Why Commercial General Liability Insurance Covers General Contractors Against Construction Defect Claims

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After nearly three decades of litigation and scores of decisions from nearly every jurisdiction, courts still do not agree on whether a commercial general liability (CGL) policy protects a general contractor against claims for property damage occurring after the construction project is complete when the damage is caused by the defective work of a subcontractor. One of the key reasons that courts are split on this issue is that the insurance industry has been litigating vehemently with its general contractor policyholders for years to limit or exclude coverage for defective construction claims under the very policies insurers sell to general contractors purportedly to cover this risk.

The plain language of the standard-form CGL policy that insurers sell to general contractors facially provides coverage for the majority of defective construction claims faced by a general contractor. This is to be expected. It should be no surprise that general contractors rely on their liability insurance programs for protection against construction defect claims. After all, a general contractor that buys liability insurance would reasonably expect the policy to cover third-party property damage claims resulting from defective construction. Perhaps recognizing that the plain language of the standard-form CGL policy does, in fact, cover defective construction liability claims, insurers routinely rely on a number of arguments not found in the policy language itself. And, frequently, courts agree with such faulty arguments and deny coverage for defective construction claims.

Subject to a number of conditions and exclusions, the CGL policy provides coverage for liability resulting from "property damage" caused by an "occurrence." A standard-form CGL policy defines "property damage" to "include physical injury to tangible property" and an "occurrence" to include an "accident" as well as "continued or repeated exposure to the same or similar conditions." (See, standard form CGL policy at Definitions 13 and 17). Thus, if a home or structure is damaged after work is complete due to defective construction -- for example, if a crack develops in a home that allows the intrusion of water, which causes additional damage -- there should be coverage.

The principal risk faced by a general contractor is a claim alleging that defective construction caused property damage that occurred after the project was completed. The CGL policy contains a number of exclusions on which insurers routinely rely to deny coverage for such claims, but a careful read of these exclusions shows that they do not bar coverage.

First, the CGL policy contains exclusions that bar coverage for liability arising directly from faulty workmanship when the damage occurs before the construction project is completed. These exclusions should not be particularly troubling to a general contractor, as general contractors rarely face the types of claims these exclusions address.

Next, Exclusion 2.j.5 of the standard form CGL policy excludes coverage for liability resulting from damage to the portion of a construction project on which a general contractor (or a subcontractor working for the contractor) is "performing operations" if the damage arises while the "operations are being performed." This should be expected by a general contractor, as damage to the project itself before work is complete typically is covered by a builders' risk policy and, therefore, few liability claims arise from this type of damage.

Next, Exclusion 2.j.6 excludes coverage for liability resulting from damage to "that particular part" of the construction project that must be restored, repaired or replaced due to work performed on it by or on behalf of the insured. Exclusion 2.j.6 contains an exception that specifically states that it does not bar coverage for liability resulting from damage that occurs *after the project is completed*. Again, damage to the project itself before completion typically is insured by a builders' risk policy, thereby reducing the risk of a third-party claim.

The standard form CGL policy also bars coverage for liability arising out of the defective work *of the general contractor itself* when the damage occurs after the project is complete. (*See*, Exclusion l). Thus, Exclusion 2.j.6 and Exclusion l operate in tandem to exclude coverage for claims resulting directly from the general contractor's defective work, regardless of when the property damage occurs. Since general contractors rarely perform construction work on a project, however, these exclusions rarely apply to claims against general contractors.

Exclusion l contains a very important exception that restores coverage for damage arising out of the work of subcontractors. It explicitly provides that it does not exclude coverage for liability arising from work performed *for the general contractor by a subcontractor* when the property damage occurs after the project is complete. Thus, the CGL policy covers the very risk about which general contractors are most concerned: the risk that they will face liability due to the defective work of one of their subcontractors for property damage that occurs after the project is completed.

While some insurers also rely on Exclusion k, which bars coverage for damage to "your product" (*see*, standard form CGL policy at Exclusion k and Definition 21), this exclusion does not bar coverage for defective construction claims because the CGL policy specifically states that "your product" does not include real property. (*See, id.*). Most courts that have addressed the issue have found that "real property" in this context includes a house or structure. *See, e.g., American States Insurance Co. v. Powers*, 262 F.Supp.2d 1245 (D. Kan. 2003) [house is "real property" for purposes of CGL policy definition]. In other words, a house or structure is not the "product" of a general contractor and, therefore, is outside the scope of this exclusion.

Therefore, the plain language of the CGL policy provides coverage for a defective construction claim against an insured general contractor when: **1)** the defective work is performed for the general contractor by a subcontractor; and **2)** the damage occurs after the project is complete.

Nevertheless, insurers often deny coverage for defective construction claims brought against general contractors based on arguments not rooted in the language of the CGL policy. For example, some insurers invoke the oft-repeated mantra that a "CGL policy is not intended to be a performance bond" even though this language is not found anywhere in the CGL policy. *See, e.g., L-J, Inc. v. Bituminous Fire and Marine Insurance Co.*, 621 S.E.2d 33 (S.C. 2005) [holding that a claim for defective construction did not involve "property damage" caused by an "occurrence" because to hold otherwise would render the CGL policy "more like a performance bond, which guarantees the work, rather than like an insurance policy, which is intended to insure against accidents"].

Similarly, many insurers also rely on the argument that the risk of defective construction is within the control of the insured and therefore should not be covered, as it is a "business risk." *See, American States Insurance Co. v. Mathis*, 974 S.W.2d 647 (Mo.App. 1998) ["The CGL policy does not serve as a performance bond, nor does it serve as a warranty of good or

services. It does not ordinarily contemplate coverage for losses which are a normal, frequent, or predictable party of the business operations."] The CGL policy does not include any language regarding "performance bonds" and "business risks." These judicially-created arguments are at odds with the language of the CGL policy and should not defeat coverage for a defective construction claim against a general contractor.

General contractor policyholders are fighting back and winning.

In one of the more recent decisions to address whether a general contractor is entitled to coverage for liability resulting from damage to the completed project when the defective work was performed by a subcontractor, the Florida Supreme Court held in *United States Fire Insurance Co. v. J.S.U.B., Inc.*, 979 So.2d 871 (Fla. 2007) that lawsuits arising out of damage to homes due to the subcontractors' use of poor soil and improper soil testing was covered under a CGL policy based on the plain language of the CGL policy. The court rejected "performance bond" and "business risk" arguments and instead applied the language of the CGL policy as drafted.

Similarly, the Texas Supreme Court ruled that the CGL policy may protect a general contractor against liability for damage to a home itself after the home has been built. *See, Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 242 S.W.3d 1 (Texas 2007). The *Lamar Homes* court correctly ruled that a deliberate act, such as construction, performed negligently can be an "occurrence" (an accident) if the effect of the act is not the intended or expected result. In other words, when a contractor does not expect construction activities to result in property damage to the home, the resulting defects can be an occurrence. The *Lamar Homes* court also ruled correctly that there is no reason why damage to a structure itself is not "property damage" (physical injury to tangible property) when a structure and its component parts were "tangible property" and that no exclusion barred coverage.

The battle still rages on as to whether a general contractor should be entitled to coverage for liability resulting from damage to the completed project caused by the defective work of a subcontractor. A close reading of the standard form CGL policy reveals that the policy should provide such coverage. Until courts agree on this issue, however, general contractors should be aware of the insurance law in their jurisdiction regarding how CGL policies are interpreted in the construction context to make sure that they truly are protected from the main risk they face on construction projects.

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