What Every Court Should Know About Insurance Coverage for Defective Construction

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I. Introduction

There is an alarming lack of predictability in the construction industry today about whether contractors’ CGL policies will cover property damage arising out of defective construction. It is particularly unpredictable for those contractors performing work in multiple states. National contractors, especially, cannot foretell the scope of the coverage in their CGL policies. The problem isn’t with the policies they procure; virtually every contractor’s CGL policy form is identical and mirrors the ISO’s standard General Liability Form, the CG 20 10. The problem is the identical policy forms are being construed in radically different ways by the courts. As a result, contractors are covered in some states, but bare in others.¹

¹The holding in Cincinnati Ins. Co. v. Beazer Homes Investments, LLC, 594 F.3d 441 (6th Cir. 2010), opinion vacated and superseded, 2010 WL 4244177 (6th Cir. 2010) (opinion vacated and case remanded for reconsideration in light of Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010), discussed below), exemplifies the national dilemma. Cincinnati issued a CGL policy to a General Contractor who developed a community of homes in and around Lexington, Kentucky. Cincinnati refused to cover claims of property damage under its policy, arguing that the allegations against the contractor did not trigger coverage under its policy. The South Carolina state courts had recently rejected Cincinnati’s arguments and ordered it to cover identical claims. The CGL policy in the South Carolina case was identical to that being construed by the Sixth Circuit. The contractor argued in the Sixth Circuit that Cincinnati should be estopped from raising all the arguments that were previously rejected by the South Carolina courts. The Sixth Circuit refused to apply collateral estoppel, but rather ruled for Cincinnati, reasoning that the controlling law in the matter before it was exactly contrary to the law applied in the South Carolina courts, and that makes all the difference.
The defining difference in the courts’ fundamentally dissimilar rulings is the role of the policy itself. The courts that find coverage for property damage caused by defective construction find it in the express language of the CGL policy. The courts that refuse to find coverage do so by ignoring the express language of the policy. This article addresses the random decisional landscape of the two divergent approaches and proposes a uniform standard for all courts to apply. The proposed standard interpretation will not only restore predictability to the construction industry, but also deliver to it the bargained-for-benefit that contractors reasonably expect to obtain in exchange for paying substantial premiums for the coverage, and that owners, who specify such policies and coverages within their contract documents, believe is being purchased with their project dollars.

The article begins by addressing the anatomy of the current CGL policy, explaining how its present form is the product of intentional tinkering by the Insurance Services Organization to accommodate the developing needs of the construction industry. Section II, in addition to undressing the CGL form, introduces the notion of “business risk,” and its evolution into what is all too commonly regarded today as a “doctrine.”

Section III addresses the Occurrence Debate, which at its base presents two competing notions about whether defective construction should, as a matter of public policy, always be considered an intentional act, barred from coverage by the language of the

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The issue in [the South Carolina] case was not whether the Policies covered the damage under some universal law, but whether the damage was covered under South Carolina insurance law. In the present case, the issue is whether such damage is covered under [another state’s] insurance law.

Id. at 445 (Emphasis in original). The controlling law in the Sixth Circuit case was Indiana law, which at that time was a particularly insurer-friendly jurisdiction in this context, where the policy language was not outcome determinative of coverage. The different judicial model controlling the question of coverage makes all the difference. Thus, the identical policy applied to identical facts in South Carolina and Indiana (at the time) resulted in exactly opposite conclusions. Subsequent to the Sixth Circuit’s decision, the Indiana Supreme Court issued a game-changing decision which in the words of the dissenting Chief Justice now puts Indiana “on the other side of this divide.” Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010). The Sheehan decision compelled the Sixth Circuit to reverse itself in the Beazer Homes case, and remand the case to the trial court to reconsider its ruling in light of Sheehan. Subsequently, the Indiana Supreme Court reconsidered its ruling in Sheehan. On rehearing, it affirmed its holding relative to coverage, but ruled in addition that the insured’s “untimely notice” barred it from obtaining coverage in that specific case. Sheehan Const. Co., Inc. v. Continental Cas. Co., 2010 WL 5135322 (Ind. 2010)
CGL’s insuring clause; or whether it is instead the consequence of mistakes in design, performance or fortuity that materialize from defects in the physical construction of the work of the insured, which the insuring clause is intended to cover.

Section IV addresses the Property Damage Debate, which is many-faceted. It explores the history of the notion of covered property damage over time and explains how its current definition in the policy may not limit coverage as the insurance industry intends. Section IV next organizes the Property Damage Debate into its two major battlefields: whether physical injury has occurred to tangible property, and whether the loss of use is to property that has not been physically injured. The former analyzes in depth the “incorporation cases” and the “economic loss cases.” The latter describes how property damage in the CGL has historically treated “loss of use” as a form of property damage; thus opening the coverage door to all sorts of losses that do not manifest themselves as physical injury to tangible property.

Section V explores the current decisional landscape addressing the question of insurance coverage for defective construction from the highest court of each state that has ruled on the issue in the last several years. There are hundreds of reported decisions on the issue, but primarily from lower appellate courts—most of which are cited somewhere in this article. Remarkably few of the decisions are reported by the states’ highest appellate court. The most current state supreme court rulings indicate a trend toward awarding coverage for property damage due to defective construction. This trend has also produced some of the most thoughtful decisions on the issue in decades, and has inspired the general theme of this article as well as the solution to the crisis that faces the construction industry today. The solution is expressed in Section VI.

II. Anatomy of the CGL & the Business Risk Doctrine

What is the anatomy of the CGL policy? The insuring language; the definitions; the conditions; the exclusions; sometimes even manuscript endorsements; all these things make up the body of the CGL policy. What isn’t in the body of the policy is the “business risk” doctrine. What the industry holds up as the main obstacle to property damage coverage caused by defective construction is actually a theoretical concept popularized by a former dean of the Nebraska School of Law in a law review article that was authored two years before the insurance industry even
published the 1973 CGL form. In the nearly forty years since the article was published, the insurance industry has yet to formalize a written “business risk” policy exclusion, much less incorporate it into the CGL policy. Why? Is it because the absence of a written “business risk” exclusion in the policy allows the insurance industry to use the courts selectively to create and enforce such an “exclusion,” without risking invalidation, by judicial construction, regulatory scrutiny, or both?

The actual underwriting history of the CGL policy form reveals a contrary intent—in fact, a cautious effort by the insurance industry to construct coverage for property damage arising out of defective construction. It is important for courts to understand the historical development of the broad grant of coverage in the current CGL and how that is intended to coexist with the tailored exclusions, which read together demonstrate an intent to broaden coverage in the policy to include property damage arising from defective construction. When courts issue coverage decisions on some basis other than the actual policy language, the decisions often frustrate the drafters’ intent and the purchasers’ expectations.

While the notion of a coverage limitation based on pure business risk is at one level a horse-sense generalization of the coverage scope of the CGL, such a notion should not govern over, much less overrule, the express coverage grant contained in the policy language. The policy has numerous written exclusions (indeed, the exclusions are the bulk of the policy) that carve out specific and often overlapping exceptions from the broad coverage grant. The notion that an unwritten “business risk exclusion” is also to be found within the carefully-crafted written exclusions in the current CGL, and have been so since the publication of the 1986 ISO CGL form—still the most popular liability form issued to

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4Wielinski has noted that frustrating the underwriters’ intent is a current litigation strategy: “[I]n 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.’” Id. at 3.
businesses in the United States today—ignores the history of the development of the CGL.

Leading up to the publication of the 1966 ISO CGL revisions, the construction industry had been clamoring for an insurance product that covered it for claims arising out of defects in contractors’ completed work. In response, the 1966 ISO CGL policy form for the first time treated a contractor differently than the insurance industry treated a product manufacturer. Beginning in 1966, the contractor’s “product” was identified by the insurance industry as something distinct from a product produced by manufacturers. The 1966 form excised from the “product itself” exclusion “worked performed” by contractors, and expressly stated that the “product itself” exclusion did not apply to improvements to real property, i.e., the construction project. The “work performed” exclusion, however, purported to exclude from the general grant of coverage property damage arising out of work performed “on behalf of the named insured.”

Thus, the 1966 ISO CGL revisions gave contractors only half a loaf. General contractors needed coverage for property damage that arose from the work of their subcontractors, a risk they could not control by the exercise of general supervision and coordination. The insurance market responded in 1973 with an “endorsement” to the CGL form that excised from the “work performed” exclusion property damage caused by subcontractors (“work performed on behalf of the named insured”). This endorsement was promulgated by the ISO as the “Broad Form Property Damage” endorsement (BFPD). The BFPD was just what the construction industry had ordered and became so essential to the construction industry that in 1986 it was incorporated into the CGL standard policy form and has remained there since.

The intent to broaden coverage under the 1986 revisions to the CGL policy form today contains the very same grant of coverage as the 1973 BFPD endorsement, and every court that has taken the time to analyze the actual policy language has concluded that today’s CGL form grants coverage
CGL, to include claims arising from defective construction, was broadcast to the construction and insurance industries by the very entity that published the form for both, the ISO. Commentators followed suit by acknowledging the importance of the 1986 policy form to the construction industry and general contractors especially.

Jack Gibson, Director of the International Risk Management Institute, described the intent and effect of the 1986 policy form accordingly:

to general contractors for property damage arising out of the defective construction of its subcontractors. See e.g., Southwest Louisiana Grain, Inc. v. Howard A. Duncan, Inc., 438 So. 2d 215 (La. Ct. App. 3d Cir. 1983), writ denied, 441 So. 2d 1224 (La. 1983) and writ denied, 442 So. 2d 447 (La. 1983); Fireguard Sprinkler Systems, Inc. v. Scottsdale Ins. Co., 864 F.2d 579 (9th Cir. 1988); Maryland Casualty Co. v. Reeder, 221 Cal. App. 3d 961, 270 Cal. Rptr. 719 (4th Dist. 1990), opinion modified, (July 25, 1990); Fejes v. Alaska Ins. Co., 984 P.2d 519 (Alaska 1999); Corner Const. Co. v. United States Fidelity & Guar. Co., 2002 SD 5, 638 N.W.2d 887 (S.D. 2002). The coverage grant, then and now, expressly covers defective construction claims that arise out of the work of the general contractor’s subs, and that occurred after substantial completion of the construction project. This “completed operations” coverage is the bargained-for exchange that justifies contractors paying billions of dollars in premiums to the insurance industry. It is an essential risk management tool of the construction industry. Procuring this coverage is today routinely made a condition of payment by owners and construction lenders.

ISO expressed the intent of the changes accordingly: “Exclusions have been completely re-written 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.” Insurance Services Office, Inc., ISO Commercial Lines Policy and Rating Simplification Project Introduction and Overview: Commercial General Liability 16 (ISO 1985).

James T. Hendrick and James P. Weizel wrote:

[The subcontractor exception] is . . . 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 damages 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 of which the damage arises was performed . . . by a subcontractor.” The only property damage to completed work which is excluded . . . is damage to the insured contractor’s work, which arises out of the insured contractor’s work.


IRMI is a respected chronicler of important advances in the insurance and construction industries. Wielinski Defective Construction at p. 7.
By virtue of the subcontractor exception [to the “your work” exclusion l.], the insured has coverage, despite exclusion l., 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.\(^{11}\)

While certainly some of the exclusions in the 1986 ISO CGL carved out “business-type” risks, one covered risk that was expressly left intact (as an exception to the “your work” exclusion in paragraph l.) was property damage arising out of a subcontractor’s defective construction. Unfortunately, many courts today fail to consider the actual policy language and the underwriting history of the CGL, and consider instead the notion of a general “business risk” doctrine as controlling the coverage determination. Where did that come from?

The “business risk” doctrine was advanced in 1971 by Dean Roger Henderson:

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.\(^{12}\)

Reasonable minds will not dispute that many of the actual

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policy exclusions contained in the ISO CGL form are premised on the principle that an insured should not “generally” look to its CGL policy to cover business risks that are within its own control. But that ephemeral principle alone does not re-write the actual language of the policy. What’s more, the mutable principle should not be used to bar coverage that is intended by the drafters of the policy and expected by the purchasers of that insurance product. Notwithstanding, the insurance industry, when called upon to defend or pay a claim, continues to offer the “business risk” doctrine as its bulwark against coverage for property damage caused by defective construction. That defensive strategy has spawned the publication of numerous reported decisions that sustain the insurers’ declinations of coverage; opinions that are characterized by a tendency of the courts to use the “idea” of the “business risk” doctrine as being outcome-determinative of the coverage issue. These courts do so at the expense of forsaking the actual language of the policy.

The New Jersey Supreme Court seized on the Henderson article as the basis of its decision in Weedo v. Stone-E-Brick, Inc.\textsuperscript{13} There the insured-contractor was sued for defective masonry work on a residence. The court ruled that the contractor’s CGL did not cover the property damage claims arising out of the defective work, reasoning that coverage was barred by the pre-1973 policy’s “work performed” and “product itself” exclusions. The court justified its holding by reasoning that risks associated with defective construction were not intended to be covered in a general liability policy:

Where the work performed by the insured-contractor is faulty, either express or implied warranties, or both, are breached. As a matter of contract law, the customer did not obtain that for which he bargained. The dissatisfied customer can, upon repair or replacement of the faulty work, recover the cost thereof from the insured-contractor as the standard measure of damages for breach of warranties . . .. [A] principal justification for imposing warranties by operation of law on contractors is that these parties are often “in a better position to prevent the occurrence of major problems” in the course of constructing a home than is the homeowner. The insured-contractor can take pains to control the quality of the goods and services supplied. At the same time he undertakes the risk that he may fail in this endeavor and thereby incur contractual liability whether express or implied. The consequence of not performing well is part of every business venture; the replacement or repair of

faulty goods and works is a business expense, to be borne by the insured-contractor in order to satisfy customers.\textsuperscript{14}

The court offered as support for its ruling the language from the Henderson law review article set out above. The Weedo court, however, failed to recognize that the express purpose of the Henderson law review article was to explain the 1966 changes to the CGL policy form—especially the then newly-denoted distinction between products liability coverage for product manufacturers and completed operations coverage for service providers like constructors. The 1966 policy form detailed in the Henderson article was out of date once the 1973 BFPD endorsement was introduced to the construction industry—by an insurance industry hungry to sell coverage to contractors for property damage caused by defective construction.\textsuperscript{15} In truth, Henderson’s “business risk” doctrine was a theory whose coming of age was Nebraska in the mid-1960s.

On the basis of its faulty foundation, the 1979 Weedo decision should have been catapulted into obscurity in the Atlantic Reporter series. Instead, it has taken longer to die than a California Redwood.

\textsuperscript{14}Id. at 791 (citations omitted).

\textsuperscript{15}The BFPD endorsement to the CGL form was first produced by the insurance industry in 1969. By the time the ISO issued the new 1973 CGL policy, it was widely marketed to the construction industry as an endorsement that an insured-contractor would want to purchase at an additional premium. See Wielinski, “Business Risks,” “Work Product,” “De Facto Performance Bonds” and Other Excuses for Denying Defective Work Claims, pp. 5–6 (ABA 2000) (Hereinafter cited as Wielinski Business Risks); Shapiro & Posner, It Was an Accident: Inadvertent Construction Defects Are an “Occurrence” Under Commercial General Liability Policies, pp. 4–8 (ABA 2000). In Maryland Casualty Co. v. Reeder, 221 Cal. App. 3d 961, 270 Cal. Rptr. 719 (4th Dist. 1990), opinion modified, (July 25, 1990), the California Court of Appeals commented:

Here, in addition to a basic policy with a broad coverage provision followed by exclusions designed to shift certain risks back to the insured, we have an additional risk altering mechanism [the BFPD]. By paying an additional 20 percent of their basic premium some of the insureds in this case purchased a [BFPD] endorsement which narrowed the exclusions set forth in the basic policy. Thus the endorsement returned to [the insurer] some of the risks it had shifted by way of the exclusions.

Id. at 722. By 1986, the coverage provided by the BFPD was so popular that the insurance industry wrote it into the basic CGL policy form. For more than fifteen years the insurance industry has marketed the basic CGL policy form to the construction industry as a product that covers property damage caused by defective construction. As a consequence, insured-contractors should never hear about the Henderson law review article. Unfortunately some courts can’t see past it to the language of the actual policy. See Wielinski Business Risks, pp. 5–14.
The Minnesota Supreme Court soon fell victim to the one-two punch of the Henderson article and the Weedo decision. Throughout the 1980s, Minnesota contractors were haunted by two supreme court decisions: Bor-Son Building Corp. v. Employers Commercial Union Ins. Co.\(^\text{16}\) and Knutson Construction Co. v. St. Paul Fire & Marine Ins. Co.\(^\text{17}\) Those two decisions ruled that general contractors were bare for property damage claims arising out of defective construction performed by their subcontractors. The court based its second decision on the strength of its first, as well as the persuasiveness of the Henderson article and the Weedo decision.\(^\text{18}\) The relative importance of those two decisions, however, was virtually obliterated in 1996, when the Minnesota Court of Appeals ruled that the two earlier supreme court decisions are applicable only to CGL policies patterned upon the pre-1986 ISO form. The Minnesota Court of Appeals held that ISO CGL forms issued after 1986 contain language that expressly cover insured contractors for property damage caused by defective construction. Specifically, the court ruled that since the Bor-Son and Knutson decisions were decided:

> It appears that “other considerations” have come into play. Prior to 1986, the products-completed operations hazard did not except work performed by subcontractors. However, the current CGL policy contains the following exclusion and exception to that exclusion:

> 1. “Property damage” to “your work” arising out of it or any

\(^{16}\)Bor-Son Bldg. Corp. v. Employers Commercial Union Ins. Co. of America, 323 N.W.2d 58 (Minn. 1982).


\(^{18}\)For an in-depth analysis of both cases, see Wielinski Business Risks, pp. 5–10. Suffice it to say here that in the first decided case, Bor-Son, the court did not seem to notice that the insured-contractor bought the BFPD so as not to go bare against property damage caused by its subs' defective construction. In its second pronouncement, Knutson, the court expressly stated that the BFPD did not clothe the insured-contractor, and that it went bare, notwithstanding. Minnesota contractors (at least those with the bargaining power to command it) faced the pronouncements of Bor-Son and Knutson in one of two ways. First, contractors and their insurers jointly agreed that, notwithstanding the cases, the insured-contractors were covered. Second, they inserted into their policies “anti-Borson/Knutson” endorsements that said the insured-contractor was covered—just as the BFPD intended. In Minnesota, it was the court of appeals, in 1996, which put to rest the question whether the BFPD coverages clothed the insured-contractor. In O'Shaughnessy v. Smuckler Corp., 543 N.W.2d 99 (Minn. Ct. App. 1996) (abrogated on other grounds by, Gordon v. Microsoft Corp., 645 N.W.2d 393, 2002-2 Trade Cas. (CCH) ¶ 73730 (Minn. 2002)), the court of appeals ruled unequivocally that the basic ISO CGL form since 1986 has provided coverage to insured-contractors for property damage caused by defective construction. Id. at 103–04.
Insurance Coverage for Defective Construction

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 second paragraph was added in 1986.
Excluded from the policy by the first paragraph is any damage to a general contractor’s work, which includes the work of its subcontractors as defined by the policy. The 1986 exception states, however, that the 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, the plain language of the exception provides that damage to “your work” is covered if the damage results from work performed by a subcontractor.19

The court of appeals stated bluntly that its ruling, based as it is upon the actual language of the new policy, “is contrary to both Bor-Son and Knutson . . .”20 Eight years later, the Minnesota Supreme Court confirmed the accuracy of the court of appeals’ O’Shaughnessy holding. Rejecting the insurer’s argument that Knutson and Borson controlled the coverage determination of a post-1986 CGL policy, the Minnesota Supreme Court reasoned:
[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.21

The Minnesota Supreme Court was not the only court to expressly reject its contrary prior precedent in coverage disputes involving post-1986 CGL policy forms. In U.S. Fire Ins. Co. v.

19O’Shaughnessy, 543 N.W.2d at 103–04. (Emphasis added.)
21Wanzek Const., Inc. v. Employers Ins. of Wausau, 679 N.W.2d 322, 327 (Minn. 2004).
J.S.U.B, Inc., 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. To the contrary, the court held that unexpected and unintended property damage to construction work 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. The Florida Supreme Court confirmed the applicability of the subcontractor exception to the “your work” exclusion, upholding coverage for the insured builder for property damage to homes caused by its subcontractor’s inadequate site preparation. As it should have, the court specifically rejected the applicability of Weedo v. Stone-E-Brick and similar cases (including LaMarche v. Shelby Mut. Ins., a prior Florida Supreme Court case) to the 1986 form policy before it, due to the difference in the policy language at issue in those cases. The Wisconsin and Tennessee Supreme Courts have likewise distinguished earlier case law interpreting pre-1986 policy forms, ruling that the current form expressly covers a general contractor against property damage claims arising out of its subcontractor’s defective construction work.

The common denominator of the reported decisions that reject as outcome-determinative the “business risk” doctrine and the old Henderson article, is the courts’ conscientious insistence that policy coverage disputes begin and end with the language of the policy. As between these two conflicting coverage criteria—the

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25 See e.g., Wanzek Const., Inc. v. Employers Ins. of Wausau, 679 N.W.2d 322 (Minn. 2004). See also Iberia Parish School Bd. v. Sandifer & Son Const. Co., Inc., 721 So. 2d 1021 (La. Ct. App. 3d Cir. 1998), where a court of appeals ruled that the general contractor was covered against property damage claims based upon its sub’s defective work. The court reasoned: “[t]he plain language of this exception to the exclusion renders the exclusion inapplicable when ‘the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.’” Id. at 1025. See also Green Const. Co. v. National Union Fire Ins. Co. of Pittsburgh, Pennsylvania, 771 F. Supp. 1000 (W.D. Mo. 1991), vacated, 975 F. Supp. 1365 (W.D. Mo. 1996) (opinion vacated after settlement); Maryland Casualty Co. v. Reeder, 221 Cal. App. 3d 961, 270 Cal. Rptr. 719 (4th Dist. 1990), opinion modified, (July 25, 1990); Fireguard Sprinkler Systems, Inc. v. Scottsdale Ins. Co., 864 F.2d 648 (9th Cir. 1988); and
"business risk" doctrine and the actual language of the policy—the latter should always control.

Considering the insurance market today, it is intellectual sleight-of-hand to use the “business risk” doctrine to invalidate coverages already contained within the CGL form. If the insurance industry wants to withdraw coverage for property damage caused by defective construction, it can write that coverage out of the CGL form. Until then, the insurance industry should base its declinations of coverage and its larger duty to defend on actual policy language. What’s more, because the insurance industry knows how to craft a written exclusion that can eliminate coverage from a policy, it is through that mechanism that the industry should accomplish such a goal, not strained constructions of the insuring language. On the off-chance that the same might be too much to expect of the insurance industry, a discussion of the insuring clause in the CGL, and the meaning of the term “occurrence,” follows in Section III.

III. The “Occurrence” Debate

CGL policies contain broad grants of insurance coverage for bodily injury and property damage claims caused by an “occurrence.” The original CGL policy form defined “occurrence” as an “accident.” The earlier forms became known as “accident” forms. In the context of that form, the industry restricted coverage to losses that were caused by some sudden and unexpected force. Insureds reacted negatively, insisting upon insurance for losses that arose gradually from continuous or repeated exposure to not-so-sudden conditions. The industry responded by removing the phrase “accidental” from the insuring clause. The result was the creation of the “occurrence” policy—which is what the insurance industry markets today. Ever since its introduction to the market place, it has been universally understood that the word “occurrence” broadens coverage for the actions or omissions of insureds.26

The CGL “occurrence” policy covers property damage and bodily injury claims that are caused by an occurrence. An occurrence is

property damage or bodily injury neither expected nor intended by the insured. Why doesn't the CGL cover these kinds of damages? Because, the loss, as a condition of coverage, must be fortuitous;\(^{27}\) such that the insured does not plan the result for which it seeks coverage.\(^{28}\) Here is a critical distinction: the CGL policy expressly states that it is the “property damage” for which the plaintiff seeks recovery that must not be expected or intended—\textit{not the construction activity that causes that property damage}.\(^{29}\)

Why highlight that distinction? Because the insurance industry continues to take a contrary coverage position in courts across the nation. Its current coverage position is as simple as this: If the “construction work” was erected as intended, then any property damage resulting from that work—even accidental property damage—must be considered expected or intended, and, therefore, not an occurrence.

The position is really nothing more than a re-hash of the “business risk” doctrine, whose success depends entirely on courts ignoring the actual language of the CGL policy. The facile, \textit{ipso facto} conclusion, that all claims of defective construction must by their nature be based on intended or expected acts, is contrary to common sense experience in the construction industry. In addition, the “it was expected” conclusion is incompatible with the post-1986 CGL policy forms that clearly and unequivocally cover property damage claims alleging defective construction. Still the insurers have been pushing the theory with some success.\(^{30}\)

What typifies the insurers’ position in this debate is how it personifies

\(^{27}\)It should be accidental, inadvertent, incidental, unexpected, unplanned, unpredimediated.


\(^{30}\)The Colorado Court of Appeals decision, in General Sec. Indem. Co. of Arizona v. Mountain States Mut. Cas. Co., 205 P.3d 529 (Colo. App. 2009) is one such case. The facts present a garden variety multi-housing defective work situation. A homeowners’ association sued the general contractor in contract, tort, and warranty, alleging a number of construction defects. In finding that no “occurrence” occurred, as required by the policy, the court reasoned:

\begin{quote}
Divisions of this court have previously defined “accident” in CGL policies as: “An unanticipated or unusual result flowing from a commonplace cause.” In addition, courts in Colorado and other jurisdictions have considered an accident to be a “fortu-
the insured-contractor as a pariah who does not deserve the

itous event.” . . . Whether defective workmanship can constitute an occurrence of purposes of both tort and breach of warranty claims is an issue of first impression in Colorado . . .. We conclude the better rule is that a claim for damages arising from poor workmanship, standing alone, does not allege an accident that constitutes a covered occurrence, regardless of the underlying legal theory pled . . .. Next, we address whether general allegations of faulty workmanship constitute an occurrence under the policies at issue here. There is a split among other jurisdictions whether a defective workmanship claim, standing alone, is an "occurrence" under CGL policies. A majority of those jurisdictions has held that claims of poor workmanship, standing alone, are not occurrences that trigger coverage under CGL policies similar to those at issue here . . .. In contrast, a minority of jurisdictions has held that the damage resulting from faulty workmanship is an accident, and thus, a covered occurrence so long as the insured did not intend the resulting damage. We are persuaded by the majority rule because it . . . relies on the necessary element of fortuity inherent in the ordinary meaning of the term "accident." Additionally, the Tenth Circuit and Colorado courts have found an "occurrence" only when additional, consequential property damages were alleged as a result of the faulty workmanship.

was not met include the following: Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co., 589 Pa. 317, 908 A.2d 888 (2006) (failure to construct coke oven battery property such that oven walls spalled, rod housings bowed, and ovens cracked paver bricks was not an accident and, therefore, was not an occurrence); French v. Assurance Co. of America, 448 F.3d 693 (4th Cir. 2006) (subcontractor's defective application of synthetic stucco system to exterior of home was not "accident," and thus was not an "occurrence"); OneBeacon Ins. v. Metro Ready-Mix, Inc., 427 F. Supp. 2d 574 (D. Md. 2006), aff'd, 242 Fed. Appx. 936 (4th Cir. 2007) (concrete manufacturer's provision of defective grout that was insufficient to support pile caps did not involve an accident within the policy definition of "occurrence"); Westfield Ins. Co. v. Coastal Group, Inc., 2006-Ohio-153, 2006 WL 120041 (Ohio Ct. App. 9th Dist. Lorain County 2006) (damages resulting from contractor's delay was not an "accident" and therefore did not arise from an "occurrence"); Viking Const. Management, Inc. v. Liberty Mut. Ins. Co., 358 Ill. App. 3d 34, 294 Ill. Dec. 478, 831 N.E.2d 1 (1st Dist. 2005) (collapse of wall under natural and ordinary circumstances did not constitute "occurrence" within the meaning of CGL policy); Century Sur. Co. v. Demolition & Development, Ltd., 2006 WL 163174 (N.D. Ill. 2006) (misidentifying building for demolition was not an occurrence). See also Liparoto Const., Inc. v. General Shale Brick, Inc., 284 Mich. App. 25, 772 N.W.2d 801 (2009) (discoloration of brick was not an "occurrence," for purposes of company's CGL policy); Greystone Const., Inc. v. National Fire & Marine Ins. Co., 649 F. Supp. 2d 1213 (D. Colo. 2009) (faulty workmanship to homes that was not caused by an occurrence since faulty workmanship caused damage only to the constructed homes themselves, without consequential damage to home buyer's personal property or property of third parties); Auto-Owners Ins. Co. v. State Farm Fire & Cas. Co., 297 Ga. App. 751, 678 S.E.2d 196 (2009), cert. denied, (Sept. 8, 2009) (contractor's defective workmanship does not constitute an occurrence and the insurer is not a guarantor of contractor's performance); Cincinnati Ins. Companies v. Collier Landholdings, LLC, 614 F. Supp. 2d 960 (W.D. Ark. 2009) (poor workmanship of subcontractor not an "occurrence" where water intrusion resulting from poor workmanship damaged non-defective portions of the project). Where the insured's behavior takes on a strong intentional flavor, even though the particular damages flowing from the behavior were not intended, a Missouri federal district court eliminated coverage based on the failure of an "occurrence." M.L.F. Investments, L.L.C. v. Quanta Specialty Lines Ins. Co., 2008 WL 4940999 (E.D. Mo. 2008). The insured was involved in the construction of a residential community. The development encroached on the utility's natural gas pipeline easement. The utility informed the insured that it did not approve of the construction because a road would encroach upon its easement. The insured, nevertheless, continued building the road while the utility sought a temporary restraining order. Road construction was rushed in order to finish before any order could be issued. During the course of the construction, a subcontractor damaged the utility's pipeline. While the subcontractor did not intend to damage the pipeline, the court found that the activities to rush the construction and to encroach upon the utility's easement were intentional, and therefore the "occurrence" element had not been met. For cases finding poor workmanship is not accidental, see Auto-Owners Ins. Co. v. Home Pride Companies, Inc., 268 Neb. 528, 684 N.W.2d 571 (2004) (faulty workmanship, standing alone, is not covered under a standard CGL policy); Oak Crest Const. Co. v. Austin Mut. Ins. Co., 329 Or. 620, 998 P.2d 1254 (2000) (no occurrence where insured sought cost of
protection of a common general liability policy. As a result, some of the reported decisions ruling in favor of the insurers are downright noxious. One such example is the Pennsylvania Superior Court’s opinion in Solcar.\(^{31}\) The court’s reasoning proves the power of the non sequitur:

Appellants erroneously contend that Solcar’s substandard performance, which contributed to massive property damage in the Regency Hill homes, makes this claim a covered one. We are not shocked that Solcar’s slipshod construction work caused the homes to be of little value. However, this was not an accident or occurrence, a prerequisite under the insurance contract for reimbursement, as negligent and nothing more. The insurance contract at issue is not a performance bond or any type of construction malpractice insurance.\(^{32}\)

So what?! Isn’t that exactly why people buy insurance policies? The surgeon who negligently leaves the sponge in the body is insured. The driver who foolishly turns left into traffic is insured. The product manufacturer who neglects to engineer a safety device in its finished product is insured. The grocer who negligently fails to sweep up the banana peel is insured. It is precisely because of this risk—that each of these insureds will fail to act in a reasonably prudent manner on occasion, and cause injury to others, or to property—that each buy liability insurance policies to answer claims alleging such negligence. Contractors are no different than these other insureds. They pay premiums for identi-
cal policy coverages and are legally entitled to the same coverage. To advocate that a negligent contractor is unworthy of coverage is nuttier than an Almond Joy.

A more difficult case is presented when the contractor should reasonably know that its construction work will fail and cause property damage. What if the contractor foresees, from the manner in which it performs its work, precisely the type of property damage that is later alleged in the complaint? In that case, since the damage is expected, there would be no occurrence triggering coverage under the policy. But what if that same property damage was foreseeable—yet not foreseen—by the insured? Most courts that have faced this question have refused to apply a “reasonable man” standard to resolve the issue. \(^{33}\)

In 1979, the United States Court of Appeals for the Eighth Circuit offered an alternative to the “purely subjective” standard.

in City of Carter Lake v. Aetna Cas. & Sur. Co. There the court was faced with a claim by an owner whose basement had flooded repeatedly due to sewage backup that was caused by the insured-contractor's defective work. Each time the owner complained about the problem, the contractor performed the same work, resulting in the same property damage. The Eighth Circuit ruled that the property damage was neither expected, nor intended by the insured contractor the first time. But once he figured out the nature of his work was the cause of the damage, the court ruled that the contractor would not be heard to contend that he was clueless about the same loss the second and third time. The court did not rule against the contractor on the theory that a reasonable person would have foreseen the loss. Instead, the court ruled that the nexus between the defective construction work and the actual property damage must be so obvious as to be “substantially probable.” Then and only then would the court bar coverage on the basis that it was not an occurrence. Rejecting the contention that “any negligent construction” fails the occurrence test, the court stated that such a standard would render the insurance company nothing “more than that of premium receiver.”

The Eighth Circuit’s approach to the issue picked up a label over the years; it is called the “objective analysis.” The analysis has been criticized by commentators as largely anachronistic and out of touch with the actual language of today’s CGL policies. For example:

The so-called “objective” analysis of “occurrence” threatens to destroy the meaning of the carefully crafted policy exclusions to the detriment of the policy holder because it assumes, incorrectly, that the current CGL policy is not intended to provide any property damage coverage for damage to the construction project itself. Worse, this incorrect assumption appears to be based on decisions that address policies that included the out-of-date and now largely non-existent broad policy exclusions that were contained in the 1973 policy form. As such, this analysis threatens to perpetuate as substantive law a legal rule that would limit the scope of the modern-day liability insurance policy to that which existed under the extremely broad policy exclusions found in the 1973 policy form. This judicially imposed “objective” interpretation of the term “occurrence” is nonsensical. The history and development of the liability insurance policy demonstrate that the intent of the parties changed dramatically over the past twenty-five years to provide

35Id. at 1058.
36Id.
broader insurance coverage to construction industry policy holders by narrowing policy exclusions and including specific exceptions like those contained in the 1986 CGL policy form.

It is perfectly appropriate to observe, as many courts have, that there is a difference between the consequence of a contractor not performing well (which is part of every business venture and ordinarily not insurable) and the risk that is inherent in a contractor’s line of work for injury to people or damage to property that are caused by faulty workmanship (which could expose the contractor to almost limitless liability and generally is deemed to be insurable). It is not appropriate, however, to apply this well reasoned analysis to arrive at result-oriented conclusions based on a mistaken analysis of the term “occurrence.” The same result will be achieved in the appropriate case through proper reference to the policy exclusions, which are specifically designed to define the scope of the coverage that is afforded for property damage caused by inadvertent construction defects.37

Consider the consequence of the insurers’ position. If the CGL does not cover intentional acts undertaken in connection with constructing a building that inadvertently produce defects in the construction and resultant property damage, then property damage coverage under the CGL is meaningless.38 There is a consistent notion expressed in the cases rejecting rote application of the “business risk” doctrine; that resultant property damage, not intended by the insured, but instead a consequence of unintended flaws in the design or performance of the work, constitutes an “occurrence” in the CGL.

Courts that look beyond the “idea” of the “business risk” doctrine demand more from the insurers who are behind the “occurrence debate.” Demanding a more intellectually honest analysis, the United States Court of Appeals for the Sixth Circuit ruled:

The fact that the claims here involved breach of warranty or negligence did not remove them from the category of accident. Bundy would not be legally obligated to pay a claim arising out of an accident occurring without its negligence or breach of warranty. If the liability policy were construed so as to cover only accidents not involving breach of warranty or negligence, then no protection would be given to the insured. The insured would not need liability insurance which did not cover the only claims for which it could be held liable. The word “accident” is common in most liability policies

38 Id. See also Yakima Cement Products Co. v. Great American Ins. Co., 93 Wash. 2d 210, 608 P.2d 254 (1980) (en banc).
and should not be construed in this type of case as not including claims involving negligence or breach of warranty.  

In Vandenberg v. Superior Court, the California Supreme Court ruled likewise. There, a property owner was sued by its tenants for allegedly contaminating the soil and groundwater of the leased premises. The theories of recovery against the tenant included “breach of contract” and “breach of the covenant of good faith and fair dealing.” The insurer declined coverage on the basis that the underlying claim constituted a “contractual risk” that is excluded by the “business risk” exclusions in the subject liability policy. The California Supreme Court disagreed, reasoning that coverage for property damage losses is not necessarily precluded simply because the claim is pleaded as a contractual loss. The court insisted, to the contrary, that it is the nature of the risk causing the loss that controls the issue of coverage.  

In Yakima Cement Prods. Co. v. Great American Ins. Co., the insured manufactured precast concrete panels. It manufactured some defective panels that were incorporated into the project. The defective panels damaged certain roofing components. The damage to the roof resulted in prolonged exposure to the weather and more property damage. The project owner sued Yakima, who tendered the suit to its insurer. The insurer declined to cover the suit, asserting, inter alia, the allegations in the complaint did not constitute an “occurrence.” It based its coverage determination on the fact that the defective panels were produced deliberately, not accidentally. In the ensuing coverage dispute the Washington Supreme Court rejected the insurer’s position, reasoning that the insurer:

improperly focused on the volitional and intentional nature of Yakima’s manufacturing operation which produced the defective concrete panels . . .. We deal here with an accident within the context of a products liability policy. In the area of products liability, if insurance coverage does not extend to the deliberate manufacture of a product which inadvertently is mis-manufactured, and thereafter results in property damage, the coverage would be rendered virtually meaningless.

The appropriate definition of “accident”, as a source and cause of

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41 Id. at 382.
damage to property, is “an unexpected, unforeseen, or undesigned happening or consequence from either a known or an unknown cause”. Applying this definition, it is clear Yakima’s unintentional and unexpected mis-manufacture of the concrete panels is an “accident” as contemplated by the [insurer’s] policy.

In High Country Associates, a homeowner’s association sued a contractor for breach of warranty and negligence. The association alleged that the contractor’s defective construction allowed moisture to penetrate through the exterior envelope of its buildings, causing the drywall interior walls to rot. The water penetration also compromised the structural integrity of the buildings. The contractor’s insurer declined to cover the loss, claiming that the allegations did not constitute an occurrence. The trial court granted the insurer summary judgment. The New Hampshire Supreme Court reversed, adopting an analytical model that makes the coverage determination dependent on the language of

Id. at 257 (citations omitted)(emphasis added). The Washington Supreme Court noted also that the term “accident” was subsumed within the broader expression “occurrence.”

[T]he word “occurrence”, to the lay mind, as well as to the judicial mind, has a meaning much broader than the word “accident”. As these words are generally understood, accident means something that must have come about or happened in a certain way, while occurrence means that something that happened or came about in any way. Thus accident is a special type of occurrence, but occurrence goes beyond such special confines and, while including accident, it encompasses many other situations as well. It would, therefore, seem that from the usual and ordinary meaning of the words used the word “occurrence” extends to events included within the terms “accident” and also to such conditions, not caused by accident, which may produce an injury not purposely or deliberately.

Id. The supreme court ultimately upheld the insurer’s declination on the basis that the damages alleged in the complaint did not arise from the mis-fabrication of the panels. The court demanded a nexus between the allegation of defective construction and the resultant property damage.


The trial court was persuaded to grant the insurer’s summary judgment on the basis of two New Hampshire Supreme Court opinions that resolved the “occurrence” issue by applying the “business risk” doctrine. In Hull v. Berkshire Mut. Ins. Co., 121 N.H. 230, 427 A.2d 523 (1981) (Mem.), a masonry contractor was sued for allegedly defective construction. Without discussion, the court concluded that the claimant did not allege property damage to the subject building that was caused by an accident, but instead alleged “money damages for [the contractor’s] defective work.” Id. at 524. In McAllister v. Peerless Ins. Co., 124 N.H. 676, 474 A.2d 1033 (1984), the supreme court ruled that a contractor was not insured for claims alleging defective construction as a result of the “work performed” and “product itself” exclusions. The court also reasoned that “[t]he fortuity implied by reference to accident or exposure is not what is commonly meant by a failure of workmanship.” Id. at 1036. The court stated bluntly that “defective work, standing alone, [does] not result from an occurrence, and
the insurance policy, not the “business risk” doctrine. The court interpreted the policy language using the plain and ordinary meaning of the policy’s words. The court cautioned against a “casual” reading of the policy, insisting instead that the coverage determination must consider the policy as a whole, and must correspond to the insured’s reasonable construction of all of the policy language.\footnote{Id. at 476.} The court concluded that the actual policy language expressed an intent to cover “circumstances, not necessarily . . . sudden and identifiable event[s], that were unexpected or unintended from the standpoint of the insured.”\footnote{Id. at 478 (emphasis added).} The court ruled that the “circumstance” of unintended defective construction that ultimately caused water seepage and resultant property damage to the condominium buildings must be considered accidental, and therefore an “occurrence” under the 1986 CGL policy form. The court held: “The damage alleged by the Association in the underlying suit was unexpected from the standpoint of [the insured] and was caused by continuing exposure to moisture seeping through the walls of the units. The allegations of damage fit within our interpretation of ‘accident’ and the definition of ‘occurrence’ in the policy.”\footnote{Id.}

In Prisco Serena Sturm Architects, Ltd. v. Liberty Mut. Ins. Co.,\footnote{Prisco Serena Sturm Architects, Ltd. v. Liberty Mut. Ins. Co., 126 F.3d 886 (7th Cir. 1997).} the United States Court of Appeals for the Seventh Circuit rejected the insurer’s contention that defective construction can never constitute an occurrence. The insured in that case was an architectural firm that was sued for property damage to a construction project caused by defective construction. The claims against the architect were based on the following allegations: (1) that it failed to guard against construction defects; (2) that it improperly approved pay applications for defective work; and (3) that it failed to properly advise the owner of the true nature of the construction work. The architect submitted the claim to its CGL carrier who declined the tender. The insurer relied on several Illinois state court decisions that were based on the Henderson and Weedo model of analysis. The Seventh Circuit analyzed the state court decisions and rejected them as inap-
posite to the issue of “occurrence,” which is determined by the language of the policy, not the “business risk” doctrine.

The court of appeals ruled that the Illinois decisional law all related to cases involving contractors who self-performed the defective work that was the subject of the lawsuits. Since the architect performed none of the actual construction work complained of, all of the traditional “business risk” exclusions were inapplicable. It cited Posing v. Merit Ins. Co.\(^\text{50}\) as controlling the applicability of the traditional “business risk” model to architects, whose services it likened more to inspectors than constructors. In Posing, the court held that the “business risk” doctrine did not bar CGL coverage for a termite inspector who negligently performed that service. Relying on Posing, the Seventh Circuit reasoned:

We agree with PSSA that the fact that it was not the party actually performing the construction work distinguishes this case from those on which Liberty relies. Insofar as the complaint was concerned, PSSA’s role was that of inspector and certifier. Its negligence in performing that role prevented the School from discovering the faulty construction work, just as the termite inspector in Posing prevented his clients from detecting the presence of the termites. The complaint governs our consideration here. It does not allege that PSSA intentionally overlooked [the contractor’s] shortcomings or that it expected to miss them or to certify payments that were not due . . . . [T]herefore, we conclude that the complaint here alleged an “occurrence” within the meaning of the Liberty policy.\(^\text{51}\)

Minnesota has staked out a position that is more insured-friendly than the “objective” standard, but less insured-friendly than the “purely subjective” standard. In Ohio Casualty Ins. Co. v. Terrace Enterprises,\(^\text{52}\) the Minnesota Supreme Court ruled that it is the actual property damage that must be expected or intended in order for the insurer to deny coverage on the basis that there is no occurrence. There, a general contractor excavated


\(^{51}\)Prisco, 126 F.3d at 891. The application of this reasoning to a CM’s services should not be overlooked. The Seventh Circuit’s analysis of the “occurrence” issue was not, however, outcome-determinative of the coverage dispute. It ultimately ruled that the architect there had no coverage under its CGL policy as a result of the “professional services” exclusion. That exclusion provided that “insurance with respect to . . . architects . . . does not apply to . . . ‘property damage’ . . . arising out of the rendering of or the failure to render any professional services by or for you, including: . . . (b) supervisory, inspection or engineering services.” Id. at 892.

the footprint and footings for a large apartment complex. During the excavation effort, its own testing engineer determined that the subsurface soil was frozen, and could not be properly compacted to adequately support the weight of the building. The testing engineer advised the general contractor to stop work, protect the soil, and wait until the soil conditions conformed to the requirements of the contract documents. The general rejected the testing engineer's instructions. The general used the soil, attempting to compact it, and then poured the footings and the slab, and constructed the building. Later, the soil thawed and settled, just as the testing engineer said it would. The building foundation failed and the entire structure threatened to collapse. The general contractor was required to remediate its faulty work-jack the building on temporary support beams; remove the failed foundation soil and replace it; re-position the building and correct damage to the structure that resulted from the remediation.

The owner sued the general contractor because the effort resulted in the owner's loss of use and profits during the remediation effort. The general contractor tendered the defense to its CGL carrier, who refused the tender on the basis that the property damage was not caused by an “occurrence.” The supreme court, affirming the trial court, rejected the insurer’s contention, reasoning:

[The general contractor] was aware, from its own knowledge and the soil report, of the dangers of freezing conditions. The company took precautions that failed to adequately protect the soil and concrete. Such conduct was perhaps negligent, but not reckless or intentional. Hence, the settling of the building was an “occurrence” within the terms of the policy.  

Explaining its holding, the Minnesota Supreme Court stated: “If property damage occurs because of mistake or carelessness on the part of the contractor or his employees, he reasonably expects that damage to be covered.”

In O'Shaughnessy v. Smuckler Corp., the Minnesota Court of Appeals applied the Terrace Enterprises rule in a case against an insured whose allegedly defective work caused property damage.

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53 Id. at 452–53.
54 Id. at 452 (emphasis added), citing Bituminous Cas. Corp. v. Bartlett, 307 Minn. 72, 240 N.W.2d 310, 313 (1976). The rule in Terrace Enterprises and Bartlett has been the controlling principle of law in Minnesota for over twenty-five years.
55 O'Shaughnessy v. Smuckler Corp., 543 N.W.2d 99 (Minn. Ct. App. 1996) (abrogated on other grounds by, Gordon v. Microsoft Corp., 645 N.W.2d 393, 2002-2 Trade Cas. (CCH) ¶ 73730 (Minn. 2002)).
Rejecting the insurer’s argument that it is the “work” that must be intended, not the resulting property damage, the court reasoned:

The above example involved damages caused by defective workmanship. General Casualty appears to distinguish damage as a result of defective workmanship from “accidental” damage. We see no reason, however, to treat defective wiring that causes a fire any differently from defective structural supports which cause collapsing of portions of a floor and cracking in both the floors and walls of a house. The damage in both cases is real and substantial as well as being the accidental result of defective workmanship.56

Most recently, the decisional law nationwide has been trending in favor of insureds, finding that inadvertent property damage caused by intended construction activity constitutes an “occurrence.”57

56 Id. at 105 (emphasis added). The O'Shaughnessy case explained that any contrary reasoning based upon the rulings in Bor-Son Bldg. Corp. v. Employers Commercial Union Ins. Co. of America, 323 N.W.2d 58 (Minn. 1982); and Knutson Const. Co. v. St. Paul Fire and Marine Ins. Co., 396 N.W.2d 229 (Minn. 1986) was the result of policy language in ISO policies prior to the 1986 modifications of the CGL form. The Minnesota rule does not fall neatly into either the “subjective” model, or the “objective” model. Nonetheless, a fair reading of the rule in Terrace Enterprises compels the conclusion that before an insurer may decline coverage on the basis that the claim is not an occurrence, it must have fairly determined that the property damage that is the subject of the lawsuit must have been intended or expected by the insured, or at the very least caused by conduct that was so “reckless” as to compel the conclusion that the property damage was likely to occur.

dumped debris on Love’s property, but that act too had unforeseen and unintended consequences due to the insured’s negligence in failing to secure a valid agreement from the property’s owner. We thus agree with the trial court that, as a matter of law, the act falls within the definition of ‘occurrence.’”); Rando v. Top Notch Properties, L.L.C., 879 So. 2d 821 (La. Ct. App. 4th Cir. 2004) (after a thorough review of competing case law, court concludes that allegations of damage due to negligent pile driving and HVAC problems were “occurrences”); American Family Mut. Ins. Co. v. American Girl, Inc., 2004 WI 2, 268 Wis. 2d 16, 675 N.W.2d 65 (2004) (damage due to harmful settlement of the soil underneath building was an “occurrence”); SawHorse, Inc. v. Southern Guar. Ins. Co. of Georgia, 269 Ga. App. 493, 604 S.E.2d 541, 546 (2004) (“Southern Guaranty has cited no Georgia authority supporting its apparent claim that faulty workmanship cannot constitute an ‘occurrence’ under a general commercial liability policy. And this claim runs counter to case law finding that policies with similar ‘occurrence’ language provide coverage for ‘the risk that . . . defective or faulty workmanship will cause injury to people or damage to other property.’ Furthermore, Southern Guaranty has pointed to no evidence that SawHorse intended for the faulty workmanship to occur. Under these circumstances, Southern Guaranty is not entitled to summary judgment based on the ‘occurrence’ language in the policy.”); 1325 North Van Buren, LLC v. T-3 Group, Ltd., 284 Wis. 2d 387, 2005 WI App 121, 701 N.W.2d 13 (Ct. App. 2005), decision aff’d in part, rev’d in part on other grounds, 2006 WI 94, 293 Wis. 2d 410, 716 N.W.2d 822 (2006) (CM-at-risk failures that result in property damage and delays were an occurrence); Broadmoor Anderson v. National Union Fire Ins. Co. of Louisiana, 912 So. 2d 400 (La. Ct. App. 2d Cir. 2005), writ denied, 925 So. 2d 1239 (La. 2006) (defective ceramic tile and stone work resulting in water infiltration constituted an “occurrence”); Mid-Continent Cas. Co. v. Camaley Energy Co., 364 F. Supp. 2d 600 (N.D. Tex. 2005) (insured’s failure to properly evaluate location of well bore was an “occurrence”); State Farm Fire and Cas. Co. v. McGowan, 421 F.3d 433, 2005 FED App. 0374P (6th Cir. 2005) (failure to adequately inspect tree which subsequently fell and caused injury was an occurrence) (applying Tennessee law); Standard Const. Co., Inc. v. Maryland Cas. Co., 359 F.3d 846, 851, 2004 FED App. 0068P (6th Cir. 2004) (holding that an insured’s negligence was an occurrence under an insurance policy because it was unintended and unforeseen) (applying Tennessee law); Westfield Ins. Co. v. Tech Dry, Inc., 336 F.3d 503, 510, 20 I.E.R. Cas. (BNA) 291, 2003 FED App. 0230P (6th Cir. 2003) (holding that an employer’s negligence in hiring and retaining an employee who caused customer’s death was an accident, and thus an occurrence under the employer’s insurance policy) (applying Kentucky law); Lennar Corp. v. Great American Ins. Co., 200 S.W.3d 651 (Tex. App. Houston 14th Dist. 2006) (suit to recover costs paid to repair water damage and replace defective exterior insulation and finish systems on hundreds of homes built in the Houston area in the late 1990s alleged an occurrence); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 33 Kan. App. 2d 504, 104 P.3d 997 (2005), judgment aff’d, 281 Kan. 844, 137 P.3d 486 (2006) (damage that occurs over time as a result of defective materials or workmanship in the construction of a home and leads to structural is an “occurrence”); Mid-Continent Cas. Co. v. JHP Development, Inc., 2005 WL 1123759 (W.D. Tex. 2005), judgment aff’d, 557 F.3d 207 (5th Cir. 2009) (faulty workmanship allegations against contractor in the construction of five condominiums that resulted in water leakage was an occurrence). Recent cases finding poor workmanship consti—
tutes an occurrence include: Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 281 Kan. 844, 137 P.3d 486 (2006) (homeowners’ claim for property damage from window leaks against general contractor constituted an “occurrence” as there is nothing in the basic coverage language of the CGL policy to support any definitive tort/contract line of demarcation for purposes of determining coverage); Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co., 292 S.W.3d 48 (Tex. App. Houston 14th Dist. 2006), judgment aff’d in part, rev’d in part on other grounds, 279 S.W.3d 650 (Tex. 2009) (property damage caused by defective construction may constitute an “occurrence” if it is inadvertent and results in damage to the insured’s own work, the result of which is unintended and unexpected); National Union Fire Ins. Co. of Pittsburgh, P.A. v. Puget Plastics Corp., 450 F. Supp. 2d 682 (S.D. Tex. 2006), aff’d, 532 F.3d 398 (5th Cir. 2008) (jury’s finding of fraud in connection with Deceptive Trade Practice Act violations did not allow court to conclude that all violations were intentional without knowing what specific conduct formed the basis for the fraud and, therefore, insured’s actions relating to defective product which caused damage to property of third parties was arguably an occurrence); Lennar Corp. v. Great American Ins. Co., 200 S.W.3d 651 (Tex. App. Houston 14th Dist. 2006) (homebuilder’s negligent construction of homes using defective exterior insulation and finish system constituted an “occurrence” within scope of CGL and commercial umbrella liability policies); Glendenning’s Limestone & Ready-Mix Co., Inc. v. Reimer, 295 Wis. 2d 556, 2006 WI App 161, 721 N.W.2d 704 ( Ct. App. 2006) (concluding, after a detailed discussion, that “occurrence” is not equivalent to faulty workmanship, but rather faulty workmanship may result in an “occurrence” and, in this case, where pleading alleges that the rubber mats that subcontractor improperly installed were damaged by a scraper that cleans manure from them is a claim for property damage caused by an occurrence in that the damage was not intended or anticipated and that it was also not intended or anticipated that using the scraper to clean the manure off the mats would damage the mats); ACUITY v. Burd & Smith Const., Inc., 2006 ND 187, 721 N.W.2d 33, 39–40 (N.D. 2006) (“We agree with the rationale of those courts holding that faulty workmanship causing damage to property other than the work product is an accidental occurrence for purposes of the CGL policy . . . . Here, the Cailliers alleged damage to the interior of the apartment building. We conclude that claim is the type of risk covered by a CGL policy and constitutes an ‘occurrence’ under ACUITY’s policy.”); Durbow v. Mike Cheek Builders, Inc., 442 F. Supp. 2d 676 (E.D. Wis. 2006) (property damage to house caused by moisture seepage due to faulty work constituted an “occurrence”); Great American Ins. Co. v. Woodside Homes Corp., 448 F. Supp. 2d 1275 (D. Utah 2006) (under Utah law, subcontractor’s faulty work causing cracks in building foundation, basement floor, and driveway involved an occurrence such that breach of warranty claim and breach of contract claim were potentially covered); North American Treatment Systems, Inc. v. Scottsdale Ins. Co., 943 So. 2d 429 (La. Ct. App. 1st Cir. 2006), writ denied, 949 So. 2d 423 (La. 2007) and writ denied, 949 So. 2d 424 (La. 2007) (claims of negligent work resulting in a collapse at a wastewater treatment plant clearly claimed damages by reason of an “occurrence”); Tri-S Corp. v. Western World Ins. Co., 110 Haw. 473, 135 P.3d 82 (2006) (although complaint alleged that insured executive officer caused injury to employee by failing to provide safe workplace, such allegation did not mean that the injury was not caused by an “occurrence,” as willful misconduct does not require a specific intent and so is a form of negligence). See also Wausau
IV. The Nature of the Damage Debate

The broad grant of coverage in the CGL’s insuring language expressly extends to claims alleging “property damage.” Delineating just what is meant by “property damage” wouldn’t be any more complicated than a childhood chemistry set if it weren’t for the artful deceit that the “business risk” doctrine has imbued into those two simple words. If courts spent less time trying to reconcile the idea of the “business risk” doctrine with the plain meaning of the words in the policy, the construction industry would see great advancement toward restoring predictability to the purchasers and providers of construction services.

A Little History About “Property Damage” in the CGL

Before 1966, the CGL policy, by its terms, covered property damage claims, although the policy form did not define the phrase “property damage.” In the 1966 form, the industry first sought to define the phrase. With that definition, the insurance industry sought to eliminate coverage for the type of property damage that had emerged as the recognized legal measure of damages caused by defective construction: diminution in value. While other courts had also recognized diminution in value as a proper measure of property damage for defective construction claims, the case that had come to emblematize the problem to the insurance industry was Hauenstein v. St. Paul-Mercury Indemnity Co. Construing a pre-1966 CGL form, the Minnesota Supreme Court concluded that the CGL form covered diminution in value damages. The insured in Hauenstein supplied defective plaster to a construction project. After the plaster had been applied to walls and ceilings in the project, the defective plaster shrank and cracked. The failure caused the owner to insist that the general contractor remEDIATE the damaged building by removing and re-plastering the damaged walls and ceilings. The general contractor sought the cost of repair from the insured supplier, who in turn tendered the claim to its CGL carrier. The insurer declined the tender on


The pre-1966 CGL forms provided coverage for injury to or destruction of property. Courts observed that the generic term property, without additional modifiers, could reasonably be construed to include obligations, rights and other intangibles. Labberton v. General Cas. Co. of America, 53 Wash. 2d 180, 332 P.2d 250, 254 (1958) (quoting Citizens State Bank of Barstow, Tex v. Vidal, 1941-1 C.B. 289, 114 F.2d 380, 382–83, 40–2 U.S. Tax Cas. (CCH) P 9603, 25 A.F.T.R. (P-H) P 643 (C.C.A. 10th Cir. 1940)).

the basis that the cost to remove and replace the insured’s defective work or product was not the kind of property damage covered by the CGL. The insured commenced a declaratory judgment action to establish coverage under the policy. The Hauenstein court rejected the insurer’s argument, reasoning that the actual injury was to the value of the building itself; that the value of the building was diminished as a consequence of its defective walls and ceilings. The court ruled that diminution in value could be measured by the diminished value of the property, or the cost to repair the defective component—whichever is less.

In 1966, the insurance industry determined that the way to “write-away” diminution in value damages in the CGL was to define the phrase “property damage” to mean “injury to or destruction of tangible property.” The industry’s objective to eliminate diminution in value damages, however, was largely unrealized by the change in the policy form. For example, in Western Casualty & Surety Co. v. Polar Panel Co., the United States Court of Appeals for the Eighth Circuit ruled that an insured supplier and installer of defective wall panels was covered for the cost of removing and replacing them. The insured contractor installed non-conforming insulating panels into the interior wall system of a refrigeration warehouse. The panels consisted of laminated sheets of aluminum affixed to sheets of fire retardant plywood. The constructed walls were essentially monolithic slabs of insulation about four inches thick and filled with a liquid urethane foam. The wall panels were installed throughout the cooling and freezer rooms in the warehouse. Unfortunately, the fire retardant material in the wall forms initiated a chemical reaction with the exterior face of the aluminum panels. In time the

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60 The court actually rejected multiple arguments raised by the carrier, including whether the supplying of defective materials constituted an accident (n/k/a occurrence), an argument that fifty years later continues off and on to find a footing in the national geography of the decisional law on this subject. See generally 4 Bruner & O’Connor on Construction Law at § 11:28 at pp. 80–89 (West 2002).

61 Hauenstein, 65 N.W.2d at 125.


63 See e.g., Hartford Acc. & Indem. Co. v. Pacific Mut. Life Ins. Co., 861 F.2d 250 (10th Cir. 1988), where the court observed that “[c]ourts and commentators generally agree that this definition of property damage . . . is broad enough to include diminution in value.” Id. at 253. See generally 4 Bruner & O’Connor on Construction Law at § 11:49 at pp. 166–67.

aluminum panels began to blister.\textsuperscript{65} Though the panels otherwise performed as intended, the court reasoned: “[i]t was apparent that the panels were defective for the purpose intended and caused a diminution in the value of the completed building.”\textsuperscript{66} The court rejected the notion that because the physical damage was contained within the insured’s own work, it did not constitute “property damage” as that phrase is defined in the policy. The court applied the Hauenstein rule to the newly-written policy language.\textsuperscript{67}

In 1973, the insurance industry introduced a new policy form and a new definition of “property damage.” The most significant addition was inserting the term “physical” as a modifier to the term “injury.” This addition has been maintained in each subsequent policy form for the last thirty-seven years.\textsuperscript{68} For the most part, the change successfully eliminated coverage for the majority of diminution of value claims.\textsuperscript{69} However, diminution in value is still a covered loss under the CGL when it is a measure-

\textsuperscript{65}The insured contractor resolved the dispute with the owner by agreeing to remediate the blistered panels. The remediation consisted of masking the unsightly blisters, not replacing all the panels. The cost to remediate was $21,000.

\textsuperscript{66}Polar Panel Co., 457 F.2d at 959.

\textsuperscript{67}Id. at 960–61. The court reasoned: “[T]he appearance of the building was affected, and the unsightly appearance of the blistered panels caused a substantial diminution in the value of the building. The building owner had a right to have this defect in the panels corrected or adjusted by [the insured].” Polar Panel Co., 457 F.2d at 960 (8th Cir. 1972). Other cases similarly construing the 1966 policy language include Continental Cas. Co. v. Gilbane Bldg. Co., 391 Mass. 143, 461 N.E.2d 209 (1984); Aetna Cas. & Sur. Co. v. PPG Industries, Inc., 554 F. Supp. 290 (D. Ariz. 1983); Sola Basic Industries, Inc. v. U. S. Fidelity & Guaranty Co., 90 Wis. 2d 641, 280 N.W.2d 211 (1979).

\textsuperscript{68}In the 1973 CGL form, property damage means: (1) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom, or (2) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period. Wielinski, The Construction Defect Case: Exclusions Redux: Construction Defect Insurance Coverage in 2009 at p. 77 (ABA Forum on the Construction Industry January 2009).

ment of injury caused as a consequence of “physical injury to tangible property.”

Currently, “property damage” in the CGL 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 occurrence that caused it; or

b. Loss of use of tangible property that is not physically injured. All such loss shall be deemed to occur at the time of the occurrence that caused it.

The battlefields of property damage coverage disputes involving defective construction can all be traced back to one of these two categories: (a) physical injury to tangible property; and (b) loss of use of tangible property that is not physically injured.

**Physical Injury to Tangible Property**

Two recurring issues that frequently arise in the context of property damage coverage disputes involving defective construction relate to: (1) defective work that is incorporated into the work or products of others; and (2) defective work that causes economic injury.

**The Incorporation Cases**

In the construction business, a contractor’s work is frequently incorporated into the work or products of others. The phenomenon is so common that questions regarding injury caused by the incorporation of defective work into others’ work or products predominate the coverage litigation landscape. Different rules control the coverage issue, depending in large part upon the nature and extent of the physical injury caused by the incorporation of the defect.

The general rule is that where a defective product manufactured or installed by an insured has been integrated into another party’s property, damage to that property as a whole, excluding the cost of repairing or replacing the defective part, constitutes property damage. The general rule provides property damage coverage to a general contractor whose construction project has been injured by a subcontractor’s incorporation of defective work or products into the Work of the general contractor. If the incorporation of the defect does not diminish the value of the building, most courts will insist that the incorporated defect cause a physical injury to the building in order for the CGL to cover the

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loss, excluding the cost to replace or repair the defect itself.\textsuperscript{71} For example, in W.E. O’Neil Construction,\textsuperscript{72} the court reasoned:

[T]he courts “have consistently differentiated between damage to the product of the insured, and damage to other property caused by that product.” . . . Physical damage to other property, however, constitutes “property damage.”\textsuperscript{73}

Applying cases involving the incorporation of the defective product into a larger part of the same product, this court extended the rule arising from them to the general contractor whose “whole” project is injured as a consequence of the defective work of one of its subcontractors. In this case, the general contractor contracted to construct two apartment towers, several adjoining town homes and a four level concrete parking structure. The general subcontracted the work of the job to multiple trade contractors. The parking structure’s poured concrete floors were strengthened with steel re-bar. Unfortunately, the subcontractor who installed the re-bar failed to perform this work properly. As a consequence, the floors cracked over time and leaked. The concrete was not defective, but the steel mesh imbedded throughout the concrete was defective. Ruling that the physical injury to the concrete constituted property damage, the court denied the insurer’s motion to dismiss and concluded that the general contractor’s CGL provided coverage for the claim.\textsuperscript{74}


\textsuperscript{73}Id. at 991 (citations omitted). The court continued: “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, excluding the cost of repairing or replacing the defective part, constitutes property damage.” Id. at 991 (N.D. Ill. 1989).

\textsuperscript{74}Id. at 991–92. See also Southwest Metalsmiths, Inc. v. Lumbermens Mut. Cas. Co., 85 Fed. Appx. 552 (9th Cir. 2004), withdrawn pursuant to settlement,
In Summit Custom Homes, Inc. v. Great Am. Lloyds Ins. Co., a Texas court evaluated a very typical construction defect. Summit Homes built a custom home for Stephen and Helen Lazarus in 1996. The homeowners claimed that defects in the exterior insulating and finishing system (EIFS) caused extensive damage. The court found these allegations sufficient to state a claim of “property damage”.

We begin by determining whether the Lazaruses’ pleadings against Summit alleged property damage. “Property damage” is defined in the Great American policy as “physical injury to tangible property, including all resulting loss of use of that property.” Physical injury is not defined; however, the plain meaning connotes an alteration in appearance, shape, color, or in other material dimension. Although the underlying pleadings do not explicitly describe the damage to the Lazaruses’ home, they repeatedly state that the home sustained “extensive damage and additional damage is likely to occur.” They further pleaded that use of EIFS causes damage within the wall cavity that is not readily apparent to one examining the exterior of the EIFS surface and that long term water penetration results in rot damage to the wooden structural elements of the house. Therefore, assuming the facts alleged are true, the Lazaruses have sufficient pleaded physical injury to tangible property resulting in “property damage.”

76 Summit Custom Homes, Inc., 202 S.W.3d at 828–29. See also Lennar Corp. v. Great American Ins. Co., 200 S.W.3d 651, 679–80 (Tex. App. Houston 14th Dist. 2006) (“[C]ourt acknowledged that there was physical injury to the project including cracked walls, blocks, joints, floor slabs, and lintels. The costs to repair these problems unquestionably constituted covered “property damage.” There were other problems which had not resulted in “property damage” but would likely have caused damage in the future. For instance, most of the walls had discontinuous rebar which rendered them susceptible to cracking in the future. The Court believed that Fidelity made a good business decision to demolish and rebuild the project due to the potential for extensive damage in the future. However, the Court was not persuaded that such a decision would have been necessary only to repair the physically injured property that currently existed. The Court held that the proper measure of damages was the amount it would have cost to repair the physically injured property. Therefore, Fidelity’s total damages had to be apportioned between its consequential costs to repair physically injured property and its costs to prevent future damage. The court reasoned: “we cannot conclude that it was necessary for Lennar to remove and replace all the EIFS in order to repair the water damage, if any, to each home.

92 Fed. Appx. 567 (9th Cir. 2004) (delamination of paint on column covers installed by subcontractor was “property damage”).
When the insured contractor's defective work does not cause physical injury to other work, some courts will refuse to find coverage, reasoning that the claim does not involve "property damage." In F & H Constr. v. ITT Hartford Ins. Co. of the Midwest, a California appellate court ruled that welding inadequate pile caps on steel composite piles did not constitute property damage. The court reasoned:

[T]he prevailing view is that the incorporation of a defective component or product into a larger structure does not constitute property damage unless and until the defective component causes physical injury to tangible property in at least some other part of the system . . .. Under these cases, property damage is not established by the mere failure of a defective product to perform as intended. Nor is it established by economic losses such as the diminution in value of the structure or the cost to repair a defective product or structure . . .. It is undisputed the grade A-36 pile caps were an inferior product and not in compliance with the contract's design specifications. However, welding the caps to the driven piles did not damage the piles or any other property; it merely rendered the piles inadequate for their intended purpose, and as noted, commercial risk is not covered by liability insurance. Moreover, F & H was able to modify the grade A-36 caps and use them along with the original piles to create an adequate structural unit that met the contractual requirements. Once modified, the caps served their intended purpose, further supporting the inference that the caps did not damage the piles or any other component of the piles.

Although F & H argues that removal of the welded caps would have damaged the piles, that fact has no bearing on the question whether there was physical injury. The undisputed evidence establishes that the piles were not removed and did not have to be removed to be adequately modified.78

Therefore, the costs incurred by Lennar to remove and replace EIFS as a preventative measure are not 'damages because of . . . property damage. Accordingly, Lennar must apportion the EIFS-related damages between its costs to remove and replace EIFS as a preventative measure and its costs to repair water damage to the homes." Id.


78 Id. at 901–903. See also Production Systems, Inc. v. Amerisure Ins. Co., 167 N.C. App. 601, 605 S.E.2d 663 (2004); West Orange Lumber Co., Inc. v. Indiana Lumbermens Mut. Ins. Co., 898 So. 2d 1147 (Fla. Dist. Ct. App. 5th Dist. 2005). While the insuring clause does not make any mention of whose property must be damaged in order to meet the "property damage" requirement, courts that are influenced by the "business risk" doctrine may read into this requirement an "other property" gloss. The court cited two previous Indiana Court of Appeals decisions for this proposition. See R.N. Thompson & Associates, Inc. v. Monroe Guar. Ins. Co., 686 N.E.2d 160 (Ind. Ct. App. 1997)
In Aetna Cas. & Sur. Co. v. McIbs, Inc., the district court rejected an insured’s request for coverage when its product, though non-conforming, did not cause any injury to other work or other products. There, the insured designed and manufactured a process for producing mortarless interlocking concrete blocks. The insured sold the process to a masonry contractor who used the manufactured concrete blocks on a construction project. Unfortunately, the process produced “over-sized” blocks. The project engineer insisted that the contractor return to the job and re-size all its block work. The contractor sued the insured for the additional costs associated with re-sizing the block work. The insured tendered that claim to its insurer, who declined it. In the ensuing declaratory judgment action, the trial court ruled for the insurer reasoning:

In order to recover, [the insured] must be able to show property belonging to [the contractor] was physically damaged or that property other than the blocks . . . installed in the . . . project was physically damaged . . . . All of the evidence shows that the damages on the . . . project resulting from the missized blocks supplied by [the contractor] related to the cutting and refitting of the blocks supplied by [the contractor] and for the cost of labor and materials to cover the joints between the blocks. There is no evidence these blocks injured or destroyed any other property.

Similarly, the Minnesota Court of Appeals ruled that an insured mechanical contractor was not entitled to a defense against a claim by a property owner against the insured contractor, who it was alleged installed a non-conforming HVAC system in the

(abrogated by, Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010)). These cases, in turn, relied upon a 1980 Indiana Supreme Court decision that quoted a 1971 article discussing the concept. See Indiana Ins. Co. v. DeZutti, 408 N.E.2d 1275, 1279 (Ind. 1980), quoting Roger C. Henderson, Insurance Protection for Products Liability and Completed Operations—What every Lawyer Should Know, 50 Neb. L. Rev. 415, 441 (1971). While not expressly reversed, all of these earlier Indiana cases have been discredited by the recent Indiana Supreme Court ruling in Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh'g, 2010 WL 5135322 (Ind. 2010). The most recent decision is discussed at length in Section V infra.


80 McIbs, 684 F. Supp. at 248. The court added: “While the McIbs forms may have caused a concrete block which was not within acceptable tolerances to have been formed, the forms did not ‘physically injure’ the components. Poor workmanship and an alleged breach of warranty as to size and shape does not constitute ‘physical injury’ within the meaning of the policy of insurance here. Id.
In the oft cited case Maryland Cas. Co. v. Reeder, the owners and association members of a condominium project sued the general contractor to remediate cracks in the building’s interior walls, exterior walls, and foundations caused by soils subsidence and a defective roof system. Observing that the various injuries to the building were derivatively caused by the work of various subcontractors, the court ruled that the general contractor’s CGL policy provided coverage for the various claims of the project and unit owners. The court’s reasoning is as important to the development of the incorporation doctrine as it is to practitioners who would be wise to craft their pleadings to specifically identify the physical injury to tangible property that follows from the general allegations of breach of contract, breach of warranty or negligence. The Reeder court ruled:

Here, of course, we have allegations of physical harm to tangible property. As we have seen, the homeowners and their association have alleged soil subsidence has cracked concrete 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 living areas . . . . [T]he homeowners and their association have gone beyond allegations that defects in material and workmanship exist at the project. Accordingly, the . . . plaintiffs have alleged property damage . . ..

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81 See Thermex Corp. v. Fireman’s Fund Ins. Companies, 393 N.W.2d 15 (Minn. Ct. App. 1986). See also Rafeiro v. American Employers’ Ins. Co., 5 Cal. App. 3d 799, 85 Cal. Rptr. 701 (1st Dist. 1970). These cases also demonstrate how some courts are led astray by policy arguments and notions regarding the proper allocation of risks between insureds and insurers even though no express policy language supports the arguments or notions. For example, in Thermex Corp., the court neglected to explain how it reached its conclusion notwithstanding one of the elements of damages claimed was loss of use of the building during the remediation of the defective HVAC system. Id. at 16–17. Relying on the general business risk doctrine, the court of appeals ruled that that doctrine trumped the definition of property damage in the policy. Today the same court of appeals should reach a contrary conclusion. See O’Shaughnessy v. Smuckler Corp., 543 N.W.2d 99 (Minn. Ct. App. 1996) (abrogated on other grounds by, Gordon v. Microsoft Corp., 645 N.W.2d 393, 2002-2 Trade Cas. (CCH) ¶ 73730 (Minn. 2002)).


83 Id. at 723.

84 Id. at 724. The installation of inferior shingles was not “property damage” where the damage was calculated in terms of the reduction of property value due to the aesthetic impact of the inferior shingles. In Down Under Masonry,
The United States Court of Appeals for the Seventh Circuit, in an opinion authored by Judge Posner, ruled that the manufacturer and supplier of a defective plumbing system that was installed in nearly 750,000 homes and apartments across the United States could look to its primary CGL policy for a defense and indemnity against the more than 17,000 claims pending as well as the potentially thousands of actions that had not yet been commenced because those systems had not yet failed. The allegations of damage included: (1) systems' leaks and resulting property damage caused by the water leakage; (2) diminution in value of the properties in which the systems were ticking "time bombs;" and (3) the mere "ominous presence of the non-leaking, but . . . destined to leak" product. The insured commenced the action seeking a declaration that the physical injury to the various homeowners occurred when the defective product was installed in the house, not when it begins to leak. The central issue for the court was whether and when the incorporation of a defective product into another causes physical injury to the other product. The court observed that the analysis pivots on a conflict between the connotations of the term "physical injury" and the objective of insurance. After a comprehensive analysis of these competing criteria, the court ruled accordingly:

We can now see more clearly that two senses of "physical injury" are competing for our support. One, which the insurers want us to adopt, is an injury that causes a harmful physical alteration in the thing injured. The other, which is what the draftsmen of the Comprehensive General Liability Insurance policy apparently intended and what rational parties to such a policy would intend in order to make the policy's coverage real and not illusory, is a loss that results from physical contact, physical linkage, as when a potentially dangerous product is incorporated into another and, because it is incorporated and not merely contained (as a piece of furniture is contained in a house but can be removed without dam-

Inc. v. Peerless Ins. Co., 183 Vt. 619, 2008 VT 46, 950 A.2d 1213 (2008), a roofing subcontractor purchased and installed eastern grade B white cedar shingles instead of the western blue label red cedar shingles that the contract required. The white cedar shingles were inferior in quality and different in color from the red cedar shingles. The homeowner sued for breach of contract, negligence and consumer fraud. Because the complaint alleged neither "physical injury" nor "loss of use" the "property damage" element had not been met. There was no physical defect in the white cedar shingles. Nor was the homeowner deprived of the use of the residence merely because it was roofed with inferior shingles. Aesthetic disappointment does not rise to the level of "property damage."


Id. at 807.
age to the house), must be removed, at some cost, in order to prevent
the danger from materializing.

* * *

[T]he drafting history of the property-damage clause, and the prob-
able understanding of the parties to liability insurance contracts,
persuade us that the incorporation of a defective product into an-
other product inflicts physical injury in the relevant sense on the
latter at the moment of incorporation—here, the moment when the
defective [plumbing] systems were installed in homes.\(^\text{87}\)

The Seventh Circuit’s decision resolved the coverage dispute be-
tween the product manufacturer and its primary CGL policies.
When the policy holder blew through its primary limits, the
excess carriers sought a contrary ruling from the Illinois state
courts—and got it.

In Traveler’s Ins. Co. v. Eljer Mfg., Inc.,\(^\text{88}\) the Illinois Supreme
Court expressly rejected the Seventh Circuit’s analysis and hold-
ing; the court’s opinion criticized virtually every clause of Judge
Posner’s opinion. In so doing, the supreme court crafted a deci-
sion that was unnecessarily broad, internally inconsistent and
far reaching in its negative implications. The supreme court
founded its ruling on the fundamental proposition that physical
injury, by its nature, requires “a harmful change in appearance,
shape, composition, or some other physical dimension of the
injured person or thing.”\(^\text{89}\) The court’s ruling prioritizes appear-
ance over reality. It fails to recognize that infection is injury.
Instead, it ruled as a matter of law that incorporating a defective
product into a structure does not constitute property damage
until the product causes a change in appearance, shape or com-
position of the building or its components.

The court reasoned that incorporating a defective plumbing
system into a building is a “physical” event, but not a “harmful”
physical event, and therefore not “property damage” under the

\(^{87}\) Id. at 810, 814. In Johnson v. Studyvin, 828 F. Supp. 877 (D. Kan. 1993),
a federal trial court concurred with Judge Posner’s reasoning, ruling that the
incorporation of a defective product into another injures the other product at
the moment of incorporation. As long as the defective product is not easily
removed from the other product, the injury occurs at the time of incorporation.
Id. at 883. See also Newark Ins. Co. v. Acupac Packaging, Inc., 328 N.J. Super.
385, 746 A.2d 47 (App. Div. 2000); Helm v. Board of County Com’rs, Teton
County, Wyo., 989 P.2d 1273 (Wyo. 1999).

\(^{88}\) Travelers Ins. Co. v. Eljer Mfg., Inc., 197 Ill. 2d 278, 258 Ill. Dec. 792, 757

\(^{89}\) Id. at 497, 502. See also Eljer, 972 F.2d at 808–09.
What if the plumbing system were wrapped in asbestos containing material? According to United States Fidelity & Guaranty Co. v. Wilkin Insulation Co., mere incorporation of that defect constitutes “harmful physical injury” to the building structure, even though the material isn’t friable, and even in the absence of changes in appearance, shape and composition of the building. The court presumed that the mere presence of a “toxic substance,” or “contaminant,” constitutes harmful physical injury to the building. The supreme court in Eljer affirmed that rule, but distinguished a contaminated mechanical system, from a contaminated insulation system.

In less than a decade, the same appellate court ruled that incorporating the defective insulation system into a building constituted property damage, but incorporating a defective mechanical system into the same building does not constitute property damage. The court justified the distinction on the basis that the contaminant, when released, would constitute a “toxic substance,” raising the curious question whether the mold spores that flourish from the defective plumbing systems are considerably different. The court, in so ruling, felt compelled to overrule Marathon Plastics, Inc. v. International Ins. Co.

The Eljer decision has already led to additional confusion. Trying to make sense of the opinion, the Illinois Court of Appeals has now concluded that Eljer must stand for the proposition that property damage is whatever isn’t economic loss.

Some courts focus on the degree of injury caused by the

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90 Travelers, 757 N.E. 2d at 497.
92 Travelers at 497–500.
93 It seems that rulings emanating from the morass that is the asbestos litigation will constantly jitterbug their attendance upon the rest of the law. Whether the court believes this or just struck a bargain with the stubbornness of its analysis, who knows. Regardless, the interaction of the two curiously inconsistent holdings presents a euphoria of uncertainty.
94 Marathon Plastics, Inc. v. International Ins. Co., 161 Ill. App. 3d 452, 112 Ill. Dec. 816, 514 N.E.2d 479 (4th Dist. 1987) (which had held that the incorporation of defective piping seals into a water transfer system constituted property damage.) Travelers at 500.
95 State Farm Fire and Cas. Co. v. Tillerson, 334 Ill. App. 3d 404, 268 Ill. Dec. 63, 777 N.E.2d 986, 991 (5th Dist. 2002) (ruling that an insured builder had no defense coverage under its CGL for physical injury caused to a building that was constructed over a cistern, which as a consequence, shifted and caused substantial damage to the building structure).
remediation effort in making the coverage determination. If the repairs to the defective work or product will entail significant physical injury to the rest (or another part) of the project, these courts will conclude that property damage coverage exists. In Esicorp, Inc. v. Liberty Mut. Ins. Co., the court of appeals reasoned that where the repair to the defective work would likely result in physical damage to the mechanical system and surrounding project property, then property damage coverage is available to the insured for the cost of the repair. If defective stucco cannot be removed from a building without unavoidably damaging the surrounding structure, then the injury to the structure is covered. The United States Court of Appeals for the Ninth Circuit has ruled that if the remediation effort would not affect any work other than the insured’s defective work, then no property damage occurs within the coverage of the CGL. In Dewitt Construction, Inc. v. Charter Oak Fire Ins. Co., the insured’s foundation piling work was performed defectively. The subcontractor was compelled to install an additional 300 piles, and leave the defective piles in place. The insured argued that the presence of the defective piles constituted property “damage to the construction site by impaling it with unremovable obstacles.” Confusing definitions with exclusions, the court concluded that “for faulty workmanship to give rise to property damage, there must be property damage separate from the defective product itself.”

There are defects, and then there are defects. Owners may accept some without serious concern. Other defects may require remediation in order to prevent future damage to property or bodily injury. Millions of dollars can be spent redesigning and reconstructing a building’s structural components when the building isn’t originally designed to withstand foreseeable wind currents, e.g., Citicorp’s Manhattan Headquarters. Does the insured have to wait for the building to fall to the ground before it can fund the remediation effort with its CGL limits?

The answer to this question depends, in part, upon just how imme-

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97 Id. at 969–70. Some courts refer to this as “resulting injury.”
99 Dewitt Const. Inc. v. Charter Oak Fire Ins. Co., 307 F.3d 1127 (9th Cir. 2002), as amended on denial of reh’g and reh’g en banc, (Dec. 4, 2002).
100 Id. at 1133.
101 Id.
diate or imminent are the prospects of future damage. Public policy will not require an insured to wait around for property damage to result where corrective action could be taken to forestall the inevitable. But this exception is narrowly construed and usually arises in connection with fire suppression cases. On the other hand, if some property damage has already occurred, the courts will often permit coverage for costs to prevent or mitigate against future damage.¹⁰²

What if the remediation effort can be accomplished without tearing out surrounding work? In New Hampshire Ins. Co. v. Vieira,¹⁰³ a federal court of appeals ruled that no property damage results in that circumstance. There, the insured was a drywall subcontractor who failed to fire-rock a building’s attic space. When the owner discovered this, it compelled the general contractor to remediate the defect. The general contractor commenced a third party action against the drywall sub to recover the cost of the repairs. The subcontractor’s insurer settled the third-party claim with the general and then sought reimbursement from its insured. The district court ruled in favor of the insurer and the Ninth Circuit affirmed the Order for reimbursement. The court’s decision was based, in part, on the fact that the remediation effort did not require damage to any other part of the building. The court reasoned that adding the two-hour rated drywall (i.e., the missing fire-rock) didn’t constitute physical injury to the property; since the repair effort did not affect any other part of the structure, no “property damage” triggered coverage.¹⁰⁴

A more problematic analysis was reported by the Maryland Court of Special Appeals in Woodfin Equities Corp. v. Harford Mutual Insurance Co.¹⁰⁵ There the court determined that even when the repair efforts damaged surrounding work and property, no “property damage” resulted from the repair of the defective


¹⁰⁴  Id. at 701–02.

Some courts confuse the issue of “property damage” with a related but distinct issue relating to the application of the CGL’s exclusions to the tendered claim. That may explain the thought process of the Maryland Court of Appeals in Woodfin. Another example of this erroneous coverage analysis is Mapes Industries, Inc. v. United States Fidelity & Guaranty Co.\textsuperscript{106}

In Mapes, a curtain wall contractor sued a supplier of defective panel materials after the contractor was compelled to remediate the failed curtain wall. The supplier of the defective panels sought coverage for the contractor’s claim. Among the injuries alleged by the owner were loss of use damages and diminution in value damages caused by the “rippling” of the exterior wall system. In ruling for the insurer, the Nebraska Supreme Court confused the property damage issue with the application of certain policy exclusions to the claims of damage. The court reasoned that “loss of use” damages could not constitute “property damage” because the loss of use alleged was caused by the insured’s defective product, an excluded loss.\textsuperscript{107} A more careful analysis would have been to concede that the allegations of loss of use triggered the insuring language of the CGL, but still deny the sub’s claim for coverage on the basis that the damages sought were excluded by the “work performed” exclusion contained in another part of the CGL.

It is particularly important for courts to think more carefully when the insured is an entity other than the supplier of the defective product or the constructor of the defective work. This is especially important when the insured is a general contractor who does not self-perform the allegedly defective work. A good example of poor thinking was reported by the Indiana Court of Appeals in R.N. Thompson & Associates, Inc.\textsuperscript{108} There, a homeowner’s association sued the general contractor of a residential development when the roof systems of the forty-five units failed. The roofs failed because the exterior envelope was constructed such that the attic spaces were not adequately vented. As a consequence, the attic spaces trapped pockets of high relative humidity. In time, the attic spaces became saturated with moisture and caused the plywood roof sub-structures to fail from the inside-out. The general contractor tendered the claim to its


\textsuperscript{107} Mapes, 560 N.W.2d at 819–20 (Neb. 1997).

insurer, who declined it on the basis that there was not property
damage, and if there were, the damages were purely economic in
nature, and not covered by the CGL. The general contractor sued
to establish coverage. The trial court ruled for the insurer, and
the court of appeals affirmed. The court framed the correct issue
when it first sought to determine whether the complaint alleged
property damage, but it slipped the wrong picture into that frame
when it then looked to the policy’s exclusions to determine
whether property damage existed. The court concluded that there
could be no property damage if the damages alleged were
excluded by the policy. Complicating matters more, the court also
incorrectly analyzed the applicability of the exclusions to the
claimed damages. In that case, none of the failed work was
performed by the insured contractor. The court got it wrong both
ways. A commentator correctly criticized the decision in this way:

This reasoning is flawed. Either there is physical injury to tangible
property or there is not. Nothing more is required to reach a finding
that “property damage” exists. Rotting roofs certainly meet the
requirement of physical injury to tangible property. There is no
policy requirement that physical injury occur to a particular class,

Very recently, the criticism resonated in Indiana’s highest

The Economic Loss Cases

The economic loss cases fall into two categories, economic losses
arising directly from physical injury to tangible property and eco-
nomic losses tied to loss of use of tangible property that is not
physically injured. The first category of cases is addressed here;
the second category is addressed later in this article, under the
heading: The Loss of Use Cases.

Contractors can sustain economic injury because of defective

109 4 Bruner & O’Connor on Construction Law at § 11:34 at p. 114. Explain-
ing why and how the court erred in applying the “work performed” and “product
itself” exclusions is beyond the scope of this article, though specific criticism of
that portion of the decision can be found at 4 Bruner & O’Connor on Construc-
tion Law at § 11:34 at pp. 114–116; and a general criticism of the court’s use of
the business risk doctrine to resolve coverage disputes is found at J. O’Connor,
What Every Construction Lawyer Should Know About CGL Coverage for Defec-

2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL
5135322 (Ind. 2010).
construction. Lost profits, increased construction costs, labor productivity losses, substantial delay costs: these kinds of losses commonly follow remediation efforts required to repair defective construction. The CGL covers these kinds of economic losses when they are tied to a physical injury to tangible property. In that situation, it is proper to characterize the economic injury as property damage; the economic injury is simply one way to measure a portion of the property damage caused by the physical injury to tangible property. The key to establishing coverage is in emphasizing the physical injury and demonstrating that the insured’s economic loss arises from it. It’s the busted stuff that triggers the application of the insuring language of the policy.\textsuperscript{111}


\textsuperscript{112} Stuart v. Weisflog’s Showroom Gallery, Inc., 296 Wis. 2d 249, 2006 WI App 184, 722 N.W.2d 766 (Ct. App. 2006), decision rev’d, 2008 WI 86, 311 Wis. 2d 492, 753 N.W.2d 448 (2008).
losses” and did not meet the “property damage” requirement. The court disagreed:

Weis/c143og's policy provides that an “occurrence” must give rise to “property damage” in order to trigger coverage; American Family next contests coverage on that basis. It asserts that the Stuarts' double damages and reasonable attorney fee awards are “economic” in nature and do not constitute “property damage.” . . . [I]t is readily apparent to us that American Family cannot prevail on this issue. The CGL policy clearly states that coverage is triggered when Weis/c143og incurs liability “because of property damage.” American Family does not argue that the Stuarts suffered no property damage. Indeed, one can hardly characterize problems like mold in the attic and “moisture stains in the original portion of the house” as anything else . . ..

Often the issue over whether the policy responds to “economic damages” or “economic losses” has more to do with the proper characterization of the injury rather than the label that’s attached to it. While there is a fairly consistent body of case law holding that purely economic losses are not recoverable under a CGL policy, much of the dispute over this issue is whether what is claimed is actually pure “economic loss.” Admiral Ins. Co. v. Little Big Inch Pipeline Co.,

illustrates this point:

Plaintiff Admiral next argues that the Underlying Defendants’ actions that resulted in a “diminution in value” are not covered under the policy because Texas law does not recognize economic damages as “property damage.” Defendants Texas Gas and LBI argue, however, that Plaintiff erroneously understood the Underlying Plaintiff’s claims to be seeking “purely economic damages” while ignoring that the “diminution in value” claim is directly tied to and

\[113\] Id. at 776. The Wisconsin Supreme Court reversed the court of appeals' holding, while expressly affirming this portion of its reported decision. The supreme court ruled that “misrepresentation claims” under the state’s Home Improvement Trade Practices Act, by definition, required the kind of volitional act that could not be reckoned with the notion of an accident, and therefore not covered under the insuring language of the CGL. However, concurrent negligent construction resulting in physical injury to tangible property would be a covered loss unless it was barred by an express exclusion in the policy. Stuart v. Weis/c143og’s Showroom Gallery, Inc., 2008 WI 86, 311 Wis. 2d 492, 753 N.W.2d 448 (2008). The court re-affirmed its holding in American Family Mut. Ins. Co. v. American Girl, Inc., 2004 WI 2, 268 Wis. 2d 16, 673 N.W.2d 65 (2004). See also Kalchthaler v. Keller Const. Co., 224 Wis. 2d 387, 591 N.W.2d 169 (Ct. App. 1999). The Wisconsin Supreme Court ultimately ruled for the insurer in the Stuart case, reasoning that the damages were self-performed by the insured, thus taking it out of the subcontractor's exception to the “your work” exclusion contained in the policy. 753 N.W.2d at 464–465.


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arises from the physically-injured tangible property . . .. The
Underlying Petition alleges that LBI dug up gas lines, concrete
driveways, concrete slabs and foundations on the Property. LBI
also left a “considerable amount of debris behind.” The Underlying
Plaintiffs claim these actions resulted in “damages to its property”
as well as “damages to its Project” to build new homes on the
Property. Moreover, the Underlying Plaintiffs claim Texas Gas and
LBI’s actions “caused Plaintiffs to incur significant expense to
restore the property to its initial state,” “caused the value of the
Plaintiffs’ Property to decrease” and “caused a diminution in value
of the remainder of the Property.”
The Court holds that the Underlying Plaintiffs have sufficiently
pleaded “property damage” with regards to the destruction of
concrete driveways, concrete slabs and foundations on the Property.
Moreover, left-over debris on surrounding land also represents
“property damage” pursuant to the Policy.\textsuperscript{115}

In American Home Assurance Co. v. Libbey-Owens-Ford Co.,\textsuperscript{116}
the owner of the John Hancock Building in Boston sued the
manufacturer and supplier of defective glass curtain wall panels.
The “busted stuff” in that massive curtain wall failure were the
glass panels that systematically popped out of the framing
components and crashed to the pavement below. The damages
included the owner’s lost profits. These economic losses, deriving
as they did from the physical injury to the insured’s tangible
property, triggered the insuring provisions of the CGL. In ruling
for the insured, the court reasoned:

Although the plain language of the policy does require that some
physical injury to tangible property must occur . . . the policy
language does not preclude the possibility that physical injury to
the insured’s own property can constitute such property damage.
Under this reading of the policy, consequential damages suffered as
a result of physical injury to any product, including that of the
insured, would be covered. Such a reasoning is a reasonable
construction of the policy and, under general principles of insur-

\textsuperscript{115}Id. at 538 (inner quotations omitted). See also Ohio Cas. Ins. Co. v.
Hanna, 2008-Ohio-3203, 2008 WL 2581675 (Ohio Ct. App. 9th Dist. Medina
County 2008), appeal not allowed, 120 Ohio St. 3d 1420, 2008-Ohio-6166, 897
N.E.2d 654 (2008) (framing that was crooked and drywall that was cracked and
crooked were more than cosmetic changes, causing the house to be out of plumb
and out of square and constituted “property damage”). But see, Stoneridge
16, 897 N.E.2d 264 (2008) (“Also, there was no ‘property damage.’ The Walskis
sought costs of repair or replacement for the diminished value of their home,
which are economic losses.”)

\textsuperscript{116}American Home Assur. Co. v. Libbey-Owens-Ford Co., 786 F.2d 22 (1st
Cir. 1986).
ance law, a reasonable construction that affords coverage for the insured should be adopted. Indeed, any alternative reading resulting in non-coverage for the insured would actually require us to add language to the policy against the insured, standing on its head the general insurance principle that policities are to be strongly construed against the insurer.\textsuperscript{117}

The court of appeals returned the case to the trial court to determine whether the claimed economic losses derived from the insured’s busted windows.

In DiMambro-Northend Associates v. United Construction, Inc.,\textsuperscript{118} the insured contractor was constructing a sewer system that was intended to interconnect with the work of other contractors. Through its negligence, a fire started in its portion of the tunnel. The remediation effort following the fire caused another contractor to sustain delay damages and lost profits in completing its work. The other contractor sued the insured contractor to recover its economic losses. The insured contractor turned to its CGL policy to fund the claim. Rejecting a \textit{per se} notion that all economic damages are non-covered losses, the Michigan Court of Appeals held that the property damage required by the CGL’s insuring clause is triggered by the insured’s own physically injured property. The court ruled that the insured’s CGL covered the consequential damages of the other contractor.\textsuperscript{119}

In Fejes v. Alaska Insurance Co.,\textsuperscript{120} the Alaska Supreme Court ruled that a subcontractor’s CGL policy covered damages caused by its own defective work. There, the contractor constructed a defective curtain drain. As a consequence of the defective work, the entire septic system backed up, flooded, and stopped functioning. The insurer refused the subcontractor’s tender, reasoning that the homeowner’s damages were loss of bargain damages. The court rejected the insurer’s economic loss argument, reasoning:

The flooding of the septic system fairly falls within the meaning of the term “destruction of tangible property.” AIC’s contention that [the homeowner’s] claims were for loss-of-bargain damages does not mean that those claims were not “because of” or resulting from property damage, which is what the policy requires . . . [T]he argument that comprehensive general liability policies do not cover damage to the work of the insured is not wholly accurate . . . In

\textsuperscript{117}Id. at 25–26 (citations omitted).


\textsuperscript{119}Id. at 550–51.

any case, such an argument could not overcome actual policy language.121

The court expressly ruled that the CGL form provides coverage for economic losses suffered “because of” property damage.

In Western World Insurance Co. v. H.D. Engineering Design & Erection Co.,122 the Minnesota Court of Appeals ruled that a general contractor’s claims against a subcontractor for increased construction costs were covered by the subcontractor’s CGL policy. Among the economic losses sought by the general contractor were delay damages, productivity losses, and additional direct costs associated with unanticipated winter conditions work.123

The general contractor’s economic injury was caused by the collapse of the structural steel components of the construction project; the structure collapsed when the subcontractor used a partially completed roof structure as a storage area for its materials. The court ruled that the physical injury to the structural steel caused a “loss of use” of that structure, and that consequential damages that flowed from that loss of use were recoverable as “property damages” under the subcontractor’s CGL.124

Diminution in value is also a type of economic injury that can flow from defective construction that manifests itself as physical injury to tangible property. Those who think that the coverage decision should derive from the actual insuring language of the policy will properly frame the question in this way: What is the cause of the diminution in value; does it derive from physical injury to tangible property?125

Courts that frame the coverage question in this way will find coverage for purely economic injury when it is caused by defective construction that manifests itself

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121Id. at 524. The policy construed by the court contained a broad form property damage (BFPD) endorsement. The court expressly ruled that the language in the endorsement compelled its conclusions. In 1986, the BFPD was incorporated into the body of the CGL, and remains materially unchanged in the current CGL form.


123Id. at 632.

124Id. at 635–36. Other reported cases finding coverage for economic or consequential damages that result from “loss of use” arising from the physical injury caused by defective construction include: Riley Stoker Corp. v. Fidelity & Guar. Ins. Underwriters, Inc., 26 F.3d 581 (5th Cir. 1994); Federated Mut. Ins. Co. v. Concrete Units, Inc., 363 N.W.2d 751 (Minn. 1985).

as physical injury to tangible property, and where other policy conditions or exclusions do not apply.126

126“Property damage” is often contrasted with pure economic losses in the form of “diminution in value.” As the common refrain goes, diminution in value damages are not covered under a CGL policy. While this may be so in certain cases, the real inquiry is just what caused the diminution in value. If caused by “property damage” as defined in the CGL policy, then the damages are covered. This distinction is discussed in Westfield Ins. Co. v. Weis Builders, Inc., 2004 WL 1630871 (D. Minn. 2004) where approximately $125,000 was spent repairing interiors damaged due to water infiltration. The developer also sought more than $15 million in damages due to higher vacancy rates and diminution of value in the sale of the property. The insurer claimed that these non-repair losses were not covered by the policy, as they were “diminution in value” damages, rather than “property damage” losses. The court disagreed:

In response, Weis [insured] points out that Westfield is ignoring the policy’s coverage grant that provides that Westfield will pay sums which Weis becomes legally obligated to pay “because of . . . property damage.” The Court agrees with Weis. Westfield is trying to suggest that its policy only covers property damage because of property damage. Concrete Units [Minnesota Supreme Court case from 1985 holding that diminution in value damages not covered under CGL policy] did not address whether a claim for diminution in value was covered under the “because of” phrase. Thus, its holding is inapplicable to the determination of whether a claim for diminution in value can be covered under the “because of” language. Thus, given the “because of” coverage grant in the Westfield policy, the Court’s inquiry does not stop after it determines that Promenade’s [developer] claim of diminution in value is not property damage; rather, it must also determine whether such a claim is “causally related” to an item of property damage, namely the damage caused by water penetration in 1997. As one commentator [sic] explained: “The real inquiry, however, is what is the cause of the diminution in value. Does it stem from the existence of physical injury to tangible property? If so, the ‘property damage’ element is satisfied.” 4 Bruner & O’Connor, Construction Law § 11:32 (2004). At this stage, the Court is faced only with the task of determining whether Promenade’s claims for vacancies and reduced rents and for a reduced sale price, if proven, would be covered by the Westfield policy. The Court is not determining whether either claim for damages has been proven. Thus, the Court concludes that claims concerning higher vacancy rates and suppressed rentals and reduced sale price, if the fact-finder determines that these claims result from the water penetration problems, are covered by the Westfield policy because they are “causally related” to the property damage that occurred as a result of water leakage in 1997.


Having found injury to tangible property in the form of physical damage to the roof, Great American’s contention that consequential damages are not covered by the policy must fail . . . [O]nce there is injury to tangible property, Yakima was entitled to recover all other damages naturally flowing from that injury whether tangible or
Loss of Use of Tangible Property that is not Physically Injured

The CGL considers the inability to use property that is not physically injured to constitute property damage, so long as it arises out of an occurrence during the policy period. It is the policy in effect at the time of the occurrence giving rise to the loss of use that covers the claim.127

When the loss of use arises from physical injury to tangible property, it is the policy in effect at the time of the property loss that covers the claim. Property damage cases can be difficult to pinpoint in time when the property damage arises from a latent defect and involves water infiltration—a common source of damage. Latent defective construction conditions which cause deterioration over long periods of time raise questions about timing and allocation. In M.L.P. Investments, L.L.C. v. Quanta Specialty Lines Ins. Co., 2008 WL 4940999 (E.D. Mo. 2008), an insurer cancelled its CGL policy for non-payment of premium. A question arose as to whether the cancellation became effective before the damage giving rise to a claim against the insured occurred. The insurer argued that its cancellation occurred prior to the claim against its insured. The insured argued that some of the claimant’s damages occurred before the policy’s cancellation. The claimant’s complaint alleged that the insured damaged its pipeline after the date the policy was cancelled. It also alleged that the insured’s construction activities threatened to or already blocked access to the pipeline. The complaint, however, was not specific as to when this blockage occurred. Nevertheless, the court concluded that even if the insured had started preparing the area by performing grading work while the policy was still in effect, that activity would not have resulted in blocking access or causing damage to the pipeline. Because the claim did not assert damages during the policy period, the insurer had no duty to defend or indemnify the insured. D.R. Sherry Const., Ltd. v. American Family Mut. Ins. Co., 2009 WL 2382386 (Mo. Ct. App. W.D. 2009), reh’g and/or transfer denied, (Sept. 22, 2009) and transferred to Mo. S. Ct., 316 S.W.3d 899 (Mo. 2010), addressed the level of proof necessary to establish injury occurred during the policy period. The underlying dispute involved cracking to a home’s foundation due to poor soil conditions. The insured’s policy expired after the parties conducted their final inspection during which no foundation problems were discovered and before the homeowners notified the contractor that cracks had begun to appear in the home’s foundation. The court of appeals ruled that the contractor failed to carry its burden that injury actually occurred to the home before the policy expired.

In defect cases, the property damage can occur over a long period of time, and over multiple policy periods. Courts have adopted several different “trigger” theories to determine which policies cover a loss. For some jurisdictions, the important factor is when the injury first manifests itself (covers the claim). For these jurisdictions, the policy in effect at the time the injury became known.

127 Id. at 377. On appeal, the Washington Supreme Court reversed, ruling that the record did not sustain the conclusion that delay damages were caused by the incorporation of the defective panels into the building. Yakima Cement Products Co. v. Great American Ins. Co., 93 Wash. 2d 210, 608 P.2d 254 (1980).
The Loss of Use Cases

The classic case involves a claim by a property owner who alleges that his business sustained economic losses during a construction delay. For example, in Geurin Contractors, Inc. v. Bituminous Casualty Corp., a store owner claimed that he lost $22,000 in profits as a consequence of a road builder’s failure to timely finish a road project that ran in front of his business. The road builder sought coverage for the claim from its CGL carrier. In the coverage case, the court ruled that the policy definition of property damage, by its terms, applies to economic losses that result from the loss of use of property that is not otherwise injured. Accordingly, a construction delay that diminished or eliminated the use of the shop owner’s property constituted a covered claim.

In Gibson & Associates, Inc. v. Home Insurance Co., multiple property owners and tenants on Main Street in Dallas, Texas, alleged economic injury caused by construction delays on a municipal street improvement project. The city tendered the claims to its contractor who sought coverage from its CGL carrier for the claims. Acknowledging that the property owners’ claims did not allege physical injury to tangible property, the court ruled that

Other jurisdictions look to when the first harmful exposure occurred. Other jurisdictions consider all policies in effect at the time any injury occurred.

The Supreme Court of Texas recently addressed many of these “trigger” theories in Pine Oak Builders, Inc. v. Great American Lloyds Ins. Co., 279 S.W.3d 650 (Tex. 2009), where a home suffered wood rot and other physical injury over a period of years. The Court of Appeals adopted the “exposure” rule for determining whether a property damage claim is covered under an occurrence-based CGL policy. The insurer urged the adoption of the “manifestation rule” for making this determination. The Texas Supreme Court rejected both theories, and instead applied an “actual injury” rule. Id. See also Don’s Bldg. Supply, Inc. v. OneBeacon Ins. Co., 267 S.W.3d 20 (Tex. 2008) (adopting actual injury rule involving a number of EIFS claims). Minnesota courts apply the same “actual injury” rule:

Minnesota applies an “actual injury” rule to determine whether insurance coverage has been triggered by an occurrence. To trigger a policy, “the insured must show that some damage occurred during the policy period.” In this state, the actual-injury rule has evolved since it was first articulated in Singsaas v. Diederich, 307 Minn. 153, 156, 238 N.W.2d 878, 880 (1976). Singsaas held that the occurrence is not when the negligent work was done but when the complaining party was actually damaged.


129 Id. at 641.

the contractor’s CGL nonetheless provided coverage for the indemnity obligation to the city, specifically to indemnify it against those shop owners’ claims for economic injury.\textsuperscript{131} The court acknowledged that there is a body of decisional law that states purely economic losses are not generally intended to be covered by a CGL, but ruled that the “loss of use” prong of the property damage definition in the policy brings these kinds of damages within the scope of coverage.\textsuperscript{132}

In Gibralter Casualty Co. v. Sargent & Lundy,\textsuperscript{133} an investment entity sued design and construction entities that it felt were responsible for delays, and ultimately the abandonment of a power generating plant. Federal regulators shut construction down for thirty months when it discovered defective concrete work at the site. That delay significantly increased the cost of construction, as well as investment costs to the plaintiff group. The spiraling costs ultimately doomed the project and doomed the plaintiffs’ economic investment. The project engineer, one of several defendants in the lawsuit, sought coverage under its professional liability policy. That policy contained a property damage definition that is materially indistinct from the definition of the phrase in the CGL. The carrier declined coverage relying on arguments based on the general notion that purely economic damages are not the kind of damages liability insurers cover. The court in the coverage action rejected that argument, ruling:

Loss of use as distinguished from loss of profits 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.\textsuperscript{134}

It has been suggested that the CGL’s present definition of property damage is so broad, it may actually present the industry

\textsuperscript{131}Id. at 476–77.

\textsuperscript{132}Id. at 473 and 476–77. Similarly, in Continental Cas. Co. v. Gilbane Bldg. Co., 391 Mass. 143, 461 N.E.2d 209 (1984), a restaurant owner’s claim for lost profits sustained by the owner as a consequence of the falling glass from the John Hancock Building was a covered claim under Gilbane’s CGL policy. Id. at 214–15.


\textsuperscript{134}Id. at 671 (citations omitted). The court ruled that the costs of correcting the defective work was part of the investor’s economic loss, and covered by the engineer’s policy.
with the same coverage problems that it tried to repair in the 1966 policy form:

Most commercial property suffers a diminution in value to the extent that its use is impaired in one way or another. Therefore, it is possible that the “loss of use” coverage may very well create the same dilemma for the industry as was experienced under the 1966 policy language. Claims may be creatively structured so as to make the distinction between “diminution in value” and “loss of use” to be nearly indistinguishable.

For example, in M. Mooney Corp. v. United States Fidelity & Guaranty Co., the cost to remediate defects in forty-seven fireplaces were covered as loss of use damages since the defects rendered “the fireplaces” unusable under applicable fire code regulations. In finding coverage, the court reasoned that while “preventative” expenditures may not be covered, the cost to repair the fireplaces actually “restored” them to use, and therefore were covered property damages. In Jacob v. Russo Builders, expenses incurred to repair interior construction defects that would not be covered in another context would nonetheless be covered property damages when they are characterized as collateral damage to “other property,” i.e., access to the interior of the residence.

V. Recent State Supreme Court Rulings Demonstrate That Constructing the Road to a Predictable Decisional Landscape May Be a Long Haul

Most of the highest state courts in the United States have yet to weigh-in on the issues addressed in this article. The majority of the reported decisions are from intermediate courts of appeals. Hope springs eternal that when the issues are finally addressed at the state court of last resort they will find a most careful and

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There is loss of use of a new or existing building or other structure where faulty construction causes construction delay and the temporary inability to use the property, and loss of use damages include the cost of correcting the defect.

Id. at 671–72.

135 4 Bruner & O’Connor on Construction Law at § 11:35 at p. 120.


137 Id. at 796.

138 Jacob v. Russo Builders, 224 Wis. 2d 436, 592 N.W.2d 271 (Ct. App. 1999).

139 Id. at 277. In Giddings v. Industrial Indemnity Co., 112 Cal. App. 3d 213, 169 Cal. Rptr. 278 (4th Dist. 1980), the court, while specifically declining to extend the coverage of the CGL to the shareholder derivative action before it, noted that there could have been coverage had the shareholder’s alleged loss of use of tangible corporate assets, such as inventory. Id. at 281–82.
deliberate analysis. But if recent rulings are any indication, it is fair to say that the problem of predictability will be without a national solution for a long time to come. Within the last several years ten state supreme courts have addressed the controversy of insurance coverage for defective construction. Seven courts ruled that coverage exists in the express language of the current ISO CGL form. The other three courts ruled that extra policy considerations operate to obliterate coverage for contractors.

Cases Finding Coverage in the Language of the Policy

Several state supreme courts have recently ruled that the current version of the ISO CGL policy expressly provides coverage for property damage claims arising out of defective construction. They are typified by a careful deliberate consideration of the CGL policy language, and as a consequence all reject the extra-policy arguments raised by the insurance industry to confound the reasonable expectations of its insureds.

In August, 2007, the Texas Supreme Court issued its long awaited decision in Lamar Homes, Inc. v. Mid-Continent Casualty Company. In LaMar, the DiMares purchased a new home from Lamar Homes, Inc. Several years later, they encountered problems that they attributed to defects in the original foundation. The homeowners sued Lamar and its subcontractor complaining about these defects. Lamar tendered the lawsuit to its CGL carrier, Mid-Continent Casualty Company. The carrier refused to defend. The contractor commenced a declaratory judgment action seeking coverage.

The trial court ruled for Mid-Continent, reasoning that the purpose of a CGL policy is “to protect the insured from liability resulting from property damage (or bodily injury) caused by the insured’s product, but not for the replacement or repair of that product.” On appeal to the Fifth Circuit, the court of appeals, noting disagreement among Texas courts about the application of the CGL policy under these circumstances, certified the question to the Texas Supreme Court.

The Texas Supreme Court undertook an extensive analysis of all the usual extra policy arguments offered by the insurance industry, rejecting each one. First, the court addressed the insurance company’s argument that damages caused by faulty workmanship can not be an “accident” because the injury caused by defective work is, ipso facto, expected and foreseeable.

140 Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1 (Tex. 2007).
141 Id. at 7, n. 6.
Rejecting the notion, the court stated that its prior decisions did “not adopt foreseeability as the boundary between accidental and intentional conduct.” The court explained that accidental damages are often the consequence of deliberate acts, particularly when the intentional act manifests itself as negligent behavior:

[A] deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly. Thus, a claim does not involve an accident or occurrence when either direct allegations purport that the insured intended the injury (which is presumed in cases of intentional tort) or circumstances confirm that the resulting damage was the natural and expected result of the insured’s actions, that is, was highly probable whether the insured was negligent or not.

The court also reasoned that “[c]ontrary to the carrier’s contentions, the CGL policy makes no distinction between tort and contract damages. The insuring agreement does not mention torts, contracts, or economic losses; nor do these terms appear in the definitions of ‘property damage’ or ‘occurrence.’” The court discredited the preconceived notion that a CGL policy is only for “tort liability.” Instead, it ruled that “[t]he duty to defend must be determined here, as in other insurance cases, by comparing the complaint’s factual allegations to the policy’s actual language.”

Second, the court dismissed the “economic loss” rule as having anything to do with coverage:

The economic-loss rule, however, is not a useful tool for determining insurance coverage. The rule generally precludes recovery in tort for economic losses resulting from the failure of a party to perform under a contract. Its focus is on determining whether the injury is to the subject of the contract itself. In operation, the rule

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142 Id.
143 242 S.W.3d at 8–9 (citations omitted) (emphasis added). The court expressly rejected the notion that all contract breaches must be the consequence of intended acts and expected results:

Yet, on even a moment’s reflection, we all understand that contracts are broken, many times, for reasons that we would call “accidental.” The wrong number of boxes was shipped because someone made a mistake in the counting. The lawsuit was filed in the wrong venue because someone made a mistake when reading the venue statute. As one court explained, “at bottom, an occurrence is simply an unexpected consequence of an insured’s act, even if due to negligence or faulty work.

Id. at 8–9 (quoting Ellen S. Pryor, The Economic Loss Rule and Liability Insurance, 48 Ariz. L. Rev. 905, 917 (2006)).
144 242 S.W.3d at 13 (citations omitted).
145 242 S.W.3d at 13.
restricts contracting parties to contractual remedies for those economic losses associated with the relationship, even when the breach might reasonably be viewed as a consequence of a contracting party’s negligence. It is a liability defense or remedies doctrine, not a test for insurance coverage.\textsuperscript{146}

Third, the court weighed-in on the “occurrence debate”:

The CGL policy . . . does not define an “occurrence” in terms of the ownership or character of the property damaged by the act or event. Rather, the policy asks whether the injury was intended or fortuitous, that is, whether the injury was an accident. As one court has observed, no logical basis within the “occurrence” definition allows for distinguishing between damage to the insured’s work and damage to some third party’s property:

The logical basis for the distinction between damage to the work itself (not caused by an occurrence) and damage to collateral property (caused by an occurrence) is less than clear. Both types of property damage are caused by the same thing—negligent or defective work. One type of damage is no more accidental than the other. Rather, . . . the basis for the distinction is not found in the definition of an occurrence but by application of the standard ‘work performed’ and ‘work product’ exclusions found in a CGL policy.

We likewise see no basis in the definition of “occurrence” for the district court’s distinction.\textsuperscript{147}

The court fashioned a rule that restores predictability to contractors performing work in Texas. It ruled that the coverage determination must be made by comparing the allegations contained in the complaint against the express grant of coverage contained in the policy. No extra-policy considerations may be used to confuse the issue.\textsuperscript{148}

The Supreme Court of Florida in United States Fire Insurance Company v. J.S.U.B., Inc.,\textsuperscript{149} reached the identical conclusions. There, First Home Builders of Florida, contracted to build several homes in Lee County, Florida, after completion and delivery of the homes to the homeowners, damage to the foundations, drywall, and other interior portions of the homes appeared. The damage to the homes was admittedly caused by subcontractors’ defective soil foundation work.

The court carefully examined the history of the CGL policy and

\begin{thebibliography}{10}
\bibitem{146} 242 S.W.3d at 12–13.
\bibitem{147} 242 S.W.3d at 9 (quoting Erie Ins. Exchange v. Colony Dev. Corp., 136 Ohio App. 3d 419, 736 N.E.2d 950, 952 n.1 (10th Dist. Franklin County 2000)).
\bibitem{148} 242 S.W.3d at 9-10.
\bibitem{149} U.S. Fire Ins. Co. v. J.S.U.B., Inc., 979 So. 2d 871 (Fla. 2007).
\end{thebibliography}
concluded correctly that the current grant of coverage was the result of a deliberate underwriting intent to expand coverage under the policy to include property damage arising out of defective construction.\textsuperscript{150} The court ruled that a subcontractor’s faulty workmanship that results in damage to the contractor’s work can constitute an “occurrence” under a post-1986 CGL policy.\textsuperscript{151} The court explicitly rejected the argument that only property damage to a third-party can be an “occurrence” under the CGL policy:

[We fail to see how defective work that results in a claim against the contractor because of injury to a third party or damage to a third party’s property is “unforeseeable,” while the same defective work that results in a claim against the contractor because of damage to the completed project is “foreseeable.” This distinction would make the definition of “occurrence” dependent on which property was damaged. For example, applying U.S. Fire’s interpretation in this case would make the subcontractor’s improper soil compaction and testing an “occurrence” when it damages the homeowners’ personal property, such as the wallpaper, but not an “occurrence” when it damages the homeowners’ foundations and drywall. As the Tennessee Supreme Court explained, in rejecting this distinction:

A shingle falling and injuring a person is a natural consequence of an improperly installed shingle just as water damage is a natural consequence of an improperly installed window. If we assume that either the shingle or the window installation will be completed negligently, it is foreseeable that damages will result. If, however, we assume that the installation of both the shingle and the window will be completed properly, then neither the falling shingle nor the water penetration is foreseeable and both events are “accidents.” Assuming that the windows would be installed properly, Moore could not have foreseen the water penetration. Because we conclude the water penetration was an event that was unforeseeable to Moore, the alleged water penetration is both an “accident” and an “occurrence” for which there is coverage under the “insuring agreement.”\textsuperscript{152}

According to the court, there is nothing in the definition of the term “occurrence” that limits coverage in the manner advanced by U.S. Fire, so it declined to read the broad “business risk” exclusions at issue in LaMarche into the definition of


\textsuperscript{151}979 So. 2d at 879.

\textsuperscript{152}979 So. 2d at 883-84 (quoting Travelers Indem. Co. of America v. Moore & Associates, Inc., 216 S.W.3d 302, 309 (Tenn. 2007)).
The decision concludes that “the appropriate consideration is whether the damage was expected or intended from the standpoint of the insured, not whose property was damaged.”

In Travelers Indemnity Company of America v. Moore & Associates, Inc., the Tennessee Supreme Court distinguished its own contrary precedent, and ruled in favor of coverage stating that an “accident” includes negligent acts of the insured causing damage which is unintended and unexpected, and that an “accident” therefore should be defined as “an unforeseen or unexpected event.” Here, the construction defects were improperly installed windows that caused water infiltration through the exterior envelope. The court rejected the insurer’s argument that water penetration was foreseeable and not a covered loss because it was a “natural consequence” of improperly installed windows. The court reasoned that the insurer’s interpretation of the term “accident” would render the coverage grant in the post-1986 CGL policy nearly meaningless:

Travelers concedes that if a contractor improperly installs a shingle that later falls and hits a passerby, this event is unforeseeable and is an “occurrence” or “accident.” However, Travelers simultaneously insists that if a contractor improperly installs windows that leak and cause flood damage to the hotel, this event is foreseeable because it is a natural consequence of improperly installed windows.

The court concluded that a more logical analysis is to assume that the contractor intended to complete the project properly and that the damage caused by the subcontractor’s defective work was the result of an “accident.”

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979 So. 2d at 885.
154 Id. (Emphasis added.)
156 216 S.W.3d at 306 (citing Vernon Williams & Son Const., Inc. v. Continental Ins. Co., 591 S.W.2d 760 (Tenn. 1979) (relying in part on Weedo v. Stone-E-Brick, Inc., 81 N.J. 233, 405 A.2d 788, 791 (1979), and holding that the “standard comprehensive general liability policy does not provide coverage to an insured-contractor for a breach of contract action grounded upon faulty workmanship or materials, where the damages claimed are the cost of correcting the work itself”).
157 216 S.W.3d at 308.
158 216 S.W.3d at 309.
In Auto Owners Ins. Co., Inc. v. Newman, the South Carolina Supreme Court reversed the primary holding of its four year old decision in L-J, Inc. v. Bituminous Fire & Marine Ins. Co., ruling that construction defects are covered “occurrences” under the CGL. The L-J, Inc. decision had cemented South Carolina in the minority camp, which employed extra-policy considerations to preclude coverage to a general contractor for damages caused by the defective construction of its subcontractors. In the Newman case, a homeowner sued a general contractor of a residential construction project because of the defective work of a stucco subcontractor whose finished work allowed water intrusion through the exterior envelope of the residence. In an about-face, the Newman court rejected L-J Inc.’s application of the business risk analysis and determined instead that the policy language of the CGL (which was identical to the policy construed in L-J, Inc.) dictated the legal conclusion that the general contractor was covered for the claim. The Newman court noted that the general contractor had no knowledge of the subcontractor’s defective work, and therefore, neither expected nor intended the property damage complained of by the homeowner. From that starting point, the court swiftly dispatched the insurer’s business risk defenses and found coverage within the four corners of the CGL policy. Specifically, the court ruled:

The facts of this case establish exactly the type of property damage the CGL policy was intended to cover after the 1986 amendment to the “your work” exclusion. In construing the provisions of an insurance policy, the Court must consider the policy as a whole and adopt a construction that gives effect to the whole instrument and to each of its various parts and provisions. To interpret “occurrence” as narrowly as Auto Owners suggests would mean that any time a subcontractor’s negligence led to the damage of any part of the contractor’s overall project, a CGL insurer could deny recovery on the basis that it is excluded from the policy’s initial grant of coverage. This interpretation would render both the “your work” exclusion and the subcontractor’s exception to the “your work” exclusion in the policy meaningless. For these reasons, we hold that the trial court correctly found that the negligence application of

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stucco resulted in an “occurrence” of water intrusion, causing “property damage” that is covered under [the] CGL policy. The court explained that its ruling gives effect to the obvious purpose of the “subcontractor’s exception” to the general’s “your work” exclusion—something that the business risk decisions fail to acknowledge in the extreme. Indeed, the Newman court explained in detail the evolution of the CGL policy that clearly and unambiguously intended to cover property damage caused by the defective construction of a general contractor’s subcontractors. The court did limit its holding to “resulting damage”—denying coverage for the cost of repairing the subcontractor’s defective work. This position is logically inconsistent with the court’s reasoning and express holding—demonstrating again the dangerous strength of the “business risk” doctrine even as it is being rejected.

The Kansas Supreme Court ruled in favor of coverage in Lee Builders, Inc. v. Farm Bureau Mutual Insurance. The court reasoned that the definition of an “accident” is controlled by “whether the resulting damage, not the act performed that led to the damage, was intentionally caused by the insured.” The court held that in Kansas “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.”

The court emphasized that the revised policy exclusions would be rendered superfluous and meaningless if construction defects were held not to constitute an “occurrence.” The court reasoned: “[a] court need only ask why the CGL policy includes an exclusion for property damage to the insured’s own work and that of its subcontractors to understand that it would be nonsensical for the policy to include such a provision if this kind of property damage could never be caused by an ‘occurrence’ in the first place.” The court also rejected the notion that CGL policies are designed to cover only tort claims. Instead, the court stated that the plain language of the policy simply does not distinguish between tort and breach of contract, and that the insurance

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162 684 S.E.2d at 545–46 (Citations omitted).
164 Id. at 492.
165 Id. at 492.
166 Id. at 493.
167 Id. at 494.
company drafting a policy has the burden to expressly clarify any such distinctions.\textsuperscript{168}

In Architex Ass’n, Inc. v. Scottsdale Ins. Co.,\textsuperscript{169} the Mississippi Supreme Court addressed as a matter of first impression whether construction defects were covered claims under a CGL. The insurer presented a particularly aggressive theory to prevent coverage. There, it was uncontroverted that the general contractor did not self perform any of the defective work. The insurer, however, argued that the general “intentionally” retained the subcontractors who did perform the work, and was contractually empowered to control them. It claimed the general should be held responsible for the defective work as though it had constructed the work, and therefore should be barred from finding coverage because of extra-policy considerations, specifically those underpinning the “business risk” doctrine. The insurer presented the court with all the usual “business risk” doctrine arguments, all of which the court dispatched quickly, reasoning:

We find the appropriate analysis should not be driven by policy justifications, but rather should be confined to the policy language.


\textsuperscript{169}Architex Ass’n, Inc. v. Scottsdale Ins. Co., 27 So. 3d 1148 (Miss. 2010).
The policy either affords coverage or not, based upon application of the policy language to the facts presented.\textsuperscript{170}

Applying that judicial model to the facts of the case, the court concluded that “CGL policies are designed to provide liability protection for the general contractor and their subcontractors for accidental, inadvertent acts which breach accepted duties and proximately cause damage to a person or property.”\textsuperscript{171} The court rejected out of hand the notion that the simple act of hiring subcontractors eliminated coverage for the general for the defective construction of those subcontractors. The court reasoned:

Plainly, an interpretation of the policy which views the term “occurrence” categorically to preclude coverage for the simple negligence of a subcontractor subverts the plain language and purpose of the CGL . . .. For example, if a roofing subcontractor negligently causes a roofing tile to fall, injuring a passerby, does such an inadvertent act on the part of the subcontractor automatically defeat coverage simply because the subcontractor was intentionally hired by the insured-general contractor? Could one legitimately argue, as a matter of law, that the “bodily injury” resulting therefrom was “expected or intended from the standpoint of the insured?” We hold it does not.\textsuperscript{172}

The precise holding of the Mississippi Supreme Court puts it in the majority of recent jurisdictions addressing the question of whether there is coverage for defective construction caused by the work of a general’s subcontractors: “The subject policy unambiguously extends coverage to [the insured-general contractor] for unexpected or unintended ‘property damage’ resulting from negligent acts or conduct of a subcontractor . . ..”\textsuperscript{173}

On September 30, 2010, the Indiana Supreme Court re-wrote decades of contrary decisional law in Sheehan Construction Co. v. Continental Cas. Co.,\textsuperscript{174} placing that jurisdiction squarely in the new majority camp, where policy language trumps the “business risk” doctrine. Sheehan involved the classic subcontractor exception to the “your work” exclusion. Sheehan was a general contractor of a residential development who subcontracted to trade contractors all of the construction work on all of the homes.

\textsuperscript{170} Id. at 1156.
\textsuperscript{171} Id.
\textsuperscript{172} Id. at 1161.
\textsuperscript{173} Id.
\textsuperscript{174} Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010).
The underlying dispute involved claims by all of the homeowners against Sheehan for exterior envelope failures and resultant damage to the homes and their interiors. Sheehan’s CGL carrier defended under a reservation of rights. Sheehan settled the claims for $2.8 million, and as part of the settlement assigned its contractual rights to coverage to the homeowners. The carrier commenced a declaratory judgment action in state court seeking a determination of no coverage. The trial court and the court of appeals ruled for the insurer, relying on decades old Indiana law that applied the “business risk” doctrine to invalidate coverage for faulty workmanship, regardless whether it was performed by the insured-general contractor or its subcontractors.\textsuperscript{175}

The Indiana courts had long held that a CGL policy provided coverage for property damage caused by defective construction only if the damaged property was something other than the work of the general contractor or its subcontractors.\textsuperscript{176} The facts in the Sheehan case fell squarely within the decades old law. The Supreme Court expressly accepted review from the court of appeals to reconsider that law in light of the newly-emerging majority rule. The court observed that its precedent could be construed to confuse the application of an exclusion with the broad initial grant of coverage in the CGL policy’s insuring clause. The latter, it reasoned, expressly provides coverage for damage to the work of the project.\textsuperscript{177} The court expressed regret that over-broad generalizations about the purpose of the policy exclusions had


\textsuperscript{176}Id.

\textsuperscript{177}Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010). The court adopted the reasoning of the Wisconsin Supreme Court, stating: “[W]e agree with the observations of the Wisconsin Supreme Court that ‘CGL policies generally do not cover contract claims arising out of the insured’s defective work . . . , but this is by operation of the CGL’s business risk exclusions, not because a loss actionable only in contract can never be the result of an ‘occurrence’ within the meaning of the CGL’s initial grant of coverage.’” Id. (quoting American Family Mut. Ins. Co. v. American Girl, Inc., 2004 WI 2, 268 Wis. 2d 16, 673 N.W.2d 65, 76 (2004)).
resulted in misconstruing the actual grant of coverage in the CGL policy.\textsuperscript{178}

The court acknowledged that the “Occurrence Debate” has divided courts across the country with the battle line drawn essentially between the notion of the “business risk” doctrine and the express language of the policy. The court carefully staked out its “side of the divide” by rejecting the “business risk” doctrine as a matter of “public policy.” It reasoned instead that the “business risk” notion is contained in the insured’s “your work” exclusion, and has been since 1986. That exclusion expressly exempts damage to property caused by the insured-general contractor’s subcontractors. Nothing in the policy or that exclusion purports to exclude the construction work itself. To the contrary, the broad grant of initial coverage in the policy’s insuring language must include the work of the project. To hold otherwise would render the “subcontractor exception” meaningless. The court reasoned that if it means anything, it must mean that the work of the subcontractor may constitute covered “property damage” under the policy\textsuperscript{179} as long as it is “caused by an occurrence.”\textsuperscript{180} The court reasoned:

A court need only ask why the CGL policy specifically includes an express exception to the “your work” exclusion for property damage arising out of the work of a subcontractor to understand that this kind of property damage must be included in the broad scope of the term “occurrence” in the coverage grant, and that the coverage determination for this kind of property damage must be made based on the construction-specific policy exclusions.\textsuperscript{181}

Addressing the meaning of the term “occurrence,” the court ruled that it must be deciphered from the plain language of the

\textsuperscript{178}It cited the recent Tennessee Supreme Court ruling which declared that “[r]eliance upon a CGL’s ‘exclusions’ to determine the meaning of ‘occurrence’ has resulted in regrettably overbroad generalization concerning CGLs.” Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010) (quoting Travelers Indem. Co. of America v. Moore & Associates, Inc., 216 S.W.3d 302, 307 (Tenn. 2007)) (internal citation and quotation omitted)).

\textsuperscript{179}Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010).

\textsuperscript{180}Id., at * 6

\textsuperscript{181}Id., at * 8 (quoting Clifford J. Shapiro, The Good, the Bad and the Ugly: New Supreme Court Decisions Address Whether an Inadvertent Construction Defect is an “Occurrence” Under CGL Policies, 25 The Construction Lawyer at 9, 12 (Summer 2005)), citing Lamar Homes, supra, 242 S.W.3d at 12; J.S.U.B, supra, 979 So.2d at 891.
policy itself. The policy defines “occurrence” as an “accident.” Looking to its own precedent, the court ruled that “accident” denotes “an unexpected happening without an intent or design.” It explained that “[i]mplicit in the meaning of ‘accident’ is the lack of intentionality.” Presented with the question whether faulty workmanship is an accident within the meaning of the CGL policy, the court ruled:

In our view the answer depends on the facts of the case. For example, faulty workmanship that is intentional from the viewpoint of the insured cannot be an “accident” or an “occurrence.” On the other hand if the faulty workmanship is “unexpected” and “without intention or design” and thus not foreseeable from the viewpoint of the insured, then it is an accident within the meaning of a CGL policy.

The court concluded ultimately that as long as the insured general contractor reasonably assumes that the work of its subcontractors will be performed correctly, then any property damage arising from the faulty work of any of its subcontractors must be considered an “accident” and therefore an “occurrence.”

Cases Extinguishing Coverage Based on Extra-Policy Considerations

In Kvaerner Metals v. Commercial Union Insurance Co., the Pennsylvania Supreme Court found no “occurrence,” and therefore no insurance coverage, in connection with property damage caused by the defective work of a subcontractor in the construction of a coke oven battery for a steel company. The insured general contractor insisted that it was covered because the alleged damages arose out of its subcontractor’s negligent behavior.

The Pennsylvania Supreme Court ruled against coverage by

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183 Sheehan Const. Co., Inc. v. Continental Cas. Co., 935 N.E.2d 160 (Ind. 2010), opinion adhered to as modified on reh’g on other grounds, 2010 WL 5135322 (Ind. 2010).
184 Id. (citing Lamar Homes, supra, 242 S.W.3d at 8–9).
185 On December 17, 2010, the Indiana Supreme Court modified its ruling in the Sheehan case. On rehearing, it affirmed its prior coverage determination, but nonetheless affirmed the grant of summary judgment for the insurer on the basis that the policy holder, Sheehan Construction Co., failed to provide timely notice to the insurer. In Indiana, prejudice is presumed if the insured fails to promptly notify its insurer of a suit or claim. See Sheehan Const. Co., Inc. v. Continental Cas. Co., 2010 WL 5135322 (Ind. 2010).
basing its holding on decisions from other courts whose decisions were largely influenced by the “business risk” doctrine, including now discredited precedent. The court’s holding is based on legal publications issued decades ago, including Dean Henderson’s tired old analysis of the ISO’s 1966 CGL form.

The Arkansas Supreme Court produced a similarly uncareful analysis of the issue in Essex Ins. Co. v. Holder. There, a general contractor was sued by homeowners for defective construction and workmanship performed by subcontractors. The Arkansas Supreme Court found no “occurrence” under the general’s CGL, and therefore no coverage.

The court reached this conclusion by redefining the term “accident,” as “an event that takes place without one’s foresight or expectation—an event that proceeds from an unknown cause, or is an unusual effect of a known cause, and therefore not expected.” Without any analysis of the actual policy language and its underwriting history, the court ruled that “[f]aulty workmanship is not an accident; instead it is a foreseeable occurrence.” The court reasoned “defective workmanship standing alone—resulting in damages only to the work product itself—is not an occurrence under a CGL policy.”

In Cincinnati Ins. Co. v. Motorists Mut. Ins. Co., the Kentucky Supreme Court issued its “first impression” decision on the issue of insurance coverage for defective construction. In that case, two insurers had provided coverage to a general contractor who was sued by a homeowner for property damage that occurred over the course of multiple policy periods. One of the insurers stepped up to the plate and provided coverage, and ultimately settled the claim. It sought contribution from the other insurer on the risk, who resisted on the basis that the owner’s allegations were not covered under CGL policies because of extra-policy considerations. The Kentucky Supreme Court fashioned the ques-

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190 Id. at 458.
191 Id. at 460.
192 Id. at 460.
tion before it in the classic way that courts do when they intend to ignore the actual language of the insurance policy: “whether faulty construction-related workmanship, standing alone, qualifies as an ‘occurrence’ under a CGL policy.”

The Kentucky Supreme Court “carefully” read the Nebraska Supreme Court’s “characterization of this . . . difficult question,” and decided to adopt the minority position, which it incorrectly described as “the majority viewpoint.” The Kentucky Supreme Court used “old law” to come to the conclusion that its ruling was a “majority ruling.” If it had focused on the most current trending in these coverage cases, it would have determined that the majority rule is actually contrary to its holding. Einstein once joked that if it weren’t for time, everything would happen at once. But time brushes its varnish over everything; it is its passage that allows us the opportunity to observe the world and its surroundings anew—the current majority rule demonstrates that this includes “observing” the actual insuring language of the CGL.

The Kentucky Supreme Court fell victim to what is more aptly described as the minority view of the coverage debate, which ignores the actual policy language and, instead, fashions a rule that defective construction should not be covered for extra-policy reasons. And what puts this decision at the top of the steaming heap of illogic is its express rejection of the policy definition of “occurrence.” Instead of applying the policy definition to the coverage issue, it insinuated the issue of theoretical “control” into the coverage determination. The court reasoned:

Clearly, [the general contractor] had control over the construction of the Mintmans’ home, either directly or thorough the subcontractors it chose. One cannot logically say, therefore, that the allegedly substandard construction of the Mintmans’ home by [its subcontractor] was a fortuitous, truly accidental event. This leads to the inevitable conclusion that the faulty workmanship claim at issue is not covered by the CGL policy.

In Kentucky, therefore, it matters not whether the general contractor had even a notion that the questionable construction activity occurred. Instead, that state’s courts will infer that knowledge to the general contractor because it had theoretical control over its subcontractors. In Kentucky, it is irrelevant whether the property damage complained of was “intended or expected” by the general contractor. Instead, as a matter of law,

194 Id. at 72 (emphasis added).
195 Id. at 76.
that knowledge will be inferred to defeat coverage. In so doing, the court also defeated the purpose and intent of the policy, and in the stroke of a pen denied contractors, subcontractors, owners, lenders, sureties and every potential injured party, coverage for what was theretofore a bargained-for covered claim. Thus is the consequence of the “business risk” doctrine and the folly that follows in its wake.

VI. Conclusion

The Contractor’s reasonable expectation of predictability in this very important context has been sideswiped by the machinery of law in too many courts across this country. While the trend is toward more careful judicial deliberation of the coverage issue tied to the language of the CGL policy, contrary decisional law continues to litter the national coverage landscape. Contractors, owners, lenders and sureties may rest easier when they are building in Florida, Indiana, Kansas, Minnesota, Mississippi, South Carolina, Tennessee, Texas, Indiana and Wisconsin. They might think twice about whether to build that same project in Arkansas, Illinois, Kentucky, Pennsylvania and West Virginia.

No right thinking contractor plans to construct a project negligently. In addition, sophisticated contracting parties to a construction project understand that complex engineered solutions to the design and delivery of a project can sometimes produce unexpected and unwanted results. Sometimes, those results manifest themselves as physical injury to tangible property—a consequence that none of the parties want, but all of the parties expect to be covered by liability insurance if it occurs.

The “business risk” doctrine and judicial models influenced by it are not characterized by the kind of thinking that is designed to break the genius machine. Builders and those who look to them for solutions are unanimous in their advocacy for an analysis that better reflects the needs and expectations of the contracting parties. They are not demanding Algonquin-caliber thinking, just a simple comparison of the actual policy language against the allegations in a Complaint or Demand for Arbitration. Analyzing coverage issues using the “business risk” doctrine is as thoughtful as a moose calf crashing through the cranberry bogs of its first winter. It’s as wrong as a thong on Mother Superior.

The time has come for courts nationally to drive a stake through the heart of the “business risk” doctrine. Policy wise, it’s right up there with camping on commuter tracks; as lame as a snowy egret in a sack race. On its best day, it’s ketchup to good meat—absolutely unnecessary and imminently regrettable.