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Full Circle Regression: The New ISO "Your Work" Endorsements

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In December, ISO issued two new endorsements for contractors' CGL policies eliminating coverage for property damage arising out of their subcontractors' defective work. Pat Wielinski examines the history and explains the problem.

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For some reason, construction defect claims have always seemed to confound the insurance industry when it comes to commercial general liability (CGL) insurance coverage. Undoubtedly, they upset the carefully cultivated compartmentalization of construction property damage claims between fortuitous accidents and uninsurable "business risks." Unfortunately, such a tidy dichotomy breaks down where an insured, such as a general contractor, uses subcontractors to perform work at a job site.

While the work of subcontractors is regarded as a general contractor's own work under the CGL policy, the contractor still cannot exert complete control over that subcontractor's operations. From the standpoint of the insured general contractor, property damage caused by defective workmanship on the part of the subcontractor may not be a controllable business risk. Rather it borders on a fortuitous occurrence.

This uneasy compromise (at least from the standpoint of the insurance industry) between the uninsurable business risk of the insured's own defective work and the occurrence of defective work performed by the named insured's subcontractors resulted in the creation of an exception to the general exclusion for defective work under a CGL policy. Under the exception, the named insured is provided coverage for property damage arising out of the defective work of its subcontractors.

This exception has been accomplished in a number of ways. It was first introduced in 1969 as part of Broad Form Property Damage (BFPD) endorsement, edition 3006 (including completed operations), and, later by incorporation into Exclusion (l) as part of the 1986 revisions of the CGL forms.

As of December 1, 2001, Insurance Services Office, Inc. (ISO), has come full circle back to pre-BFPD endorsement days by offering two new endorsements for attachment to an insured contractor's CGL policy. Endorsements CG 22 94 and CG 22 95 eliminate the subcontractor exception to Exclusion (l), one on a blanket basis and one on a project-specific basis.

By issuing standard endorsements, ISO has, in effect, stamped its imprimatur on a significant reduction in coverage for many construction insureds. At the same time, these new endorsements are sure to alter the way in which construction-related "business risks" have been previously treated by the courts.

Endorsements CG 22 94 and CG 22 95

The new endorsements have been submitted for approval and were released for use in December of 2001. Endorsement CG 22 94 provides as follows:

ISO Endorsement CG 22 94

EXCLUSION—DAMAGE TO WORK PERFORMED BY

SUBCONTRACTORS ON YOUR BEHALF

Exclusion 1. of Section 1—Coverage A—Bodily Injury and Property Damage Liability is replaced by the following.

> 2. Exclusions This insurance does not apply to:
>
> 1. Damage To Your Work "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."
>
> *Source*: ISO Properties, Inc., Copyright 2000

In turn, Endorsement CG 22 95 Exclusion—Damage to Work Performed by Subcontractors on Your Behalf—Designated Sites or Operations," is identical to CG 22 94, except it states that it applies only to those sites or operations designated in the schedule of the endorsement.

Historical Perspective

The development, application, and court interpretation of the subcontractor exception to the exclusion of coverage for the insured's work has not only provided significant coverage for insured contractors, but it has also provided a framework for the development of much of the law surrounding coverage for construction defects.[1] Naturally, much of the importance of the exception is due to its extension of coverage for subcontractor's defective work since subcontractors are extensively used throughout the construction industry.

However, the significance of the subcontractor exception also derives from the fact that it constitutes a major inroad into the "business risk" doctrine, a major defense relied on by insurers to deny coverage for defective construction claims. In other words, by focusing on the subcontractor exception and the precise language of the CGL policy (whether under the BFPD endorsement or the 1986 Exclusion (l)), construction insureds have often been able to rein in a court from going off on a pure "business risk" tangent by focusing on the fact that a certain amount of coverage is actually provided under a CGL policy for business risks, including defective workmanship of subcontractors. In this way, an insurer's denial of a claim based on the blanket assertion that "business risks are not covered under a CGL policy" can be demonstrated to be overly broad and contrary to the language of the policy itself.

Prior to introduction of the 1986 CGL insurance program, CGL policies not endorsed with BFPD endorsement 3006 had been interpreted to exclude coverage for the insured contractor's faulty workmanship. A classic statement of that notion is found in *Weedo v Stone-E-Brick, Inc.*, 405 A2d 7 (88 NJ 1979). There, the court applied Exclusion (n), the products exclusion, and Exclusion (o), the "work performed" exclusion, in the 1973 standard CGL policy form to deny coverage for defective masonry work performed by the insured.

In doing so, the court placed heavy reliance on a law review article published in 1970, which analyzed the effect of the 1966 revisions to the CGL policy forms. That revision split products liability coverage for manufacturers from completed operations coverage for contractors and other providers of services by separating the products hazard and the completed operations hazard. In one of the more classic statements of the "business risk" doctrine contained in that law review article, *Insurance Protection Products Liability and Complete Operations—What Every Lawyer Should Know*, 15 Nebraska Law Review 415 (1970), by Professor Roger Henderson stated:

> 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.

In contrast to the scenario addressed by Professor Henderson, under the BFPD endorsement, in the completed operations context, the damage to work exclusion (o) of the pre-1986 CGL policy is modified so that it no longer applies to property damage to work performed "by or on behalf of" the named insured, but only to work performed "by the named insured." By virtue of the deletion of the "or on behalf of" language, an insured general contractor is covered for property damage arising out of work performed on its behalf by subcontractors. Only property damage to work performed by the named insured itself is excluded.

Despite the careful drafting, some courts, relying on the "uninsurable business risk" rationale, and quoting the Henderson Nebraska Law Review article and cases such as *Weedo*, refused to acknowledge the

underwriting intent.[2] For example, the court in *Knutson Constr. Co. v St. Paul Fire & Marine Insurance Co.*, 396 NW2d 229 (Mich 1986), denied coverage to the insured general contractor for property damage arising out of its subcontractor's work. It found support from the Henderson business risk analysis, referring to the deletion of the "or on behalf of" language from Exclusion (o) at a "slight difference in wording" which did not affect the exclusion for damage to a general contractor's product.

In another case, *Tucker Construction Co. v Michigan Mutual Insurance Co.*, 423 S2d 525 (Fla App 1982), the court also discounted the effect of the deletion of the "or on behalf of" language from Exclusion (o) by simply reiterating that in the completed operations context, the insured general contractor has accepted its subcontractor's work, so that any defects in it should be regarded as defects in the contractor's own work.

Of course, numerous other cases have given effect to the subcontractor exception and upheld coverage for an insured general contractor under the circumstances. Many of those cases openly criticize the business risk rationale of cases such as Knutson, including cases such as:

- *Fireguard Sprinkler Systems v Scottsdale Insurance Co.*, 864 F2d 648 (9th Cir 1998)
- *Maryland Casualty Co. v Reeder*, 221 Cal App 3d 961, 270 Cal Rptr 719 (1990)
- *Green Construction Co. v National Union Fire Insurance Co. of Pittsburgh, Pa.*, 771 F Supp 1000 (WD Mo 1991)

The manner in which BFPD endorsement 3006 (including completed operations) accomplished the exception for property damage arising out of a subcontractor's work, through the deletion of the "or on behalf of" language from Exclusion (o) from the 1973 policy form, was rather cumbersome. So, in 1986 ISO expressly stated the subcontractor exception within the "your work" exclusion, Exclusion (l), which provides that "this exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your [the named insured's] behalf by a subcontractor."

This exclusion seems to have fared a bit better in terms of court interpretation according to the underwriting intent. Even in Minnesota, where the *Knutson* case continues to apply to a 1973 policy endorsed with a BFPD endorsement, in *O'Shaughnessy v Smuckler Corp.*, 543 NW2d 99 (Minn App 1996, petition for review denied) (Minn 1996), the court distinguished Knutson on that basis and upheld coverage for the insured general contractor for property damage arising out of its subcontractor's work under the 1986 policy form.

Due to the new language in the exclusion, the court stated that it would be "willful and perverse for this court simply to ignore the exception that has now been added to the exclusion." On the other hand, other courts have had no difficulty doing just that. For a court case citing to the Henderson Law Review article analysis in support of a denial of coverage to a contractor for property damage arising out of the work of its subcontractors and involving a 1986 policy form, see *Oak Crest Construction Co. v Austin Mutual Insurance Co.*, 998 P2d 54 (Or 2000).

The Fallout for Construction Insureds

Obviously, insurers have previously been able to eliminate the subcontractor exception in individual policies via the use of manuscript endorsements. Now, however, the availability of standard form ISO endorsements will undoubtedly make it simpler to accomplish the elimination of that coverage. Coupled with a hardening insurance market and the tightening of coverage for other related risks, such as mold, an increasing number of construction insureds may be forced to accept this reduction in coverage upon renewal or, at least, to pay an increased premium to retain coverage for subcontractors' defective work.

This will resemble the situation under the earlier BFPD endorsement arrangement, where ISO advised an extra premium of 20 percent of the policy's property damage liability premium to add a BFPD endorsement including completed operations to a contractor's CGL policy and 10 percent for a BFPD endorsement excluding completed operations. Although ISO has made no recommendations as to pricing of the new endorsements, it is reasonable to expect that an increased premium may be charged to avoid the attachment of the endorsements reducing coverage.

Admittedly, the extra coverage to an insured general contractor provided through the subcontractor exception should be worth a higher premium, which construction insureds are already paying. Moreover, from a purely legal standpoint, the danger in eliminating the subcontractor exception amounts to a significant expansion of the "business risk" rationale in that it also eliminates the concession from the insurance industry that a general contractor may not have the ability to control all risks associated with a subcontractor's work. It may have the unintended result of making it more difficult for insureds to argue that such defective work constitutes an occurrence, or even property damage since, due to the subcontractor exception, a thorough analysis of a construction defect claim requires consideration of the exclusions.

Absent that exception, insurers may argue even more strenuously that such claims should be eliminated on the basis of the lack of occurrence, or even property damage. This will eliminate coverage for claims that should be otherwise be covered, resulting in an overall reduction of coverage for construction insureds. Unfortunately, with the hardening insurance market, it may be difficult for insureds to obtain alternative types of coverage for the defective work exposure, such as gap policies or rip and tear coverage.

Conclusion

It remains to be seen how widespread the use of the new ISO endorsements will become, but all signs seem to indicate that construction insureds will be faced with hard choices upon renewal due to their potential use. The insurance industry appears to have come full circle back to pre-BFPD endorsement days as to property damage due to subcontractors' work. Unfortunately, full circle does not amount to advancement for construction insureds—it amounts to regression.

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[1]For a more in depth discussion of the historical development of the subcontractor exception and the BFPD endorsement and its progeny, see Patrick J. Wielinski, *INSURANCE FOR DEFECTIVE CONSTRUCTION: BEYOND BROAD FORM PROPERTY DAMAGE COVERAGE* (International Risk Management Institute, Inc., 2000).

[2]Since its publication in 1970, the Henderson law review article has been cited for its business risk analysis in no less than 184 appellate opinions, the most recent being *Corder v William W. Smith Excavating Co.*, 2001 WL 1401585 (WVa Nov. 8, 2001). In many of those instances, the rationale of the article has been incorrectly applied for the general proposition that the CGL policy does not cover an insured's business risks and improperly denying coverage to a general contractor for the defective work of its subcontractors under CGL policies written under the 1986 policy forms or under a 1973 policy form endorsed with a BFPD endorsement including completed operations.

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