

BINDING AUTHORITY

Insurance Coverage Decisions: Issued Today - Impact Tomorrow



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Editor's Note (as if there really is an Editor of this thing): Lately *Binding Authority* has been all about the Pollution Exclusion and license plates (and a plug or two, or five, for "[Insurance Key Issues](#)"). Today *Binding Authority* happily returns to its core mission – discussion of a recent decision, on a widely-followed issue, in a jurisdiction of importance, with not a huge body of existing case law, a national split of authority and an outcome that leaves one side shaking its head in a state of disbelief. Ironically, *Binding Authority's* return to seriousness comes in the April 1st issue.

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New York State Of Bind For Policyholder: District Court Does Not Allow General Contractor To Reach The “Subcontractor Exception”

Start spreading the news. A New York court has issued an opinion addressing coverage for construction defects. Construction defect – the coverage issue that never sleeps. The court cut through the heart of it and said that a CGL policy is not a vagabond, err, performance bond. Other insurers will want to be a part of it. If this decision can make it here, it can make it anywhere. [My goodness. That was awful. That has got to be the worst *Binding Authority* opening ever. Sorry. I've been struggling lately with these.]

I've always found it curious that, while New York is the real estate capital of the world, the state does not have a large body of case law addressing coverage for construction defect. That is not to say that there is none. There certainly is. But the state's highest court has never addressed the issues. As a result, the law is based on a few Appellate Division cases (with the most frequently cited one being nearly 20 years old) and a hodgepodge of trial court and federal court decisions.

I would have expected a different situation when it comes to New York law and CD coverage. But then again, maybe it makes sense. Given how expensive construction is in New York, those who can afford to build something there can also seemingly afford to

make sure that it is done right. They probably don't use Legos to build houses in New York like they do in some states.

Despite it being unpublished and from a federal court, last week's decision from the Eastern District of New York in *Aquatectonics, Inc. v. Hartford* is definitely worthy of note. *Aquatectonics* contains paradigm construction defect coverage facts – a general contractor seeking coverage for property damage caused by the work of a subcontractor. While the decision addresses the issue that is at the heart of the national battle over coverage for construction defects – whether faulty workmanship is an “occurrence” – it does so, much more importantly, in the context of how the “occurrence” issue impacts the “subcontractor exception” to the “your work” exclusion. That's the real issue when it comes to coverage for CD. The *Aquatectonics* opinion also contains a good discussion of New York law to date concerning coverage for construction defects. It summarizes the law and provides the cites to the main cases in the area. It will be a good place to start when confronted with a New York CD case.

Aquatectonics, Inc. v. Hartford addressed coverage under the following circumstances. In 2008, K & D Wright & Co. Construction, Inc. was retained as a general contractor in connection with a residential construction project in Water Mill, New York. K & D engaged Loeb's & Gordon PoolCraft as a subcontractor to construct and install a swimming pool (which would include the installation of glass mosaic tiles). Loeb's, in turn, retained a sub-subcontractor, Top Tile, to install the glass mosaic tiles. Prior to the job's completion, a mild 'shading' condition was visible at several locations, consisting of geometric shapes that tracked some of the sheets of installed tiles. Because the tiles used were a “custom blend,” it was unknown if this how they were supposed to look. After the pool was filled with water, the mild shading conditions, that no one had previously stated to be unacceptable, dramatically darkened and expanded. K & D ultimately determined that the installation of the glass mosaic tiles was unsatisfactory, and the work had to be re-done. *Aquatectonics* at 3-4.

A Loeb's employee who participated in demolishing the tile job was of the opinion “that a contributing factor to the damage was that the pool was filled with water too early in relation to the grouting, so that the grout not having cured sufficiently had allowed moisture to get behind the tiles that was affecting the condition of the setting bed.’ ... The tile itself was not ‘physically injured[,] but had to be demolished because it was inextricably embedded in the physically injured substrate beneath it.’” *Id.* at 4.

K&D commenced an action against Loeb's. K&D alleged that Loeb's negligently, carelessly and recklessly constructed and installed the swimming pool, including the glass mosaic tiles, which resulted in several defects throughout the swimming pool. As a result, K & D was required to remove the mosaic tile improperly installed and purchase and install replacement mosaic tile, and incur other additional expenses in connection with remedying the defects. *Id.* at 5.

Loeb's notified Hartford, its CGL insurer, of the K&D action and sought defense and indemnification. Hartford refused to defend or indemnify Loeb's on the basis that there had been no “occurrence” within the meaning of the Policy, and also on the basis of

various exclusions. Loeb sent Hartford several letters informing it of Top Tile's involvement as a subcontractor, and argued that the Subcontractor Exception to the "Damage to Your Work" exclusion applied. Hartford did not change its position. *Id.* at 5-6.

The *Aquatectonics* court turned to the frequently cited 1994 Appellate Division decision in *George Fuller v. USF&G* for New York's rule concerning coverage for construction defects:

A CGL policy does not insure against faulty workmanship in the work product itself but rather faulty workmanship in the work product which creates a legal liability by causing bodily injury or property damage *to something other than the work product*. The policy was never intended to provide contractual indemnification for economic loss to a contracting party because the work product contracted for is defectively produced.

Id. at 10 (quoting *Fuller*) (emphasis added by *Aquatectonics*).

Based on this rule, the *Aquatectonics* court had no difficulty concluding that no coverage was owed to Loeb because any damage was not caused by an "occurrence."

The Underlying Action alleges that faulty workmanship in connection with the installation of tile in the pool caused damage only to the pool—and not to anything other than the pool. Moreover, the Underlying Action seeks damages solely in connection with the costs incurred in remedying those defects. Because "an 'occurrence' of property damage under a CGL policy cannot exist where a[] contractor's 'negligent acts only affect[] [the property owner's] economic interest in the [work product],' "i.e., the sub-standard pool, the Court finds that the property damage alleged in the Underlying Action did not arise from an "occurrence" under the Policy.

Id. at 10-11.

Having determined that the property damage to the pool did not arise out of an "occurrence," the court concluded that it "need not determine whether any exclusions from coverage would apply." *Id.* at 12-13. Therein lies the most important part of the opinion.

Loeb argued that it was entitled to coverage (or there was a reasonable possibility that it was entitled to coverage) because a subcontractor (Top Tile) performed the tile work on the pool. While Loeb agreed that the "Your Work" exclusion would ordinarily exclude coverage for damage to the pool, the Subcontractor Exception to the "Your Work" exclusion (pursuant to which coverage for damage arising out of Top Tile's work would not be excluded) affords coverage. *Id.* at 14. Loeb sought for the court to follow the lead of other jurisdictions that "read policy language initially granting coverage together with exclusions and exceptions to exclusions (such as the Subcontractor Exception) in order to determine whether costs to repair property damage resulting from faulty workmanship should be covered." *Id.*

The court rejected Loeb's effort: "Unfortunately for Loeb's, however, it has cited no authority within either New York State or the Second Circuit that would support its position. In fact, as set forth at length above, New York and Second Circuit courts addressing this issue have come down squarely on the opposite side. There is, simply put, no authority from within this jurisdiction that would support Loeb's argument, and the Court is not persuaded by the cited outside authority." *Id.* at 15.

The morale of the *Aquatectonics* story is simple and one that many courts follow, to the consternation of policyholders. The *Aquatectonics* court's determination, at the outset, that damage solely to an insured's work product was not caused by an "occurrence" ended the discussion right there. By concluding that coverage was not owed, because the "occurrence" requirement of the Insuring Agreement had not been satisfied, the exclusions did not need to be reached. In particular, there was no need for the court to reach the "Your Work" exclusion, which really means that there was no need for the court to reach the "Subcontractor Exception" to the "Your Work" exclusion. As a result, despite the fact that Loeb's used a subcontractor to install the mosaic tiles, coverage nonetheless remained unavailable for damage caused by its subcontractor's work.

A copy of the Eastern District of New York's March 23 decision in *Aquatectonics, Inc. v. Hartford* is attached.

Please let me know if you have any questions.

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