SURVEY OF RECENT CASE LAW ON BUSINESS RISK EXCLUSIONS

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Introduction

Many people, especially those who do not work with insurance policies everyday (e.g. many judges, policyholders and lawyers), have two misconceptions about general liability policies. First, they incorrectly believe that the insuring agreement of a general liability policy is all encompassing in its scope. Second, they incorrectly believe that if a risk is mentioned in an exclusion that means it was covered by the insuring agreement in the first place.

Neither premise is correct. First, the insuring agreements of most general liability policies are similar and by the very terms are not all encompassing. The insuring agreements typically require that an insured (not just anyone) be legally obligated to pay (not just feel like paying money to maintain good will with other parties) sums as damages (not injunctive relief) because of property damage (not just something that was not done right in the first place) or bodily injury (not just I would like to have medical monitoring because I might develop an illness someday) during the policy period (not just speculation or assumption that there might have been property damage or bodily injury during the policy period) because of an occurrence which is defined as an accident (not faulty workmanship). A wide range of claims is not included within that insuring agreement, including in the judgment of the majority of jurisdictions claims to repair, replace or redo the work a contractor put into the stream of commerce. If the insured was a framing contractor, claims to repair, replace or redo the framing work, which is what that insured put into the stream of commerce, would not fall within the insuring agreement. Likewise, if the insured was a general contractor, claims to repair, replace or redo the building the general contractor put into the stream of commerce would not fall within the insuring agreement.

The second premise is equally incorrect, but widely held. One of the best examples of the error in the premise is the expected or intended exclusion. Those claims are not covered by the insuring agreement in the first place, but many courts failed to enforce the insuring agreement as written. So, the exclusion seeks to make clear the intent of the scope of the insuring agreement. As another example, consider the auto exclusion. Most would assume that the insuring agreement applies to every claim involving an auto or the exclusion would not be in the policy. However, consider a claim asserting that the insured terrorized a claimant by threatening to run over the claimant with his car while revving the engine. Assuming that the policy did not define bodily injury to include mental anguish, that claim would not come within the insuring agreement for a variety of reasons, including that there was no bodily injury within the meaning of the policy and because there was no "occurrence"—no accident—he intended to terrorize the claimant. More than likely, the claim handler, the lawyer addressing the coverage issue and the judge would immediately go to the auto exclusion to deny coverage. However, the claim was not covered in the first place.

These misconceptions about the general liability policy, in combination with general laziness in policy analysis, led to many of the old coverage cases that address construction defect claims skipping over the insuring agreement analysis and referencing the so-called business risk exclusions. Only more recently have courts been encouraged to examine the insuring agreement when addressing these claims, many finding that the claims do not fall within the insuring agreement of the policies. The fact that the earlier courts skipped the first step does not weaken the significance of those decisions finding that general liability policies are not designed to address claims to repair, replace or redo what the insured put into the stream of commerce.

Claims people and insurer counsel will be well-served to free themselves of these misconceptions and to strive to explain the errors in the misconceptions to others. Analysis of every claim should start with whether the claim comes within the insuring agreement. The existence of an applicable exclusion does not excuse the failure to consider whether the claim is covered at all.

The exclusions have their place, however. First, there are some jurisdictions that have concluded that general liability policies are performance bonds, so resort to exclusions is required. Secondly, there are instances where a claim will fall within the insuring agreement and all or parts of it are barred by one or more of the exclusions. So, this paper will survey some of the most recent caselaw addressing the so-called business risk exclusions.

Your Work Exclusion

On August 9, 2004, the South Carolina Supreme Court joined the majority of jurisdictions holding that claims to repair, replace or redo what the insured put into the stream of commerce is not covered by a general liability policy because it does not constitute an occurrence within the meaning of the general liability policy. *L-J, Inc. v. Bituminous Fire and Marine Insurance* Company, South Carolina Supreme Court, No.

25854, August 9, 2004. Reversing the South Carolina Court of Appeals decision, the Supreme Court held:

> We disagree with the court of appeals that the contractual definition of "occurrence"—"an accident, including continuous or repeated exposure to substantially the same general harmful conditions"—includes the road damage caused by continuous exposure to surface water runoff. *Bituminous*, 350 S.C. at 555, 567 S.E.2d at 492. In our view, the sole cause of the deterioration was the Contractor's faulty workmanship in designing and constructing the road system. That the roads were subject to surface water damage was not an "accident" as the court of appeals held. Rather, the damage was caused by the Contractor's negligently designed drainage system to handle the water runoff and failure to properly compact the road's subgrade.

Id. at p.6.

The South Carolina Court of Appeals had been swayed particularly by the involvement of subcontractors in the faulty work: "It is undisputed in this case that the defective work was performed by a subcontractor. This clear and unambiguous policy language [the exception to the your work exclusion] restores coverage." *L-J, Inc. v. Bituminous Fire and Marine Ins. Co.*, 350 S.C. 549, 558, 567 S.E.2d 489, 494 (2002) revd. by *L-J, Inc. v. Bituminous Fire and Marine Insurance* Company, South Carolina Supreme Court, No. 25854, August 9, 2004. The Court of Appeals cited to *Kalchthaler v. Keller Constr. Co.,* 224 Wis.2d 387, 591 N.W.2d 169 (Wis.Ct.App.1999) and *O'Shaugnessy v. Smuckler Corp.*, 543 N.W.2d 99 (Minn.Ct.App.1996).

The South Carolina Supreme Court made short order of this conclusion by the Court of Appeals and its reliance on the analysis in the Wisconsin and Minnesota decisions. The South Carolina Supreme Court went out of its way to address the "your work" exclusion:

> Since there was no "occurrence," the Contractor has no insurable interest in the road damage, and there is no need to address whether the damage falls under the "your work" exclusion. Nevertheless, we write further to reverse the court of appeals' determination that an exception to an exclusion "restores" coverage. *Bituminous*, 350 S.C. at 558, 567 S.E.2d at 494.

L-J, Inc. v. Bituminous Fire and Marine Insurance Company, South Carolina Supreme Court, No. 25854, August 9, 2004 at p. 7.

The Supreme Court observed that the exclusion does not apply because subcontractors were involved. However, the court specifically rejected the conclusion that the exception could "restore" coverage—it was not there in the first place. Several

other courts also have reached this conclusion. *ACS Construction Co., Inc. of Mississippi v. CGU,* 332 F.3d 885 (5th Cir. 2003); *Auto Owners Ins. Co. v. Travelers Cas. and Sur. Co.,* 227 F. Supp. 2d 1248 (M.D. Fla. 2002); *Homeowners Warranty Corp. v. Hanover Ins. Co.,* 683 So.2d 527 (Fla. 3d Dist. Ct. App. 1996); *Lassiter Constr. Co. v. Am. States Ins. Co.,* 699 So.2d 768 (Fla. 4th Dist. Ct. App. 1997); *R.N. Thompson & Associates, Inc. v. Monroe Guaranty Insurance Co.,* 686 N.E.2d 160 (Ind. Ct. App. 1997); *Hawkeye-Security Ins. Co. v. Davis*, 6 S.W.3d 419 (Mo.App.1999).

In fact, just this year, the Court of Appeals of Ohio reached the same holding applying West Virginia law to interpret the contract. *Nationwide Insurance Company v. Phelps*, Court of Appeals of Ohio, Seventh District, Columbiana County, No. 03 CO 23 March 8, 2004. Homeowners sued the insured general contractor when the house was alleged to have been defective. The insured contractor used subcontractors to do the work. The homeowners took a judgment against the contractors and pursued the contractor's carrier. The homeowners argued that the judgment was covered under the policy since the damage arose via "accidents" by the subcontractors, citing the subcontractor exception to the "your work" exclusion. The court stated:

> [Homeowners] are likely correct in their assertion that their damages occurred as a result of the work performed by [] subcontractors. However [homeowners] fail to recognize that the Policy must first provide underlying coverage. Only after the Policy provides apparent coverage will Nationwide seek to apply the exclusion set forth in B.1.m.[your work exclusion]. At that point, [homeowners] would be able to argue that the exception to exclusion B.1.m applies. If there is no coverage given under the Policy in the first place, an exception to an exclusion will never operate to provide coverage. Further, an exception to an exclusion from coverage does not extend coverage where the contract of insurance contained other applicable exclusions and where the insurance contract was a liability policy and not a builder's risk policy.

Id. at 5.

Your Product and Your Work Exclusions

The "your product" exclusion was addressed in *Patrick Archer Construction, Inc., et al. v. Mutual of Enumclaw Insurance Co.*, No. 52943-9-I, Wash, App., Div. I, August 16, 2004; Mealeys Litigation Report: Construction Defects Insurance, Vol. 1, Iss. 7 (8/04) at p. A-1. Patrick Archer Construction ("Archer") was the general contractor for the construction of a condominium project. Following construction, defects were apparent. Problems with the siding resulted in damage to the building itself and personal property within the building. When the condominium association sued, Archer tendered the claim to its carrier, which defended under a reservation and brought a declaratory judgment action. The parties did not contest the insuring agreement. Instead, they focused on the "your product" exclusion which stated: "this insurance does not apply: (n)

to property damage to the named insured's products arising out of such products or any part of such products." Id. "Named insured's product" was defined as "goods or products manufactured, sold, handled or distributed by the named insured or by others trading under his named (sic)." Note that this definition differs from the one found in many ISO forms, which says in pertinent part: "a. Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by: (1) You."

The Washington court observed that:

> Washington case law interprets such product exclusions to encompass entire buildings as defective products. This view is consistent with Washington courts' reluctance to interpret such general liability policies as a form of performance bond, product liability insurance or malpractice insurance. A building constructed by a builder is its product, for purposes of a products exclusion. (A) products exclusion applies to damages to an insured's product regardless of whether the insured's business also involves the provision of services.

Id. (citations omitted)

Among other arguments, Archer argued that the work was done by subcontractors, so was not the "product" of the general contractor. The court rejected this argument, noting that to so hold would not reflect the realities of the commercial construction process. Archer entered into the contract with the developer and was responsible for construction of the entire building. The fact that it chose to hire subcontractors to perform part of its obligation did not change the fact that what the general contractor put into the stream of commerce was the entire building and the exclusion barred coverage.

Please note that the court's conclusion was that the exclusion barred coverage for the entire claim. The only mention of the scope of the damages was at the beginning of the opinion when the court explained that there was damage to the building and to the personal property within the building. There is no mention of the scope of the claim by the COA. To the extent the damages included the personal property within the building (which would be the basis for finding an occurrence), the exclusion was applied very broadly.

Contrast the Washington Court of Appeals discussion with the United States District Court for the Northwestern Division of North Dakota's discussion in *Scottsdale Insurance Company v. Tri-State Insurance Company of Minnesota*, 302 F.Supp.2d 1100 (D. ND 2004). In that case, the court also was asked to consider the application of the "your product" exclusion. However, this time the definition of "your product" included the exception for "real property." The insured, Commercial Group West (CGW), manufactured and erected modular buildings. Each modular unit was custom designed and complete from floor to ceiling. When completed, the top of the modular units are covered by reinforced plastic and transported to a construction site for assembly on a

foundation provided by CGW. Once the modular units were assembled, the plastic covers were removed and a roof was built over the resulting structure.

CGW contracted with Lake Metigoshe Properties to construct modular units and transport them to a site to be assembled to form a motel. CGW subcontracted with another contractor to set the individual modules on a foundation and to install the roof. As work on the roof began, the plastic covering was removed from part of the modules. A severe rainstorm doused the site and caused the plastic covering on the remaining unroofed modular units to rupture. Those units sustained substantial damage.

While the court addressed a number of issues, the focus here is on the "your product" exclusion. Scottsdale Insurance Company, insurer for CGW, argued that the "your product" exclusion barred coverage. CGW countered with two arguments. First, CGW argued that the modules were no longer owned by CGW at the time of the loss, rather they were owned by Lake Metigoshe Properties. The court was unpersuaded that ownership was of any significance. The issue was whether the modules had ever been the product of the insured and they were.

CGW was more successful in its second argument, however. CGW argued that the modular units had been affixed to real property at the time of the loss and constituted real property, which is an exception to the exclusionary clause. The court found that North Dakota law expressly provides that real property consists of land; that which is affixed to land; that which is incidental or appurtenant to land; and that which is immovable by law. At the time of the loss, the record established that the modular units were attached or affixed to the foundation prior to the time that the units sustained water damage. The annexation was made in an inherently permanent manner that would establish the modular units as part of the real estate.

Hence, the Washington court concluded that the modular units were "real property," so no longer fell within the definition of "your product." The "your product" exclusion did not bar coverage for the damages to the modular units.

On June 30, 2004, the United States District Court for the Southern District of Indiana provided another example of a court that leaped to the exclusions to bar coverage when an examination of the insuring agreement would have led to the conclusion that the claim was not covered. *Transcontinental Insurance Co. v. RTW Industries, Inc., et al.*, No. 1:02-cv-01733 [LJM-WTL], S.D. Ind. June 30, 2004; discussed in Mealeys Litigation Report: Construction Defects Insurance, Vol. 1, Iss. 7 (8/04) at p. 9.

RTW entered into an agreement for RTW to provide all material and labor, fabricate, blast clean, and shop paint work platforms for performing maintenance on aircraft in accordance with the specifications and drawings. After construction was completed, there was a partial collapse of the platform and investigation revealed faulty welds and other problems throughout the platform that had to be corrected. The owner of the facility sued the general contractor and recovered damages for consulting fees, repairs and disruption. The general contractor then sued RTW. RTW's carrier denied coverage

and filed a declaratory judgment action, arguing in part that the your work and your product exclusions applied to bar coverage.

The parties disputed the scope of RTW's work and product. RTW contended that the welds were the work and product, whereas the carrier contended that the entire platform was the work and product of RTW. The court agreed with the carrier.

> The parties seem to dispute the scope of RTW's "work product" with respect to the damages at issue in *AGSE v. United Airlines.* But, AGSE admitted that RTW contracted to provide "all material and labor, to fabricate, blast clean and shop paint the work platforms in accordance with the specifications and drawings provided by AGSE...." [citation omitted] Moreover, AGSE admitted that "[t]he consulting fees and disruption damages claimed by United Airlines against AGSE resulted from the partial collapse, inspection, and repairs to the platforms." [citation omitted] The scope of RTW's work then, was the platforms themselves, not just the welds as AGSE argues.
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> Based on this finding, from the language of the CGL policy between Transcontinental and RTW, the damages are not covered because the only damage alleged was to the platforms themselves, or in other words, the only damage alleged is damage to RTW's "work" or RTW's "product." The CGL defines "Your product" as "[a]ny goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by: (1) You...." Policy Sec. V, ¶ 18a.. Moreover, the CGL defines "Your work" as "a. Work ... performed by you ... and b. Materials, parts or equipment furnished in connection with such work...." *Id.* Sec. V, ¶ 19. Therefore, at least two of the CGL policy exclusions apply.

Id. at 6.

The court chose to decide the case solely on those exclusions and did not address the insuring agreement arguments, although its conclusion that the damage was solely to what RTW put into the stream of commerce would have put the policy outside the insuring agreement.

On August 9, 2004, the United States District Court for the District of Columbia addressed the scope of the "your work" and "your product" exclusions. *Young Women's Christian Association of the National Capital Area Inc. v. Allstate Insurance Co. et al.*, No. 94-0741 [RMU], D. D.C.; Mealeys Litigation Report: Insurance, Vol. 18, Iss. 40 (8/31/04) at p. D-1. The YWCA hired a general contractor to build a new building. The general contractor subcontracted with Beer Precast Concrete Limited, a Canadian concrete products company to provide all labor, material, equipment and services necessary to furnish and install the precast panels for the building's exterior. Beer cast

the panels, acid-etched them to achieve a reddish coloration and finish, shipped them to the site and installed them. The architect asserted they were not uniform in color or texture, so Beer arranged to have the panels washed with acid cleaning agents and scrub brushes to achieve a uniform color and texture.

Nine years later, the YWCA detected deterioration in the panels including cracks, staining and blemishes and the YWCA sued the general contractor and Beers. At trial, the experts opined that Beer's failure to manufacture the panels with adequate concrete cover over the imbedded steel and failure to use galvanized reinforcing mesh contributed to the panel deterioration as did the introduction of excessive chloride ions during the acid cleaning process, which caused the steel imbedded in the panels to corrode and crack. The jury awarded $4.5 million to the YWCA, which then sued the insurers for the then defunct Beer. Only $649,195 went to the material cost of the replacement panels. The remainder was for costs of inspections, repairs and removal and replacement of the defective panels.

At the summary judgment stage, three carriers remained in the case, with varying "your product" and "your work" exclusions, some more broadly worded than the standard ISO exclusions but others very similar to ISO. The YWCA conceded that the exclusions barred coverage for the material cost of the replacement panels, but sought recovery of the other costs. In a lengthy decision, the court considered each of the exclusions, finding that none of the policies covered any of the damages. The court held that none of the costs at issue were caused by the panel deterioration itself. Rather, the costs were incurred in repairing and replacing the defective panels. The court included the so-called rip and tear expenses in the scope of the exclusion.

Performing Operations Exclusions

In August of this year, the Supreme Court of North Dakota addressed the "performing operations" exclusions in the policies, commonly found at J5 and J6 in the ISO policies. *Grinnell Mutual Reinsurance Company v. Lynne*, Supreme Court of North Dakota, No. 20030217, August 31, 2004. Those exclusions provide:

> This insurance does not apply to: . . . [t]hat particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the `property damage' arises out of those operation, and
>
> This insurance does not apply to . . . that particular part of any property that must be restored, repaired or replaced because `your work' was incorrectly performed on it.

Lynne, the insured, was hired to construct a new foundation for a farm house built on Larson's property. The process involved lifting the house from its foundation and supporting it with iron timbers while a new foundation was constructed under the house. In the process of building the new foundation, a subcontractor hired by Lynne to install

the concrete blocks on the foundation discovered that the house needed to be raised a few additional inches. Lynne began to raise the house the additional distance and the timbers rolled causing the house to fall into the basement causing damage to the house and to the work on the foundation done by the subcontractor.

Lynne was sued by the subcontractor for failing to pay him for the foundation work and by Larson for the expenses allegedly incurred in connection with the removal and replacement of the house. Lynne's insurer raised the J5 and 6 exclusions in response to the tender of the lawsuits. The Supreme Court held that Lynne was performing operations on real property owned by Larson and damage to the property arose out of those operations. Lynne advanced a number of arguments including claims of ambiguity in the exclusions, all of which were rejected by the court.

The court considered separately whether the exclusions barred coverage for the subcontractor's claims of damage to his work. The court held that J5, even if narrowly construed, precluded coverage for the subcontractor's claim, concluding that the purpose of the business risk exclusion in a contractor's general liability policy is to preclude coverage for claims arising out of contract, rather than tort. The subcontractor's claim was part of the contractual obligation of Lynne to the subcontractor, rather than a tort claim.

In April 2004, the Colorado Court of Appeals also considered the "performing operations" exclusions, which were found at exclusion 11(e) and (f) in the policy at issue. *McGowan v. State Farm Fire and Casualty Company*, Colorado Court of Appeals, Div. III, No. 03CA0025 April 22, 2004. The McGowans contracted with Eagle Summit Construction Co., Inc., to build a house for them. Eagle Summit had completed the excavation, foundation and framing of the house and had constructed three levels encompassing 3,200 square feet when several structural defects were discovered. The McGowans terminated the contract and hired another contractor to make the necessary repairs and complete construction. The McGowans sued, obtained a default judgment against Eagle Summit and pursued State Farm's policy through garnishment.

The court concluded that because the McGowans sought to recover the expenditures they were required to make to repair the damage caused by Eagle Summit's faulty and incomplete work, the claims fell squarely within the "performing operations" exclusions. The court also rejected the argument that the exception to the exclusion applied. The exclusions provide that they do not apply to a completed operation. The McGowans argued that the house was completed at the time the judgment was entered against Eagle Summit. However, the court emphasized that the exception bars application of the exclusion only if the work at issue was completed when the damage occurred. The Court also rejected the argument that the exception would apply to bar application of the exclusion for those portions of the work completed by Eagle Summit, holding that Eagle Summit had not completed "all" of its work as required by the contract.

Loss of Use Exclusion

While many call this exclusion the "impaired property" exclusion, that label is not completely accurate as the exclusion applies both to "impaired property" and property that has not been physically injured. It is more accurate to call it the "loss of use" exclusion as the United States Court of Appeals for the Eighth Circuit did in January of this year in *Modern Equipment Company v. Continental Western Insurance Company, Inc.*, 355 F.3d 1125 (8th Cir. 2004). The insured, Modern Equipment, designed a meat storage rack system that Nebraska Beef purchased for use in its refrigerated warehouse. Three months after installation, two rack sections collapsed, followed a few months later by collapses of other rack sections. Neither collapse caused damage to the warehouse, but Nebraska Beef was forced to dismantle, remove and replace the collapsed rack sections and lost some meat to spoilage. Eventually, Nebraska Beef replaced the entire system with a new one that had a lower total storage capacity than the Modern Equipment system.

Nebraska Beef sued Modern Equipment claiming damages for production and shipping costs and loss of sales due to the collapsed racks. Modern Equipment tendered the suit to its carrier, which provided a defense under a reservation of rights. The carrier agreed to pay for the damage to any of Nebraska Beef's product, but disputed any obligation for the remaining damages. The court stated that the effect of the "loss of use" exclusion was to exclude damages for the loss of use of property—other than the insured's product—that is less useful because of a defect in the insured's product, except when the loss of use is caused by a sudden and accidental physical injury to the insured's product or the insured's work after it has been put to its intended use. The court summed up the effect of the exclusion in the case by saying that any damages flowing from the loss of use of Modern's storage rack system were not covered, but any loss of use of Nebraska Beef's warehouse, attributable to the collapse of the rack system was covered.

Nebraska Beef and Modern Equipment argued long and hard that the damages flowed from the loss of use of the warehouse. The court rejected that contention, however, recognizing that the loss of use was as to the shelving system, not the warehouse itself. Nebraska Beef continued use of the warehouse throughout the ordeal. The court also rejected the argument that a marginally less useful warehouse was "inoperable." The court emphasized that the majority of damages flowed not from the loss of use of the warehouse when the shelves were being dismantled and remove, but rather from the diminished shelving capacity of the freezer.

Conclusion

Proper analysis of a claim under an insurance policy should always begin with the question of whether the claim comes within the insuring agreement. Only then should the inquiry move to application of the exclusions. As these recent cases show, a wide range of caselaw exists to explain the scope and application of the exclusions.