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No GCL Coverage for Subcontractor's Work

Court's reliance on *Weedo* ensures broad application of decision

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In a declaratory action arising from a construction defect suit, the Appellate Division ruled that a general contractor was not entitled to coverage of claims premised on defective work performed by subcontractors. *Firemen's Insurance Co. of Newark v. National Union Fire Ins. Co.*, DDS No. 23-2-4876 (App. Div. Aug. 28, 2006). The case reinvigorates the New Jersey Supreme Court's decision in *Weedo*, which many thought obsolete. *Weedo v. Stone-E-Brick, Inc.*, 81 N.J. 233 (1979).

The court held that no coverage existed under CGL insurance policies incorporating the 1973 form promulgated by the Insurance Services Office (ISO). The decision rested heavily on philosophical notions regarding the purpose of general liability insurance and societal interests in efficient risk allocation in the construction industry. Given the public-policy based rationale, the decision should apply to claims under more modern CGL policy forms.

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In the declaratory action, the court indicated that coverage was sought for "seven specific construction defects," which it declined to enumerate. Later, however, the court described the damages as simply "the cost of replacing sub-standard firewalls" and noted that the underlying complaint "did not allege that the firewalls caused damage to the rest of the building or to any other person or property." Curiously, the court made no reference to the other six types of defects.

The *Firemen's* court excerpted the key policy language. The insuring clause stated:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of...property damage...to which this insurance applies, caused by an occurrence...

Property damage was defined as:

[P]hysical injury to or destruction of tangible property which occurs during the policy period, including the loss of use

thereof at any time resulting therefrom, or (2) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period.

Occurrence was defined as

[An] accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured.

The court held the claims were beyond coverage on two grounds: the alleged defects (1) did not constitute "property damage" and (2) did not result from an "occurrence." The court derived its conclusion from a careful examination of *Weedo*, which it deemed the "seminal case regarding insurance coverage for a contractor's defective work." In *Weedo*, a masonry contractor was sued for defective stucco work and sought coverage under a CGL policy for the expense of repairing the defective work. The court found, per the exclu-

sions barring coverage of claims for damages to the insured's "work" and "product," no coverage existed. *Weedo* noted:

The insured-contractor can take pains to control the quality of the goods and services supplied. At the same time he undertakes the risk that he may fail in this endeavor and thereby incur contractual liability whether express or implied. The consequence of not performing well is part of every business venture; the replacement or repair of faulty goods and works is a business expense, to be borne by the insured-contractor in order to satisfy customers.

In *Firemen's*, the decision did not involve the so-called "business risk exclusion"; it was premised exclusively on the insuring agreement. The court expressly recognized the distinction, but nevertheless rested its decision on the "principle" espoused by *Weedo*. That critical point assures the broad application of the *Firemen's* decision.

On construction defect claims, the insured's first hurdle is establishing that the claim is premised on "property damage." In ruling against the insured, the *Firemen's* court appeared to conclude that the phrase connotes some nondegenerative alteration in the condition of the property caused by external forces. Certain "property" may be defective from the moment of its creation and degrade as a result of the defect. Because such property incorporates a defect from the moment of its creation, its natural deterioration would not result in any coverage-triggering "damage."

The court could have ended its decision with the pro-insurer ruling on the "property damage" issue. Instead, the court elected to share its views on the circumscribing effect of the "occurrence" definition. That issue has generated an extraordinary amount of litigation around the country in the construction defect context. No New Jersey court had

weighed in on the issue since *Aetna v. PlyGem*, 343 N.J. Super. 430 (App. Div.), *certif. denied*, 170 N.J. 390 (2001). Consistent with the majority rule, *Firemen's* found that the breakdown or deterioration of a contractor's work, per se, cannot be regarded as an "accident" and, therefore, is not covered.

Thus, to satisfy the threshold requirements of "property damage" and "occurrence" definitions, the claim must involve damage to "other" property. A Persian rug damaged by a leaking window certainly would qualify as "other" property. But what about a hardwood floor damaged by the leaking window? From the perspective of the window subcontractor, the floor damage would be to "other" property. From the viewpoint of the developer or general contractor, however, *Weedo* dictates a different result. In *Firemen's*, the insured argued that there had been "'property damage' to someone else's property" because the defective work was performed by subcontractors and that "work damaged the property of others," specifically the general contractor and property owner. The court rejected the contention that, for purposes of evaluating coverage available to a party who bears responsibility for the entire structure, certain elements of work may be cleaved and compartmentalized in a gratuitous effort to characterize the damage as affecting "other" property:

The named insured is the general contractor and work performed by the insured must necessarily be such work as the named insured is required to perform under the construction contract. How the insured performs the work is a matter for its decision in the exercise of sound business practice. The contractor can employ subcontractors or use employees to do the work, but in the end, when the work is completed, all the work called for by the contract on the part of the contractor must be deemed to be work per-

formed by the contractor. We hold that the language of the policy excludes liability coverage for the plaintiffs for damage to the property constructed pursuant to the contract.

General contractors typically assume contractual responsibility to provide a workmanlike structure. General contractors, of course, may elect to perform the construction work themselves or they may delegate the obligation to various others via subcontracts. In either event, the general contractor retains contractual responsibility for the entire building. The liability is neither "limitless" nor "unpredictable." It is effectively capped at the purchase price of the home, less profit margins. If the general contractor did the hands-on work, it could not shift to its CGL insurer responsibility for any defects and potentially collect double payment (from the owner for doing the initial faulty work and then from the insurer for repairing it). If, just after completion of a home, the hardwood floor warped, then the general contractor would be responsible for its repair. Whether the floor damage was caused by pre-existing defects in the planks or by leakage from the plumbing system would be wholly irrelevant to the general contractor's liability to the homeowner. Equally irrelevant to the owner vs. general contractor claim would be whether the work was performed by subcontractors. In either case, the claim would seek to impose "contractual liability" and portend "economic loss because the completed work is not that for which the damaged person bargained." Per *Weedo*, the economic loss is to be borne by the general contractor, not its insurer.

As noted above, the standard CGL policy underwent some significant changes circa 1986. In the construction defect context, the most significant changes are reflected in the policy exclusions. Specifically, the "work" exclusion no longer applies to tasks completed by subcontractors. The "product" exclusion does not apply to real property. As noted

above, *Firemen's* is based on a public-policy influenced interpretation of the insuring agreement. The pertinent terms were unaffected by the 1986 policy revisions. An "occurrence" is still defined as an "accident." The "property damage" inquiry still usually distills to whether property was "injured" or rendered unusable. Because *Firemen's* was based upon the terms of the insuring grant and not the exclusions, the decision should be applicable to claims under the post-1986 policies.

Some have argued that the 1986 revisions to the exclusions should color the interpretation of the insuring agreement. The arguments essentially assert that, if damage is within an exception to an exclusion, it must be covered (i.e., "property damage" to "work" performed by a subcontractor is excepted from the

"work" exclusion and, therefore, must be covered or else there would be no need to address it in the exclusion). *Firemen's* anticipated and snuffed out those arguments. As the court correctly pointed out, the argument is logically flawed and ignores the sequence of proper insurance contract interpretation, which involves an orderly winnowing process. That a claim may be excepted from an exclusion in no way suggests that it is within the scope of the insuring agreement. The exclusions are not relevant unless the claim is within the insuring agreement.

The argument also incorrectly presumes that the exclusion applies only to faulty workmanship claims. The conclusion that faulty workmanship claims are beyond the insuring agreement, however, does not render the exclusions

superfluous. For example, during a post-construction repair, a repairman may leave a sink running over a weekend and flood portions of a home. The accidental incident would result in "property damage." In evaluating a developer's entitlement to coverage for such damages, the dispositive coverage issue likely would be whether the damaged work had been done by the developer or a subcontractor. If the latter, then the "work" exclusion would be inapplicable and coverage likely would exist; if the former, coverage would not exist. The point, of course, is that coverage indeed may hinge upon the interplay between the "work" exclusion and its exception. The exclusion and its exception, thus, continue to serve an important role in defining the scope of coverage. ■