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# State Courts Trend: Coverage for Faulty Workmanship

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Allegations of defective workmanship on construction projects lead to eventual claims of property damage and consequential loss. Counsel who represent owners, general contractors, and subcontractors faced with such liability claims need to analyze whether the claims are covered by insurance, in terms of defense and indemnification. Several states' supreme courts have recently addressed the question of whether coverage is available for construction defect claims and the majority trend is to find coverage.

Before 1976, a widely held consensus existed that commercial general liability (CGL) policies covered only "tort liability for physical damages to others and not for contractual liability of the insured for economic loss."<sup>1</sup> However, after the 1976 Broad Form Property Damage Endorsement and the 1986 revisions to the standard CGL policy, consensus began to falter. The issue of whether a CGL policy covers damages caused by a contractor's or subcontractor's defective workmanship has produced a split in reasoning among the highest state courts of the United States.

In interpreting the 1986 CGL revisions, courts have generally focused their analyses on what constitutes an occurrence and property damage under the applicable policy. Although some courts find that coverage now exists for faulty workmanship under the 1986 revisions,<sup>2</sup> others still cling to broad pre-1976 concepts to find coverage lacking.<sup>3</sup> The present scorecard demonstrates that a majority of state high courts have concluded that there is coverage for faulty construction work now available under the 1986 CGL revisions.

The purpose of this article is to briefly examine the evolution of the



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occurrence and property damage provisions in light of their applicable exclusions, and to provide examples of how the highest state courts have interpreted such provisions to provide or preclude coverage in the context of a contractor's or subcontractor's faulty workmanship.

## Evolution of the CGL Policy's Occurrence and Property Damage Terms

In 1940, the insurance industry drafted the first standard form CGL insurance policy "to address the misunderstanding, coverage disputes, and litigation" that resulted from the different language that individual liability insurers used.<sup>4</sup> In general, the policy provided a broad assumption of risk for all property damage caused by an occurrence during the policy period.<sup>5</sup> However, the standard CGL policy also provides limitations or exclusions that carve out categories of property damage from initial coverage. Critics have claimed that "[d]uring the past thirty years, these limitations have been *narrowed* to provide *broader* coverage for construction property damage."<sup>6</sup>

For example, the business risk exclusions contained in the 1973 standard form CGL policy, which included the your-work and your-product exclusions, barred coverage

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

performed by or on behalf of the named insured arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith.<sup>7</sup>

In 1976, the Insurance Services Office<sup>8</sup> issued the Broad Form Property Damage Endorsement (hereafter, the 1976 endorsement), which an insured could purchase for an additional premium.<sup>9</sup> That endorsement deleted the original exclusion (o) and replaced it with three more-specific exclusions, thereby broadening coverage provided by the 1973 CGL policy.<sup>10</sup> The 1976 endorsement provided that coverage did not apply

- (p) To that particular part of any property . . .
  - (i) upon which operations are being performed by or on behalf of the insured at the time of the property damage arising out of such operations; or
  - (ii) out of which any property damage arises; or
  - (iii) the restoration, repair or replacement of which has been made or is necessary by reason of faulty workmanship thereon by or on behalf of the insured.<sup>11</sup>

While litigation arose over the faulty workmanship language, confusion also grew as to whether that exclusion concerned only work in progress or whether it also applied to completed projects (i.e., completed operations) as well. In regard to completed operations, the 1976 endorsement further illustrated in pertinent part that the insurance did not apply "to property damage *to work performed by the named insured* arising out of such work or any portion thereof, or out of such material, parts or equipment furnished in connection there-

with.”<sup>12</sup> By excluding coverage only to work performed by the name insured, the 1976 endorsement appeared to broaden coverage for property damage caused by subcontractors.

The CGL policy was revised again in 1986 to incorporate the provisions of the 1976 endorsement (hereafter, the 1986 revisions). The 1986 revisions, however, clarified the 1976 endorsement by incorporating new exclusion (j)(6) and excepting from that exclusion faulty workmanship related to the products-completed operation provision:

This insurance does not apply to:

j. Damage to property

“Property damage” to:

....

(6) That particular part of any property that must be restored, repaired or replaced because “your work” was incorrectly performed on it.

....

*Paragraph (6) of this exclusion does not apply to “property damage” included in the “products-completed operations hazard.”*<sup>13</sup>

The 1986 revisions also added new exclusion (l), the your-work exclusion, which expressly created an exception for subcontractor work.

This insurance does not apply to:

....

l. Damage To Your Work

“Property damage” to “your work” arising out of it or any part of it and included in the “Products-Completed Operations Hazard.”

*This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.*<sup>14</sup>

The 1986 revisions were based on the policyholder community and the insurance industry agreeing “that the CGL policy should provide coverage for defective construction claims so long as the allegedly defec-

tive work had been performed by a subcontractor rather than the policyholder itself.”<sup>15</sup> That agreement was forged under pressure from policyholders and the perception of the insurance industry that the 1986 revisions provided a more attractive product to policyholders that it could sell more easily.<sup>16</sup>

As a result of the 1986 revisions, the timing of the property damage has become increasingly important.

## Insurers argue that damage caused by a contractor’s faulty workmanship does not constitute an occurrence on CGL policy.

If the damage occurs during construction operations, the particular-part exclusion of the 1986 revisions appears to bar coverage. However, if the damage occurs after the work was completed, the claim should fall under the completed operations hazard for coverage under the 1986 revisions’ exception to the exclusion.

As this brief drafting history shows, the CGL policy has been modified over the years to address the concerns of both policyholders and the insurance industry. In addition, as would be expected, differences in how policyholders and insurers interpret those changes have resulted in a substantial amount of litigation. However, the key to the interpreta-

tive struggle lies within the language changes, a fact that is not lost on states’ highest courts that have had to grapple with that historical evolution of the CGL policy provisions. The next section addresses how the high courts have recently construed the 1986 revisions’ policy provisions.

### State Supreme Courts Interpret Occurrence and Property Damage Provisions

The New Jersey Supreme Court’s seminal case concerning coverage for construction defect-related claims, *Weedo v. Stone-E-Brick, Inc.*, explained that the insuring provisions “set forth, in fundamental terms, the general outlines of coverage,” while “[t]he limitations on coverage are set forth in the exclusion clauses of the policy, whose function it is to restrict and shape the coverage otherwise afforded.”<sup>17</sup> In *Weedo*, the court concluded that coverage for faulty workmanship was lacking, not because of the insuring provisions, but because the work was specifically excluded from coverage under the 1973 business risk exclusionary clauses.

Within the past few years, however, several state supreme courts have discarded their prior *Weedo*-supported state court decisions. Such courts have reasoned that their prior decisions—which interpreted pre-1986 CGL policies—are now inapplicable to analogizing coverage for faulty workmanship claims in light of the 1986 revisions.<sup>18</sup>

The following sections briefly discuss how some states’ highest courts have analyzed the issues of whether faulty workmanship constitutes an occurrence or property damage in light of the 1986 revisions.

### Can Faulty Workmanship Constitute an Occurrence?

Insurers typically argue that damage caused by a contractor’s own faulty workmanship does not constitute an occurrence under a CGL policy. Although each state’s interpretation governs each policy’s definition of an occurrence, the term has generally been held to constitute an “accident” or injuries that are not expected or intended from the “standpoint of

the insured.”<sup>19</sup> Several of the highest courts that have ruled on this issue have found that those expectations should not depend on the type of property that was damaged but rather on the circumstances surrounding the event.<sup>20</sup> As the Tennessee Supreme Court explained:

A shingle falling and injuring a person is a natural consequence of an improperly installed shingle, just as water damage is a natural consequence of an improperly installed window. . . . If, however, we assume that the installation of both the shingle and the window will be completed properly, then neither the falling shingle nor the water penetration is foreseeable and both events are “accidents.”<sup>21</sup>

Significantly, an occurrence under the CGL policy is not defined in terms of ownership of property. Instead, that term is linked to the fortuity of an event. From the “standpoint of the insured,” the foreseeability of its work causing damage to either a third party’s property or to the completed project is the same and should accordingly be treated.<sup>22</sup>

Insurers also argue that a faulty workmanship claim is contractual in nature and, thus, can never result in an accident. In other words, the argument follows these lines: Because a claim of faulty workmanship is nothing more than a breach-of-contract claim, there can be no coverage under a CGL policy because that type of policy is intended to cover only tortious conduct. In advancing that argument, insurers incorrectly assume that contracts can be breached only intentionally. Further, the argument is questionable because the policy’s plain language, which makes no distinction between torts or contracts in determining whether the policy covers a loss, does not support limiting claims to only tortious acts.<sup>23</sup> As the Wisconsin Supreme Court observed in *American Family Mutual Insurance Co. v. American Girl, Inc.*:

There is nothing in the basic coverage language of the current CGL policy to support any definitive tort/contract line of demarcation for

purpose of determining whether a loss is covered by the CGL’s initial grant of coverage. “Occurrence” is not defined by reference to the legal category of the claim. The term “tort” does not appear in the CGL policy.<sup>24</sup>

The Kansas Supreme Court followed *American Girl’s* reasoning to find that a subcontractor’s work can constitute an occurrence under Kan-

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sas law.<sup>25</sup> Most recently, the Florida Supreme Court, in *United States Fire Insurance Company v. J.S.U.B., Inc.* similarly concluded that if an insurer desires to preclude coverage on the basis of a breach-of-contract claim, the carrier is certainly able to provide clearer language to do so, or to take advantage of the breach-of-contract endorsement exclusion.<sup>26</sup>

A minority of courts, however, have rejected this occurrence construct, viewing the term very narrowly to find that coverage is not applicable. The supreme courts of Nebraska, South Carolina, Oregon, West Virginia, and Pennsylvania have all ruled that faulty workmanship does not constitute an accident because it is not a fortuitous event but merely a failure to perform under one’s contract.<sup>27</sup>

For example, the Pennsylvania Supreme Court found that an insured contractor was not covered under its CGL policy for the damages to the

coke oven battery it had contracted to install. The court found the damages to the insured’s work could not alone constitute an accident or occurrence because it did “not present the degree of fortuity contemplated by the ordinary definition of ‘accident’ or its common judicial construction in this context.”<sup>28</sup> However, such courts fail to explain fully why damage sustained by a third party contains the requisite fortuity as an occurrence but subsequent damage to the completed work product does not.

Those minority cases also fail to explain the internal conflict within the 1986 revisions if their interpretations are accepted. If claims for faulty workmanship do not qualify as an occurrence, there would be no reason for the your-work exclusion to exist, which expressly concerns faulty workmanship.<sup>29</sup> As the Wisconsin Supreme Court pointed out:

The business risk exclusions eliminate coverage for liability for property damage to the insured’s own work or product-liability that is typically actionable between the parties pursuant to the terms of their contract, not in tort. If the insuring agreement never confers coverage for this type of liability as an original definitional matter, then there is no need to specifically exclude it.<sup>30</sup>

A minority of high courts also justify their position on the basis that allowing coverage for faulty or defective work would improperly convert the CGL policy into a performance bond.<sup>31</sup> However, as the majority of high courts point out, that argument also fails because of the material differences between a CGL policy and a surety-type agreement. First, the purpose of a performance bond is to “guarantee the performance” of a contract, which inures to the benefit of the owner, not the contractor.<sup>32</sup> Second, a CGL policy simply spreads a contractor’s risk, whereas a bond guarantees its eventual performance.<sup>33</sup> Third, CGL policies are issued according to a risk evaluation with the expectation of losses, whereas performance bonds are underwritten on the basis of a credit

evaluation of a contractor's ability to perform and complete a project, where no losses are expected.<sup>34</sup>

Assuming that the court considers the faulty or defective work to constitute an occurrence, the inquiry does not end there. The insured still must demonstrate that the defective work caused property damage and, further, that an exclusion in the policy does not preclude coverage.

### **Does Faulty Workmanship Constitute Property Damage?**

CGL policies define property damage as "[p]hysical injury to tangible property, including all resulting loss of use of that property."<sup>35</sup> Insurers have argued that an insured's own faulty construction work is not property damage under the CGL policy but, rather, a contractual economic loss that is not covered.<sup>36</sup> A majority of state high courts have rejected that argument, noting that the economic loss rule may determine "what cause of action is available to recover economic losses—tort or contract—but not whether an insurance policy covers a claim, which depends on the policy language."<sup>37</sup>

Although there is a divergence of opinion regarding whether an occurrence exists, the courts are generally of one mind in their determination that damage to property beyond the insured's work product is covered. However, damage to the insured's work product alone is not. For example, most recently, the Supreme Court of Florida found that damage to a homeowner's foundation, dry-wall, and other interior portions of the home, caused by the subcontractor's use of poor soil and improper soil compaction and testing, qualified as property damage.<sup>38</sup> The Wisconsin Supreme Court similarly found that a subcontractor's failure to apply soil adequately, which caused damage to a warehouse, constituted covered property damage.<sup>39</sup> Further, the Supreme Court of Tennessee found that water damage to a building caused by faulty window installation constituted property damage.<sup>40</sup> In all those cases, the property damage went beyond the work performed by the insured.

However, where the damage claimed is solely for the insured's work, courts have found no coverage. For example, in *Auto-Owners Insurance Company v. Pozzi Window Company*,<sup>41</sup> the Supreme Court of Florida, in a companion case to *J.S.U.B.*, found that damage to the insured's poorly installed windows, while constituting an occurrence, did not constitute property damage under the CGL policy. Because the claim was simply for a defective

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component of the completed project generated by the subcontractor, no property damage existed.<sup>42</sup>

In short, courts generally conclude that claims requiring only the replacement of the subcontractor's defective work—and no more—are not covered under a CGL policy because there is no property damage. Only

when the claim involves extraneous damage caused by the subcontractor's work will the property damage term be satisfied and thus provide potential coverage.

For those who practice in construction law, it is important to appreciate how the courts of a particular jurisdiction will interpret complex policy language to arrive at a decision as to whether there is coverage for faulty work. A court's analysis will inevitably take into account how certain terms of the CGL policy should be defined and construed, such as *occurrence*<sup>43</sup> and *property damage*.<sup>44</sup> The majority of state supreme courts that have confronted these coverage issues have concluded that the insurance industry intended to expand coverage for unintentional property damages caused by subcontractors to the contractor-insured's completed project.<sup>45</sup> That was the apparent purpose of the 1986 revisions to the 1973 CGL policy. Undoubtedly, however, those coverage issues will continue to be hotly debated as other state supreme courts are asked to determine whether a CGL policy covers faulty workmanship.

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### **Endnotes**

1. Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations: What Every Lawyer Should Know*, 50 NEB. L. REV. 415, 441 (1971).

2. *See, e.g.*, French v. Assurance Co. of Am., 448 F.3d 693 (4th Cir. 2006) (Va. law); Ferrell v. W. Bend Mut. Ins. Co., 393 F.3d 786 (8th Cir. 2005) (Ark. and Wis. law); Transportes Ferreos de Venezuela II CA v. NKK Corp., 239 F.3d 555 (3d Cir. 2001) (N.J. law); Fejes v. Alaska Ins. Co., 984 P.2d 519 (Alaska 1999); U.S. Fire Ins. Co. v. J.S.U.B., Inc., No. SC05-1295, 2007 WL 4440232 (D. Fla. Dec. 20, 2007); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 137 P.3d 486 (Kan. 2006); Wanzek Constr., Inc. v. Employers Ins., 679 N.W.2d 322

(Minn. 2004); *Webster v. Acadia Ins. Co.*, 934 A.2d 567 (N.H. 2007); *Corner Constr., Inc. v. U.S. Fid. & Guar.*, 638 N.W.2d 887 (S.D. 2002); *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302 (Tenn. 2007); *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 239 S.W.3d 236 (Tex. 2007); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004).

3. *See, e.g.*, *Auto-Owners Ins. Co. v. Home Pride Cos.*, 684 N.W.2d 571 (Neb. 2004); *Oak Crest Constr. Co. v. Austin Mut. Ins. Co.*, 998 P.2d 1254 (Ore. 2000); *Kvaerner Metal Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 908 A.2d 888 (Pa. 2006); *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 621 S.E.2d 33 (S.C. 2005); *Webster County Solid Waste Auth. v. Brackenrich & Assocs., Inc.*, 617 S.E.2d 851 (W. Va. 2005).

4. *See* J.S.U.B., 2007 WL 4440232, at \*4 (citing 21 ERIC MILLS HOLMES, HOLMES' APPLEMAN ON INSURANCE 2D, § 129.1, at 7 (2002)).

5. Clifford J. Shapiro, *Point/Counterpoint: Inadvertent Construction Defects Are an "Occurrence" under CGL Policies*, CONSTRUCTION LAW, Spring 2002, at 13. Although the policy has been changed several times since its inception, the most notable change is the language providing coverage for damages "caused by an accident" to include coverage for damages caused by an "occurrence," which has been defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." J.S.U.B., 2007 WL 4440232, at \*4.

6. Shapiro, *supra* note 5, at 13 (emphasis added).

7. HOLMES, *supra* note 4, § 132.1, at 11 (emphasis added).

8. The Insurance Services Office, Inc., also known as ISO, is an "industry organization that promulgates various standard insurance policies that are utilized by insurers throughout the country." J.S.U.B., 2007 WL 4440232, at \*5 n.6.

9. Shapiro, *supra* note 5, at 14.

10. 1 *Id.*; *see also* J.S.U.B., 2007 WL 4440232, at \*4.

11. Shapiro, *supra* note 5, at 14.

12. *Id.* (emphasis added).

13. J.S.U.B., 2007 WL 4440232, at \*5.

14. *Id.*

15. *Id.*

16. *Id.* (citing 2 JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS § 14.13[D] at 14-224.8 (3d ed. Supp. 2007)).

17. *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788, 790 (N.J. 1979).

18. J.S.U.B., 2007 WL 4440232, at \*8; *Wanzek*, 679 N.W.2d at 327; *Moore*, 216 S.W.3d at 307; *Am. Girl*, 673 N.W.2d at 77.

19. *Lamar Homes*, 239 S.W.3d at 244 (citing 1A JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 360 at 449 (1981)) ("accidents" are "something unforeseen, unexpected, and unpremeditated").

20. J.S.U.B., 2007 WL 4440232, at \*9; *Lamar Homes*, 239 S.W.3d at 245.

21. *Moore*, 216 S.W.3d at 309; *see* J.S.U.B., 2007 WL 4440232, at \*10.

22. *See* *Lamar Homes*, 239 S.W.3d at 245.

23. *See* *Lee Builders*, 137 P.3d at 491 (Kan. 2006); *Am. Girl*, 673 N.W.2d at 77.

24. *Am. Girl*, 673 N.W.2d at 77.

25. *Lee Builders*, 137 P.3d at 491.

26. J.S.U.B., 2007 WL 4440232, at \*10 (citing *B. Hall Contracting Inc. v. Evanston Ins. Co.*, 447 F. Supp. 2d 634, 639 (N.D. Tex. 2006)). The breach-of-contract endorsement exclusion provides: "This insurance does not apply to claims for breach of contract, whether express or oral, nor claims for breach of an implied in law or implied in fact contract, whether 'bodily injury,' 'property damage,' 'advertising injury,' 'personal injury' or an 'occurrence' or damages of any type is alleged; this exclusion also applies to any additional insured under this policy." *Id.*

27. *See* *Auto-Owners*; *Oak Crest*; *Kvaerner*; *L-J*; *Webster County*.

28. *Kvaerner*, 908 A.2d at 898-99 (citing *L-J, Inc.*, 621 S.E.2d at 36 and *McAllister v. Peerless Ins. Co.*, 474 A.2d 1033, 1036 (N.H. 1984)).

29. *Lamar Homes*, 239 S.W.3d at 248 (Tex. 2007); *Am. Girl*, 673 N.W.2d at 78.

30. *Am. Girl*, 673 N.W.2d at 78; *see also* J.S.U.B., 2007 WL 4440232,

at \*12 (citing *Lee Builders*, 137 P.3d at 494) ("A construction of the insuring agreement that precludes recovery for damage caused to the completed project by the subcontractor's defective work renders the 'products-completed operations hazard' exception to the exclusion (j)(6) and the subcontractor exception to the exclusion (l) meaningless."); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 673 (Tex. App. 2006) ("[F]inding no occurrence for defective construction resulting in damage to the insured's work would render the subcontractor exception superfluous and meaningless.").

31. *Kvaerner*, 908 A.2d at 899.

32. J.S.U.B., 2007 WL 4440232, at \*13; *Fid. & Deposit Co. of Md. v. Hartford Cas. Ins. Co.*, 189 F. Supp. 2d 1212, 1218 (D. Kan. 2002) (citing difference between CGL policy and bond in that bond in no way protects contractor or subcontractor from liability).

33. *See* *Lamar Homes*, 239 S.W.3d at 246 n.7.

34. *Id.*

35. J.S.U.B., 2007 WL 4440232, at \*14.

36. *See* J.S.U.B., 2007 WL 4440232, at \*14 n.11; *Lamar Homes*, 239 S.W.3d at 248.

37. J.S.U.B., 2007 WL 4440232, at \*14 n.11; *see* *Ferrell*, 393 F.3d at 795; *Lamar Homes*, 239 S.W.3d at 248.

38. J.S.U.B., 2007 WL 4440232, at \*15.

39. *Am. Girl*, 673 N.W.2d at 74-75.

40. *Moore*, 216 S.W.3d at 310.

41. *Auto-Owners Ins. Co. v. Pozzi Window Co.*, No. SC06-779, 2007 WL 4440389, at \*2 (D. Fla. Dec. 20, 2007).

42. *Id.* at \*5 (citing *Moore*, 216 S.W.3d at 310) ("[The contractor's] subcontractor allegedly installed the windows defectively. *Without more, this alleged defect is equivalent of the 'mere inclusion of a defective component' such as the installation of a defective tire, and no 'property damage' has occurred.*").

43. *See* *Webster*, 934 A.2d at 573 (N.H. 2007) (distinguishing *McAllister* [*supra* note 28], which held that

“defective work, standing alone, did not result from an occurrence,” to find that damage to purlins that were attached to damaged roof did constitute an “occurrence” under policy because damage to purlins was unexpected).

44. *See Pozzi*, 2007 WL 4440389, at \*5 (finding recovery for defective window installation alone did not constitute “property damage” under policy).

45. *J.S.U.B.*, 2007 WL 4440232, at \*19 (Lewis, C.J., concurring).