

# ARE CGL POLICIES STILL WORTH HAVING?

By

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## INTRODUCTION

Plaintiffs typically look to the party with whom it has contracted (the general contractor) to satisfy a claim for defective construction.<sup>1</sup> All too often, this party has carefully shielded its assets and attempts to collect from the empty corporate shell are futile. Fortunately, most general contractors obtain commercial general liability insurance policies to ostensibly satisfy claims for defective construction. These policies are typically referred to as “CGL” policies. Over the last several years, however, insurance companies have attempted to deny coverage to general contractors in these types of disputes with varying success around the country. Obviously, ultimate success by the insurance companies would severely restrict the ability of plaintiffs for a successful recovery.

A question often encountered is whether the applicable Commercial General Liability (CGL) insurance policies issued by the general contractor’s insurance provider impose a duty upon the insurer to defend or indemnify the general contractor in an underlying arbitration or lawsuit.

The proper analysis regarding the insurer’s potential indemnity and defense obligations is a modified three step process under the typical express language of the policies:

1. Is there “property damage”?
2. Was “property damage” caused by an “occurrence”?
- 3a. Is there a policy exclusion which bars coverage?
- 3b. Does the subcontractor exception restore coverage?

## GENERAL CONTRACTOR LIABILITY

### **1. Property Damage**

The policies typically define, in pertinent part, “property damage” as:

- a. Physical injury to tangible property, including all resulting loss of use of that property. . . ; or
- b. Loss of use of tangible property that is not physically injured.

It is well settled that damage in the nature of repair and completion of the project necessitated by the general contractor’s faulty workmanship is not “property damage” within the meaning of the builder’s CGL policy. However, a review of these cases reveals that the court is referring to the cost to repair and complete the faulty work, not the cost to repair and replace injured property resulting from the faulty work. See Western World Ins. Co. v. Carrington, 90 N.C. App. 520, 369 S.E.2d 128 (1988) (finding no coverage where, instead of seeking costs for repairing the cracked concrete that was caused by the general contractor’s having improperly installed tubing under concrete, the property owner sought costs for replacing only the

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<sup>1</sup> A detailed discussion of the numerous provisions within a construction contract and the impact on pursuit of those claims is beyond the scope of this paper.

improperly installed tubing); see also Reliance Ins. Co. v. Aetna Cas. And Surety Co., 1998 WL 337244 (N.D. Cal. 1998) (distinguishing between the cost to repair or replace the defective part itself, and cost to repair or replace the loss or destruction to other property beyond that necessary to repair only the defective part).

As often is the case, the property owner presents evidence demonstrating areas of defective construction on the property which in turn damaged numerous other areas of the property which were not originally damaged. It is this originally undamaged work, which is “tangible property,” for which the insured will seek coverage for repair costs.

Insurance providers often argue that there is no coverage for the damage because no property damage exists. Three cases that they tend to rely upon are Wm. C. Vick Constr. Co. v. Pennsylvania Nat’l Mut. Cas. Ins., Co., 52 F.Supp.2d 569, 582 (E.D.N.C. 1999), aff’d, 213 F.3d 634 (4<sup>th</sup> Cir. 2000), Hobson Constr. Co. v. Great Am. Ins. Co., 71 N.C.App. 586, 322 S.E.2d 632 (1984) and Production Systems, Inc. v. Amerisure Ins. Co., 167 N.C.App. 601, 605 S.E.2d 663 (2004).

These opinions, among other things, support the proposition that “to be considered property damage, the property allegedly damaged has to have been undamaged or uninjured at some previous point in time.” Also, that “damages based solely on shoddy workmanship . . . are not ‘property damage’ within the meaning of a standard form CGL policy.” Vick, 52 F.Supp.2d at 583. However, careful analysis of the Vick, Hobson and Production Systems decisions shows that they are not contrary to the argument that property damage can occur when portions of a larger project are defective. See Vick, 52 F.Supp.2d 569; Hobson, 71 N.C.App. 586; Production Systems, 167 N.C.App. 601.

In Vick, the property owner sought coverage for the cost to repair and complete the improper installation of the waterproof membrane and stucco, not for injury to property caused by the improperly installed waterproof membrane or stucco. Id. The court in Vick determined that “the property allegedly damaged has to have been undamaged or uninjured at some previous point in time.” Id. at 582. The court found that this requirement had not been satisfied because the owner sought to recover only for the cost to repair the defective work of the contractor/insured - the improperly installed waterproofing membrane and the cracks in the stucco wall. Id. at 583. The owner did not seek to recover for damage to other property that was properly constructed but later damaged by the contractor’s negligence. Id.

Similarly, in Hobson the insured builder constructed a dam that did not properly hold water. Id. The property owner sought coverage under the builder’s liability policy for the cost to replace the dam, not for injury to other property caused by the faulty dam. Id. The North Carolina Court of Appeals properly held that there was no “property damage” within the meaning of the policy because there was no “physical injury” to any property. Id. Although the dam was defective because it did not hold water, the dam itself was not “injured.” Id. Also, none of the owner’s other property was flooded or damaged by the inability of the dam to hold water. Id. Thus, the court’s decision to not find coverage in Hobson was based upon the absence of “physical injury.” Id.

The North Carolina Court of Appeals in Hobson and the District Court in Vick both state that damage in the nature of repair and completion of the project necessitated by the general contractor's faulty workmanship are not "property damage" within the meaning of the liability policies in those cases. See Vick, 52 F.Supp.2d 569, Hobson, 71 N.C.App. 586. The Vick and Hobson courts found that the cost to repair and complete faulty work, not the cost to repair and replace injured property which results from the faulty work, does not fall within the definition of "property damage." Id. It is also critical to note that the Vick court, and the decisions relied upon therein, never states that the property damage cannot be a portion of the larger project itself that was initially undamaged. Id.

In Production Systems, PSI entered into a contract with Rubatex for PSI to design, construct and install two foam rubber sheet line systems. 605 S.E.2d 664. Each line system was to consist of an oven, nine conveyor belts, and associated components. Id. After the systems were completed, Rubatex began experiencing problems. Id. An investigation revealed that certain components were improperly installed, were misaligned and would not track properly. Id. Eventually a lawsuit was filed. Id. PSI notified its insurance carriers of the suit and asked each to defend or indemnify it. Id. Each carrier refused PSI's request. Rubatex and PSI then reached a settlement of their lawsuits under the terms of which PSI paid Rubatex \$500,000.00. Id. at 665. PSI then filed suit against its carriers seeking a determination that the companies were obligated to defend and indemnify it under the terms of the CGL policies. Id. Summary Judgment was eventually entered in favor of the carriers. Id.

The facts before the Court at Summary Judgment revealed that there were no damages being sought other than the cost of repairing the defective line systems, and the loss of use of the line systems. Id. at 666. The Court stated that the term "property damage" means damage to property that was previously undamaged, and not the expense of repairing property or completing a project that was not done correctly or according to contract in the first place. Id.

Although not discussed by Vick, Hobson or Production Systems, several other North Carolina decisions do indicate that "property damage" can be a portion of the larger project itself that was initially undamaged. In Western World, where a general contractor sued a subcontractor that had defectively installed waterproofing on a parking deck project, the appellate court considered the issue of property damage under an insurance policy. Id. The defective work allowed leakage which caused concrete walls within the parking deck to crack. Id. The subcontractor's insurer filed a declaratory judgment action. Id. In finding no coverage, the appellate court upheld the lower court's decision that the only damages being sought by the general contractor were to replace the defective waterproofing system. Id. The court then noted that the general contractor was not seeking damages or "costs for repairing the cracking in the concrete . . ." Id. at 524-525. This analysis supports the conclusion that had the general contractor sought damages for the previously undamaged concrete walls, coverage would have existed. See id.

Another North Carolina case which discusses this issue is Washington Housing Authority v. North Carolina Housing Authorities Risk Retention Pool, 130 N.C. App. 279, 502 S.E.2d 626, rev. denied, 526 S.E.2d 477 (1998). In this case, the Washington Housing Authority ("WHA") managed an apartment complex owned by Runyon Creek. Id. Runyon sued the WHA for,

among other things, serious damage to the complex caused by a series of faulty plumbing repairs that had extensively damaged floors and walls in the complex. *Id.* The insurance company for WHA, the North Carolina Housing Authorities Risk Retention Pool (“NCHARRP”), denied coverage. *Id.* WHA filed a declaratory judgment action. *Id.* The appellate court affirmed the lower court’s determination that property damage had been sufficiently alleged to trigger a duty to defend and a duty to pay “all sums which it [NCHARRP] may or shall become legally obligated to pay as damages.” *Id.* at 281.

Furthermore, a recent Fourth Circuit decision, interpreting Maryland law, lends additional support to the view that shoddy workmanship causing damage to an otherwise defect-free portion of a building constitutes physical damage to tangible property, and is covered under a policy as “property damage.” In French v. Assurance Company of America, 448 F.3d 693 (4<sup>th</sup> Cir. 2006), homeowners contracted with a general contractor for the construction of a home. A subcontractor was hired to finish the exterior of the home with an EIFS synthetic stucco system. *Id.* Nearly five years later, the homeowners filed suit against the general contractor for water damage to the exterior EIFS covered wall and the resulting damage suffered by the otherwise non-defective structure and walls of their home. *Id.* Thereafter, the homeowners settled with the general contractor and were assigned all claims that the general contractor could pursue against two of its insurers. *Id.* These two insurers, who had both issued commercial general liability coverage to the general contractor under a 1986 ISO CGL policy, denied coverage relating to the damage and the homeowners, on behalf of the general contractor, subsequently brought a declaratory action. *Id.*

In contrast to prior North Carolina case law discussed above, the Fourth Circuit divided the homeowners’ claims into two categories: (1) the defective EIFS exterior; and (2) the damage to the non-defective structure and walls of the home directly resulting from moisture intrusion through the defective EIFS exterior. *See id.* The Fourth Circuit affirmed the district court’s order granting summary judgment for the defendant insurers relating to the defective EIFS exterior, holding that the defective application of EIFS to the exterior of the home did not constitute damage to property other than the EIFS itself and represented merely economic loss which did not trigger a duty to indemnify under the policy. *Id.* at 703. However, the Fourth Circuit reversed the district court’s order granting summary judgment for the insurers in regard to the second category of the costs to remedy the property damage to the structure and walls of the home. *Id.* Significantly, the court held that the moisture intrusion into the non-defective structure and walls of the home constituted damage to tangible property other than the defective EIFS itself and the insurers had a duty to indemnify the general contractor against the claims of the homeowners for the costs to remedy such damages. *Id.* at 704.

The concept that “property damage” can occur when defective work damages another portion of the project has also been directly addressed by a number of other jurisdictions. In Taylor-Morley-Simon, Inc. v. Michigan Mutual Ins. Co., 645 F. Supp. 596 (E.D. Mo. 1986), *aff’d*, 822 F.2d 1093 (8<sup>th</sup> Cir. 1987), the court held that the cracking of walls, ceilings and floors, stress on water and gas lines, and the loosening of ducts throughout the house, all of which were caused by the builder’s failure to support concrete slabs by piers and properly compact subsoil, constituted physical damage to tangible property so as to fall within the definition of property damage.

In Kalchthaler v. Keller Construction Company, 224 Wis.2d 387, 591 N.W.2d 169 (1999), the builder was hired to construct a residential facility for the elderly. After the project was completed, the building leaked causing water damage to the interior. Id. The owner of the property, Kalchthaler, brought suit against the general contractor and its insurer, Aetna. Id. The court found “property damage” caused by an “occurrence.” Id. The court held, “[p]roperty damage, as defined by the policy, means physical injury to tangible property. Id. Here, water entering leaky windows wrecked drapery and wallpaper. Id. This is physical injury to tangible property.” Id. at 397.

The U.S. District Court for the Northern District of Illinois addressed whether integration of a defective product into a building, which subsequently suffered damage, constituted “property damage” in W.E. O’Neil Construction Co. v. National Union Fire Insurance Company of Pittsburgh, PA, 721 F.Supp. 984 (1989). O’Neil Construction, similar to the general contractor in Western World, supra, was hired to construct a parking garage for a series of townhomes. W.E. O’Neil, 721 F.Supp. 984. Shortly after completion the garage started to suffer cracks in the walls and floors. Id. Two different experts determined the cracking was primarily caused by the improper placement, by one of O’Neil’s subcontractors, of the steel mesh imbedded in the concrete. Id. The court reasoned, “where a defective product manufactured or installed by the insured has been integrated with someone else’s property, it is clear that damage to that property as a whole...constitutes property damage.” Id. at 991.

In California, the Court of Appeals found that:

[W]e have allegations of physical harm to tangible property. As we have seen, the homeowners and their associations have alleged soil subsidence has cracked concreted floor slabs, foundations, retaining walls, interior and exterior walls and ceilings and exterior concrete patio areas. Moreover, failure of the roofing system has allegedly allowed rain water to damage building structures and the contents of the living areas. Thus. . .the homeowners and their association have gone beyond allegations that defects in materials and workmanship exist at the project. Accordingly, the underlying plaintiffs have alleged property damage within the meaning of the insuring provisions of the...policy.

Maryland Casualty Company v. Reeder, 221 Cal.App.3d 961, 970-971, 270 Cal.Rptr. 719, 724 (1990). The court went on to discuss another case, from Minnesota, which addressed the use of a defective material in a final product. Citing Hauenstein v. Saint Paul-Mercury Indemnity Co., 242 Minn. 354, 65 N.W.2d 122 (1954), the court found “property damage” and insurance coverage. In Hauenstein, the insured supplied defective plaster which had to be removed and replaced with a different material. Id. The court reasoned:

No one can reasonably contend that the application of a useless plaster, which has to be removed before the walls can be properly re-plastered, does not lower the market value of a building. Although injury to the walls and ceilings can be rectified by removal of the defective plaster, nevertheless, the presence of the

defective plaster on the walls and ceilings reduced the value of the building and constituted property damage.

Id. at 358.

The United States District Court in Maryland has also addressed the issue of “property damage.” See Harbor Court Associates v. Kiewit Construction Company, 6 F.Supp.2d 449, 455 (1998). A brick veneer which had been installed on a building suffered cracking, buckling and had otherwise failed in several locations. Id. The court found that, under the ordinary meaning of the policy terms, the alleged damage to the brick veneer was sufficient to constitute “property damage.” Id. Furthermore, if the injured property cannot be repaired or replaced without removing or destroying non-injured components of the property, then the cost of removing or destroying the non-injured components is also covered under the CGL policy. See Bundy Tubing Co. v. Royal Indem. Co., 298 F.2d 151 (6<sup>th</sup> Cir. 1962) (radiant heat tubing installed in concrete floors was defective, causing leaks that in turn caused damage to interior of buildings; in order to replace the tubing, the concrete had to be removed and repoured; held: insurer was required to indemnify insured for the cost of removing defective tubing and the cost of installing new tubing); St. Paul Fire & Marine Ins. Co. v. Sears, Roebuck & Co., 603 F.2d 780 (9<sup>th</sup> Cir. 1979) (damage to roof caused by the replacement of defective components of the roof constituted property damage).

It is undisputed that “property damage” can also be shown by demonstrating a “loss of use” of the property at issue. Although reported North Carolina law on this topic is sparse, there are a series of cases in other jurisdictions which find “property damage” through “loss of use” under circumstances similar to the facts and policies discussed above. In a recent Pennsylvania case, a contractor instituted a declaratory judgment action against its insurer. Mattiola Construction Corp. v. Commercial Union Insurance Co., 2002 WL 434296 (Pa.Com.Pl.). The contractor had accidentally cut structural steel cables in a bridge during construction. Id. This event significantly delayed completion of the bridge work. Id. The court, while evaluating a liquidated damages provision involved in the dispute, held that:

[C]learly, the physical injury to the bridge resulting from the accident caused a substantial delay in the completion of the project. This delay can be considered a loss of use, and any resultant damages, including the liquidated damages, are attributable to the accident.

Id. The Mattiola court, finding support from the Illinois Court of Appeals, held that “alleged increased costs resulting from construction delays attributable to the design errors were sufficient to allege loss of use within the policy definition of property damage and that the insurer had a duty to defend.” Id. The Illinois court stated:

Loss of use...is the loss of the right to use property which is an incident of ownership. Loss of use claims are not the same as claims for anticipated profits or loss of investment, and a party’s description of loss of use damages as merely economic does not take them outside the coverage of an insurance policy that defines property damage as including loss of use.

Gibraltar Casualty Co. v. Sargeant & Lundy, 574 N.E.2d 664, 671 (Ill.App.Ct. 1991).

The United States District Court for the Southern District of Ohio has also addressed the issue of loss of use damages. See Hartzell Industries, Inc. v. Federal Insurance Company, 168 F.Supp.2d 789 (2001). In this case, the owner of a boiler house, Allegheny, purchased and installed roof fans to cool the boiler house. Id. The fans malfunctioned and were unusable for some period of time. Id. During the time when the fans were not being operated, the owner alleged decreased worker productivity because of the inability to use the roof fans. Id. Allegheny's carrier, Federal, argued that these were purely economic losses. Id. The court was not persuaded and stated:

This allegation qualifies as a covered "loss of use of tangible property that is not physically injured." Although Allegheny did not shut down the boiler house after the fan disintegration (i.e., there was not a total loss of use), the boiler house became less useful because the fans were turned off. As a result of the increased heat, Allegheny suffered a loss of productivity in its boiler house (i.e., there was a partial loss of use). The Federal insurance policy at issue defines "property damage" as the "loss of use of tangible property that is not physically injured." The policy does not specify that the loss of use must be total as opposed to partial.

Id. at 795.

The Hartzell court also refers to a Texas case which addresses the "economic loss" aspect of this discussion. Id. The court in Gibson & Associates, Inc. v. Home Ins. Co., 966 F.Supp. 468, 477 (N.D.Tex.1997) "cites case law from numerous jurisdictions and recognizing that while 'purely economic injuries' ordinarily do not qualify as 'property damage,' such economic losses do constitute 'property damage' when a commercial general liability policy defines the phrase 'property damage' to include the 'loss of use of tangible property that is not physically injured.'" Hartzell, 168 F.Supp.2d at 796.

## 2. Occurrence

After establishing property damage, one must next determine if the property damage was caused by an "occurrence." "Occurrence" is often defined in the policies as "an accident including continuous or repeated exposure to substantially the same general harmful condition." The policies tend not to define "accident." However, the Supreme Court of North Carolina has long defined an "accident" as an "unforeseen, unexpected, unusual, or unprecedented consequence." Waste Mgmt. of Carolinas, Inc. v. Peerless Ins. Co., 315 N.C. 688, 340 S.E.2d 374 (1986). By way of background, it is important to understand that in 1986, the standard definition of "occurrence" was changed. The prior policy language defined "occurrence" in the same manner as above, but added language at the end as follows: ". . . which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured." In other words, there was no occurrence if the insured expected or intended the property damage. However, because this language was specifically removed in later versions, the current definition

of occurrence by its plain language has nothing to do with whether the insured “expected” or “intended” the property damage.

In Waste Mgmt., the insured sought coverage against allegations that it dumped contaminating materials at a landfill over a number of years, eventually rendering the groundwater hazardous for human consumption. Id. Discussing the definition of “occurrence” under the language of the policy, the court held the definition was restricted to “events that are unexpected and unintended as viewed from the standpoint of the insured.” Id. at 695. The court noted that even “intentional acts, the consequences of which are unexpected, have been held to qualify as ‘occurrences.’” Id. Based on this definition, the court concluded that the intentional dumping of the waste materials by the insured did qualify as an occurrence:

Whether events are “accidental” and constitute an “occurrence” depends upon whether they were expected or intended from the point of view of the insured...it was not the routine dumping but the arguably unintended, unexpected leaching of contaminants into the groundwater that constituted the “occurrence” for the purpose of [the insured’s] insurance coverage.

Id. at 696.

This concept was also recognized by another North Carolina court in Washington Housing Authority, supra. As discussed above, the underlying suit involved claims against the insured/property manager by the property owner for damage to apartment units, including negligent management of the apartments. Washington Housing, 130 N.C. App. 279. The Washington Housing Authority sought a declaratory judgment that the insurer had a duty to defend and provide coverage. Id. Rejecting the insurer’s argument that the conduct alleged in the underlying complaint was not an “occurrence,” the court held that the test “should be a ‘subjective one, from the standpoint of the insured, and not an objective one asking whether the insured ‘should have’ expected the resulting damage,’ i.e., whether the resulting damage was unexpected or unintended, not whether the act itself was unintended.” Id. at 285, quoting Waste Mgmt., 72 N.C. App. at 87. Based on this test, the court found that the damages alleged by the property owner in the underlying suit were caused by “occurrences”:

Runyon Creek [the property owner] alleged that plaintiff caused serious damage to the Apartments through “faulty” repair of plumbing leaks which “ruined floors and walls,” inadequate attempts at termite control which caused “termite infestations which have caused severe damage,” and inadequate management of the grounds which resulted in “undue and excessive accumulations of trash, debris and weeds.” While plaintiff’s actions taken in an attempt to manage and maintain the property with plumbing, pest control and grounds keeping were intentional, the resulting damage to the property occasioned thereby was not. Therefore, the conduct alleged by Runyon Creek constituted an “occurrence” under the policy.

Id. at 285-286, 502 S.E.2d at 631.

The North Carolina Supreme Court in N.C. Farm Bureau v. Stox, 330 N.C. 697, 412 S.E.2d 318 (1992) provides further elucidation into the term “accident” and what constitutes an “occurrence.” The court held, “[i]n choosing not to define the term ‘accident’ in its policy, the plaintiff Farm Bureau left its interpretation open and subject to ambiguities. Id. As our rules of construction dictate, all ambiguities must be resolved in favor of the insured.” Id. at 702. In Stox, an employee intentionally pushed another employee who fell and sustained a severe fracture. Id. Farm Bureau argued that this intentional or foreseeable act was not an “accident” and thus not an “occurrence,” under the insurance policy. Id.

In rejecting this argument, the North Carolina Supreme Court concluded there was an occurrence because the term “accident” included “injury resulting from an intentional act, [even] if the injury is not intentional...” Id. Thus, one can surmise that there would have been no occurrence if there had been evidence that the employee intended to cause a fracture or injury when he pushed the employee down and injured him. Id. Stox held that “an accident does not occur when property damage is caused by defective or poor workmanship, because an insured should foresee and expect the resulting damage.” Id. In other words, even if the various subcontractors knew they were performing defective or poor work, the subcontractors would have had to intend to damage other property with their defective work. Id. As stated in the Washington Housing Authority, supra, and Waste Mgmt. cases, the test is a subjective one. See Washington Housing, 130 N.C. App. 279; Waste Mgmt., 315 N.C. 688.

Additionally, a recent Fourth Circuit decision involving the defective construction of a hotel, interpreting North Carolina law, addressed the issue of whether a claim caused by an “accident” under the terms of the policy can be described as such when the claim involves the foreseeable consequence of the general contractor’s shoddy workmanship. Travelers Indemnity Company v. Miller Building Corp., 97 Fed.Appx. 431 (2004). The Fourth Circuit recognized that under North Carolina law, foreseeability in the context of an insurance dispute does not carry the same meaning as it does in the context of a negligence claim. Id. The Court cites Iowa Mutual Insurance Co. v. Fred M. Simmons, Inc., 258 N.C. 69, 128 S.E.2d 19 (1962) for the proposition that “the fact that the consequences of an action are foreseeable for purposes of a negligence claim does not mean that the consequences are not accidental for purposes of determining coverage under a general liability insurance policy.” Travelers, 97 Fed.Appx. at 435. Any other interpretation of the term “accident” in this context would simply not be reasonable because it render the policy virtually meaningless. See id. at 436-37.

Consequently, the Fourth Circuit applied a subjective standard to the facts to determine that “[w]hile it is certainly foreseeable (in the tort sense) that defective windows and sliding glass doors could lead to water intrusion and water damage, there is nothing in the record indicating that [the general contractor] subjectively intended to cause damage to the guest rooms.” Id. at 437. Therefore, even though the damage to the guest-room carpet was a foreseeable consequence of the improper installation of windows and sliding glass doors, the claim nonetheless sufficiently alleged an “occurrence” within the meaning of the policy. Id.

Notwithstanding North Carolina law, numerous other jurisdictions also have acknowledged that unexpected or unintended damage to other property constitutes an “occurrence” under certain insurance policies. For example, in High Country Associates v. New

Hampshire Ins. Co., 139 N.H. 39, 648 A.2d 474 (1994), a homeowners' association sued the general contractor alleging that the contractor's "faulty design, selection of materials, construction, supervision and inspection of the condominium units resulted in substantial moisture seepage into the buildings, causing mildew and rotting of the walls, and loss of structural integrity." Id. at 41. The contractor then filed suit against its insurer to determine whether the insurer had a duty to provide coverage for the claims of property damage in the underlying action. Id. The insurance policy at issue in High Country defined "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Id. at 42. Based on this definition, the trial court found that because the homeowners' allegations were based on the contractor's defective workmanship, they did not constitute an occurrence under the policy. Id. Reversing this decision, the New Hampshire Supreme Court found that the trial court improperly relied on prior cases in which there were no allegations of property damage "beyond the improper performance of the task itself." Id. at 42. By contrast, the court found that the homeowners:

Alleged actual damage to the buildings caused by exposure to water seeping into the walls that resulted from the negligent construction methods of High Country Associates [the contractor]. The damages claimed are for the water-damaged walls, not the diminution in value or cost of repairing work of inferior quality. Therefore, the property damage described in the amended writ, caused by continuous exposure to moisture through leaky walls, is not simply a claim for the contractor's defective work. Instead, the plaintiff in the underlying suit alleged negligent construction that resulted in property damage rather than merely negligent construction.

Id. at 43.

In response, the insurer argued that its policy was intended to cover "accidents, not the 'business risks' of poor workmanship," defining accident to mean "a sudden event that is identifiable in time and place." Id. Rejecting this argument, the court adopted a definition of accident to mean "circumstances that were unexpected or unintended from the standpoint of the insured, but not limited to a sudden, precipitous event." Id. at 44. Because the property damage alleged by the homeowners in the underlying suit was "unexpected from the standpoint of High Country Associates [the contractor/insured] and was caused by continuing exposure to moisture seeping through the walls of the units," the court found it to constitute an "accident" and "occurrence" under the terms of the policy. Id.; see also Federated Mutual Ins. Co. v. Grapevine Excavation Inc., 197 F.3d 720 (5<sup>th</sup> Cir. 2000) (contractor's claim that subcontractor negligently damaged the work of the paving contractor by failing to install the correct fill materials for a parking lot sufficiently alleged an "occurrence" under a CGL policy because it alleged property damage that was unexpected or unforeseen); Fidelity & Deposit Co. v. Hartford Casualty Inc. Co., 189 P. Supp.2d 1212, 1218-19 (D. Kansas 2002) ("damage that occurs as a result of faulty or negligent workmanship constitutes an 'occurrence' as long as the insured did not intend for the damage to occur;" court also noted that policy provisions excluding some construction but not others "become meaningless if all construction defects are excluded from coverage because they do not constitute an 'occurrence'").

In 2002, the South Dakota appellate court held that the definition of “occurrence” is satisfied when a contractor is forced to tear out properly constructed work to fix or replace work that was defectively constructed. Corner Construction Co. v. United States Fidelity and Guaranty Co., 638 N.W.2d 887 (S.D. 2002). In Corner Construction, the insulation subcontractor left voids in the insulation and failed to securely attach the vapor barrier. Id. The barrier subsequently fell, causing damage to the contractor’s work. Id. The insured/contractor was “forced to remove the drywall, fix the vapor barrier, replace the drywall, and then re-tape, retexture and repaint the portions of the building that had been damaged.” Id. at 895. The court held that this type of damage was covered by the insurer’s CGL policy because it was an “accident or unintended event, resulting in property damage that was neither expected nor intended by the insured.” Id.

The Texas Court of Appeals also addressed the definition of “accident” in the context of a general liability insurance policy, finding that it “include[s] negligent acts of the insured causing damage which is undersigned and unexpected.” CU Lloyd’s of Texas v. Main Street Homes, Inc., 79 S.W.3d 687, 692 (2002). The Lloyd’s court found that the claims asserted were sufficient to constitute an “occurrence,” based on allegations that the builder relied on inaccurate soil surveys and improperly constructed several homes. Id. The court also held that sufficient allegations were made regarding damage caused by the work of subcontractors triggering the duty to defend the builder. Id. at 698.

The South Carolina Court of Appeals addressed what is encompassed by the term “occurrence” in L-J, Inc. v. Bituminous Fire and Marine Insurance Company, 567 S.E.2d 489 (2002). In L-J, Inc., the general contractor was hired to develop the site and construct roads for a new subdivision. Id. The general contractor hired a subcontractor to clear, grade and construct the base for the roads. Id. The sub-grade was improperly prepared, which ultimately caused surface runoff water to damage the pavement. Id. The court stated:

In this case, it is undisputed that repeated exposure to surface water runoff caused the pavement to fail. The pavement is tangible property. The policy provides coverage for continuous and repeated exposure to harmful conditions causing damage to tangible property. Under the clear language of the policy, the repeated exposure to water is an “accident” and therefore an “occurrence.”

Id. at 492. The South Carolina Court of Appeals continued, saying that because the general contractor had no knowledge of the problems with the sub-road until the damage became evident some years later, the general contractor could not have expected or foreseen this result. Id. The water runoff causing damage to the road fell within the definition of “occurrence.” Id. Bituminous, the insurance carrier, argued that faulty workmanship cannot constitute an “occurrence.” The court agreed. Id. “We agree that faulty workmanship, standing alone, does not constitute an ‘accident’ and cannot therefore be an ‘occurrence’. . . but, faulty workmanship that causes an accident is covered.” Id. at 493.

However, the Supreme Court of South Carolina ultimately disagreed with the Court of Appeals and after hearing the matter twice, held that “faulty workmanship standing alone, resulting in damage only to the work product itself, does not constitute an occurrence under a

CGL policy.” L-J, Inc. v. Bituminous Fire and Marine Ins. Co., 366 S.C. 117, 121, 621 S.E.2d 33, 35 (2005). The Supreme Court found that the damage in the present case did not constitute an “occurrence” because the negligent acts constitute faulty workmanship which damaged the roadway system only. Id. “[B]ecause faulty workmanship is not something that is typically caused by an accident or by exposure to the same general harmful conditions, we hold that the damage in this case did not constitute an occurrence.” Id. at 36. The Supreme Court noted, though, that “[t]he CGL policy may...provide coverage in cases where faulty workmanship causes a third party bodily injury or damage to other property, *not in cases where faulty workmanship damages the work product alone.*” Id. It is our understanding, however, that another similar case is pending before the Supreme Court due to extreme criticism of this decision.

In Louisiana, the Court of Appeals looked to a treatise on insurance law for guidance. See Massey v. Parker, 98-1497 (La.App. 3 Cir. 3/3/99), 733 So.2d 74 (1999). The court quoted from McKenzie and Johnson 15 Louisiana Civil Law Treatise, Insurance Law and Practice § 183 at p. 370 (2d. Ed. 1996):

Whether there has been an occurrence, however, depends on whether there has been an accident, not upon the legal cause or consequence of that accident. Defective workmanship or the incorporation of defective materials is an “accident” . . . If the roof leaks or the wall collapses, the resulting property damage triggers coverage under an “occurrence” basis policy, even if the sole cause is improper construction and the only damage is to the work performed by the contractor. Whether coverage for such an “occurrence” is excluded by the work, product or other exclusion is a separate, very important inquiry.

Id.

### **3a. Exclusions**

Often, the insurance provider will argue that the property owner’s alleged loss of use would be barred by several exclusions. The typical language of one of these exclusions reads in pertinent part:

Damage to Property

“Property damage” to:

That particular part of any property:

on which you or any contractor or subcontractor working directly or indirectly on your behalf are performing operations, if the “property damage” arises out of these operations

This exclusion does not apply where the work has been completed and no one is presently “performing operations.” The intent of the exclusion is:

To bar coverage for the work being done by a contractor when claims arise at the time the work is being performed. This bar exists irrespective of whether the claim is being made against the contractor performing the work or the upstream contractor supervising the work . . . Thus, in unambiguous terms, [this] exclusion...bars coverage only for damage involving “works in progress.”

Spears v. Smith, 117 Ohio App.3d 262, 266, 690 N.E.2d 557, 559 (1996), quoting, Franco, Insurance Coverage for Faulty Workmanship claims under Commercial General Liability Policies (1995), 30 Tort & Ins. L.J. 785, 796-97. For example, in Spears, the damage caused by the contractor’s defective work arose after the contractor completed the work; the court therefore found this exclusion “inapplicable” because it was “written in the present tense.” Id. at 266, 690 N.E.2d at 559; see also Action Auto Stores, Inc. v. United Capitol Ins. Co., 845 F.Supp. 428, 434 (W.D. Mich. 1993) (interpreting the exclusion to preclude only “damage that occurred at the time defendant [the insured] was performing work and not to damages that occurred after the work was completed”).

Another common exclusion cited by insurance providers posits that, in essence, a contractor cannot expect coverage if the loss of use damages are due to the contractor’s delay in completing the project. By its terms, this exclusion generally applies to “property that has not been physically injured.” See Fidelity & Deposit Co. of Maryland v. Hartford Casualty Ins. Co., 189 F.Supp.2d 1212, 1225 n.8 (D. Kan. 2002) (this exclusion “does not apply if there is physical injury to the property at issue”); Standard Fire Ins. Co. v. Chester-O’Donley & Assoc., 972 S.W.2d 1, 10 (Tenn. Ct. App. 1998) (the exclusion “does not apply if there is damage to property other than the insured’s work”); McKinney Builders II, Ltd. V. Nationwide Mutual Insurance Co., 1999 WL 608851 (N.D. Tex.) (exclusion inapplicable because there were allegations of property damage and “physical injury to homeowner’s property”). Additionally, in writing about this particular exclusion, one legal commentator noted that:

Although it has been a decade since this language first appeared, few courts have examined the effectiveness of [this]...exclusion. Many commentators have criticized it, “calling it too complex to receive a uniform interpretation,” “difficult” and “tricky.” Based on the negative reception by commentators, Scott Turner, author of Insurance Coverage of Construction Disputes, has concluded that this exclusion may be attacked as unintelligible or at least ineffective to overcome the insured’s reasonable expectation of coverage. (citations omitted).

Brady, Michael J., The Impaired Property Exclusion: Finding a Path through the Morass, 63 Def. Couns. J. 380 (1996).

Generally speaking, any provisions which seek to narrow the insured’s obligation are strictly construed against the insurer. Wachovia Bank & Trust Co. v. Westchester Fire Ins. Co., 276 N.C. 348, 172 S.E.2d 518 (1970). See also Garcia v. St. Bernard Parish School Board, 576 So.2d 975 (La. 1991).

### 3b. Subcontractor Exception

Many CGL policies provide an express exception to the exclusion for a contractor's defective work if the property damage was caused by a subcontractor. The relevant exclusion is typically entitled "Damage to Your Work" and excludes from coverage:

"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

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

Thus, once "property damage" has been shown that arises out of an "occurrence," a grant of coverage exists. Once coverage by the policy has been established, one must next look to the exclusions in the policy. It is important to recognize that the "your work" exclusion is actually an exception to other common exclusions and restores coverage if "the work out of which the damage arises was performed on your behalf by a subcontractor." Kalchthaler, 224 Wis.2d at 398.

To further nail down this point, in early 2002, the Insurance Services Office ("ISO") drafted two endorsements for the standard CGL policy which amended the "your work" exclusion.<sup>2</sup> Both of the proposed endorsements would delete, to some degree, the subcontractor exception to the "your work" exclusion. Clearly, ISO acknowledges that in order to delete coverage, it must have actually been granted in the first place. In the "Introduction" to the new proposed Endorsement, ISO states:

Since the building boom of the 1980's and large scale construction of condominium housing, litigation and claims relating to construction defects has skyrocketed. While no official definition of construction defects exists, generally speaking, a construction defect has been described as the failure to erect the building or any component thereof in a reasonably workman-like manner or to erect a building that is able to serve the purpose intended by the manufacturer or reasonably expected by the buyer.

The CGL excludes coverage for "damage to your work". "Your work" includes work or operations performed by you (the named insured) or on your behalf. The rationale behind the "damage to your work" exclusion is that damage to an insured's work is considered a business risk, which is not intended to be covered under a CGL policy. For the most part, courts throughout the country have ruled that construction defects, as defined above, fall within the "damage to your work" exclusion.

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<sup>2</sup> The insurance industry reviews and revises the standard CGL policy forms and endorsements on a regular basis. ISO is an insurance industry organization that, among other things, prepares and disseminates standard form policies.

However, an exception to the “damage to your work” exclusion exists. *The exception provides coverage for damaged work resulting from work performed by a subcontractor who is working on behalf of the named insured. The rationale behind the exception is that the named insured has not directly performed the work and has limited control over the work of a subcontractor and should have coverage available if the work performed by the subcontractor should result in damage.* (emphasis supplied).

The Kalchthaler court, addressing a case involving the same policy language and type of situation, continued:

For whatever reason, the industry chose to add the new exception to the business risk exclusion in 1986. We may not ignore that language when interpreting case law decided before and after the addition. To do so would render the new language superfluous. We realize that our holding a general contractor who contracts out all the work to subcontractors, remaining on the job in a merely supervisory capacity, can ensure complete coverage for faulty workmanship. However, it is not our holding that creates this result: it is the addition of the new language to the policy. We have not made the policy closer to a performance bond for general contractors, the insurance industry has. (citation omitted).

Id. at 400.

The Court of Appeals of Minnesota has also addressed the issue of the subcontractor’s work being excepted from the common “your work” exclusion. See O’Shaughnessy v. Smuckler Corporation, 543 N.W.2d 99 (1996). The Court in Minnesota held, “[T]he plain language of the exception provides that damage to ‘your work’ is covered if the damage results from the work performed by a subcontractor.” Id. The appellate court stated:

[W]e are faced with an affirmative statement on the part of those who drafted the policy language, asserting that the exclusion does not apply to damages arising out of the work of a subcontractor. It would be willful and perverse for this court to simply ignore the exception that has now been added to the exclusion.

Id. at 104. See also Massey v. Parker, 733 So.2d at 76 (“The work exclusion of the . . . policy does not apply to work performed by subcontractors”).

In First Texas Homes, Inc. v. Mid-Continent Casualty Company, 2001 WL 238112 (N.D. Tex.) the U.S. District Court in Texas addressed the subcontractor’s work exception. The Texas court held that even when it is unclear who actually did the damaging work, allegations suggesting that someone other than the builder did the work allowed the court to look at extrinsic evidence to determine whether the underlying claims are excluded from coverage. Id. The court went on to review affidavit testimony which conclusively established that a subcontractor was hired to complete the work which resulted in damage to the house. Id. “Therefore, the ‘business risk’ exclusion does not apply.” Id. at \*4.

The Court of Appeals in South Carolina, addressing this same section of the standard CGL policy examined the exclusions which may preclude coverage of the general contractor's work and found that the "products-completed operations hazard" applied to the circumstances before them, thereby excluding coverage for damage. L-J, Inc., 567 S.E.2d 489; rev'd on other grounds L-J, Inc. v. Bituminous, 366 S.C. 117, 621 S.E.2d 33 (2005). However, the appellate court continued:

Once again an exclusion appears to bar coverage, but reading further we see the "your work" 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." It is undisputed in this case that the defective work was performed by a subcontractor. This clear and unambiguous policy language restores coverage.

Id. Because this was a new issue for South Carolina, the court looked to other jurisdictions for guidance. Id. The court cited to the Kalchthaler, supra, and O'Shaughnessy, supra, courts' discussions of the 1986 addition of the subcontractor exception to the "your work" exclusion. Id. "We find the above reasoning [of the Kalchthaler and O'Shaughnessy courts] persuasive and conclude in this case that the products-completed operations hazard provision and the exception to exclusion (1) restore coverage. This is not, as the insurer argues in L-J, Inc., an 'extension' of coverage." Id. at 494. Although the Supreme Court of South Carolina later overruled the Court of Appeals in L-J, Inc., it did so by not finding the existence of an "occurrence" and did not analyze or address the Court of Appeals' application of the policy exclusions. See id.

Furthermore, two recent decisions by the Fourth Circuit Court of Appeals provide enlightenment regarding how North Carolina courts may rule on this issue. Although the Fourth Circuit applied Pennsylvania and Maryland law, the relevant definitions and applicable laws are the same. In Limbach v. Zurich American Ins. Co., 396 F.3d 358 (4<sup>th</sup> Cir. 2005), the insured entered into a subcontract to install a prefabricated, insulated, underground steam line. Id. The insured contracted with a third-party for the production of the steam pipe. Id. Another party was contracted to excavate the trench for the steam pipe and backfill it after the pipe was installed. Id. After the steam line was put into use a leak was discovered. Id. It was undisputed that the insured's employees caused the leak when they improperly unpackaged the pipe prior to installation. Id.

The policy issued to the insured in Limbach excluded coverage for Damage to Your Work which was defined as "property damage to your work arising out of it or any part of it and included in the products completed operations hazard." Id. Also, the exclusion in Limbach contained an exception which provided, "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." Id.

A portion of the insured's claim covered the cost of repairing the damaged backfill which was damaged by the leak from the steam line. Id. The parties had stipulated that the backfill work was performed on behalf of the insured by a subcontractor. Id. The insurer maintained that the "your work exclusion" precluded coverage for the cost of repairing the damaged backfill. Id. The Court disagreed and, citing the "subcontractor exception," stated that the "your work

exclusion” does not preclude coverage for the cost of repairing the damaged backfill. *Id.* Similarly, the Court found that coverage existed for the pipe which was manufactured by a subcontractor. *Id.* Lastly, the Court found that the insured’s claim for the costs of replacing concrete and repairing damaged landscape was covered under the policy. *Id.* The Court stated, “the ‘your work’ exclusion only excludes coverage for damage to an insured’s work that arises out of the insured’s faulty workmanship. It does not exclude coverage for damage to a third party’s work.” *Id.* Furthermore, it is axiomatic that there was a determination of both property damage and an occurrence, otherwise the exclusion would have been inapplicable.

Additionally, in *French, supra*, the Fourth Circuit, under Maryland law, gave effect to the subcontractor exception to the “Your Work” exclusion in the ISO CGL Policies. *French*, 448 F.3d at 705. The Fourth Circuit observed that “[i]t is a recognized rule of construction that a contract must be construed in its entirety and, if reasonably possible, effect must be given to each clause or phrase so that a court does not cast out or disregard a meaningful part of the writing.” *Id.* (citing *Bausch & Lomb, Inc. v. Utica Mutual Ins. Co.*, 330 Md. 758, 625 A.2d 1021, 1033 (1993)). The Fourth Circuit found that “[t]he very existence of the ‘Your Work’ exclusion and the history of subcontractor exception to that exclusion” provides solid confirmation that its holding, specifically that the moisture intrusion into the non-defective structure and walls of the home constituted damage to tangible property other than the defective EIFS itself and the insurers had a duty to indemnify the general contractor against the claims of the homeowners for the costs to remedy such damages, is correct. *See French*, 448 F.3d at 705-06. The Fourth Circuit then quoted the Court of Appeals of Kansas, stating that “[r]eading the policy as a whole, it is clear that the intent of the policy was to cover the risk to the insured created by the insured’s use of a subcontractor.” *Id.* at 706 (citing *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 33 Kan.App.2d 504, 104 P.3d 997, 1003 (2005)). In sum, the Fourth Circuit found that its holding was consistent with the intent and structure of the ISO CGL Policies in that the ISO CGL Policies provide “liability coverage for the cost to remedy unexpected and unintended property damage to the contractor’s otherwise nondefective work-product caused by the subcontractor’s defective workmanship.” *Id.* at 706.

Unfortunately for North Carolina, in *Travelers Indem. Co. v. Miller Bldg. Corp.*, 221 Fed.Appx. 265, (4<sup>th</sup> Cir., 2007), following the North Carolina *Production Systems* case, *supra*, the 4<sup>th</sup> Circuit agreed that an insurer had no duty to defend an insured in an arbitration proceeding involving a third-party’s claims alleging that the insured’s shoddy workmanship in constructing a hotel caused damage to guest-room carpets. The United States District Court for the Eastern District of North Carolina granted the insurer’s motion for summary judgment, and the insured appealed. The United States Court of Appeals, Fourth Circuit, held that: (1) district court was not required to wait until the cause and extent of the third-party’s damage had been fleshed out and determined before defining the scope of coverage under the policy, and (2) the policy only covered damage to property separate from the hotel if the occurrence was not subjectively foreseeable to the insured. The insurer’s coverage also did not include consequential damages from the delay in opening the hotel.

Another recent case affirms coverage, and illustrates that North Carolina, at least according to the 4<sup>th</sup> Circuit, is in the minority in not finding coverage. In *Travelers Indem. Co. of America v. Moore & Associates, Inc.*, 216 S.W.3d 302 (Tenn. 2007), a Commercial general

liability (CGL) insurer brought an action against an insured contractor for a declaratory judgment that an insurer owed no duty to defend or indemnify an insured in a property owner's demand for arbitration alleging faulty window installation by a subcontractor. The trial court held that the insurer had a duty to defend the insured. The Court of Appeals granted the appeal to determine: 1) whether an insured contractor's defective workmanship may constitute an "occurrence" under the terms of the "insuring agreement" of a commercial general liability policy; 2) whether damages resulting from faulty workmanship are "property damage"; and 3) whether damages to the insured contractor's work are excluded from coverage if those damages are caused by the faulty workmanship of a subcontractor. The Court held that defective workmanship may constitute an "occurrence" and that damages caused by faulty workmanship are "property damage." The Court further held that damages resulting from the faulty workmanship of a subcontractor are not excluded from coverage. Therefore, the Court held that under the language of the commercial general liability policy in this case, the insurer has a duty to defend the insured against a claim that water penetration resulting from the faulty workmanship of a subcontractor caused damages to the insured's work.

Also, in Lamar Homes, Inc. v. Mid-Continent Cas. Co., --- S.W.3d ----, 2007 WL 2459193 (Tex.,2007), an insured builder sought a declaratory judgment that commercial general liability (CGL) insurer owed duty to defend and indemnify the insured in a homeowners' suit alleging construction defects. The United States District Court for the Western District of Texas, granted summary judgment in favor of insurer. On appeal, the Supreme Court of Texas held that (1) a builder's allegedly defective construction or faulty workmanship in building house foundation was occurrence; (2) cracks in sheetrock and stone veneer allegedly as result of defective construction or faulty workmanship in building foundation were property damage; and (3) an insured's claim against liability insurer for defense costs is a "first party claim" within the meaning of the prompt payment statute making the insurer liable for interest and attorney fees if it does not promptly respond to or pay first party claim. Therefore, the insurer had a duty to defend the insured.

### CONCLUSION

The courts have analyzed this issue on multiple occasions in various jurisdictions. Each time, they determine whether "property damage" exists; they decide if the property damage was caused by an "occurrence;" they review the exclusions to evaluate whether the grant of coverage is revoked by one of the exclusions; and finally, they look at the exceptions to the exclusions to determine if coverage is restored.

The foregoing discussion touches on only a few of the many arguments, and cites to only a few of the numerous cases that discuss these issues. The issues are complicated by the fact that many of the CGL policies vary slightly in language. However, in summary, the typical CGL policy for a general contractor should provide coverage if the damages were caused by a subcontractor of the general contractor and if the damages are to areas of the project that were undamaged until the defective workmanship caused the damage.

Unfortunately, North Carolina is one of the few jurisdictions that does not follow the plain language of ISO, the very company that wrote the policies, which plainly indicates that there is coverage available to general contractors for the defective workmanship of their general

contractors. Hopefully, there will be a North Carolina appellate decision on point dealing with this situation so that the flawed reliance on the Production Systems case can be ignored. Otherwise, hundreds of general contractors will be in for a big surprise when they are sued and their insurance carrier declines to provide coverage or even a defense.