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Insuring Conflicts on the Construction Site

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Résumé de l'article

Le but de cet article est d'examiner les plus récents développements en matière d'assurance construction. Une couverture globale et adaptée aux besoins exige les efforts et la maîtrise de différentes disciplines, notamment dans les domaines juridique et technique. L'auteur tente de démontrer comment le milieu de l'assurance peut répondre aux problèmes les plus particularisés par une analyse exhaustive des principales clauses et conditions en vertu de l'assurance des biens et de l'assurance des responsabilités. La première partie de cet article a été publiée dans le numéro précédent.

Insuring Conflicts on the Construction Site*

by

Eric A. Dolden**

Le but de cet article est d'examiner les plus récents développements en matière d'assurance construction. Une couverture globale et adaptée aux besoins exige les efforts et la maîtrise de différentes disciplines, notamment dans les domaines juridique et technique. L'auteur tente de démontrer comment le milieu de l'assurance peut répondre aux problèmes les plus particularisés par une analyse exhaustive des principales clauses et conditions en vertu de l'assurance des biens et de l'assurance des responsabilités.

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PART TWO OF THREE

E. The Impact of Turnkey or "Desing/Build" Contracts for CGL Coverage

The past two decades have witnessed the development of construction management as a means to improve the efficiency of the construction process, reduce costs and improve the quality of completed construction. That has meant that contractors have increasingly assumed the design function traditionally handled by architects and engineers. Secondly, construction managers have intruded upon a portion of the design and inspection functions of the architect. Many contractors have been quick to act as construction managers without adequate regard to the impact this type of activity

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can have on the contractor's insurance coverage as its activities shift into a "grey area" of design responsibility that raises the spectre of both CGL and E & O coverage. To fully appreciate the potential for problems, it is useful to examine the traditional structure which has existed in the construction setting.

The initial element in the traditional construction alignment is a contract between the owner and the architect or engineer. Utilizing standard form contracts, the architect is normally stipulated to be an agent of the owner and obligates himself to develop a schematic which is ultimately converted into design documents. Customarily, *534* the architect will prepare project specifications and the bidding information. Once construction begins, the architect will assume responsibility for the administration of the construction contract entered into by the owner with the contractor, which could entail site visits, certifying payments to the contractor, interpreting the contract documents, rejecting nonconforming work and determining the date of substantial completion.

The next element in the traditional construction structure entails the owner entering into a contract with the contractor who is contractually obligated to perform the entire construction and provide labour, materials, and equipment in accordance with the contract documents prepared by the prime consultant and his subconsultants. The contractor, in turn, delegates a portion of his obligations to a series of subcontractors, who have expertise in their own chosen fields. The general contractor bears both management and production responsibilities. These obligations are made clear in the 1982 CCDC Form contract which states that the contractor "... shall have complete control of the Work and shall effectively direct and supervise the Work..." (General Condition #25), and "...shall employ a competent supervisor..." (General Condition #26). It is in directing the subcontractors, especially in scheduling and coordinating their work, that the general contractor bears an onerous burden.

1. Alternative Contractual Arrangements

More recently, the construction industry has seen the emergence of the "turnkey" or design/build form of agreement which results in a differing structure. In a turnkey or design/build arrangement, the contractor contractually commits himself to provide

a completed development to the owner. The obligation necessarily entails the land assembly, design, construction, supervision of construction and commissioning of a fully operative facility. This design/build scenario often results in the owner hiring a separate project or construction manager to interact with the design/build firm during the course of construction.

The term *turnkey* arises because the owner has no legal responsibility for the project until the building is completed and the contractor/developer provides the owner with a key to open the door. The "turnkey" contractor/developer in this modern setting bears a greater risk than the customary building contractor in the traditional construction setting. Since the contractor/developer is responsible not only for the building's construction, but as well for its design and performance, the developer essentially warrants that the building is fit for its intended purpose.

Within the traditional structure, without resorting to a desing/build concept, other variations can occur. For example, the owner can engage a series of trade contractors and an architect or engineers on a direct contracting basis. Since no single entity has carriage of the entire construction, the owner will hire a construction manager to bear supervisory responsibility for the on-site work. The presence of a construction manager can alter the traditional contractual structure relationships in subtle ways. While the owner may still hire an architect, at least a portion of the duties traditionally placed in the hands of the architect are now shared with the construction manager. These "shared" responsibilities can include an obligation to inspect to ensure completion, the duty to reject nonconforming work, and certification of that portion of the work completed by the contractor.

The more striking change that occurs by reason of this altered structure arises from the elimination of the general contractor as the manager of the work. Assuming the retention of a construction manager the owner will contract directly with numerous prime contractors. These prime contractors customarily contracted as subcontractors with a general contractor in the more traditional format, but now enjoy a contract directly with the owner. In this arrangement, the construction manager assumes the obligation of coordinating the work, providing a detailed schedule for the completion of the work, and inspecting the contractors.

2. Effect on CGL and E & O Policies

This realignment in the traditional relationships can have a profound effect on insurance coverage, particularly when it is appreciated that the traditional coverages — the CGL and the E & O — inherently assume that the design function is performed by a party distinct in identity from the entity that provides the management of the project. To the extent that each coverage assumes that the insured is providing one function and not both, neither coverage adequately guards against both types of risks should a loss
536 arise when the insured is providing both functions.

There are few reported decisions which examine in a considered way whether the CGL will respond to a general contractor that undertakes a "desing/build" project that entails design responsibility for the completed structure. The decision in *Baugh Construction Co v. Mission Insurance Co., Underwriters at Lloyds's et al,*[1] a 1988 decision of the Washington State courts, serves as a graphic example of how easily a general contractor can lose the benefit of a CGL by engaging in a "desing/build" project. In *Baugh Construction (supra)* the general contractor had contractually assumed liability for design errors, notwithstanding that the plans were prepared by an engineering firm, and, as a result, the court invoked the "professional services" exclusion to deny indemnity to the insured.

The facts in *Baugh Construction (supra)* are worthy of consideration. The general contractor commenced construction of an eleven-storey office structure located close to the Seattle-Tacoma International Airport. Following substantial completion, it was determined that the general contractor had installed floor slabs that lacked adequate reinforcing steel, and that the building's seismic system was defective. The owner had sued the general contractor and the general contractor sought reimbursement for its defence costs. In the tort lawsuit the general contractor defended against four differing types of allegations made by the owner:

(a) a claim of physical damage of the building;

(b) the owner's loss of use of the building;

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[1]836 F.2d 1164 (1988).

(c) diminution in value of the building attributable to the "taint" of having been a defective building;

(d) damage to tenant improvements and the related cost of demolition.

The contractor, having undertaken the design of the building, was met by the insurer's argument that coverage for items (a) and (b) was excluded on the basis of a "professional services" exclusion, which, not unlike the CCDC Form 101 counterpart, read:

> This insurance does not cover liability... arising out of the rendering of, or the failure to render, professional services by or on behalf of the insured, for others, in the insured's capacity as an architect, engineer or surveyor, including, but not limited to, any negligent act, error, omission or mistake involving the preparation of surveys, maps, plans, designs or specifications or supervisory inspection or engineering services furnished in connection therewith.

Notwithstanding that the structural design had been prepared by an architect, the mere fact that the contractor was contractually responsible for any structural design defect excluded indemnity. In the Court's opinion, the contractor's role in acting as an engineer fell squarely within the ambit of the exclusion. It is noteworthy, however, that the "professional services" exclusion only entitled the insurer to avoid any obligation to defend against allegations of negligent design, but did not relieve the insurer of his obligation to defend against claims of negligent construction. While the CGL may provide indemnity for loss attributable to faulty construction, the same cannot be said of loss attributable to site design or supervision not inherent in the actual construction.

The decision in *Baugh Construction (supra)* serves as a clear warning that contractors intending to engage in "desing/build" work, or purporting to act as a construction manager, ought to obtain E & O coverage to ensure coverage where the CGL need not respond.

F. The "Product Itself" Exclusion in the Construction Setting

The construction project poses a variety of risks which potentially are the subject matter of insurance. These risks are of four types:

1. The owner has the risk that the contractor will fail to properly perform his contractual obligations. That risk can be shifted from the owner by means of a performance bond. If the contractor defaults, the owner can look to the surety for indemnification of the cost of repair or of completion of the project. Ultimate responsibility remains with the contractor who is liable to the surety who has completed the work.

2. The owner or the contractor bears the risk that the project may be destroyed by fire or explosion during construction. Who bears that risk during construction depends upon the terms of the contract by ascertaining which party is at risk during construction. That risk is guarded against by means of a Builders' All Risk policy or "course of construction" coverage.

3. The owner and the contractor bear the risk of third-party claims that entail property damage or personal injury as a result of the project being defectively constructed. This risk can be shifted to an insurer by means of the CGL.

4. The contractor bears the "business" risk that it may be liable to the owner resulting from the contractor's failure to properly complete the project in a manner which does not cause damage to it.

This last risk is one that the general contractor can control and which the insurer does not assume. Each of the "care, custody or control," "work performed" and "product itself" exclusions typically contained in the CGL are intended to ensure that the contractor, and not the insurer, bear the "business risks" associated with the project.

It is for this reason that both the IBC Form 2003 and the CCDC Form 101 CGL wordings contain an identically worded "product itself" exclusion which provides:

> This insurance does not apply to...

(i) property damage to the Named Insured's products arising out of such products or any part of such products.

The "product itself" exclusion, like the related "work performed" exclusion, was intended to eliminate coverage for business risks which the contractor undertakes and which can be governed as a matter of contract. Risk allocation of this type lies solely with the contractor and can be governed by means of contractual conditions and warranties. To provide the general contractor with indemnity for matters which are a matter of contract as between the contractor and the owner would amount to a license for the contractor to engage in faulty workmanship, and secondly, would furnish a disincentive for the parties to properly address how and in what manner such risk ought to be allocated.

Accepting this as the rationale for the exclusion, what is of interest is the extent to which that same exclusion alleviates the underlying tension that can arise over those risks which, in many respects, the general contractor cannot control. The most pronounced of these uncontrolled risks is the risk that a subcontractor will cause loss or damage to that portion of the construction project which the general contractor did not in fact construct.

While generally the contractor will be contractually bound to supervise and direct all of the sub-trades, the contractor cannot possibly guard against every contingency that can occur on the construction site. That reality raises the question as to whether, assuming that a general contractor covenants to construct the entire building and yet only constructs a portion of the building, the general contractor can obtain indemnity for loss to those portions of the building which were built by other parties, including the subcontractor.

Decisions on this question are divided as the United States courts attempt to reconcile three underlying sources of conflict:

1. Judicial unwillingness to allow a CGL to be converted into a type of performance bond for the completed project;
2. Even greater judicial unwillingness to allow the contractor's own carelessness to constitute a basis for indemnity if the loss relates solely to the bargain contracted for;

3. Judicial willingness to allow recovery where the policy is ambiguous.

It is useful to examine the divergent lines of authority. Some American courts have concluded that the general contractor's completed building does not constitute a "product." That conclusion allows the general contractor to obtain indemnity for what would otherwise be characterized as a loss that arose from a "business risk." In effect the CGL is converted into a form of performance bond.

540 Representative of this line of authority are decisions such as *Kisell v. Aetna Casualty and Surety Co.*,[2] a 1964 decision of the Missouri courts. The insured had been hired to build a school. In fact the insured undertook the carpentry work and subcontracted the balance of the project. Defects in the building developed following substantial completion. The court concluded that the building of contracting entailed a "service" and that the end product of that service was not in the nature of a "product."

A similar result occurred in *Kammeyer et al. v. Concordia Telephone Co. et al.*[3] The court stated that as the goods or products of the insured are those "created or manufactured and placed in the ordinary channels of commerce, or intended to be so placed" that "any effort to define 'product' as the end result of any activity [such as contracting work]... will be rejected."[4]

In *Mid-United Contractors, Inc. v. Providence Lloyd's Insurance Co.*,[5] a 1988 decision of the Texas Court of Appeal, the insured had been hired to construct an office building for the owner. Following completion the owner alleged that prefabricated brick panels were improperly installed. The evidence demonstrated that the insured had installed inadequate flashing and weepholes causing moisture to be absorbed behind the walls and the steel reinforcing rods to rust which, in turn, resulted in rows of supporting brick to crack.

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[2]380 S.W. 2d 497 (1964).

[3]446 S.W. 2d 486 (Mo App. 1969).

[4]*Supra* at page 489.

[5]754 S.W. 2d 824.

The issue in *Mid-United Contractors (supra)* was whether the general contractor was entitled to a defence. The Court's view was that the completed building did not amount to a "product," but rather, resulted from a service. Unlike retail "products" which are manufactured, a building is erected or constructed. Inferentially, the Court is suggesting that as the predominant component of any construction contract is the labour, and not the materials, a building does not fall within the definition of *Named Insured's Product.*

The case is somewhat anomalous as the result appears to have been shaped, in the writer's view, by the existence of a Broad Form Property Endorsement (BFPE). The BFPE replaced several existing exclusions and extended coverage to property damage resulting from the fault of any subcontractors. For that reason alone the case should be viewed with some caution in terms of its possible application within Canada.

In the writer's view, this approach seriously undermines the true purpose of the CGL. The view that an entire completed building falls within the "product itself" exclusion is more analytically sound. That view is supported by judicial authority which is completely at odds with the decision of the Texas Court of Appeal in *Mid-United Contractors (supra).* In *J. G. A. Construction Corporation v. The Charter Oak Fire Ins. Co.*,[6] a decision of the New York Supreme Court, Appellate Division, the insured, a general contractor, had been sued on two separate building projects. In respect of one building the owner complained of a leaky roof and in connection with the second building it was suggested that the bulkheads of the swimming pool were unsafe.

The New York court, in concluding that the two buildings did constitute the insured's "product," resorted to dictionary definitions suggesting that *product* meant "something produced by physical labour or intellectual effort." While most in the insurance industry would recognize that a completed building is not a product but rather a service, the Court was also mindful of the fact that to conclude that a completed building was a service, rather than a product, would in effect turn the CGL into a performance bond. For that reason it was concluded that the building was the insured's "product" and that the loss was excluded from coverage.

[6]414 N.Y.S. 2d 385.

A similar conclusion was reached in *Knutson Construction Company v. St. Paul Fire and Marine Insurance Company et al,*[7] a decision of the Minnesota courts. In *Knutson Construction (supra)* the general contractor hired to construct an apartment building obtained a CGL with completed operations coverage and a BFPE which extended to operations and completed operations. The insured had agreed to construct the apartment in accordance with plans and specifications prepared by architects and engineers, and secondly, to correct any defects due to faulty materials or workmanship for one year following the date of substantial completion. The insured had
542 subcontracted much of the work including the installation of the windows, prefabricated brick masonry panels, plumbing, heating and ventilation.

Four years following substantial completion, the owner detected cracks, staining and chipping on the exterior brick of the building. Upon further inspection it was determined that the prefabricated brick panels were loose and that the steel connectors were corroding. The owner commenced action against the insured to recover its repair costs.

The Court noted that, unlike previous cases, including *Kissel v. Aetna Casualty & Surety Co. (supra),* the owner's claims against the general contractor entailed solely the cost of correcting defects in the building itself and not third party claims involving bodily injury or other property damage. Quoting from its own earlier decision in *Bor-son Building Corp. v. Employers Commercial Union,* decided in 1982,[8] the Court stated:

> The risk intended to be insured is the possibility that the goods, products or work of the insured, once relinquished or completed, will cause bodily injury or damage to property other than to the product or completed work itself, and for which the insured may be found liable. The insured, as a source of goods or services, may be liable as a matter of contract law to make good on products or work which is defective or otherwise unsuitable because it is lacking in some capacity. This may even extend to an obligation to completely replace or rebuild the deficient product or work. This liability, however, is not what

[7]396 N.W. 2d 229 (Minn. 1986).

[8](1982) Fire and Casualty Cases 88.

> the coverages in question are designed to protect against. The coverage is for tort liability for physical damage to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.[9]

The insurer argued that to allow the risk of loss due to poor workmanship or inferior materials to be shifted to the CGL insurer would be to make the cost of such insurance prohibitive as the policy would, in effect, be converted into a performance bond. While implicitly acknowledging the potential for that type of problem, the Court preferred, instead, to rest its reasoning on the premise that to allow indemnity in these circumstances would provide an incentive to engage in sloppy workmanship. Outlining its concerns the Court stated:

> ... undoubtedly it would present the opportunity or incentive for the insured general contractor to be less than optimally diligent in these regards in the performance of his contractual obligations to complete a project in a good workmanlike manner. To accept the [general contractor's] contention would be to provide the contractor with assurance that notwithstanding shoddy workmanship, the construction project would be properly completed by indemnification paid to the owner by the comprehensive general liability insurer. In and of itself, the incentive for the contractor to fairly and accurately bid a contract in order to secure the job would be removed. Even if such a result would not always be inevitable, the possibility of such consequences, in our view, is incompatible with the general public policy concerning the relationship between owners and contractors.[10]

Other cases supportive of the view that a completed building constitutes the general contractor's "product" include: *S.W. Forest Indus. Inc. v. Pole Bldgs., Inc.*,[11] *Home Indemnity Co. v. Miller*,[12]

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[9]*Supra* at page 93.

[10]*Supra* at page 93.

[11]478 F.2d 185 (9th Cir. 1973).

[12]399 F.2d 78 (8th Cir. 1968).

St. Paul Fire & Marine Ins. Co. v. Coss,[13] *Zanco, Inc. v. Michigan Mutual Ins. Co.*[14]

The opinion expressed in *Knutson Construction Company (supra),* which in the writer's view reflects the court's appreciation of the role that a CGL ought to assume in the construction setting, as contrasted with the role to be assumed by a performance bond, is probably analytically correct. The decision in *Knutson Construction Company (supra)* probably reflects the position that a Canadian court would take if confronted with a similar claim.

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G. The Scope of the "Work Performed" Exclusion in the Construction Setting

The CGL does not indemnify the insured against the consequences of poor workmanship. The consequences of poor workmanship are treated as a business risk to be regulated as a matter of contract law by means of contractual warranties and "hold harmless" provisions. Like the "product itself" exclusion, the "work performed" exclusion is intended to prevent the insured from obtaining indemnity for repair costs due to the insured's defective or deficient work. To do otherwise would convert the CGL into a performance bond. It is for this reason that the IBC Form 2003 wording contains an exclusion which provides:

> This insurance does not apply to :
>
> (j) property damage to work performed by or on behalf of the Named Insured arising out of the work or any portion thereof; or out of the materials, parts or equipment furnished in connection therewith;

This rationale for the exclusion is made clear in *Weedo v. Stone-E-Brick inc.*[15] The contractor sought to obtain a defence in light of a lawsuit brought by a dissatisfied property owner. The New Jersey Supreme Court concluded that the CGL policy "does not cover an accident of faulty workmanship but rather faulty workmanship which causes an accident.". In distinguishing between these two types of risks the Court provided an example:

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[13] 80 Cal App. 3d 888.

[14] 11 Ohio St. 3d 114, 464 N.E.2d 513 (1984).

> When a craftsman applies stucco to an exterior wall of a home in a faulty manner and discolouration, peeling and chipping result, the poorly-performed work will perforce have to be replaced or repaired by the tradesman or by a surety. On the other hand, should the stucco peel and fall from the wall, and thereby cause injury to the homeowner or his neighbor standing below or to a passing autmobile, an occurrence of harm arises which is the proper subject of risk-sharing as provided by the type of poicy before us in this case. The heppenstance and extent of the latter liability is entirely unpredictable - the neighbor could suffer a scratched arm or a fatal blow to the skull from the peeling stonework. Whether the liability of the businessman is predicated upon warranty theory or, preferably and more accurately, upon tort concepts, injury to persons and damage to other property constitute the risks intended to be covered under the CGL.[16]

The most difficult question in the construction setting is determining what properly constitutes the insured's "work."

Generally, the general contractor's "work" is the entire buildings. In contrast, the subcontractor's or supplier's work product is the component part that it constructed or furnished to the site. The contrast in the position of the contractor and subcontractor is best illustrated by the decision in *Indiana Insurance Co. v. DeZutti,*[17] a 1980 decision of the Indiana Supreme Court. In *DeZutti* the general contractor had built a home and seven years after its completion, the owners discovered cracks in the bricks.

The owners brought action contending that the loss was due to settlement caused by improper construction of the footings. The general contractor sought to argue that the exclusion only applied to the defective component of the project which constituted the defective "work." In rejecting that submission, the Indiana court stated:

> [The insured in this case] is a general contractor and his product or work must be the entire project or house which he built and sold. The exclusion for damages to his work arising from the

[15]81 N.J. 233 A.2d 788.

[16]Supra at page 791-792.

> product or work itself will necessarily be broader than a subcontractor's exclusion. A subcontractor's product or work is merely a component part of a larger work or product. Thus, a subcontractor's exclusion would be less encompassing and any damage to the larger work or item caused by his product or work would be damage to the other property which would fall outside exclusions (n) or (o) and be covered. In both situations the exclusion applies to what the insured or those on his behalf worked upon or produced. [18]

546 A similar approach has been adopted by the United States courts. In *Western Employers Insurance Co. v. Arciero & Sons, Inc.* [19] the general contractor had agreed to build a condominium project for the owner. Subcontractors had both designed and built the units together with a retaining wall. Following completion of the project the retaining wall collapsed causing damage to the condominium units.

The insured argued that, while the retaining wall was caught by the "work performed" exclusion, it should be indemnified for damage caused to the condominium units. The Court refused to accept that position, noting that to do otherwise would practically convert the CGL into a performance bond or Builders' All Risk policy. Accepting that the contractor must bear any losses due to repair and replacement of its completed product, the Court stated:

> This makes sense from the standpoint of the insurer and the insured. By excluding repair and replacement losses, the insurer gives the contractor an incentive to exercise care in the workmanship thereby reducing the risk that is covered : damage to property of third parties. Coverage of repair and replacement costs would undermine this incentive. If the work failed the insurer would end up holding the scrap. Excluding repair and replacement costs also reduces the cost of the policy. The insurer is freed from administering frequent claims for minor repairs and can set its rate based on the less frequent but

[17] 408 N.E.2d. 1275.

[18] At page 1280.

[19] 146 Cal. App.3d 1027, 194 Cal Rptr. 688 (1983).

> potentially large claims for damage to the property of others. The contractor bears the cost of repair and replacement which is usually small and, in any event, cannot exceed the cost of total replacement of the work. He is protected from the risk of damage to the property of others which, in contrast, knows no limitation. [20]

Subcontractors have attempted, unsuccessfully, to argue that the "work performed" exclusion diminishes in scope following completion of the building, by arguing that its work product is merged into a larger physical structure. Representative of this attempt is the decision in *Simons et al v. Great Southwest Fire Insurance Co.*[21] The insured had been hired to re-roof a building. Cracking developed following completion, ultimately requiring repair and replacement of all of the defective material and workmanship. While accepting that the cost of removing and replacing the defective material could not be recovered, it was argued that as the damage occurred after the defective product had been integrated into the building, the damage was to the building and not to the insured's product per se. At that point the exclusion no longer applied. The Court rejected that argument noting that the entire roof constituted the insured's work product and it did not cease to be such for the purpose of the exclusion simply because it was physically integrated into the building.

The scope of the "work performed" exclusion has significant implications for the insured performing the role of a construction manager. Many contractors operate construction management divisions that perform no actual construction work, but instead, supervise the work of the sub-trades for an agreed fee. In such circumstances it could be argued that no portion of the physical project constitutes its "work performed" and as a consequence the exclusion has no application.

That approach, arguable in the context of the CCDC Form 101, is untenable in the context of the IBC wording. The latter excludes indemnity for property damage "arising out of the work." That choice of words denotes the performance of the work, as opposed to

[20] Supra at page 690.

[21] 569 F. Supp. 1429 (1983).

physical object, and may be sufficiently broad to encompass the construction manager that merely provides consulting services.

[To be continued in our next issue.]