Faulty Work and the CGL

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We all make them (even if we don't admit to them). Mistakes, that is. It's just a matter of what, when and how. Lives can be defined by a mistake (without always having the benefit of errors or omissions insurance). Take Fred Merkle, for instance. Almost 100 years later, he is still remembered for one misjudgment, just one mistake that will be forever known as the Merkle Boner.

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With two out in the last of the ninth, and the scored tied against the Chicago Cubs, New York Giant's Fred Merkle stood on first base. His teammate, representing the winning run and the National League pennant, waited at third. The hitter promptly singled, driving in the winning run and clinching the pennant for the Giants! Or so Fred Merkle thought.

As the celebration began, he went from first base to the dugout, never touching second base. An alert Cub player fought through the crowd, retrieved the ball and jumped up and down on second, getting Merkle out by a force play and nullifying the run. The game was declared a tie and had to be replayed—and the Giants lost the replayed game and the pennant to the Cubs in 1908. At the ripe old age of 19, Fred Merkle had made a mistake—and cost his team a World Series berth.[1]

An Occurrence

What could the Merkle Boner possibly teach us about the commercial general liability (CGL) insurance policy? For starters, while it certainly was a lapse in judgment, Fred Merkle neither intended nor expected to be put out at second base (or lose the game and the pennant). It was an accident—the prime element of an "occurrence" as defined in the CGL policy. Are all mistakes—i.e., accidents—covered by the CGL?

Bodily Injury

An occurrence first must result in either property damage or bodily injury for the CGL to respond. While there reportedly was a great deal of mental anguish by many fans and players (including Fred Merkle), no one was physically harmed by the play. No bodily injury resulted.

Property Damage

The owners of the Giants certainly lost significant revenues because the Polo Grounds (the Giants' home field) would not host the World Series that year. However, property damage requires more than just the loss of revenue or unexpected additional costs. Property damage requires *physical injury* to *tangible property* and the consequential loss of use of the damaged property. Property damage also includes the loss of use of tangible property that *is not physically injured*.

The Polo Grounds was neither physically damaged (physical injury to tangible property) nor somehow unfit for playing baseball (loss of use of tangible property not physically injured) as the result of Fred Merkle's play. As no property damage had occurred, there is no coverage in the CGL, despite a mistake that was truly an accident.

Faulty Work

What about mistakes that involve "faulty work?" Is "faulty work" covered by the CGL? It depends—a definite maybe.

Faulty work can be loosely defined as any type of operation performed, including materials, parts, or equipment *that is part of the work*, which is done incorrectly. It might be something that is installed, repaired, built, or maintained in a manner that falls below generally recognized standards of quality or fails to meet representations or warrantees. Even failing to provide instructions or warnings can make it faulty work.

Property Damage Exclusions

As already noted, for the CGL (Coverage A) to be triggered, bodily injury or property damage must result from an occurrence. In addition, regardless of when the occurrence happens, the bodily injury or property damage resulting from the occurrence must take place during the policy period. The phrase found in the insuring agreement "to which this insurance applies" lets us know that coverage limitations and exclusions will follow.

Presuming a claim for faulty work is considered property damage caused by an occurrence (occasionally a big leap), we need to examine a series of property damage *exclusions* to determine the extent of coverage found in the Insurance Services Office, Inc. (ISO), CGL policy for faulty work (December 2004 edition). Unfortunately, the wording of these exclusions is a little arcane, resulting in not only significant misunderstandings but also grounds for coverage disputes. How the exclusions apply to faulty work is best explained by some examples.

Our Players

For the purposes of our examples, we have Great Big General Contractor, Inc. (we'll call it GBGC, Inc.), and Not So Big Subcontractor, Inc. (we'll call it NSBS, Inc.). Of course, we are talking about construction or contracting operations. At the outset, it is important to define a couple of terms to avoid confusion. (All definitions come from *Black's Law Dictionary*, 7th ed.).

- **Contractor**—One who contracts to do work or provide supplies to another.
- **General Contractor**—One who contracts for completion of the entire project, including purchasing all materials, hiring and paying subcontractors, and coordinating all work. Also termed original contractor or prime contractor.
- **Subcontractor**—One who is awarded a portion of an existing contract by a contractor, especially a general contractor.

Example One—That Particular Part of Real Property (j. (5))
"Property damage" to: (5) That 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 operations;

GBGC is engaged by the owner to repair portions of a sprinkler system in an older industrial building. In its haste to finish the job, GBGC snaps a pipe when tightening it with the wrong type of equipment. The broken pipe falls and breaks other pipes already installed by GBGC, tripping the sprinkler system. Portions of the building are extensively damaged by the water.

The owner makes claim against GBGC for damage to the sprinkler system as well as water damage to the rest of the building. As GBGC has incorrectly performed its work, some may consider this to be faulty work.

Exclusion j. (5) eliminates from coverage property damage to that particular part of real property on which GBGC is *performing* operations if the damage arises out of the operations. In this example, the property damage did arise from GBGC's operations—the damage happened while GBGC *was actually repairing the sprinkler system*. But what is the meaning of "that particular part of real property?" Clearly, the portions of the building damaged by the water cannot be considered to be that particular part of the real property on which GBGC was working. Thus, property damage coverage would apply to all portions of the building damaged by the water.

Conversely, damage to the pipe that snapped is excluded—it was the negligent tightening of the pipe that caused it to snap. But what about the other portions of the sprinkler systems already repaired by GBGC that were damaged when the broken pipe fell. While not universally held, the other pipes of the sprinkler system are *generally not* considered to be "that particular part" upon which GBGC was actually performing operations when the property damage occurred. Therefore, GBGC would have coverage for the cost of replacing the pipes damaged by the falling pipe.

Example Two—Cost of Replacing Property Because of Faulty Work (j. (6))
"Property damage" to: (6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

The state hires GBGC to resurface portions of the highway. The work involves removing the existing surface and laying bituminous concrete (asphalt) over the "grooved" pavement. Unfortunately, GBGC scrapes away far too much, accidentally scraping way most of the compacted gravel that is the base of the highway. The resurfacing project quickly becomes a disaster—the new asphalt being applied by GBGC crumbles into small pieces only hours after the roller passes over it. The project is quickly halted, and the state brings a claim against GBGC for the cost of replacing the compacted gravel base.

Exclusion j. (6) expressly excludes damage to the highway base—the compacted gravel—as it is property that must be replaced or repaired because GBGC's work was incorrectly performed on it. GBGC has no CGL coverage for the claim by the state.

Another Example

Here is another example of exclusion j. (6) that more clearly distinguishes it from exclusion j. (5). GBGC, Inc., is engaged by the Steamship Authority to perform repair work on the ship's steam turbines, specifically to inspect and replace the turbine blades. After completing the inspection and replacing some blades on one of several turbines to be serviced, a marine contractor engaged by the Steamship Authority, NSBS, Inc., tests the turbine. Because a few of the blades were not securely installed by GBGC, the testing causes some of these blades to break apart, rendering the turbine useless. The Steamship Authority makes claim against GBGC, Inc., for the cost of replacing the damaged turbine blades.

As the turbine blades are not likely be considered *real property*, exclusion j.(5) would not apply. Exclusion j. (6) excludes property damage to "that particular part of *any property*," thus eliminating coverage for GBGC, Inc., for the cost of replacing the blades. The damage to the blades was a result of work incorrectly performed by GBGC on the blades, necessitating their replacement.

It is important to note that exclusion j. (5) applies only if the damage occurs during the operation. Exclusion j. (6) eliminates coverage for damage during as well as after the some portions of the work are finished, provided the work does not fall into the "products-completed operations hazard." Further, the exclusions apply whether the work was done directly by GBGC's employees or was performed on behalf of GBGC by a subcontractor engaged by GBGC.

Example Three—Damage to Your Work (Exclusion l.)
"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".
This 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.

GBGC is hired by the state to put in the new ramp for the highway. The project involves site preparation, such as excavation, grading, and compaction, as well as laying down the compacted gravel base and the proper layers and thickness of bituminous concrete to meet state highway standards.

GBGC completes the project and it is put to its intended use—the ramp is open to all traffic. But 3 weeks after completion, the highway ramp begins to cave in and crumble. The state investigates and finds that the earth was not properly compacted and the depth of compacted gravel base put down was inadequate. The base and the earth under the base of the highway had collapsed, resulting in the crumbling of the bituminous concrete. In short, the work performed was faulty. The state subsequently sues GBGC for the cost of completely rebuilding the highway ramp.

Exclusion l. eliminates coverage for property damage to "your work" arising out of it or any part of it. In order for the exclusion to apply, the work has to be included in the "products-completed operations hazard." Does this exclusion apply to the cost of rebuilding the highway ramp?

There is no question that the highway ramp was the work of GBGC. And since the cause of the damage (the highway crumbling is property damage) resulted from the work itself (inadequate compaction of the earth and gravel base), the damage to the highway did "arise" out of the work.

But unlike the prior exclusions j. (5) and j. (6), this exclusion only applies if the work that caused the damage is included within the "products-completed operations" hazard.

The CGL contains three measures of when work is considered completed—and thus included within the products-completed operations hazard. One such measure is that the work at the jobsite has been put to its intended use by the owner. In the above example, the state has opened the highway to the public. GBGC's work has been put to its intended use, and thus its work now falls squarely within the products-completed operations hazard.

Based on the above, GBGC has no coverage for the cost to replace the highway ramp. The work is faulty, and insurance is not meant to pay for the cost of fixing work not properly done. The cost of fixing faulty work is seen as a business expense or business risk.

Important Exception—Damage to Your Work

As is the tendency, the above "no coverage" conclusion has been reached without determining all the facts and, most importantly, without examining the entire exclusion. All too often, insurers cite exclusion (l) in either a denial letter or reservation of rights letter and *completely leave out any mention of the exception to the exclusion*.

This exclusion is limited—it does eliminate coverage for the cost of repairing "your work" ("your work" does include operations performed on your behalf), but does not apply if:

- the *damaged work* or the *work out of which the damage arises* was performed on your behalf by a subcontractor.

Subcontractor Exception

A closer look at the facts of the above ramp work reveals that the GBGC, Inc., subcontracted to NSBS, Inc., the site preparation—the excavation, grading, compaction, and laying down the compacted gravel base. GBGC operations were to put down the layers of bituminous concrete.

As the damage to *GBGC's work* (bituminous concrete) arose out *work performed on behalf of GBGC, Inc. by a subcontractor* (the improperly compacted earth and gravel base), GBGC has coverage for the cost of replacing the bituminous concrete.

In addition, as the *damaged work* (the damaged work here is the collapsed base) was also performed on GBGC's behalf, GBGC has coverage for the cost of properly compacting the soil and properly installing the compacted gravel base.

In short, using the above fact scenario, *exclusion (l) does not apply to GBGC, Inc. at all*—full coverage for the damage to all work performed is granted by the exception to the exclusion. As the cause of the damage to GBGC's work was due to a subcontractor's work, GBGC has coverage for its own work. Further, GBGC also has coverage for damage to the subcontractor's work.

Another Example

What if the facts were reversed—GBGC performed the highway site work: excavation, grading, laying, and compaction of the gravel base—and subcontracted to NSBS, Inc., application of the layers of the bituminous concrete. Assume the same reason for the damage—GBGC did not properly compact the earth and the gravel base, which later collapsed.

The exception still applies—but a little differently. GBGC would *not* have coverage for the cost of replacing the gravel base as the damage to GBGC's work did not arise out of the work performed by a GBGC subcontractor. However, the damage to the bituminous concrete (the damaged work) was performed on GBGC's behalf by a subcontractor and thus the cost of replacing the bituminous concrete is covered by GBGC's CGL policy.

Example Four—Impaired Property or Property Not Physically Injured—Exclusion (m.)
"Property damage" to "impaired property" or property that has not been physically injured, arising out of: (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms. This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

Let's go back to our first example, but change the facts a little. GBGC installs a sprinkler system for the owner of a new office building. This time, no pipes snap or break—there is no physical injury to tangible property. However, it is discovered that the system has not been installed to building code—the owner can replace portions of the sprinkler system to bring it up to code, but only at considerable cost.

The owner makes claim against GBGC for the cost of replacing the incorrectly installed portions of the sprinkler system and also for the loss of use of the office building as the owner cannot obtain an occupancy permit until the sprinkler system is installed to building code.

Impaired Property

From the viewpoint of GBGC, the owner's office building is "impaired property." That is, the office building is less useful because GBGC's work (the sprinkler system) is known to be inadequate (it does not meet building codes), and the property can be restored to use by replacing GBGC's work—bringing the sprinkler system up to code.

GBGC has no coverage for the cost of replacing or repairing the sprinkler system as the sprinkler system itself, which is tangible property, has not been damaged. Thus there is no property damage to the GBGC's work—the sprinkler system.

The improper installation of the sprinkler systems has, however, caused loss of use of tangible property—the office building. The owner cannot collect rent until the sprinkler system is installed to code. Even though the definition of "property damage" in the CGL policy does include loss of use of tangible property (even if not physically injured), exclusion (m.) expressly eliminates coverage for any property damage to impaired property. As the office is impaired property, GBGC has no coverage for the loss of use claim made by the building owner.

Exception to Impaired Property

There is an exception to this exclusion. Assume that GBGC goes ahead and replaces the appropriate parts of the sprinkler system, bringing it up to code. The landlord is able to rent space to his tenants and collect rental income. Unfortunately, 4 months after full occupancy, the main riser of the sprinkler system suddenly cracks and needs to be replaced (no damage is done to any other property). GBGC is found to have used defective piping materials—the reason the riser cracked.

Because the cracked riser renders the building unusable as an office building, the owner again makes claim against GBGC for loss of use—the tenants are not required to pay the rent if damage to the building prevents them from occupying their space.

Because the loss of use of the office building arose out of the sudden and accidental physical injury to GBGC's work (the cracked riser), the exception, applies and GBGC has coverage for this loss of use claim made by the owner.

Conclusion

Faulty work can be covered by the CGL policy. Properly determining coverage does require a detailed understanding of precisely what happened as well as a thorough understanding how the property damage exclusions (and their exceptions) apply. Too often, coverage is denied without a good faith effort to ascertain the facts or by a less than careful reading of the CGL policy. Doctrines such as "business risk" or "economic loss" as reasons for denial are not a substitute for the plain meaning of the policy. While it may be easier and more expedient to deny coverage using such buzz phrases, the public and the industry will be better served by paying close attention to facts, coverage wording, and applicable case law.

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[1]Geoffrey C. Ward and Ken Burns, *Baseball- An Illustrated History* (New York: Alfred A. Knopf, 1994), 92–93.

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