

Raising the Roof—What’s Hot in Construction Defect Litigation

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Raising the Roof—What’s Hot in Construction Defect Litigation

I. Introduction

The period spanning from the mid-1990s to the “crash” of the real estate market in 2007 saw an unprecedented explosion of new construction throughout the United States, particularly in the “Sun Belt.” As with any boom, the frenzy of ever-increasing real estate prices tempted many of the players involved to cut corners and increase profits. Thus, the term “value engineering” took on a new meaning in the construction field.

The basic tenet of “value engineering” is to increase the ratio of function to cost. This can be done either by increasing functionality or decreasing cost. The fast buck artists chose the latter with obvious consequences.

Unfortunately for the purchasers of “value engineered” projects, the reduction of cost generally resulted in a decrease in function. However, the decreased function generally did not make itself evident until years after the developer had packed up and left town. Just like Sylvester McMonkey McBean in Dr. Seuss’s *The Sneetches*, “... when every last cent of their money was spent, [t]he fix-it-up Chappie packed up. And he went.” Dr. Seuss, *The Sneetches*, Random House Pub. (1961). Years after construction was completed, owners of properties, riddled with defects, sued the developer, builder and/or sub-contractor(s) to recover the cost of repairing the defective construction.

Ever eager to share the misery, the sued entities then turned to their general liability insurers, claiming the defective construction was an “accident” and therefore covered under their general liability policies. Not since asbestos litigation has any one coverage issue spawned so much litigation. As of the date of this article, only seven states in the country have escaped addressing the issue of whether defective construction meets the definition of an “accident” and therefore constitutes a covered “occurrence” within the meaning of the I.S.O. general liability policy in use since 1986. See Table 1, below. This paper explores the various approaches taken by courts considering the issue. It then presents other issues which are beginning to be addressed by courts which found defective construction to be an “occurrence.”

II. Is Defective Construction an “Occurrence?”

The broad form general liability policy widely in use since the 1960’s grants the following coverage:

We will pay those sums that the insured becomes legally obligated to pay as damages because of “bodily injury” or “property damage” to which this insurance applies. ...

b. This insurance applies to “bodily injury” and “property damage” only if:

- (1) The “bodily injury” or “property damage” is caused by an “occurrence” that takes place in the “coverage territory”; and
- (2) The “bodily injury” or “property damage” occurs during the policy period.

Insurance Services Office, Form CG 00 01 12 04. From this language, it is clear that, in order to trigger the coverage agreement in the first instance, there must be “property damage ... caused by an ‘occurrence.’” What then is an “occurrence?” The I.S.O. policy defines an “occurrence” as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” See *United States Fire Ins. Co. v J.S.U.B., Inc.*, 979 So. 2d 871 (Fla. 2007). Enter the fortuity principle—that which is accidental is necessarily fortuitous. Therefore, the policy is obviously intended only to cover fortuitous events, or those which are foreseeable, but not within the insured’s control. Arguably, if the resultant defect was “accidental” then the loss was an “occurrence.”

Other courts reached the same result but looked to the policy exclusions to justify their decisions. Comprehensive General Liability (“CGL”) policies contain a number of exclusions which might apply to bar coverage even where the court finds the defective construction to be an occurrence. The I.S.O. broad form general liability policy currently in use contains three exclusions, generally referred to collectively as the “business risk exclusions,” as follows:

This insurance does not apply to:

j. Damage to Property

“Property damage” to:

* * *

- (5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the “property damage” arises out of those operations; or
- (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”.

* * *

k. Damage to Your Product

“Property damage” to “your product” arising out of it or any part of it.

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 sub-contractor.

The policy then defines the “products-completed operations hazard” as:

all “bodily injury” and “property damage” occurring away from premises you own or rent and arising out of “your product” or “your work” except:

- (1) Products that are still in your physical possession; or
- (2) Work that has not yet been completed or abandoned. However, “your work” will be deemed completed at the earliest of the following times:
 - (a) When all of the work called for in your contract has been completed.
 - (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
 - (c) When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed.

Insurance Services Office, form CG 00 01 12 04.

A state-by-state review of the decisions on this subject reveals a broad spectrum of decisions spanning the gap from those which find that defective construction is never an “occurrence” (and, therefore, regardless of the extent of damage beyond the insured’s own work product, the claim is not covered), to those which find not only that defective construction is an “occurrence” but that the business risk exclusions are ambiguous and therefore do not even bar coverage for repair and replacement of the insured’s own work product. Those decisions define the extremes, while the overwhelming majority of decisions within the two extremes can be harmonized into a distinct set of broad principles. The true majority rule as to construction defects (as will be shown below) is that claims of defective construction, *standing alone*, do not meet the element of fortuity necessary to constitute an accident and are therefore not covered. However, where the work in question was performed by the insured’s sub-contractor, the damage is either considered “accidental from the standpoint of the insured” or fits within the sub-contractor exception to the “your work” exclusions. To the extent the insured’s defective work results in damage to other property which was not the subject of the insured’s work, that damage is covered. The decisions of each state are summarized in Table I following this article.

A. Defective Construction Is Never an “Occurrence”

The Supreme Court of New Jersey first recognized the requirement of a fortuity analysis as a bedrock principle of insurance law in 1979 in what was and remains a landmark case. *See Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979). *Weedo* involved a contractor who installed stucco on the side of its customer’s house, which later cracked and peeled. The homeowners sued the contractor, Stone-E-Brick, for the cost of removing and replacing the defective stucco. The New Jersey Supreme Court was thus faced with the question of whether defective construction, standing alone, constitutes an “occurrence.” The Court held that it did not. Its reasoning is simple and its logic irrefutable.

The Court first distinguished between the kinds of risks faced by a typical contractor, namely: 1) the risk that his work will not meet the customer’s expectation, thereby exposing him to liability in contract; and 2) the risk that some mistake on his part may result in bodily injury or property damage to a third party. In this regard, the Court noted:

While it may be true that the same neglectful craftsmanship can be the cause of both a business expense of repair and a loss represented by damage to persons and property, the two consequences are vastly different in relation to sharing the cost of such risks as a matter of insurance underwriting.

Weedo, 405 A.2d at 791. Quoting the words of Dean Roger Henderson, who espoused the principle in the *Nebraska Law Review*, the Court noted:

The risk intended to be insured is the possibility that the goods, products or work of the insured, once relinquished or completed, will cause bodily injury or damage to property other than to the product or completed work itself, and for which the insured may be found liable. The insured, as a source of goods or services, may be liable as a matter of contract law to make good on products or work which is defective or otherwise unsuitable because it is lacking in some capacity. This may even extend to an obligation to completely replace or rebuild the deficient product or work. This liability, however, is not what the coverages in question are designed to protect against. The coverage is for tort liability for physical damages to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.

An illustration of this fundamental point may serve to mark the boundaries between “business risks” and occurrences giving rise to insurable liability. When a craftsman applies stucco to an

exterior wall of a home in a faulty manner and discoloration, peeling and chipping result, the poorly-performed work will perforce have to be replaced or repaired by the tradesman or by a surety. On the other hand, should the stucco peel and fall from the wall, and thereby cause injury to the homeowner or his neighbor standing below or to a passing automobile, an occurrence of harm arises which is the proper subject of risk-sharing as provided by the type of policy before us in this case.

Henderson, *Insurance Protection for Products Liability and Completed Operations, What Every Lawyer Should Know*, 50 Neb. L. Rev. 415, 441 (1971).

Another prime example of the extreme on the “occurrence” spectrum is the recent decision of the Kentucky Supreme Court in *Cincinnati Ins. Co. v. Motorists Mutual Ins. Co.*, 306 S.W.3d 69 (Ky. 2010). In *Motorists Mutual*, the Court considered a claim against the insured general contractor brought by a couple which purchased a home built by the insured (the decision is silent regarding whether the contractor used sub-contractors to perform any of the work). Relying on the fortuity principle, the Court held simply:

Inherent in the plain meaning of “accident” is the doctrine of fortuity. Indeed, “[t]he fortuity principle is central to the notion of what constitutes insurance....” Although we have used the term fortuity in the past, we have not fully explored its breadth and scope. In short, fortuity consists of two central aspects: intent, which we have discussed in earlier opinions, and control, which we have not previously discussed.

Motorists Mutual, 306 S.W.3d at 74 (internal footnote omitted). Obviously, intent is relevant in determining fortuity. That which is intended is, by definition, not accidental. The applicability of the second concept, control, is less obvious but equally compelling. A general liability policy is not intended to provide coverage for those risks which are within the insured’s control, such as the selection of competent sub-contractors and the furnishing of quality building materials properly installed to provide protection from the elements. Since the quality of construction is always within the control of the contractor, whether the work is performed by a sub-contractor or the contractor’s own employees, any loss which results from poor workmanship cannot possibly be considered fortuitous. No fortuity, no accident, no occurrence, no coverage.

The Missouri Court of Appeals followed this rationale in concluding that a claim against a builder for building a defective home was not covered even though much of the work was performed by sub-contractors. See *Hawkeye-Security Ins. Co. v. Davis*, 6 S.W.3d 419 (Mo. Ct. App. 1999). The Court simply held that the construction was entirely within the insured’s control and therefore any damage resulting therefrom could not be fortuitous. The Court also chose to rest its decision on the distinction between tort and contract theories:

These uncontroverted facts establish that Appellants’ losses stem *solely* from Davis’s breach of his contractual obligations, breach of his express warranties, or breach of implied warranties in connection with this construction. However, “breach of a defined contractual duty cannot fall within the term ‘accident.’” [*American Stats Ins. Co. v. Mathis*, 974 S.W.2d 647, 650 [(Mo. Ct. App. 1998)]. As the *Mathis* court explained: “Performance of [the] contract according to the terms specified therein was within [the insured contractor’s] control and management and its failure to perform cannot be described as an undesigned or unexpected event.”

Davis, 6 S.W.3d at 426.

B. Defective Construction, Standing Alone, Is Not an “Occurrence”

The next step on the spectrum is well illustrated by the decision of the Nebraska Supreme Court in *Auto-Owners Ins. Co. v. Home Pride Cos., Inc.*, 684 N.W.2d 571 (Neb. 2004). In *Home Pride*, the Court considered

a claim against a contractor who replaced a number of roofs in an apartment complex. The insured contractor used a sub-contractor to perform the work. Following completion of the work, the shingles began to fall off the roofs and they leaked, resulting in damage to portions of the buildings other than the roofs themselves. The Court drew a distinction between damage to the roofs (the insured's work) and damage to the buildings resulting from water intrusion (other property):

Important here, although faulty workmanship *standing alone*, is not an occurrence under a CGL policy, an accident caused by faulty workmanship is a covered occurrence. ... Stated otherwise, although a standard CGL policy does not provide coverage for faulty workmanship that damages only the resulting work product, if faulty workmanship causes bodily injury or property damage to something other than the insured's work product, an unintended and unexpected event has occurred, and coverage exists.

Home Pride, 684 N.W.2d at 577-78 (internal citations omitted) (emphasis in original).

This approach seems entirely reasonable and consistent with Dean Henderson's statements quoted in the *Weedo* decision. Clearly, since the insured has full control over the quality of its work, whether it uses sub-contractors or not, any damage to the work product of the insured itself is inherently non-fortuitous. Dean Henderson drew this precise distinction in the context of the defective stucco wall:

[S]hould the stucco peel and fall from the wall, and thereby cause injury to the homeowner or his neighbor standing below or to a passing automobile, an occurrence of harm arises which is the proper subject of risk-sharing as provided by the type of policy before us in this case.

Henderson, *Insurance Protection for Products Liability and Completed Operations, What Every Lawyer Should Know*, 50 Neb. L. Rev. 415, 441 (1971). Consistently, in *Home Pride*, the damage to property resulting from water intrusion is a perfect analog to the damage to the passing automobile referenced above. The only difference (and it is truly a difference without a distinction) is that the passing automobile is not connected to the work of the insured. It is therefore logically much easier to understand why that damage to the other property is covered, whereas the damage to the roof itself is not. As the argument goes, the fact that the property damaged by the insured's faulty work happens to be connected to the work product of the insured should not be treated differently from the passing automobile; it is damage to property *other than the insured's work* which was damaged *as a result of the insured's work*. Like the passing automobile, the water intrusion damage is covered.

C. Defective Construction Is an "Occurrence," But the Business Risk Exclusions Apply

The next line along the spectrum consists of those courts which find that defective construction is an "occurrence" (or the courts skipped that analysis completely), but that the business risk exclusions apply to bar coverage entirely. This viewpoint is illustrated by the decision of the Massachusetts Supreme Judicial Court in *Commerce Ins. Co. v. Betty Caplette Builders, Inc.*, 647 N.E.2d 1211 (Mass. 1995). In *Betty Caplette*, the insured was a general contractor who was sued based upon defective septic systems installed by sub-contractors. That Court skipped the "occurrence" analysis and instead interpreted the business risk exclusions. After referring to the *Weedo* decision and quoting Dean Henderson, the court took a novel approach and held that the houses were the insured's "product" and the claims were therefore excluded by exclusion (k) of the broad form general liability policy. (The exclusion at issue in *Betty Caplette* was actually numbered (n), but it was the identical "your product" exclusion to exclusion (k) in the current broad form policy.)

Since the Court applied the "your product" exclusion, the fact that the septic systems were installed by sub-contractors was irrelevant. The Court addressed the insured's contention that the home was more properly characterized as "your work," such that the sub-contractor exception to the exclusion would apply. It rejected

that argument, relying on precedent which held that the entire house is a builder's "product." See *Gary L. Shaw Builders, Inc. v. State Automobile Mutual Ins. Co.*, 355 S.E.2d 130 (Ga. 1987); *Indiana Ins. Co. v. DeZutti*, 408 N.E.2d 1275 (Ind. 1980); *Owings v. Gifford*, 697 P.2d 864 (Kan. 1985); *Allen v. Lawton & Moore Builders, Inc.*, 535 So. 2d 779 (La. Ct. App. 1988); *Gene & Harvey Builders, Inc. v. Pennsylvania Mfr Ass'n Ins. Co.*, 517 A.2d 910 (Pa. 1986). Many of the cases relied upon by the Court have since been superseded by opinions considering the post-1986 I.S.O. coverage form (although in only one was the result at all different—see *Lee Builders, Inc. v. Farm Bureau Mutual Ins. Co.*, 137 P.3d 486 (Kan. 2006) (holding that defective construction was an "occurrence" but not considering the business risk exclusions)). The end result in these cases seems to be dictated more by policy than interpretation.

Ironically, a builder who uses sub-contractors in Massachusetts will enjoy the same coverage as the same builder in Nebraska, despite the fact that in Massachusetts, defective construction is considered an "occurrence." Obviously, different approaches to the same question can yield the same result. Parenthetically, this approach, which was originally described by the Massachusetts Supreme Court as the majority approach, is now the approach of only a single court—Massachusetts.

D. Defective Construction Is an "Occurrence" and the Business Risk Exclusions Do Not Apply

Finally, at the most liberal end of the spectrum, we find decisions which made builders very happy. See *United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871 (Fla. 2007); *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007). The Florida Supreme Court's decision in *J.S.U.B.* followed the same rationale as that of the Texas Supreme Court in *Lamar Homes*.

In *J.S.U.B.*, the builder built several homes under contract. After delivery of the homes, the homeowners began discovering cracks in the ceilings, drywall and concrete slabs of the homes. Investigation revealed that the cracking was a result of differential settlement caused by poor soil compaction and failure to remove loose organic material by the site preparation contractors. When sued by the homeowners, the builder sought coverage under its policy with U.S. Fire. This insurer, relying on a prior decision of the Florida Supreme Court, *LaMarche v. Shelby Mutual Ins. Co.*, 390 So. 2d 325 (Fla. 1980), denied coverage for anything other than personal property of the homeowners damaged by the settlement.

J.S.U.B. repaired the homes and filed suit against U.S. Fire to determine coverage. On appeal, the intermediate court held that *LaMarche* did not apply and found coverage for all of the damages sought by the homeowners. The Florida Supreme Court agreed with the intermediate court and issued a lengthy decision in an attempt to justify the wholesale abandonment of decades of precedent.

First, the Court considered the "occurrence" issue. Putting the cart well before the horse, the Court engaged in a lengthy exposé of the history of the "your work" exclusion in the broad form general liability policy. Putting aside its own rule that exclusionary clauses cannot be relied upon to create coverage, it chose instead to read the policy "as a whole" to determine whether work performed by a sub-contractor came within the definition of an "occurrence." The Court found that the sub-contractor exception to the "your work" exclusion indicated that work performed by a sub-contractor was meant to be covered in the first instance.

In doing so, the Court explained that its prior decision in *LaMarche* was based not on whether defective construction was an "occurrence," but whether the business risk exclusions were ambiguous. From that unremarkable proposition, the Court concluded that consideration of the "your work" exclusion was a proper method of determining whether the defective work constituted an "occurrence" in the first instance. Its justification was as follows:

We conclude that the holding in *LaMarche*, which relied on *Weedo* and involved the issue of whether there was coverage for the contractor's own defective work, was dependent on the policy language of pre-1986 CGL policies, including the relevant insuring provisions and applicable exclusions. ...

Because *LaMarche* involved a claim of faulty workmanship by the contractor, rather than a claim of faulty work by the subcontractor, and because the policy being interpreted involved distinct exclusions and exceptions, we do not regard *LaMarche* as binding precedent in this case.

J.S.U.B., 979 So. 2d at 882.

The problem with that transparent justification is that it fails to explain how considering the language of an exclusion can aid in the determination of the insuring agreement. In *LaMarche*, the coverage grant was identical to that at issue in *J.S.U.B.*, requiring an "occurrence" resulting in "property damage." The exclusion at issue in *LaMarche* was the former exclusion (o), which equates to the current exclusion (l), or the damage to "your work" exclusion. The former provision stated that the insurance did not apply:

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.

Lamarche, 390 So. 2d at 326. By contrast, the current exclusion (l), excludes coverage for:

"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 sub-contractor.

So, the newer provision removes work performed on the insured's behalf from the exclusion, whereas the older version expressly included work performed on the insured's behalf.

Having recited the foregoing differences, the Court then resumed its analysis of whether defective construction constituted an "occurrence." After citing to several other state decisions that found *that such defects were "occurrences,"* it then completely omitted any analysis of the issue and simply put forth the bold proposition that:

If U.S. Fire intended to preclude coverage based on the cause of action asserted, it was incumbent on U.S. Fire to include clear language to accomplish this result. ... In fact, there is a breach of contract endorsement exclusion, not present in the CGL policies at issue in this case, that excludes coverage for breach of contract claims. ...

J.S.U.B., 979 So. 2d at 884. Of course the Court did not explain why U.S. Fire needed to include an endorsement to exclude coverage which the Florida Supreme Court had already announced did not exist. Analyzing whether the insuring agreement of the policy is triggered in the first instance is certainly different from analyzing whether the exclusions bar coverage which otherwise exists. In other words, the Court put the proverbial cart before the horse by concluding that U.S. Fire failed to use clear language to *preclude coverage*.

The question of whether defective construction is an "occurrence" asks whether the loss itself is the type contemplated by the policy. Only if the answer to that question is "Yes" is there any need to consider whether any other provision of the policy *precludes* that coverage. Therefore, the Court's reliance on U.S. Fire's failure to use clear *preclusionary* language in support of its conclusion that defective construction constitutes an "occurrence" is nonsensical. Its analysis demonstrates that the Court never really analyzed whether defective construction is accidental or fortuitous. Rather, it simply cited to changes in the relevant exclusions to justify its departure from decades of settled precedent.

E. Harmonization of the Decisions

Despite what appear to be a fairly significant divergence of views on the scope of coverage under the broad form general liability policy, the reality is that only in a few states will builders have the equivalent of performance bond coverage (but without the insurer's concomitant right to recoup any payments thereunder from the insured). Obviously, contractors in Florida and Texas and the other states which apply their rationale (see Table I) will enjoy broad coverage. Even in those states, however, it is fair to assume that work done by the contractor itself will not be covered. In *J.S.U.B.*, the contractor sub-contracted all of the work on the home. Therefore, all of the property damage was covered. But even the *J.S.U.B.* decision makes it fairly clear that defective work that is performed by the contractor itself will not be covered.

As a result, we discern a broad theme which runs through the great majority of decisions, such that several broad principles of law can be said to be the overwhelming majority rule. First, claims of defective construction, *standing alone*, do not meet the element of fortuity necessary to constitute an accident and are therefore not covered. Second, where the work in question was performed by a sub-contractor, the damage is either considered accidental from the standpoint of the insured or fits within the sub-contractor exception to the "your work" exclusion. Third, to the extent the insured's defective work results in damage to other property which was not the subject of the insured's work, that damage is likely covered. In essence, after forty-two years of litigation, we end up at the same place Dean Henderson described in 1971.

III. Other Issues

In the aftermath of the construction defect litigation explosion, insurers, claims professionals and attorneys continue to struggle with other issues which remain to be addressed. For example, while it is simple to say that damage to the insured's work is not covered, application of that principle is more difficult, particularly in the context of the all-too-common water intrusion claim which seems to define much of the current litigation. In the event the stucco is defective, resulting in rotting of structural framing members and damage to drywall, how do we parse the cost of removing and replacing the stucco (which may or may not be covered, depending on whether it was performed by a sub-contractor) from the cost of repairing the damaged structural elements (alleged "other property")?

This issue becomes more complex on further examination. For example, a wise insured will argue that it is not possible to access the framing members without removing the stucco. Therefore, for argument's sake, even if the water intrusion resulted from a different cause, even non-defective stucco would have to be removed and replaced as part of the cost of repairing the damaged structural elements. The players involved are just beginning, relatively speaking, to address that kind of issue, sometimes referred to as "rip and tear" damages.

In addition, as a result of the sub-contractor exception which is almost universally recognized, contractors simply use sub-contractors for all work on a project. Clearly, had the builder in *J.S.U.B.* done its own site preparation, it would have deprived itself of coverage which it otherwise enjoyed. Of course, sub-contractors purchasing the same form CGL policy usually do not have that option.

Then there are the ever-present issues of indemnity, subrogation and contribution. Obviously, the builder who utilized sub-contractors and/or its insurer will have an excellent argument that the entire liability should be passed down the line to the sub-contractors. Certainly, U.S. Fire should have a right of subrogation to pursue the site preparation contractor for indemnity since the builder cannot have contributed to the loss. In that case, is the sub-contractor's insurer in any better position to deny coverage than the builder's insurer would have been since the sub-contractor exception should not apply? That question is debatable given the "rationale" used by the Florida Supreme Court to conclude that defective construction is an "occurrence." One could cer-

tainly cite that decision for the proposition that defective construction is only an “occurrence” when the work is performed by a sub-contractor. For the sub-contractor then, is there no “occurrence” because the sub-contractor did not use a sub-sub-contractor? That is a question which will also likely be litigated in the coming years.

IV. New Endorsements

As a result of the flood of litigation concerning the I.S.O. broad form general liability policy in relation to construction defects, the industry has developed several new endorsements which may be added to the general liability policy (presumably for a reduced premium). The first is the Breach of Contract Endorsement, referenced in the *J.S.U.B.* decision, which states:

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 insureds under this policy.

Furthermore, no obligation to defend will arise or be provided by us for such excluded claims.

Form IC0238099 (included in Appendix “A”). *See also* Form IC02381006 (included in Appendix “A”).

In addition, I.S.O. has made available two endorsements which have the effect of deleting the sub-contractor exception to the “your work” exclusion. That endorsement simply provides:

Exclusion I. of Section I – Coverage A – Bodily Injury And Property Damage Liability is replaced by the following:

2. Exclusions

This insurance does not apply to:

I. 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”.

Insurance Services Office, form CG 22 94 10 01.

Finally, I.S.O. created a site-specific endorsement for deleting the sub-contractor exception to the “your work” exclusion. That endorsement states:

With respect to those sites or operations designated in the Schedule of this endorsement, Exclusion I. of Section I – Coverage A – Bodily Injury And Property Damage Liability is replaced by the following:

2. Exclusions

This insurance does not apply to:

I. 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”.

Insurance Services Office, form CG 22 95 10 01. The forms are reproduced in Appendix “A.”

Contractors will likely be offered policies with one or more of the foregoing endorsements included automatically. Presumably, the endorsements could be removed for an additional premium. While these endorsements appear to be a simple solution to a complex problem, even these endorsements are likely to engender further litigation as courts grapple with their interpretation.

V. Conclusion

Have 42 years of litigation really changed anything? On the judicially conservative end of the spectrum, things are as Dean Henderson described them in 1971. Builders who build shoddy buildings will have to bear the cost of replacement of their own shoddy work. This is, of course, the way it should be. Perhaps the real point of demarcation should be the distinction between tort liability and contract liability. Without saying so, Dean Henderson's example certainly drew the line there. For the person injured by the falling stucco wall or the passing car damaged by that same falling stucco, the only remedy against the person responsible is in tort. While it is true that, but for the contract between the builder and the stucco contractor, there would be no liability for the injured person or the passing car. But that does not mean that the liability arises out of contract.

The problem arises when the damage becomes internal. When the insured's work damages only itself, there is no coverage even in Florida and Texas. But when the insured's faulty work damages "other property," it is likely covered by the builder's general liability policy. Is it a coincidence that these principles seem to mirror those of the economic loss rule before it became whittled away with exceptions? Under that rule, a defective product which damages only itself gives rise to a cause of action in contract only. Only when the product damages "other property" does the breach of contract (the defect) become actionable in tort.

Perhaps the erosion of the economic loss rule runs parallel to the erosion of the concept that insurance is meant to cover accidents, not business risks. Certainly in Dean Henderson's time, a complaint against a builder which was based on negligence would have been summarily dismissed under the economic loss rule. Today, it might well stand based upon the many exceptions courts have created to what was otherwise a bright-line rule. Just as the line between tort and contract is blurred, so too is the line between accidents and business risks.

Table 1: State by State Compendium

Alabama: *United States Fidelity & Guaranty Co. v. Bonitz Insulation Co. of Ala.*, 424 So. 2d 569 (Ala. 1982).

Occurrence? Yes. Defective construction can be an "occurrence" where the insured did not expect or intend the result of the defective construction.

Insured's work covered? No. The business risk exclusions preclude coverage for the repair of the insured's defective product. Only damage to "other property" is covered.

Alaska: *Fejes v. Alaska Ins. Co., Inc.*, 984 P.2d 519 (Alaska 1999).

Occurrence? Yes. Defective construction can be an "occurrence" where the insured did not expect or intend the result of the defective construction.

Insured's work covered? Yes, if performed by a subcontractor. No, if performed by the insured.

Arizona: *United States Fidelity & Guaranty Corp. v. Advance Roofing & Supply Co., Inc.*, 788 P.2d 1227 (Ariz. Ct. App. 1989).

Occurrence? No.

Insured's work covered? No.

Arkansas: *United States Fidelity & Guaranty Co. v. Continental Cas. Co.*, 120 S.W.3d 556 (Ark. 2003).

Occurrence? This is a fact question to be determined by a jury.

Insured's work covered? Undetermined.

California: *Standard Fire Ins. Co. v. Spectrum Community Ass'n*, 46 Cal. Rptr. 3d 804 (Cal. Ct. App. 2006).

Occurrence? Yes, implicitly. California courts seem to have glossed over this question. There are a number of opinions like *Standard Fire* which address the question of whether a defect which

occurs over time triggers multiple policies. However, none of the decisions actually addresses the threshold issue of whether such defects constitute an “occurrence” in the first instance.

Insured’s work covered? Yes, implicitly, based upon the same rationale.

Colorado: *General Security Indemnity Co. of Arizona v. Mountain States Mut. Casualty Co.*, 205 P.2d 529 (Colo. Ct. App. 2009).

Occurrence? No. Defective construction lacks the fortuity implicit in the concept of an accident.

Insured’s work covered? No.

Connecticut: *Travelers Prop. Casualty Co. of Am. v. Laticrete, Int’l, Inc.*, 2006 WL 2349079 (Conn. Super. Ct. 2006).

Occurrence? Yes, implicitly. Like the California court in *Standard Fire*, the court glossed over the initial “occurrence” analysis and analyzed when property damage occurred for trigger purposes.

Insured’s work covered? Yes, implicitly.

Delaware: *Charles E. Brohawn & Bros, Inc. v. Employers Commercial Union Ins. Co.*, 409 A.2d 1055 (Del. 1979).

Occurrence? Yes, implicitly. The court assumed that defective construction constituted property damage caused by an occurrence and decided the case based upon the “sistership” exclusion.

Insured’s work covered? Possibly, depending upon the applicability of a “sistership” or other exclusion.

Florida: *United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871 (Fla. 2007).

Occurrence? Yes. Defective work performed by a sub-contractor was not expected or intended by the general contractor and is therefore an “accident.”

Insured’s work covered? Yes, if the work was performed by a sub-contractor. No, if it was performed by the insured. However, damage to work other than the insured’s work is covered regardless.

Georgia: *Custom Planning & Development v. American Nat’l Fire Ins. Co.*, 606 S.E.2d 39 (Ga. 2004).

Occurrence? No. Defective construction lacks the element of fortuity necessary to constitute an accident.

Insured’s work covered? No.

Hawaii: *Group Builders, Inc. v. Admiral Ins. Co.*, 231 P.3d 67 (Haw. Ct. App. 2010).

Occurrence? No. Whether couched as contractual or tort-based claims, claims of defective construction do not constitute an “occurrence.”

Insured’s work covered? No.

Idaho: Undecided.

Illinois: *Country Mutual Ins. Co. v. Carr*, 867 N.E.2d 1157 (Ill. Ct. App. 2007).

Occurrence? Yes. If the insured did not intend or expect damage to result from his work, then the resulting damage is accidental and therefore an “occurrence.”

Insured’s work covered? Unknown. Since the business risk exclusions were not addressed in the trial court, the appeals court remanded for the trial court to consider the exclusions in the first instance.

Indiana: *Sheehan Const. Co., Inc. v. Continental Casualty Co.*, 935 N.E.2d 160 (Ind. 2010).

Occurrence? Yes. As long as the resulting damage is an event that occurs without expectation or foresight, defective construction can constitute an accident and therefore an “occurrence.”

Insured's work covered? No. Only damage to property other than the insured's work is covered. The business risk exclusions clearly exclude coverage for damage to the insured's work.

Iowa: *Pursell Const., Inc. v. Hawkeye Security Ins. Co.*, 596 N.W.2d 67 (Iowa 1999).

Occurrence? No. Defective work *standing alone*, that is, defective work which only results in damage to the insured's work, is not an accident, and therefore not an "occurrence."

Insured's work covered? No, but damage to property other than the insured's work would presumably be covered.

Kansas: *Lee Builders, Inc. v. Farm Bureau Mutual Ins. Co.*, 137 P.3d 486 (Kan. 2006).

Occurrence? Yes. As long as the damage resulting from defective construction was unforeseen and unintended by the insured, it is accidental and therefore an "occurrence."

Insured's work covered? Yes, implicitly. The *Lee Builders* court could have considered the business risk exclusions, but did not, choosing instead to hold simply that the defective construction was an "occurrence" and therefore covered.

Kentucky: *Cincinnati Ins. Co. v. Motorists Mutual Ins. Co.*, 306 S.W.3d 69 (Ky. 2010).

Occurrence? No. Although an insured would almost never have intended to perform substandard work, the concept of fortuity has a second aspect: control. For the defective construction to be an accident, it must be a chance event, beyond the insured's control.

Insured's work covered? No.

Louisiana: *Joe Banks Drywall & Acoustics, Inc. v. Transcontinental Ins. Co.*, 753 So. 2d 980 (La. Ct. App. 2000).

Occurrence? Yes. As long as the complaint does not allege that the insured intended the damage, the defective construction was accidental and therefore an "occurrence."

Insured's work covered? No. The business risk exclusions clearly apply to bar coverage for damage to the insured's work. Damage to other property would presumably be covered.

Maine: Undecided.

Maryland: *French v. Assurance Co. of Am.*, 448 F.3d 693 (4th Cir. 2006) (applying Maryland law).

Occurrence? No. The defective performance of work can never be an accident and therefore is not an "occurrence."

Insured's work covered? No, unless the damage was to non-defective work of the insured which resulted from defective work performed by a sub-contractor (under the sub-contractor exception to the "your work" exclusion).

Massachusetts: *Commerce Ins. Co. v. Betty Caplette Builders, Inc.*, 647 N.E.2d 1211 (Mass. 1995).

Occurrence? Yes. The court appeared to gloss over this question since the insurer did not dispute that the claims would be covered in the absence of the "your work" exclusions.

Insured's work covered? No. The court rejected the applicability of the "your work" exclusion and its sub-contractor exception, choosing instead to hold that the entire house was the insured's "product." Thus, the "your product" exclusion applies to bar coverage entirely.

Michigan: *Auto Owners Ins. Co. v. Long's Tri-County Mobile Home, Inc.*, 2005 WL 1522169 (Mich. Ct. App. 2005).

Occurrence? No, unless the defective construction causes damage to property other than the insured's work.

Insured's work covered? No. Only damage to property other than the insured's work is covered.

Minnesota: *Bor-Son Bldg. Corp. v. Employers Commercial Union Ins. Co.*, 323 N.W.2d 58 (Minn. 1982).

Occurrence? No, in concept. A general liability policy is intended to cover tort risks, not contractual risks which are within the insured's control. However, damage to property other than the insured's work is caused by an "occurrence" and therefore covered. *See Integrity Mutual Ins. Co. v. Klampe*, 2008 WL 5335690 (Minn. Ct. App. 2008).

Insured's work covered? No.

Mississippi: *Architex Ass'n, Inc. v. Scottsdale Ins. Co.*, 27 So. 3d 1148 (Miss. 2010).

Occurrence? Yes, in certain instances. The court distinguished between intentional and negligent acts by the insured and its sub-contractors, holding that the question of whether the damage was accidental from the standpoint of the insured will govern the question of whether there was an "occurrence."

Insured's work covered? Possibly. If the insured negligently performed its work, then presumably the damage to the insured's work would be covered. Work performed by a sub-contractor would presumably be covered since the damage would not be intended or expected from the standpoint of the insured.

Missouri: *Hawkeye-Security Ins. Co. v. Davis*, 6 S.W.3d 419 (Mo. Ct. App. 1999).

Occurrence? No. A builder's breach of contract and warranty is inherently not an accident and therefore not an "occurrence."

Insured's work covered? No.

Montana: *Story v. Hawkeye-Security Ins. Co.*, 2001 WL 35735573 (Mont. Ct. App. 2001).

Occurrence? Yes, implicitly. The court simply applied the business risk exclusions as being unambiguous to negate coverage for construction defects, even where the work was performed by a sub-contractor.

Insured's work covered? No. The business risk exclusions clearly bar coverage for any damage to the insured's work or arising out that work.

Nebraska: *Auto-Owners Ins. Co. v. Home Pride Co's, Inc.*, 684 N.W.2d 571 (Neb. 2004).

Occurrence? No. Faulty workmanship, standing alone, is not an "occurrence" because the element of fortuity is lacking. However, faulty workmanship which causes an accident is an "occurrence."

Insured's work covered? No. However, damage to property other than the insured's work is covered.

Nevada: *United States Fidelity & Guaranty Co. v. Nevada Cement Co.*, 561 P.2d 1335 (Nev. 1977).

Occurrence? Yes. While the court did not directly address the issue, its conclusion is implicit in its holding that the "your product" exclusions do not otherwise bar coverage.

Insured's work covered? Yes. Where the insured's defective product is incorporated into another structure and weakens that structure, property damage has occurred, which is covered by a general liability policy.

New Hampshire: *High Country Associates v. New Hampshire Ins. Co.*, 648 A.2d 474 (N.H. 1994).

Occurrence? Yes. The court found the term "occurrence" to be ambiguous and therefore interpreted it to encompass events which were not expected or intended by the insured.

Insured's work covered? Possibly. The court distinguished between an "occurrence of negligent construction" and "negligent construction which causes an occurrence." This ethereal language presumably distinguishes between coverage for the insured's work (occurrence of negligent con-

struction) and damage to other property (negligent construction which causes an occurrence). The court did not consider the business risk exclusions because they were not considered by the trial court.

New Jersey: *Firemen's Insurance Co. of Newark v. Nat'l Union Fire Ins. Co.*, 904 A.2d 754 (N.J. 2006).

Occurrence? No. The court followed the *Weedo v. Stone-E-Brick*, 405 A.2d 788 (N.J. 1979), logic that mere defective work, standing alone, is not an "occurrence." However, damage to other property can be covered as an "occurrence." The court applied the familiar distinction between sub-standard work which must be removed and replaced (not an "occurrence") and sub-standard work which results in accidental damage to other property (an "occurrence"), which came from the *Weedo* opinion.

Insured's work covered? No.

New Mexico: Undecided.

New York: *J.Z.G. Resources, Inc. v. King*, 987 F.2d 98 (2d Cir. 1993) (applying New York law).

Occurrence? No. Defective construction which results only in damage to the insured's work product lacks the element of fortuity necessary to constitute an "occurrence." However, defective work which results in consequential damage to other property which is not the subject of the insured's work is covered as an "occurrence."

Insured's work covered? No.

North Carolina: *Production Systems, Inc. v. Amerisure Ins. Co.*, 605 S.E.2d 663 (N.C. 2004).

Occurrence? Yes, implicitly. The court decided the case based upon the lack of property damage and appears to have assumed the existence of an "occurrence."

Insured's work covered? No. Damages resulting from the insured's defective construction are not "property damage" but instead the cost to repair the defects in the insured's own work product.

North Dakota: *Acuity v. Burd & Smith Const., Inc.*, 721 N.W.2d 33 (N.D. 2006).

Occurrence? Yes. Faulty workmanship which causes damage to property other than the insured's work is an accidental "occurrence."

Insured's work covered? No. Damage to the insured's work is excluded by the business risk exclusions. Only damage to other property is covered.

Ohio: *Heile v. Herrmann*, 736 N.E.2d 566 (Ohio Ct. App. 1999).

Occurrence? No. Faulty workmanship standing alone lacks fortuity and therefore is not an accident, and not an "occurrence."

Insured's work covered? No. Only damage to property which is not the subject of the insured's work is covered.

Oklahoma: Undecided.

Oregon: *Oak Crest Const. Co. v. Austin Mutual Ins. Co.*, 998 P.2d 1254 (Or. 2000).

Occurrence? No. Damage which is redressable under pure contract principles cannot be an accident and therefore is not an "occurrence."

Insured's work covered? No. However, damage to other property as a result of the insured's breach of contract may be covered.

Pennsylvania: *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 908 A.2d 888 (Pa. 2006).

Occurrence? No. Defective work standing alone lacks the element of fortuity necessary to constitute an accident.

Insured's work covered? No. The court had no occasion to consider whether damage to other property would be covered, as the underlying suit only sought to recover for defective construction.

Rhode Island: Undecided.

South Carolina: *Crossman Communities of North Carolina, Inc. v. Harleysville Mutual Ins. Co.*, 2011 WL 93716 (S.C. 2011).

Occurrence? No. Defective construction, which only results in damage to the insured's work, is not fortuitous and therefore not an "occurrence." However, if the insured's defective work results in damage to other property, that damage is a covered "occurrence." See *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 621 S.E.2d 33 (S.C. 2004) (reaffirmed in *Crossman*).

Insured's work covered? No.

South Dakota: *Corner Const. Co. v. United States Fidelity & Guaranty Co.*, 638 N.W.2d 887 (S.D. 2002).

Occurrence? Yes. To the extent a sub-contractor's work results in damage to the insured's work, it is the result of an "occurrence," because it was not expected or intended by the insured.

Insured's work covered? Yes, but only if it is the result of a sub-contractor's faulty work. If the damage to the insured's work is a result of the insured's faulty work, there is no "occurrence."

Tennessee: *Travelers Indemnity Co. of Am. v. Moore & Assoc., Inc.*, 216 S.W.3d 302 (Tenn. 2007).

Occurrence? Yes. Where damage to the insured's work was caused by a sub-contractor's defective work, the damage was accidental from the insured's standpoint and therefore an "occurrence."

Insured's work covered? Yes, but only if it is the result of a sub-contractor's faulty work. If the damage to the insured's work is a result of the insured's faulty work, there is no "property damage."

Texas: *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Tex. 2007).

Occurrence? Yes. As long as the damage in question results from an accident, *i.e.*, negligence by the insured, and is not intentional, the damage resulted from a covered "occurrence." There is no logical basis to determine whether the damage was accidental based simply on whether the property damaged was the work product of the insured or some other property.

Insured's work covered? Yes, as long as the work was done by a sub-contractor. The court held that the sub-contractor exception to the "your work" exclusion resurrected coverage which would otherwise be barred.

Utah: *Great Am. Ins. Co. v. Woodside Homes Corp.*, 448 F. Supp. 2d 1275 (D. Utah 2006) (applying Utah law).

Occurrence? Yes. Defective construction performed by a sub-contractor is accidental from the standpoint of the insured and therefore a covered "occurrence."

Insured's work covered? No. Defective work performed by the insured itself is not accidental and therefore not an "occurrence."

Vermont: Undecided.

Virginia: *Nationwide Mutual Ins. Co. v. Wenger*, 278 S.E.2d 874 (Va. 1981).

Occurrence? Yes, implicitly. The court simply considered the business risk exclusions and concluded that they unambiguously barred coverage for the insured's own defective work.

Insured's work covered? No. The business risk exclusions bar coverage for the insured's own faulty work.

Washington: *Yakima Cement Products Co. v. Great Am. Ins. Co.*, 608 P.2d 254 (Wash. 1980) (en banc).

Occurrence? Yes. The insured would almost never be seen to have wrongly constructed a building or portion thereof on purpose. Therefore, even from the insured's perspective, defects in the insured's own work product are accidental and therefore an "occurrence."

Insured's work covered? No. Even when the insured's defective work is incorporated into other non-defective work, there is no "property damage" within the meaning of the policy.

West Virginia: *Corder v. William W. Smith Excavating Co.*, 556 S.E.2d 77 (W. Va. 2001).

Occurrence? No. Damage to the insured's work product based on defective construction is not accidental and therefore not an "occurrence." However, if the defective work results in damage to other property, that damage is accidental and therefore an "occurrence."

Insured's work covered? No.

Wisconsin: *Am. Family Mutual Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004).

Occurrence? Yes. Regardless of whether the damage is actionable in tort or contract, defective construction will rarely be intended or expected by the insured, particularly where the defective work is performed by a sub-contractor.

Insured's work covered? Yes, if performed by a sub-contractor. Implicit in the court's decision is the recognition that if the work is performed by the insured, the defective construction would be excluded by the business risk exclusions.

Wyoming: Undecided.

Appendix "A"

COMMERCIAL GENERAL LIABILITY
CG 22 94 10 01

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

EXCLUSION – DAMAGE TO WORK PERFORMED BY SUBCONTRACTORS ON YOUR BEHALF

This endorsement modifies insurance provided under the following:

COMMERCIAL GENERAL LIABILITY COVERAGE PART

Exclusion I. of **Section I – Coverage A – Bodily Injury And Property Damage Liability** is replaced by the following:

2. Exclusions

This insurance does not apply to:

I. 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".

POLICY NUMBER:

COMMERCIAL GENERAL LIABILITY
CG 22 95 10 01

EXCLUSION – DAMAGE TO WORK PERFORMED BY SUBCONTRACTORS ON YOUR BEHALF – DESIGNATED SITES OR OPERATIONS

This endorsement modifies insurance provided under the following:

COMMERCIAL GENERAL LIABILITY COVERAGE PART

SCHEDULE

Description Of Designated Sites Or Operations

(If no entry appears above, information required to completed this endorsement will be shown in the Declarations as applicable to this endorsement.)

With respect to those sites or operations designated in the Schedule of this endorsement, Exclusion I. of **Section I – Coverage A – Bodily Injury And Property Damage Liability** is replaced by the following:

2. Exclusions

This insurance does not apply to:

I. 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 ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY

BREACH OF CONTRACT EXCLUSION

This endorsement modifies insurance provided under the following:

COMMERCIAL GENERAL LIABILITY COVERAGE PART PRODUCTS/COMPLETED OPERATIONS LIABILITY COVERAGE FORM

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" is alleged.

This exclusion also applies to any additional insureds under this policy.

Furthermore, no obligation to defend will arise or be provided by the Company for such excluded claims.

IC02380999

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY

BREACH OF CONTRACT EXCLUSION

This endorsement modifies insurance provided under the following:

**COMMERCIAL GENERAL LIABILITY COVERAGE PART
COMMERCIAL GENERAL LIABILITY WRAP COVERAGE PART
PRODUCTS/COMPLETED OPERATIONS LIABILITY COVERAGE FORM**

This insurance does not apply to any "bodily injury" or "property damage" arising out of, caused by, or contributed to by your failing to fulfill the terms of a contract or agreement. The company shall have no obligation to defend or indemnify any insured for any alleged breach of contract, whether such contract is written, oral or implied in law or in fact.

The Company shall have no obligation to indemnify you for any sums which you may be found legally obligated to pay as a result of the breach of any such contract, or as a result of the breach of any warranty, whether express or implied.

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