

CONTRACTOR COVERAGE FOR CONSTRUCTION
CLAIMS UNDER CGL POLICIES: THE BASICS
AND BEYOND

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I. INTRODUCTION

Most comprehensive general liability (CGL) policies follow one of the standard formats promulgated by the Insurance Services Organization (ISO),¹ which—despite various changes from time to time—maintain the same basic features. While these CGL policies come in both occurrence and claims made forms,² the occurrence based policy is the most prevalent and will be the subject of this article. Not surprisingly, unraveling coverage can be a rather difficult process unless a logical regimen is employed to help wade through the definitions, exclusions, and exceptions to exclusions. The following is intended to provide a guide to such analysis in the context of liability claims for the costs to correct deficient construction work and damages arising from that deficient work.

This article will first outline the basic issues necessary to address coverage for relatively simple damage claims arising from a single construction defect, which is the type of situation most frequently presented in reported decisions. Next, the complexities involved in unraveling coverage for alleged liability involving different defects causing or contributing to mul-

1. ISO Policy refers to the 2006 Commercial General Liability Coverage Form (CG 00 01 12 7) promulgated by ISO Properties, Inc. which, with respect to the provisions discussed in this article, is identical to the 2003 Commercial General Liability Coverage Form (CG 00 01 12 04).

2. The 2003 ISO occurrence based CGL policy is form CG 00 01 12 04 and the claims made CGL policy is form CG 00 02 12 04.

multiple occurrences of property damage over various policy periods will be discussed. This will be done with the intent of identifying the issues that should be considered due to the surprising absence of judicial authority on cases involving multiple defects.³

II. BASIC COVERAGE ANALYSIS

The insuring agreement of the CGL policy provides coverage for “those sums that the insured becomes legally obligated to pay as damages because of ‘bodily injury’ or ‘property damage’ to which this insurance applies.”⁴ This article focuses on property damage, which seems to present the most difficult coverage questions.⁵ CGL insurance applies to damages because of property damage only if the property damage is caused by an occurrence, and if the property damage (not the occurrence) takes place during the policy period.

The policy requirement of property damage caused by an occurrence has generated a surprising amount of confusion in the construction defect context. Courts have been fairly uniform in recognizing that faulty workmanship alone, in the absence of property damage (physical injury to or loss of use of tangible property), does not give rise to coverage. The concept that the insured is responsible for repairing its own defective work underlies the often cited “business risk doctrine.” It is also consistent with the CGL policy language, which requires an occurrence that results in property damage.

Uniformity is completely lacking, however, when it comes to defining what constitutes property damage caused by an occurrence. Much of the confusion appears to be attributable to court decisions that have continued to apply interpretations of the pre-1986 CGL policy form to the significantly amended 1986 CGL policy form. The pre-1986 policy form included exclusions that negated coverage for business risk, i.e., for any property damage to work performed by or on behalf of the insured. The policy form was amended in 1986 to preserve the coverage granted by the insuring agreement for property damage involving a subcontractor’s work. Failing to give effect to this change, some court decisions have improperly read the business risk doctrine into the policy’s insuring agreement, determining that there is no property damage caused by an

3. Because of the wide range of decisions on some issues and the uniformity of treatment on others, it is impractical and unnecessary to specifically address the law of each state. Rather, this article is designed to provide a framework for assessing contractor CGL coverage issues regardless of the venue. Detailed local research will be necessary in any event.

4. ISO Policy § I, ¶ 1(a).

5. The business risk exclusions, which are central to any coverage analysis in the construction context, apply only to property damage.

occurrence if the damage is to the insured's work—even work of subcontractors. However, the current CGL policy is designed to afford coverage under the insuring agreement for all accidental property damage, and it limits coverage in a manner consistent with the business risk concept (which makes the insured responsible for self-performed work) through policy exclusions. This disparity of decisions makes any coverage assessment a jurisdiction specific task.

A. "Property Damage" Requirement

The first step in assessing available cover for any claim to recoup costs of repairing damaged work or damage to some other contractor's work⁶ is whether property damage has occurred. "Property Damage" is defined as physical injury to tangible property or loss of use of tangible property that is not physically injured.⁷

The phrase "physical injury to tangible property" has generally been regarded by the courts as not ambiguous or complicated.⁸ It has been recognized that "to the average, ordinary person, tangible property suffers a 'physical' injury when the property is altered in appearance, shape, color, or in the other material dimension."⁹ While this appears straight forward, there has been some confusion regarding whether property damage exists if the only damage is to the insured's work or product itself. In one recent decision, for example, the court stated: "[f]or a claim of faulty workmanship to give rise to 'property damage,' a claimant must demonstrate that there

6. For purposes of this article, the term "contractor" shall generally include both a general contractor and a first-tier subcontractor, with "subcontractor" including both a first-tier subcontractor and a second-tier subcontractor to a first-tier subcontractor.

7. ISO Policy § V, ¶ 17 (Definitions).

8. *Wis. Label Corp. v. Northbrook Prop. & Cas. Ins. Co.*, 607 N.W.2d 276, 284 (Wis. 2000).

9. *Tweet/Garot-August Winter, LLC v. Liberty Mut. Fire Ins. Co.*, No. 06-C-800, 2007 WL 445988, at *5 (E.D. Wis. Feb 7, 2007), quoting *Travelers Ins. Co. v. Eljer Mfg. Inc.*, 757 N.E.2d 481, 496 (Ill. 2001). In *Eljer Manufacturing, Inc. v. Liberty Mutual Insurance Co.*, 972 F.2d 805, 814 (7th Cir. 1992), the Seventh Circuit predicted that Illinois law would hold that "physical injury to tangible property" existed when the insured's defective plumbing system was installed in homes, even if the system had never leaked or manifested defects. The Seventh Circuit's decision has been "soundly rejected because it failed to give the full and ordinary meaning to the policy's definitional words 'physical injury.'" *F&H Constr., Inc. v. ITT Hartford Ins. Co.*, 12 Cal. Rptr. 3d 896, 903 (Ct. App. 2004). The most solid repudiation came from the Illinois Supreme Court itself, when it later addressed a claim involving the same plumbing system but as to a different insurer. The court ruled that "*Eljer* ignored the plain meaning of the phrase 'physical injury' and instead adopted a construction which fails to give effect to both words at the same time." *Eljer Mfg., Inc.*, 757 N.E.2d at 495. The court went on to hold that the crucial policy term "physical injury" was unambiguous and that "under its plain and ordinary meaning, the term 'physical injury' unambiguously connotes damage to tangible property causing an alteration in appearance, shape, color or in other material dimension." *Eljer Mfg., Inc.*, 757 N.E.2d at 496, 502.

is damage to property separate from the defective property itself.¹⁰ The rationale usually expressed is that CGL policies are intended to afford coverage for physical damage caused to other property, not for the business risk or economic loss of repairing or replacing faulty or damaged work.¹¹

Courts applying Indiana law have held that property damage to a home or project caused by the defective work of a subcontractor of an insured general contractor does not qualify as property damage for CGL purposes because the CGL policy is intended to cover only the risk that the insureds work will cause damage to property other than to the work itself.¹² In *Westfield Insurance Co. v. Sheehan Construction*, the Southern District of Indiana reasoned that under Indiana law, a general contractor's product is the entire house or project; accordingly, any damage to the home or project is damage to the insured's product (even if the work is performed by a subcontractor) and does not satisfy the property damage requirement.¹³ Using this rationale, the court found that the property damage requirement was not met even though residential homes suffered a variety of different types of water damage (water stains on walls and ceilings, damaged carpeting, warped floor boards, etc.) as a result of numerous faults in the workmanship of several different subcontractors (lack of flashing and caulking around windows, improperly installed roof shingles, bricks installed without weep holes, etc.).¹⁴

This type of analysis, however, is not true to the language of the CGL policy. It merges the property damage requirement in the insuring agreement with other policy provisions, most notably, the business risk exclusions (which exclude coverage for property damage to the insured's own work or

10. *MW Builders, Inc. v. Safeco Ins. Co. of Am.*, 267 Fed. Appx. 552, 554 (9th Cir. 2008) (applying Oregon law). The court found the property damage requirement was satisfied because the insured's subcontractor's faulty installation of an exterior insulation and finishing system (EIFS) on a hotel caused damage to other parts of the hotel, and that damage was covered under the insured's policy. *See also* *Adair Group, Inc. v. St. Paul Fire & Mar. Ins. Co.*, 477 F.3d 1186, 1188 (10th Cir. 2007) (no coverage for cost to repair faulty workmanship itself, even though work was performed by subcontractor).

11. *Westfield Ins. Co. v. Sheehan Constr. Co.*, 580 F. Supp. 2d 701, 711–12 (S.D. Ind. 2008), *aff'd* 564 F.3d 817 7th Cir. 2009); *Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 396 N.W.2d 229, 235–37 (Minn. 1986) (noting a distinction between faulty workmanship that requires a business expenditure to repair the work and faulty workmanship that results in tort liability for damage to a third party's property); *Auto-Owners Ins. Co. v. Pozzi Window Co.*, 984 So. 2d 1241, 1248 (Fla. 2008) (“there is a difference between a claim for the costs of repairing or removing defective work, which is not a claim for ‘property damage,’ and a claim for the costs of repairing damage caused by the defective work, which is a claim for ‘property damage.’”) quoting *United States Fire Ins. Co. v. J.S.U.B, Inc.*, 979 So. 2d 871, 889 (Fla. 2007).

12. *See, e.g., Sheehan Constr.*, 580 F. Supp. 2d at 711–12 and the cases cited therein.

13. This ignores the fact that the CGL policy defines the insured's product as goods “other than real property.” ISO Policy § V, ¶ 21(a)(1) (Definitions).

14. *See Sheehan Constr.*, 580 F. Supp. 2d at 711–13.

product), to conclude that property damage does not exist if the damage is only to the insured contractor's own work or product. But the initial inquiry regarding whether property damage exists has nothing to do with whose property or work is damaged—the policy definition requires only physical injury to tangible property. Coverage may very well end up being precluded if the only damage is to the insured's work or product, but that is by virtue of the policy exclusions, not because there is not property damage as defined in the policy.¹⁵ In fact, buckling and cracking to exterior insulation and finishing systems (EIFS) or to any other work or product of an insured is physical injury to tangible property,¹⁶ as is water damage to interior walls, floors, and finishes.¹⁷ As recognized by the Wisconsin Supreme Court, there would be no need to exclude coverage for property damage to the insured's own work or product if damage to that work or product did not qualify as property damage in the first place.¹⁸

It appears, however, that courts are fairly uniform in finding that damage to property other than the insured's own work qualifies as property damage under the policy definition.¹⁹ Addressing each policy requirement separately becomes critical to a correct coverage analysis when the cost of repairing or replacing faulty workmanship that is itself physically damaged is at issue.

15. Nevertheless, in *Sheehan Construction*, the court rejected the insured's argument that the court's analysis was unsound because of the 1986 addition of the subcontractor exception to the CGL policy form. Although the policy at issue deleted the subcontractor exception by endorsement, the court also stated that because there was no property damage under the insuring agreement, the policy exclusions were never implicated. The court relied on *R.N. Thompson & Associates, Inc. v. Monroe Guaranty Insurance Co.*, 686 N.E.2d 160, 163 n.5 (Ind. Ct. App. 1997) (business risk exclusions are irrelevant, even after the 1986 addition of the subcontractor exception to the "your work" exclusion, because damage to the insured's own work or product is not "property damage" as defined in the insuring agreement of the CGL policy in the first place). See also *Adair Group*, 477 F.3d at 1188 (a contractor "should not be able to turn its failure to complete construction according to the contract into a covered event 'by bootstrapping on its subcontractor's negligence.'") The Seventh Circuit did not address the district court's ruling that damage to the home did not constitute property damage. Instead, the appellate court affirmed, relying on the fact that the "your work" exclusion in Sheehan's policy did not include the subcontractor exception.

16. See *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65, 75 (Wis. 2004) ("buckling and cracking . . . qualifies as 'physical injury to tangible property'").

17. *Kalchthaler v. Keller Constr. Co.*, 591 N.W.2d 169, 173 (Wis. Ct. App. 1999) (water entering leaking windows and damaging drapery and wallpaper is physical injury to tangible property).

18. *Am. Girl*, 673 N.W. 2d at 78.

19. *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 310 (Tenn. 2007) (because a subcontractor's defective installation of windows resulted in water penetration that caused further damage, the property damage requirement was met); *Auto-Owners Ins. Co. v. Pozzi Window Co.*, 984 So. 2d 1241, 1248 (Fla. 2008) (the mere inclusion of a defective window "does not constitute property damage unless that defective component results in physical injury to some other tangible property").

B. Determining if Property Damage Is Caused by an “Occurrence”

To be covered, property damage must have been caused by an occurrence taking place within the coverage territory.²⁰ Occurrence is defined as an “accident, including continuous or repeated exposure to substantially the same general harmful conditions.”²¹ An accident is an “event or change occurring without intent or volition through carelessness, unawareness, ignorance, or a combination of causes and producing an unfortunate result.”²² In other words, the CGL policy defines an occurrence as an accident consisting either of a single event or an accidental repeated exposure to substantially the same general harmful conditions.

1. Breach of Contract as an Occurrence

Insurers are quick to argue that a breach of contract or warranty, in and of itself, is not an accident, and some courts have agreed.²³ As far as it goes, that may or may not be correct. But, neither the general principle of fortuity, which is a prerequisite for any liability coverage, nor the CGL policy language supports such an assertion across the board. If a breach of contract constitutes or gives rise to an accident, there may be coverage if property damage results.

Courts have recognized on various occasions that the term “[o]ccurrence’ is not defined by reference to the legal category of the claim.”²⁴ Nor is there anything in the insuring agreement itself “to support any definitive tort/contract line of demarcation for purposes of determining whether a loss is covered by the CGL’s initial grant of coverage.”²⁵ Rather, the core inquiry with respect to whether an occurrence exists is whether the facts underlying the theories of liability constitute an “accident [an event which takes place without one’s foresight or expectation], including continuous or

20. ISO Policy § I, ¶ 1(b)(1) (Coverage A).

21. ISO Policy § V, ¶ 13 (Definitions).

22. WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 11 (1993).

23. See, e.g., *Transp. Ins. Co. v. AARK Constr. Group Ltd.*, 526 F. Supp. 2d 350, 356–57 (E.D.N.Y. 2007) (holding that a CGL insurer is not a surety of a contractor’s work and, consequently, a contract claim does not involve an occurrence); *Great Divide Ins. Co. v. Bitterroot Timberframes of Wyo., LLC.*, No. 06-CV-020-WCB, 2006 WL 3933078 (D. Wyo. Oct. 20, 2006) (allegations of defective workmanship are for “losses resulting from breach of contract, as water damage is the natural and foreseeable result of improper installation and waterproofing of exterior siding” and cannot satisfy the occurrence requirement even if couched in terms of negligence); *Kvaerner Metals v. Commercial Union Ins. Co.*, 908 A.2d 888 (Pa. 2006).

24. *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65, 77 (Wis. 2004); *Glendenning’s Limestone & Ready-Mix Co. v. Reimer*, 721 N.W.2d 704, 712 (Wis. Ct. App. 2006) (“the analysis focuses on the factual basis for the claim and not on the theory of liability”).

25. *Am. Girl*, 673 N.W.2d at 77; *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 13 (Tex. 2007) (“[A]ny preconceived notion that a CGL policy is only for tort liability must yield to the policy’s actual language.”); *J.S.U.B., Inc.*, 979 So. 2d at 884 (the policy does not differentiate between tort and contract claims).

repeated exposure to substantially the same general harmful conditions.”²⁶ The breach of contract itself does not preclude coverage under the policy language. As noted by the Wisconsin Supreme Court:

The business risk exclusions eliminate coverage for liability for property damage to the insured’s own work or product—liability that is typically actionable between the parties pursuant to the terms of their contract, not in tort. If the insuring agreement never confers coverage for this type of liability as an original definitional matter, then there is no need to specifically exclude it. Why would the insurance industry exclude damage to the insured’s own work or product if the damage could never be considered to have arisen from a covered “occurrence” in the first place?²⁷

2. Faulty Workmanship as an Occurrence

Another fertile area for dispute surrounds whether faulty workmanship itself can qualify as an occurrence giving rise to property damage. Some courts have held that property damage is the natural and ordinary consequence of faulty work and, therefore, faulty work cannot constitute an occurrence.²⁸ Stated slightly differently, the Nebraska Supreme Court held that “faulty workmanship, standing alone, is not covered under a standard CGL policy because it is not a fortuitous event.”²⁹

26. *Am. Girl*, 673 N.W.2d at 75–76; *Lamar Homes, Inc.*, 242 S.W.3d at 16 (“[t]he proper inquiry is whether an ‘occurrence’ has caused ‘property damage,’ not whether the ultimate remedy for that claim lies in contract or in tort.”).

27. *Am. Girl*, 673 N.W.2d at 78; see also *Auto Owners Ins. Co. v. Newman*, No. 26450, 2008 WL 648546 (S.C. Mar. 10, 2008) (a narrow interpretation of “occurrence” would render the business risk exclusions meaningless); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 137 P.3d 486, 494 (Kan. 2006) (“If there can be no occurrence, the [your work] exclusion—and its exception—appear to be superfluous.”).

28. *Westfield Ins. Co. v. Sheehan Constr. Co.*, 580 F. Supp. 2d 701, 714 (S.D. Ind. 2008) (damage to homes caused by the faulty work of various subcontractors was “the natural and ordinary consequence of the faulty work—it is not accidental. Since the damage . . . is not an ‘accident,’ this case simply cannot be seen as one where ‘faulty workmanship . . . causes an accident.’”) (citing *R.N. Thompson*, 686 N.E.2d at 165); see also *Monticello Ins. Co. v. Wil-Freds Constr., Inc.* 661 N.E.2d 451, 456 (Ill. App. Ct. 1996); *French v. Assurance Co. of Am.*, 448 F.3d 693, 703 (4th Cir. 2006) (applying Maryland law) (the cost to repair defectively installed stucco is expected and intended under the terms of the parties’ contract). Note, however, that the court in *French* also found that the moisture intrusion into the home was unexpected, as was the subcontractor’s negligent performance of its work, so that the moisture intrusion was an occurrence, and the cost of correcting the damage to the insured contractor’s otherwise nondefective work caused by the subcontractor’s negligence was covered. *French*, 448 F.3d at 704–06.

29. *Auto-Owners Ins. Co. v. Home Pride Cos.*, 684 N.W.2d 571, 577 (Neb. 2004); see also *Selective Ins. Co. v. Cagnoni Dev., LLC.*, No. 106-CV-0760-DFH-TAB, 2008 WL 126950, at *11 n.4 (S.D. Ind. Jan. 10, 2008), where the court characterized the rule that faulty work cannot be an occurrence because it is not accidental as the “majority” rule, citing cases from Indiana, Illinois, Michigan, Ohio, Iowa, and New Hampshire.

Although most (but not all) courts agree that faulty workmanship alone is not an occurrence, many courts will find the occurrence requirement is satisfied if the faulty workmanship causes damage that is unexpected or unintended.³⁰ Courts adopting this rule frequently point out that contractors do not usually set out to perform negligently or to cause damage, and that if the defective work was inadvertent, damage was unintended by definition.³¹ Many cases require damage to property of a third party, not just damage to the insured's own work.³² Texas courts, however, have found that even defective construction that damages only the insured's work can be an occurrence.³³ These decisions reason that if the faulty work is negligent, and therefore inadvertent, the resulting damage is unexpected

30. *Pozzi Window*, 984 So. 2d at 1241 (subcontractor's faulty installation of windows, which the insured builder did not expect or intend, was an occurrence); *J.S.U.B., Inc.*, 979 So. 2d at 888 (subcontractor's faulty soil preparation, which was neither expected nor intended by the insured contractor, was an occurrence); *Webster v. Acadia Ins. Co.*, 934 A.2d 567 (N.H. 2007) (defective work may be an occurrence if it causes unexpected and unintended damage to other property); *Lee Builders, Inc.*, 137 P.3d at 495 (faulty materials and workmanship of subcontractor was an occurrence, as it caused unforeseen and unintended damage); *Auto-Owners*, 684 N.W.2d at 578 (“[A]lthough a standard CGL policy does not provide coverage for faulty workmanship that damages only the resulting work product, if faulty workmanship causes bodily injury or property damage to something other than the insured's work product, an unintended and unexpected event has occurred, and coverage exists.”).

31. In *Lennar Corp. v. Auto-Owners Insurance Co.*, 151 P.3d 538, 546 (Ariz. Ct. App. 2007), the court recognized that even if a contractor (or a subcontractor) intends to perform construction work, it does not follow that the contractor intended to provide faulty work, or that the contractor should have anticipated damage as the natural consequence of its work. See also *Travelers Indem. Co. of Am. v. Moore & Assocs., Inc.*, 216 S.W.3d 302, 308 (Tenn. 2007) (explaining that if the foreseeability of damage is determined from presumed faulty work, “the negligent acts of the insured will almost never be ‘accidents’ because, by definition, negligence requires that damages be foreseeable.” Accordingly, determining whether there has been an occurrence requires consideration of whether damage would have been foreseeable if the insured had completed the work properly.); *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 669 n.18 (Tex. App. 2006) (in determining if there is an occurrence, whether the damage was unexpected and unintended, the question is whether the damage was expected if the work was properly performed, not if the damage was expected from negligent performance of the work).

32. See, e.g., *Lennar Corp.*, 151 P.3d at 545 (there is “a distinction between faulty workmanship standing alone and faulty workmanship that causes damage to property”); *Lennar Corp.*, 200 S.W.3d at 669 n.18 (listing cases that have so ruled). See also *Home Pride Cos.*, 684 N.W.2d at 535.

33. *Lennar Corp.*, 200 S.W.2d at 664 (The court rejected the insurers' argument that defective construction resulting in damage to the insured's own work is an economic loss sounding in contract, not an occurrence, finding that “negligently created, or inadvertent, defective construction resulting in damage to the insured's own work which is unintended and unexpected can constitute an occurrence.”). The Texas Supreme Court reached the same conclusion in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 16 (Tex. 2007) (“‘claims for damage caused by an insured's defective performance or faulty workmanship’ may constitute an ‘occurrence’ when ‘property damage’ results from the ‘unexpected, unforeseen or undesigned happening or consequence’ of the insured's negligent behavior”), quoting *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 725 (5th Cir. 1999).

and unintended, regardless of who performs the work or who owns the property that is damaged.³⁴ Moreover, the definition of occurrence in the policy does not focus on who owns the property that is damaged. Again, if there was no occurrence when the insured's defective construction damages its own work, there would be no need for the business risk exclusions, which generally eliminate coverage for the damage to the insured's own work, unless the work is performed or the damage is caused by a subcontractor.³⁵

Wisconsin cases have most often held that the failure of a contractor or a subcontractor to properly perform work can give rise to an occurrence that results in property damage for purposes of the general contractor's CGL coverage, but does not itself qualify as an occurrence.³⁶ The catch phrase is that "a CGL policy does not cover faulty workmanship, only faulty workmanship that causes damage to other property."³⁷ Nevertheless, even within Wisconsin, decisions have gone both ways.³⁸ This is true

34. *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 669 n.18 (Tex. App. 2006) ("we do not see how damage to the insured's own work is any more expected than damage to the work or property of a third-party if the faulty construction was inadvertent"); *Lamar Homes, Inc.*, 242 S.W.3d at 9.

35. *Lennar Corp.*, 200 S.W.3d at 671.

36. *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65, 70 (Wis. 2004) (soil engineer's negligent advice (faulty workmanship) gave rise to soil settlement (the occurrence) which caused property damage to a building (cracking and buckling)); *Toldt Woods Condos. Owner's Ass'n. v. Madeline Square, LLC*, No. 2007AP1763, 2008 WL 3387532 (Wis. Ct. App. Aug. 13, 2008) (mud rivers that caused damage to adjacent property were occurrences that arose from faulty workmanship in the nature of negligent erosion control practices); *Kalchthaler*, 591 N.W.2d at 173 (the occurrence, leaking windows, was caused by a subcontractor's faulty workmanship); *Glendinning's Limestone*, 721 N.W.2d at 714 (construing the ruling in *American Girl*, stated: "We understand this to mean that faulty workmanship may cause, or be a cause of, an 'occurrence,' such as . . . the settling of soil under a building; we do not read it to say that faulty workmanship itself is an 'occurrence.'")

37. *Toldt Woods Condos. Owner's Ass'n*, 2008 WL 3387532, at *16; *R.N. Thompson*, 686 N.E.2d at 165. Insurers often argue that if faulty workmanship is an occurrence, then the CGL policy is really a performance bond. This argument has been rejected for a number of reasons, most of which point out that even if the insuring agreement requirements for property damage caused by an occurrence are satisfied, coverage may still be negated by application of policy exclusions, if the damage is truly a business risk. See also *Travelers Indem. Co. of Am.*, 216 S.W.3d at 309; *Lennar Corp.*, 200 S.W.3d at 673-74.

38. In *Doyle v. Engelke*, 580 N.W.2d 245 (Wis. 1998), the Wisconsin Supreme Court held that a subcontractor's negligent workmanship is, in and of itself, an occurrence. Subsequently in *Glendinning's Limestone*, it was acknowledged that under the *Doyle* decision, "the 'occurrence' is the faulty or negligent workmanship itself." 721 N.W. 2d at 716. Yet, the *Glendinning* court ultimately chose to follow the analysis used more recently in *American Girl*, rather than the analysis in *Doyle*. *Id.* The fact remains: there is conflict or at least confusion among Wisconsin Supreme Court decisions on whether faulty workmanship itself may satisfy the occurrence requirement. The most recent pronouncement on the issue in *Toldt*, an appellate court decision, followed the majority of Wisconsin decisions, finding that the occurrence (mud rivers) arose from the faulty workmanship (negligent erosion control practices) and caused damage to adjacent property, but never mentioned the *Doyle* decision.

in Illinois (and several other states) as well, where the state's supreme court has yet to resolve the issue.³⁹

Cases in jurisdictions other than Wisconsin also hold, for varying reasons, that the defective work itself is not an accident (i.e., the occurrence) but may give rise to an occurrence.⁴⁰ For example, the South Carolina Supreme Court recently held that the subcontractor's negligent installation of stucco that "allowed for continuous moisture intrusion resulting in substantial water damage to the home's exterior sheathing and wooden framing . . . led to an 'occurrence' invoking coverage under the CGL policy for the resulting 'property damage' to other property not the work product."⁴¹

The point is that cases must be carefully scrutinized to assess the validity of, and basis for, their holdings before extending any particular case to a superficially similar fact circumstance where the relationship between faulty workmanship and an occurrence is at issue. For example, two cases frequently cited for the proposition that CGL policies cover faulty workmanship which causes an accident, not the accident of faulty workmanship, suggesting the rulings are a function of the occurrence requirement, were in fact based on application of the policy exclusions.⁴²

39. See *Viking Constr. Management, Inc. v. Liberty Mut. Fire Ins. Co.*, 831 N.E. 2d 1 (Ill. App. Ct. 2005) (collapsed wall was natural and ordinary consequence of subcontractor's failure to brace wall); *Country Mut. Ins. Co. v. Carr*, 867 N.E. 2d 1157 (Ill. App. Ct. 2007) (subcontractor's negligent performance of backfill work was an occurrence because the resulting basement damage was unintended).

40. *Travelers Indem. Co. of Am.*, 216 S.W.3d at 309 (unexpected water penetration arising from faulty window installation was an occurrence). A recent American Bar Association presentation offered the following tally on whether faulty workmanship can constitute an occurrence: twenty-three states favor the policyholder (Alabama, Alaska, Arizona, California, Colorado, Florida, Kansas, Louisiana, Maine, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Oregon, South Carolina, Tennessee, Texas, Washington and Wisconsin); fourteen states favor the insurer (Arkansas, Connecticut, Delaware, Hawaii, Indiana, Iowa, Maryland, Massachusetts, Mississippi, North Carolina, Pennsylvania, Virginia, West Virginia, Wyoming); eleven states have mixed results (District of Columbia, Georgia, Illinois, Kentucky, Michigan, Minnesota, New Jersey, New York, Oklahoma, Rhode Island, Utah; and two states have not addressed the issue (Idaho and Vermont)). ARE YOUR CONSTRUCTION DEFECTS COVERED? NAVIGATING THE CGL POLICY MAZE, The American Bar Association Forum on the Construction Industry (October 23, 2008).

41. *Auto Owners Ins. Co. v. Newman*, 2008 WL 648546 at *3 relying upon *High Country Associates v. New Hampshire Insurance Co.*, 648 A.2d 474, 477 (N.H. 1994), where the court found that continuous exposure of a condominium building to moisture resulting from a subcontractor's defective installation of siding constituted an "occurrence." In other words, the defective work was not the occurrence but rather gave rise to the later occurrence—namely the continuous water intrusion.

42. *Bulen v. West Bend Mut. Ins. Co.*, 371 N.W.2d 392 (Wis. Ct. App. 1985) and *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979). In *American Girl*, the Wisconsin Supreme Court pointed out that *Bulen* and *Weedo* were decided on the basis of the business risk exclusions, not on the basis of the occurrence requirement of the insuring agreement. 673 N.W.2d at 77. See also *Travelers Indem. Co. of Am.*, 216 S.2d 3d at 307.

In short, there clearly are disparate approaches to whether faulty workmanship can constitute or can give rise to an occurrence, and the analysis in most cases is closely tied to whether there is damage to property, i.e. something other than simply defective work. Those decisions that apply the policy language as written tend to find coverage under the insuring agreement (before addressing policy exclusions) where the effect of faulty workmanship is unintended damage to property.

3. Occurrence Within the Coverage Territory

Other considerations arise from the requirement that the occurrence take place in the coverage territory. If the occurrence is an event arising from defective work that causes the physical injury to tangible property, then it makes no difference *where* the defective work is performed for purposes of determining available coverage. The design and fabrication of defective trusses, for example, outside the policy territory would be immaterial. On the other hand, should the performance of defective work by the out-of-territory truss supplier be determined to be the accident/occurrence itself under the policy, then this would defeat coverage for the insured general contractor for resulting property damage due to that defect because the occurrence must take place within the coverage territory.

C. "Known Loss" Coverage Defenses

Three different types of known loss defenses are available to an insurer. First, a common law known loss defense exists if an insured, prior to commencement of a policy, knows of an existing loss that the insured does not disclose to the insurer.⁴³ In some jurisdictions, including Wisconsin, the insured must also appreciate his likely legal liability for the loss at the time the policy is issued.⁴⁴ This makes sense because the risk insured against by a general liability policy is the *liability to a third party* for covered property damage.⁴⁵ In the context of an excess policy, an insured must also be aware

43. *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65, 85 (Wis. 2004) (describing the common law known loss doctrine as the principle that "insurers are not obligated to cover losses which are already occurring when the coverage is written or which has already occurred.")

44. *State v. Hydrite Chem. Co.*, 695 N.W.2d 816, 828-29 (Wis. Ct. App. 2005) ("[I]n order for the known loss doctrine to apply under a CGL policy, the insured must know more than the fact that there has been an occurrence that has caused damage to the property of a third party; the insured must also know that it is substantially probable that the insured will be liable for the damage."). See also *Montrose Chem. Corp. v. Admiral Ins. Co.*, 913 P.2d 878, 905-06 (Cal. 1995) ("Where . . . there is uncertainty about *the imposition of liability* and no 'legal obligation to pay' yet established, there is an insurable risk.") (emphasis in original).

45. 1 ALLAN D. WINDT, *INSURANCE CLAIMS & DISPUTES* § 6:46 (5th ed. 2007). See *Pittson Co. Ultramar America Ltd. v. Allianz Ins. Co.*, 124 F.3d 508, 518 (3d Cir. 1997) (in the third party context, the insurable risk is the uncertainty of liability, so only certainly of legal liability

that it is substantially probable the damages will exceed the primary policy limits.⁴⁶

For application of the common law doctrine, some courts have found that it is insufficient that the insured should have known of the damage but negligently failed to acquire such knowledge.⁴⁷ Even knowledge that damage may eventually occur has been found insufficient to bar coverage as a known loss, unless it is shown that the insured knew the damage would occur within the upcoming policy period.⁴⁸ In short, knowledge that something will occur (for example, that a building will eventually settle) is not the same as knowledge that it will settle during the upcoming policy period and result in liability.⁴⁹

CGL policies also exclude coverage for property damage “expected or intended from the standpoint of the insured.”⁵⁰ The exclusion applies where property damage has not occurred at the inception of the policy, but when it occurs, it is expected or intended by the insured. In order for this exclusion to apply in many jurisdictions, including Wisconsin, not only must the *cause* be expected or intended but so must the resulting *harm*.⁵¹ Thus, if the insured contractor becomes aware before a policy period that windows are improperly installed and will likely lead to water infiltration, the damage caused by the water infiltration may be deemed expected or intended from the standpoint of the insured. In other words, coverage may be negated for property damage during a policy that results from a construction defect known to the insured prior to the policy period, if the insured expected damage to result from the defect.⁵² At least one court,

rather than certainty of damage will trigger the known loss doctrine); *Stonehenge Eng'g v. Employers Ins.*, 201 F.3d 296, 302 (4th Cir. 2000) (letter from condominium association threatening and actually commencing suit before effective dates of renewal policies did not trigger the known loss doctrine because it did not establish the insured “knew that such liability was substantially certain to occur,” since Stonehenge believed that the claims were defensible).

46. *Hydrite*, 695 N.W.2d at 831.

47. *Chu v. Canadian Indem. Co.*, 274 Cal. Rptr. 20, 28 (Ct. App. 1990) (“Since a major purpose of third party liability insurance is to protect the insured from claims for negligence, [insured’s] third party coverage is not forfeited merely because they should have known of the existence of defects but negligently failed to discover such defects.”) (citation omitted).

48. *Montrose Chem. Corp.*, 913 P.2d at 904 (an insurable risk only requires “some contingency” or risk that might or might not occur within the term of the policy).

49. *Insurance Co. of North Am. Inc. v. U.S. Gypsum Co.*, 870 F.2d 148, 152 (4th Cir. 1989) (in addressing first party coverage, the court stated: “As the District Court noted, the fact that it is known that subsidence will occur does not mean that it will occur during the policy period.”). The known loss doctrine applies in both first and third party cases. *Hillhaven Props. Ltd v. Sellen Const. Co.*, 948 P.2d 796, 804 (Wash. 1997).

50. ISO Policy § I, ¶ 2 (a) (Coverage A).

51. *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65 (Wis. 2004) (discussing the expected or intended exclusion); *Just v. Land Reclamation, Ltd.*, 456 N.W.2d 570, 573 (Wis. 1990); *Raby v. Moe*, 450 N.W.2d 452, 455 (Wis. 1990).

52. *Chu v. Canadian Indem. Co.*, 274 Cal. Rptr. 20, 27 n.5 (Ct. App. 1990).

however, has rejected an insurer's argument that the exclusion applies because a construction professional should expect damage to result from the performance of faulty workmanship.⁵³

Finally, the current CGL policy form provides that if the insured contractor knew, prior to the policy period, that property damage "had occurred, in whole or in part," then any continuation, change, or resumption of such property damage during or after the policy period is deemed known prior to the policy period and is specifically excluded from coverage.⁵⁴ Even though this provision, like the common law known loss doctrine, focuses on the insured's knowledge of existing damage, the policy provision will eliminate coverage even if the insured did not appreciate its legal liability for the damage. Under the policy language, there is a known loss if the contractor⁵⁵ receives a written or verbal demand or claim for damages because of property damage,⁵⁶ if the contractor gives notice of the damage to any insurer,⁵⁷ or if the contractor otherwise becomes aware that property damage "has occurred or begun to occur."⁵⁸ This presumably will be true even if the contractor believes there is a defense to liability (such as expiration of a written warranty), or if the contractor repairs the damage and believes the repair to have been effective.

What is not clear is whether there will be coverage for property damage that takes place during the policy period that is the same type of damage that occurred prior to the policy period but results from different causes. For example, if the insured knows that a defectively installed window allowed water damage to occur to the window sill and flooring near the window, and later, the same type of water damage occurs at a different window because of defective roof flashing, is the later damage a continuation of the former? As discussed later in this article, all limiting provisions of the policy should be construed narrowly, and the best interpretation of the known loss provisions of the policies seems to require that there be a continuation of the same damage and the same cause before coverage is eliminated. However, no reported decisions have been found specifically addressing this issue.

53. *Newman*, 2008 WL 648546, at *5 ("[I]t is unreasonable to believe that [the insured] expected or intended its subcontractor to perform negligently. Therefore, [the insured] could not have expected or intended the resulting property damage.").

54. ISO Policy § I, ¶ 1(b)(3) and (c) (Coverage A).

55. This is defined to include any employee who is authorized by the contractor to give or receive notices of an occurrence or claim. ISO Policy § I, ¶ 1(d) (Coverage A). Consequently, notice to an ordinary site laborer does not trigger this notice obligation.

56. *Id.* § I, ¶ 1(d)(2) (Coverage A).

57. *Id.* § I, ¶ 1(d)(1) (Coverage A).

58. *Id.* ¶ 1(d)(3).

D. “Owned Property” Exclusion

Assuming the property damage is not subject to a “known loss” defense, the analysis then turns to whether the property damage is to property owned by the insured contractor at the time of the damage, as the CGL policy eliminates coverage for damage to property owned by the insured.⁵⁹ This deserves particular attention in instances where the contractor, such as a developer that acts as its own general contractor, has an ownership interest in the constructed project, or a contractor acquires ownership of one or more units in a condominium project as partial compensation for its services or otherwise. The few cases that have addressed the application of the exclusion in these circumstances have reached varied results.⁶⁰

1. Illusory Coverage Assessment

A trial court in Wisconsin held that the blanket exclusion of liability coverage involving damage to “owned property” was illusory in the context of a policy issued to a condominium developer that acted as its own general contractor and subcontracted out the construction of the condominiums.⁶¹ As a condominium developer, the insured’s condominium projects would qualify at all times as property the developer owned. Thus, the purported coverage for property damage caused by an occurrence would never apply and was illusory in a policy issued to an insured whose principle activity was to build, temporarily own, and sell condominium units. Defining coverage so it will never be triggered is the essence of illusory coverage.⁶² This decision was driven by the fact that the insured’s sole business was as a condominium developer, so it is fact specific, and certainly does not

59. *Id.* ¶ 2(j)(1). Subsections (5) and (6) of exclusion (j) apply respectively to preclude coverage for: (1) damage to that particular part of property on which the insured or its subcontractors are performing ongoing operations if the damage arises out of the ongoing operations; and (2) that part of property that must be repaired or replaced because of the insured’s defective work. The exclusions do not apply to damage within the completed operations hazard, which is the focus of this article.

60. For example, in *State Farm Fire & Casualty Co. v. English Cove Ass’n*, 88 P.3d 986, 992–93 (Wash. Ct. App. 2004) the court addressed the concept of allocating covered physical damage on the basis of the number of condominium units owned versus those sold to third parties at the time of the physical damage. In *Erie Insurance Exchange v. Colony Development Corp.*, No. 02AP-1087, 2003 WL 23096010, at *10 (Ohio Ct. App. Dec. 31, 2003), the general contractor was found to have no coverage under its CGL policy for certain condominium association’s claims when the damage in question occurred while the contractor retained an ownership interest in the project.

61. *Highbridge Condo. Owner’s Ass’n, Inc. v. New Land Enters., LLP*, Case No. 05-CV-007221 (Milwaukee Cty. (Wis.) Cir. Ct. Aug. 15, 2005).

62. *See Allstate Ins. Co. v. Gifford*, 504 N.W.2d 370, 373 (Wis. Ct. App. 1993) (“a policy provision is illusory if it defines coverage so that, in practice, it will never be triggered.”) In *Allstate*, the court noted that a policy that provides illusory coverage “may need to be reformed to conform to the insured’s expectations.” *Id.* at 373.

represent a determination that the owned and sold property exclusion will always render coverage illusory,

2. Allocation of Coverage Absent a Finding of Illusory Coverage

The owned property exclusion, by its plain terms, applies to preclude coverage only for damage to property owned by the insured.⁶³ Nevertheless, one court applied the exclusion across the board, eliminating all coverage even though not all of the damaged property was owned by the insured.⁶⁴ A more moderate approach, and one that gives effect to the policy language, is to allocate the coverage based on the number of condominium units and associated percentage interests in common elements owned by an insured-condominium developer. Because the number of units owned by the developer will decrease over time as it sells units, the percentage of liability for damages subject to the owned property exclusion should decrease over time, and the insurer's coverage should similarly increase over time.

One case discussed several potentially reasonable means of allocation, suggesting that the ratio of the number of units the insured owned to the total number of units be used.⁶⁵ However, the decision provided no guidance as to when such a ratio should be determined.⁶⁶ If damage results from multiple occurrences of water infiltration at different times over several years and is caused by different construction defects, the percentage of ownership at the time of each instance of property damage would arguably have to be determined—with coverage increasing each time a unit is sold. This could be a virtually impossible task for the insurer that normally bears the burden to present the evidence necessary to permit a proper allocation of damages subject to the owned property exclusion.⁶⁷

E. "Sold Property" Exclusion

The same analysis could apply to the sold property exclusion, which eliminates coverage for property damage to premises the insured sold, if the property damage arises out of the premises. An exception to this exclusion, however, restores coverage if the premises qualify as the insured's work,

63. While the amount of the insured's liability cover may be limited by its percentage of ownership at any given time, the percentage of ownership does not in any way reduce the limits of liability of the CGL policy.

64. *First Londonderry Dev. Corp. v. CNA Ins. Cos.*, 669 A.2d 232, 234–35 (N.H. 1995). In virtually all jurisdictions, exclusions are applied narrowly. Applying the owned property exclusion as a complete bar to coverage when the insured owned only a percentage of the damaged property arguably is at odds with this fundamental and long standing practice.

65. *English Cove*, 88 P.3d at 992–93.

66. In *English Cove*, the court also did not consider whether the owned property exclusion renders coverage for a condominium developer illusory.

67. *Kozlik v. Gulf Ins. Co.*, 673 N.W.2d 343, 347 (Wis. Ct. App. 2003) (insurer bears burden of proving an exclusion negates coverage).

and the premises “were never occupied . . . by you.”⁶⁸ “You” refers to the named insured under the policies.⁶⁹ To occupy premises means “to reside in as an owner or tenant.”⁷⁰

Consequently, the sold property exclusion can easily be avoided if the insured has never resided in a condominium unit as an owner or tenant. Presumably, coverage should not be forfeited if the developer-insured occupies a residential unit as a sales model although insurers are free to argue otherwise. If a sales model is used by a broker without paying any rent, an insurer still might succeed in asserting that rent is effectively being paid in the form of a lower sales commission so as to avoid this exception to the sold property exclusion. Yet, if this were successful, it would still seem the coverage for the developer would be illusory.

F. “Your Product” Exclusion

Assuming the owned and sold exclusions are found inapplicable, the next step is to assess precisely what property is damaged. If it is to a “product” of the insured contractor, defined as goods or products (other than real property) manufactured, sold, handled, or distributed by the contractor,⁷¹ then there is no liability coverage for property damage to that product.⁷² This should rarely be the case, however, as a contractor’s contribution to the construction of real property improvements should generally be considered its work and not its product. Thus, claims for such damage will normally fall outside the scope of the “your product” exclusion.

G. “Your Work” Exclusion and the Subcontractor Exception

In all likelihood, damage will be to an insured general contractor’s own work, which, as defined in the CGL policy, includes work “performed by you or on your behalf . . . and . . . materials . . . furnished in connection with such work.”⁷³ The “your work” exclusion generally precludes coverage for property damage to the insured’s own work “arising out of it or any part of it and included in the products-completed operations hazard.”⁷⁴ Regarded

68. ISO Policy, § I, ¶ 2(j) (Coverage A) (Exclusions).

69. *Id.*

70. MERRIAM-WEBSTER ONLINE, available at www.m-w.com/dictionary.

71. ISO Policy § V, ¶ 21 (Definitions). Tolomeo v. Emanuelson, No. 04-C-0486, 2005 WL 1629900 (E.D. Wis. July 7, 2005) (product exclusion applying to the insured’s products “other than real property” was not applicable to claim against residential homebuilder for defects in construction); 1325 North Van Buren, LLC v. T-3 Group, Ltd., 701 N.W.2d 13, 22 (Wis. Ct. App. 2005) (product exclusion had no application to claim against construction manager, as the remodeling project was real estate and not a “product” of the construction manager).

72. ISO Policy § I, ¶ 2(k) (Coverage A).

73. *Id.* § V, ¶ 22 (Definitions).

74. *Id.* § I, ¶ 2(l). Note the exclusion applies only to damage that falls within the completed operations hazard, which includes damage occurring away from premises the insured owns

as one of the business risk exclusions, the rationale is that the insured absorbs the economic risk that its own work will need repair or replacement as a cost of doing business, whereas liability insurance is intended to cover the insured's liability for damage to property other than the insured's own work.⁷⁵

In 1986, however, the subcontractor exception to the "your work" exclusion was added in direct response to the construction industry's concerns that the business risk exclusions otherwise negated coverage for damage to construction projects caused not only by the insured's own work, but also by the work of subcontractors.⁷⁶ To maintain the objective of preserving coverage for the insured's liability for damage to work (or because of work) other than its own work, the exception provides that the "your work" 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."⁷⁷ The exception unambiguously "restores coverage when the property damage arises out of work performed by a subcontractor."⁷⁸

Thus, if the damage first occurs after the insured contractor completes its work, there are two possible scenarios for coverage, depending on who actually did the work. If the damaged work was performed by the contractor itself, then there is no coverage due to the exclusion for damage to the insured's work. However, if the damaged work was actually performed by a subcontractor, or if a subcontractor's work caused the damage (even to the insured contractor's work), then the subcontractor exception to the exclusion applies and, in most jurisdictions,⁷⁹ the damage is covered provided other conditions are satisfied.⁸⁰

and arising from the insured's completed work. *Id.* § V, ¶ 16 (Definitions). Damage that occurs during ongoing operations is addressed by exclusion (j), which eliminates coverage for: (1) damage to that particular part of real property on which the insured or its subcontractors are performing operations if the damage arises out of those operations; and (2) damage to "that particular part of any property that must be restored, repaired or replaced [before work is completed] because 'your work' was incorrectly performed on it" *Id.* § I, ¶ 2(j)(5)(6) (Coverage A).

75. See Vogel v. Russo, 613 N.W.2d 177, 182 (Wis. 2000); *Weedo*, 405 A.2d at 791.

76. *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65, 82-83 (Wis. 2004).

77. ISO Policy, Coverage 1, ¶ 2(l).

78. *Id.*; *Kalebthaler*, 591 N.W. 2d at 174; *French*, 448 F.3d at 706. There are nevertheless policy endorsements that restrict subcontractor coverage or eliminate it altogether, such as ISO Endorsement CB 22 94 10 01, which eliminates the subcontractor exception to the "your work" exclusion.

79. *But see, e.g.*, note 13, *supra*.

80. *Am. Girl*, 673 N.W. 2d at 84 (subcontractor exception restored coverage for damage to warehouse built by insured caused by faulty site preparation advice of subcontracted soil engineer); *French*, 448 F.3d at 706 (CGL policy provides "coverage for the cost to remedy unexpected and unintended property damage to the contractor's otherwise nondefective work-product caused by the subcontractor's defective workmanship."); *Lamar Homes, Inc.*, 242 S.W.3d at 11 (the subcontractor exception preserves coverage that the "your work"

An insurer may argue that an owner-developer acting as its own general contractor precludes application of the subcontractor exception to the your work exclusion because there can be no subcontract without a primary contract between an owner and a general contractor. Nothing in the exclusion or the exception requires the insured to act as a general contractor—the term fails to appear anywhere in the CGL policy, let alone in the exclusion or exception. An insured’s status as an owner, a general contractor, or both should be immaterial. Nevertheless, there may be circumstances where an insured owner serves as its own general contractor, and the contractors hired to perform the work are then prime contractors, not subcontractors.

A subcontractor is variously defined, but the core of each definition includes two prongs: (1) an original contract requiring an individual or business to perform work, and (2) a second contract requiring the subcontractor to perform part or all of the work under the original contract. The term subcontractor is generally recognized to mean “one who has entered into a contract, express or implied, for the performance of an act with the person who has already contracted for its performance.”⁸¹ *Webster’s Dictionary of Law* defines a subcontract as “a contract between a party to an original contract and a third party that assigns part of the performance of the original contract to the third party,” and subcontractor as “one that contracts to perform part or all of the obligations of another’s contract.”⁸² Although the use of subcontractors is usually not disputed in the context of a general contractor’s undertaking with an owner entity, an insurer’s argument that a pure owner-general contractor does not subcontract (because the owner-general contractor cannot contract with itself) may have merit.

However, there are several ways the prime contract requirement might be satisfied even for an insured-developer.⁸³ First, if there is a formal development agreement with a municipal or other governmental entity requiring the construction—such as may exist with conveyances of blighted property—the development agreement may qualify as the original con-

exclusion otherwise would negate); *Travelers Indem. Co. of Am.*, 216 S.W.3d at 311 (damage to hotel resulting from subcontractor’s faulty installation of windows covered).

81. 9A COUCH ON INSURANCE § 129:18 (3d. ed. 2008).

82. MERRIAM-WEBSTER’S DICTIONARY OF LAW 475 (1966); see also AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th Ed. 2006). Even a material supplier has been found to be a subcontractor where it custom-fabricated materials and provided on-site installation services, because it performed part of the work. *Wanzek Const., Inc. v. Employer Ins.*, 679 N.W.2d 322, 329 (Minn. 2004).

83. In a coverage dispute, the insurer’s underwriting file may demonstrate the insurer’s knowledge that the insured acted as its own general contractor, and that premiums were charged to provide coverage to the insured in that capacity.

tract.⁸⁴ Another example would be if the developer obtains one or more presales of condominium units that obligate the insured to construct the project and particular units. Either of these situations should suffice. Another option for a condominium developer would be to use an affiliated limited liability entity to serve as general contractor, with both the developer and general contractor entity named as insureds. In this way, there would be a prime contract under which the general contractor entity can subcontract any or all of its obligations.

H. *Impaired Property Exclusion*

The impaired property exclusion precludes coverage for loss of use claims when there is no physical damage to property. The exclusion applies to property damage to impaired property (property other than the insured's work or product⁸⁵ that cannot be used or that is less useful because it incorporates the insured's defective work or product) and to any property (the insured's or a third party's) that has not been physically injured, if the resulting loss of use arises out of a defect in the insured's work. Coverage is excluded for the loss of use unless the loss of use arises out of a sudden and accidental physical injury to the insured contractor's work after it was put to its intended use.⁸⁶

One court explained that the effect of the impaired property exclusion "is to bar coverage for loss of use claims (1) when the loss was caused solely by the insured's failure to provide work of the quality or performance capabilities called for by the contract, and (2) when there has been no physical injury to property other than the insured's work itself."⁸⁷ As an example, the court described a heating and ventilation system in a new building that proves to be defective, resulting in the loss of use of the building while the system is being repaired or replaced.

This exclusion has been described as "problematic, ambiguous, 'difficult,' 'tricky,' 'unintelligible,' or 'too complex to receive a uniform inter-

84. The insurer may argue that such an agreement is insufficient because it does not require the insured-contractor to build the project for the municipality's ownership or occupation. However, there is nothing in the CGL policy that would specifically require this—the only requirement is that the insured contract out some or all of its own obligation to construct a project. Moreover, the rule that ambiguities get most strictly construed against the insurer preparing the policy would seem to be fatal to such an argument.

85. Recall that in most cases, the entire construction project will qualify as a general contractor's work under the CGL policy definition.

86. ISO Policy § I, ¶ 2—Exclusion (m) (Coverage A); *id.* § V, ¶ 8 (Definitions). The exclusion eliminates coverage for "property damage" to "impaired property" or "property that has not been physically injured" due to a defect in the contractor's work or product. *Id.*

87. Standard Fire Ins. Co. v. Chester-O'Donley & Assocs., Inc., 972 S.W.2d 1, 10 (Tenn. Ct. App. 1998).

pretation.’”⁸⁸ In any event, the impaired property exclusion is designed to exclude coverage where the insured’s work or product is incorporated into some other work or product and then fails to perform as expected, causing the impairment or loss of use of the other work or product.⁸⁹ While the subcontractor exception to the “your work” exclusion generally saves coverage for damage caused by or to faulty work performed by a subcontractor, coverage for loss of use of faulty subcontractor work that is not physically injured is still likely to be excluded by the impaired property exclusion, whether that work is ongoing or completed.

I. “Sistership” Exclusion

The sistership exclusion eliminates coverage for loss or expense incurred by an insured for repair, replacement, removal, or disposal of “your work” (or “your product” or “impaired property”) if the work is withdrawn or recalled from use by any person or organization because of a known or suspected defect.⁹⁰ It is designed to exclude coverage for expenses incurred when the insured’s work, believed to be defective, is temporarily or permanently withdrawn from use in order to prevent anticipated losses from the deficiency.⁹¹ A previous version of this exclusion was far narrower than the present CGL policy, because it applied only to withdrawals from the market initiated by the manufacturer of the defective product or component. The current version applies to any withdrawal from the market *or from use by any person or organization*. It is therefore important to ensure that any cases relied upon for authority interpret the same version of the exclusion at issue in a given dispute.

The exclusion has been held to apply only to situations where a product or work is recalled from the market, or from use to prevent failures similar to those that occurred in “sister” products or work, because the product or work is suspected to suffer from the same deficiency.⁹² The

88. *Watts Indus. Inc. v. Zurich Am. Ins. Co.*, 18 Cal. Rptr. 3d 61, 73 n.4 (Ct. App. 2004).

89. The exclusion was summarized in *Chester-O’Donley & Associates, Inc.*, 972 S.W.2d at 10, as excluding “coverage for loss of use claims (1) when the loss was caused solely by the insured’s failure to provide work of the quality or performance capabilities called for by the contract, and (2) when there has been no physical injury to property other than the insured’s work itself.”

90. ISO Policy, § I, ¶ 2 (n) (Coverage A).

91. *Paper Mach. Corp. v. Nelson Foundry Co.*, 323 N.W.2d 160, 163-64 (Wis. Ct. App. 1982); cited with approval in *Tweet/Garot-August Winter, LLC. v. Liberty Mut. Fire Ins. Co.*, No. 06-C-800, 2007 WL 445988, at *9 (E.D. Wis. Feb 7, 2007), where the exclusion was applied to bar coverage for costs the insured incurred to replace hundreds of valves in a stadium plumbing system to prevent anticipated failures after a few of the valves leaked and were found to be defective.

92. *Paper Mach. Corp.*, 323 N.W. 2d at 163-64; *Erie Ins. Exch. v. Colony Dev. Corp.*, 736 N.E.2d 941, 950 (Ohio Ct. App. 1999) (the sistership exclusion does not apply where

exclusion does not eliminate coverage for damage initially caused by the product that failed.⁹³ In short, the sistership exclusion applies only to costs associated with the withdrawal of the insured's work or products that have not failed, in order to prevent future failures similar to failures that have already occurred.

J. *Contractual Liability Exclusion*

The CGL policy excludes coverage for damages the insured is obligated to pay "by reason of the assumption of liability in a contract or agreement."⁹⁴ At first blush, the "contractual liability" exclusion would seem to apply to most construction situations, because contractors contract to perform their work. But there are two important exceptions to the exclusion.

First, the exclusion does not apply to liability that the insured would incur even in the absence of a contract.⁹⁵ Because contractors owe common law duties of care, they may be liable in tort for damage caused by their failure to exercise reasonable care (i.e., negligence), even if they could also be held liable for breach of contract.⁹⁶ This exception ensures damages related to such negligence will be covered.

Second, the exclusion does not apply to liability the insured assumes in an "insured contract," which refers, in relevant part, to any contract

condominium association's complaint against developer included "no allegations . . . indicating that anything (let alone the condominium units or any other condominium units designed and/or constructed by [the insured]) has been recalled or otherwise withdrawn from the market"); *Chester O'Donley & Assocs., Inc.*, 972 S.W.2d at 11 (the removal of subcontractor's defective ductwork from new construction "does not come within the sistership exclusion of the insured's general liability policy because there has been no general withdrawal of similar products from the general marketplace."); *Elco Indus. Inc. v. Liberty Mut. Ins. Co.*, 414 N.E.2d 41, 45 (Ill. App. Ct. 1980); *Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co.*, 314 N.E.2d 37, 38 (N.Y. 1974); *Olympic S.S. Co. v. Centennial Ins. Co.*, 811 P.2d 673, 676 (Wash. 1991).

93. *Atlantic Mut. Ins. Co. v. Judd Co.*, 380 N.W.2d 122, 125 (Minn. 1986) (exclusion did not preclude coverage for cost of removing and replacing piping and valves that leaked after installation, because only those pipes and valves that actually failed were replaced); *Erie Ins. Exchange*, 736 N.E.2d at 950.

94. ISO Policy, § I, ¶ 2 (b) (Coverage A).

95. *Id.* § I, ¶ 2(b)(1).

96. The economic loss doctrine, which limits claimants to contractual rather than tort remedies in some circumstances (usually not in connection with contracts for services), is beyond the scope of this article, but Wisconsin courts, at least, have been consistent in distinguishing the economic loss analysis from the analysis of coverage under a general liability policy for construction related damage. *Linden v. Cascade Stone Co.*, 699 N.W. 2d 189, 194-95 (Wis. 2005); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65, 75 n.4 (Wis. 2004); *Bay Breeze Condo. Ass'n v. Norco Windows, Inc.*, 651 N.W. 2d 738, 744 n.5 (Wis. Ct. App. 2002). In *American Girl*, the court explained that even assuming the economic loss doctrine limited the claimant to contract remedies against the insured, the insured's liability (even for breach of warranty) may still be covered under the CGL policy if the subcontractor's work gave rise to property damage caused by an occurrence. *American Girl*, 673 N.W. 2d at 70 ("That the property damage at issue here is actionable in contract but not in tort does not make it 'non-accidental' or otherwise remove it from the CGL's definition of 'occurrence.'").

related to the insured's business.⁹⁷ This exception has been construed to afford coverage for the insured's contractually assumed obligation to indemnify a third party for that third party's negligence or other tort liability, as opposed to merely its own liability for breach of contract. Specifically, where the insured agrees to defend and indemnify a third party for that third party's tort liabilities (usually, those of an owner or a higher tiered contractor), the costs and attorney fees incurred to defend the third party are "deemed to be damages because of . . . 'property damage.'"⁹⁸

K. *Summary Analysis*

A preliminary analysis of available coverage for an insured contractor or subcontractor under a CGL policy can start with a simple set of questions applied to each element of a property damage claim:

- (1) Is there "property damage"—i.e., a physical injury to or loss of use of tangible property?
If not, stop—no coverage. If so, continue analysis.
- (2) Was the property damage caused by an "occurrence" within the coverage territory?
If not, stop—no coverage. If so, continue analysis.
- (3) Has property damage occurred during the policy period?
If not, stop—no coverage. If so, continue analysis.
- (4) Did the insured have knowledge of the property damage prior to the policy application?
If so, stop—no coverage. If not, continue analysis.
- (5) Was the damaged property entirely owned by the insured contractor at the time of damage?
If so, stop—no coverage. If not, continue analysis (including potential allocation opportunities).
- (6) Was the damage to property or work of the owner or another contractor?
 - (i) If so, did it occur after completion of the insured's work?
If not, stop—no coverage. If so, coverage exists under P-COH.
 - (ii) If not, continue analysis.
- (7) Was the damage solely to goods or products manufactured or sold, handled, or distributed by the insured and arising out of it?
If so, stop—no coverage. If not, continue analysis.
- (8) Was the damage solely to the insured's own work, materials, parts, or equipment— as opposed to that of one of its subcontractors?
If so, stop—no coverage.
If not, was the damaged work or work out of which the damage arose performed by a subcontractor?
If so, coverage exists.
If not, stop—no coverage.

97. ISO Policy § I, ¶ 2(b)(2) (Coverage A).

98. *Id.* ¶ 2(b). See also *Am. Girl*, 673 N.W.2d at 80–81, and the cases cited therein.

III. BEYOND THE BASICS

A. *Categorization of Damages*

Assuming physical damage is sustained to a construction project during the policy period and was not previously known to the contractor, coverage related issues can range from the simple to the extremely complex. The first step in the process of applying the policy provisions to a practical coverage analysis is to identify the subject of the physical damage and then determine what has to be done to accomplish the repair.⁹⁹ The following categories of damage will determine which policy provisions apply to either confer or negate coverage:

- (1) A contractor's self-performed work damaged due to a defect in that work;
- (2) Defective work performed by or on behalf of the contractor which is not physically damaged;
- (3) Damage to another contractor's work due to a defect in the insured contractor's work;
- (4) Damage to a contractor's subcontracted work due to the subcontractor's defective performance;
- (5) Damage to a contractor's subcontracted work due to another subcontractor's defective performance;
- (6) Damage to property owned by a third person that was not constructed by or on behalf of the contractor or another contractor.

Coverage, or the lack of coverage, for some categories of damage is relatively straightforward in most jurisdictions. Damage to a contractor's self-performed work due to a defect in the work, for example, will almost always be excluded from coverage, either because the insured's defective work causing damage to only the work is not regarded as an occurrence (in some jurisdictions) or because of the exclusion for property damage to the insured's own work. Similarly, damage to work performed by a subcontractor, or damage to other property caused by a subcontractor, will almost always be covered by virtue of the subcontractor exception to the your work exclusion, except in those jurisdictions that eliminate coverage under the insuring agreement (no property damage caused by an occurrence) before ever getting to the policy exclusions. But the analysis can quickly become more complicated, regardless of the jurisdiction, in other circumstances.

99. See 4 PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., *BRUNER & O'CONNOR ON CONSTRUCTION LAW* § 11:46, at 158-59 (2002), identifying five categories of damage from defective work that require separate analysis under the products-completed operations provisions of a CGL policy.

B. Costs Incurred to Investigate, Repair, or Replace Undamaged Work May Be Covered as Sums the Insured Becomes Obligated to Pay as Damages “Because Of” Property Damage—Even if the Work Is Self-Performed

The language of the CGL policy’s insuring agreement affords coverage for more than the cost to repair physically damaged property itself: The policy covers “those sums that the insured becomes legally obligated to pay as damages *because of* . . . property damage.” Under a fair reading of the policy language, coverage extends to costs incurred as a consequence of property damage. Costs incurred to remove and replace undamaged property, even defective work of the insured, should be covered as damages “because of property damage”: (1) where the repair work is necessary to investigate, access, and repair other property damage; or (2) where the repair work is necessary to prevent the reoccurrence of or the continuation of property damage in the future.

1. Repair or Replacement to Remediate Property Damage

If faulty work is not damaged but needs to be removed in order to gain access to a part of the building that the work physically damaged and that requires repair, the removal and replacement of the defective work should be covered as sums that the insured becomes legally obligated to pay damages “because of property damage.” In one case, the insured home builder was liable for damage caused by a subcontractor’s defectively designed synthetic stucco, which trapped water, causing wood rot, mold, and termite infestation to the wood walls of hundreds of homes. The insured builder was liable to the homeowners for the defective product supplied by its subcontractor.¹⁰⁰ The costs incurred to repair the water damage to the homes were, unsurprisingly, found to be “damages because of . . . property damage.” But the court also found coverage for the cost of removing the defective, though undamaged, stucco where necessary to “to access and repair underlying water damage or determine the areas of underlying damage.”¹⁰¹ The court found these costs were “damages because of . . . property damage.”

100. Of course, the insured has to face liability for the claimed damages, or the CGL policy is not implicated at all. Accordingly, the cost to remove and replace the insured’s own defective, but undamaged, work is potentially covered only if the work has allegedly caused damage to other property. There would be no coverage, at least under the insured’s CGL policy, if the insured’s work was defective, but caused no damage and had to be removed and replaced to access property that was physically damaged by another contractor’s work. Presumably, those removal and replacement costs would be covered under the policy of the contractor whose work caused the physical damage.

101. *Lenmar Corp.*, 200 S.W.3d at 678 n.33; see also *Newman*, 2008 WL 648546, at *5 (replacing defectively installed stucco causing interior moisture damage was a covered liability “associated with remedying the other property damage” . . . [b]ecause this underlying moisture damage could neither be assessed nor repaired without first removing the entire stucco exterior.”).

2. Repair or Replacement to Prevent the Reoccurrence or Continuation of Damage

Under normal circumstances, if an insured's defective work is not damaged, but it causes physical damage to other portions of a building, there will be coverage for the cost to repair the physically damaged property, but the cost to repair the insured's defective work itself will be excluded from coverage if the work was self-performed. But if the physical damage to other building elements is ongoing, and the only way to prevent the continuation of additional damage is to remove and replace the insured's defective work, the costs of that removal and replacement should be covered as "damages because of . . . property damage." The "your work" exclusion only applies to eliminate coverage for the cost of repairing physical injury to the insured's self-performed work. Where the insured's work is not itself physically damaged, but has to be removed and replaced in order to fully remediate continuing physical damage to other building components, the costs to fully repair that ongoing damage to the other components includes the cost to remove and replace the insured's defective work. In other words, the removal and replacement costs are incurred to repair the physical damage to other property, not to repair damage to the insured's work, even if the insured's defective work happens to be removed and replaced in the process.

For example, if an insured installs a brick wall without proper sealant, which allows continuing water leakage that, in turn, damages interior walls, windows, and flooring, the only way to fully repair the physically damaged property and to prevent the reoccurrence of that damage is to fix the defect in the insured's brick wall. That cost, therefore, should be covered as consequential damages incurred "because of" the property damage to the interior walls, windows, and flooring.

A California court determined that the insurer had a duty to defend its insured in a lawsuit that sought to recover the cost of replacing metal parts manufactured by the insured that were used in municipal water systems and were allegedly causing ongoing lead contamination.¹⁰² The court reasoned that "[s]ince the municipalities allege that lead contamination is ongoing, the requested remedies are necessarily at least partly remedial and mitigative, rather than entirely prophylactic, for they address harm which is already occurring, not just harm that might occur."¹⁰³ The court distinguished between uncovered "prophylactic" expenses and covered "remedial" costs, explaining:

102. *Watts Indus., Inc. v. Zurich Am. Ins. Co.*, 18 Cal. Rptr. 3d 61 (Ct App. 2004).

103. *Id.* at 68.

Preventing releases that have not yet occurred or caused harm is different from stopping releases that already are occurring and causing harm. The former is prophylactic; the latter is remedial or mitigative and results in costs that constitute covered damages. . . . To stop that ongoing release is not mere prophylaxis.¹⁰⁴

In another decision, a condominium unit owner and certain portions of the common areas sustained water damage intermittently over eight years.¹⁰⁵ The water leakage was finally traced to a glass enclosure in the insured's condominium. The condominium association repaired the glass enclosure in order to prevent further water leaks and then sought recovery from the insured (the owner).¹⁰⁶ The court concluded the owner was entitled to a defense from its insurer, and further agreed that "under certain circumstances, an insurer may be obligated to indemnify its insured for remediation expenses incurred in connection with the insured's property."¹⁰⁷ The court stated: "In our view, repairs to prevent imminent and further damage . . . are potentially a component or consequence of third-party property damage . . . and a claim 'for damages because of . . . property damage.'"¹⁰⁸

3. Purely Prophylactic Repairs

The foregoing circumstances are to be distinguished from a circumstance of removing and replacing defective work for purely prophylactic reasons, to prevent future property damage that has not yet occurred. In litigation arising out of the renovation of a football stadium, the plumbing and HVAC contractor incurred substantial costs to investigate, remove, and replace valves in the piping of the heating and cooling system that had not yet failed and had not yet caused any damage. All of the valves were removed after a few of the valves failed and caused some relatively nominal water damage. An investigation then showed the rest of the valves were defective as well, and the contractor was required to remove and replace the valves (under warranty) to prevent any future damage. The insurer's denial of coverage for the removal and replacement costs was upheld.¹⁰⁹

104. *Id.* at 69.

105. *Aetna Ins. Co. v. Aaron*, 685 A.2d 858 (Md. Ct. Spec. App. 1996).

106. *Id.* at 860.

107. *Id.*

108. *Id.*

109. *Tweet/Garot-August Winter, LLC v. Liberty Mut. Fire Ins. Co.*, No. 06-C-800, 2007 WL 445988, at *9 (E.D. Wis. Feb 7, 2007) (the court found there was no property damage and that, even if there were, coverage was precluded by the sistership exclusion); *see also* *Lennar Corp. v. Great Am. Ins. Co.*, 200 S.W.3d 651, 679 (Tex. App. 2006) (costs to remove and replace stucco solely as a preventive measure, rather than to repair exiting damage to homes, are not "damages because of . . . property damage.").

The notable factual distinction between this case and the other cases discussed above is that in this case, there was discrete failure and discrete property damage, and the remaining defective valves had not yet caused or contributed to any damage. This contrasts with the fact that the other cases involved ongoing or recurring water infiltration and damage, so removing and repairing the defective work was actually a cost incurred “because of” the property damage that had occurred and was continuing.

4. Impairment of a Functional Element

An interesting and as yet unanswered question arises where faulty workmanship does not cause direct physical damage, but nevertheless alters the intended function of a building component. This issue was raised in a case before a Wisconsin trial court that involved an insured’s allegations of a subcontractor’s faulty installation of exterior face brick.¹¹⁰ In this case, an exterior face brick wall was installed on a building with mortar bridging between the inside surface of the face brick and the sheathing.¹¹¹ The mortar bridging altered the functional performance of the drainage plane, by trapping water behind the brick and allowing the water to infiltrate the building interior, thereby causing various interior damage. Because the subcontractor exception to the your work exclusion preserves coverage for damage to a subcontractor’s work, the question was whether the exterior brick, which was installed by a subcontractor, was physically damaged so that the cost to remove and replace the brick was a covered expense.¹¹² Again, the physical damage to tangible property component of the definition of property damage is generally satisfied if there is an alteration in appearance, shape, color, or other material dimension.¹¹³ What is not clear is whether this requires an alteration from what is physically constructed (in which event the altered drainage plane would not constitute property damage) or if an alteration in the intended function of the work will suffice (in which case the altered drainage plane would amount to property damage). As indicated, it does not appear any court has resolved this issue.

110. *Highbridge Condo. Owner’s Ass’n, Inc. v. New Land Enters., LLP*, Case No. 05-CV-007221 (Milwaukee Cty. (Wis.) Cir. Ct. Aug. 15, 2005).

111. *Compl., Highbridge Condo. Owner’s Ass’n*, Case No. 05-CV-007221.

112. Alternative arguments were also advanced. Since the mortar bridging caused damage to the building interior, and the water infiltration would continue unless and until the exterior brick was removed and replaced absent the mortar bridging, the cost of removing and replacing the brick arguably was covered as a consequential cost of repairing the physical damage to the building interior, regardless of whether or not the brick was itself physically damaged. *See id.*; *see also* Part B(2) above.

113. The other portion of the property damage definition—loss of use of tangible property that has not been physically injured—has been interpreted in Wisconsin to require a complete loss of use, rather than simply a diminished value. *Everson v. Lorenz*, 695 N.W.2d 298, 307–08 (Wis. 2005).

C. *Impact of Known Property Damage*

As discussed previously, if the insured knew, prior to commencement of a policy period, that “‘property damage’ had occurred in whole or in part,” then any “continuation, change or resumption” of such property damage during the policy period will be deemed to have been known before the policy was effective. There will be no coverage for the continuation or resumption of damage under that policy.¹¹⁴ This provision works in conjunction with another, however, as the CGL policy also extends coverage to any “continuation, change or resumption” of property damage after the end of the policy period, provided the damage took place during the policy period and was not known by the insured to have occurred prior to the policy period.¹¹⁵ In other words, these provisions temper the requirement that coverage applies only to property damage that occurs during the policy period,¹¹⁶ and designate the policies in effect prior to and at the time the insured becomes aware that damage “has occurred or has begun to occur”¹¹⁷ as the responsive policies. As a practical matter, if only one policy is triggered, the insured will be limited to the “per occurrence” limit of the responsive policy for known damage, and will not be entitled to the limits of policies issued after the damage occurs.¹¹⁸ In circumstances where successive policies are issued by different insurance companies, the known loss provisions may define which company is responsible for claims arising from the damage.

The question then becomes what constitutes a “continuation, change, or resumption” of known property damage. For example, if a building constructed by an insured experiences persistent water leakage and resulting damage before a policy period, will new water damage occurring during the policy period be excluded from coverage as a known loss, regardless of the cause of the water infiltration? Arguably, an insured’s knowledge of damage caused by leaking of one window because the window was improperly installed may not fairly be deemed knowledge of other water

114. ISO Policy § I, Coverage, ¶ (b)(3).

115. *Id.* § I, Coverage, ¶ c.

116. *Id.* § I, ¶ b(2).

117. *Id.* § I, ¶ d.

118. A different scenario exists if property damage continuously spans more than one policy period before it is discovered. In that circumstance, in the many jurisdictions that follow a continuous trigger theory, the limits of each policy in effect at any time during the continuum of property damage can be stacked. *See, e.g., Society Ins. v. Town of Franklin*, 607 N.W.2d 342, 346 (Wis. Ct. App.), *rev. granted*, 616 N.W. 2d 114 (Wis. 2000) (reasoning that “the insured should get the full benefit of the coverage it purchased from the insurer,” the court found the insured has a reasonable expectation to recover up to the limit purchased with those premiums from each policy triggered by property damage during the policy period); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W. 2d 65, 84 (Wis. 2004).

damage that occurs later at another location because improperly installed siding has permitted water to penetrate to interior walls. Even though the later damage is the same type of damage as the earlier damage, it is not a continuation, change or resumption of *that damage*. What happens if the insured contractor repairs the cause of water infiltration, believing it to be fixed before the policy is issued. If the repair does not work, is the resumption of water leakage and damage during the policy period a known loss?

Obviously, the answers to these types of questions are fact intensive but a few courts have grappled with similar problems. In one case, a condominium project developed a variety of problems after completion but before sale of any of the units.¹¹⁹ There were problems with the design of the laundry facilities and with the HVAC system; leaks in unit balconies, windows, and interior plumbing; and cracks in unit slabs. The developer ultimately sold the condominium units and, not surprisingly, ended up being sued by the buyers after additional problems, including water drainage, decaying stucco, sinking footings, etc., became manifest.

The developer's insurer argued the later problems that gave rise to the unit owners' claims were simply a continuation of the damage manifested before the policy was issued, and that there was no coverage for this non-fortuitous "loss in progress." The appellate court found triable issues of fact on two basic principles. First, "knowledge of one defect or set of defects is not the equivalent of knowledge of other, distinct defects in the same project."¹²⁰ Rather than concluding that a project suffers from a generic defect of "faulty construction," each defect must be analyzed separately to determine if the insured had knowledge of that defect.¹²¹ Second, while any damage flowing from a known defect would be expected and intended by the insured, for coverage to be barred, the insured must have had actual knowledge of the defect before the policy inception date—it is not enough that the insured was negligent in failing to discover the defect.¹²²

Because the known loss provisions of the policy restrict coverage, the language of the CGL policy form should be strictly construed to limit coverage only for a continuation or resumption of the actual property damage known to the insured. Later damage that is similar in type, but is caused by a different defect or source, is not a continuation or resumption of "such" property damage and should be covered. This necessarily requires

119. *Chu v. Canadian Indem. Co.*, 274 Cal. Rptr. 20 (Ct. App. 1990).

120. *Id.* at 27.

121. *Id.* at 28.

122. *Id.*

consideration of not only the specific item of property damaged, but also the cause of the property damage.¹²³

For example, an insurer may argue that if the insured knew, prior to the issuance of a policy, that water infiltration and damage had occurred at one location in a building, any reoccurrence of water infiltration and damage to the building during the policy period is not covered. Arguably, if the initial water damage is to a window sill and is caused by missing caulk around the window opening and both the damage and missing caulk are repaired, but in the course of doing so the repairman inadvertently punches a hole in the flashing that results in subsequent water infiltration and damage to the repaired window sill, the damaged sill is not a resumption of the property damage the insured knew of and repaired, even though it is the same type of damage to the same property. Rather, the damage arising from the hole in the flashing was unknown to the insured when the policy was issued, because the hole in the flashing had not caused any damage to the window until after the policy was issued. The result may, however, be different if the subsequent damage to the window sill arose because the caulking was improperly applied during the repair.

The recurrence of damage that was thought to have been repaired before a policy became effective is more likely to be excluded as known property damage, but this result is not automatic. In a Washington decision, summary judgment was denied to an insurer despite evidence that the insured had tried to repair water seepage and window damage problems several times before the policy period.¹²⁴ The insured did not discover until after the policy was issued that the vapor barrier was improperly installed, which allowed water to saturate the siding, wood framing, and sheathing, and eventually required a portion of the building to be rebuilt at a cost in excess of \$1 million. The insurer argued it was irrelevant that the cause of the

123. In *Lennar Corp. v. Great American Insurance Company*, 200 S.W.3d 651 (Tex. App. 2006), where the insured made a claim for damages caused by defective synthetic stucco it installed on hundreds of homes, the court found coverage would be barred as a known loss to the extent the insured had discovered and/or repaired stucco-related damage to a home prior to the policy period. But there were factual issues regarding when the insured understood there was an inherent defect in all of the stucco (as opposed to installation errors on a few homes) that made summary judgment for the insurer inappropriate with respect to coverage for stucco-related damage that occurred after the policy was issued. Specifically, the court found “a genuine issue of material fact on whether [the insured] should have known when it purchased the . . . policy that EIFS had damaged, or was in the process of damaging, all the homes on which it was installed.” *Id.* at 689. This may be a unique circumstance, given that the damage was occurring on separate homes rather than reoccurring on homes that had been repaired, but the decision does suggest that the insured’s knowledge of the cause of the damage may define, or at least be relevant to, the determination of whether the insured expected additional property damage to occur, making the damage nonfortuitous, which is the premise of known loss defenses.

124. *Hillhaven Props. Ltd.*, 948 P.2d at 796.

problem was not discovered until after the policy went into effect, because the focus should be on whether a loss occurred before the policy. The insurer further argued that a “loss that persistently defies repair and continues to cause damage over a period of time is not a *new* and *distinct* loss each time the problem reappears.” The court, however, pointed to evidence that the building owner and the insured both thought the water problems were insignificant at the time the policy was issued. The court concluded evidence of past problems was insufficient to establish the level of knowledge required by the known loss doctrine, namely, that the insured know “with substantial probability” of the loss.¹²⁵

Rules of policy construction instruct that courts should fairly consider the entire phrase “property damage caused by an occurrence” in determining whether knowledge by an insured contractor of a given item of property damage will bar future liability coverage. If this is done, knowledge of physical damage to one item of tangible property does not preclude coverage for similar damage to other similar or dissimilar items of tangible property at the project.

D. *Timeliness of Notice of Occurrence*

An insured is required to immediately provide notice to the insurer if a claim is made against the insured or if a lawsuit is filed.¹²⁶ These requirements are usually straightforward, although the effect of a failure to provide timely notice varies in different jurisdictions and has been widely litigated.¹²⁷ The less straightforward circumstance involves the policy requirement that the insured “see to it that [the insurer is] notified as soon as practicable of an ‘occurrence’ . . . which may result in a claim.”¹²⁸ While this notice requirement is geared toward knowledge of an occurrence rather than to knowledge of property damage, the fact that the insured’s notice obligation arises only with respect to an occurrence “which may result in a claim” means, as a practical matter, that the duty to give notice is unlikely to arise before an occurrence (however defined) causes property damage. Without property damage, of course, there is no basis for a claim that might be covered under the CGL policy, which only covers sums the insured becomes obligated to pay as property damage.

125. *Id.* at 804.

126. ISO Policy, § IV, Conditions, ¶ 2(b).

127. In Wisconsin, for example, the failure to provide timely notice as required by the policy does not defeat coverage unless the insurer is prejudiced by the late notice. Where notice is more than one year overdue, the burden is on the insured to demonstrate lack of prejudice. See WIS. STAT. §§ 631.81, 632.26 (2005–06). *Int’l Flavors & Fragrances, Inc. v. Valley Forge Ins. Co.*, 738 N.W.2d 159 (Wis. Ct. App. 2007).

128. ISO Policy § V, ¶ 2(a).

For instance, if a general contractor finds out that one of his subcontractors performed deficient caulking work in a given location, and the relevant jurisdiction treats defective work in the absence of other damage as an occurrence, must the contractor give notice to its insurer or risk a late notice defense? If the defect is discovered during the subcontractor's warranty period and is corrected, there is no reason to anticipate a claim (the defect has been corrected, and it caused no property damage), and there is little reason to provide the insurer notice. Even in a circumstance where caulking deteriorates after the expiration of the subcontractor's warranty, until the lack of caulking results in property damage, there is no reason to anticipate a claim for property damage.

Nevertheless, even after property damage occurs, whether and when an insured (or, more accurately under an objective standard, when a reasonable insured) should appreciate the likelihood of a claim is subject to debate. In the case of one condominium project, various instances of water infiltration were brought to the developer's attention shortly after construction was completed, arising at different locations and times and from a variety of causes. The developer tried to address each instance over time, but it did not become clear for several years that the condominium association would actually bring a claim, because the parties were working to find a solution to the problems. The developer argued, in part, that a reasonable insured would not expect a claim if the damage resulting from the occurrence is repaired. Nor, according to the developer, was it clear when during the course of ongoing problems the developer should have given notice to the insurer or what the notice should have addressed. If the developer had given notice that window trim in one unit had to be replaced because of water damage at one time, would that have been sufficient notice of the water infiltration that subsequently occurred in another unit that led to replacement of window framing and window reinstallation? The developer gave notice to the insurer immediately after receiving a written demand from the association. The court in that case ultimately determined issues of fact existed regarding whether notice was timely.¹²⁹

The purpose of requiring notice of an occurrence that may result in a claim is to afford the insurer the opportunity to promptly investigate the circumstances of the occurrence if it chooses to do so.¹³⁰ An insurer's obligation to defend does not arise until a lawsuit is filed.¹³¹ While notice

129. Highbridge Condo. Owner's Ass'n, Inc. v. New Land Enters., LLP, Case No. 05-CV-007221 (Milwaukee Cty. (Wis.) Cir. Ct.).

130. ISO Policy § I, ¶ 1(a) ("We may, at our discretion, investigate any 'occurrence' and settle any claim or 'suit' that may result.")

131. *Id.* ("We will have the right and duty to defend the insured against any 'suit' seeking damages" because of property damage.)

of an occurrence is a legitimate requirement and a condition precedent to coverage in most instances, it is difficult for an insurer to deny coverage based solely on an insured's failure to give notice of an occurrence that may give rise to a claim, at least in a jurisdiction where late notice must prejudice the insurer, as long as the insured provides prompt notice of the claim once it is made.

E. *Determining the Number of "Occurrences"*

The limits of most CGL policies include per occurrence and aggregate limits. Provided the aggregate limit is higher than the per occurrence limit (which is not always the case), each occurrence during a policy period will trigger a separate per occurrence limit, up to the aggregate limit. Thus under a policy with \$1 million per occurrence limits, and \$3 million aggregate limits, a construction project that gives rise to claims for property damage arising out of three occurrences will yield a total payout of \$3 million, assuming all other terms for coverage are satisfied. The number of occurrences may also determine the number of per occurrence deductibles or retentions the insured must satisfy.

Recall that an occurrence is defined in the policy as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."¹³² What constitutes "substantially the same general harmful condition" is undefined by the policy, but it is apparent the phrase is intended to ensure that all damage arising from substantially the same cause or causes will be treated as a single occurrence. This is consistent with majority rule that "the number of occurrences . . . is determined by using the 'cause' theory . . . , rather than to the number of individual claims or injuries."¹³³ However, what causes the damage is not always entirely clear.

In *Lennar Corporation v. Great American*,¹³⁴ a homebuilder sought coverage for damages related to defective synthetic stucco (EIFS) applied to hundreds of homes, arguing that all homeowner claims arose out of a single occurrence, namely, the EIFS's continuous and repeated entrapment of water. The homebuilder was motivated by its desire to satisfy its substantial per occurrence self-insured retention. If the homeowner claims were separate occurrences, the homebuilder would have to satisfy the \$250,000

132. ISO Policy § V, ¶ 13 (Definitions).

133. 44 Am. Jur. 2d INSURANCE § 1525 and n. 2 (2003); *Lee v. Interstate Fire & Cas. Co.*, 86 F.3d 101, 103 (7th Cir. 1996) ("[m]ultiple injuries with a single cause do not count as multiple occurrences"). Still, courts have not had an easy time identifying what constitutes substantially the same cause, and the decisions tend to be very fact specific, as demonstrated by the *Lennar Corporation* case discussed next.

134. 200 S.W.3d at 681-82.

retention for each home before coverage would be triggered. Because the damages for any one home were less than the retention, there would be no coverage.

The court concluded each homeowner's damage arose from a separate occurrence. Even though the EIFS was a generally defective product that trapped water, the homebuilder's liability arose from its application of the EIFS to each home and the damage to that particular home: "Therefore, [the homebuilder] was exposed to a new and separate liability for each home on which EIFS was applied."¹³⁵

In another example of the application of the cause test, the South Carolina Supreme Court considered whether the insured manufacturer's distribution of defective synthetic stucco to various buyers was a single occurrence, triggering the \$1 million per occurrence limit, or if each sale was a separate occurrence, leading to application of the \$2 million aggregate limit. The court noted that the case involved "the distribution of inherently defective goods, and not the defective distribution of otherwise satisfactory goods," and reasoned that the distributor did not take any distinct action that would give rise to liability in each sale. Accordingly, the insured's distribution of the stucco was a single occurrence.¹³⁶

In an illustration of how complex application of the phrase can become, in the context of discovery in one state court coverage dispute involving damage to various building components arising from a variety of defects in subcontractor work, all of which gave rise to water infiltration, the insurer offered the following steps for identifying whether harmful conditions are substantially the same:

- (a) The conditions associated with the accident should be identified;
- (b) A determination should be made as to whether the conditions identified are likely to cause property damage;
- (c) A determination should be made as to whether the conditions are prevalent or widespread; and
- (d) The essential character of the conditions identified by way of the above analysis should be evaluated to determine whether such conditions have one nature or set of characteristics.¹³⁷

The insurer stated that it believed that water leakage at the condominium project qualified as continuous or repeated exposure to the same general harmful conditions. Therefore, the insurer argued that the occurrence was

135. *Id.* at 682–83.

136. *Owner's Ins. Co. v. Salmonsens*, 622 S.E.2d 525, 526 (S.C. 2005).

137. *Am. Family Mut. Ins. Co. Suppl. Resp. to New Land Enters, LLP Interrog. No. 11, Highbridge Condo. Owner's Ass'n, Inc. v. New Land Enters., LLP*, Case No. 05-CV-007221 (Milwaukee Cty (Wis.) Cir. Ct. Aug. 15, 2005).

any “repeated leakage.”¹³⁸ The insured, seeking to trigger the aggregate limit, argued that under the policy language, the water infiltration could not be both the occurrence/accident/exposure *and* the harmful condition, because the policy defines an occurrence to include “exposure to . . . harmful conditions.”¹³⁹ They are separate elements, as follows:

Harmful Conditions

- Common Condition (rain water)
- Variable Conditions
 - Defective Masonry
 - Defective Caulking
 - Defective Windows
 - Defective Flashing

Occurrence/Accident/Exposure

- Water Infiltration

Property Damage

- Water Damage to Tangible Property

The insured argued that because there were multiple causes of the property damage, and the water infiltration itself was caused at different times and in different locations by different faulty workmanship, each type of faulty workmanship was a separate occurrence under the insured’s approach.¹⁴⁰ The disparate approaches of the insurer and the insured were never resolved, as the trial court found that issues of fact barred summary judgment for the insurer on the issue of the number of occurrences.¹⁴¹

Obviously, the determination of the number of occurrences is both fact intensive and, often, outcome determinative. Although one court has indicated there is no such thing as a “generic defect of ‘faulty construction,’”¹⁴² and that each construction defect must be considered separately, the court was addressing application of the known loss doctrine, not the number of occurrences. The *Lennar* decision discussed above found multiple occurrences even though all of the damage, albeit to different homes, arose from water infiltration caused by the same defective stucco product. Although a few court decisions have characterized continuous water intrusion into

138. Am. Family Mut. Ins. Co. Br. in Supp. of Am. Family Mut. Ins. Co. Motion for Summ. J., at 41.

139. Def. Brief in Opposition to Am. Family Mut. Ins. Co.’s Motion for Summ. J. at 41–42.

140. *See id.*

141. *See* Oct. 25, 2007 Order, Highbridge Condo. Owner’s Ass’n, Inc. v. New Land Enters., LLP, Case No. 05-CV-007221 (Aug. 15, 2005 Milwaukee County (Wis.) Cir. Ct.).

142. *Chu*, 274 Cal. Rptr. at 28.

a building as an occurrence (and specifically, as a continuous and repeated exposure to the same general harmful condition), the water intrusion in each of the decisions arose from a single subcontractor's defective work, rather than from a combination of discrete instances of faulty workmanship by different subcontractors.¹⁴³ It could even be that the position of the insurer in the example above will be favored in jurisdictions that say the accident arising out of the faulty work is the occurrence and the insured's position will be favored in jurisdictions that regard the faulty work as the occurrence. It appears that whether repeated water infiltration caused by different construction defects qualifies as a single or multiple occurrence is still subject to debate in most jurisdictions.

IV. CONCLUSION

Determining coverage for damage caused by construction defects is fact intensive and very much contingent on which jurisdiction's law controls the interpretation of the CGL policy in any give case. It is important to address each policy requirement separately under the applicable law, starting with the insuring agreement's requirements for property damage caused by an occurrence, moving to policy exclusions, and then to exceptions to those exclusions. At each step, it is helpful to keep in mind the purpose of CGL coverage, which is generally to provide protection to the insured for liability to third parties for damages "because of property damage" caused by the insured's work. This includes protection to the insured for damage caused by, or damage to, subcontracted work. Additionally, there are few jurisdictions that completely eliminate coverage for property damage to other property arising from defective work, and the potential for coverage will obligate the carrier to defend the insured, in most jurisdictions, unless and until there is a determination that no coverage exists. The defense benefit provided by the CGL policy may be just as valuable as the indemnity benefit.

143. *Newman*, 2008 WL 648546, at *3 ("the continuous water intrusion into the home resulting from the subcontractor's [negligent application of stucco] qualifies as an 'accident' involving 'continuous or repeated exposure to substantially the same harmful conditions'); *High Country Assocs.*, 648 A.2d at 478 (continuous exposure to moisture due to a subcontractor's defective installation of siding was an occurrence); *but see Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 137 P.3d 486 (Kan. 2006) (court found that continuous exposure of home to moisture was an occurrence where it resulted from subcontractors' faulty work—it is not clear from the opinion whether the only faulty work at issue was the defective windows or cracking stucco, which also contributed to leakage).

