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A Good Defense: What Makes for a Good Coverage Defense?

Through the use of four to six claims scenarios involving the standard exclusions and coverage defenses raised in typical construction defect law suits, this panel of attorneys and seasoned claims professionals will present actual best practices solutions and procedures for the claims professionals to use that will assist in preserving and actually using those coverage defenses to assure proper allocation and payment of covered losses and damages. Preliminary to the scenarios, however, the panel will quickly explain operation of those exclusions and coverage defenses in order to set the stage for a clearer understanding as to how defense counsel and the claims professionals can work together to achieve a result more in line with the intended coverage.

BACKGROUND

Generally speaking, a Commercial General Liability ("CGL") insurance policy is designed to cover bodily injury, property damage, or personal and advertising injury to others. The focus on this presentation will be on the key exclusions and exceptions to exclusions implicated in insurance claims stemming from construction incidents.

CGL policies are not intended to protect business owners against every risk of operating a business. *Heile v. Herrmann*, 136 Ohio App.3d 351, 353, 736 N.E.2d 566 (1999). "Business risks" are considered the "normal, frequent, or predictable consequences of doing business, and which business management can and should control or manage." *Id*., *See Columbia Mut. Ins. Co. v. Schauf*, 967 S.W.2d 74, 77 (Mo.1998). Courts have generally concluded that such policies are intended to insure the risks of an insured causing damage to other persons and their property, but they are not intended to insure the risks of the insured causing damages to the insured's own work. *Id*. CGL policies are not intended to insure against a breach of contract or poor workmanship, but instead are intended to insure against "the unpredictable, potentially unlimited liability that can result from business accidents." *Erie Ins. Exchange v. Colony Dev. Corp*., 10th Dist. Nos. 02AP-1087 & 02AP1088, 2003 Ohio 7232, ¶29, citing 4 Bruner & O'Connor on Construction Law (2002) 126-127, Section 11:37.

Furthermore, since policy language is construed against the insurer, "an exclusion in an insurance policy will be interpreted as applying only to that which is clearly intended to be excluded." *City of Sharonville v. Am. Employers Ins. Co*., 109 Ohio St. 3d 186, 2006-Ohio-2180, 846 N.E.2d 833, ¶6.

COMMON DEFECT CLAIM EXCLUSIONS

I. That Particular Part of Real Property Exclusion

"Property damage" to:

That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the "property damage" arises out of those operations;

Standard form CGL policies contain an exclusion for property damage to "that particular part of real property" on which the general contractor or its subcontractors "are performing operations." Couch on Insurance § 129:20 (3d ed. 2010). Courts have interpreted this language as applying **only** to property damage occurring on projects, which have **not** been completed. *See, e.g., Advantage Homebuilding, LLC v. Maryland Cas. Co*., 470 F.3d 1003, 1011 (10th Cir. 2006); *Oscar W. Larson Co. v. United Capitol Ins. Co*., 845 F. Supp. 451, 455 (W.D. Mich.1993). The justification for excluding damage during on-going operations is that the insured, while on the site, can still monitor and control the quality of the workmanship to prevent damage.

This exclusion reflects the public policy general contractors normally obtain coverage for damage to a construction project before its completion under a separate builder's risk policy.

Example:

- ABC Contractors has been retained to repair a sprinkler system in an industrial building. In a hurry to finish the job, ABC snaps a pipe when tightening it with the wrong type of equipment. The broken pipe falls and breaks other pipes already installed by ABC, tripping the sprinkler system. Portions of the building suffer extensive water damage.

- The owner makes a claim against ABC for damage to the sprinkler system, as well as water damage to the rest of the building. Because ABC incorrectly performed its work, some may consider this to be faulty or negligent workmanship.

- The That Particular Part of Real Property Exclusion eliminates from coverage property damage to the particular part of real property on which ABC performed operations if the damage arises out of the operations. In this example, the property damage did arise from ABC's operations. The damage happened while ABC was actually repairing the sprinkler system.

- But what is the meaning of *"that particular part of real property?"* The portions of the building damaged by the water cannot be considered to be that particular part of the real property on which ABC was working. Thus, property damage coverage would apply to all portions of the building damaged by the water. *See Erie Ins. Exch. v. Pugh*, 1999 Ohio App. LEXIS 4763, *4-5 (Ohio Ct. App., Miami County Oct. 8, 1999) ("Since 'that particular part of real property upon which operations are being performed' involved

the foundation which supported the entire residence, and since such operations set off the reaction which caused all of the subsequent damage, the appellant's argument must give way to the exclusionary language of Erie's policy.").

- Damage to the pipe that snapped is excluded. The negligent tightening of the pipe that caused it to snap. But what about the other portions of the sprinkler systems already repaired by ABC that were damaged when the broken pipe fell? While not universally held, the other pipes of the sprinkler system are generally not considered to be "that particular part" upon which ABC was actually performing operations when the property damage occurred. Therefore, ABC would have coverage for the cost of replacing the pipes damaged by the falling pipe.

II. Cost of Replacing Property Because of Faulty Work Exclusion

> *"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.*

This related exclusion applies to *"that particular part of any property that must be restored, repaired or replaced"* because work was not properly performed on it by the general contractor or its subcontractors. The broad reach of this exclusion is narrowed dramatically by an exception for property damage to work that has been completed, as defined by the *"products-completed operations hazard."* Completed work includes work otherwise complete, but requires *"service, maintenance, correction, repair or replacement."* As modified, this exclusion also serves to prevent duplication of coverage normally provided by builder's risk policies.

Example:

- ABC Contractors is hired to resurface a highway. The work involves removing the existing surface and laying asphalt over the pavement. Unfortunately, ABC scrapes away far too much, accidentally scraping way most of the compacted gravel forming the base of the highway. The resurfacing project quickly becomes a disaster. The new asphalt being applied crumbles into small pieces only hours after the roller passes. The project is quickly halted, and the State of California brings a claim against ABC for the cost of replacing the compacted gravel base.

- The Cost of Replacing Property Because of Faulty Work Exclusion expressly excludes damage to the highway base (i.e. the compacted gravel) as it is property that must be replaced or repaired because ABC's work was incorrectly performed. ABC has no CGL coverage for the claim by California.

Example:

- ABC Contractors is engaged by XYZ Shipping Company to perform repair work on a ship's steam turbines. After completing the inspection and replacing some blades on one of several turbines to be serviced, a marine contractor engaged by XYZ tests the turbine. Because a few of the blades were not securely installed by ABC, the testing causes some of these blades to break apart, rendering the turbine useless. XYZ makes claim against ABC for the cost of replacing the damaged turbine blades.

- As the turbine blades are not likely be considered real property, That Particular Part of Real Property Exclusion would not apply. The Cost of Replacing Property Because of Faulty Work Exclusion excludes property damage to "that particular part of any property," thus eliminating coverage for ABC for the cost of replacing the blades. The damage to the blades was a result of work incorrectly performed by ABC on the blades, necessitating their replacement.

It is important to note That Particular Part of Real Property Exclusion applies **only if** the damage occurs during the operation. The Cost of Replacing Property Because of Faulty Work Exclusion eliminates coverage for damage during as well as after the same portions of the work are finished, provided the work does not fall into the "products-completed operations hazard." Further, the exclusions apply whether the work was done directly by ABC's employees or was performed on behalf of ABC by a subcontractor engaged by ABC.

Example:

- *Employers Mut. Cas. Co. v. Pires*, 723 A.2d 295 (R.I. 1999): A painting contractor was hired to paint replacement windows and doors that a general contractor had installed in a home. After the painting was completed, the general contractor noticed scratches on the window panes which, it believed, the painting contractor had caused while it was sanding the window frames. The general contractor sued the painting contractor for the cost of repairs, and the painting contractor tendered defense of the action to its liability insurer. The liability insurer brought a declaratory judgment action, seeking a ruling that it had no duty to defend the painting contractor because of an exclusion in its policy. The court determined that whether the insurer had a duty to defend depended on what the contractor was doing when it caused the damage:

- The record before us is unclear concerning whether Pires "incorrectly performed" work on the damaged window panes or whether Pires damaged the panes accidentally when he performed work on the frames. If Pires performed work on the window panes in connection with painting the window frames (for example, by taping the surface of the panes during the pre-painting process, or by cleaning and/or scraping the panes before or after applying paint to the frames) and he negligently damaged the panes as part of such a preparation or cleanup operation, then the damage would fall within the exclusion for incorrectly performed work. If, on the other hand, Pires did not intentionally perform work on the window panes in connection with painting the window frames, but only damaged them accidentally when he was performing work on

the frames, then such damage would not fall within the policy's exclusion for "incorrectly performed" work on such property.

III. Your Work Exclusion

> *This insurance does 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.*

This exclusion means that the CGL policy will not cover damages to a structure built by the insured contractor. *Nationwide Mut. Ins. Co. v. Wenger*, 222 Va. 263, 266 (1981). This is not the type of risk typically covered by a CGL policy because it is considered to be a business risk assumed by the contractor when he signed the contract with the owner. This exclusion will apply, even in cases where the CGL policy also includes coverage for *"completed operation hazards"* insuring the contractor against bodily injury and property damage arising out of operations and/or warranties occurring after a project has been completed or abandoned. *Id.* at 265.

Where the CGL policy has a Your Work Exclusion, property damage claims of third-parties resulting from an insured contractor's breach of warranty are only covered if the claimed loss is not to the contractor's own work or work product. *Id*.

The public policy behind the Your Work Exclusion is the contractor controls the own quality of his own work, it is fair to hold him liable if the work is faulty. *Id*. at 267. Moreover, the CGL insurance policy is not intended to act as a performance bond, which guarantees the satisfactory completion of a construction project by a contractor. *Id*. at 269.

If the contractor's CGL policy includes a Your Work Exclusion, any damage to the structure resulting from alleged construction defects would not be covered. However, the CGL policy will cover the risk of injury to people and damage to property other than the completed work itself (assuming no other exclusions apply). For example, if the siding applied to the exterior of a building falls and injures a pedestrian or an automobile, the CGL policy would likely cover these claims.

This exclusion serves as a companion to the Cost of Replacing Property Because of Faulty Work Exclusion. Whereas the former encompasses only property damage to the work falling outside the "products-completed operations hazard," the Your Work Exclusion specifically applies to property damage to the work falling inside it. Together, these exclusions would appear to encompass the entirety of any property damage to the work arising out of the operations.

Important Exception – Subcontractor Work

> *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.*

The Your Work Exclusion, however, contains a crucial exception for property damage arising out of work performed by a subcontractor on behalf of the general contractor. Courts have used this exception to find in favor of coverage in construction defect cases involving the work of the exception for subcontractors, nor does it distinguish between ongoing and completed projects. Under CGL policies where Your Product applies to work on a construction project, this exclusion can therefore serve to defeat coverage even if the above exclusions do not apply.

The articulated rationale of the exception is that a contractor cannot control a subcontractor's negligence as it can its own.

As is the tendency, the above "no coverage" conclusion has been reached without determining all the facts and, most importantly, without examining the entire exclusion. All too often, insurers cite the Your Work Exclusion in either a coverage decision letter or Reservation of Rights letter and completely leave out any mention of the exception to the exclusion.

The subcontractor's work may not need to have caused the damage. The Fourth Circuit held a policyholder could recover for the costs of repairing damages caused by its negligence where the damaged work was performed by a subcontractor. In that case, Limbach Company subcontracted with Morse Diesel/Essex to install a prefabricated, insulated, underground steam line. Limbach in turn subcontracted with Legacy to excavate the trench for the steam pipe. It was undisputed that Limbach's improper unpacking of the steam pipe caused a leak in the steam line, which in turn damaged the insulation, backfill around the steam line, and the landscaping in the area. The court held, however, that the cost of repairing the damaged backfill—which backfill work had been performed by Legacy—was not excluded based on the subcontractor exception. *Limbach Co. v. Zurich Am. Ins. Co*., 396 F.3d 358, 363 (4th Cir. 2005) (applying Pennsylvania law)

In the above example, because the damage to ABC's work arose out work performed on behalf of ABC by a subcontractor, ABC has coverage for the cost of replacing the asphalt.

Example:

- *Ohio Cas. Ins. Co. v. Hanna*, 9th Dist. Case Nos. 07CA0016-M and 07CA0017-M, 2008-Ohio-3203: Mr. Hanna began constructing a house in Westfield Township in the summer of 2002. He hired Amish workers to frame the house, but a tornado leveled it a few months later. The Amish workers began framing the house again, but had to stop when the weather turned cold. Mr. Hanna hired Quality to complete the job. While finishing framing and installing the roof rafters of the home, the company caused the frame to go out of plumb and out of square, leading to problems with the roof, doors, drywall, wood trim, and windows.

- This Court agrees that the "products-completed operations hazard" exception applies. Although the damage to the windows' cranks and gears arose out of Quality's out-of-plumb installation of the windows, it did not occur while Quality was installing them and did not occur until after Quality finished its work on the house. *See Spears v. Smith*, 117 Ohio App. 3d 262, 267, 690 N.E.2d 557 (1996) (concluding "completed operations"

exception applied when damage occurred at a home construction site that the builder did not own or rent, the damage arose out of the builder's work on the floor support system, and the home was no longer in the builder's possession when it occurred). Accordingly, even though the windows may need replacement or repair because Quality installed them out of plumb, because any damage to them did not begin until after it finished its work, the first exclusion does not apply. *Id.* at ¶27.

- The court explained that the application of the Your Work Exclusion in the context of a construction project: [O]ften entails categorizing damages that flow from defective work into five groups: (1) the insured's work causes damage to the insured's work-to which the exclusion applies; (2) the insured's work is damaged by a subcontractor-to which the exclusion does not apply; (3) a subcontractor's work is damaged by the insured['s] improperly performed work-to which the exclusion does not apply; (4) a subcontractor's work damaged by improperly performed work by one or more subcontractors-to which the exclusion does not apply; and (5) damage to third-party property is caused by improperly performed work of the insured or others working on its behalf-to which the exclusion does not apply. Accordingly, because the exclusion only applies to property damage to "your, work" arising out of "your work," it only applies in this case if Quality's work caused damage to Quality's work. *Id.* at ¶28.

- Quality's out-of-plumb installation of the windows did not cause property damage to other work performed by Quality. Rather, it caused damage to third-party property, specifically, the Hannas' prefabricated windows' cranks and gears. This Court, therefore, concludes that neither "your work" exclusion applies to the Hannas' window claims. *Id*. at ¶29.

IV. Your Product Exclusion

> *"Property damage" to "your product" arising out of it or any part of it.*
>
> *Generally, "your product" includes any goods or products manufactured, sold, handled, distributed or disposed of by the named insured, their containers and related warranties, but expressly does not include within its scope "real property."*

Whether the Your Product Exclusion applies to property damage in connection with defective construction depends primarily on how the particular CGL policy defines "your product."

- Under policies that define "your product" without qualification, the "your product" exclusion has been held to apply to finished structures. *See Zanco, Inc. v. Michigan Mut. Ins. Co*., 464 N.E.2d 513, 515 (Ohio,1984).

- Most CGL policies, however, specifically exclude "real property" from the definition of "your product." Courts have interpreted "real property" in this context to include the structures affixed to the land. *See, e.g., Essex Ins. Co. v. BloomSouth Flooring Corp*., 562 F.3d 399, 410 (1st Cir. 2009). Given such an interpretation, the "your product" exclusion would have no application in the construction defect context because a structure built on land is not "your product." In *Dublin Building Systems v. Selective Ins. Co*., 172 Ohio App.3d 196, 2007-Ohio-494, 874 N.E.2d 788, the insured was a general contractor of office buildings, and building tenants filed claims for property damages arising from mold exposure allegedly caused by faulty construction. The exclusion in *Dublin* contained an exception covering damage to "real property." Construing the language against the insurer, the court found "real property" included not only land, but also the buildings which the insured had constructed. *Id*. at ¶30.

While the Your Product Exclusion gets little attention, a case out of Florida examined this very topic in *Liberty Mutual Fire Ins. Co. v. MI Windows & Doors, Inc*., 2013 WL 4734045 (Fla.App. 2 Dist. Sept. 4, 2013). MI Windows was a manufacturer of windows and doors. It had a CGL policy with Liberty Mutual. In the late 1990's and early 2000's, MI sold windows and doors to All Seasons, which installed these windows and doors in five condominium projects along the Alabama coast. In two of these condominiums, the doors were installed with no change. In the other three, All Seasons manufactured and installed transoms running atop the sliding-glass doors. This change weakened the structural integrity of the doors.

During MI Windows' policy period, the Alabama coast was slammed by several tropical storms and Hurricane Ivan. These storms severely damaged the condominiums where MI Windows' doors and windows had been installed by All Seasons. MI Windows settled these lawsuits, and then sued Liberty Mutual to recover the consequential damages and cost of repairing and replacing the defective doors or windows at each condominium. The CGL contained a Your Products Exclusion which stated: "Exclusions -- This insurance does not apply to: Damage to Your Product. 'Property damage' to 'your product' arising out of it or any part of it."

During the trial, the court determined that the "your product" exclusion did not apply to the doors with transoms, altered by All Seasons, because the doors "significantly changed by others after the sale, contributing to the consequential damages suffered." The Court found damages of $3.4 Million and awarded MI Windows the policy limit of $2 Million. Liberty Mutual appealed, asserting the trial court erred in its interpretation of the exclusion.

In one such case, the insured was a manufacturer of sheet metal that was later stamped into washers by the purchaser. These new washers became a "new product" and therefore the exclusion did not apply. In a separate case, the court held that paint that had baked into jalousies were "no longer identifiable as a separate entity" and was covered by the liability insurance policy. Based on these rulings, the appellate court was charged with determining whether All Seasons created a "new product" by adding the transoms onto the doors and windows manufactured by MI Windows. The appellate court held, despite the addition of these transoms, "[t]he doors retained their identity *** They continued to operate as sliding glass doors. Thus, the doors remained MI Windows' product, and the 'Your Product' exclusion precludes any damages awarded to replace them."

V. Impaired Property or Property Not Physically Injured Exclusion

"Property damage" to "impaired property" or property that has not been physically injured, arising out of:

(1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or

(2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion prevents coverage for "impaired" property – property which cannot be used or is less useful due to "your product" or "your work," where full use of the property can be obtained by removing or repairing "your work" or "your product." Essentially, this exclusion is intended to exclude coverage for the costs of repairing or replacing the insured's defective work or product where it has not caused any physical injury, but has merely rendered other property less valuable.

The two biggest issues are: (1) whether there has been "sudden and accidental physical injury," and (2) whether the damaged property can be "restored to use." If physical injury arising out of the insured's product or work causes a loss of use of other property, damages may be covered through the exception for "sudden and accidental physical injury." Not surprisingly, the meaning of "sudden and accidental" has been hotly disputed.

Moreover, the exclusion will not apply if: (1) mere removal of the insured's product will not alleviate the impairment or (2) the insured's work has been irreversibly incorporated into other work. *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc*., 197 F.3d 720, 728 (5th Cir. 1999). Thus, it is important to assess whether the insured's work has been so incorporated or integrated into the whole such that removal or replacement of the insured's work is not feasible or if doing so would itself cause property damage.

Example:

- Let's go back to our first example, but change the facts a little. ABC installs a sprinkler system for the owner of a new office building. This time, no pipes snap or break—there is no physical injury to tangible property. However, it is discovered that the system has not been installed to building code—the owner can replace portions of the sprinkler system to bring it up to code, but only at considerable cost.

- The owner makes claim against ABC for the cost of replacing the incorrectly installed portions of the sprinkler system and also for the loss of use of the office building as the owner cannot obtain an occupancy permit until the sprinkler system is installed to building code.

- From the viewpoint of ABC, the owner's office building is "impaired property." That is, the office building is less useful because ABC's work is known to be inadequate (it does

not meet building codes), and the property can be restored to use by replacing ABC's work by bringing the sprinkler system up to code.

- ABC has no coverage for the cost of replacing or repairing the sprinkler system as the sprinkler system itself, which is tangible property, has not been damaged. Thus there is no property damage to the ABC's work—the sprinkler system.

- The improper installation of the sprinkler systems has, however, caused loss of use of tangible property—the office building. The owner cannot collect rent until the sprinkler system is installed to code. Even though the definition of "property damage" in the CGL policy does include loss of use of tangible property (even if not physically injured), the exclusion expressly eliminates coverage for any property damage to impaired property. As the office is impaired property, ABC has no coverage for the loss of use claim made by the building owner.

Important Exception – Sudden and Accidental Physical Injury

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

There is an exception to this exclusion. Assume ABC goes ahead and replaces the appropriate parts of the sprinkler system, bringing it up to code. The landlord is able to rent space to his tenants and collect rental income. Unfortunately, four months after full occupancy, the main riser of the sprinkler system suddenly cracks and needs to be replaced (no damage is done to any other property). ABC is found to have used defective piping materials—the reason the riser cracked.

Because the cracked riser renders the building unusable as an office building, the owner again makes claim against ABC for loss of use—the tenants are not required to pay the rent if damage to the building prevents them from occupying their space.

Because the loss of use of the office building arose out of the sudden and accidental physical injury to ABC's work (the cracked riser), the exception, applies and ABC has coverage for this loss of use claim made by the owner.