

Workshop T4

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

DEFECTIVE WORK AND THE CGL POLICY

"Refining the Business Risk Doctrine: The Meaning of 'Occurrence' and 'Property Damage' after 1986"

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

REFINING THE BUSINESS RISK DOCTRINE: THE MEANING OF "OCCURRENCE" AND "PROPERTY DAMAGE" AFTER 1986*

**Linda B. Foster
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I. Introduction

Prior to 1986, courts generally held that a commercial general liability (CGL) policy did not cover the cost of repairs to a building constructed by the policyholder. Courts grounded this holding in the standard CGL “business risk” exclusions, such as those for property damage to the policyholder’s own “work” or “product.”¹

A number of revisions to the standard CGL form in 1986, however, forced a reexamination of this “business risk” doctrine, particularly with respect to general contractors. First, the “work” exclusion, which excludes coverage for property damage to the policyholder’s work, arising out of that work, was amended to include an exception for the work of subcontractors. Since a general contractor typically employs subcontractors to perform most or all of the construction, this change effectively rendered the “work” exclusion inapplicable to general contractors. Second, the “product” exclusion, which excludes coverage for damage to the policyholder’s product, was amended to exclude real property from the definition of “product.”

Courts have split as to the effect of these policy revisions. Some courts, notably those in Wisconsin and Minnesota, have concluded that the revisions expanded the scope of CGL policies to cover the cost of repairing the defective work of the policyholder’s subcontractors.² Other courts, however, have held that the business risk doctrine finds expression in the general liability policy in places other than the “work” and “product” exclusions.

Courts adopting the latter view have noted that the 1986 revisions affect the coverage analysis only to the extent that the underlying damages fall within the insuring agreement of the

¹See, e.g., *Weedo v. Stone-E-Brick*, 405 A.2d 788, 791 (N.J. 1979).

²See *American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 83 (Wis. 2004) (citing cases); *O’Shaughnessy v. Smuckler Corp.*, 543 N.W.2d 99, 104 (Minn. Ct. App. 1996).

*This article was coauthored with Ms. Foster by Lee H. Ogburn and Susan M. Hogan, Kramon & Graham, P.A.

policy. Construing the terms “occurrence”³ and “property damage”⁴ in the context of the construction industry, these courts have determined that damage to the insured’s work caused by faulty workmanship, standing alone, does not constitute “property damage” caused by an “occurrence.” Most of these courts have focused on the term “occurrence,” determining that the ordinary consequences of defective workmanship—that is, the cost of compliance with the insured’s contractual undertaking—are not accidental and therefore not within the definition of “occurrence.” Less frequently, courts have found that the damage to the insureds’ work is not “property damage.”

Although the precise rationales have varied, the unifying theme among these decisions is that the CGL insuring agreement is not intended to cover the ordinary consequences of defective workmanship. This article provides a survey of the various jurisdictions in which some or all of the pertinent authorities support this view of the business risk doctrine. Section II provides a survey of the various jurisdictions in which courts have held that defective workmanship does not constitute an occurrence. Section III provides a survey of these cases in which courts have found that the damage to the insureds’ work is not property damage.

II. Survey of Jurisdictions in Which Faulty Construction is Not An Occurrence

A. Jurisdictions With Precedential State Appellate Authority

This section identifies those jurisdictions where precedential state court decisions have adopted the view that the cost to the policyholder of meeting its contractual obligation to supply a non-defective project is not an occurrence and thus outside the insuring agreement of a CGL policy. This section further and discusses how state and federal courts have applied that authority.

1. South Carolina

South Carolina law on coverage for construction defects recently underwent a dramatic transformation in *L-J, Inc. v. Bituminous Fire & Marine Insurance Co.* (“*L-J I*”),⁵ which overruled the two-year-old intermediate appellate decision (“*L-J P*”)⁶ in that case. These decisions addressed coverage for L-J, a general contractor who contracted to prepare the site and construct the roads for a residential subdivision. L-J hired one subcontractor to clear, grub, rough grade, fine grade, and construct the sub-base and base for the roads and another sub-

³A CGL policy typically defines an “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.”

⁴A CGL policy typically defines “property damage” as “[p]hysical injury to tangible property, including all resulting loss of use of that property . . . ; or [l]oss of use of tangible property that is not physically injured.”

⁵--- S.E.2d ---, 2004 WL 1775571 (S.C. Aug. 9, 2004) *rehearing granted* (February 3, 2005)

⁶*L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 567 S.E.2d 489, 494 (S.C. Ct. App. 2002)

contractor to pave the roads. The first subcontractor's inadequate clearing of tree stumps from the site caused the road surfaces to deteriorate and fail.⁷

In *L-J I*, the intermediate appellate court held that the damage to the pavement constituted accidental property damage within the insuring agreement. Rejecting the insurer's reliance on the business risk doctrine, the court quoted from the Minnesota and Wisconsin authorities holding that the 1986 revisions to the "work" exclusion in fact made a CGL policy closer to a performance bond.⁸

The Supreme Court of South Carolina reversed, holding that the contractor could not shift to its CGL insurer the risk of economic loss associated with the defective construction. Such faulty workmanship did not constitute an "occurrence." It rejected the lower court's reliance on the "subcontractor" exception to the "work" exclusion, holding that such a construction violated the principle that an exclusion cannot provide coverage.⁹

L-J sought a rehearing, which was granted by the Supreme Court. On September 26, 2005, the South Carolina Supreme Court affirmed its "no occurrence" ruling.¹⁰

2. Illinois

A number of Illinois decisions have held that construction defects causing damage solely to the project itself are foreseeable and, therefore, not occurrences within the insuring agreement of a CGL policy.¹¹ For example, *State Farm Fire & Casualty Co. v. Tillerson*¹² held that an insurer was not obligated to defend a contractor in a suit alleging that the policyholder breached warranties to the plaintiff homeowners by building over a cistern without taking precautions to prevent the soil from settling. Reversing the trial court's ruling, the appellate court held that damages to the home were the natural and ordinary

⁷*L-J I*, 567 S.E.2d at 551-52.

⁸*Id.* at 556-59.

⁹*L-J II*, 2004 WL 1775571 at *3-5.

¹⁰*L-J Inc. v. Bituminous Fire & Marine Ins. Co.*, --- S.E.2d ---, 2004 WL 3540903 (S.C. Sept. 26, 2005).

¹¹See *Monticello Ins. Co. v. Wil-Freds Constr.*, 661 N.E.2d 451 (Ill. App. Ct. 1996); *Indiana Ins. Co. v. Hydra Corp.*, 615 N.E.2d 70 (Ill. App. Ct. 1993). See also *Hartford Fire Ins. Co. v. Flex Membrane Int'l, Inc.*, 2001 WL 869623 at *2 (N.D. Ill. 2001); *American Fire & Cas. Co. v. Broeren Russo Constr., Inc.*, 54 F. Supp. 2d 842, 847-48 (C.D. Ill. 1999)

¹²777 N.E.2d 986 (Ill. App. Ct. 2002).

consequences of the contractor's defective construction and therefore could not be considered accidental.¹³

3. Maryland

The policyholder in *Lerner Corp. v. Assurance Co. of America*¹⁴ sought indemnification for the cost of repairing a poorly constructed facade of a building it developed and sold to the federal government. When the latent defect in the facade was discovered, the government alleged a breach of contract, and the developers made the necessary repairs. In the subsequent declaratory judgment action between the developer and its general liability insurer, the court held that the developer's failure to satisfy its contractual obligation to supply a defect-free building was not an "occurrence" since the cost to repair the building was the expected and foreseeable result of defective construction.

A Maryland federal court applied *Lerner* in *Harbor Court Associates v. Kiewit Construction Co.*,¹⁵ which addressed coverage for defective steelwork in a condominium complex that damaged the brick facade of the building. The court carefully distinguished between the coverage available for the general contractor and its steel subcontractor, both of whom sought coverage under the same "wrap-around" general liability policy. The same general principle applied to each—to the extent that the underlying complaint sought "the cost of repairing the work called for in each of their respective construction contracts, any property damages claimed were 'expected' and thus not caused by an occurrence."¹⁶ But the application of this principle varied according to the scope of each insured's contractual obligation. From the perspective of the subcontractor, the damage to the brick facade, which was outside of its contractual obligation, was fortuitous and therefore the result of an "occurrence." But from the perspective of the general contractor, which contracted to erect a complete, non-defective building, the damage to the brick facade was foreseeable and not fortuitous.

4. New York

In *George A. Fuller Co. v. United States Fidelity & Guaranty Co.*,¹⁷ the court determined that no potential coverage existed for an underlying lawsuit

¹³Relying on *Tillerson*, an Illinois appellate court recently held that the collapse of a building wall under natural and ordinary circumstances due to the lack of required bracing was not an "occurrence" within the meaning of the implicated CGL policy. *Viking Construction Management, Inc. v. Liberty Mutual Ins. Co.*, 831 N.E.2d 1 (Ill.App.Ct. 2005).

¹⁴707 A.2d 906, 911-12 (Md. Ct. Spec. App. 1998).

¹⁵6 F. Supp. 2d 449, 453-58 (D. Md. 1998).

¹⁶*Id.* at 457.

¹⁷613 N.Y.S.2d 152 (App. Div.), *cert. denied*, 84 N.Y.2d 806 (1994).

brought by a developer who hired Fuller to construct a building that was allegedly defective. Determining that the claims against Fuller sounded solely in contract, the court held that the policy “does not insure against faulty workmanship in the work product itself but rather faulty workmanship in the work product which creates a legal liability by causing bodily injury or property damage to something other than the work product.”¹⁸ Subsequent intermediate appellate decisions have reinforced this tort/contract distinction under New York law.¹⁹

5. Iowa

The Supreme Court of Iowa, in *Pursell Construction v. Hawkeye-Security Insurance Co.*,²⁰ held that defective workmanship, standing alone, is not an occurrence. Pursell was a subcontractor hired to construct basements in homes the general contractor was constructing. When Pursell was finished its work, a city inspection found that the basement level violated a floodplain ordinance. The general contractor sued Pursell for breach of contract and negligence, and Pursell sought a declaratory judgment from the district court as to its CGL insurer’s duty to provide a defense. Reversing the trial court’s determination that a defense obligation existed, the court recognized the existence of conflicting authority but adopted “the majority rule and now join those jurisdictions that hold that defective workmanship standing alone, that is, resulting in damages only to the work product itself, is not an occurrence under a CGL policy.”²¹

6. West Virginia

The Supreme Court of Appeals of West Virginia has held on three occasions that faulty workmanship, standing alone, cannot constitute an occurrence under a CGL insurance policy.²² In *Corder v. William W. Smith Excavating Co.*, Corder, a developer, brought suit against the construction company that Corder hired to repair sewer lines. On appeal from the trial court’s grant of summary judgment in favor of the insurer, the Supreme Court of Appeals remanded the issue because it found that there was an unresolved issue of fact as to the cause of the sewer lines’ malfunction. If the trial court determined that the sewer

¹⁸*Id.* at 155.

¹⁹See *Pavarini Constr. Co., Inc. v. Continental Ins. Co.*, 759 N.Y.S.2d 56, 57 (App. Div. 2003); *Mid-Hudson Castle, LTD v PJ Exteriors, Inc.*, 738 N.Y.S.2d 96, 97 (App. Div. 2002) (“a commercial general liability insurance policy does not afford coverage for breach of contract”).

²⁰596 N.W. 2d 67 (Iowa 1999).

²¹*Id.* at 71.

²²See *Webster County Solid Waste Authority v. Brackenrich & Associates, Inc.*,--S.E.--, 2005 WL 1545273 (W. Va. June 30, 2005); *Corder v. William W. Smith Excavating Co.*, 556 S.E.2d 77 (W. Va. 2001); *Erie Ins. v. Pioneer Home Improvement, Inc.*, 526 S.E.2d 28 (W. Va. 1999).

malfunction was caused by an independent event, it would be an occurrence, but if it was due solely to the work of Smith, it would not.

Most recently, in *Webster County Solid Waste Authority v. Brackenrich, & Associates, Inc.*, the Supreme Court of Appeals, relying on its decision in *Corder*, affirmed the trial court’s declaratory judgment in favor of Nationwide based on its determination that Nationwide’s CGL policy provided no coverage for the insured’s faulty workmanship in design, engineering, and inspection of a land-fill.

Finally, applying West Virginia law, an Ohio court specifically held that, because the faulty construction of a home’s foundation did not fall within the insuring agreement of the contractor’s insurance policy, the “subcontractor” exception to the “your work” exclusion was not implicated.²³

7. Colorado

In *Union Insurance Co. v. Hottenstein*,²⁴ a homeowner was awarded damages against a contractor for repairs necessitated by the substandard remodeling of her home. The contractor’s insurer admitted coverage for the damage that the defective remodeling caused to the existing roof of the home, but it disputed coverage for the damages for repairing inadequate work under the contract. Explaining that “an ‘accident’ is an unanticipated or unusual result flowing from a commonplace cause,” the appellate court agreed with the insurer that “poor workmanship constituting a breach of contract is not a covered occurrence.”²⁵ Thus, repairs to the home that fell outside the scope of the contractor’s contractual obligation were the result of an occurrence, while those within the scope of the contract were not.

Hottenstein confirmed that the federal courts in *Bangert Brothers Construction Co., Inc. v. Americas Insurance Co.*²⁶ correctly predicted Colorado law on the business risk doctrine. In *Bangert*, the District Court of Colorado and the Tenth Circuit held that the “subcontractor” exception to the “work” exclusion did not create coverage for a general contractor on an airplane runway project, even

²³*Nationwide Ins. Co. v. Phelps*, 2004-Ohio-1200 (Ohio Ct. App.), *appeal not allowed*, 811 N.E.2d 1151 (Ohio 2004).

²⁴83 P.3d 1196, 1198 (Colo. Ct. App. 2003). *McGowan v. State Farm Fire & Cas. Co.*, --- P.3d ---, 2004 WL 856511 (Colo. Ct. App. April 22, 2004), addressed coverage for the defective construction of a home that the contractor never completed. The trial court ruled that the defective construction constituted “property damage” caused by an “occurrence,” but that policy exclusions barred coverage. The appellate court, which cited with approval to *Phelps*, affirmed solely on the basis of the policy exclusions without addressing whether the defects fell within the insuring agreement.

²⁵*Id.* at 1202.

²⁶888 F. Supp. 1069 (D. Colo. 1995), *on remand from* 1995 WL 539479 (10th Cir. Sept. 11, 1995).

though the cracks in the runway at issue were due to the faulty work of the mixing subcontractor.²⁷ Applying *Bangert*, the federal district court in *DCB Construction Co. v. Travelers Indemnity Co. of America* held that a general contractor's CGL policy did not cover the cost of replacing hotel walls that a subcontractor had inadequately soundproofed.²⁸ The same federal court that decided *DCB Construction* recently held, in an unpublished opinion, that construction defects that formed the basis of an arbitration award against the insured did not constitute an accident that gave rise to an "event" under the CGL policy issued to the insured.²⁹ The court found the "event" language, which was substantially similar to the "occurrence" language contained in the policy at issue in *Hottenstein, supra*, to be ambiguous. However, when the court interpreted the "event" language in favor of the insured, it concluded that there was no "event" as defined in the policy.

8. Missouri

In *American States Ins. Co. v. Mathis*,³⁰ an electrical subcontractor filed suit against its sub-subcontractor for digging trenches and installing ducts inconsistent with contractual specifications. Affirming the trial court's grant of summary judgment in favor of the sub-subcontractor's insurer, the court held that performance of the contract according to its terms was within the policyholder's control, and that the failure to perform could not be described as an undesigned or unexpected event. The court rejected the policyholder's contention that third-party property damage occurred when, in the course of replacing the defective duct banks, electrical conduit and cables needed to be torn out and replaced. Although the policyholder was not contractually responsible for the conduit and cables, these damages were an expected consequence of the defective duct work.³¹

Reiterating this principle, the court in *Hawkeye-Security Ins. Co. v. Davis*³² held that coverage did not exist for the defective construction of a home, even though subcontractors performed the defective work on behalf of the insured general contractor. The "subcontractor" exception to the "work" exclusion was irrelevant because, under *Mathis*, the construction defects did not constitute an "occurrence."

²⁷1995 WL 539479 at *3; 88 F. Supp. at 1074.

²⁸225 F. Supp. 2d 1230, 1232 (D. Colo. 2002).

²⁹*Adair Group, Inc. v. St. Paul Fire & Marine Insurance Company*, 2005 WL 1522085 (D. Colo. June 28, 2005).

³⁰974 S.W.2d 647, 648 (Mo. App. 1998).

³¹*Id.* at 649-50.

³²6 S.W.3d 419, 426 (Mo. App. 1999).

9. Oregon

The Oregon Supreme Court, in *Oak Crest Construction Co. v. Austin Mutual Insurance Co.*,³³ addressed a general contractor's suit against its CGL insurer, seeking reimbursement for the cost of replacing paint defectively applied by the subcontractor. The court held that where the resulting damage is merely a breach of contract, there is no occurrence. Therefore, the insurer owed no duty to indemnify the general contractor. But the court noted in *dicta* that there might have been coverage, had the contractor demonstrated that the problem with the painting resulted from the subcontractor's breach of a duty to act with due care.

The *dicta* in *Oak Crest* raised a question as to whether defects in a contractor's own work could, in the absence of third-party property damage, be found to result from an "occurrence" under some circumstances. Potentially clarifying matters, an unreported federal decision held, in a case involving coverage for various lawsuits arising out of the policyholder's allegedly defective hardboard siding, that the insurer was obligated to defend the policyholder against only those suits alleging third-party property damage.³⁴

However, a more recent unpublished federal decision from the same district court held that property damage that results from the negligent performance of a contract can qualify as being caused by an "accident" if the damage results from a tort.³⁵ In this case, the insured contracted to rehabilitate an existing water well. During that process, one of its employees unintentionally bumped a rotation lever on a drill, which caused the drill to rotate and damage a screen assembly that had been installed by the insured. The damaged screen obstructed water passage, hindering the completion of the well. Noting that the sole claim for relief against the insured was one for negligence, and that the complaint alleged that the insured failed to adequately supervise or monitor the work in progress sounded in tort, the district court found that the damage to the well was caused by an "occurrence."

10. Indiana

The Indiana appellate courts have twice considered whether faulty construction constituted "property damage" caused by an "occurrence" from the perspective of the insured general contractor.³⁶ In both instances, the courts have held that

³³998 P.2d 1254, 1257-58 (Or. 2000).

³⁴See *California Ins. Co. v. Stimson Lumber Co.*, 2004 WL 1173185, at *6-7 (D. Or. May 26, 2004).

³⁵*Schneider Equipment, Inc. v. The Travelers Indemnity Company of Illinois*, 2005 WL 1565006 (D.Or. June 29, 2005).

³⁶*Amerisure, Inc. v. Wurster Construction Co, Inc.*, 818 N.E.2d 998 (Ind. App. 2004); *R.N. Thompson v. Monroe Guar. Ins. Co.*, 686 N.E.2d 160 (Ind. App. 1997).

defective workmanship that results in damages only to the work itself is not an occurrence under a general liability policy. In *Thompson v. Monroe*, the Indiana appellate court considered whether the deterioration of roofs at a condominium complex constituted “property damage” caused by an “occurrence” from the perspective of the insured general contractor. The court noted that the “work” exclusion in the builder’s policy did not bar coverage for claims arising out of the work of a subcontractor. Nevertheless, the court concluded that it was unnecessary to consider whether a subcontractor built the roofs because the losses constituted neither an “occurrence” nor, in the absence of damage to other property, “property damage.” The court declined to follow Minnesota authority regarding the effect of the 1986 modifications to the “work” exclusion, holding that the revisions did not alter the fundamental purpose of a CGL policy.

In *Amerisure v. Wurster*, the Indiana appellate court, relying on *Thompson* and out of state authority, held that the defective work of the general contractor did not constitute an “accident,” and thus was not an “occurrence” under the policy. The court also rejected the insured’s argument that the failure of the exterior sheathing and finish was “property damage” under the Amerisure policy because the damage was damage to the insured’s project and not damage to other property as mandated by the term “property damage” in the policy.

B. Jurisdictions With Persuasive Authority

This section addresses jurisdictions where persuasive authority—federal court predictions of state law, unpublished state appellate decisions, or state trial court decisions—supports the proposition that defective workmanship falls outside the insuring agreement of the policy.

1. Virginia

In *Travelers Indemnity Company of America v. Miller Building Corporation, et. al.*,³⁷ the Fourth Circuit, in a recent unpublished opinion, reversed the United States District Court for the Eastern District of Virginia and held that under Virginia law, the allegedly defective performance of a subcontractor was not an “occurrence” within the meaning of the general liability policies. The Fourth Circuit also held that the subcontractor exception to the “your work” exclusion in the policies did not grant or extend coverage. In reaching its holdings, the Fourth Circuit relied on the Virginia federal court’s decision in *Hotel Roanoke Conference Center Comm’n v. Cincinnati Ins. Company*,³⁸ which predicted Virginia law on the “occurrence” issue.

³⁷2005 WL 1690552 (4th Cir. 2005).

³⁸303 F.Supp.2d 784 (W.D. Va. 2004).

In *Hotel Roanoke*, the Virginia federal court held that a conference commission's CGL policy did not cover a lawsuit alleging that the commission's contractors used defective fill material beneath the foundation of a conference center, causing the foundation to crack and forcing the closure for five months of the conference center and sixty rooms in the adjacent hotel. Recognizing that the Virginia Supreme Court had not addressed the "occurrence" issue in the construction defect context, the court looked to Virginia trial court decisions³⁹ and out of state authority holding that defective performance of a contract, resulting in damage solely to the project itself, in not an "occurrence" under a CGL policy. Applying this authority, the court held that the commission's liability policy did not cover the damages at issue because damages arising from faulty workmanship are both expected and non-fortuitous.

2. Tennessee

An unpublished decision of the Tennessee Court of Appeals held that an insurer had no duty to defend a construction company against claims for defective repairs on the house because there was no "occurrence."⁴⁰ Although the underlying complaint sought incidental and consequential damages, those damages did not include covered third-party bodily injury or property damage.

3. Utah

In *H.E. Davis & Sons, Inc v. North Pacific Insurance Co.*,⁴¹ a Utah federal court held that a claim to repair a construction defect did not fall within the CGL insuring agreement. The policyholder performed a substandard job of compacting the soil in preparing the construction site for a school. Defining an "accident" as something that is not a natural or intended consequence, the court determined that the repairs to the soil pad were not accidental. Moreover, it held that the site, which required only repairs to the soil pad and was not rendered totally useless, sustained no "property damage."

In a recent unpublished opinion,⁴² a Utah federal court held that faulty construction by a general contractor was not an "event" under the general liability policy issued to the insured. The federal court noted that the "event" language contained in the implicated policy was virtually identical to the "occurrence"

³⁹*Pulte Home Corp. v. Fidelity & Guar. Ins. Co.*, 2004 WL 516216 (Va. Cir. Ct.—Fairfax Feb. 6, 2004); *RML Corp. v. Assurance Co. of Am.*, Chancery No. CH02-127 (Va. Cir. Ct.—Norfolk December 31, 2002) (review of "subcontractor" exception unnecessary in absence of "occurrence"); *American Fire & Casualty Ins. Co. v. Doverspike*, 36 Va. Cir. 263, 1995 WL 1055839 (Va. Cir. Ct.—Fairfax April 25, 1995).

⁴⁰*State Auto Ins. Cos. v. Gordon Constr., Inc.*, 2001 WL 513884, at *4-5 (Tenn. Ct. App. May 15, 2001).

⁴¹248 F. Supp. 2d 1079, 1084-85 (D. Utah 2002).

⁴²*Metric Construction Co. v. St. Paul Fire & Marine Insurance Co.*, 2005 WL 2100939 (D. Utah August 31, 2005).

language contained in the CGL policy in *H.E. Davis & Sons*. The court reasoned that because the insured performed inadequately and the resulting property damage was a natural and foreseeable consequence of its intended performance, there was no “event” as defined by the policy.

4. Mississippi

Predicting Mississippi law, the Fifth Circuit held that faulty workmanship is not an occurrence in *ACS Construction Co., Inc. of Mississippi v. CGU*.⁴³ The policyholder, ACS, contracted with the government to build munition bunkers, and ACS in turn hired a subcontractor to install a waterproof membrane. When the membrane began to leak, ACS was required to pay for its repair, and it sought indemnification from its CGL insurer. The Fifth Circuit determined that the existence of an occurrence was based on the intention of the underlying action, as opposed to the consequence of that action. Since ACS had intended to hire the subcontractor to install the waterproofing, the leaks resulting from that act were not accidental and thus not occurrences. It specifically rejected the contention that the “subcontractor” exception to the “work” exclusion created coverage, for such an interpretation would transform the policy into a performance bond.

5. Arkansas

In *Nabholz Construction Corporation v. St. Paul Fire and Marine Insurance Company*,⁴⁴ an Arkansas federal court held that a general contractor’s obligation to repair or replace its subcontractor’s defective workmanship could not be deemed unexpected on the part of the contractor, and therefore, failed to constitute an “event” for which coverage existed under the policy. Noting that the Arkansas courts had not directly addressed⁴⁵ the issue of whether faulty construction is an “occurrence” under a CGL policy, the federal court looked to out of state authority, and determined 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.’” The court noted that the definition of “event” in the implicated policy was essentially the same as the “occurrence” definition found in the policies at issue in the cases upon which it relied.

⁴³332 F.3d 885 (5th Cir. 2003).

⁴⁴354 F.Supp.2d 917 (E.D.Ark. 2005)

⁴⁵In *United States Fid. & Guar. Co. v. Continental Cas. Co.*, 353 Ark. 834, n. 4 (2003), the Arkansas Supreme Court acknowledged a split in the jurisdictions concerning whether defective workmanship is an “accident” and therefore an “occurrence” covered under a general liability policy, but did not resolve the issue. (The court instructed that the issue be resolved on remand, but the federal court in *Nabholz* noted that it could find no indication of whether, and if so how, the issue was resolved on remand).

6. Massachusetts

In *American Home Assurance Company v. AGM Marine Contractors, Inc.*,⁴⁶ Massachusetts federal court recently held that faulty workmanship was not a covered “occurrence” under the commercial marine liability policy at issue, which defined “occurrence” as an “accident.” The court noted that only the floating docks themselves, which were installed by the insured, sustained property damage and this damage resulted from the insured’s faulty workmanship. The court relied on an unpublished Massachusetts decision⁴⁷ and the weight of authority nationwide in reaching its holding.

C. Jurisdictions With Conflicting Authority

In a number of jurisdictions, some authority supports the broad view of the business risk doctrine, while other coordinate authority raises questions as to the scope of the doctrine.

1. Ohio

Ohio’s various appellate districts have taken diametrically opposing views on the “occurrence” question. The First District held that no coverage existed for a suit against a homebuilder to repair construction defects because “courts in Ohio, as well as the majority of courts in jurisdictions throughout the country, have concluded that defective workmanship does not constitute an ‘occurrence’ in policies such as the one here.”⁴⁸ The Eighth and Tenth Districts, however, have disagreed with this interpretation of Ohio law in a number of cases⁴⁹ as has an Ohio federal court in a recent unpublished opinion.⁵⁰

2. North Carolina

No North Carolina state court has directly addressed whether a construction defect constitutes an occurrence, and the Fourth Circuit has given conflicting interpretations on the subject in three unpublished decisions. In *Wm. C. Vick Construction Co. v. Great American Insurance Co.*,⁵¹ a federal district court

⁴⁶379 F.Supp.2d 134 (D.Ma. 2005).

⁴⁷*Davenport v. U.S. Fidelity & Guar. Co.*, 2002 WL 31549391 (2002).

⁴⁸*Heile v. Herrmann*, 736 N.E.2d 566, 568 (Ohio Ct. App. 1 Dist. 1999).

⁴⁹*National Eng’g & Contracting Co. v. United States Fid. & Guar. Co.*, 2004-Ohio-2503 (Ohio Ct. App. 10 Dist. 2004) (recognizing conflict between districts but refusing to reconsider its position); *Acme Constr. v. Continental Nat. Indem. Co.*, 2003-Ohio-434 (Ohio Ct. App. 8 Dist. 2003); *Erie Ins. Exchange v. Colony Dev. Corp.*, 736 N.E.2d 941, 948 (Ohio Ct. App. 10 Dist. 1999).

⁵⁰*Fortney & Weygandt, Inc. v. American Manufacturers Mutual Insurance Company*, 2005 WL 1566744 (N.D. Ohio July 5, 2005).

⁵¹52 F. Supp. 2d 569 (E.D.N.C. 1999), *aff’d*, 213 F.3d 634 (4th Cir. 2000) (unpublished opinion at 2000 WL 504197).

applying North Carolina law adopted an expansive view of the business risk doctrine, holding that damages to a building caused by defective waterproofing constituted neither an “occurrence” nor “property damage” from the perspective of the general contractor. The Fourth Circuit, in an unpublished *per curiam* decision, affirmed on the basis of the district court’s reasoning. A subsequent unpublished decision of the Fourth Circuit followed *Vick* to hold that, under North Carolina law, “an ‘accident’ does not occur when property damage is caused by defective or poor workmanship, because an insured should foresee and expect the resulting damage.”⁵²

Refusing to follow the previous panel decisions, the recent decision of the Fourth Circuit in *Travelers Indemnity Co. v. Miller Building Corp.* held that the definition of an “accident” is entirely subjective under North Carolina law and, therefore, that damage to the interior of a hotel caused by improper installation of windows and sliding glass doors constituted an “occurrence” from the perspective of the general contractor.⁵³ Nevertheless, the court did hold that, to the extent that the hotel owner sought to recover the cost of correcting the general contractor’s faulty workmanship, the claims were not covered because faulty workmanship did not constitute “property damage.”⁵⁴ Determining that the alleged damage to the owner-supplied carpeting constituted “property damage,” the court held that a defense obligation existed.

It should be noted that the *Miller Building* decision, which stressed that the decisions of prior panels were not binding because they were unpublished, was itself unpublished.

3. Texas

Although there is case law to the contrary,⁵⁵ several Texas decisions have held that faulty workmanship that damages the insured’s project is not an occurrence under a CGL policy. In *Devoe v. Great American Insurance Co.*,⁵⁶ the court held that an insurer had no duty to defend or indemnify a contractor with respect to a suit seeking the cost of repairs to a home because the damages, even if subjectively unexpected from the standpoint of the insured, was the natural and probable result of shoddy workmanship.

⁵²*Penn Am. Ins. Co. v. Valade*, 28 Fed. Appx. 253, 258 (4th Cir. 2002).

⁵³97 Fed. Appx. 431, 437 (4th Cir. 2004).

⁵⁴*Id.* at 434.

⁵⁵*Archon Investments, Inc. v. Great American Lloyds Ins. Co.*, 2005 WL 2037177 *5+ (Tex. App. August 25, 2005); *Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202 (S.D. Tex. Sept. 10, 2003) (discussing two lines of authority); *CU Lloyd’s of Tex. v. Main St. Homes, Inc.*, 79 S.W.3d 687 (Tex. App.—Austin 2002).

⁵⁶50 S.W.3d 567 (Tex. App.—Austin 2001).

In *Hartrick v. Great American Lloyds Insurance Co.*,⁵⁷ the court similarly held that an insurer was not obligated to indemnify a contractor with respect to an underlying lawsuit based on construction defects in the soil preparation and pouring of the foundation, which caused damage to the house. Since the damages were the reasonably foreseeable consequence of the contractor's defective workmanship, they were not the result of an "occurrence."

Relying on *Devoe* and *Hartrick* over contrary state appellate authority, three Texas federal courts have held that there is no "occurrence" when the underlying lawsuit merely alleges defective construction.⁵⁸ In *Jim Johnson Homes v. Mid-Continent*, the federal court held that because the underlying suit alleged only that the insured contractor constructed the foundation of the home in a defective manner, causing cracking in the foundation, there was no "occurrence."

Likewise, in *Mid Arc v. Mid-Continent*, the federal court, in an unpublished opinion, held that the insured contractor's faulty work (as opposed to damage done by their construction) did not constitute an "occurrence" under the general liability policy issued by Mid-Continent.

Finally, in *Lamar Homes v. Mid-Continent*, the federal court held that the homebuilder insured's negligent acts that caused undesigned and unexpected damage qualified as an "accident" as included in the definition of "occurrence" under Texas law.

4. Arizona

In 1989, an Arizona intermediate appellate court became one of the first courts to determine that defective workmanship is not an "occurrence," holding that an insurer was not obligated to defend its policyholder against claims that it incorrectly installed roofs at a condominium complex.⁵⁹ Nevertheless, the Ninth Circuit, applying Arizona law, recently declined to follow that authority, determining that a 1986 decision of the Arizona Supreme Court "indicates that faulty workmanship, even faulty installation standing alone, may in some cases constitute an 'occurrence' under the terms of a CGL policy."⁶⁰ Although the

⁵⁷62 S.W.3d 270, 277-78 (Tex. App.—Houston [1 Dist.] 2001).

⁵⁸*Lenmar Homes, Inc. v. Mid-Continent Casualty Company*, 335 F. Supp. 2d 754, (W.D. Tex. 2004); *Mid Arc, Inc. v. Mid-Continent Casualty Company*, 2004 WL 1125588 (W.D. Tex. February 26, 2004); *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706, 715-16 (N.D. Tex. 2003).

⁵⁹*U.S. Fid. & Guar. Corp. v. Advance Roofing & Supply Co., Inc.*, 788 P.2d 1227, 1233 (Ariz. Ct. App. 1989).

⁶⁰*Southwest Metalsmiths, Inc. v. Lumbermens Mut. Cas. Co.*, 85 Fed. Appx. 552, 554 (9th Cir.), *withdrawn pursuant to settlement*, 92 Fed. Appx. 567 (9th Cir. 2004). In the case at issue, *University Mech. Contractors of Ariz., Inc. v. Puritan Ins. Co.*, 723 P.2d 648 (Ariz. 1986), the insurer apparently did not dispute that the policyholder's negligent installation of a heating and cooling system could constitute an "occurrence." The dispute was whether the "occurrence" needed to take place during the insurer's policy period. *Id.* at 651.

Ninth Circuit’s decision was unpublished and later withdrawn pursuant to settlement, it at least raises questions as to the scope of the business risk doctrine under Arizona law.

III. The Meaning of “Property Damage” in a Construction Defect Case.

A. Can Defective Work Ever Be Property Damage?

Some courts find that there cannot be property damage where the work or product was defective in the first place. In *Vick Construction Co. v. Pennsylvania National Mutual Casualty Insurance Company*,⁶¹ Vick contracted with North Carolina Farm Bureau Federation for the construction of an addition to the Farm Bureau’s office building. Great American Insurance Company was one of Vick’s insurers.

Vick subcontracted with Chamberlin to do a portion of the roofing work that involved the installation of a waterproofing system. The installation of the system was faulty—it was later discovered that the membrane was installed upside down. The membrane leaked from the first test. Over time the roof leaked in several places. Farm Bureau demanded that Vick remedy the problem. Farm Bureau and Vick met multiple times and much investigative work was done, but to no avail. Farm Bureau instituted arbitration proceedings against Vick. In the arbitration, Farm Bureau stated that it sought damages for the cost of repair of the defective waterproofing membrane and sought to recover the cost to repair cracks in a stucco wall.

Vick sued its carriers for a declaration that they were obligated to defend and indemnify it for the arbitration claim. The carriers filed comprehensive motions for summary judgment. In a lengthy decision addressing multiple issues, the court considered the insurers’ argument that there was no property damage within the meaning of the policies. After reviewing several well-established principles under North Carolina law, the court found that the damages sought in the arbitration claims were not because of property damage.

The court stated:

Under the clear language of the policies, property damage requires either (1) a “physical injury to” or “destruction of” tangible property, or (2) “loss of use of tangible property which has no been physically injured or destroyed[.]” These requirements, in this court’s opinion, infer that the property allegedly damaged has to have been undamaged or uninjured at some previous point in time. This is inconsistent with the allegations that the subject property was never constructed properly in the first place. As noted *supra*, Farm Bureau’s arbitration claims against Plaintiff sought recovery for repairs for allegedly unworkman-

⁶¹52 F.Supp.2d 569 (W.D.N.C. 1999) (unpublished), *aff’d*.213 F.3d 634 (4th Cir. 2000).

like construction. Moreover, Farm Bureau's theories of recovery were premised solely [sic] allegations that Plaintiff never brought the quality of its work on the Construction Project up to the standard bargained for.⁶²

Because Farm Bureau's entire basis of recovery against Plaintiff was for repair costs necessitated by the poor workmanship, the court granted the insurer's summary judgment motion on the ground that there was no property damage within the meaning of the policies. The Fourth Circuit affirmed.⁶³

B. Are the Damages Sought "Economic" Damages?

Some courts call repair and replacement costs "economic damages" and refuse to permit recovery under the policies on that basis. In *United States Fire Insurance Company v. Milton Company*,⁶⁴ the insurers filed a declaratory judgment action seeking a declaration that they had no obligation to indemnify for the \$7 million judgment held by the owners of condos developed by the developer and builder insureds. In deciding the motions for summary judgment, the court concluded that the record created questions of fact. However, the court reviewed Maryland law on both the occurrence issue and the property damage issue. As to property damage, the court observed that Maryland law holds that the standard definition of "property damage" excludes the replacement of substandard materials and repair of inferior workmanship. The court cited from the Maryland Court of Appeals decision in *Sheets v. Brethren Mutual Insurance Company*: "The Sheetses concede that the money spent to fix the system was economic loss and thus not covered under the policy as property damage."⁶⁵ In ruling on the damages in the case before the court, the court stated that the damages awarded in the underlying litigation for the replacement of inferior or omitted materials and the correction of substandard workmanship were not covered. Likewise, the court stated that other damages apparently awarded to compensate the unit owners for losses they suffered as a result of the use of inferior materials and substandard workmanship also were not covered.

The appellate courts in Illinois reach similar conclusions. In *State Farm Fire and Casualty Company v. Tillerson*, the insured had contracted with the plaintiff to construct a new room addition and convert a carport into a garage. The plaintiff homeowners alleged that the insured built over a cistern and failed to take the necessary precautions to prevent uneven settling of the soil beneath the room addition. The court first held that under Illinois law, these allegations did not allege an occurrence. "Where the defect is no more than the natural and ordinary consequences of faulty workmanship, it is not caused by an accident."⁶⁶ The court then addressed whether there was

⁶²52 F.Supp.2d 569, 583 (W.D.N.C. 1999) (unpublished), *aff'd*, 213 F.3d 634 (4th Cir. 2000).

⁶³213 F.3d 634 (4th Cir. 2000).

⁶⁴35 F.Supp.2d 83 (D.C.D.C. 1998).

⁶⁵342 Md. 634, 645, 679 A.2d 540, 545 (1996).

⁶⁶334 Ill.App.3d 404, 409, 777 N.E.2d 986, 991, 268 Ill. Dec. 63, 68 (2002).

any property damage within the meaning of the policy. Citing the Illinois Supreme Court's decision of *Travelers Insurance Co. v. Eljer Manufacturing, Inc.*,⁶⁷ the court held that the plaintiffs merely sought either the repair of the replacement of defective work or the diminishing value of their home. They sought recovery for economic loss, not physical injury to tangible property, so there was no property damage within the meaning of the policy and no coverage under the policy.

This year, in *Viking Construction Mgt. Inc. v. Liberty Mutual Ins. Co.*,⁶⁸ the Illinois appellate court concluded that the underlying complaint sought merely repair and replacement of the damaged product. Consistent with the earlier decisions, the court held these damages to be "economic damages" and not recoverable as damages because of property damage within the meaning of the CGL policy.

Recently the U.S. District Court for the Eastern District of Arkansas predicted the Arkansas Supreme Court would reach a similar conclusion:

The court concludes that CONARK may not recover the "economic damages" incurred in connection with its subcontractor's construction of a faulty roof, which resulted in a foreseeable breach of contract. This is not a qualifying event which triggers coverage for the resulting "property damage." This would include the cost of removing and replacing the improperly installed roof. CONARK may, however, recover for any resulting property damage which resulted because the roof leaked, such as water stained ceiling tiles.⁶⁹

C. What if there is a Claim for Diminution of Value?

Many courts have also addressed the issue of whether there is coverage where the claim is that the product or structure has suffered diminution in value by virtue of incorporation of defective work.⁷⁰ Many have concluded what has been described as

⁶⁷197 Ill.2d 278, 757 N.E.2d 481, 258 Ill. Dec. 792 (2001).

⁶⁸358 Ill.App.3d 34, 831 N.E.2d 1, 294 Ill. Dec. 478 (2005).

⁶⁹*Nabholz Construction Corp. v. St. Paul Fire and Marine Ins. Co.*, 354 F.Supp.2d 917 (E.D. Ark. 2005).

⁷⁰*Travelers Insurance Co. v. Eljer Manufacturing, Inc.*, 197 Ill.2d 278, 757 N.E.2d 481, 258 Ill. Dec. 792 (2001) (some physical injury to tangible property must be shown in order to trigger coverage); *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 266 F.3d 859, 862-63 (8th Cir. 2001) (the costs of repairing defective welds not covered "damages because of property damage"); *New Hampshire Insurance Co. v. Vieira*, 930 F.2d 696, 701-702 (9th Cir. 1991) ("if the harm—Vieira's defective work—is not covered as measured by the diminished value [of the end product], it is not covered as measured by the cost of repair"); *Aetna Life & Cas. v. Patrick Industries, Inc.*, 645 N.E.2d 656, 661-62 (Ind.Ct.App. 1995) (must have physical injury to tangible property, so diminution in value does not create coverage); *Wyoming Sawmills, Inc. v. Transportation Ins. Co.*, 282 Or. 401, 578 P.2d 1253, 1256 (1978); *Columbia National Ins. v. Pacesetter Homes*, 248 Neb. 1, 532 N.W.2d 1, 8 (1995) ("diminution in value or loss of enjoyment ... is not a loss of use covered under the policy"); *Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc.*, 78 Cal.App. 4th 847, 93 Cal.Rptr. 2d 364, 376 (2000); *Aetna Cas. & Sur. Co. v. Ply Gem Indus. Inc.*, 343 N.J.Super. 430, 778 A.2d 1132, 1137 (2001); *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805 (7th Cir. 1992); *National Union Fire Insurance Company of Pittsburgh, P.A. v. Terra Industries, Inc.*, 216 F.Supp. 2d 899 (N.D. Iowa 2002).

the majority view⁷¹ that the definition of property damage set out *supra* requires that there be a physical injury such that mere diminution in value by virtue of incorporation of a defective part is not property damage within the meaning of the policy.⁷²

In 2001, the Illinois Supreme Court surprised some counsel when it issued *Travelers Insurance Co. v. Eljer Manufacturing, Inc.*⁷³ In addressing the issues in that case, the Illinois Supreme Court was faced with the Seventh Circuit Court of Appeals' decision in *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*,⁷⁴ which appeared to decide the issue under Illinois law—unfavorably to the insurer. However, the Illinois Supreme Court rightfully observed that they were not bound by the Seventh Circuit and concluded that there must be a harmful change in appearance, shape, composition or some other physical dimension to the claimants' property for there to be damages because of property damage. In a very lengthy opinion, the court explained the basis for its ruling contrary to the Seventh Circuit's decision. The court concluded by saying:

In sum, this court now finds that, under its plain and ordinary meaning, the term “physical injury” unambiguously connotes damage to tangible property causing an alteration in appearance, shape, color or in other material dimension ... We also conclude that under its plain and ordinary meaning, the phrase “physical injury” does not include intangible damage to property, such as economic loss. We agree with the ruling of our appellate court ... that the diminution in value of a whole, resulting from the failure of a component to perform as promised, does not constitute a physical injury.⁷⁵

Another example is *Amtrol, Inc. v. Tudor Insurance Company*.⁷⁶ The court cited *Eljer*.⁷⁷

The physical injury requirement in standard CGL policies exists to prevent recovery of mere economic loss In other words, CGL policies are intended to protect the insured from liability for injury or damage to the persons or property of others; they are not intended to pay the costs associated with repairing or replacing the insured's effective work and products, which are purely econom-

⁷¹*Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 266 F.3d 859, 862 (8th Cir. 2001).

⁷²See Footnote 71.

⁷³197 Ill.2d 278, 757 N.E.2d 481, 258 Ill. Dec. 792 (2001).

⁷⁴972 F.2d 805 (7th Cir. 1992).

⁷⁵197 Ill.2d 278, 312, 757 N.E.2d 481, 502, 258 Ill. Dec. 792, 813 (2001).

⁷⁶2002 WL 31194863 (D.C. Mass.).

⁷⁷197 Ill.2d 278, 757 N.E.2d 481, 258 Ill. Dec. 792 (2001).

ic losses. Finding coverage for the cost of replacing or repairing defective work would transform the policy into something akin to a performance bond.^{78 79}

D. What About Damages Caused by the Repair and/or Replacement?

Another argument frequently made is that the damage done during the repair and replacement of the defective work is property damage within the meaning of the policy and converts the repair/replacement cost into covered damages. Some courts that have been asked to address this argument—sometimes referred to as the “rip and tear” argument—have outright rejected it.⁸⁰

In *NAS Surety Group v. Precision Wood Products, Inc.*,⁸¹ the court declined to rule on the issue of whether the damages were because of property damage within the meaning of the policy, but did address one aspect of what is commonly referred to as the “rip and tear” issue: is the damage that is done when defective work is repaired or replaced covered? In *NAS*, the Almance Regional Medical Center (ARMC) hired Rodgers Builders, Inc. to serve as general contractor for an extensive renovation and expansion of the Center. Rodgers hired Fowler Jones Construction Company to serve as the prime contractor. Fowler hired PWP as a subcontractor to provide cabinets and millwork on the project. PWP obtained a performance bond from NAS Surety and purchased a general liability policy from Lumber Insurance Company.

PWP supplied the cabinetry and millwork to Fowler and subcontracted the installation to Laboratory Services. After AKMC took possession of the work, extensive defects were discovered in the cabinetry and millwork provided by PWP. The problems included delamination of the countertops and inadequate construction of the drawers and doors.

ARMC demanded that Rodgers and Fowler correct the cabinetry and millwork problems. Fowler made demand on PWP and NAS, as PWP’s surety. Fowler, claiming rights as an additional insured, PWP and NAS all tendered the ARMC claim to Lum-

⁷⁸2002 WL 31194863 (D.C. Mass.)

⁷⁹This court also dealt with the frequently heard argument that the repair and was being undertaken to prevent future property damage, so it should be considered to be sums they were legally obligated to pay because of property damage within the meaning of the policy. The court ultimately rejected this argument concluding that to embrace this argument the court would have to ignore the requirement of the policy that there be property damage. The policyholder argued that in environmental cases court frequently ruled that remediation costs were covered even though their purpose was to prevent future contamination. The court observed that property damage in the form of contamination was present in those cases from the beginning, unlike in the construction defect case before it.

⁸⁰One way that the argument should be subject to defeat is that the insurance market has products available to address this very type of claim. Referred to as “rip and tear” or “rework” endorsements, coverage can be bought to pay for costs associated with replacing faulty work or products.

⁸¹271 F.Supp. 2d 776 (M.D.N.C. 2003).

ber. Lumber issued reservation of rights letters to each, noting that there was no duty to defendant because there was no lawsuit.

The claim was settled by a payment by NAS as surety for PWP and by the CGL carrier for Fowler. NAS was assigned the rights of Fowler and its CGL carrier. NAS then sued Lumber.

Lumber moved for summary judgment, which was granted. The order addressed several coverage issues, including the lack of an occurrence under South Carolina or North Carolina law where the claim is for damages for repair or replacement of faulty or defective workmanship standing alone. In particular, the court addressed whether ARMC experienced other damages as a result of PWP's defective cabinetry that would trigger coverage under the CGL policy.

The settlement agreement in the case included a provision that PWP's defective cabinetry and millwork would cause "significant damage to other portions of the Project in the hospital, including but not limited to sheet rock, painting, wallpaper, floor covering, plumbing and fixtures, and wiring and electrical work" and "would result in a disruption of its business, thereby causing it substantial economic loss."⁸² NAS counsel argued that this anticipatory damage should be the focus of the analysis.

Lumber was able to obtain from the executive vice president of ARMC an affidavit that ARMC did not experience any "collateral property damage" during the repair and replacement of PWP's defective work. Apparently, Lumber's counsel conceded at argument that ARMC incurred some minor damages for repair of drywall, repainting of walls and removal and reinstallation of sinks incident to the replacement of the cabinetry and millwork. However, Lumber argued that such damages were not "collateral damages," but rather a foreseeable consequence of the repair and replacement effort. Thus, those damages did not arise from an occurrence, so would not be covered. The court agreed.

The court concluded that the potential for anticipatory damages outlined in the settlement agreement were defeated by the affidavit of the ARMC vice president who said that the damages were not incurred. Another case that has addressed these issues is *Woodfin Equities Corp v. Harford Mutual Insurance Company*.⁸³ In that case, the court also addressed the so-called "rip and tear" issue, finding that the ripping out of the subject hotel walls, molding and carpeting to replace failed HVAC units was not "property damage" within the meaning of the policy. The reader will note when it reviews the case that is red flagged in the computer research systems. On appeal from the Court of Special Appeals, the Court of Appeals ruled that the failure of the circuit court to file written declaration with regard to the disputed insurance coverage dis-

⁸²271 F.Supp.2d 776, 783 (M.D.N.C. 2003).

⁸³110 Md. App. 616, 678 A.2d 116 (1996), *overruled on procedural grounds* 344 Md. 399, 687 A.2d 652 (1997).

putes was reversible error and the Court of Special Appeals should not have reached the merits of the dispute in absence of such declaration.⁸⁴ In effect, the Court of Appeals did not reject the analysis, but rather ruled that it should not have been addressed. Some courts have noted that the case was overruled on “procedural” grounds and have cited the case anyway.⁸⁵ Other courts and commentators have just cited the case as “affirmed in part and reversed in part.”⁸⁶

In *Woodfin*, Woodfin developed a hotel in Rockville, Maryland. Woodfin hired HCC to serve as general contractor. HCC subcontracted with Deerfield Engineering, Inc. to perform the mechanical work for the project, specifically the HVAC system. Deerfield was insured by Hartford Mutual Insurance Company.

Allegedly, the hotel opened on February 23, 1988, and in March 1988, the hotel began to experience problems with the HVAC system. By June 1989, 130 of the HVAC units had failed at least once. Woodfin sued Deerfield and the suppliers for the HVAC units. Woodfin asserted that they incurred considerable losses and expenses, including the loss of income from the unavailability of guest rooms, costs associated with the repair and replacement of pumps in the HVAC systems, consultant fees for conducting tests and providing opinions as to the reasons for the HVAC failures, management time expended with respect to customer relations and correcting the problems, increased energy costs, loss of goodwill, and attorneys fees and costs related to the lawsuit.

Deerfield’s insurer filed a declaratory judgment action. The case went to trial and the developers put on evidence that the failure of the system resulted from a number of acts that were performed by Deerfield including rupturing or fracturing capillary tubes in the units during installation and placing the temperature-sensing bulb in the wrong position. As the units failed, they were replaced. The witness testified that replacement caused damage to the walls and carpeting of the hotel and testified that there were damages for loss of room occupancies, replacement of the HVAC units, consultant fees, management time and loss of goodwill.

In reviewing the trial court’s determination that none of the damages were covered, the appellate court started with the basic premise in Maryland that “CGL policy coverage compensates for physical damage to the property of others, and not for an insured’s contractual liability because the product of completed work supplied by the

⁸⁴*Hartford Mutual Insurance Company v. Woodfin Equities Corp.*, 344 Md. 399, 687 A.2d 652 (1997).

⁸⁵*Lords Landing Village Condominium Council of Unit Owners v. Continental Insurance Company*, 191 F.3d 448 (4th Cir. 1999) (unpublished).

⁸⁶*United States Fire Insurance Company v. Milton Company*, 35 F.Supp.2d 83 (D.C.D.C. 1998); 4 *Bruner & O’Connor Construction Law* 11:35.

insured is not that for which the damaged third party bargained.⁸⁷ The appellate court concluded that the trial court was correct in part and incorrect in part.

Looking at the issue of whether there was property damage within the meaning of the policy, the appellate court ruled that the evidence demonstrated physical injury to tangible property in the form of the broken capillary tubes, burnt out compressors, damaged pipes and contaminated HVAC system. However, the court explained that the insured would have to show also that the property damage resulted from an occurrence. The court held that it could not do so when the property damage is confined to the insured's own work product. Interestingly, then, the court went on to hold that the policy also would not cover the costs associated with tearing out walls, molding, and carpeting in order to repair and remove the HVAC units, nor would the policy cover the economic costs of paying consultants or the economic costs associated with loss of management time—all because these damages were not caused by an occurrence.

In a footnote, the court further explained its reasoning:

We reject appellants' suggestion that there was "property damage" to the walls, molding, and carpeting in the suites. Simply stated, no such evidence was presented—not during the hearing below and not during the Trane default judgment damages hearing. For example, appellants produced no evidence that fluids leaked out of the HVAC system and ruined walls or carpeting in the hotel. Voluntarily pulling up carpeting or breaking through dry-wall to access the HVAC units is not property damage; it is the cost incurred in replacing and repairing the HVAC systems. Even if it could be considered "property damage," we would hold that it was not caused by an "occurrence," because the so-called damage was not accidental. To be sure, these are damages under the CGL policy that have resulted from "property damage" to the HVAC system, but they are not, in and of themselves, "property damage." In this regard, appellants have failed to appreciate the critical difference under the CGL policy between "damages" on the one hand, and "property damage," on the other hand. As we have demonstrated, the CGL policy defines the term "property damage." The term "damages," however, is not defined in the CGL policy. In *Bausch & Lomb*—where the term "damages" also was not defined in the general coverage provision of a CGL policy—the Court of Appeals determined that "damages" should be interpreted according to its ordinary dictionary meaning. ... The Court, therefore, held that "damages" means the money estimated for reparation for an injury sustained or the money paid to make good on an insurance loss.⁸⁸

⁸⁷110 Md. App. 616, 642, 678 A.2d 116, 127 (1996), *overruled on procedural grounds* 344 Md. 399, 687 A.2d 652 (Md. 1997).

⁸⁸110 Md. App. 616, 649, fn 8, 678 A.2e 116, 131 (1996), *overruled on procedural grounds*, 344 Md. 399, 687 A.2d 652 (1997) (citations omitted).

In *Auto Owners Insurance Company v. Travelers Casualty & Surety Company*,⁸⁹ a Florida federal district court addressed several coverage issues arising from this dispute in which the surety argued that the contractor’s general liability carrier was obligated to reimburse the surety for its payments. The court framed the rip and tear issue as follows:

The costs to repair the leaking pipe at Wellcraft would necessarily include the costs to dig up the facility and replace the floor once the pipe was repaired or replaced—part of the original construction. Therefore, this court finds that the liability Reliance alleges it was paying pursuant to the performance bond—the cost to dig up the facility, repair or replace the pipe and once the pipe is replaced or repaired, reconstruct the floors—is liability to correct the defect (the leaking pipe) and not liability for damages as a result of the defect. Reliance argues that the costs to dig up the pipe and reconstruct the lay up facility after replacing the pipe are “damage” to other property and should be covered by the CGL carrier Interpreting a CGL policy to cover replacement and repair of defective construction would “enable a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from his insurance company to repair or correct the deficiencies in his work.”⁹⁰

IV. Conclusion

Significant state and federal authorities from across the nation support the proposition that CGL policies do not cover the cost of a contractor’s compliance with its contractual obligation to provide a non-defective project. Regardless of whether a court focuses on the term “occurrence” or “property damage,” the critical inquiry is to look at the scope of the policyholder’s contract. If the damage is to work within the scope of the policyholder’s contractual undertaking, many cases hold that, either because there is no “occurrence” or no “property damage” (or both), the policy does not apply. According to these cases, only damage to something outside of the policyholder’s contract, such as third-party bodily injury and property damage, fall within the insuring agreement. These cases are based on the proposition that the 1986 revisions to the standard CGL exclusions did not change the fundamental purpose of liability insurance.

⁸⁹227 F.Supp.2d 1248 (M.D. Fla. 2002)

⁹⁰227 F.Supp. 2d 1248, 1270-71 (M.D. Fla. 2002); *See also, Nabholz Construction Corp. v. St. Paul Fire and Marine Insurance Company*; 354 F. Supp. 2d 917 (E.D. Ark. 2005).

Notes

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