Contractual Liability Exclusion—The Ball Is in Your Court

June 2012

As a non-attorney insurance practitioner who has been closely studying the commercial general liability (CGL) policy for some time now—including its history and evolution to its current form—I occasionally come across a coverage decision that seems so anomalous that it commands my attention. The recent decision by the Fifth Circuit Court of Appeals in *Ewing Constr. Co., Inc. v. Amerisure Ins. Co.*, 2012 U.S. App. LEXIS 12154 (5th Cir. Tex. June 15, 2012), is one of those cases.

by Craig F. Stanovich
Austin & Stanovich Risk Managers, LLC

Applying Texas law, the Fifth Circuit expanded a previous holding by the Texas Supreme Court in *Gilbert Tex. Constr. LP v. Underwriters at Lloyd's of London*, 327 S.W.3d 118 (Tex. 2010), as to the scope and meaning of the contractual liability exclusion in the CGL policy.

A Few Facts

Ewing contracted with a school district to build tennis courts. Shortly after the courts were finished, they were cracking and flaking and unfit for playing tennis. Because the Texas Supreme Court had decided earlier in *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d.1 (Tex. 2007), that faulty work *could* be an occurrence and cause property damage (but coverage may be eliminated by subsequent exclusions), the usual arguments of "no occurrence" and "no property damage" were apparently not advanced by the insurer. In fact, there was agreement that the physical defects in the tennis courts constituted property damage caused by an occurrence.

Nonetheless, the insurer denied coverage in what can only be described as a novel argument in the construction defect wars. The insurer contended that the CGL's *contractual liability exclusion* eliminated coverage for defective construction, so there was no duty to defend Ewing for the suit brought by the school district for damages alleging defective construction to the tennis courts. Specifically, the Fifth Circuit ruled:

> Deficient performance that constitutes a mere breach of contract is not covered by the GL policy because liability for deficient performance is contractual liability excluded under the contractual liability exclusion.

The Contractual Liability Exclusion—Texas Style

In the *Gilbert* case, the Texas Supreme Court found that the contractual liability exclusion applied to what all observers seem to agree was a rather unique set of circumstances. Gilbert was contracted to work with the Dallas Area Rapid Transit (DART) agency to construct a rail system. Gilbert agreed in its contract with DART to protect from damage and repair damage to third-party properties that resulted from the construction.

Heavy rains during the construction caused flooding in a building near the work site, and the building owner sued Gilbert. Here is the unique part—*Gilbert was protected by DART's tort immunity*, so Gilbert could not be held liable under tort law for the damage to the third party's flooded property.

The only obligation that the building owner was able to enforce (as a third-party beneficiary) was the contract to repair the damage to the building caused by the construction. Gilbert's excess insurer, Lloyd's of London (referred to as Underwriters) denied coverage to Gilbert, asserting that the contractual liability exclusion eliminated coverage. In short, as Gilbert was not liable under "general law," Gilbert had "assumed the liability" to protect and repair the third party's property, and thus this "assumed liability" was excluded.

Liability Assumed by Contract

After a lengthy review of the holdings of other jurisdictions on the interpretation and construction of the CGL policy's contractual liability exclusion, the *Gilbert* court focused on the portion of the contractual liability exclusion as respects Gilbert's obligation to pay damages "by reason of the assumption of liability in a contract or agreement."

The *Gilbert* court concluded that the "plain meaning" of the phrase "assumption of liability" should be determined by using dictionary definitions, that "assume" means to "undertake" (*Webster's Third New International Dictionary* 133, 2002), and that "liability" is "the state or quality of being legally obligated or accountable" (*Black's Law Dictionary* 997, 9th ed. 2009).

Thus, the Texas Supreme Court agreed with Lloyd's, the excess insurer, and ruled that Gilbert had undertaken legal accountability for property damage to the third party's property. The result was that Gilbert's undertaking constituted an "assumption of liability" that "extended beyond Gilbert's obligations under general law and incorporates contractual standards to which Gilbert obligated itself." Thus, the damages claimed by the third-party property owner were excluded by the contractual liability exclusion of Gilbert's liability policy.

One Step Beyond

The Fifth Circuit in *Ewing* took a leap, concluding that simply because Ewing had contracted to build a tennis court, Ewing had also "assumed liability for a construction defect." The result was that the insurer was able to apply the CGL policy's contractual liability exclusion to avoid coverage for the construction defect claim.

Unlike *Gilbert*, which did not involve damage to the policyholder's work, the Fifth Circuit concluded that the CGL policy should not apply to *construction defect* claims. The majority conceded as much in its holding:

> Applying this plain meaning approach preserves the longstanding principle that a CGL policy is not protection for the insured's poor performance of a contract. Although other jurisdictions adopt this principle by holding that poor contractual performance is not, under a CGL policy, an occurrence causing property damage, Texas chooses to arrive at this holding through its interpretation of exclusions. Our holding today respects this choice.

The Contractual Liability Exclusion—A Policyholder's View

Consider a builder that contracts with an owner to build a new garage for the owner. The contract will spell out the scope of work, the costs, etc. But it is very hard to imagine that either the builder or the owner would describe the contract as one that *assumes liability*.

Of course, the builder is accountable to build the garage. If the garage that is built is defective and collapses, certainly the owner will seek a remedy. But the builder did not agree to build a defective garage and further did not agree to pay damages for that defective garage. All of that results from something the builder did not agree to—defective construction. Yet, this is how the majority in the Fifth Circuit characterizes all construction contracts, as an assumption of liability.

The dissent in Ewing correctly points this out: "no one interpreted this case as the majority does here, to hold an 'assumption of liability' is *inherent in every agreement to perform a construction contract*." [Emphasis added]

Products and Completed Operations Coverage

It is well settled that the standard Insurance Services Office, Inc. (ISO), CGL policy includes coverage for "products and completed operations" subject, of course, to all policy exclusions, limitations, conditions, and definitions. Coverage provided within products and completed operations has to be considered in interpreting the CGL policy, particularly when deciding whether *contractual warranties* amount to an assumption of liability and are thus *excluded* by the CGL.[1]

The coverage is defined in policy form CG 00 01 12 07 under the "product-completed operations hazard" as including "all 'bodily injury' and 'property damage' occurring away from premises you own or rent and arising out of 'your product' or 'your work....'" "Your work" is also defined to mean "(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." This 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 failing to provide warning or instructions...." [Emphasis added.]

What is abundantly clear from even a cursory review of the *entire* CGL policy is that coverage is granted for bodily injury or property damage arising out of "your work" and that "your work" includes any warranties or representations made about the work—its quality, performance, or use. Stated differently, the CGL policy expressly provides coverage for bodily injury or property damage that may result from a breach of a warranty made with respect to work performed.

The Fifth Circuit's holding that the contractual liability exclusion is intended to eliminate all coverage for *contractual warranties* is contrary to the plain meaning of products and completed operations coverage and further renders the definition of "your work" meaningless.

The 1973 CGL and the 1986 CGL—Changes to Contractual Liability

The Fifth Circuit's opinion appears to be based in part on the assumption that ISO intended to change the scope of coverage for warranties for work performed because of changes to the wording in the contractual liability exclusion made with the 1986 ISO CGL (and later editions).

The contractual liability exclusion in the ISO comprehensive general liability insurance policy, 1973 edition, included this exception: "… but this exclusion does not apply to a warranty of fitness or quality of the named insured's products or a warranty that work performed by or on behalf of the named insured will be done in a workmanlike manner…." As this exception does not appear in today's CGL contractual liability exclusion, some have speculated that ISO intended to *remove* coverage for damages because of bodily injury or property damage if the bodily injury or property damage results from the policyholder's work, specifically if the liability is alleged to be a breach of warranty.

Such speculation is unsupported by *actual* policy wording found in the 1986 CGL edition (and later editions). It is quite clear that coverage is still included within today's CGL policy; the reference to warranties has simply been moved from the contractual liability exclusion to the definition of "your work," a term not defined in the 1973 CGL policy.[2]

The "Your Work" Exclusion and the Subcontractor's Exception—A Policyholder's View

Today's CGL policy excludes property damage to "your work" (which includes work done on behalf of the policyholder by a subcontractor) arising out of it (the work) or any part of it. For the exclusion to apply, the work must fall within the "product-completed operations hazard" when it suffers property damage. This exclusion is commonly understood, both within and outside of the insurance industry, to eliminate coverage when the policyholder's work is defective and damages itself.

With the earlier illustration, if the garage is completely built and then collapses due to defective construction, it is clear that the builder's CGL will not pay for the damages for which the builder may be liable as property damage. The nature of the allegations do not matter—negligence, breach of warranty, failure to complete the garage in a workmanlike manner—the property damage to the builder's finished work is excluded by the "your work" exclusion.

The Fifth Circuit recognizes that its interpretation of the contractual liability exclusion "overlaps" with the "your work" exclusion and suggests they would rather avoid the "confusion of overlapping exclusions," but nonetheless maintains that the contractual liability exclusion eliminates coverage for defective construction.

The Subcontractor's Exception

A very important exception to the "your work" exclusion establishes that the exclusion for property damage to the policyholder's finished work *does not apply* if the work out of which the damage arises (or the damaged work itself) is work performed on behalf of the policyholder by a subcontractor.

In our garage example, if the builder had used a subcontractor to prepare the site, and the cause of the garage collapse was the subcontractor's failure to adequately prepare the footings and foundation, the builder that contracted with the owner would have coverage for property damage claimed by the owner against the builder for the collapsed garage. Stated differently, the builder will have coverage for defective construction if the defect that *caused* the collapse was the faulty work of a subcontractor.

Origin of the Subcontractor's Exception

What may be easily overlooked and too often summarily dismissed is the critical importance of the "subcontractor exception" and the insurance industry's time-honored recognition of its role in the CGL policy. The "subcontractor exception" has been an integral part of the CGL policy for decades and has been coverage offered by the insurance industry and purchased by policyholders (for an additional premium) for almost 40 years.

In the 1973 ISO comprehensive general liability policy, a policyholder could readily purchase for an a*dditional premium* broad form property damage liability coverage (including completed operations), which limited the application of the exclusion to work performed by the named insured.

The exclusion to property damage to work performed within the 1973 CGL *without* the broad form property damage liability coverage was "(o) to property damage to work performed *by or on behalf of the named insured* arising out of the work or any portion thereof."

> The broad form property damage liability coverage endorsement made the following changes:
>
> (A) Exclusions (k) and (o) are replaced by the following:
>
> (3) with respect to the completed operations hazard … to property damage to work *performed by the named insured* arising out of such work….

Coverage for property damage caused by a subcontractor's faulty work (i.e., the subcontractor exception) was formerly provided by removing from exclusion (o) the phrase "*or on behalf* of the named insured" and limiting the exclusion for property damage to only the work performed directly by the named insured.

The 1986 (and Later) Editions of the CGL

In its publications announcing the changes to the CGL policy (the commercial general liability policy, 1986 edition), ISO unequivocally acknowledged that the broad form property damage liability coverage was included within the new CGL policy:

> Broad Form Endorsement … also covers damages caused by faulty workmanship … *and damage to or caused by a subcontractor's work after the insured's operations are completed*. Broad Form coverage has been incorporated in the new provisions … so that broad form coverage for work and completed operations *clearly applies*.[3] [Emphasis added.]

It is well understood by those in the insurance industry that today's CGL policy includes the broad form coverage, the additional charge now *included* in the policyholder's CGL premium. In fact, not only does the insurance industry understand the import of the subcontractor exception, but everyone also knows that an insurer may eliminate the subcontract exception found in today's CGL—provided the insurer and policyholder agree to this restriction in coverage.[4]

Avoiding the Subcontractor's Exception

Relying on the contractual exclusion instead of the "overlapping" exclusion for "your work" has the effect of avoiding entirely the subcontractor exception to the "your work" exclusion—protection the policyholder has purchased for years but will never receive if the contractual exclusion is applied in the manner decided by the Fifth Circuit. Failing to provide the policyholder the benefit of this bargain—by negating the effect of the subcontractor's exception—is the basis of the dissent by W. Eugene Davis, who was "troubled by this predicament":

In this case, the underlying petition alleges faulty workmanship by the subcontractors and the contractor, and the policy does not include an endorsement eliminating the subcontractor exception. Thus, the well known endorsement discussed in the above cases was available in this case to exclude coverage for defects caused by the subcontractor's work had the parties bargained it in the policy. They did not do so. We should respect that bargain.

Conclusion

Ewing Construction agreed to build tennis courts. In its contract with the school district, Ewing did not agree to assume liability for defective construction. The majority's position that every construction contract is an "assumption of liability" is not only contrary to an ordinary person's understanding of what is agreed upon in a construction contract; such an interpretation robs policyholders of the benefit of the bargain—the CGL insurance for which they have paid—the subcontractor's exception to the "your work" exclusion.

In other words, it is clear that the majority sought to eliminate coverage for construction defects but could not do so through the "occurrence as property damage" route. This typical argument was not available to Amerisure because of the holding in *Lamar Homes*. Left with only the "your work" exclusion and its subcontractor exception, the Fifth Circuit's majority instead chose another avenue to eliminate coverage—by imposing an expansive interpretation of what constitutes "assumption of liability" in a contract—and thus avoided the "your work" exclusion and the well-established subcontractor exception.

Amerisure could have chosen to eliminate the subcontractor exception but chose not to do so, and therefore Amerisure's bargain with Ewing Construction was to *include* the subcontractor exception. As correctly pointed out by the dissent, the majority has read the subcontractor exception out of existence, rendering a major portion of the CGL superfluous.[5] As the dissent suggests, the bargain made between the insurer and its policyholder must be respected.

---

[1] "The principles Texas courts use in interpreting an insurance policy are well established. We examine the entire agreement and seek to harmonize and give effect to all provisions so none will be meaningless." *Gilbert Tex. Constr. LP v. Underwriters at Lloyd's of London*, 327 S.W.3d 118 (Tex. 2010), quoting *MCI Telecomms. Corp. v. Texas Utils. Elec. Co.*, 995 S.W.2d 647 (Tex. 1999).

[2] "We explained that the 'label attached to the cause of action--whether it be tort, contract or warranty--does not determine the duty to defend' and that 'any preconceived notion that a *CGL policy is only for tort liability must yield to the policy's actual language*.'" *Gilbert Tex. Constr. LP v. Underwriters at Lloyd's of London*, 327 S.W.3d 118 (Tex. 2010). [Emphasis added.]

[3] **Important Notice to Policyholder**—ISO General Liability Policy Revision—Highlights of Current and Revised Contracts, pg. 6. Copyright, Insurance Services Office, Inc. 1984, 1985, 1986.

[4] CG 22 94 exclusion—"Damage to Your Work Performed by a Subcontractor on Your Behalf."

[5] "The majority acknowledges this issue but endorses the contractual liability exclusion as merely another way to resolve these type cases. This position would be acceptable if the application of the contractual liability exclusion and the 'your work' exclusion led to the same result. However, the 'your work' exclusion contains the 'subcontractor exception,' for which the contractual liability exclusion contains no equivalent. The majority thus reads this exception out of existence." W. Eugene Davis, circuit judge, dissenting.
