If Defective Work Is An Accident, Does That Mean It’s Covered?

In our last issue, we discussed the growing trend of courts recognizing that most defective work is accidental for purposes of commercial general liability insurance coverage. Does this mean that CGL insurance will pay for property damage caused by defective work? In many cases the answer is no, it will not. A CGL insurance policy is a contract. Most CGL insurance policies/contracts cover property damage caused by an occurrence. The policy/contract defines an “occurrence” as an accident, but does not define “accident.” The common meaning of accident is an event that occurs unexpectedly and unintentionally. Since the vast majority of defective construction work is the result of negligence, not intentional wrongdoing, the modern trend merely applies the widely accepted rule that undefined contract terms are to be given their ordinary and common meaning.

The old majority view was that insurance, as a matter of public policy, should not pay for defective work because work quality is within a contractor’s or subcontractor’s control. This public policy approach to enforcing contracts, which is still followed by some courts, produces decisions that can be at odds with the language of the insurance policy/contract itself. The modern trend does not condone or encourage defective work. It does recognize that insurance is a contract, that rates are based on the contract’s terms, and that insurance companies should be held to the terms of their contracts. The modern trend also recognizes that standard form CGL policies do a good job of protecting insurance companies from business risks within a contractor’s control.

As was discussed in our last issue, standard form CGL policies start with a broad grant of coverage that is then limited by a long list of exclusions. The bodily injury and property damage part of the Insurance Services Office’s latest CGL policy, issued in 2013, has 17 major exclusions (a – q) most of which have numerous subparts. Exclusions j.(5), j,(6), l., and m. are directly applicable to defective construction work. These four exclusions will be discussed in detail, but first we need to look at four defined terms that are integral parts of these exclusions. You can read these now or skip on and refer back to them as needed.

8. “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 the repair, replacement, adjustment or removal of "your product" or "your work" or your fulfilling the terms of the contract or agreement.

16. "Products-completed operations hazard":

a. Includes all . . . “property damage” occurring away from premises you own or rent and arising out of . . . “your work” except:

(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.

17. “Property damage” means:

a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or

b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the “occurrence” that caused it.
22. "Your work":

a. Means:

(1) Work or operations performed by you or on your behalf; and

(2) Materials, parts or equipment furnished in connection with such work or operations.

b. Includes:

(1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work"; and

(2) The providing of or failure to provide warnings or instructions.

Exclusion j.(5) That Particular Part of Real Property.

Exclusion j.(5) excludes coverage for property damage to:

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

Consider the following example. General contractor contracts to convert a warehouse to a student dormitory. The work includes erecting steel framework and structural wood decking within the existing exterior walls. During erection, part of the steel framing is incorrectly bolted and collapses damaging the wood decking and the exterior walls. The steel members that collapsed are also damaged. The owner makes a claim against the contractor for the damage to the steel, wooden decking and exterior wall. The contractor submits the claim to its CGL carrier. The incorrect bolting is defective work. Is there coverage for the resulting property damage?

The steel framing is the particular part of the real property, the student dormitory, on which the contractor was performing operations, so there is no coverage for the damaged steel. The existing exterior walls were not part of the real property on which the contractor was working. Damage to the exterior walls is covered. What about the wood decking? Was it included in the "particular part" of the real property on which the contractor was working? That is less than clear, and, depending on the amount of money involved,
could easily lead to a coverage dispute.

**Exclusion j.(6) Any Property Damaged By Defective Work.**

Exclusion j.(6) excludes coverage for property damage to:

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

This exclusion would also bar coverage for the steel damaged in the example above, but exclusion j.(6) is broader than j.(5) in that it applies to "any property" not just "real property." Suppose the dormitory contract includes installation of furniture and that bookcases and desks are damaged because they were incorrectly assembled by contractor's furniture subcontractor. Exclusion j.(5) would not apply because the desks and bookcases are not real property. Exclusion j.(6) would apply even though the defective work was done by a subcontractor. The definition of "your work" includes work performed on the contractor's behalf and materials furnished in connection with such work.

**Exclusion l. Damage To “Your (Completed) Work”**

Exclusion l. excludes coverage for:

“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.

While exclusions j.(5) and j.(6) apply to property damage caused while work is ongoing, exclusion l. excludes coverage for work that has been completed or put to its intended use. Unlike exclusions j.(5) and j.(6), exclusion l. does not apply to property damage caused by a subcontractor. Continuing with the dormitory example, suppose the contractor incorrectly bolted the steel framing such that the bolts worked loose over time causing the steel frame to sag after the dormitory was occupied causing damage to the frame and to the studs, ceiling grid, walls and ceilings attached to the frame. Because the dormitory was occupied all of the damaged property is included in the “products completed operations hazard”. Since the contractor installed the steel framing, there is no coverage for the damage to the steel itself. But there is coverage for damaged property such as metal studs, drywall, ceiling grid, ceiling tile and any other work installed by subcontractors. If the steel framing had been installed by a subcontractor, all property damage caused by the defective work would be covered under the general contractor’s CGL policy. Courts that adhere to the “defective work is not an occurrence” doctrine do not give contractors the benefit of subcontractor exception to exclusion l.
Exclusion m. Impaired Property

“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 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.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to . . . “your work” after it has been put to its intended use.

Referring back to the definition of “property damage,” remember that property damage includes “loss of use of tangible property that is not physically injured.” Suppose the fire marshal refuses to issue a certificate of occupancy for the dormitory because she determines that the smoke detector and fire alarm installation does not meet code. While the fire alarm system can be reworked to meet code, the rework will take a month or more at considerable expense. This delay prevents the owner from leasing rooms at the beginning of the new school term. The owner asserts a claim for the cost of the rework and lost revenue. For purposes of the contractor’s CGL coverage, the dormitory is impaired property. The dormitory cannot be used because it incorporates the contractor’s defective smoke detectors and fire alarm and the contractor has failed to meet the requirements of its contract, but that failure can be remedied. Exclusion m. precludes insurance coverage for either the repair of the fire alarm system or the owner’s claim for lost rents.

What about the exception to the exclusion? Suppose the fire marshal does not object to the smoke detector and fire alarm installation, and students occupy the dormitory. Several months later, a short somewhere in the system causes the fire alarm to sound throughout the building and the owner’s maintenance personnel cannot turn it off. The owner is required to vacate the building, rehouse the students, and spend substantial time and money to locate the short and repair the system. Again the owner makes a claim for the cost of repair and the cost of rehousing the students necessitated by owner’s loss of use of the dormitory. Here there has been sudden and accidental physical injury to the contractor’s work, so the exception to the exclusion should apply to allow coverage of the owner’s claim for the loss of use of its impaired property. Moreover, if the fire alarm system was installed by a subcontractor, the contractor should have coverage for the cost of repair under the exception to exclusion l. discussed above.

The Takeaway

There is a clear judicial trend recognizing that defective work can be occurrence triggering the potential for CGL insurance coverage. In
many cases that potential will not be realized because coverage is eliminated by one of the business risk exclusions discussed above. Still, the trend is important because it gives contractors the benefit of the exceptions to exclusions l. and m. States that continue to adhere to the defective work is not accidental doctrine will deny coverage for defective work that falls squarely within the subcontractor exception to the exclusion l. and the sudden and accidental exception to exclusion m. Contractors who pay for the coverage provided by those two exceptions are well advised to investigate whether that coverage is judicially revoked in any of the states where they are working.