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CONSTRUCTION LEGAL EDGE

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ARTICLES CONTAINED IN THIS ISSUE OF THE CLE:

Kvaerner Decision Has Been Expanded by Federal Courts thereby Jeopardizing Insurance Coverage for Construction Contractors Under Products-Completed Operations Coverage

Since 2006, Pennsylvania federal and state courts have consistently held that insurance coverage does not exist under standard commercial general liability policies for faulty workmanship that causes harm to the insured's own work or product. The courts justified that rule on the basis that faulty workmanship did not involve the element of fortuity necessary for the loss to be deemed the result of an occurrence, as required by the language of the insuring agreement. Pennsylvania state court cases carved out an exception, however, to that rule when the faulty workmanship injured persons or damaged other property. Newer federal cases, decided under Pennsylvania law, suggest that the faulty workmanship rule ought to be extended to instances of foreseeable damage to other property. So far, no Pennsylvania state court has had the opportunity to extend the faulty workmanship rule to foreseeable damage to other property. Following the lead of the federal courts could result in dire consequences for the construction industry. Contractors and subcontractors often pay considerable sums to obtain protection for such losses by purchasing products and completed operations coverage. If the federal approach takes hold in the state courts of Pennsylvania, products-completed operations coverage could become a shadow of its former self and the construction industry may lose valuable insurance protection for foreseeable losses. To guard against this, the construction industry

needs to develop an increased awareness of policy language and it must consider the feasibility of negotiating modifications to the standard forms or developing self-insured or captive programs that can be tailored to provide the desired coverage.

Commercial general liability policy forms prepared by the Insurance Services Office (ISO is a leading provider of policy forms and other services to the insurance industry) provide coverage for bodily injuries and property damages caused by an occurrence. Such policy forms define the term occurrence to mean an accident, including continuous or repeated exposure to substantially the same general harmful conditions. While the forms do not define the term accident, courts typically construe that term to apply to unforeseen, unexpected, or unplanned events, circumstances or happenings that cause injury or loss. From such policy language, courts have derived the requirement that covered losses must involve an element of fortuity in order to qualify for coverage.

Most commercial general liability policies sold to members of the construction industry provide some measure of protection for losses falling within the products-completed operations hazard. In short, the products-completed operations hazard includes bodily injuries and property damages arising out of the construction company's work. This can either be accomplished through the express grant of coverage for the products and completed operations hazards (as was often the case in policies issued before the early 1980's) or through the omission of or modification to various exclusions that would otherwise restrict the broad grant of coverage made in the insuring agreement. Current ISO forms take the latter approach. In either event, the extension of coverage for products-completed operations comes with a price tag which can be obvious (if a specific premium charge appears in the declarations) or which can be hidden in the composite rates charged for the general liability coverage.

For the purposes of such policies, the products-completed operations hazard includes all bodily injuries and property damages occurring away from the premises owned or rented by the insured and arising out of the insured's work or product, except work or product that has not yet been completed or abandoned. The term "your work" is defined in typical policies to mean work or operations performed by the insured or on its behalf, and it includes warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work." Likewise, the term "your product" is defined to mean any goods or products (other than real property) manufactured, sold, handled, distributed, or disposed of by the insured. It too includes warranties or representations made at any time with respect to the fitness, quality, durability, performance, or use of "your product."

The leading case in Pennsylvania regarding coverage for allegations of faulty workmanship is the Pennsylvania Supreme Court case of Kvaerner Metals Division of Kvaerner U.S., Inc. v. Commercial Union Insurance Co., 589 Pa. 317, 908 A.2d 888 (2006). In that case, the insured agreed to build a coke oven battery for a steel mill. There were numerous defects in the

work, but the only property damaged was the coke oven battery itself. The steel mill sued for the cost to replace the coke oven battery or the difference in value between the defective battery that it received and the one that the insured warranted that it would deliver. The insured sought defense and indemnity under two commercial general liability policies issued by National Union. After National Union denied coverage, the insured brought a declaratory judgment action. National Union resisted coverage on several bases, including the argument that there was no occurrence.

The court began its analysis by noting that the policies defined the term occurrence to mean an accident, but that they lacked a definition for the term accident. It then consulted a common dictionary definition of that term to determine its ordinary usage, noting that an accident was an unexpected and undesirable event or something that occurred unexpectedly or unintentionally. The court concluded that the key term in the ordinary definition of the word accident was "unexpected." The court then said "[t]his implies a degree of fortuity that is not present in a claim for faulty workmanship."

The court then discussed Snyder Heating Co. v. Pennsylvania Manufacturers' Association Insurance Co., 715 A.2d 483 (Pa. Super. 1998), which the court said reached a similar conclusion regarding the construction of the word accident. Snyder Heating involved allegations of damage to a school's boilers due to the insured's failure to maintain them properly. The Superior Court in that case held that there was no coverage under a commercial general liability policy because the complaint set forth solely claims for breach of contract. It explained that provisions of a general liability policy provide coverage if the insured work or product actively malfunctions, causing injury to an individual or damage to another's property. The Supreme Court drew from that case the proposition that contractual claims of poor workmanship did not present the active malfunction needed to establish coverage under such a policy.

The Supreme Court in Kvaerner then discussed several cases from other jurisdictions recognizing the proposition that a commercial general liability policy may provide coverage when faulty workmanship caused a bodily injury or damage to other property, but not in cases when the faulty workmanship damaged the work product alone.

It ultimately concluded that the definition of accident required to establish an occurrence under such policies could not be satisfied by claims based upon faulty workmanship. "Such claims simply do not present the degree of fortuity contemplated by the ordinary definition of 'accident' or its common judicial construction in this context." It added that, "[t]o hold otherwise would be to convert a policy for insurance into a performance bond." The court was unwilling to do so, especially because such protections were readily available for this contractor. Indeed, the court noted that the contractor did recover under a builder's risk policy, as well as under a professional liability policy.

Nearly a year later, the Superior Court reached a similar conclusion in Millers Capital Insurance Co. v. Gambone Brothers Development Co., 941 A.2d 706 (Pa. Super. 2007). In that case, the insured contractor built two housing developments. A number of the homes experienced water leaks due to construction defects. After the affected homeowners brought suits against the contractor, it sought coverage under its commercial general liability policy. Coverage litigation soon followed.

The insured tried to distinguish Kvaerner on the basis that the underlying actions did not merely involve claims for faulty workmanship that led to the failure of the stucco exteriors, but they also involved claims for ancillary and accidental damage caused by the resulting water leaks to non defective work inside the homes. The Superior Court saw no merit to the attempted distinction. Rejecting the insured's argument, it noted that both Complaints filed against the insured alleged that, when the defects manifested themselves, water damage resulted to the interior of the larger product, the home interiors. The court went onto note that the weight of common sense collapsed the distinction that the contractor attempted to create. The court noted that Kvaerner held that the terms occurrence and accident in a commercial general liability policy contemplated a degree of fortuity that did not accompany faulty workmanship. Continuing on, the Superior Court explained that the Supreme Court, in Kvaerner, "suggested that natural and foreseeable acts, such as rainfall, which tend to exacerbate the damage, effect, or consequences caused *ab initio* by faulty workmanship also cannot be considered sufficiently fortuitous to constitute an 'occurrence' or 'accident' for the purposes of an occurrence based CGL policy."

Based upon Kvaerner and Millers Capital, it appears that Pennsylvania law denies coverage to an insured only when its faulty workmanship causes damage to the work or product itself, but leaves open the possibility for coverage when other property has been damaged.

Two Third Circuit decisions, however, have expanded the application of Kvaerner to situations involving foreseeable damage to other property.

In Nationwide Mutual Insurance Co. v. CPB International, Inc., 562 F.3d 591 (3d Cir. 2009), the insured supplied chondroitin to a company that combined it with glucosamine and other ingredients to manufacture nutritional tablets for sale to people who suffered from osteoarthritis. When a dispute arose over payment for the chondroitin, the purchaser filed a counterclaim alleging that the chondroitin was deficient, of improper composition, and unusable for its intended purpose. The customer sought a return of its initial payment for some of the chondroitin and consequential damages. The consequential damage claim sought to recover the value of other ingredients that had been combined with the defective chondroitin. The insurance company denied coverage and brought a declaratory judgment action.

The insured argued that Kvaerner was not controlling precedent because the consequential

damages (value of other ingredients that was combined with defective chondroitin came within the ambit of the policy. Rejecting that argument, the Third Circuit noted that the precise holding of Kvaerner was limited to claims that averred only property damage from the work product itself due to poor workmanship, but the Third Circuit explained that "the foundation of that holding is that claims for faulty workmanship 'simply do not present the degree of fortuity contemplated by the ordinary definition of "accident" or its common judicial construction in this context.'" The Third Circuit noted that "it is largely within the insured's control whether it supplies the agreed-upon product, and the fact that contractual liability flows from the failure to provide that product is too foreseeable to be considered an accident."

The Third Circuit rejected the insured's alternative argument that even if the delivery of defective chondroitin were not considered to be an accident, the purchaser's use of it should be considered one. The court explained that it was certainly foreseeable that the purchaser would use the product for the purpose for which it was sold; otherwise, it would lack a claim for consequential damages. Thus, the court concluded that the degree of fortuity in that case was no different than that involved in Kvaerner. In that regard, the Third Circuit buttressed its decision by reference to Millers Capital v. Gambone. The Third Circuit stated that the Superior Court, in Millers Capital v. Gambone, interpreted Kvaerner "as stating that 'natural and foreseeable acts … which tend to exacerbate the damage, effect or consequences caused *ab initio* by faulty workmanship also cannot be considered sufficiently fortuitous to constitute an "occurrence" or "accident" for the purposes of an occurrence based CGL policy.'"

In Specialty Surfaces International, Inc. v. Continental Casualty Co., 609 F.3d 223 (3d Cir. 2010), the court again rejected an argument that damage to other property removed the case from the Kvaerner rule. In Specialty Surfaces, the insured was engaged by a general contractor to provide synthetic turf football fields and all weather tracks at four schools. The general contractor prepared the base for each field. About one year after installation, the turf systems began to show defects in materials and workmanship. In addition, the fields experienced failures of the drainage systems. As a direct result, water leaked from the subdrain system into the subgrade, dirt was washed away from the subgrade, the subgrade settled, and soil stabilizers remulsified. Consequently, the fields developed depressions and unstable playing surfaces. Initially, the insurance company refused to defend it insured, Specialty Surfaces. However, after an Amended Complaint was filed, it agreed to defend subject to a reservation of rights. The insured then commenced a declaratory judgment action seeking defense and indemnity. In that action, the insured contended that the insurer was required to provide a defense when it received notice of the original Complaint and the Amended Complaint because they alleged damage to another party's work product.

The Third Circuit held that the insurance company did not have a duty to provide coverage with regard to the original Complaint, which alleged that the insured breached its contract by failing to make good defects in materials and workmanship in a timely fashion. That claim

constituted a breach of contract claim that was not an occurrence under Pennsylvania law.

With regard to the Amended Complaint, the Third Circuit held that the insurance company was not required to defend because the Amended Complaint did not support any determination that there were damages caused by an occurrence. "Any damages to [the insured's] own work product based on [the insured's] alleged negligence are claims of damage based on faulty workmanship." Relying upon Kvaerner, the Third Circuit deemed them not to be a covered occurrence under the policy.

The Third Circuit specifically rejected the insured's argument that damage to the subgrade (installed by the general contractor) was accidental and, thus, a covered occurrence. The court regarded this argument to be foreclosed by the Superior Court's decision in Millers Capital v. Gambone. The court explained that "damages that are a reasonably foreseeable result of the faulty workmanship are also not covered under a commercial general liability policy." The court further explained that Superior Court, in Millers Capital v. Gambone and in following Kvaerner, "clearly focused on whether the alleged damage was caused by an accident or unexpected event, or was a foreseeable result of the faulty workmanship when deciding whether the policy covered the damage." The court concluded that water damage to the subgrade was a foreseeable result of the failure to supply a suitable liner or to ensure the proper design, manufacture, or installation of the synthetic turf and subdrain system.

If the federal approach is adopted by the Pennsylvania state courts, the implications on products completed operations coverage could be drastic. Coverage would no longer be available to contractors and subcontractors for foreseeable damage to property of others.

In order to guard against this unfortunate outcome, members of the construction industry must be familiar with the standard policy forms and the gloss placed upon them by the courts. Unsuspecting policyholders could purchase policies believing that coverage would be available under the products-completed operations hazard only to learn, after a loss, that the desired coverage would not be provided. Insurance professionals or legal counsel familiar with coverage could be consulted to determine the scope of coverage before losses may occur. Equipped with the proper knowledge and guidance, insureds could attempt to negotiate changes to the basic forms in order to accommodate their needs. Larger and more sophisticated entities could try to avoid the restrictions of the commercial insurance marketplace by creating their own self-insured or captive insurance programs, for they would have sufficient control over their programs to design them in a way that would ensure that coverage would be provided.

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Can a Construction Company Get Around the "Your Work" Exclusion in a Standard CGL Policy of Insurance if it is Sued by an Owner for Faulty Workmanship?

If an owner sues a construction company for faulty workmanship, is there insurance coverage under the terms of the construction company's standard Commercial General Liability (CGL) policy? The answer is that a CGL policy does not provide coverage for the cost to repair the damage to the construction company's own work based on the "your work" policy exclusion.

Can a construction company get around the "your work" policy exclusion when it approaches its insurance company and requests insurance coverage for a claim by an owner? The answer is generally no. Note, however, if it is the construction company's subcontractor who causes damage to the construction company's work, there may be coverage under the "subcontractor exception" to the "your work" exclusion provided that there is an "occurrence". The problem is that the federal courts in Pennsylvania have been interpreting the term "occurrence" narrowly. See the article in this issue of the *Construction Legal Edge* titled "Kvaerner Decision Has Been Expanded by Federal Courts, thereby Jeopardizing Insurance Coverage for Construction Contractors Under Products-Completed Operations Coverage."

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How Some States Are Getting Around the Narrow Interpretation Given by the Courts of the Term "Occurrence" in CGL Policies

As an introduction to this article, it is recommended that you review the following articles in this issue of the *Construction Legal Edge*:

1. Kvaerner Decision Has Been Expanded by Federal Courts thereby Jeopardizing Insurance Coverage for Construction Contractors Under Products-Completed Operations Coverage;

2. Can a Construction Company Get Around the "Your Work" Exclusion in a Standard CGL Policy of Insurance if it is Sued by an Owner?

Legislation in a number of states was designed to get around court decisions that limited coverage for faulty workmanship that did not qualify as having been caused by an "occurrence".

In May 2011, South Carolina enacted into law pro-policyholder legislation aimed at combatting a narrow interpretation of the term "occurrence". The statute states:

"Commercial general liability insurance policies shall contain or be deemed to contain a definition of 'occurrence' that includes: (1) an accident, including continuous or repeated exposure to substantially the same general harmful conditions; and (2) **property damage** or bodily injury **resulting from faulty workmanship**, exclusive of the faulty workmanship itself." (Emphasis supplied.)

The South Carolina statute provides coverage for property damage resulting from faulty workmanship. Although the statute does not eliminate the effect of the "your work" exclusion, it makes clear that damages flowing from faulty workmanship constitute an "occurrence" that would be covered under standard CGL policies.

Similar legislation has been introduced in Arkansas and Hawaii. In fact, the Arkansas legislation became law in March 2011.

If Pennsylvania follows the lead of the above states and enacts legislation similar to that in South Carolina, then there would be insurance coverage for construction companies in a situation when a subcontractor's faulty work causes damage to the general contractor's work under the "subcontractor exception" to the "your work" exclusion. At this time, no bills have been introduced in the Pennsylvania legislature that state that faulty workmanship constitutes a covered "occurrence" under standard CGL policy. If the legislature does not change the law and the Pennsylvania Supreme Court adopts the federal courts' approach, then the "subcontractor exception" to the "your work" exclusion may not be available to construction contractors when requesting insurance coverage under their CGL policies for property damage resulting from faulty workmanship.

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Are You Ready for the Construction Workplace Misclassification Act?

Earlier this year a statute took effect in Pennsylvania that may significantly affect any company in the construction business in Pennsylvania. The new statute sets forth specific and detailed criteria that contractors must be able to establish before individuals providing services to them can properly be classified as "independent contractors" for purposes of workers' compensation and unemployment compensation.

The provisions of the statute are demanding and are intended to force contractors to seriously assess whether the individuals providing services to them are truly "independent contractors" or are more appropriately considered to be employees. First, the new Act applies to all entities engaged in the "construction" business in Pennsylvania. The definition of "construction" is very broad. It includes: erection, reconstruction, demolition, alteration, modification, custom fabrication, building, assembling, site preparation, and repair work done on any real property or premises under contract, whether or not the work is for a public body and paid for by public funds.

Once it is determined whether the new Act is applicable to your business, the question of whether the individuals providing services to your company are "independent contractors" comes under close scrutiny. Most significantly, the statute provides that an individual who performs services in the construction industry for remuneration can be classified as an independent contractor only if the individual has a written contract to perform those services. This represents a significant change for some employers who may be operating under the understanding that an oral agreement with an individual can establish the existence of an independent contractor relationship. That notion of an oral understanding has now been eliminated.

Second, the statute provides that an individual will not be considered to be an independent contractor unless they are "free from control or direction over performance of such services under both the contract of service and in fact." That is, both the written contract between the individual and the construction company and the facts of the services being provided must establish that the individual providing those services is free from the control and direction over that performance.

Third, the statute provides that no individual will be deemed to be an independent contractor unless the individual is "customarily engaged in an independently established trade, occupation, profession, or business." To be "customarily engaged in an independently established trade, occupation, profession or business" the individual must possess the essential tools, equipment or other assets to perform the services being provided; the individual must realize a profit or suffer a loss as the result of performing those services; the individual must perform those services through a business in which they have a proprietary interest; must maintain a business location that is separate from the location of the entity for which the services are being performed; must have previously performed the same or similar services for other persons or hold himself out to other persons as able and available to perform those services; and maintained liability insurance during the term of the contract of at least $50,000.00.

Factors which have often been used to establish the existence of an independent contractor relationship will now no longer be considered in determining whether an independent contractor relationship exists. Traditionally, employers would point to the lack of withholding for federal or state income taxes and the lack of payment of contributions for unemployment compensation and the lack of payment of workers' compensation premiums as factors which would tend to establish the existence of an independent contractor relationship. The statute now specifically provides that those factors will not be considered.

Companies that fail to properly classify individuals as employees within the framework set forth in the Construction Workplace Misclassification Act run the risk of having individuals who had previously been considered to be independent contractors be classified, now, as employees and, therefore, resulting in liability to employers for workers' compensation benefits and unemployment compensation benefits. In addition to this effect, employers also run the risk of the imposition of penalties ranging from a criminal misdemeanor charge for an intentional violation to a $1,000.00 summary offense, or other administrative enforcement, which can result in the imposition of significant fines and the issuance of a stop-order for a construction site.

It is important, then, that construction companies examine their relationships with individuals providing services, particularly those that have been treated as independent contractors, to assure compliance with this new statute. The Act is clear in requiring a written agreement and is clear in identifying what factors must be addressed in the contract in order for the relationship to truly be considered that of an independent contractor. Failure to do so can result in the unintended consequence of having the individual be treated as an employee.

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Contractors Beware: Increased Exposure for Injuries on Owner's Property

Are property owners responsible for construction related injuries that occur on their property during construction projects? For years, the general rule of non-liability has been swallowed up by exceptions leading to confusion and uncertainty for all involved. The recent Pennsylvania Supreme Court case, Beil v. Telesis Construction, Inc., 11 A.3d 456 (Pa. 2011), sets the record straight and restores in large measure the rule of non-liability for property owners.

To understand the impact of Beil, one must understand the debate which has occurred

regarding the issue of responsibility for injuries at a construction site. Pennsylvania Courts had historically ruled that property owners who employ independent contractors are not liable for injuries to employees of the independent contractor. This "general rule" however, began to erode over time, and more exceptions began to foist liability unto the property owner for an independent contractor's injuries. The most notable exception to the general rule has been the "retained control" exception. This exception comes into play when an owner retains control of the means and methods of performing the work, or in plain terms, controls the way the work is performed. This "retained control" can be evidenced by any number of actions of the part of the owner, and have in the past included things such as an owner's representative being present at the work site, or owner involvement with safety inspections or work site coordination. The theory behind the "retained control" exception was that if a property owner was involved in the project, they should have been on notice of the dangerous condition. Given that owners of large commercial projects routinely assign a work site representative, plaintiffs were successful in overcoming the "general rule" and apportioning a percentage of liability against the property owner.

That is until the Beil decision put a stop to the erosion of the "general rule". In Beil, an employee of a roofing contractor was injured when he fell from scaffolding that was not OSHA compliant. He sued the property owner as well as several other parties. The owner moved for Summary Judgment arguing the "general rule". The Motion was denied and the case proceeded to trial with a verdict in favor of the plaintiff. The owner was apportioned 35% of the liability.

On appeal to the Superior Court, 961 A.2d 1268 (Pa. Super. 2008), the trial court's denial of the owner's motion for judgment notwithstanding the verdict was overturned. The Superior Court cited the "general rule" and stated that the owner has no duty to warn the contractor or its employees of dangers that are at least as obvious to the contractor. The plaintiff then filed an appeal to the Pennsylvania Supreme Court.

The Supreme Court focused the issue on the whether the owner retained sufficient control over the work to be legally responsible for the plaintiff's injuries. The Court determined that the owner did not and stated that an owner can only be found liable when the owner has "control [over] substantial portions of the work at issue". It is not enough "control" merely because an owner has "the general right to order work stopped or resumed or to suggest changes or recommendations to the work which need not necessarily be followed, or to prescribe alterations or deviations. … There must be such retention of a right of supervision that the contractor is not entirely free to do the work in his own way."

In reaching this decision, the Court addressed the issue of work place safety. It

determined that safety related conduct on the part of the owner, such as owner representatives walking the site, did not constitute the type of retained control that leads to owner liability. The Court emphasized the public policy of encouraging attention to safety matters and promoting work place safety and thus held that safety related conduct does not constitute "control". Further, the Court held that an owner's refusal to allow contractors access to certain areas of their property ("work site access"), also did not constitute control.

This ruling, while favorable for owners, presents a reminder to contractors that "the buck stops with them" when it comes to safety. To assume that a property owner will share in any judgment for damages incurred on the construction site, merely because an owner's representative is present on the site, or a clause in the contact permits the owner to review safety standards would be remiss.

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