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## CONSTRUCTION DEFECT CLAIMS ARE COVERED UNDER CGL POLICIES – BUT WATCH OUT FOR THE LOOPHOLES

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General contractors frequently buy commercial general liability (or “CGL”) insurance on the assumption that it will cover third-party property damage claims in connection with defective construction. This assumption is often encouraged by the insurance companies themselves.

Unfortunately, when general contractors seek coverage in connection with construction defect claims, they quickly learn that their insurance company has a number of tried and true roadblocks in store for them. Some of these obstacles are found within the CGL policy itself, which is riddled with numerous and complex limitations and exclusions. Others have been erected by the courts, which have been successfully persuaded by insurance companies to give the standard-form CGL policy a narrower meaning than its express language would otherwise suggest.

### When construction defects are not an “occurrence”

CGL policies expressly require that covered property damage must have been caused by an “occurrence.” An “occurrence” is often defined by CGL policies as “an accident, including continuous or repeated exposure” to “conditions” or “substantially the same general harmful conditions.” Defective construction itself would seem to fall within this express definition because of its inherently unintentional, inadvertent nature. A number of courts have found this reasoning persuasive. See, e.g., *Dublin Bldg. Sys. v. Selective Ins. Co. of Am.*, 874 N.E.2d 788, 792 (Ohio 2007); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 137 P.3d 486, 495 (Kan. 2006); *Am. Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 76 (Wis. 2004).

Other courts, however, have reached a far different conclusion, one less favorable to the policyholder. In determining that defective construction is not an

“occurrence,” these courts look beyond the express language of the policy, reasoning that defective construction represents a normal business risk, and not the sort of risk assumed by the CGL insurer. They contend that a CGL policy, regardless of how it is actually worded, is not intended to function as a warranty or performance bond for contractors. See, e.g., *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 908 A.2d 888, 899 (Pa. 2006); *Lenning v. Commercial Union Ins. Co.*, 260 F.3d 574, 583 (6th Cir. 2001); *Heile v. Hermann*, 736 N.E.2d 566, 568 (Ohio Ct. App. 1999); *American States Ins. Co. v. Mathis*, 974 S.W.2d 647, 649 (Mo. App. 1998); *McAllister v. Peerless Ins. Co.*, 474 A.2d 1033, 1036 (N.H. 1984).

### Understanding key exclusions

Even if property damage associated with defective construction is found to fall within the scope of the general contractor’s CGL policy, coverage may still be defeated by the operation of one or more exclusions within the policy.

Standard-form CGL policies typically 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 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). As evidenced by the specific reference to “real property,” this exclusion reflects the fact that general contractors normally obtain coverage for damage to a construction project prior to its completion under a separate builder’s risk policy.

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Another 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 potentially 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 that is 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.

CGL policies also commonly contain what is known as the “your work” exclusion. This exclusion serves as a companion to the previous 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.

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 subcontractor. See, e.g., *Spears v. Smith*, 690 N.E.2d 557, 560 (Ohio App. 1996). Other courts, relying on the premise that a CGL policy cannot cover construction defect claims regardless of the contractual language, have contended that the exclusionary language, as favorable as it is to the insured, “cannot be used to create coverage where none exists.” *ACS Const. Co., Inc. of Mississippi v. CGU*, 332 F.3d 885, 892 (5th Cir. 2003).

Taking these exclusions and their exceptions together, property damage connected with defective work of the subcontractor may be covered as long as it arises after the completion of the project, provided the jurisdiction agrees that such damage constitutes an “occurrence” in the first place. This serves to cover many claims against general contractors, since most of the work on any given project is performed by subcontractors.

Insurance companies have another weapon in the form of the “your product” exclusion. This exclusion concerns property damage to “your product.” Its reach is broader than the “your work” exclusion because it does not have an

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.

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.”

Insurance companies also frequently attempt to take advantage of a related exclusion known as the “impaired property” exclusion. This exclusion prevents coverage for “impaired” property – that is, 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.” While insurance companies have been generally successful in excluding coverage for the impaired property damage, their attempts to expand the scope of the exclusion to the repairs to “your work” or “your product” itself in this context have not been successful. See, e.g., *Mut. of Enumclaw Ins. Co. v. T & G Construction, Inc.*, 199 P.3d 376, 384-85.

Obtaining coverage for property damage caused by defective workmanship under a CGL policy can be an uphill task for general contractors. This task is made no easier by the aggressive efforts of insurance companies to limit the scope of coverage afforded by CGL policies, and courts which have proven all too willing to accept their contentions. Nonetheless, a CGL policy is still a valuable asset for those policyholders that understand its benefits and limitations and plan their insurance programs accordingly.

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