American Educational Institute, Inc.

CLAIMS LAW UPDATE

A SUPPLEMENT TO CLAIMS LAW COURSES IN CASUALTY, PROPERTY, WORKERS COMPENSATION, FRAUD INVESTIGATION AND AUTOMOBILE

Summer, 2018

AEI CLAIMS LAW QUIZ

FAULTY CONSTRUCTION AND CGL COVERAGE

[Ref. Law of Insurance: General Liability, Paras. 2.04, 3.04, and 3.09]

FACTS: The Browns hired general contractor Tibke Construction to build a house. Tibke brought in subcontractor Jerry's Excavating to prepare and excavate the soil. But Jerry's failed to perform a soil test and it was later determined that the house was built on expansive soil that caused damage in the form of excessive settlement, cracking, and structural unsoundness.

The Browns sued and the general contractor sought coverage under its CGL with Owners Insurance Company. The Browns did not claim that the general contractor improperly constructed any part of the house. Rather, they argued that the damage to the house was caused by the failure to test the soil prior to construction.

The insurer disputed coverage and defended under a reservation of rights. It argued that it did not have a duty to defend or indemnify because property damage caused by the intentional choice not to perform a soil test was not an accident and, therefore, not an occurrence under the policy. The insurer also argued that two policy exclusions applied. The insured countered that there was coverage because the failure to test the soil was an occurrence and the exclusions did not apply.

QUESTION: Is property damage to a general contractor's work, caused by the faulty workmanship of a subcontractor, covered by the general contractor's CGL?

ANSWER: Yes, according to South Dakota's Supreme Court in *Owners Ins. Co. v. Tibke Construction, Inc*., 901 NW2d 80 (S.D. 2017).

The first issue raised in the case was whether the damage alleged by the Browns was caused by an occurrence as required by the policy. The policy defines occurrence as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." The insurer argued that the policy was not intended to cover faulty workmanship, and that the damage to the house was not an occurrence because it was not caused by an accident. According to the insurer, failing to test the soil beneath the construction site was not an accident, but a deliberate decision to construct the house on that soil despite the failure to test it.

The South Dakota Supreme Court disagreed:

> The CGL policy does not define accident, but we have defined it as "an event that is undesigned, sudden, and unexpected." In determining whether an event is an accident, we assess the event according to the quality of the result rather than the quality of the causes. Thus, if inadvertent faulty workmanship causes unexpected injuries to people or property, it may constitute an accident and thus an occurrence. Currently, the majority of state supreme courts that have decided the issue of whether inadvertent faulty workmanship is an accidental occurrence potentially covered under the CGL policy have decided that it can be an occurrence.
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> Owners' argument that the alleged faulty work was intentional and thus not an accident is unavailing. The failure to test the soil was not an intentional or deliberate action but an unplanned omission, which caused an unexpected result. A deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly.

The court found that there was an occurrence because the failure to test the soil caused damage to the insured's work and that failure was an "unplanned omission," not an intentional act. This omission caused property damage to the house in the form of "excessive settlement, cracking, and structural unsoundness."

This, however, did not end the court's analysis. Owners also argued that even if the failure to test the soil was an occurrence, two policy exclusions applied to bar coverage. First, it argued that subsection j(7) of the CGL excludes coverage for property damage that must be restored, repaired, or replaced because the insured or anyone acting on behalf of the insured incorrectly performed work on it. The pertinent part of j(7) excludes coverage for property damage to:

That particular part of any property that must be restored, repaired, or replaced because "your work" was incorrectly performed on it.

According to the policy "your work" :

a. Means:

   (1) Work or operations performed by you or on your behalf; and

   (2) Materials, parts or equipment furnished in connection with such work or operations.

b. Includes:

   (1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work"; and

   (2) The providing of or failure to provide warnings or instructions.

The insured argued that this exclusion only applies to damaged property that is the subject of incorrectly performed work. According to the insured the parts of the house that sustained damage, such as the foundation and walls, were not the subject of incorrectly performed work. Rather, that damage was caused by the failure to test the soil. The insurer countered that the exclusion applies to damage to any part of the construction project. The South Dakota Supreme Court, however, rejected the insurer's argument and said that j(7):

> ... only excludes property damage to "that particular part of any property that must be restored, repaired or replaced because your work was incorrectly performed on it." The word *it* refers back to *that particular part* of the property on which the insured's work was incorrectly performed. The plain language of j(7) is concerned with the repair, restoration, or replacement of a specific part of the property, not damage to a property as a whole. "Liability for damage to property other than that specific incorrectly performed part is beyond the reach of j(7)." In this case, Tibke and Jerry's Excavating allegedly performed faulty work only by failing to test the soil. The Browns made no allegation concerning defective construction of the foundation, walls, or other parts of the house that allegedly suffered property damage. The house was not that part of the property on which Jerry's Excavating's failure to test the soil was improperly performed. Therefore, j(7) does not exclude coverage for the alleged property damage to the house.

The court went on to distinguish these facts from situations in which the damage to an entire house is excluded, such as when contractors incorporate damaged or defective building materials into an entire construction project. The court reasoned that the exclusion applies in the latter situation because the incorrectly performed work is on an entire structure, which was not the case with the failure to test the soil.

Lastly, Owners asserted that exclusion l also applied to preclude coverage. This exclusion applies to "property damage to your work arising out of it or any part of it and included within the products-completed operations hazard." This includes property damage that occurs away from premises the insured owns or rents arising out of the insured's product or its work. But it applies only to work that's been completed. Work is deemed completed at the earliest of the following:

(a) When all the work called for in your contract has been completed.

(b) When all the work to be done at the job site has been completed if your contract calls for work at more than one job site.

(c) When the part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

Tibke argued that the exclusion didn't apply because it only bars coverage for property damage that occurs after the insured's work is complete. The subcontractor's failure to test the soil occurred at the start of the project and, therefore, the foundation and the rest of the house were exposed to the expansive soil throughout the duration of the project. This exposure caused the damage. It may have been imperceptible in the beginning, nonetheless the damage was ongoing throughout the construction of the house.

The court agreed with the insured and said:

> Although the property damage to Tibke's work arose out of Jerry's Excavating's work (failure to test the soil), exclusion l applies only if the damage is included in the products-completed operations hazard (PCOH). Here, the property damage does not meet the definition of the PCOH because the construction of the house had not yet been completed or abandoned. In other words, exclusion l does not apply to property damage which first began before the insured's work was completed. It is undisputed that the alleged failure to test the soil occurred at the beginning of the construction project. Tibke asserts the house suffered damage throughout construction from

ongoing soil expansion and contraction before the work was finished. Owners bears the burden of proving the exclusion applies but has not produced evidence that the damage occurred after completion of construction. Accordingly, the alleged damage to the house is not included in the PCOH, and exclusion l therefore does not exclude coverage.

CONCLUSION: The majority of states that have considered the issue of whether inadvertent faulty workmanship is an accidental occurrence under a CGL have held that it can be a covered occurrence.

Aside from this, however, generalizations are difficult to make. The outcome depends on the policy language and the court's interpretation of that language based on the facts of each case. For example, some policies have an exception to exclusion l that applies when the damaged work or the work out of which the damage arose was performed on the insured's behalf by a subcontractor. While the policy in this case did not include this exception, the court held that it didn't matter because the work out of which the damage arose was not completed. The point is that the specific language in the applicable policy, along with the interpretation of that language by the courts in the jurisdiction, must be carefully considered in each case.