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Cover Me: The Subcontractor Exception to the Your [Completed] Work Exclusion

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One of the most contested provisions of the commercial general liability (CGL) policy is the provision excluding coverage for property damage to the insured's completed work. In 1986 Insurance Services Office, Inc. (ISO), revised the standard CGL policy form to include an exception to this exclusion if a subcontractor performed the work for the insured. This revision has become heavily litigated.

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Most jurisdictions considering this exclusion and its exception apply the plain language of the policy to find coverage for property damage to the insured's completed work if a subcontractor performed the work.

The standard ISO policy form designates the exclusion for the insured's completed work as exclusion (l) (and we refer to it that way in this article). Non-ISO CGL policies also contain this exclusion, as do excess and umbrella policies, although excess and umbrella policies often omit the subcontractor exception.

Standard CGL Policy Language

Exclusion (l) states that the insurance policy does not apply to:

> "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

Exclusion (l) is one of several standard CGL policy exclusions often called the business risk exclusions. The business risk exclusions "are designed to exclude coverage for defective workmanship by the insured builder causing damage to the construction project itself." *Sapp v. State Farm Fire & Cas.*, 486 S.E.2d 71, 74 (Ga. App. 1997). The business risk exclusions (j) through (n) preclude coverage generally for property damage to the work of the insured. *American Farm Mut. Ins. v. American Girl, Inc.*, 673 N.W.2d 65, 81 (Wis. 2004).

The scope of the business risk exclusions varies widely from one jurisdiction to another. Several factors govern each jurisdiction's interpretation of the policy language upon the facts presented. As one court has explained, "where the alleged occurrence involves the builder's risk exclusion ... the alleged occurrence and the builder's risk issues are so intertwined that they must be analyzed together...." *Custom Planning & Dev., Inc. v. American Nat'l Fire Ins.*, 606 S.E.2d 39, 42 (Ga. App. 2004). In this article, though, we've limited our discussion to the issues surrounding the interpretation and application of the subcontractor exception to exclusion (l).

The Business Risk Doctrine

Exclusion (l) precludes coverage for "property damage" to the insured's work arising after a construction project is finished and in the owner's possession. *Lennar Corp. v. Great Am. Ins.*, 200 S.W.3d 651, 670 (Tex. App. 2006). The exception raises the issue of whether it modifies the business risk doctrine to provide coverage for faulty work, ordinarily not covered, when performed by a subcontractor. *See e.g.*, *J.S.U.B., Inc. v. U.S. Fire Ins.*, 906 So. 2d 303 (Fla. App. 2005), *rev. granted*, 925 So. 2d 1032 (Fla. 2006) (reviewing the precise issue of whether the exception to the exclusion provides coverage for the general contractor for property damage arising out of the work performed by a subcontractor).

The business risk doctrine emerged from a comparison of the "two types of risk undertaken by the insured-contractor." *Thommes v. Milwaukee Mut. Ins.*, 641 N.W.2d 877, 881 (Minn. 2002). The first is the business risk borne by the contractor to replace or repair defective work to make the building project conform to the agreed contractual requirements. *Grinnell Mut. Reins. v. Lynne*, 686 N.W.2d 118, 124 (N.D. 2004)(citation omitted). The second is the risk that the defective or faulty workmanship will cause injury to people or damage to other property. The former is not covered by the CGL policy pursuant to the business risk exclusions. The latter is covered because of the potentially limitless liability associated with it; this risk is precisely the type of risk covered by CGL policies. *Weedo v. Stone E. Brick, Inc.*, 405 A.2d 788, 791 (N.J. 1979).

The courts applying the business risk doctrine note that "a CGL policy is not a performance bond and is not intended to protect a contractor's business risk to replace or repair defective work that does not conform to the agreed contractual requirements." *ACUITY v. Burd & Smith Constr., Inc.*, 721 N.W.2d 33, 40 (N.D. 2006). Thus, "the CGL policy excludes coverage for damage sustained by a part of an insured's work due to his own 'incorrect' work." *Minery Neenah LLC v. Rotary Dryer Parts, Inc.*, 2006 WL 2711808, 3 (E.D. Wis. 2006). These exclusions "are intended to provide coverage for tort liability, but not for contract liability of the insured for loss because the product or completed work was not that for which the other party bargained." *Grinnell* at 124.

The majority of jurisdictions considering the effect of the subcontractor exception conclude that this exception has modified the traditional business risk doctrine to no longer exclude coverage for faulty work performed by a subcontractor. *Lennar* at 672. Courts reason that the contractor can control its own performance but cannot necessarily control a subcontractor's performance. *Lennar* at 675 n.29 (*citingFireguard Sprinkler Sys., Inc. v. Scottsdale Ins.*, 864 F.2d 648, 653-4 (9th Cir. 1988)).

History of the Exception

Before 1976, the business risk exclusions precluded coverage for damages arising out of the work of subcontractors. Many contractors were unhappy with the unavailability of coverage because more projects were being completed using subcontractors. *American Girl*, at 82. In response, for an additional premium, insurers began offering the broad form property damage (BFPD) endorsement in 1976. The BFPD endorsement deleted several portions from the "business risk" exclusions and replaced them with more specific exclusions that effectively broadened coverage. Among other changes, the BFPD narrowed the "your work" exclusion and extended coverage for "property damage" to the work of a subcontractor or "property damage" arising out of the work of a subcontractor. *Lennar* at 672. In 1986 the insurance industry incorporated this aspect of the BFPD endorsement directly into the CGL policy form by inserting the subcontractor exception into the "your work" exclusion.

Interpretation of the Subcontractor Exception

The majority of courts apply the exception to exclusion (l) to provide coverage for "damages to the insured's own work that arise out of the work of a subcontractor." *Wanzek Constr., Inc. v. Employers Ins. of Wausau*, 667 N.W.2d 473, 478-9 (Minn. Ct. App. 2003). In doing so, these courts either apply the plain language of the policy or explain that caselaw interpreting the business risk doctrine within the context of the pre-1986 policy form no longer applies because that form did not contain the exception. *See e.g.*, *Lennar* at 672-3.

The opponents of coverage argue that an exception to an exclusion cannot create coverage where none exists. *See e.g.*, *Lassiter Constr., Inc. v. American States Ins.*, 699 So. 2d 768 (Fla. App. 1997); *see alsoReliance Nat'l Ins. v. Hatfield*, 228 F.3d 909 (8th Cir. 2000). Responding to this argument, courts find that the exception to the exclusion merely "restore[s] otherwise excluded coverage." *French v. Assurance Co. of Am.*, 448 F.3d 693, 706 (4th Cir. 2006). The exception does not create coverage because the policy initially granted such coverage under the insuring agreement. The business risk exclusions exclude this coverage but the exception restores the initially granted, but subsequently excluded, coverage. *SeeAmerican Girl* at 83-4.

Responding to the argument that applying the exclusion to provide coverage for faulty subcontractor work turning the CGL policy into a performance bond or making the general contractor the de facto surety for incorrect subcontractor work, *Travelers Indem. Co. of Am. v. Moore & Assoc., Inc.*, 2005 WL 2293009 (Tenn. App. 2005), explained:

> [w]e realize that under our holding a general contractor who contracts out all the work to subcontractors, remaining on the job in a merely supervisory capacity, can ensure complete coverage for faulty workmanship. However, it is not our holding that creates this result: it is the addition of the

> new language to the policy. We have not made the policy closer to a performance bond for general contractors, the insurance industry has.

Moore & Assoc. at 9.

Trends

Several jurisdictions continue to adhere to the position that faulty completed work is not an occurrence and thus not within the insuring agreement of the CGL policy. *See e.g.*, *Amin Realty, LLC v. Travelers Prop. Cas.*, 2006 WL 1720401, 7 (E.D.N.Y. 2006). These jurisdictions similarly find that faulty completed subcontractor work also fails to trigger the insuring agreement, primarily because, once the work is turned over to the owner, the general contractor has accepted the subcontractors' work and incorporated it into its own finished product. *SeeKnutson Constr. v. St. Paul Fire & Marine Ins.*, 396 N.W.2d 229 (Minn. 1986), and *Tucker Constr. v. Michigan Mut. Ins.*, 423 So. 2d 525 (Fla. App. 1982).

Courts taking this position do so by finding that faulty work, causing damage only to the work itself, and not to third-party property, is not an accident, within the definition of occurrence, but rather the failure of the contractor to complete the work in a workmanlike manner as bargained-for in the construction contract. *Amin* at 6. However, the trend in recent decisions considers the defective work of a subcontractor (i.e., improper installation of the windows) an accident from the standpoint of the general contractor insured. *SeeTravelers Indem. of Am. v. Moore & Assoc.*, 2006 WL 4099997 (Tenn. 2007). This is "because the acts were not done with the intent or expectation of causing damage or injury." *National Eng'g & Contacting v. U.S. Fid. & Guar. Co.*, 2004 WL 1103993, 5 (Ohio App. 2004).

As courts continue to find coverage, the insurance industry has responded by drafting an endorsement to the CGL policy which eliminates the exception to exclusion (l). Endorsement CG 22 94 10 01 simply states that exclusion (l) is deleted and replaced by an identical exclusion (l) without the subcontractor exception. The endorsement effectively returns the available coverage under the general contractor's CGL policy for faulty completed work to that which existed prior to the 1976 creation of the BFPD: none.

Conclusion

Although not all jurisdictions have addressed the issue, the majority of those that have find that the insured general contractor or developer's CGL policies cover faulty completed subcontractor work. In response, insurers are adding endorsements to the policies that eliminate the subcontractor exception.

Given the concerns prompting the creation of the broad form property damage endorsement, judicial interpretation of the policy language, and usage of the endorsement eliminating the subcontractor exception, the issue of whether the general contractor's CGL policy covers faulty completed subcontractor work is far from settled.

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