

Protecting Against Faulty Workmanship Claims

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Traditionally, general contractors have relied on insurance coverage provided by their own commercial general liability (CGL) policies, as well as additional insured coverage provided by their subcontractors, for third-party protection against claims arising from the faulty workmanship of subcontractors. However, recent court decisions in a number of states have significantly, if not completely, eliminated insurance coverage under a CGL policy for faulty workmanship claims. As an alternative, general contractors should consider having their subcontractors purchase performance and maintenance bonds to provide protection against such claims.

HISTORICAL DEVELOPMENTS

Historically, CGL policies excluded coverage for property damage claims arising out of a contractor's work occurring after the contractor completed the project (i.e., claims covered under the "products-completed operations hazard").

This Damage To Your Work exclusion was modified when the Insurance Services Office (ISO) issued its simplified CGL

policy forms in 1986. Significantly, ISO's 1986 CGL policy form included the following exception to the Damage To Your Work exclusion: "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."

Put simply, this exception effectively provides insurance coverage to a general contractor if the property damage claim took place after the completion of the project and arose from the work performed by a subcontractor.

NEW DEVELOPMENTS

Recent court decisions virtually eliminated any coverage under CGL policies for claims brought against general contractors arising from the faulty workmanship of their subcontractors. The Pennsylvania Supreme Court reached such a conclusion in *Kvaerner v. Commercial Union Ins. Co.*, and similar decisions were reached in Massachusetts, West Virginia, Arkansas and Hawaii.

In *Kvaerner* and following cases, Pennsylvania courts held that no coverage for claims arises from faulty workmanship because such claims do not arise from an

"accident," and therefore are not an "occurrence" within the meaning of a CGL policy. According to the Pennsylvania Supreme Court, such "claims do not present the degree of fortuity contemplated by the ordinary definition of 'accident' or its common judicial construction in this context. To hold otherwise would be to convert a policy for insurance into a performance bond."

Because the threshold trigger for coverage under a CGL policy is whether a claim constitutes an occurrence, and by holding that claims arising from faulty workmanship do not constitute an occurrence, the court never addressed the significance of the existence of the exception to the Damage To Your Work exclusion.

These *Kvaerner*-related decisions not only eliminate coverage for a general contractor under its own CGL policy, but they also eliminate additional insurance coverage that would be available to the general contractor under the subcontractor's CGL policy. In short, in states that follow the *Kvaerner* rationale, general contractors now face the prospect of having no insurance coverage for such faulty workmanship claims.

AN ALTERNATIVE TO CGL COVERAGE

Many carriers in Pennsylvania have responded to these decisions by drafting and issuing so-called “resultant damage endorsements.” These endorsements seek to define an occurrence under a CGL policy to include, under the product-completed operations coverage, property damage claims that arise from the faulty workmanship of a subcontractor. However, each insurer has developed its own damage endorsement, and each endorsement is subject to interpretation by the adjuster handling the claim. As a result, the *Kvaerner*-related decisions created coverage uncertainty and exposed GCs to potential uninsured risk.

General contractors can protect against this uncertainty by requiring their subcontractors to post performance and maintenance bonds. Generally, a performance bond guarantees the subcontractor will perform its work in accordance with the applicable contract (the subcontract), and a maintenance bond guarantees against defective work and materials for a certain amount of time once the project is complete. The bonds represent a third-party

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guarantee from a financially secure surety company.

Under a performance bond:

- The work required under the subcontract is guaranteed, including defective workmanship;
- The subcontractor’s failure to fulfill its obligations under the subcontract is covered for any reason, including financial failure, death of the owner, mismanagement, defective work and material, or the inability to complete the job; and
- Protection is provided through the usual one-year warranty period for a project.

Under a maintenance bond:

- The work required under the subcontract

is guaranteed against defective work and materials for a certain period of time after the work under a subcontract is completed and the surety’s obligation under the performance bond has expired;

- The period of coverage is typically one to two additional years, but longer periods can be purchased; and
- The protection is relatively inexpensive—typically \$1.50 per thousand of the value of the guaranteed work.

Although performance and maintenance bonds may not make sense on every project due to cost considerations or the inability of a subcontractor to obtain bonding, general contractors should consider these as an added level of risk-shifting protection against claims of faulty workmanship.

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