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Builders, Contractors and Homeowners: Beware

Insurance carriers are deleting construction deficiencies coverage

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There is a dangerous trend emerging in New Jersey, leaving many builders and homeowners surprised to find themselves without insurance protection for consequential property damage caused by the negligent workmanship of subcontractors — protection which standard commercial general liability insurance policies have afforded in New Jersey since 1986. Given the high number of bankruptcies, insolvencies, and business failures in the construction industry, the shift away from providing coverage for property damage caused by substandard subcontractor workmanship would, in many cases, leave injured home-owners without practical recourse. The net effect is to gut CGL insurance of the benefits contractors and the general public have come to expect and rely upon for over 20 years.

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Before 1973, CGL policies excluded coverage for "Your work" stating that the policy did not apply to property damage to work performed by or on behalf of the named insured (the builder) arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith. In other words, a builder's CGL coverage did not cover consequential loss to the building itself arising from faulty workmanship, regardless of whether that workmanship was performed by the builder's employees or by a subcontractor hired by the builder.

Beginning in 1976, in an effort by the insurance industry to broaden coverage, and thereby make it more attractive to builders, the insurance industry began offering a Broad Form Property Damage Endorsement (BFPD) that replaced the 1973 "Your work" exclusion with regard to completed operations, by eliminating the exclusion (and thereby restoring coverage) for "work performed on behalf of the named insured." This "subcontractor exception" language provided coverage for consequential or resulting damage arising from work performed by the builder's subcontractors which causes damage to other property, including the work of the general contractor or other subcontractors, after the insured contractor has completed operations.

When the ISO CGL policy was revised again in 1986, it contained new provisions that incorporated the Broad Form Property Damage Endorsement into the body of the policy. The revised 1986 work exclusion included by direct and explicit reference the subcontractor exception, which read:

> 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.

This change in the standard CGL to cover resulting damage caused by the work of a subcontractor was logically consistent with the "business risk" principles underlying CGL coverage analysis. As was explained by the New Jersey Supreme Court in *Weedo v. Stone-E-Brick*, 81 N.J. 233 (1979), a CGL insurance policy is not a performance bond; it is insurance which

is intended to protect a contractor from liability arising from an accident causing injury to people or damage to property, even if caused by faulty workmanship. Parties to a CGL policy understand that the insured contractor bears the risk of damage caused by the insured contractor's own negligent workmanship, if the property damages are confined solely to replacing the faulty workmanship, where there has been no consequential damage to any other work or property.

Since *Weedo* was decided, these principles have been consistently upheld in several reported cases, so that by 2001 it was well established under New Jersey law, and in most jurisdictions throughout the country, that there is coverage under a CGL policy for property damage caused by faulty workmanship.

In an effort at retrenchment, to turn back the clock to greatly reduced and restricted coverage, beginning in 2001, insurance carriers began issuing Endorsement 2294. The Endorsement returns to a 1970s-era form by eliminating the very "subcontractor exception" the insurance industry itself had devised in the 1970s and adopted in its form CGL policy in 1986 to sell more policies by modifying yet again, the "Your work" exclusion.

Insurance companies have been brazenly adding this endorsement to their CGL policies. It provides as follows:

> **Exclusions:** This insurance does not apply to: ….
> **Damage To Your Work**: "Property damage" to "your work" arising out of it or any part of it and included in the "products completed operations hazard."

The endorsement stops here, replacing, and thus leaving out the subcontractor exception.

This endorsement is intended by the industry, and by the issuing carriers, to remove any coverage for resulting or consequential damage to homes or condominium units arising from work performed by the insured builder's subcontractors. The effect of this change is that if, for example, a subcontractor employed by the developer/general contractor [builder] installs flashings above, below and behind the deck ledger board in such a way that water infiltration occurs, damaging sheathing and framing, the carrier would seek to exclude coverage under the CGL.

Builders must be alert to whether their insurance carriers are charging the same premiums for CGL policies which include this endorsement as they were for policies without the endorsement, even though policies with the endorsement are gutted of this most valuable coverage protection. The full import of policies including Endorsement 2294 and what it means may not be effectively communicated to policyholders, or in some cases, not mentioned at all. Contractors are not always told, nor do they always understand, that they can "buy back" this coverage for an additional premium. Without this protection, they are paying premiums for essentially watered-down policies which afford little real-world protection against the most expensive types of claims they are likely to encounter based on widely ranging and pervasive construction defects, often resulting in millions of dollars of damages.

As a result, contractors are shocked when they are sued for construction deficiencies caused by their subcontractors which cause resulting damage to other property and their carriers refuse to provide them with the indemnity and defense previously afforded to them under standard CGL policies in effect over the last 20 years or more.

Homeowners who have contracted with general contractors expecting them to be fully insured with CGL policies are also in for quite a surprise when they find out there is a problem in recovering damages under the builder's CGL policy, often the only viable recovery source.

As lawyers who handle construction deficiency cases in New Jersey are aware, since 1976 insurance companies have been providing defense and indemnity to contractors from covered claims arising from consequential damage to property, as distinguished from replacement of only the faulty work of the insured contractor. Insurance companies have collected huge premiums for this insurance protection and both contractors and consumers have reasonably come to rely upon this understanding of how CGL coverage works. Recently, however, with the advent of this endorsement, insurance companies have been increasingly changing the rules of the game by quietly deleting the "subcontractor exception," thus laying a trap for the unsuspecting builder or aggrieved homeowner.

It has been reported that some carriers who offer to allow their insureds the opportunity to "buy back" the coverage provided by the subcontractor exception may try to condition this buy back with a requirement that the subcontractor have CGL insurance which names the general contractor as an "additional insured" so that the general contractor is indemnified and defended primarily by the subcontractor's carrier. Unfortunately, many builders and prime subcontractors lack a full understanding of this fundamental change in their insurance coverage, or don't secure the necessary protection by insisting upon, and actually obtaining from their subcontractors, the necessary additional insured protections.

Even if they are offered the chance to "buy back" the subcontractor exception language, in the absence of a coherent explanation of what this coverage means to them, many will choose to save the money and not buy back the coverage. Later, when they are sued for damages caused by construction, design or material deficiencies, these contractors will discover that, although they paid their premiums for CGL insurance, their carrier disclaims providing either a defense or indemnity, leaving the builder with the choice of either paying for a defense and taking the risk of loss upon itself, filing a bankruptcy petition or allowing a default judgment to be entered against it.

Ironically, by issuing Endorsement 2294, ISO and all carriers embracing the endorsement have confirmed, despite protestations over many years, that the basic CGL form containing the subcontractor exception does provide coverage for consequential property damage arising from the subcontractor's work. If that were not the case, Endorsement 2294 would be unnecessary and superfluous. Introduction of Endorsement 2294 is thus the best evidence of the insurance industry's admission that post-1986 CGL policies provide coverage for fortuitous damage caused by faulty subcontractor work.

The current endorsement represents a desperate attempt by the industry at retrenchment, having regretted openly

providing coverage for the unexpected or unintended consequences of bad workmanship. The endorsement is intended to stem the tide of legitimate claims under CGL policies which the subcontractor exception clearly affords. This major inroad into the ephemeral business risk doctrine through Endorsement 2294 is the industry's attempt to put the genie back into the bottle.

Since a strict reading of a policy including Endorsement 2294 may well result in no coverage for consequential property damage arising from the work of subcontractors, it is imperative that general contractors scrupulously avoid buying policies with this endorsement included, and that contractors insist upon policy language consistent with the post-1986 CGL form which provides necessary coverage under the subcontractor exception. ■