Expanding Insurance Coverage for Faulty Workmanship

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Introduction

In what amounts to good news for contractors and bad news for insurance companies, coverage has expanded under commercial general liability policies for damages arising out of faulty or defective workmanship. Courts continue to acknowledge that faulty workmanship is not an "occurrence" and further that there is generally no coverage solely for repairing or replacing faulty work. However, defective work can become an "occurrence" where it causes damage to other property, even to the insured's own work or product. For many years, courts have found coverage for damages caused by faulty work to personal property or other property *outside the scope of the insured's work*. Recently, however, courts have gone further, finding coverage for damage to the insured's own "work" and, in at least one instance, coverage for replacing faulty work.

The CGL Policy

CGL policies are intended to protect an insured from unexpected and accidental damage to people or property arising out of business operations, while performance bonds are intended to insure the contractor against claims for repairing or replacing faulty work. Like most insurance policies, a CGL policy begins with a broad grant of coverage in an "Insuring Agreement," followed by various exclusions from coverage. Some of the exclusions have exceptions which operate to add back coverage that would otherwise be excluded by the policy. A CGL's Insuring Agreement provides liability coverage for "those sums that the insured becomes legally obligated

to pay as damages because of 'bodily injury' or 'property damage' . . . caused by an 'occurrence.'" The key words, defined in the policy, are "bodily injury," "property damage," and "occurrence." For purposes of this discussion, the focus is on "occurrence" and whether faulty workmanship can ever be an "occurrence" or result in an "occurrence." An "occurrence" is generally defined in the policy as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Historically, courts have held that faulty workmanship is not an accident and thus not an "occurrence." CGL policies also have exclusions such as the following "your work" exclusion which courts have held excluded coverage for losses due to faulty work:

> This insurance does not apply to:
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> * * *
>
> **L. Damage To Your Work**
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> "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".
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> 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 "your work" exclusion is designed, in part, to help ensure that a CGL policy does not act as a warranty for a contractor's or builder's completed work. The last phrase of the "your work" exclusion is an exception to the exclusion which provides that the exclusion does not apply to any damages to or by work performed on the named insured's behalf by a subcontractor. In other words, if the damage is caused to or by work performed by one of the insured's subcontractors, the exclusion does not apply, and there could be coverage if all other terms and conditions are met.

Historical Precedent in Alabama as to Coverage for Faulty Work

Alabama Supreme Court jurisprudence on coverage for construction defects frequently involves leaky roofs. That is helpful because the leaky roof cases are usually easy to understand and visualize. The typical situation in those cases is that a contractor is hired to install, repair, or replace a roof. They don't their job properly, and the roof leaks causing damage to personal property within the building or house. The Alabama Supreme Court has consistently held that in such a situation, there is no coverage for fixing or replacing the defective roof, but there is coverage for the water damage to property other than the roof. *See, e.g., Moss v. Champion Insurance Company*, 442 So. 2d 26 (Ala. 1983) (where insured roofing company failed to properly cover roof during repairs, court found coverage for resulting water damage); *USF&G v. Bonitz Insulation Company of Alabama*, 424 So. 2d 569 (Ala. 1982) (damage to defective roof installed by insured was not covered but damage caused by leaks to other property was covered, such as damage to the ceilings, walls, carpets, and floor). In *Bonitz*, the carriers argued that the water entry problem due to the defective roof was not an "occurrence" under the CGL policies. The Alabama Supreme Court disagreed, ruling that when the roof leaked causing property damage, there was an occurrence. *Bonitz*, 424 So. 2d at 571.

Those well-known and oft-cited leaky roof cases from the 1980s involved damage to other property which was not part of the insured's product or work. They did not expressly address whether there could be coverage for damage to the insured's own work or product, caused by the insured's defective work.

In a case released on the same day as *Moss v. Champion*, the Alabama Supreme Court in *USF&G v. Warwick Development Company*, 446 So. 2d 1021 (Ala. 1984), held there was no

coverage for defective construction of a new home. In *Warwick*, the insured contractor was hired to build a new home. The purchasers alleged structural defects and filed suit. The contractor's CGL carrier denied coverage, arguing there was no insurable loss and that damages to the insured's work (construction of the new home) caused by faulty workmanship were not covered. The Alabama Supreme Court framed the issue as "whether the policy provided coverage for alleged faulty workmanship and noncomplying materials in the construction of plaintiff's residence when the alleged damage was confined to the residence." *Warwick*, 446 So. 2d at 1023. The Court held there was no coverage, finding that the defective construction of the new home was not an "occurrence." Based on the way the Court framed the issue in *Warwick* and its ultimate ruling in that case, it appeared there is no coverage for damage caused to the insured's own non-defective work where the damage is caused by faulty workmanship—the insured built the home in *Warwick* so the entire house was the insured's work. In *Warwick*, the Court found that faulty work itself was not an "occurrence." In *Moss*, the Court ruled that the rain damage due to faulty work was caused by an "occurrence."

In *USF&G v. Andalusia Ready Mix*, 436 So. 2d 868 (Ala. 1983), released about the same time as *Moss* and *Warwick*, the Supreme Court ruled there was an "occurrence" where the insured supplied defective grout for use in the construction of a sewage treatment plant. The underlying plaintiffs alleged the defective quality of the grout necessitated repairs and remodeling of the treatment plant. In relying on the definitions of "occurrence," "property damage," and policy exclusions, the Court found coverage for all damages caused by the insured's defective grout, <u>except</u> for the cost of the actual removal and replacement of the grout itself.

In reconciling the above cases coming out of the early 1980s, the following principles appeared to apply, until recently: (1) damage to the insured's own work or product is not covered where caused by the insured's faulty work and (2) repairing or replacing faulty work is never covered. However, in light of recent court decisions, these principles appear to have been either revised or no longer apply. Damage to the insured's own work, caused by defective work, can be covered. And the cost of repairing or replacing faulty work is potentially covered under certain circumstances such as where needed to fix other damage caused by the faulty work.

Recent Alabama Cases

In *Town & Country Property, LLC v. Amerisure Insurance Company*, 111 So. 3d 699 (Ala. 2011), a car dealer hired a contractor to build a car dealership facility. After construction was completed, the dealer discovered construction defects and sued the contractor. While the contractor's CGL carrier defended the contractor, the carrier sought a declaration that it did not owe indemnity for the judgment against the contractor based on faulty construction. The carrier argued there had been no "occurrence" or accident and, even if there had been, exclusions applied. The trial court entered judgment for the carrier, finding that, in Alabama, faulty construction is not an occurrence.

On appeal, the Alabama Supreme Court agreed there was no coverage for repairing or replacing the contractor's faulty work. The Court explained, "reading *Moss* and *Warwick* together, we may conclude that faulty workmanship itself is not an occurrence but that faulty workmanship may lead to an occurrence if it subjects personal property or other parts of the structure to 'continuous or repeated exposure' to some other 'general harmful condition' . . . and as a result of that exposure, personal property or other parts of the structure are damaged."

Town & Country, 111 So. 3d at 706. The Supreme Court in *Town & Country* remanded the case for the trial court to determine if any of the damages represented compensation for damaged "personal property" or "otherwise nondefective portions of the facility," which the Court said would be covered under the CGL policy. *Id.* at 708. The underlined phrases above in *Town & Country* foreshadowed future decisions finding coverage for damage to the insured's own work.

About two years after *Town & Country*, in May 2013, the Alabama Supreme Court reiterated there is no coverage where there are only allegations of faulty workmanship, without any resulting property damage. *Shane Traylor Cabinetmaker, LLC v. American Resources Insurance Company, Inc.*, 126 So. 3d 163 (Ala. 2013). In that case, a cabinet subcontractor sued a builder (who also was the homeowner) for payment; the builder/homeowner counterclaimed for defective work but did not claim any other resulting damages. The Supreme Court found no coverage solely for defective work. There was nothing controversial or new with that ruling. In its reasoning, the Court quoted its prior language from *Town & Country* holding that "faulty workmanship itself" is not an accident or "occurrence." The Supreme Court found that the only allegations in *Cabinetmaker* were solely for faulty workmanship, which were not covered by the policy. However, the Court went further, suggesting types of construction defect damages that could be covered, if they had been alleged, by noting that the claims in *Cabinetmaker* did not include any alleged damages to the subject properties as a result of the defective work, additional repairs or remodeling to the property necessitated by the faulty work, or any loss of use of the properties due to defective work (implying the Court thought all such damages could have been covered). *Id*. at 168. In his concurrence in *Cabinetmaker*, Justice Murdock suggested that, in an appropriate case, there could be coverage for damage to a contractor's own work where caused by defective workmanship. *Id*. at 172. Less than one year later, the Alabama Supreme Court, in

a 180-degree turnaround on rehearing, found coverage where faulty workmanship caused damage to the insured's own work.

In *Owners Insurance Company v. Jim Carr Homebuilder, LLC*, 157 So. 3d 148 (Ala. Mar. 28, 2014), a couple hired a contractor to build a lake house. After completion of construction, the couple noticed several problems with the house relating to water leaking through the roof, walls, and floors resulting in water damage to those and other areas of the house. After remedial efforts failed, the homeowners sued the contractor. The contractor's carrier defended under a reservation of rights and also filed a declaratory judgment action as to its coverage obligations. The homeowners obtained a $600,000 award against the contractor based on numerous findings of faulty construction throughout the house which caused the water damage. The trial court in the declaratory judgment action ruled that the carrier owed coverage for the entire verdict. The carrier appealed.

In its initial 5-0 decision released on September 20, 2013, the Alabama Supreme Court reversed the trial court and found in favor of the carrier, holding there was no coverage for any part of the verdict. The Court first noted "the issue of whether poor workmanship constitutes an occurrence . . . depends on the nature of the damage caused by the faulty workmanship." The Court then quoted at length from *Warwick* and *Moss*, comparing those two cases and reconciling them by stating they made "clear that faulty workmanship performed as part of a construction or repair project may lead to an occurrence if the faulty workmanship" causes property damage to "personal property or other parts of the structure outside the scope of the construction or repair project." (Emphasis in original). The Court stated that *Owners Insurance Company* was "substantially identical" to *Warwick*, in which it held there was no coverage for damages caused by defective construction of a new house—the entire new house was the insured's work.

Accordingly, on September 20, 2013, the Court reversed the trial court and ruled there was no coverage. The Court reasoned there was no "occurrence" because the poor workmanship only caused damage to the insured's own work.

After reconsideration on rehearing, the Alabama Supreme Court withdrew its September 20, 2013 opinion and issued a new, unanimous opinion on March 28, 2014 reaching the opposite result. The Court rejected the argument that there must be damage to "other property" outside the scope of the insured's work in order for there to be an "occurrence" under a CGL policy. The Court said that, in making that argument, the carrier "asks the term 'occurrence' to do too much." The Court reasoned that the policy defines "occurrence" simply as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The definition does not make any mention of the nature, location, or ownership of the property damaged. It simply looks to whether there was an accident. According to the Court, reading into the term "occurrence" a requirement of damage outside the scope of the insured's work or product would render coverage "illusory" for an insured contractor who is hired to build a new building or new house—in such a situation, the Court said that no damage to any portion of the project could be covered since it would all be the insured's work. Under *Owners Insurance Company*, faulty work is not an "occurrence," but if the faulty work causes damage to <u>any</u> property (including within the scope of the insured's own work), then it becomes an "occurrence."

While prior cases stated the principle that "faulty workmanship itself is not an occurrence," the Alabama Supreme Court revised that principle, by citing and quoting Justice Murdock's concurrence from *Cabinetmaker*, to say that "faulty workmanship itself is not 'property damage' 'caused by' or 'arising out of' an 'occurrence.'" Under this revised principle,

there still is no coverage for repairing or replacing faulty work itself, but there could be coverage if the faulty work causes additional damage to a contractor's own work. Justice Shaw wrote separately to reiterate that "the cost to repair and replace the faulty work itself is not covered as an 'occurrence' even if all resulting damage caused by the faulty work is covered."

After finding that there was an occurrence of property damage, the Court then considered whether the "your work" exclusion applied in *Owners Insurance Company*. The Court ruled it did not. The "your work" exclusion in *Owners Insurance Company* did not include the usual subcontractor exception for work performed by subcontractors. If it had, the exclusion would not have applied because the work in that case was performed by subcontractors. In spite of the absence of the subcontractor exception, the Court still found that the "your work" exclusion did not apply because the insured had purchased products-completed operations hazard coverage. Despite the "your work" exclusion's appearance in the exclusion section of the policy, which apparently had not be modified by endorsement, the Court looked to the Policy Declarations, saw that the insured had purchased products-completed operations coverage, and thereby ruled that the "your work" exclusion did not apply. The Court noted that CGL policies are designed to provide coverage for any liability incurred during ongoing operations while the insured is engaged in performing work, but the Court further noted that an insured can buy "products completed operations hazard" coverage to provide coverage for any liability arising after the insured finishes work on the project. According to the Court, if the "your work" exclusion applied, that would have been inconsistent with, and rendered illusory, the supplemental products completed operations coverage purchased by the insured. Thus, the Court refused to apply the "your work" exclusion in that case.

The Supreme Court considered an insured having products-completed operations coverage and the "your work" exclusions mutually exclusive or inconsistent and thus refused to enforce the "your work" exclusion. However, the "your work" exclusion simply excludes coverage for damage to the insured's own work. It does not exclude coverage to other property outside the scope of the insured's work. Even under the "your work" exclusion, products-completed operations coverage still would apply to damages to other property, arising after the insured has finished its work on the project. In the leaky roof example, if the insured had products-completed operations coverage and the "your work" exclusion remained in the policy, there would not be any coverage for damage to the defective roof itself (because of the "your work" exclusion), but there could be coverage to other property that is not the insured's work such as anything that is damaged within the building when the roof leaks.

In *Owners Insurance Company*, the Alabama Supreme Court did not overrule *Warwick*, even though *Owners Insurance Company* would seem to be much like the facts in *Warwick*. However, the Court reached opposite results in the two cases. Both involved defective construction of new houses. However, *Warwick* found no coverage for the construction defects, whereas *Owners Insurance Company*, on rehearing, found coverage.

Having said that, the Alabama Supreme Court's decision in *Owners Insurance Company* places the Court within the growing majority of courts nationwide finding coverage for damage to construction or building projects caused by faulty work or construction defects.

In another recent example of expanding coverage for faulty work, in *Pennsylvania National Mutual Casualty Insurance Company v. St. Catherine of Siena Parish*, 790 F.3d 1173 (11th Cir. June 10, 2015), the Eleventh Circuit found coverage under a CGL policy for the costs

of removing and replacing the insured's own faulty work, in addition to finding coverage for other damages caused by that faulty work. In that case, a church hired a contractor to repair an existing roof by removing old shingles and installing new ones. The contractor used the wrong materials and wrong process for that particular type of roof. After the insured had completed its work, the roof leaked significantly causing water damage. The church filed suit in state court and obtained a verdict against the contractor. The contractor's carrier provided a defense under a reservation of rights but then sought a declaration in federal court that it did not owe indemnity for the verdict. Consistent with case law dating back to at least the early 1980s, the Eleventh Circuit ruled there was coverage under the contractor's CGL policy for the damage to other property (*e.g.*, the ceiling) caused by the leaky roof. However, the court went further and held that the cost of repairing and replacing the insured's own work, removing and replacing the shingles, also was covered. The court reasoned that replacing the insured's work in this instance was necessary to correct the damage caused by the faulty work to other, existing property that was not installed by the insured contractor.

Even after *Owners Insurance Company*, there still is no coverage for merely repairing or replacing faulty work, without any other damage. The Alabama Supreme Court in 2013 in *Cabinetmaker* held there was no coverage for faulty work without any other damage. The Court in *Owners Insurance Company* reiterated that "the cost of repairing or replacing faulty workmanship is not the intended object of a CGL policy issued to a builder or contractor." *Owners Insurance Company*, 157 So. 3d at 156. Justice Shaw, in his concurrence in *Owners Insurance Company*, stated "our caselaw makes clear that faulty workmanship itself is not 'damage' caused by an 'occurrence' or 'accident;' thus, the cost to repair or replace faulty workmanship is not covered by the policy." Federal courts also continue to exclude coverage

where the damage is solely the cost of repairing or replacing defective work. *Pennsylvania National Mutual Casualty Ins. Co. v. Snider,* 2015 U.S. App. LEXIS 5550 (11th Cir. Apr. 7, 2015) ("when a contractor performs faulty work, generally his conduct is not considered an accident [*i.e.*, an occurrence] . . . when the contractor's faulty work creates a condition that in turn damages property, however, the conduct is considered an accident"—costs to repair faulty work were not covered, while policy would cover damages for repairing conditions caused by faulty work); *Pennsylvania National Mutual Casualty Ins. Co. v. The Retirement Systems of Alabama*, 2015 U.S. Dist. LEXIS 52055 (N.D. Ala. Apr. 21, 2015) (finding no coverage for repair of defectively installed firewall where it did not comply with the city building code and resulted in the growth of mold—mold damage was excluded by mold exclusion; there was no covered damage to other property beyond the insured's defective work, the firewall).

Conclusion

The take-aways appear to be: (1) there still is no coverage for repairing or replacing faulty work where there is no other damage; (2) faulty work can result in a covered occurrence where it causes damage to any property, including to the insured's own work; and (3) coverage can even include the cost to repair or replace faulty work if necessary to address damage caused to other property by the faulty work. In addition, following the Supreme Court's recent decision in *Owners Insurance Company*, contractors should consider purchasing products-completed operations hazard coverage in order to attempt to avoid application of the "your work" exclusion and to support coverage for liabilities incurred after their work is completed. And carriers should be mindful in analyzing construction defect claims whether the policy includes completed operations coverage.