Coming Full Circle?—The Elimination of the Subcontractor Exception

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Introduction

It is not often in the ever-evolving world of insurance coverage litigation that concepts come "full circle." However, that appears to be exactly what is happening with regard to one of the most litigated exclusions in CGL policies. Nearly every CGL policy contains a "your work" exclusion which precludes coverage for property damage to "your work" or arising out of "your work" and included in the "products-completed operations hazard." For several decades, however, that standard "your work" exclusion contained an exception precluding use of the exclusion when the faulty work was performed by a subcontractor. The subcontractor exception to the "your work" exclusion increased completed operations coverage for contractors, particularly for general contractors who relied on subcontractors to perform the majority of their work. In the last ten years, however, insurers have significantly limited that coverage, taking the industry back to where it stood almost forty years ago. The effects of those changes are now starting to be seen in litigation circles.

Generally, there are two distinct risks at play in construction litigation: (1) the risk of faulty workmanship and associated repair of that faulty workmanship; and (2) the risk of accidental injuries or property damage *caused by* faulty workmanship. Under normal circumstances, the former is a loss borne by the insured and not covered under a CGL policy, while the latter is a risk for which there is coverage under the CGL policy.[1]

I. The History of the Subcontractor Exception

In the 1970s and early 1980s, standard CGL policies excluded coverage for "property damage to work performed by or on behalf of the Named Insured arising out of any of the work or any portion thereof." Insurers offered broad form endorsements that removed the "on or behalf of" language from the exclusion, arguably extending completed operations coverage to faulty work of persons not under the contractor's direct control. Still, there was significant question for courts interpreting that endorsement as to whether it covered faulty work of the subcontractor.[2]

The increased litigation reflected a change that was occurring at the time in the construction industry—general contractors were becoming larger and delegating more work to subcontractors. As such, general contractors were seeking through insurance to control risks that they could not directly control—i.e., work being performed by non-employee subcontractors. Those general contractors, seeing increased exposure, lobbied insurers to increase completed operations coverage so as to cover property damage caused by faulty subcontractor work. Soon, insurers began to offer products that eliminated the question almost entirely. In 1986, Insurance Services Office, Inc. (ISO), changed its forms to specifically address the subcontractor dilemma. As such, the "your work" exclusion, as most current practitioners now know it, was born. The exclusion reads as follows:

This coverage does not apply to:

1. "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.

With the advent of the "your work" exclusion that included the subcontractor exception, completed operations coverage extended, and litigation accordingly increased. In Wisconsin, a number of decisions addressed the effect of the subcontractor exception. These decisions culminated in *American Family Mutual Ins. Co. v. American Girl, Inc.*,[3] where the Supreme Court upheld the plain language of the "your work" exclusion, noting that the subcontractor exception, while not creating new coverage, operated to restore coverage (i.e., poor workmanship, so long as the work was performed by a subcontractor) that was otherwise excluded by policy.[4]

II. The Movement Toward Removal of the Exception

In recent years, faced with increasing construction claims, the insurance industry is, at least on some level, seeking a return to the pre-1986 days. In 2001, ISO offered two new endorsements to the contractor's CGL policy. Both eliminated the subcontractor exception in exclusion (l)—one on a blanket basis and another on a project basis.[5] Other insurers simply removed the subcontractor exception from exclusion (l) entirely. In recent years, courts have addressed the changes to the subcontractor exception.

In *Builders Mut. Ins. Co. v. Kalman*,[6] the United States District Court of South Carolina was faced with application of the new ISO endorsement removing the subcontractor exception from the "your work" exclusion. In that case, Kalman was a general contractor on the construction of a multi-million dollar home. After occupancy, the homeowner noticed significant areas of faulty workmanship and resulting water damage. The court held that the endorsement eviscerated coverage entirely for the general contractor:

> This court is the first court in South Carolina and appears to be the first court nationwide to analyze [the] CG 22 94 10 01 endorsement and its application to a particular claim. In this case, the Court finds that the property damage claimed by the Kimmers clearly falls into the "your work" exclusion. As noted above, the endorsement CG 22 94 10 01 removes the subcontractor's exception from the "your work" exclusion. Without the subcontractor's exception … the property damage claimed by the Kimmers in the Underlying Complaint falls within the "your work" exclusion. The faulty workmanship and defective construction of the Kimmer Residence and resulting water damage is "property damage" to work that was performed by Kalman and by subcontractors on Kalman's behalf. Because Kalman was the general contractor, for purposes of the "your work" exclusion, the entire Kimmer Residence was either Kalman's work or work performed on Kalman's behalf as defined by the policy, and the Kimmers only claim property damage to their Residence …. Therefore, while the "property damage" in this case is caused by an "occurrence" and fits within the initial grant of coverage …, the removal of the subcontractor exception to the "your work" exclusion bars coverage in this case.[7]

The *Kalman* decision highlights the problem that the "new" ISO endorsements, and policies which eliminate the subcontractor exception altogether, cause for general contractors in particular. Unlike

contractors who supply component parts of the project, a general contractor's "work" is arguably the entire construction project. Thus, the elimination of the subcontractor exception, either specifically or by endorsement, effectively eliminates any potential completed operations coverage for the general contractor. Despite this harsh result, insurers seem intent on limiting that coverage unless it is specifically contracted for by the general contractor.

Conclusion

The impact of the ISO endorsements removing the subcontractor exception and policies which do not include the exception in the "your work" exclusion are only starting to be felt in construction claims across the country. The limitations do not only have the obvious effect of precluding coverage in the specific instance, but also strengthen the insurer's general assertion that business risks are not covered at all under the CGL policy. While it remains to be seen how Wisconsin courts will deal with this limitation, practitioners representing insurers in construction disputes should pay close attention to the specific language of their "your work" exclusion and any endorsements that may limit the exclusion.

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References

1 *Glendenning's Limestone & Ready-Mix Company, Inc. v. Reimer*, 2006 WI App 161, 295 Wis. 2d 556, 721 N.W.2d 704.
2 *Fireguard Sprinkler Systems, Inc. v. Scottsdale Insurance Co.*, 864 F.2d 648 (9th Cir. 1988) (holding that broad form endorsement created coverage for faulty subcontractor work); *Knutson Const. Co. v. St. Paul Fire & Marine Ins. Co.*, 396 N.W.2d 229 (Minn. 1986) (finding no coverage for work done by subcontractor despite endorsement).
3 2004 WI 2, 268 Wis. 2d 16, 673 N.W.2d 65.
4 *Id.*, ¶ 74.
5 ISO Endorsement CG 22 94 (blanket) and ISO Endorsement CG 22 95 (project specific).
6 2009 WL 4807003 (D.S.C. 2009) (unpublished decision).
7 *Kalman*, 2009 WL 4807003, at *6; *see also Grinnell Mutual Reins. Co. v. Wollak Const. Inc.*, 2010 WL 4121906 (D. Minn. 2010) (unpublished decision); *Builders Mut. Ins. Co. v. Wingard Properties, Inc.*, 2010 WL 3069544 (D.S.C. 2010) (unpublished decision).

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1 *Larsen v. General Motors*, 391 F.2d 495 (8th Cir. 1968).
2 James Niquet, *Evidentiary Problems of Apportionment under Wisconsin Second Collision Law*, 72 Marq. L. Rev. 539, 540 (1989); *Huff v. White Motor Corp.*, 565 F.2d 104 (7th Cir. 1977); *Grundmanis v. British Motor Corp.*, 305 F. Supp. 303 (1969).
3 *Arbet v. Gussarson*, 66 Wis. 2d 551, 225 N.W.2d 431 (1975).
4 *Farrell v. John Deere Co.*, 151 Wis. 2d 45, 443 N.W.2d 50 (1989).
5 *Id.* at 61-62.
6 *Id.*
7 Foland, *Enhanced Injury: Proof in "Second Collision" and "Crashworthy" Cases*, 16 Washburn L.J. 600, 606-07 (1977).
8 *Butzow v. Wausau Memorial Hospital*, 51 Wis. 2d 281, 288-89, 187 N.W.2d 349 (1971) (finding both accident causing tortfeasors and negligent medical practitioners liable for the injuries aggravated by the medical malpractice).
9 *Sumnicht v. Toyota Motor Sales, U.S.A., Inc.*, 121 Wis. 2d 338, 360 N.W.2d 2 (1984).
10 *Maskrey v. Vokswagenwerk, A.G.*, 125 Wis. 2d 145, 370 N.W.2d 815 (Ct. App. 1985).
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12 *Id.*
13 *Hansen v. Crown Controls Corp.*, 181 Wis. 2d 673, 512 N.W.2d 509 (Ct. App. 1993).
14 *Sumnicht*, 121 Wis. 2d at 358.
15 *Maskrey*, 125 Wis. 2d at 158-59.
16 James D. Ghiardi, *Second Collision Law—Wisconsin*, 69 Marq. L. Rev. 1 (1985).
17 Niquet, *Evidentiary Issues*, *supra* note 2, at 545.
18 *Id.*
19 Monte Weiss, *The Enhanced Injury Doctrine as Defense*, Wis. Lawyer (Nov. 1996), at 3.
20 *Id.*
21 Niquet, *Evidentiary Issues*, *supra* note 2, at 551-55.