

CGL EXCLUSIONS COMMON TO CONSTRUCTION-RELATED CLAIMS

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The Commercial General Liability policy (CGL) is an essential factor in the equation that consists of building planning, financing, construction, operation, and protection from risk. While its coverage potential is determined by claim professionals and insurance coverage counsel daily throughout the country, it is useful to step back and consider application examples of some of the standard form's most prominent provisions. The following is a primer on three of the CGL form's exclusions which most commonly come into play in the world of construction defect claims.

Standard ISO form CGL policies contain an insuring clause subject to long-standing exclusions, which while remaining substantially the same, have been the subject of interpretation and case law over the years.¹ This article focuses on the operation of the form's exclusions j, k, and l, and while industry specific examples could run the gamut, considerable interest exists with regard to construction defect applications in the commercial context.² These provisions generally exclude (1) coverage for property that the insured has management and control over and for which separate first-party property insurance should be obtained; (2) and property damage caused by the insured's faulty workmanship or products, which commercially the insured has to stand behind and warranty.

Illustrations using a variation of the same hypothetical follow: an owner/insured builds a spec house with the intention of renting it out on a short-term basis, through applications such as VRBO, Airbnb, and the like.

COVERAGE EXCLUSION EXAMPLES

Exclusion j(1) excludes coverage for defined "property damage" to "property you [the insured] own, rent, or occupy, including any costs or expenses incurred by you, or any other person, organization or entity, for repair, replacement, enhancement, restoration or maintenance of such property for any reason, including prevention of injury to a person or damage to another's property." In our hypothetical scenario, assume a CGL insured, acting as an owner/builder, constructs a house for the purpose of renting it out on an internet site, and the owner and his renter store personal property in the attic. Leaks in the roof begin following the first heavy rain storm, and subsequent investigation reveals that the roof was improperly installed. Some of the owner's, and renter's expensive belongings, including fur coats, are ruined as a result of the leaks, and walls are damaged by water intrusion. Exclusion j(1) excludes coverage for property damage to personal property owned by the owner/insured and its renter, as well as for damage to the structure.

The damage to the personal and real property in this case would presumably be covered by the owner's first-party property insurance policy, and a subrogation action by the carrier issuing that policy against responsible subcontractors could be covered by their policies. In the case of an Owner Controlled Insurance Program (OCIP) covering the original construction, while there may not be coverage for the owner, if there is a distinction between the owner and general contractor, the general contractor as well as its enrolled subcontractors could receive coverage for damage claims relating to the personal and real property. In addition, an express exception to exclusion j(1) is discussed further below.

Exclusion j(2) excludes "property damage" to "premises you sell, give away or abandon, if the 'property damage' arises out of any part of those premises." Sometimes referred to as the "alienated property exclusion," this exclusion precludes coverage for liability based on a seller's failure to correct a known defect in the premises, when the damage arises out of the premises. Assume the owner/insured in the example above later, after owning and renting it out, decides to sell his home, and knows that the roof is defective at the time of the sale. If the subsequent owner sues the insured because his or her personal property, or other parts of the structure, are damaged as a result of leaks in the defective roof, the insured seller/builder would not have coverage under this exclusion.

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Conversely, under an exception to exclusion j(2), it does not apply “if the premises are ‘your work’ and were never occupied, rented or held for rental by you.” Therefore, if the owner/insured in the example above had instead built the house and immediately sold it to a subsequent owner without ever occupying or renting the home first, the j(2) exclusion would not apply, and the insured could, absent other policy exclusions, receive coverage for liability owed to the subsequent owner as a result of the “property damage.”

Exclusion j(3) precludes coverage for “property damage” to “property loaned to you [the insured].” Assume someone loaned the owner/insured an expensive work of art which he stored in the attic of his home. A torrential rain storm floods the attic, and the art work is ruined as a result of the leaky roof. In this scenario, the owner/insured’s CGL coverage is excluded under j(3) for liability for the damage to the art work. Again, there is an express exception to this exclusion, discussed further below.

Exclusion j(4) excludes coverage for property damage to “personal property in the care, custody or control of the insured.” Assume the insured/owner is a clothing tailor and someone brings an expensive fur coat into his shop for him to tailor. The tailor takes it with him to his vacation home where the roof is defective, and as a result of a rain storm, the roof leaks and ruins the fur coat. The tailor/insured would have no coverage under the CGL policy for the damage to the fur coat as it was directly in his possession, custody or control. Additionally, if the tailor’s assistant took the fur coat to the house and the fur was ruined by roof leaks, the tailor would not have coverage because the coat was indirectly in the care, custody or control of the tailor, as his assistant would be considered an agent of the insured. Once again an express exception is stated to this exclusion.

In the construction context j(4)’s words, “care, custody or control” may apply differently to additional insureds (“AIs”), creating two different outcomes for a named versus an additional insured. Under these circumstances, the “indirect control” application for the “agent” of the insured may not apply. Assume a general contractor (“GC”) subcontracts with a CGL insured roofer who properly names the GC as an AI, and while performing construction on the roof allows leakage that damages the owner/GC’s or its renter’s personal property in the attic. In this scenario, the property may be interpreted to be in the care, custody and control of the subcontractor, but not of the owner/general contractor. As a consequence, exclusion j(4) could withdraw coverage for the subcontractor, while potentially still allowing coverage to apply to the owner/general contractor.

It is important to note that exclusions j(1), j(3) and j(4) are subject to an express exception, and “Do not apply to ‘property damage’ (other than damage by fire) to premises, including the contents of such premises, rented to you [the insured] for a period of 7 or fewer consecutive days. A separate limit of insurance applies to Damage To Premises Rented To You as described in Section III – Limits Of Insurance.” This exception to these exclusions could result in a finding of coverage depending upon the fact pattern, but the exception to the exclusion does not apply to damage by fire. Common examples that fall within this exception are damage to a hotel room, its contents, or to special event facilities rented by a CGL insured on a short-term basis. Thus, if a CGL insured rented the house on Airbnb for 6 days, left the tub running, and a flood ruined floors and some of the insured’s belongings [j(1)], including the borrowed art work [j(3)], and the tailored fur coat [j(4)], absent other exclusions or provisions, the j exclusions could be excepted, and the property damage could be covered under the CGL policy. However, should such coverage exist, it will be under a separate limit of insurance for “Premises Rented To The Insured.”

Exclusions j(5) and j(6) apply directly to the construction context. Exclusion j(5) eliminates coverage for “property damage” to “that particular part of real property on which you [the insured] or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the ‘property damage’ arises out of those operations.” This portion of the exclusion was intended to apply to ongoing construction operations on real property. Assume that while performing roof work, the insured roofing subcontractor has three-quarters of the roof completed, but as a result of his negligent work, the roof falls through. Under j(5), the insured would have no coverage under his CGL policy for the damage done to the roof he was working on. The same would also be true if the insured was an owner/builder or general contractor and the roof fell through as a result of the insured’s subcontractor who was negligently working on the roof.

If, however, as a result of the roof falling through, damage is done to wood flooring in the floors below, the insured could arguably be covered under his CGL policy for liability for damage done to the wood flooring, as it was not “that particular part” on which he or his subcontractors were working. Thus, the insured would be excluded from coverage only for the damage done to the roof, but he would nonetheless be covered under his CGL policy for any other “property damage” to the home as a result of his work on the roof. The meaning of “that particular part” has been the subject of interpretation by courts in numerous jurisdictions over the years with varying applications.

Exclusion j(6) excludes coverage for property damage to “that particular part of any property that must be restored, repaired or replaced because ‘your work’ [the insured’s] was incorrectly performed on it.” Broader than j(5), this exclusion, sometimes referred to as the “faulty workmanship exclusion,” applies to both personal and real property, and not only to the work of the named insured, but also to work incorrectly performed by the insured’s subcontractors. Additionally, under an express exception to exclusion j(6), it only applies to work in progress, not to damage that arises out of the insured’s completed operations.³ Assume that when the owner/builder’s house was three-quarters of the way completed, with the defective roof installed, a major rainstorm causes tremendous leakage, damaging both the roof structure and the wood flooring below. Investigation reveals that the insured improperly installed the joists in the roof, and the entire roof must be replaced as a result. Under the insured’s CGL policy, he should have no coverage for the costs of replacing the entire roof or for repairing damage to the wood flooring, whether the roofing work was self-performed by the owner/builder or subcontracted to a roofing subcontractor. However, this analysis is subject to the following caveat.

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Aggressive policyholder attorneys in major construction jurisdictions such as Texas and California often seek to expand the traditional coverage of the CGL as a liability policy into areas that would normally be covered by builder's risk policies or contractor's bonds. In this instance, they seek to very narrowly construe exclusions j(5) and j(6), adopting an interpretation of "that particular part" to mean only the very specific portion of work causing the damage. Under such interpretation, sometimes well received by courts, damage to all other parts of the building, other than that narrowly construed portion of the work in progress, would be covered as "consequential damages." This coverage position is often taken in instances where no builder's risk policy or contractor's bond was obtained, thereby seeking to expand the arguable intention of the CGL as a liability policy.

Exclusion "k. Damage To Your Product" operates to eliminate coverage for "'property damage' to 'your product' [insured's product] arising out of it or any part of it."⁴ This is a limitation on liability coverage that is directly tied to the quality of the insured's own product, which commercially the insured must stand behind. A liability policy is not a commercial guaranty or warranty for an insured's work or product it puts into the marketplace. It is designed to protect the insured from liability for harm caused by the insured, but not if that harm is the insured's own product it placed into the stream of commerce. Thus, under the CGL exclusion "k," there is no coverage for the cost of repairing or replacing the insured's goods that prove to be defective. This exclusion is predicated on the idea that liability insurers are not warrantors or guarantors of their insureds' products. While exclusions j(5) and j(6) are similar, they more expansively apply to "that particular part" of the damaged property, whereas exclusion "k" does not limit coverage for any damage caused by the insured's product, other than damage to the product itself.

While "your product" is defined elsewhere in the CGL form to exclude real property, such as a house, application of exclusion "k" does arise from time to time in the construction context. Assume that the insured builder, in the course of building the roof of the spec house, constructs the joists for the roof defectively. The defective joists are installed, and a major rainstorm causes massive leaks in the roof, damaging the joists and the roof system itself. Investigation reveals that the leaks were caused by the installation of the defectively constructed joists. Under exclusion "k" to the CGL policy, the insured will have no coverage for claims relating to property damage to the joists in the roof system, and in some jurisdictions, no coverage for damage to the roof system itself.

While there is no coverage for the property damage to the insured's roof joists, if the roof leaked or caved into the house and wood flooring on other floors was damaged as a result, exclusion "k" would not apply to that other damage, and absent other considerations, the insured could have coverage for liability for the damage to the wood floors. In other words, the insured would have coverage under his CGL policy where the separate negligently installed defect in the insured's product causes "consequential damage" to other parts of the property. This would also be the case if someone had been injured while working on the roof at the time it caved in because of the insured's defective joists. Whereas claims for damage to an insured's product itself may not be covered, where other types of concurrently expressed claims stem from consequential damage, such as loss of use, certain jurisdictions have found coverage for these claims.

Exclusion "l. Damage To Your Work" eliminates coverage for "property damage to 'your work' [the insured's 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.⁵ Given the CGL form's broad definition of "your work" to include real property construction, this exclusion has a direct impact on CGL coverage for GCs and subcontractors. This exclusion removes coverage for property damage to the insured's own work when the damage was caused *after* operations have been completed. Similar to "k," this exclusion is again based on the principle that a liability insurer will not be a guarantor of the quality of an insured's product or work. Thus, if the insured builder had self-performed the defective construction of the roof of the house, and a major rain storm causes damaging leakage after the house had already been completed, the insured would have no coverage for damage claims to replace the roof.

The policy form's definition of "your work" for an insured general contractor includes work or operations performed on its behalf by subcontractors, so at first analysis, the exclusion would apply to the entire construction by the GC. However, the second sentence's "subcontractor exception" to exclusion "l" removes the exclusion of coverage if the damaged work, or the work that causes damage, was performed on the insured's behalf by a subcontractor. Therefore, if the improper roof work in the example above had instead been performed by the insured's roofing subcontractor, the insured would have coverage for the damage to the roof itself, and other portions of the residence. The term "subcontractor" is not defined in the CGL form, but in California it has been fairly narrowly construed.⁶

Ultimately, in order for exclusion "l" to apply to limit coverage, the work must be performed by the named insured, and damaged by work performed by the named insured. The subcontractor exception to the exclusion will apply, removing the exclusion to allow coverage where the damaged work itself was performed by a subcontractor or when damage to any part of the work was caused by a subcontractor's work. This is true even when the subcontractor damages its own work, thus potentially resulting in coverage for all of the work. However, should the subcontracted work cause property damage without itself being injured, some courts have found coverage for the consequential damage, but not for replacement of the subcontracted work. Modern policy forms allow insurers and their insureds to adopt a standard endorsement replacing the CGL form's exclusion "l" with one that simply omits the second sentence of the exclusion. This effectively eliminates the exception to the exclusion, and results, in the instance of a general contractor, in the exclusion of coverage for all of the damage. This would include even that consequential damage from the work of a subcontractor, such as damage to walls caused by subcontracted defective roofing.

Factual scenarios in the claims setting are as individual as fingerprints, and while the CGL policy form is intended to allow consistent and uniform application, often in-depth analysis and advice from claims professionals and insurance coverage counsel are necessary to arrive at the best coverage position.

- ¹ All quoted policy provisions are taken from the Insurance Services Office (ISO) Commercial General Liability Coverage Form CG 00 01 04 13 © Insurance Services Office, Inc. 2012
- ² The hypothetical application of the policy exclusions considered in this article are for illustrative purposes only and could be impacted by ancillary facts, insurance contract provisions, and jurisdictional law variations. Views expressed here do not constitute legal advice. The information contained herein is for general guidance of matter only and not for the purpose of providing legal advice. Discussion of insurance policy language is descriptive only. Every policy has different policy language. Coverage afforded under any insurance policy issued is subject to individual policy terms and conditions. Please refer to your policy for the actual language.
- ³ “Paragraph (6) of this exclusion does not apply to ‘property damage’ included in the ‘products-completed operations hazard.’” The insured may be covered under a products-completed operations hazard depending on the form of CGL policy and whether that coverage was purchased. However, the cost of repair or replacement of the insured or its subcontractor’s work may still be excluded by exclusion “I. Damage To Your Work.”
- ⁴ “‘Your product’ is defined, in pertinent part, in the CGL policy as ‘Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by...you.’”
- ⁵ “‘Your work’ is defined, in pertinent part, in the CGL form as “Work or operations performed by you or on your behalf; and... Materials, parts or equipment furnished in connection with such work or operations...”
- ⁶ In *Collett v. Insurance Co. of the West* (1998) 64 Cal. App. 4th, 338, 343, the California Court of Appeal found that the “subcontractor exception” is inapplicable to negligence by an inspector employed by the insured contractor. Thus, the term “subcontractor” as used in exclusion I is not broad enough to include any worker hired to perform work on the insured’s behalf.

