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10th Circ. Split Adds Wrinkle To NY Faulty Work Coverage Law

By **Jeff Sistrunk**

Law360 (February 15, 2018, 7:25 PM EST) -- The Tenth Circuit recently held under New York law that general contractor Black & Veatch Corp.'s liability policy covers damages resulting from a subcontractor's shoddy work, wading into an unsettled area of Empire State jurisprudence and likely setting the stage for the state's highest court to weigh in on the issue.

In a 2-1 opinion issued Tuesday, a panel of the appeals court agreed with B&V that the company's $25 million umbrella policy with Aspen Insurance Ltd. and Lloyd's Syndicate 2003 — collectively referred to as "Aspen" in the decision — applies to claims alleging damage to a third party's property as the result of faulty work by its subcontractor and other lower-tier subcontractors.

The majority predicted that the highest court in New York — whose law governs B&V's policy — would likely follow a "clear trend" among state supreme courts holding that damages tied to a subcontractor's faulty work can constitute an occurrence under a commercial general liability insurance policy. Despite the massive volume of construction projects in New York, the state's high court, known as the Court of Appeals, has yet to issue a definitive ruling on the subject.

Attorneys who represent policyholders told Law360 the Tenth Circuit plainly made the right call, given the evolution of CGL policy language and case law regarding coverage for faulty workmanship by subcontractors.

For several decades, CGL policies have typically carved out an exception to what's known as the "your work" exclusion — which bars coverage for property damage to the insured's own work — for damage attributable to faulty work performed by subcontractors. The function of the subcontractor exception was confirmed in a 1986 memo issued by the Insurance Services Office, which had developed the provision.

"The exception to the 'your work' exclusion, combined with the ISO 1986 circular interpreting that provision, makes it unambiguously and perfectly clear that damages arising from the subcontractor's work are covered, as is damage to the subcontractor's work," said Carl Salisbury, leader of Bramnick Rodriguez Grabas Arnold & Mangan LLC's insurance recovery and commercial litigation group.

But Tenth Circuit Judge Mary Beck Briscoe was not convinced that the New York Court of Appeals would find coverage for the damages stemming from the faulty work of B&V's subcontractors, writing in a dissenting opinion that she believes rulings issued by the state's intermediate appeals courts broadly foreclose coverage for "damage to the work product of the insured."

"It is not difficult to ascertain how New York courts would decide the issues presented here — nor does the majority say it would be difficult," Judge Briscoe wrote. "The majority merely attempts to distinguish New York case law as if 'this case apparently raises an issue of first impression.'"

According to attorneys, Judge Briscoe's strongly worded dissent makes it probable that the New York Court of Appeals will seize the next available opportunity to settle the debate over coverage for subcontractors' faulty workmanship. All it will take is the appropriate case — and since general contractors will now be likely to cite to the Tenth Circuit's opinion in similar coverage disputes in New York, the right case could present itself sooner rather than later.

"I do agree with the dissent that the New York courts will have to decide this," said Hinshaw & Culbertson LLP partner Larry Golub, who represents insurers. "The Tenth Circuit's opinion cannot serve as precedent as to what New York law is."

The underlying claims against B&V involved seven "jet bubbling reactors," which scrub contaminants from the exhaust emitted by coal-fired power plants, that the company contracted to build for American Electric Power Service Corp. B&V has alleged subcontractor Midwest Towers Inc. and other lower-tier subcontractors performed faulty work on the systems, which were installed in four plants in Ohio and Indiana.

In 2010, B&V settled with the owners of the four plants for $225 million, pledging to replace faulty components and also reimburse repair costs, according to court documents. B&V then filed suit in pursuit of coverage from several insurers, including Aspen, for a $72 million portion of the settlement sum.

In late 2015, B&V and Aspen filed cross-motions for summary judgment on whether Aspen's first-layer umbrella policy covered damages arising from the alleged faulty work of B&V's subcontractors. A year later, Senior U.S. District Judge Sam Crow of the District of Kansas sided with Aspen, finding the construction defects didn't qualify as a covered occurrence because only B&V's own work product was damaged.

The Tenth Circuit panel's analysis of B&V's appeal focused on a key threshold question: whether the New York Court of Appeals would hold that the Aspen policy's basic insuring agreement covers the damage to the jet bubbling reactors from the subcontractors' purported shoddy work.

The policy extends coverage for damage to a third party's property resulting from an accidental occurrence, according to the opinion. Here, the panel majority found, both requirements are met: The damage to the reactors was an accident because B&V didn't expect or intend its subcontractors to perform faulty work, and a third party, American Electric Power, asserted property damage claims against B&V.

In addition, the majority said a ruling adopting Aspen's position would render the subcontractor exception and several other policy provisions meaningless, which would violate core New York contract interpretation principles.

"Applying these analytical tools, we predict the New York Court of Appeals would conclude that the damages at issue here are 'occurrences' under the policy's basic insuring agreement," U.S. Circuit Judge Scott Matheson Jr. wrote for the panel.

David Wood, a partner in Barnes & Thornburg LLP's insurance recovery and counseling practice, said the Tenth Circuit's ruling vindicates the reasonable expectations of insured contractors, which have long faced arguments like those advanced by Aspen.

"If you are a big contractor, and your job is to manage subcontractors, you don't have as much ability to control a subcontractor's employees as you would your own," Wood said. "When a carrier comes back and says, 'Your subcontractor's faulty work isn't covered,' that is plainly inconsistent with the subcontractor exception. Why have that exception if neither your faulty work nor the subcontractor's faulty work is an occurrence?"

The appellate majority rebuffed Aspen's reliance on several intermediate New York decisions rejecting liability coverage for faulty workmanship, most notably the state Appellate Division's 1994 ruling in George A. Fuller Co. v. U.S. Fidelity & Guaranty Co. According to the majority, the Fuller decision doesn't control B&V's case because the policy it interpreted didn't contain a subcontractor exception.

In dissent, though, Judge Briscoe opined that Fuller and its progeny have established a general rule in New York's intermediate appellate courts that CGL policies containing a standard definition of an occurrence cannot cover damage to the insured's own work product — "even when errors by the insured or its subcontractors cause the damage."

Zelle McDonough & Cohen senior associate Suzanne Whitehead, who represents insurers, said the dissent raised a compelling point about the consistency with which New York appeals courts have applied the rule announced in Fuller.

"It is pretty clear to me that New York intermediate appellate courts have consistently applied the general rule, although not all of those cases have involved the subcontractor exception," Whitehead said. "The courts looked at the occurrence issue, and if there was faulty workmanship to the insured's work, it was not covered."

However, attorneys who counsel policyholders said the panel majority correctly rejected Fuller, given that its reasoning was based on outdated policy language.

"The court that decided Fuller was deprived of the opportunity to consider the meaning of the 'subcontractor exception' language that now exists in standard CGL polices," said Anderson Kill PC shareholder Allen Wolff. "If Fuller still controlled, the changed terms of the insurance contract would be of no force or effect until the state's highest court someday rendered a decision on that change. That is unworkable in the marketplace and it improperly impairs the freedom of contract."

The majority also emphasized that state supreme courts that have considered the issue at hand have reached "near unanimity" that "construction defects can constitute occurrences and contractors have coverage under CGL policies at least for the unexpected damage caused by defective workmanship done by subcontractors." The New York Court of Appeals would likely follow that trend, it concluded.

Sandberg Phoenix & Von Gontard PC shareholder Phil Graham said it wasn't surprising the Tenth Circuit majority opted to follow the national trend, given the prevailing policyholder-friendly definition of what constitutes an occurrence in New York.

"I think the majority reached a fair decision based on looking at what other jurisdictions have done," Graham said. "It is hard to see how the New York Court of Appeals would come to a different decision

when looking at the subcontractor exception. I think the Court of Appeals would definitely have found an occurrence."

Because the Tenth Circuit's decision isn't binding on New York courts, litigation over the scope of the "your work" exclusion and subcontractor exception will persist in the Empire State, according to attorneys.

"Because the Fuller decision has not been expressly overruled, these issues will continue to be litigated and debated in New York," said Anderson Kill's Wolff. "Policyholders seeking to obtain coverage under the 'subcontractor exception' to the 'your work' exclusion would be wise to make use of the majority's persuasive analysis in the Black & Veatch decision."

Attorneys say the debate over coverage for subcontractors' faulty workmanship in New York appears to be on an inevitable collision course with the Court of Appeals, which would be able to put the issue to rest once and for all.

"With this decision, the New York Court of Appeals may be more likely to take up a case to clarify the rule in New York," said Whitehead of Zelle McDonough. "It remains to be seen whether the Court of Appeals will follow the lower courts in New York or courts in other jurisdictions that have taken a narrower approach to the occurrence issue and then applied the subcontractor exception to the exclusion."

The case is Black & Veatch Corp. v. Aspen Insurance (U.K.) Ltd. et al., case number 16-3359, in the U.S. Court of Appeals for the Tenth Circuit.

--Editing by Mark Lebetkin and Catherine Sum.
