

Supreme Court Rules on Construction Defects

The Texas Supreme Court lay to rest once and for all the theory advanced by some insurers that bodily injury or property damage caused by a construction defect can't be covered by the standard unendorsed CGL policy. In its Aug. 31 opinion in *Lamar Homes, Inc. v. Mid-Continent Casualty Company*, the Court said "The CGL policy covers what it covers." And what it covers are sums the insured becomes legally obligated to pay as damages because of bodily injury or damage to tangible property caused by an accident or occurrence, subject to the exclusions stated in the policy.

The policy defines occurrence as an accident, which the Court said is generally understood to be a fortuitous, unexpected and unintended event. Even a deliberate act, according to the Court, is an accident if the act is performed negligently and the effect is not the intended or expected result. After debunking the insurer's contention that bodily injury or property damage caused by a construction defect can't be an "occurrence," the court went on to squash the insurer's primary target: damage caused by a construction defect is simply a contractual economic loss and can't be "property damage" covered by the policy. In doing so, the Court concentrated on Exclusion "I" which begins with an absolute exclusion of property damage to the insured's work under the completed operations hazard.

By definition, the named insured's work includes work completed by the named insured as well as work completed by subcontractors on behalf of the named insured. However, the second half of Exclusion "I" says the exclusion does not apply if (1) the damaged work was performed by a subcontractor, or (2) the work out of which the damage arises was performed by a subcontractor. According to the Court, therefore, it is clear that the insurance industry – those who drafted the standard ISO CGL policy – intended to provide coverage for damage to a general contractor's "product" when caused by a subcontractor's defective performance.

Beware the CG 22 94

Endorsement CG 22 94 (Exclusion – Damage to Work Performed by Subcontractors on Your Behalf) was introduced by ISO with the 10-01 edition of the CGL policy and is now widely used by insurers that write general contracting risks, especially home builders. The endorsement eliminates the subcontractor exception under Exclusion "I" and thus eliminates coverage for virtually any claim involving damage to a general contractor's completed work.

Here's an example of a catastrophic uninsured loss a general contractor might face as a result of this exclusion. Three months after the general contractor sold a \$500,000 home, the structure is destroyed by fire. The fire marshal determines the fire was caused by an electrical malfunction resulting from the electrician's defective work. The homeowners insurer pays for the loss and files a subrogation claim against the general contractor and the electrician. The electrician can't be found. After completing work on this house 6 months ago, he decided to fulfill his lifelong dream to become a missionary in Africa.

He canceled his CGL policy – the policy that was supposed to cover the general contractor as an additional insured as well as contractual liability for the hold-harmless provision so carefully inserted in the contract by the general contractor. Now the general contractor is left holding the bag – a \$500,000 uninsured claim because his CGL policy with endorsement CG 22 94 excludes all property damage to his completed work arising of the work, whether the work was completed by him or by his subcontractor.