreted these provisions to exclude consequential damages directly resulting from defective workmanship, such as damages for repair costs.” *Id.* at 682-83.

In this particular case, the court then went on to hold that the evidence presented showed there was no physical damage to the condominium units, but only to Dupuy’s work or product. As such, the “your work” and “your product” exceptions eliminated coverage that otherwise might have been provided under the policy.

Additionally, in so holding, the court rejected the insured’s argument that because Dupuy’s materials became incorporated into real property, the product exclusion did not apply. The “your product” exclusion at issue in the case specifically defined “your product” as “goods or products, other than real property....” The court rejected the insured’s argument “...because the clear import of the exception is to remove only real property itself from the definition of ‘your product.’ Had the exception meant to remove materials incorporated into real property from the definition of ‘your product,’ it would have said so.” *Id.* at 683. Thus, the court found that under the plain meaning of the exclusion, coverage was eliminated.

Similarly, in a case already described previously, *American Home Assurance Co. v. AGM Marine Contractors, Inc.*, 379 F.Supp.2d 134 (D. Mass. 2005), the court held that claims relating to physical damage to concrete floating docks installed by the insured were barred by the “your product” exclusion which specifically excluded “‘property damage’ to the Assured’s product arising out of it or any part of it and where the ‘Assured’s product’ was defined as ‘any goods or products other than real property manufactured, sold, handled, distributed, or disposed of by...the Assured.’” *Id.* at 138. The court found that the assured’s product definition applied to the floating docks because they were “handled” by the insured. *Id.*

Another good example of the application of the “your product” exclusion to deny coverage is the case of *Transcontinental Ins. Co. v. RTW Industries, Inc.*, 2004 WL 1638221 (S.D. Ind. 2004). RTW agreed to provide all material and labor to fabricate, blast clean, and shop paint work platforms in order to perform maintenance on aircraft. After completion of construction, the platform partially collapsed due to faulty welds and other deficient work. The owner of the facility sued the general contractor who then sued RTW. RTW’s carrier denied coverage based, in part, on the “your work” and “your product” exclusions. The court chose to decide the case solely

on those exclusions and did not address the insuring agreement arguments, although its conclusion that the damage was solely to what RTW put into the stream of commerce would have resulted in no coverage under the insuring agreement itself.

In any event, the parties disputed the scope of RTW's work and product. RTW contended that the welds were the work and product whereas the carrier contended that the entire platform was the work and product of RTW. The court agreed with the carrier:

The parties seem to dispute the scope of RTW's "work product" with respect to the damages at issue in *AGSE v. United Airlines*. But, AGSE admitted that RTW contracted to provide "all material and labor, to fabricate, blast clean and shop paint the work platforms in accordance with the specifications and drawings provided by AGSE...." [citation omitted] Moreover, AGSE admitted that "[t]he consulting fees and disruption damages claimed by United Airlines against AGSE resulted from the partial collapse, inspection, and repairs to the platforms." [citation omitted] The scope of RTW's work then, was the platforms themselves, not just the welds as AGSE argues.

Based on this finding, from the language of the CGL policy between Transcontinental and RTW, the damages are not covered because the only damage alleged was to the platforms themselves, or in other words, the only damage alleged is damage to RTW's "work" or RTW's "product." The CGL defines "Your product" as "[a]ny goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by: (1) You...." Policy Sec. V, ¶ 18a. Moreover, the CGL defines "Your work" as "a. Work ... performed by you ... and b. Materials, parts or equipment furnished in connection with such work...." *Id.* Sec. V, ¶ 19. Therefore, at least two of the CGL policy exclusions apply.

Id. at *6.

Contrasted with the above decisions is the case of *Scottsdale Ins. Co. v. Tri-State Ins. Co. of Minnesota*, 302 F.Supp.2d 1100 (D.N.D. 2004). In *Scottsdale*, the court was also asked to consider the application of the "your product" exclusion. The insured, Commercial Group West ("CGW"), manufactured and erected modular buildings. Each modular unit was custom designed and complete from floor to ceiling. When completed, the tops of the modular units were covered by reinforced plastic and transported to a construction site for assembly on the foundation

provided by CGW. Once the modular units were assembled, the plastic covers were removed and a roof was built over the resulting structure.

CGW contracted with Lake Metigoshe Properties to construct the modular units and transport them to a site to be assembled to form a motel. CGW subcontracted with another contractor to set the individual modules on a foundation and to install the roof. As work on the roof began, the plastic covering was removed from part of the modules. A severe rain storm caused the plastic covering on the remaining unroofed modular units to rupture, and those units sustained substantial damage.

CGW argued against application of the “your product” exclusion on the ground that the modular units had been affixed to real property at the time of the loss and constituted real property, which is an exception to the exclusionary clause. The court agreed, finding that North Dakota law expressly provided that real property consists of land and items affixed to the land. At the time of the loss, the evidence showed that the modular units were attached or affixed to the foundation prior to the time that they sustained water damage. As a result, the North Dakota court concluded that the modular units were real property, which was an exception to the “your product” exclusion.

Performing Operations Exclusions

The performing operations exclusions are customarily contained at j.5 and j.6 or k.5 and k.6 of the ISO forms. Exclusion j.5 typically provides that “property damage” is excluded to “that particular part of real property in which you or any contractor or subcontractor working directly or indirectly on your behalf is performing operations, if the ‘property damage’ arises out of those operations.” Exclusion j.6 typically excludes “property damage” to “that particular part of any property that must be restored, repaired or replaced” because “your work” was incorrectly performed on it. Exclusion j.6 does not apply to “property damage” included in the “products-completed operations hazard.” Thus, exclusion j.6 essentially provides that property damage, which occurs after the work is complete, is not excluded by that exclusion.

In *Farmington Cas. Co. v. Duggan*, 417 F.3d 1141 (10th Cir. 2005), the owner, Duggan, contracted with Schubert as the general contractor to construct an office building. Schubert subcontracted with Masonry Designs to construct the masonry block walls. Before the office building was complete, the masonry block walls came tumbling down in a high wind. An arbitrator determined that the walls collapsed due to the negligence of Masonry Designs who allowed the supportive braces to be removed prematurely and who performed substandard masonry work. At the outset, the court acknowledged that “[t]he purpose of a commercial general liability policy is to protect the insured from liability for damages when his own defective work or product damages someone else’s property. [citations omitted] Damage to an insured’s own work resulting from his faulty workmanship on it is usually covered by a performance bond, not a

commercial general liability policy.” *Id.* at 1142. In so holding, the court cited several cases which held that “finding the breach of a business contract to be a covered occurrence would distort the purpose of liability insurance policies;” “an insurer does not, by its contract of liability insurance, become a guarantor of perfect performance;” and “most policies of commercial general liability insurance exclude the insured’s faulty workmanship from coverage. The rationale for such exclusions is the faulty workmanship is not an insurable ‘fortuitous event,’ but a business risk to be borne by the insured.” *Id.*

As other courts have done, despite the above-quoted language, the court did not specifically deny coverage based on the lack of an occurrence, but instead proceeded immediately to the performing operations exclusion at j.6. *Id.* at 1143. After setting forth the specific language of exclusion j.6, the court noted that portion of the definition for the products completed operations hazard which was an exception to exclusion j.6 and which provided that work is completed “when all of the work called for in your contract has been completed.” The contract between Schubert and Masonry required that Masonry not only build the masonry block walls, but also clean the walls with a light acid solution. The undisputed facts established that only one-third of the acid washing had been completed when the walls fell.

In discounting exclusion j.6, the lower court offered two justifications. First, the court identified a potential ambiguity in the definition of “your work” as that term was contained in the products-completed operations hazard. The district court found that the definition of “your work” is not restricted to work called for in the contract but includes materials, parts or equipment furnished in connection with such work. On the other hand, “your work” is deemed completed when the work called for in the contract is complete. The district court concluded that the intersection of these two provisions created an ambiguity which had to be construed against the insurer in favor of coverage. Second, the district court determined that the work called for in the contract was mostly complete when the walls fell and that “mostly complete” was good enough to fall within the products-completed operations hazard.

The Tenth Circuit rejected both of these justifications. The Tenth Circuit ruled that the fact that the policy sometimes restricts the definition of “your work” to the work called for in the contract and sometimes defines “your work” more broadly to include materials, parts, or equipment furnished in connection with the contractual work made no difference with respect to the acid washing that was not completed under the contract. Thus, even if the narrower definition of work was adopted (namely, the work specified in the contract), Masonry would still lose. Second, the Tenth Circuit rejected the district court’s adoption of a substantial completeness test. As stated by the court, “a provision that applies when all the work is completed applies only when *all* the work has been completed: ‘the plain language of the products-completed operations hazard provision belies the assertion’ that the provision can operate when only part of the work is completed.” *Id.* at 1144 (emphasis in original). Therefore, the Tenth Circuit held that exclusion j.6 excluded coverage.

In *Advantage Home Building, LLC v. Assurance Co. of America*, 2005 WL 850992 (D. Kan. 2005), Advantage Home Building, Inc. contracted with various individuals to construct several homes. Subsequently, the homeowners sued Advantage to recover for damages to the windows in their homes. The homeowners alleged that Advantage had failed to install the windows in a workmanlike manner without material defects or damage and that when they took possession of their homes, a number of the windows were scratched. The trial court found that the windows had sustained damage during construction when McGarrah Masonry, a subcontractor of Advantage, dropped mortar and bricks on them.

The insurer argued that it had no duty to defend because exclusions j.5 and j.6 excluded liability. Advantage argued that the exclusions did not apply because the claims for the damaged windows arose after the homes were completed and not while Advantage was working on the homes. The court found, however, that this distinction was immaterial. Rather, under exclusion j.5, the question is whether McGarrah Masonry was performing its work when the damage occurred. *Id.* at *3. The critical fact in this case was that the property damage occurred concurrently with the negligent acts of the Advantage subcontractor. In other words, the windows were scratched when the subcontractor dropped mortar on them and the work was in progress when the subcontractor damaged the windows. *Id.* at *4. As a result, exclusion j.5 applied, and there was no coverage. Similarly, exclusion j.6 also applied because the damage occurred before Advantage completed its work. Therefore, the products-completed operations hazard exception to exclusion j.6 did not apply.

Acceptance Ins. Co. v. Ross Contractors, Inc., 2005 WL 1870688 (Minn. App. 2005), is a good example of the application of the performing operations exclusions where some work was complete and some work was not complete. In that case, Ross agreed to replace a roof by installing a new roof over the existing roof for Nolan. Dwayne Jones, whose employment status was disputed by the parties with respect to whether he was an employee of Ross or a subcontractor, performed most of the work on the roof. While the roof was being constructed, the old roof leaked causing damage. Ultimately, the new roof was completed and additional leaks were discovered. The roof ultimately had to be replaced due to the defective construction. In the underlying case, a jury awarded damages for leaks for the old roof that occurred during construction as well as damages for the costs of repair and replacement of the roof and other damages.

In addressing the performing operations exclusions, the court held that those exclusions apply only to damage that occurred while the defendant was working on the property of the plaintiff. Therefore, the damages caused by leaks to the old roof during construction were excluded by exclusion j.5. *Id.* at *4. However, because there was a factual question as to whether the additional damages took place during construction, that issue was remanded for trial.

In *Grinnell Mut. Reinsurance Co. v. Lynne*, 686 N.W.2d 118 (N.D. 2004), Lynne orally contracted with Larson to construct a new foundation for a farmhouse. The process involved

lifting the house from its foundation and supporting it with iron timbers while a new foundation was constructed under the house. After Lynne removed the existing foundation and constructed footings, he hired a subcontractor, Dena Karna, to place concrete blocks on top of the footings. In doing so, they determined that the house would have to be raised another eight inches in order for the basement walls to be sufficiently accommodated. While Lynne was in the process of raising the house, the iron timbers rolled over and the house fell off the support jacks and into the basement.

Karna brought an action against Larson and Lynn for payment for work performed, and Larson filed a cross-claim against Lynne seeking to recover expenses incurred in connection with the removal and replacement of the house. Lynne then submitted the claim to its carrier who agreed to defend under a reservation of rights but denied coverage.

In another classic case of failing to first analyze the insuring agreement with respect to whether there was an occurrence and property damage, the North Dakota Supreme Court immediately considered the performing operations exclusions at j.5 and j.6. Lynne first attempted to argue that the damage was caused by high winds, an act of God, rather than faulty work. The court found, however, that there was no sufficient evidence to support this argument. The court then turned to an analysis of the performing operations exclusions which it noted were generally known as business risk exclusions. At the outset, the court recognized that “the purpose of these provisions is to prevent policy holders from converting liability insurance into protection from foreseeable business risks. [citations omitted] Insurance companies theorize that a business risk, such as costs resulting from improper performance of contract, should be built into the price of the product. Business risk exclusions are intended to provide coverage for tort liability, but not for contract liability of the insured for loss because the product or completed work was not that for which the other party had bargained.” *Id.* at 123-24. The court further noted that “[a] commercial liability insurance policy is not meant to act as a warranty of the insured’s work.” *Id.* at 124. In so holding, the court quoted extensively from cases in other jurisdictions which have held as follows:

The exclusions from coverage for property damage contained in paragraphs j, m, and n and other similar exclusions in the CGL policy are generally referred to as “business risk” exclusions, and are designed to exclude coverage for defective workmanship by the insured causing damage to the project itself. [citations omitted] The principle behind such exclusions is based on the distinction made between two kinds of risks incurred by a contractor....The first is the business risk borne by the contractor to replace or repair defective work to make the building project conform to the agreed contractual requirements. This type of risk is not covered by the CGL policy and the ‘business risk’ exclusions in the policy make this clear. [citations omitted] The second is the risk that the

defective or faulty workmanship will cause injury to people or damage to other property. Because of the potentially limitless liability associated with this risk, it is the type for which CGL coverage is contemplated. [citations omitted]

Id.

In turning specifically to the performing operations exclusions at issue in the case before it, the North Dakota Supreme Court found that all of the work called for in the contract with Lynne had not been completed at the time the house fell into the basement. Accordingly, the court found that the exception to exclusion j.6 did not operate to provide coverage. Similarly, coverage was denied under exclusion j.5. *Id.* at 126-27.

In *Fortney & Wygandt, Inc. v. American Manufacturer's Mut. Ins. Co.*, 2005 WL 1566744 (N.D. Ohio 2005), the court made an interesting distinction between the requirements of the two performing operations exclusions commonly found at j.5 and j.6 in the ISO forms. In that case, Fortney contracted with Frisch's Restaurant to build a Golden Coral restaurant and subcontracted the foundation of the restaurant to F.J. Shirack and J. Goss Concrete, Inc. After the foundation was completed, soil around the foundation shifted and the underground utility lines attached to the foundation broke and disconnected from the structure. After an inspection of the foundation, the owner of the restaurant concluded that the foundation was improperly designed and defectively constructed and, as a result, the owner demolished and rebuilt the restaurant. Although other arguments were presented in the case with respect to whether the defective work was covered under the CGL policy issued to Fortney, with respect to the performing operations exclusions, the court found that exclusion j.5 did not apply but that j.6 did apply.

The j.5 exclusion in the policy barred coverage for "property damage" to "that particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the property damage arises out of those operations." The carrier argued that exclusion j.5 barred coverage because the clause "are performing operations" prohibited coverage if Fortney was still working on the restaurant. In rejecting this argument, the court adopted the insured's argument that the exclusion should not apply because the foundation was completed when the defects surfaced. The court found that the foundation (the "particular part") must be viewed separately from the remainder of the building and that the allegations in the underlying complaint alleged that the damage arose after the foundation system was installed. Because the damages arose out of the defective foundation, which was completed prior to the property damage arising, the exclusion did not apply.

On the other hand, with respect to exclusion j.6, the court relied on language in that exclusion referencing the insured's work. Exclusion j.6 excluded from coverage any property damage to "that particular part of any property that must be restored, repaired or replaced because

‘your work’ was incorrectly performed on it.” Exclusion j.6 also contained an exception—the products completed operations hazard. That exception essentially provided that if the work was complete, the exclusion did not apply. In applying exclusion j.6, the court determined that, as the general contractor, all of the work on the restaurant was Fortney’s work. Therefore, any work that was incorrectly performed on the restaurant constituted Fortney’s work. Because the entire restaurant, which was the subject of Fortney’s contract was not complete and the restaurant had to be repaired or replaced because of deficient work on the foundation, exclusion j.6 barred coverage. *Id.* at *6.

In *Mid-Continent Cas. Co. v. Camaley Energy Co., Inc.*, 364 F. Supp. 2d 600 (N.D. Tex. 2005), the insured, a drilling company, was sued for failure to properly and adequately evaluate the location of a well bore being drilled, resulting in the insured drilling over a property line and into neighboring property. The court held that, under Texas law, the underlying suit alleged an “occurrence” leading to “property damage.” However, the court held that coverage was barred due to exclusion j(5). According to the court, the negligence of the insured and the resulting damage occurred while the drilling work was being performed. Therefore, the claim fell squarely within exclusion j(5). *Id.* at 607.

Loss of Use Exclusion

While this exclusion is often called the “impaired property” exclusion, that label is not completely accurate as the exclusion applies both to “impaired property” and property that has not been physically injured. It is therefore more accurately termed the “loss of use” exclusion as the Court of Appeals of Michigan did in a case noted above, *Afcon, Inc. v. Ellis-Don Michigan, Inc.*, 2005 WL 415671 (Mich. App. 2005) at *4. As noted previously, in that case, Ellis-Don was a general contractor for the construction of a sewer overflow detention basin and treatment facility which required the construction of retaining walls to protect workers in the project from the collapse of surrounding earth as it was excavated. Ellis-Don subcontracted with Afcon to build the walls which later began to move and which then required the construction of berms which had to be moved constantly in order for the work to proceed. The loss of use exclusion essentially provides that damage to impaired property or property not physically injured is excluded from coverage if it arises out of “a defect, deficiency, inadequacy, or dangerous condition in ‘your product’ or ‘your work,’ or a delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.” The exclusion further provides that it “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.

In this case, the parties did not dispute the applicability of the exclusion in general but argued that the sudden and accidental exception to the exclusion applied. Ellis-Don argued that the wall movement was unexpected, unintended, and unanticipated and, therefore, the wall defect qualified as “sudden and accidental.” However, because Ellis-Don alleged that Afcon failed to

construct the wall in a workmanlike manner and to specification, the court rejected the argument that the accident was sudden and accidental because the construction was done purposefully and according to a plan of action. As such, Ellis-Don's damages were its additional costs associated with rectifying Afcon's allegedly faulty work product, not the result of some sudden and accidental injury. *Id.* at *4.

In *Auto Owners Ins. Co. v. Essex Homes S.E., Inc.*, 136 Fed. Appx. 590 (2005), several builders and developers were sued by purchasers of upscale homes that were constructed on a former Department of Defense site that contained ordinance and explosive wastes. As a result, the homeowners alleged that they could not enjoy the full use of their property and had loss of use.

In applying the loss of use exclusion, the Fourth Circuit found that the homeowners' claims were limited to loss of use to property that was not physically injured. There was no property damage to the homes themselves. Additionally, all the property damage was caused by defects, deficiencies, or inadequacies in the work. The contractors and developers attempted to avoid the application of the loss of use exclusion by arguing that the allegations of the homeowners consisted of the defendant's failure to conduct geographic and environmental surveys and failure to remove the ordinance and explosive waste and that such failures did not fall within the definition of "your work" because no work was *performed*. The Fourth Circuit easily dismissed this argument because the development of the site, including subdividing the lots and building the homes, constituted the defendant's work. Defendant's failure to properly investigate and remove the ordinance and explosive waste constituted a defect, deficiency or inadequacy in their development of the site, *i.e.* in the performance of their work. As a result, the loss of use exclusion applied to deny coverage.

In *McKenna v. Zurich Ins. Co.*, 829 N.E.2d 115 (Mass. App. 2005), McKenna hired a contractor to perform renovations on his home. Subsequently, the contractor ceased work because of differences related to the progress and quality of the work. McKenna then sued the contractor alleging inferior, defective, and substandard building materials and work. McKenna alleged that he was forced to move out of the home as a result of the contractor's work. The contractor brought a third party complaint against its subcontractor, Carpentry Contractors, Inc. ("CCC"), and a default judgment was entered against CCC. McKenna then made demand upon Zurich to pay the default judgment, which Zurich refused. McKenna then brought this action against Zurich.

The Massachusetts Court of Appeals found that the evidence indisputably showed that the plaintiffs alleged a loss of use of their home as a result of the renovation work on parts of the home. They also alleged deficiencies in the insured's work. The court found that the home was impaired property under the policy because it was property that allegedly could not be used due to its incorporating the insured's allegedly defective work or, alternatively, due to the insured's breach of the contract. Furthermore, the plaintiffs alleged that the home could be restored to use by repair of the defects. As a result, the court found that the plaintiffs' allegations fell squarely within the loss of use exclusion. *Id.* at *2.

In *Lennar Corp. v. Great American Ins. Co.*, 2006 WL 406609 (Tex. App. 2006), the Texas Court of Appeals made an interesting distinction between the application of the exclusion to claims for damages for the removal of defective construction materials and the application of the exclusion to the cost of repairing damage to other, non-defective materials caused by the defective materials.

In *Lennar Corp.*, the insured, a general contractor, was sued by a number of homeowners for alleged moisture infiltration damages resulting from the insured's application of defective stucco material to their homes. The damages being claimed included the cost of the replacement of the defective stucco as well as the costs incurred to repair the water damage to the homes caused by the defective stucco. The insurer contended that the loss of use exclusion precluded coverage for the replacement of the stucco because the stucco was not physically injured but was, instead, replaced because it was defective. The court agreed that the loss of use "might arguably apply to the replacement of [the stucco]..." because the stucco itself was not damaged. However, the court held that the exclusion did not apply to the costs incurred to repair the resultant water damage to the homes. *Id.* at *23.

In *Westfield Ins. Co. v. Coastal Group, Inc.*, 2006 WL 120041 (Ohio App. 2006), the insured was sued for, among other things, delay in rectifying faulty workmanship, thereby causing loss of use of the construction project at issue. The court began its analysis by noting that the claim of loss of use due to negligent delay qualifies as "property damage" as defined by the CGL policy. However, the court held that the claims did not constitute an "occurrence." According to the court, "after a review of the record, it is clear that [the] underlying claim is for the economic losses sustained due to [the insureds] delay in remedying deficiencies in its work. However, delay is a risk inherent in construction contracts, not an 'accident' and therefore not an 'occurrence'." *Id.* at *2.

Nevertheless, the court went on to examine the exclusions to the policy and held that, even assuming *arguendo* that delay constituted an "occurrence," the claim was still barred by the loss of use exclusion. According to the court, the underlying claim alleged property damage in the form of loss of use of the building, which was not physically injured. Therefore, the claim was for damage to "impaired property" because the property was tangible and could not be used due to the insured's failure to abide by its contract, but could be restored to use by the insured repairing the work or fulfilling the terms of the contract. *Id.* at *4. Therefore, the court held that the underlying claims fell squarely within the parameters of the loss of use exclusion. *Id.*

Repair Exclusion

Most CGL policies also contain exclusion n. or o. which is typically entitled "recall of products, work, or impaired property" but which is more accurately described in the construction defect context as the "repair exclusion." That exclusion in the ISO form excludes "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. There are very few reported cases construing this exclusion. However, in the past year, in *West Orange Lumber Co., Inc. v. Indiana Lumbermens Mut. Ins. Co.*, 898 So.2d 1147 (Fla. 5th D.C.A. 2005), the Fifth District Court of Appeals for Florida construed this exclusion to preclude coverage in a construction defect case. In *West Orange Lumber*, Centrex Rooney Construction Company subcontracted with Forrec Construction on a portion of the Animal Kingdom Lodge Resort project at Walt Disney World. Forrec obtained cedar wood from West Orange for completion of its subcontract and requested “C” select or better cedar. While the cedar was being installed, Disney questioned the grade of the cedar, and Centrex directed Forrec to remove the installed cedar and replace it with the specified product.

Forrec then filed a complaint against West Orange for damages suffered by it as a result of the failure to supply the proper grade of cedar siding. Those damages consisted of replacing the cedar, increased material costs, labor costs, installation costs, subcontractor costs, transportation costs, additional overhead, and legal fees. Although Lumbermens initially defended West Orange, it filed a declaratory action for a ruling that it owed no duty to defend or indemnify West Orange. Lumbermens argued that the repair exclusion barred coverage. West Orange argued that the repair exclusion did not apply because the cedar siding was not replaced due to its being defective, deficient, inadequate or dangerous. However, the Florida Court of Appeals noted that the repair exclusion also encompasses deficient or inadequate materials and that liability policies do not cover pure construction defects, absent damage to the property or person of third parties. Here, the cedar had to be removed and replaced and was withdrawn from use because it was deficient and inadequate. It essentially failed to meet contract specifications. As such, coverage was barred under the repair exclusion.

Conclusion

Proper analysis of a claim under an insurance policy should always begin with the question of whether the claim comes within the insuring agreement. This requires an analysis of whether the claim constitutes an “occurrence” and “property damage” as required by the policy. Only once a determination has been made that a claim comes within the insuring agreement should the exclusions be considered. As these cases show, a wide range of caselaw exists to explain the scope and application of the exclusions. The coverage analysis is not complete until all of the exclusions have been properly considered.

Notes