States Differ on CGL Policies' Coverage for Faulty Workmanship

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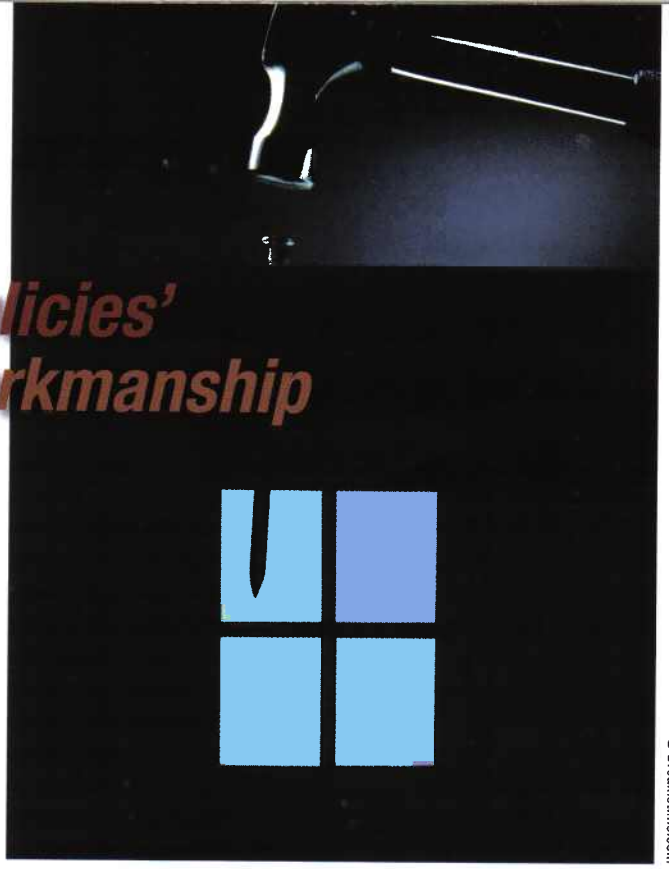

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Contractors and subcontractors are typically required by contract to obtain commercial general liability (CGL) insurance. CGL policies are designed to protect the insured from liability for certain losses arising out of business operations. In determining whether a CGL policy provides coverage for a particular loss, a court considers the terms of the particular policy, the specific facts of the case, and the applicable state law. In the context of a construction project, faulty workmanship by the insured or its subcontractor can result in damage not only to the insured's own work, but to other parts of the structure or property of third parties. State and federal courts across the country take different approaches in analyzing coverage for damage resulting from faulty workmanship under a CGL policy. The different analyses have resulted in a distinct split of authority on the issue.

Three-Step Coverage Analysis

Determining whether a particular loss is covered by a CGL policy requires a three-step analysis. The first determination that must be made is whether the policy provides coverage for a particular loss. This is done by analyzing the policy's insuring agreement. If it is determined there is no coverage for a particular loss, the analysis stops. If it is determined there is coverage, then the policy exclusions must be analyzed to determine whether coverage is excluded. If coverage is excluded, then the exceptions to the exclusions must be analyzed. If the particular loss falls under the exceptions to the applicable exclusions, then the exclusions do not apply and coverage is reinstated.

Determining Coverage for Faulty Workmanship

Standard CGL policies provide coverage for property damage (or bodily injury) caused by an "occurrence." "Occurrence" is typically defined in a CGL policy as "an accident, including continuous or repeated exposure to substantially the same or general harmful conditions." Standard CGL policies do not define the term "accident." Therefore, the courts are tasked with supplying a definition. While the majority of courts seem to agree that the word "accident" generally means an event that is either unexpected, unintended or unforeseen, whether faulty workmanship or any resulting damage constitutes an "accident" is the subject of great debate.

The recent case of *Lamar Homes, Inc. v. Mid-Continent Casualty*, decided by the Supreme Court of Texas, is illustrative of the dispute that typically arises over coverage under a standard CGL policy for damage caused by faulty workmanship. In *Lamar Homes*, a homeowner sued Lamar Homes, Inc. (Lamar), the homebuilder, and its subcontractor several years after the home was purchased. The homeowners alleged that defective construction or faulty workmanship in the foundation of the home caused cracks in the home's sheetrock and stone veneer. Lamar forwarded the suit to its insurer requesting a defense and indemnification under its CGL policy. The insurer denied Lamar's claim. Lamar then filed suit against the insurer. The insurer took the position that the alleged loss resulting from the defective construction was not an "accident," and, therefore, not an "occurrence" under the CGL policy. [*Editor's note:* ASA and ASA of Texas successfully argued in two "friends of the court" briefs filed in *Lamar Homes* that the homebuilder's CGL policy covered the accidental property damage.]

Arguments Against Coverage

One of the initial questions courts must wrestle with is whether faulty workmanship is an "occurrence." In their analysis of this question, many courts focus on whether the faulty workmanship resulted in damage only to the insured's own work, or whether it resulted in damage to the work or property of a third party. States such as Illinois, New York, North Carolina, Pennsylvania, and South Carolina, have determined that faulty workmanship that results in damage only to the insured's own work is not an "occurrence" under a CGL policy, and, therefore, is not covered.

These states have employed various concepts and lines of reasoning in reaching this conclusion. Some states are of the opinion that faulty workmanship does not involve the degree of fortuity or unexpectedness to be considered an "accident." Some reason that damage from faulty workmanship is the natural and ordinary consequence of performing the work negligently, and, therefore, is foreseeable and not an "accident." Some states are of the opinion that claims based on faulty workmanship are essentially claims sounding in breach of contract for the costs

of repair or corrective work as a result of the insured's defective performance, and, therefore, not the subject of insurance coverage. Others reason that permitting coverage for damage to the insured's work alone resulting from its own faulty workmanship would convert CGL policies into performance bonds, which guarantee work as opposed to insuring against accidents.

The case law of these states creates an issue for subcontractors in particular. Many standard CGL policies contain an exclusion for "your work." This exclusion precludes coverage for property damage to the insured's completed work. There is, however, an exception to this exclusion for property damage to the insured's work caused by a subcontractor. The purpose of the exception to the "your work" exclusion is to reinstate the initial grant of coverage provided under the CGL policy for property damage to the insured's work caused by a subcontractor. Herein lies the problem. If there is no initial grant of coverage under the CGL policy for damage to the insured's work resulting from faulty workmanship, as these states have held, then the exception to the "your work" exclusion is meaningless as there is no coverage to reinstate. Contractors and subcontractors doing business in these jurisdictions may not be covered for damage to their work resulting from faulty workmanship by their subcontractors.

Arguments for Coverage

On the other hand, states such as Florida, Kansas, Ohio, Tennessee, Texas and Wisconsin have recently held that damage to the insured's work can constitute an "occurrence" under a CGL policy. [*Editor's note:* ASA also successfully argued the issue of CGL coverage in briefs to the Florida and Wisconsin Supreme Courts.] These states are of the view that the determination of whether faulty workmanship constitutes an "occurrence" in a particular case does not depend on whether the faulty workmanship resulted only in damages to the insured's work, or whether the faulty workmanship resulted in damage to property of a third party. These states limit their analysis of coverage to the language of the CGL policy and, in doing so, conclude there is no basis in the policy language for making such a distinction.

These states also take the position that faulty workmanship can constitute an "accident" if the resulting damage was not intended or expected. In *Lamar*, the Supreme Court of Texas stated: "[A] deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly."

These states tend to reject the carving out of "contract-type" claims from the definition of "occurrence" on the basis that the definition of "occurrence" in the policy does not make any such distinction. Some states have rejected the comparison of a CGL policy to a performance bond, citing a variety of inherent differences. In *Lamar*, the Supreme Court of Texas astutely observed that any similarities between a CGL policy and a performance bond are irrelevant to the analysis of the coverage provided under the language of a CGL policy.

Florida, Kansas, Texas and Wisconsin have determined that the "your work" exclusion, and the exception for damage caused by a subcontractor's work, is evidence that the standard CGL policy provides an initial grant of coverage for damage to the insured's work resulting from faulty workmanship by the insured or its subcontractors. They reason that if there were no such initial grant of coverage, then the exclusion would be meaningless.

Depending on the facts of the particular case, the courts of these states are more likely to find an initial grant of coverage for property damage resulting from faulty workmanship. As a result, the exception to the "your work" exclusion for damage to the insured's work caused by a subcontractor would have the intended effect of reinstating coverage for such damage.

Conclusion

State law governs the interpretation of insurance policies. Considering the different approaches taken by the states in analyzing coverage under CGL policies, subcontractors are advised to consult with their legal advisors to determine or confirm the scope of coverage under their particular CGL policies. ■

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