

**American Bar Association
Forum on the Construction Industry**

**Plenary Session 2:
The Construction Defect Case:
Litigating the Defect or Litigating to Coverage**

**Exclusions Redux: Construction Defect
Insurance Coverage in 2009**

**Patrick J. Wielinski
Cokinos, Bosien & Young
Arlington, Texas**

**January 15 &16, 2009
Hyatt Coconut Point Resort & Spa**

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I. INTRODUCTION

As insurance coverage and construction lawyers are aware, the past decade witnessed a trend among some courts to accept a novel interpretation of the standard commercial general liability (CGL) insurance policy. Based on the definition of “occurrence,” that interpretation is relied upon to deny claims involving defective work that had previously been covered under a more traditional policy approach. That interpretation ignores the coverage preserved for defective work claims under the carefully drafted property damage exclusions in the policy. Those exclusions include Exclusion (l), the Your Work Exclusion, which contains an exception preserving coverage for property damage to, or arising out of, the work of the named insured’s subcontractors subsequent to completion. In addition, Exclusions (j)(5) and (6), the Ongoing Operations and the Faulty Work Exclusions were drafted to preserve coverage under the proper circumstances. Those exclusions deny coverage only for the “particular part” of damage to real property upon which the insured is performing operations or that must be repaired or replaced because the work was performed incorrectly.

By focusing on the definition of occurrence, and at the same time diverting attention away from the coverage preserved under the exclusions discussed above, these cases depart from the language of the CGL policy itself. Insurers that make this argument borrow concepts from the substantive law of contracts and even products liability law. Undaunted by the fact that the policy contains no language prohibiting coverage for damages arising out of breach of contract (as opposed to tort), they argue that all damages awarded for breach of contract are foreseeable under contract law, and thus, cannot constitute an accident or an occurrence. In addition, some insurers also argue that damage to the subject matter of a construction contract is mere economic

loss, and based upon the economic loss rule commandeered from substantive products liability law, a cause of action for negligence is barred.

In several states, the above description could be framed in the past tense since the last few years saw the issuance of a number of significant court opinions from key states as to the issue of whether damage attributable to defective construction is covered under the CGL insurance policy. In response to the various arguments set out above, those opinions out of necessity centered on whether damage to a construction project meets the definitions of “occurrence” and “property damage” in the policy. Nevertheless, those courts, including the highest courts of Florida, Texas, Tennessee and South Carolina, which have recently rejected the occurrence and property damage arguments, also of necessity addressed the effect of the policy exclusions in ultimately determining coverage.¹

This paper will not extensively address the substantive holdings of those courts as to the status of defective workmanship as an “occurrence” and “property damage.” Rather, the purpose of this paper is to reassess the viability of the property damage exclusions (sometimes referred to as the “business risk” exclusions). In light of the recent trend toward upholding the existence of “occurrence” and “property damage” in the context of construction defect claims, coverage litigation should now shift back to the application of the property damage exclusions, the portions of the policies where these issues were traditionally and more properly addressed.

II. THE HISTORICAL CIRCUMSCRIPTION OF BUSINESS RISK UNDER THE CGL FORM

Contrary to the arguments made by many insurers, the underwriting history of the CGL policy form indicates a careful effort to provide a degree of coverage for property damage arising out of defective construction.

An understanding of the historical development of the “business risk doctrine” and its limitations under the CGL policy is helpful in order to also understand how the arguments based upon the definitions of “occurrence” and “property damage” amount to an attempt by insurers to rewrite the terms of their own policies. As stated, in recent years, insurers have sought to divert attention away from the CGL policy contract in favor of opaque notions borrowed from substantive products liability or contracts law, such as “damage arising out of defective work is mere economic loss” or that “all defective work performed in breach of a contract is foreseeable.” Numerous of the cases relied upon to support these propositions address the issue in terms of “business risk,” in that a CGL policy is not designed to cover an insured’s ordinary business risks, including a construction contractor’s own faulty workmanship. Obviously, that doctrine has some support in insurance underwriting, case law interpreting older policy forms – and common sense. Nevertheless, that doctrine is carefully circumscribed and limited in the CGL policy form, particularly the form promulgated in 1986, the form that is issued to most insured businesses in the United States.

A historical tension has existed between CGL coverage for defective construction work and what insurance underwriters have traditionally referred to as an uninsured “business risk.” This tension gained momentum with the 1966 revisions to the CGL form promulgated by the Insurance Services Office (“ISO”), the industry organization responsible for drafting the industry-wide standard forms used by insurers. The 1966 revisions separated the exclusion for property damage arising out of work performed by the named insured from the exclusion for property damage arising out of the named insured’s product. Then, in 1973, ISO promulgated the Broad Form Property Damage Endorsement (“BFPDE”) to the standard policy form. That endorsement expanded the coverage under the 1973 form by modifying the “work performed”

exclusion to delete the exclusion for work performed “on behalf of” the named insured, so as to provide an insured general contractor with coverage for property damage arising out of the defective work of its subcontractors. The only caveat was that the property damage must occur after the completion of the work.

Nevertheless, the argument persisted that, despite the intent behind the attachment of a BFPDE to an insured contractor’s CGL policy, *all* property damage arising from defective workmanship, *including* property damage arising from a subcontractor’s defective work in the completed operations context, was an uninsurable business risk. For example, in *Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, the Minnesota Supreme Court applied a business risk rationale in derogation of the language of the policy before the court.² The policy was written on the 1973 CGL form as modified by a BFPDE, specifically attached to the policy in order to provide the insured general contractor with coverage for claims involving property damage arising out of the work of its subcontractors and occurring after completion of the project. In *Knutson*, the court inexplicably dismissed the profound effect of the endorsement as merely a “slight difference in wording.”

In contrast, other courts, under virtually identical facts, upheld the underwriting intent behind the subcontractor exception contained in the 1973 BFPDE. *See Southwest Louisiana Grain, Inc. v. Howard A. Duncan, Inc.*³ *Fireguard Sprinkler Sys. v. Scottsdale Ins. Co.*⁴ *Maryland Cas. Co. v. Reeder*;⁵ *Fejes v. Alaska Ins. Co., Inc.*⁶ and *Corner Constr. Co. v. U.S. Fid. & Guar. Ins. Co.*⁷

III. THE 1986 CGL REVISIONS AND THE SUBCONTRACTOR EXCEPTION TO THE YOUR WORK EXCLUSION

The CGL policy form was revised in 1986, and through those revisions to the CGL form, the Insurance Services Office (“ISO”), the industry organization responsible for drafting the

form, sought to clarify the limitations on the business risk concept previously introduced in 1973 by the BFPDE. Due to the popularity of the increased coverage provided by the BFPDE, the centerpiece of the revisions (at least as to construction risks) was the express insertion of the subcontractor exception into Exclusion (1), the Your Work Exclusion, in the standard coverage of the policy. That revision clarified the existence of completed operations coverage for property damage arising out the work of subcontractors and in the process, reduced the possibility of contrary results in cases such as *Knutson Construction v. St. Paul*. Exclusion (1) states that the insurance does not apply to:

“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.

The defined term “your work” includes work performed by or on behalf of the named insured. Moreover, it applies only to property damage that occurs in the “products-completed operations hazard,” defined in the policy as follows:

“Products-completed operations hazard”:

- a. Includes all “bodily injury” and “property damage” occurring away from premises you own or rent and arising out of “your product” or “your work” except:
 - (1) Products that are still in your physical possession; or
 - (2) Work that has not yet been completed or abandoned. However, “your work” will be deemed completed at the earliest of the following times:
 - (a) When all of the work called for in your contract has been completed.
 - (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.

- (c) When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed.

In the completed operations context, the 1986 work performed exclusion would preclude coverage for property damage arising out of work performed by or on behalf of the named insured if the exception to the exclusion was not applicable.

Commentary summarizes the intent of the insurance industry to eliminate the confusion over CGL coverage for subcontractor work through the 1986 revisions. ISO itself, when it promulgated the 1986 revisions, stated as follows with regard to the property damage exclusions in the 1986 policy form:

Exclusions have been completely rewritten and clarified with no change in overall scope of coverage. 'Broad Form' coverage has been incorporated in the new provisions. Real property is specifically eliminated from the definition of 'your product,' *so that the broad form coverage for work and completed operations clearly applies*. Care, custody, or control exclusion has been restricted to personal property to clarify further the application of these provisions. A new definition of 'impaired property' clarifies the application of the "failure to perform" and 'sistership' exclusions (m and n). [Emphasis added.]⁸

Other commentators, writing contemporaneously as to the effect of the 1986 policy revisions state as follows:

There is, however, an exception to exclusion '1' of substantial importance to insured contractors, which provides that '[t]his 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.' *This exception should allow for coverage, for example, if an insured general contractor is sued by an owner for property damage to a completed residence caused by faulty plumbing or electrical work done by a subcontractor*. The coverage in that circumstance should extend to all 'work' damaged, whether it was done by the contractor or by any subcontractor, since the 'work out which the damage arises was performed . . . by a subcontractor.' The only property damage to completed work which is excluded

by exclusion '1' is damage *to* the insured contractor's work, *which arises out of* the insured contractor's work. [Emphasis added.]⁹

The emphasized language confirms the intent to provide coverage to insured contractors in common defective construction claim scenarios. The line of argument that focuses on the definitions of "occurrence" and "property damage" as to construction defects attempts to deemphasize the coverage preserved under the CGL exclusions for contractors.

Moreover, International Risk Management Institute, Inc. ("IRMI"), a source relied upon by insurers and insureds alike, sets out the effect of the subcontractor exception and states as follows:

By virtue of the subcontractor exception, the insured has coverage, despite exclusion 1., with respect to the following exposures.

- Property damage to work performed by the insured when the damage results from the work of the insured's subcontractor.
- Property damage to work performed by the insured's subcontractor when the damage results from that subcontractor's work.
- Property damage to work performed by the insured's subcontractor when the damage results from work performed by the insured.
- Property damage to work performed by the insured's subcontractor when the damage results from the work of another contractor or subcontractor.¹⁰

By virtue of the plain language of the subcontractor exception, insurers specifically agreed to provide insured contractors with considerable coverage for property damage arising out of the defective work of subcontractors.

The notion that a CGL policy should not cover a contractor's business risk of defective workmanship has a proper, but nevertheless, somewhat limited place in the analysis of insurance coverage for defective construction work under a CGL policy. It sets the outer limit, but any coverage analysis must begin and end at the same point: the plain language of the policy. That

recognition is in full accord with the intent of the drafters of the CGL policy. In a landmark commentary, published shortly after the 1973 revisions to the CGL policy were promulgated, George H. Tinker, Associate General Counsel of Kemper Insurance Company, described the role of the business risk doctrine in analyzing coverage under a CGL policy as follows:

The foregoing is designed to be a descriptive, not a definitive, treatment of an important underwriting concept [the business risk doctrine]. It is recognized that regardless of what concepts underwriters may employ and regardless of what their intent may be, the scope of coverage is found in the four corners of the contract. Nonetheless, an awareness of the business risk concept helps to give dimension and understanding to some of the key provisions of the policy.¹¹

Thus, even the drafters of the 1973 revisions of the CGL policy recognized that the policy language itself can modify underwriting concepts, such as the business risk doctrine. That is exactly what the subcontractor exception in the 1986 form accomplishes, as did the predecessor BFPDE attached to the 1973 form. They circumscribe and limit the business risk concept as to insurance coverage for certain types of defective work.

A. “Pre-Broad Form” Cases Do Not Apply

Insurers often rely upon inapplicable and easily distinguishable case law to support their plea to courts to abandon the terms of its policy in favor of vague notions that defective workmanship can never amount to an “occurrence” or “property damage” under a CGL policy. Many of those authorities address coverage under policy forms that were not modified to limit the business risk concept.

For example, one of those authorities that is still frequently cited by insurers for the business risk proposition is an early New Jersey case, *Weedo v. Stone-E-Brick, Inc.*¹² In that case, claim was made against the insured contractor for faulty masonry work on a home. The insured had also performed defective roofing and gutter work on another home for which another claim was made against him. In the course of ultimately denying coverage based on the damage

to products and the work performed exclusions, the court engaged in an extended analysis of insurable versus uninsurable risks. However, that analysis applied to the limited coverage under the 1966 CGL policy form before the court. That policy form was *not endorsed with a BFPDE* so it was not intended to provide for an exception for a subcontractor's work. As such, the court's analysis was relatively uncomplicated, though inapplicable to other cases, including this one.

In support of its denial of coverage, the *Weedo* court quoted from a law review article authored by Professor Roger Henderson and published in 1971:

The risk intended to be insured is the possibility that the goods, products or work of the insured, once relinquished or completed, will cause bodily injury or damage to property other than to the product or completed work itself, and for which the insured may be found liable. The insured, as a source of goods or services, may be liable as a matter of contract law to make good on products or work which is defective or otherwise unsuitable because it is lacking in some capacity. This may even extend to an obligation to completely replace or rebuild the deficient product or work. This liability, however, is not what the coverages in question are designed to protect against. The coverage is for tort liability for physical damages to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.¹³

This law review article, for better or for worse, is another of the most frequently cited authorities in support of the denial of coverage for defective workmanship to an insured contractor. At the time of its publication in 1971, the 1973 revisions to the CGL policy were in the works, thus rendering the article's analysis already dated and moot for subsequent policies. Nevertheless, the primary purpose of the Henderson article was to analyze the *1966* revisions to the CGL form, and more specifically, the dichotomy established in those revisions between the "products hazard," the hazard applicable to product manufacturers, and the "completed operations hazard," the hazard describing the risks associated with service providers such as construction contractors. That dichotomy between products coverage on the one hand, and

completed operations coverage on the other hand, is maintained in the 1986 forms through the separate definitions of “Your Work” and “Your Product.” The article contains no analysis as to the effect of the addition of the exception for a subcontractor’s work through the BFPDE in 1973, or the addition of the subcontractor exception to the 1986 forms. Despite the fact that hundreds of cases have cited them, much of the analysis of *Weedo* and the *Henderson* law review article has been rendered obsolete as to the newer policy forms that expand coverage for insured contractors.

This obsolescence was recently recognized by the Florida Supreme Court in *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*¹⁴ There, the Florida Supreme Court reversed prior Florida case law that had been read to hold that providing CGL insurance coverage for defective work was against public policy. Rather, the court held that unexpected and unintended property damage to a number of homes arising out of the faulty site preparation by a subcontractor constituted an “occurrence” of “property damage,” as defined in the insured general contractor's CGL policy. In addition, the Florida Supreme Court went on to confirm the applicability of the subcontractor exception to Exclusion (I), the Your Work Exclusion, by upholding coverage for the insured builder for the property damage to homes caused by inadequate site preparation performed by a subcontractor. In doing so, the Florida Supreme Court specifically rejected the applicability of *Weedo v. Stone-E-Brick* and similar cases, including *LaMarche v. Shelby Mut. Ins.*,¹⁵ a prior Florida Supreme Court case, to the 1986 policy form before it, due to the difference in the policy language addressed in those cases. The older policies in those cases lacked the coverage enhancements as to coverage for defective work contained in the 1986 policy form. The supreme courts of Wisconsin and Tennessee have made the same distinction between case law interpreting older policy forms and the current form.¹⁶

Another case to recognize the profound difference between coverage for “business risks” under the earlier CGL forms and the present day 1986 form is *Wanzek Construction, Inc. v. Employers Insurance of Wausau*.¹⁷ In that case, the Minnesota Supreme Court held that prior Minnesota precedent dealing with prior policy forms, including the 1973 form interpreted in *Knutson Construction v. St. Paul*,¹⁸ simply do not apply to the language of the 1986 form. The court stated as follows:

Consequently, the suggestion by Wausau that the principles of *Bor-Son* and *Knutson*, in combination with the general principles of the business-risk doctrine, should drive the interpretation of the words of the 1986 standard-form exclusions, is incorrect. We conclude that the extent to which Wausau’s CGL policy covers the business risk of Wanzek must be determined by the specific terms of the insurance contract.

Not surprisingly, most of the courts that have considered the scope of coverage available under the 1986 CGL form have looked to the property damage exclusions, particularly the subcontractor exception to Exclusion (1) as indicating the intent to provide at least a modicum of coverage for property damage arising out of defective construction. For a definitive statement as to the difference between treatment of CGL coverage for faulty work under older forms and the current 1986 form, see *O’Shaughnessy v. Smuckler Corp.*,¹⁹ in which the Minnesota Court of Appeals stated that it would be “willful and perverse” for a court simply to ignore the exception that has now been added to the exclusion as to subcontractor work.

B. Case Law Upholds The Intended Coverage For Property Damage Arising Out Of Subcontractor Work

Although not the most recent of the case law on this issue, the Wisconsin Supreme Court’s opinion in *American Family Mut. Ins. Co. v. American Girl, Inc.*, remains one of the leading cases as to the broadening effect of the subcontractor exception to the Your Work Exclusion.²⁰ There, a subcontractor gave Renschler, the insured general contractor, faulty site

preparation advice, resulting in excessive settlement and eventual demolition of a warehouse. The court upheld coverage for the property damage attributable to the actions of the subcontractor, relying extensively on the drafting history of the CGL policy and stating as follows:

This subcontractor exception dates to the 1986 revision of the standard CGL policy form. Prior to 1986 the CGL business risk exclusions operated collectively to preclude coverage for damage to construction projects caused by subcontractors. Many contractors were unhappy with this state of affairs, since more and more projects were being completed with the help of subcontractors. In response to this changing reality, insurers began to offer coverage for damage caused by subcontractors through an endorsement to the CGL known as the Broad Form Property Damage Endorsement, or BFPDE. Introduced in 1976, the BFPDE deleted several portions from the business risk exclusions and replaced them with more specific exclusions that effectively broadened coverage. Among other changes, the BFPDE extended coverage to property damage caused by the work of subcontractors. In 1986 the insurance industry incorporated this aspect of the BFPDE directly into the CGL itself by inserting the subcontractor exception to the “your work” exclusion.

A more recent opinion to engage in similar analysis is from the Texas Supreme Court in *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, a case involving CGL coverage for the insured homebuilder for property damage caused to a home by the defective workmanship of a foundation subcontractor.²¹ While that opinion is most frequently cited for its analysis and rejection of the arguments related to the definitions of occurrence and property damage,²² the court’s decision also interpreted the property damage exclusions in the policy to ultimately uphold coverage for the insured. The court traced the expanded coverage provided under the CGL policy for certain business risks, recognizing the effect of the Broad Form Property Damage (BFPD) endorsement which culminated in the insertion of the subcontractor exception into Exclusion (1), the Your Work Exclusion, in 1986. By incorporating the subcontractor exception into the Your Work Exclusion, the Texas Supreme Court found that the insurance industry specifically contemplated coverage for property damage caused by a subcontractor’s

defective performance. In construing the subcontractor exception to the Your Work Exclusion, the Court rejected the notion that the subcontractor exception creates coverage, finding rather that it reinstates coverage that would otherwise be excluded under that exclusion.

A similar case is *Auto Owners Ins. Co., Inc. v. Newman*, involving defective stucco work performed by the insured homebuilder's subcontractor.²³ Specifically, the defective stucco application by a subcontractor allowed water to seep into the home, causing severe damage to the home's framing and exterior sheathing. Relying on the plain language in the policy, the South Carolina Supreme Court found there had been an "occurrence" of "property damage" caused by the subcontractor's defective work. In doing so, the court, though not explicitly overruling its recent decision in *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, in which the same court had held that damage to a roadway due to cracking caused by a subcontractor's work was not an occurrence since the only damage was to the road, the insured contractor's work.²⁴

The South Carolina Supreme Court found that the insurer's argument that the property damage caused by the subcontractor's defective work was expected and intended since it was pursuant to a foreseeable breach of contract was "unreasonable," in that no insured homebuilder would expect its subcontractor to perform negligently. The court further distinguished between "a claim for faulty workmanship versus a claim for damage to the work product caused by the negligence of a third party," noting that the latter would be covered under a CGL policy. Having upheld the existence of an occurrence and property damage, the South Carolina Supreme Court then discussed the applicability of the subcontractor exception to the Your Work Exclusion, Exclusion (I), recognizing that through the 1986 revisions of the standard CGL policy, the exception expanded liability coverage for property damage to a contractor's completed work arising out of work performed by the subcontractor.

An additional example of a case rejecting the “defective work is not an occurrence” argument is *Travelers Indemnity Co. of America v. Moore & Assocs. Inc.*²⁵ In that case, the Tennessee Supreme Court rejected the insurer's argument that defective work installed pursuant to a contract is foreseeable and not an occurrence. Rather, the court found the alleged water penetration from faulty window installation by the named insured’s subcontractor was unexpected and unforeseen, and thus, an “accident” and an “occurrence” within the meaning of the CGL policy. The court applied the subcontractor exception to Exclusion (l) to uphold coverage for the insured general contractor for property damage resulting from the water penetration. Citations to other cases applying the subcontractor exception to the Your Work Exclusion are in the endnote.²⁶

Of course, application of the property damage exclusions does not always result in a finding of coverage under the facts of a particular claim. For example, in *Calcasieu Parish School Bd. v. Lewing Const. Co., Inc.*, on remand, the court found that despite its previous finding of coverage, various exclusions, including Exclusion (l), the Your Work Exclusion, applied to bar coverage for property damage to a floor installed in a school by the insured flooring subcontractor.²⁷ The court did not differentiate between whether the insured’s installation of the flooring was considered “your work” or “your product,” as defined under the policy, but instead simply held that either the Your Work Exclusion or the Your Product Exclusion would apply to deny coverage.²⁸

C. The “No Coverage Through An Exception to Exclusion” Argument

Insurers argue that applying the explicit terms of the subcontractor provision amounts to an impermissible creation of coverage by an exclusion. This line of argument is based on the questionable assumption that defective workmanship can never give rise to an “occurrence” of

property damage, and thus, can never be within the initial coverage grant of the CGL policy. This position is contrary to the definitions in the policy as well as the carefully crafted property damage exclusions. These exclusions would serve little purpose if the coverage grant did not include the type of damages that are sought against general contractors in many construction cases.

This argument was made by the insurer and rejected by the Wisconsin Supreme Court in *American Family Mut. Ins. Co. v. American Girl, Inc.*, as follows:

This interpretation of the subcontractor exception to the business risk exclusion does not “create coverage” where none existed before, as American Family contends. There is coverage under the insuring agreement’s initial coverage grant. Coverage would be excluded by the business risk exclusionary language, except that the subcontractor exception to the business risk exclusion applies, which operates to restore the otherwise excluded coverage.²⁹

The most recent cases on this issue also echo the same rejection of this argument. For example, citing to *American Mutual v. American Girl*, the Texas Supreme Court in *Lamar Homes v. Mid-Continent Casualty* stated: “[W]e have not said that the subcontractor exception creates coverage; rather, it reinstates coverage that would otherwise be excluded under the your-work exclusion.”³⁰

Another similar case is *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*,³¹ in which the Florida Supreme Court held that the principle that an exclusion cannot be relied upon to create coverage did not apply to the subcontractor exception to the Your Work Exclusion. Rather, the court observed that if the insuring provisions did not confer an initial grant of coverage for faulty workmanship, there would be no reason for the policy to exclude damage to the insured contractor’s work.³² In other words, coverage for defective construction involving an “occurrence” of “property damage” under the insuring agreement of the CGL policy is preserved from exclusion under the subcontractor exception.

IV. EXCLUSION (j)5 – THE ONGOING OPERATIONS EXCLUSION

These materials have so far focused on the exception to Exclusion (l), the Your Work Exclusion, preserving coverage for property damage arising out of a subcontractor's work, as a primary example of the limitations placed upon the business risk doctrine under the CGL policy. While that coverage extension is probably the most familiar to construction lawyers, other exclusions also circumscribe the business risk doctrine, and thus allow coverage for property damage arising out of defective construction under certain circumstances. Moreover, while the Your Work Exclusion and the subcontractor exception only apply to completed operations claims, other exclusions apply to property damage that occurs during the course of construction.

One of those exclusions is Exclusion (j)(5), the Ongoing Operations Exclusion, which states that the insurance does not apply to property damage to:

That particular part of real property on which you [the named insured] or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations.

Due to the use of the present tense, it is recognized that this exclusion does not apply to property damage within the product-completed operations hazard, but only to property damage that occurs while operations are in progress. *CU Lloyd's of Texas v. Main Street Homes, Inc.*³³ For example, in *Mid-Continent Casualty Co. v. JHP Development, Inc.*,³⁴ the court found that Exclusion j(5) did not apply to water damage to the interior of the building arising out of the insured contractor's own workmanship since the property damage took place after the contractor's termination, but prior to completion. In other words, at the time of the property damage, i.e., the water infiltration, the contractor was not onsite and was not performing any operations. At the same time, the project was not a completed operation so the Your Work Exclusion, likewise, did not apply.

Perhaps the most significant limitation on the scope of Exclusion j(5) is that it applies only to property damage to the “particular part” of the property upon which the insured or its subcontractors are performing operations. In other words, only the portion of the work upon which operations are actually being performed and is damaged is excluded. Under the classic example provided by the Insurance Services Office, the policy drafting organization, a steel erector is erecting steel beams furnished by the general contractor. Having erected four of the beams, the subcontractor is in the process of erecting a fifth steel beam when this beam falls, resulting in damage to all five beams. Only the damage to the fifth beam is excluded.³⁵

While insurers often argue that the “particular part” of the real property that is subject to exclusion is the entire project, many courts give meaning to the “particular part” formulation. For example, in *Fejes v. Alaska Ins. Co., Inc.*,³⁶ the insured general contractor sought coverage under its CGL policy endorsed with a broad form property damage endorsement for damage arising out of the defective installation of a curtain drain by a subcontractor. The defective drain caused the entire septic system in the home to fail. In response, the carrier raised, among other policy defenses, Exclusion (2)(d)(ii) of the broad form property damage endorsement to deny coverage. That exclusion, although contained in the 1973 policy form before the court, contains the identical “that particular part” formulation as Exclusion j(5). Specifically, the carrier contended that the exclusion eliminated coverage for the particular part of any property out of which the property damage arose, that is, the entire septic system. The court stated as follows:

Fejes [the insured] argues that ‘that particular part of any property . . . out of which property damage arises’ refers to the curtain drain, since it was the failure of the curtain drain from which subsequent damage arose. Fejes claims that since Reeves [the homeowner] did not seek compensation for damage to the curtain drain, nor was it restored, repaired or replaced, Exclusion (A)(ii)(d)(ii)-(iii) does not apply. AIC [the insurer] contends that the holding tank system Reeves installed instead of restoring the septic system and curtain drain is effectively a repair of the defective system.

We reject AIC's argument as an overly broad interpretation of the exclusion. Fejes's interpretation is reasonable: The exclusion would exclude claims for the cost of repairing or replacing the curtain drain, but not the cost of alternative waste disposal systems made necessary by the failure of the curtain drain.

The classic *Fejes* case illustrates that where an insured's work is divisible into component parts, the determination of the "particular part" out of which the property damage arose may be a fairly straightforward exercise. However, that is not always the situation, such as in *Admiral Ins. Co. v. Little Big Inch Pipeline Co., Inc.*³⁷ There, the court applied the Ongoing Operations Exclusion to all of the property damage arising out of the insured subcontractor's defective work in turning off natural gas service to a mobile home park. The court was influenced by the fact that the damage was widespread throughout the mobile home park and clearly occurred during the performance of the work.

Applying the Ongoing Operations Exclusion, necessitating the determination of the "particular part" and whether the property damage arose out of the operations of the named insured is often a tremendously fact-intensive endeavor. On several occasions, the efforts to apply the exclusions to difficult scenarios have led various courts to find the exclusion ambiguous and to uphold coverage on that basis. In *Bituminous Cas. Corp. v. Kenway Contracting, Inc.*, the court found Exclusions j(5) and j(6), did not apply to a claim which arose out of the unintentional demolition of a home when only the carport was to be demolished.³⁸ Both exclusions were ambiguous since the policy did not define the phrases "that particular part of real property" or "operations," and there was no allegation that any of the work on the carport itself was faulty.³⁹

V. EXCLUSION j(6) – THE FAULTY WORK EXCLUSION

A companion exclusion to Exclusion j(5) is Exclusion (j)(6), the Faulty Work Exclusion, which states that the insurance does not apply to property damage to:

That particular part of any property that must be restored, repaired, or replaced because ‘your work’ was incorrectly performed on it.

Exclusion (j)(6) is subject to an exception that it does not apply to property damage included in the products-completed operations hazard. The explicit provision that Exclusion (j)(6) does not apply to the products-completed operations hazard is routinely upheld by the courts and makes it clear that the exclusion does not apply to a completed operations loss. Rather, it is Exclusion (l), the Your Work Exclusion, which would apply under that scenario. *See Lamar Homes v. Mid-Continent Casualty*.⁴⁰

Exclusion j(6) is subject to the same “particular part” limitation and likewise, courts may give effect to that limitation where the work is divisible into various elements. For example, in *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 2005 WL 1123759 (W.D. Tex. April 21, 2005), *appeal pending*, the owner of a condominium complex obtained a default judgment against the insured contractor in an amount in excess of \$1.5 million and despite the fact that virtually all work performed on the project was defective, the owner segregated out \$438,000 of non-defective work that was required to be repaired due to the defective work of the insured contractor. That work did not constitute “that particular part,” the repair or replacement of which was necessary by the defective work of JHP, and was outside the exclusion. On the other hand, the insurer argued that all property damage was excluded under the faulty workmanship exclusion. The court rejected the insurer’s position, stating that if defective work is performed by or on behalf of the insured contractor, and such defective work causes damage to other work

of the insured that was not defective, then there would be coverage for the repair, replacement or restoration of the work which was not defective.

A similar result was reached by the court in *Gore Design Completions, Ltd. v. Hartford Fire Ins. Co.*⁴¹ Applying Texas law, the court held that Exclusion j(6) does not exclude coverage with respect to the entire aircraft in which the insured was renovating the electrical system, but only the aircraft's electrical system on which the insured performed faulty work. In doing so, the court specifically observed that it was required under the term of the exclusion to give meaning to the "particular part" formulation.

In *Mello Constr., Inc. v. Acadia Ins. Co.*, the court interpreted Exclusion j(6), the Faulty Workmanship Exclusion, finding that because the entire project was considered the insured general contractor's work, the "particular part" distinction in the exclusion was irrelevant, and thus the exclusion applied to bar coverage for the contractor's defective foundation work.⁴²

Another recent case discussing the applicability of the property damage exclusions is *Burlington Ins. Co. v. Steve's Ag Services, Ltd*, applying Hawaii law.⁴³ There, the court held that Exclusion j(6), the Faulty Workmanship Exclusion, applied to deny coverage to an insured contractor that logged state lands without a permit, since the claim for the value of the timber taken constituted an effort to repair and replace the insured's work within the meaning of the exclusion.

Finally, consider *Southwest Tank & Treater Manufacturing Co. v. Mid-Continent Casualty Co.*, a case involving property damage arising out of a tank explosion.⁴⁴ At the time of the explosion, the insured was modifying an asphalt storage tank by installing heating elements within the confines of the tank and, in cutting the hole in the tank to install the second heating element, an explosion and fire occurred. The court applied Exclusion j(6), excluding coverage

for that particular part of any property that must be restored, repaired or replaced because the named insured's work was incorrectly performed upon it. The court determined that the tank was a self-contained, collective unit, which constituted a single item of property, and this single item of property was damaged while the insured was performing its work on it. Since the tank was a self-contained unit, the court could not construe the provision to limit the exclusion to the precise and isolated spot upon which work was being done, that is, where the holes were being cut. The insured was hired to install heating tubes in the entire tank and therefore, the tank, in its entirety, was the particular part of the property and the exclusion applied.

Insurers routinely argue that the "that particular part" limitation applies, contending that coverage for all of the insured's work is excluded under the Faulty Workmanship Exclusion. Thus, the insured must be able to segregate out the defective from the non-defective portions of the work in determining "that particular part" in order to limit the scope of the exclusion.

VI. EXCLUSION (m) – THE IMPAIRED PROPERTY EXCLUSION

The 1986 revisions to the CGL policy form added Exclusion (m), the Impaired Property Exclusion, to the policy. That exclusion states that the insurance does not apply to:

"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.

Moreover, the term "impaired property" is defined as follows:

"Impaired property" means tangible property, other than "your product" or "your work," that cannot be used or is less useful because:

- a. It incorporates "your product" or "your work" that is known or

thought to be defective, deficient, inadequate or dangerous; or

- b. You have failed to fulfill the terms of a contract or agreement;

If such property can be restored to use by:

- a. The repair, replacement, adjustment or removal of “your product” or “your work;” or
- b. Your fulfilling the terms of the contract or agreement.

While usually referred to as the Impaired Property Exclusion, Exclusion (m) actually applies to two different types of property damage, (a) impaired property, and (b) property that has not been physically injured. The new term “impaired property” appears to be primarily directed at exclusion of loss of use damages, in that it means tangible property other than the insured's product or work that cannot be used or is less useful. In addition to excluding coverage for property damage to “impaired property,” the exclusion also denies coverage for property that has not been physically injured, so that the exclusion appears to be directed at denial of coverage for diminution in value claims where there has been no loss of use of property which has neither been physically injured nor destroyed.

In the event the insured's product or work causes physical injury to tangible property, it would not qualify as “impaired property” under the definition. This is because where the product or work causes physical injury to property, it is most likely not possible to restore that property to use by merely repairing or replacing the insured's product or work (due to the fact that the other property must also be repaired or replaced). Thus, the exclusion may not apply to such property because it is not impaired and because the property has been physically injured. For example, in *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, the sub-base installed by an insured excavation subcontractor on a parking lot caused the asphalt overlay to crack.⁴⁵ The parking lot could not be repaired by removal of the sub-base; rather, it was repaired by adding

another overlay of asphalt. Therefore, even though the defective work of the subcontractor rendered the parking lot less useful, it was not “impaired” within the terms of the definition, and the insured subcontractor was entitled to coverage.

In contrast, other courts have had more difficulty in applying the complex exclusion. It has been recently described by the Court of Appeals of New Mexico as a “semantic bog” which would be extremely discouraging to a layperson attempting to read and understand the exclusion. *Computer Corner, Inc. v. Fireman's Fund Ins. Co.*⁴⁶ Moreover, other courts which have wrestled with this exclusion have held that the exclusion is simply not applicable where property damage has occurred. *Mount Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc.*⁴⁷

In *Standard Fire Ins. Co. v. Chester-O'Donley & Associates, Inc.*, the insured mechanical subcontractor sought coverage under its CGL policy for claims by the architect, general contractor and performance bond surety arising out of the need to replace the subcontractor's duct work.⁴⁸ The carrier raised the Impaired Property Exclusion in response to a portion of the claim for the cost to repair water damage to walls, ceilings and other parts of the building caused by the faulty duct work. The court stated:

The exclusion targets situations where a defective product, after being incorporated into the property of another, must be replaced or removed at great expense, thereby causing loss of use of the property.

The effect of the ‘impaired property’ exclusion to bar coverage for loss of use claims (1) when the loss was caused solely by the insured's failure to provide work of the quality or performance capabilities called for by the contract and (2) where there has been no physical injury to property other than the insured's work itself. The exclusion does not apply if there is damage to property other than the insured's work [citations omitted], or if the insured's work cannot be repaired or replaced without causing physical injury to other property. [Citations omitted.]

The court determined that the Impaired Property Exclusion did not apply under the circumstances of the case, that is where the claim involved actual physical damage to portions of

the building not within the scope of the insured's work and that damage resulted from the repair or replacement of the insured's defective duct work.

A recent Texas case applying various property damage exclusions was *Admiral Ins. Co. v. Little Big Inch Pipeline Co., Inc.*⁴⁹ There, the court found that Exclusion (m), the Impaired Property Exclusion, applied to bar coverage for diminution of value claims arising out of the insured subcontractor's defective work in turning off natural gas service to a mobile home park since no property had been physically injured and the loss arose out of the insured's inadequate performance.

Note that in the event that the insured is the general contractor, no portion of the project constitutes "impaired property." Property is, by definition, "impaired" only if it is property *other than* the named insured's work. Moreover, as discussed above, it must be emphasized that property can only be "impaired" if it can be restored to use by the repair, replacement, adjustment or removal of the insured's product or work. Often, such repair, replacement, adjustment or removal is not possible in the context of defective workmanship.

These and other relatively difficult concepts appear to have prevented insurers from placing heavy reliance on the Impaired Property Exclusion, and therefore, judicial trends are only emerging. Nevertheless, in light of the re-emerging emphasis on the role of the property exclusions to define coverage for defective work, the Impaired Property Exclusion, together with the other property damage exclusions is sure to garner additional attention in coverage litigation.

¹ See *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007); *U.S. Fire Ins. Co. v. J.S.U.B. Inc.*, 979 So.2d 871 (Fla. 2007); *Auto Owners Ins. Co., Inc. v. Newman*, 2008 WL 648546 (S.C. Mar. 10, 2008); *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302 (Tenn. 2007).

² 396 N.W.2d 229 (Minn. 1986).

³ 438 So.2d 215 (La.App. 1983), *writs denied*, 441 So.2d 1224, 442 So.2d 447 (La. 1983).

⁴ 864 F.2d 648 (9th Cir. 1988).

⁵ 221 Cal.App. 3d 961, 270 Cal.Rptr. 719 (Cal. Ct. App. 1990).

⁶ 984 P.2d 519 (Alaska 1999).

⁷ 638 N.W. 2d 887 (S.D. 2002).

⁸ INSURANCE SERVICES OFFICE, INC., ISO COMMERCIAL LINES POLICY AND RATING SIMPLIFICATION PROJECT INTRODUCTION AND OVERVIEW: COMMERCIAL GENERAL LIABILITY 16 (1985).

⁹ James D. Hendrick and James P. Wiesel, *The New Commercial General Liability Forms – an Introduction and Critique*, 36 FED’N INS. COUNS. Q. 317, 360 (1986).

¹⁰ Maureen McLendon, Jack Gibson & W. Jeffrey Woodward, COMMERCIAL LIABILITY INSURANCE (IRMI 2003).

¹¹ G. H. Tinker, *Comprehensive General Liability Insurance—Perspective and Overview*, 25 FED’N INS. COUNS. Q. 217, 226 (1975).

¹² 405 A.2d 788 (N.J. 1979).

¹³ R. Henderson, *Insurance Protection for Products Liability and Completed Operations – What Every Lawyer Should Know*, 50 NEB. L. REV. 415, 441 (1971).

¹⁴ 979 So.2d 871 (Fla. 2007).

¹⁵ 390 So.2d 325 (Fla. 1980).

¹⁶ *American Family Mut. Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 77 (Wis. 2004); *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 307 (Tenn. 2007).

¹⁷ 679 N.W.2d 322 (Minn. 2004).

¹⁸ 396 N.W.2d 229 (Minn. 1986).

¹⁹ 543 N.W.2d 99 (Minn. App. 1996).

²⁰ 673 N.W.2d 65 (Wis. 2004).

²¹ 242 S.W.3d 1 (Tex. 2007).

²² The Texas Supreme Court rejected the following broad propositions in favor of applying the terms of the CGL policy: (a) the CGL policy distinguishes between tort liability and breach of contract; (b) property damage to a construction project flowing from a breach of contract is foreseeable and not an “occurrence” under the CGL policy; (c) the economic loss rule determines the existence of property damage under a CGL policy; (d) damages flowing from defective work in breach of a construction contract are necessarily an uninsured economic loss; (e) upholding coverage for property damage arising out of defective work transforms the CGL policy into a performance bond; and (f) defective workmanship is an uninsurable business risk.

²³ 2008 WL 648546 (S.C. March 10, 2008).

²⁴ 621 S.E.2d 33 (S.C. 2005).

²⁵ 216 S.W.3d 302 (Tenn. 2007).

²⁶ *Lennar Corp. v. Auto-Owners Ins. Co.*, 151 P.3d 538 (Ariz. Ct. App. 2007); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651 (Tex. App. - Houston [14th Dist.] 2006, pet. denied); *Aten v. Scottsdale Ins. Co.*, 511 F.3d 818 (8th Cir. 2008) (Minnesota law); *MW Builders, Inc. v. Safeco Ins. Co. of America*, 267 Fed.Appx. 552, 2008 WL 422222 (9th Cir. 2008) (Oregon law).

²⁷ 2007 WL 4322161 (La. Ct. App. Dec. 12, 2007).

²⁸ The Your Product Exclusion, Exclusion (k) denies coverage for property damage to “your product” arising out of it or any part of it. The term “your product” is defined in the policy, in general, as “goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by . . .” the named insured. The insertion of the exception for real property into the definition by the 1986 revisions made it clear that the intent was that the exclusion was to be applied to construction projects. See *Wanzek Constr., Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322 (Minn. 2004). As such, extensive treatment of the Your Product Exclusion in the context of insurance coverage for defective construction is not necessary.

²⁹ 673 N.W.2d at 83-84.

³⁰ 242 S.W.3d 1, 14 (Tex. 2007).

³¹ 979 So.2d 871 (Fla. 2007).

³² 979 So.2d 871, 886-87 (Fla. 2007).

³³ 79 S.W.3d 687 (Tex.App. - Austin 2002, no pet.).

³⁴ 2005 WL 1123759 (W.D. Tex. April 21, 2005), *appeal pending*, Case No. 05-50796 (5th Cir).

³⁵ INSURANCE SERVICES OFFICE, INC., ISO CIRCULAR GENERAL LIABILITY GL 79-12 (January 29, 1979).

³⁶ 984 P.2d 519 (Alaska 1990).

³⁷ 523 F.Supp.2d 524 (W.D. Tex. 2007).

³⁸ 2007 WL 1790685 (Ky. June 21, 2007).

³⁹ *See also, Thommes v. Milwaukee Ins. Co.*, 641 N.W.2d 877 (Minn. 2002) for a case finding Exclusions j(5) and j(6) to be ambiguous.

⁴⁰ 242 S.W.3d 1, 11 (Tex. 2007).

⁴¹ 538 F.3d 365 (5th Cir. 2008).

⁴² 874 N.E.2d 1142, 2007 WL 2908267 (Mass. App. Ct. Oct. 5, 2007).

⁴³ 2007 WL 4357767 (9th Cir. Dec. 10, 2007).

⁴⁴ 243 F.Supp.2d 597 (E.D. Tex. 2003).

⁴⁵ 197 F.3d 720 (5th Cir. 1999).

⁴⁶ 46 P.3d 1264 (N.M. Ct. App. 2002).

⁴⁷ 215 F.Supp.2d 783 (E.D.Tex. 2002).

⁴⁸ 972 S.W.2d 1 (Tenn. Ct. App. 1998).

⁴⁹ 523 F.Supp.2d 524 (W.D. Tex. 2007).