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Construction Defects and the Space Between: Gap and Overlap In the Combined Coverage of Performance Bonds and CGL Policies for Construction Defects

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Commentary

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Among other harbingers of a gradually convalescing economy, construction activity is on the rise, and is projected to remain on that trajectory throughout 2014.[1] As a consequence of such growth, there will also be an increase in construction-related loss and an inevitable uptick in construction litigation. Although few of its consequences are certain, both surety bonds and CGL cover will likely be implicated simultaneously by many of the same claims.

> Potential loss scenarios abound. Consider, for example, this common fact pattern:
>
> State decides to build a new Convention Center. An architect and design company issue preliminary plans, and State solicits bids from general contractors. State selects Contractor to be the general contractor, and requires Contractor to procure performance and payment surety bonds. Contractor also obtains commercial general liability ("CGL") cover. Contractor later builds the Convention Center and receives payment for its work. Six years later, State discovers significant leaks in the roof, due to latent defects in the roofing material used by Contractor and defective work performed by the Contractor's roofing subcontractor. State sues Contractor and its surety for the costs of repairing the roof, damages to other portions of the Convention Center and its contents caused by the leaks, as well as its costs associated with the conventions and other events it was forced to cancel during repairs. In an attempt to bring deeper pockets to the table, State also sues Contractor for negligence, seeking to trigger Contractor's CGL cover. Contractor, in turn, tenders the claim to its CGL carrier.

Under this scenario, the surety's obligations may not be triggered at all. Even if the surety's obligations were triggered, the surety might not be required to pay if the Contractor remains a financially viable company, and there is no default. Any obligation of the CGL carrier to defend or indemnify will, of course, depend on the facts of the case and State's law. Consider,

however, Contractor's near-term default risk, as portended by the more generic, market-wide comments of a major broker:

> [There is] pent up demand, particularly for infrastructure projects where needed improvements are being delayed, but eventually will need to be addressed. A rapid up-turn in the economy will create a potential increase in default risk as contractors will need to shift from a slower cash flow environment to an accelerated need for cash to expand backlog.[2]

Assume that the broker's prognostication comes to fruition in the case of Contractor, and that Contractor becomes insolvent. In that event, the multi-million dollar question is "who pays" for the damage and loss occasioned by the referenced construction defect — the surety, the CGL carrier, both, or *neither*? Notwithstanding the seemingly expansive coverage provided by each product, it is possible that neither the surety nor the CGL carrier will cover the subject loss. This article addresses the array of risks that may reside in the "space between" a performance bond and CGL cover in these circumstances.

I. Background

A. Surety Bonds

Surety bonds are used by the construction industry to shift the risk of contractor default and non-payment for labor and materials by the contractor from the owner of a project to the surety. There are two principal types of construction bonds: performance and payment. At the most rudimentary level of analysis, the scope of a surety's obligations is determined by the specific terms of its bond.[3] Payment bonds protect subcontractors and suppliers who provide labor and materials to a project, in the event the contractor fails to pay them.[4] Performance bonds typically protect the project owner from a contractor's failure, inability or refusal to complete the work required by the construction contract.[5] This article focuses on a surety's obligations under its performance bond.

Performance bonds represent an optional feature of a private construction project. In material contrast, performance bonds are required by federal or state statutes in the context of most government construction projects. For example, the Miller Act requires that a contractor working on a federal project obtain a performance bond. *See* 40 U.S.C. § 3131(b)(1).[6] In addition, many states have enacted "little Miller Acts," which require contractors to obtain performance and payment bonds to support their state construction project contract obligations.[7]

B. Commercial General Liability Insurance

Owners and contractors also generally obtain CGL cover, in order to protect themselves against unexpected loss and liability arising from their construction activities.[8] Common CGL wording provides that the insurer will pay those sums that the insured becomes "legally obligated to pay" as damages because of "bodily injury" or "property damage" caused by an "occurrence."[9] CGL wordings also obligate the insurer to defend its insured against any suit seeking such damages.[10] An "occurrence" is commonly defined as an "accident, including continuous or repeated exposure to substantially the same general harmful conditions."[11] CGL policies do not define "accident," or the specific attributes of an "accident" in the construction context, thereby leaving more precise definition to the courts, which have issued diverse pronouncements. *See infra* Part II.A.2.i.

In addition, CGL coverage grants are limited by various exclusions, some of which may apply, in certain circumstances, to construction defect claims. In fact, it is generally acknowledged that CGL policies do not cover insureds for risks assumed in the normal course of business. *E.g.*, Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations: What Every Lawyer Should Know*, 50 Neb. L. Rev. 415, 441 (1971).[12] This principle derives primarily from the content of "business risk" exclusions embedded in the CGL policy form. *See infra* Part II.A.2.ii.

For example, Exclusion (j)(6) to the standard (ISO) form CGL policy precludes coverage for property damage to "[t]hat particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it."[13] An exception to this exclusion reinstates cover for "property damage" included in the "products-completed operations hazard." Generally speaking, the "products-completed operations hazard" refers to damage arising from the insured's work occurring after that work is "complete."[14] Reading the exception and the exclusion

together, Exclusion j(6) precludes coverage for property damage arising out of the policyholder's continuing operations.

Another exclusion often encountered in the context of construction defects is Exclusion (l) — "Damage to Your Work" — which is commonly known as the "your work exclusion." Exclusion (l) precludes coverage for " 'property damage' to 'your work' arising out of it or any part of it and included in the 'products-completed operations hazard.' "[15] In other words, unlike Exclusion j(6), Exclusion (l) bars coverage for damage to the insured's work *after* the insured's work is complete. A "subcontractor" exception to the exclusion reinstates cover, "if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor."[16]

Other "business risk" exclusions that may be implicated by construction defect claims include: Exclusion (k), which precludes coverage for damage to the policyholder's own products; Exclusion (m), which eliminates coverage for certain economic damages to property rendered less valuable by the policyholder's work; and Exclusion (n), which bars cover for damages incurred by the policyholder for the withdrawal or recall of the policyholder's product or work from the market because of a known or suspected defect.[17]

Finally, CGL policies may include any number of endorsements which alter the scope of coverage provided by the form. For example, a products-completed operations endorsement ("PCOH") may either *extend* or *eliminate* coverage for damages falling within the PCOH. As the illustration suggests, such amendments can dramatically expand or limit an insurer's liability for construction defect claims. Endorsements, however, must be read in conjunction with the policy exclusions. For example, even if an endorsement extends coverage for damages falling within the PCOH, if Exclusion l does not contain a subcontractor exception, coverage may not exist for damages falling within the PCOH.

C. So What's The Difference?

As noted above, a performance bond is not an insurance policy, and vice versa. To the contrary, the protections afforded by performance bonds and CGL policies — and their asserted purposes and essential *raison d'etre* — differ materially, even though both are likely to be implicated in any sizeable project. In the idiom of one court:

> [T]he insurer indemnifies the insured only for resulting "property damage" arising after the project is completed. In contrast, a performance bond is broader than a CGL policy in that it guarantees "the completion of a construction contract upon the default of the general contractor." Therefore, a "variety of deficiencies that do not constitute 'property damage' may be covered by a performance bond, and not all deficiencies cause additional property damage."

Lennar Corp. v. Great Am. Ins. Co., 200 S.W.3d 651, 673-74 (Tex. App. 14th Dist. 2006) (internal citations omitted). The difference is, however, arguably less a pristine question of degree — as the Court's comments may intimate — and more a question of kind and application. A CGL carrier, for example, has a duty to defend the insured contractor against suits seeking damages emanating from property damage. In material contrast, a surety, after conducting an independent investigation of a claim and determining that its bonded contractor has valid contract defenses, has the right to *tender its defense* to the solvent *contractor and demand to be held harmless*, in the event that the surety is sued for performance under the relevant bond.

There are other important differences that defy simple, linear measurement according to the quantum of protection afforded. A performance bond is issued for the protection of the owner of a project, whereas insurance cover protects the contractor (*i.e.*, the policyholder). A performance bond is a tripartite contract among principal (the contractor and primary obligor), obligee (the owner of the construction project), and surety (the secondary obligor) — it is a product designed to protect the owner against the risk of the contractor's failure to perform its contractual obligations. Insurance contracts, on the other hand, are binary agreements between the insurer and the policyholder (the contractor or subcontractor), which are designed to protect the contractor, in the event of an accidental loss unknown at policy inception.

Moreover, unlike CGL insurers, a surety does not expect to incur some number and quantum of losses

for purposes of its underwriting and pricing. Because sureties guarantee the performance of qualified contractors, they do not expect to incur loss and they do not price their product to accommodate reserves in the event that loss occurs. Instead, a bond is underwritten based on what amounts to a prequalification by the surety of the particular contractors predicted financial capacity, technical expertise and ability to perform its contracts. Unlike sureties, insurers calculate premiums across a range or cluster of live policies, using loss experience data and actuarial methods, to create a pool of reserves available to address the inevitability of loss.

Finally, sureties arguably have a broader array of defenses at their disposal when a claim is made against the bond. A surety may assert any of the rights and defenses available to the contractor, as well as those rights and defenses uniquely available to the surety under its performance bond. The surety will also shift loss to the contractor through its right to indemnification to the extent the contractor is financially capable of exonerating or reimbursing the surety. By contrast, the insurer's rights and defenses are generally limited by its contract — *i.e.*, those described by the four corners of its policy wording. It typically cannot shift its costs to the insured contractor — simply put, the insurer cannot seek indemnification from its own policyholder.

II. "The Space Between"

In the event that a construction defect is discovered, both performance bond and CGL policies may be implicated. The project owner will seek to recover its losses from the surety under the bond, as well as the financially troubled contractor. The owner may also seek to induce performance by the surety to complete the construction contract if the project is not completed. The contractor ultimately may, in turn, seek defense and indemnification from its own CGL carrier. If the contractor recovers from its insurer, the policy proceeds would also benefit the owner — albeit, indirectly. In those states which allow direct action against an insurer — *e.g.*, Louisiana and Wisconsin — the owner may bring a claim directly against the contractor's insurer.[18] Alternatively, the owner and contractor may settle their claims, and the owner may proceed against the CGL carrier under an assignment of rights.

With both a performance bond and a CGL policy in play, many owners may believe they have ample coverage in the event of a construction defect, but they may also be deluded by the wishful (and perhaps naïve) surmise that more coverage means sufficient and appropriate protection.

A. Latent Defects

As in the loss scenario described above, one of the most commonly litigated construction disputes arises from the discovery of latent defects many years after a project is completed. Latent defects are defined as "defective work that was not apparent at the time the contractor's work was accepted," which may go undetected for many years after the project is accepted by the owner and the work is put to its intended use.[19] The surety and the CGL carrier may each invoke several potentially viable defenses to latent defect claims, including those described more fully below.

1. "Not My Bond"

(i) Scope Of Performance Bond

Because the surety only guarantees the Principal's contract obligations, the substantial completion of the bonded contract by the contractor may relieve the surety of liability on the bond, including any latent defects that may arise after substantial completion. According to one commentary:

> [T]he bond duration traditionally has been deemed to extend only to the point of 'substantial completion' . . . at which point the owner is determined to have received performance substantially as bargained for and thus is not legally justified in terminating the bonded contract for default.[20]

At least one court has adopted this position. *See Indep. Sch. Dist. No. 74 v. Shurtleff-Gaharan, Inc.*, 2007 U.S. Dist. Lexis 57214, at *3-4 (E.D. Okla. Aug. 2, 2007). In *Shurtleff-Gaharan*, a school district engaged a contractor to install a metal roof at an elementary school. Nine years later, when the school began experiencing problems with the roof, it learned that the contractor had used a non-conforming substrate in its installation. *Id.* at *2. The district sued both the contractor and its surety, asserting the surety's liability under a

performance bond it issued to the contractor. The federal trial court rejected the claim:

> A performance bond protects the owner of the property by assuring completion of a project in the event of default [by the general contractor] . . . Here, there was no "default." The contractor finished its work, but allegedly created a latent defect in so doing. In the Court's view, a performance bond does not establish a surety as a guarantor of work quality *ad infinitum.* Although plaintiff will not agree with this interpretation in its brief, the Court subscribes to this passage: "So, here, there is no project to 'complete,' but rather a latent defect to correct . . .". Because this situation is not contemplated by the bond, liability under the bond does not exist.

Id. at *3-4 (internal citations omitted). *See also Florida Board Of Regents v. Fidelity & Deposit Co. of Maryland*, 416 So. 2d 30, 32 (Fla. Ct. App. 5th Dist. 1982). The state intermediate appeals court in *Florida Board* took a similar tack:

> Once the building is completed, or as we have said using the words of art in the construction industry, "substantially completed," then the surety under the performance bond is relieved of any further responsibility. The purpose of a performance bond is 'to ensure the physical completion of the work upon default,' and to insure against any losses which the owner may suffer if performance default occurs.

Id. The Florida Supreme Court, however, rejected that approach several years later, in favor of a strict construction of the term "completion":

> [Surety's] promise that the project would be completed according to the terms and conditions of the construction contract means that [surety] would be liable for defective work performed by the general contractor upon the general contractor's default. This liability is not dependent upon whether the defect was discovered before or after substantial completion.

Fed. Ins. Co. v. Southwest Fl. Retirement Ctr., Inc., 707 So. 2d 1119, 1121 (Fla. 1998).

The liberating proposition that a surety is relieved of liability after construction is substantially complete remains largely untested, and it is not yet settled as a matter of U.S. law. Whether a surety may successfully assert this defense depends largely on the terms of the relevant performance bond, the bonded construction contract, applicable statutes, state-specific caselaw and, as evinced by the three quotations above, the proclivities of the court. If the bond is conditioned on contractor default or material breach of the underlying contract, then a surety may argue that — once the project is substantially complete — the owner received the performance for which it bargained under the construction contract, and there can no longer be a material breach, or contractor default, triggering the surety's obligations under the bond. However, even in the event latent defects are covered by the bond, the surety may assert other defenses — such as expiration of the contractual limitations period, statute of limitations, and statute of repose — that may discharge the surety.

(ii) Contractual Limitations Period

The contractual limitations period in a performance bond may expressly bar cover for latent defects. Many performance bonds contain an express limitation period circumscribing the temporal window in which an owner may sue. Two such forms, drafted by the American Institute of Architects ("AIA"), are AIA A311 (still in use), and its successor, AIA A312 (2010). The A311 performance bond provides: "Any suit under this bond must be instituted before the expiration of two (2) years from the date on which final payment under the Contract falls due."[21] The A312 iteration provides:

> Any proceeding, legal or equitable, under this Bond . . . shall be instituted within two years after a declaration of Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails

> to perform its obligations under this Bond, whichever occurs first.[22]

Contractual limitation periods generally have been enforced by U.S. courts.[23] For example, the West Virginia Supreme Court of Appeals held that an owner's action against a surety was barred by the two-year limitation period contained in the A311 performance bond. *Gateway Communs., Inc. v. John R. Hess, Inc.*, 208 W. Va. 505, 511 (W. Va. 2000). More recently, the Kentucky Court of Appeals determined that an action against a surety on a performance bond was barred by its two-year time limitation. *Five Star Lodging, Inc. v. George Construction, LLC*, 344 S.W.3d 119, 121 (Ky. Ct. App. 2010). Other courts, however, have held that, if the limitation period in the bond conflicts with a state statute of limitations, particularly if the limitations period in the bond is shorter than the applicable statutory period, the bond limitation period is void.[24] These cases teach that contractual limitation periods are not bullet proof, and that their efficacy may depend not only on the terms of the bond, but also the law of the applicable jurisdiction.

(iii) Statutes Of Limitation And Repose

Finally, a surety's exposure for latent defects may be limited by the applicable state statute of limitations. A statute of limitations "establish[es] a time limit for suing in a civil case, based on the date when the *claim accrued* (as when the injury occurred or was discovered)."[25] Unlike a statute of limitations, a statute of repose bars "any suit that is brought after a specified time since the *defendant acted* (such as by designing or manufacturing a product), even if this period ends before the plaintiff has suffered a resulting injury."[26] Because a statute of repose is not related to the accrual of a cause of action, the subject injury need not have occurred or been discovered for it to bar a plaintiff's claim.

Elimination of a surety's exposure for latent defects by a state statute of limitations turns on the date when the owner's cause of action is deemed to have accrued. The Supreme Court of Florida has determined, for example, that a subject cause of action accrues on the date of project completion:

> As to the statute of limitations for latent defects . . . We expressly hold that Section 95.11(2)(b), Florida Statutes (1981), as it applies to an action on a performance bond, accrues on the date of acceptance of the project as having been completed according to terms and conditions set out in the construction contract.

Southwest Fl. Retirement Ctr., Inc., 707 So. 2d at 1121. In so holding, the Court also expressly rejected a discovery rule for latent defects. *Id.* at 1122.

The West Virginia Supreme Court of Appeals took a similar approach. It held, in the context of latent defects, that the owner's action against the contractor and its surety accrued either when the work was completed, or when the owner made its final payment on the project. *See Gateway Communs.*, 208 W. Va. at 511. By material contrast, in other U.S. jurisdictions, a statute of limitations does not begin to run until *discovery* of a latent defect.[27] A discovery-based regime tends to undermine the defense, because the statute of limitations is unlikely to bar suits against sureties arising out of latent defects, assuming the owner brings its claims within the statutorily prescribed period of time after the defect is discovered.

Even if a statute of limitations is inoperative or ineffective, a statute of repose may provide refuge to a surety. Unlike a limitations period, a repose period begins to run at a statutorily defined event. For example, in New Jersey, no action to recover damages for any deficiency in the design, planning, surveying, supervision or construction of an improvement to real property, or for any injury to property, may be brought more than ten years after the *performance or furnishing of such services and construction*. *See* N.J. Stat. Ann. § 2A:14-1.1. As a result, if a latent defect did not arise until a decade after completion, the New Jersey statute of repose would relieve the surety of any resulting liability. *See County of Hudson v. Terminal Constr. Corp.*, 154 N.J. Super. 264 (N.J. Super. Ct. 1977). In sum, statutes of repose provide a valuable, temporal outer-limitation to a surety's liability, but only following the passage of a protracted period of time during which a defect remains hidden or innocuous. Like statutes of limitations, application of statutes of repose varies by jurisdiction.

2. "Not My CGL Policy"

(i) Latent Defects Resulting From Defective Work As A Covered "Occurrence"

CGL carriers also possess a wide array of defenses to construction defect claims. The most fundamental,

perhaps, is the contention that defective work resulting in a (latent) construction defect does not constitute an "occurrence".[28] There is a split in authority with respect to whether defective work (standing alone) that causes latent defects, in particular, is considered a covered "occurrence."[29] In *Kvaerner Metals* — one of the cases most often cited for the proposition that faulty work is not a covered "occurrence" — the Pennsylvania Supreme Court held:

> [T]he definition of "accident" required to establish an "occurrence" under the policies cannot 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. To hold otherwise would be to convert a policy for insurance into a performance bond. We are unwilling to do so, especially since such protections are already readily available for the protection of contractors.

Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co., 908 A.2d 888, 899 (Pa. 2006) (emphasis supplied). Other courts have agreed that faulty workmanship is not an "accident".[30]

A different constellation of courts has perceived the opposite in construction defects — *i.e.*, the degree of fortuity requisite to identifying an "occurrence" eligible for CGL cover. The Connecticut Supreme Court, for example, recently determined that faulty workmanship can be a covered "occurrence".[31] In *Capstone Building*, the University of Connecticut ("UConn") engaged a general contractor to supervise construction of a student housing complex. *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 308 Conn. 760 (Conn. 2013). Over three years after completion of the project, UConn identified defects producing elevated levels of carbon monoxide. The ensuing dispute between UConn and its contractor eventually settled, and the contractor approached its CGL carrier. The insurer denied coverage because the claimed damage was caused by faulty workmanship and, therefore, did not constitute an "occurrence" under the policy. Connecticut's highest Court disagreed:

> [B]ecause negligent work is ***unintentional*** from the point of view of the insured, we find that it may constitute the basis for an "accident" or "occurrence" under the plain terms of the commercial general liability policy.

Id. at 776.

In sum, whether latent defects constitute an "occurrence" eligible for coverage depends on the law of the relevant jurisdiction and, more specifically, whether its jurisprudence considers faulty work to be an "accident," or merely a happening devoid of the degree of fortuity needed to support an insurable "occurrence." Even if a latent defect is considered a covered "occurrence," coverage may nevertheless be defeated for the reasons described below. *See infra* Part II.A.2.ii-iii.

(ii) Application Of Business Risk Exclusions To Latent Defects

The standard form CGL policy contains 15 exclusions which limit the policy's coverage grant. Exclusions (j) through (n), which generally preclude cover for damage to the insured's work, are often called "business risk" exclusions. In appropriate circumstances, some number of them may apply to construction defect claims.

The most common business risk exclusion in this context is Exclusion (l) — the "Your Work" exclusion. As its moniker communicates, it bars coverage for "property damage to 'your work' arising out of it or any part of it and included in the products-completed operations hazard" or PCOH.[32] The PCOH refers to damage arising from the insured's work that occurs after the insured's work is "complete." As a result, Exclusion (l) is aimed at eliminating coverage for latent defects arising out of the insured's work, which cause property damage to the insured's work.

An exception to this exclusion reinstates cover, if "the damaged work or the work out of which the damage arises was performed on [the insured's] behalf by a subcontractor."[33] Read together, the "your work" exclusion — and its "subcontractor exception" —

preclude cover for damage to the insured contractor's work, but restore it to the extent that the work arguably producing the claimed defect was performed by a subcontractor.[34] Although the exception is, on its face, ostensibly simple, the intricacies of subcontracts and purchase orders — and their sometimes ambiguous references to the roles of various involved entities — are often scrutinized by both the policyholder and the carrier, in an effort to apply or defeat the subcontractor exclusion. *E.g.*, *Limbach Co. LLC v. Zurich Am. Ins. Co.*, 396 F.3d 358, 365 (4th Cir. 2005) ("the parties' differing interpretations of the term 'subcontractor' demonstrate that the term is ambiguous").

Nonetheless, the exception can, in some cases, swallow the bargained-for exclusion — owing to the extensive use of subcontractors in major construction projects. In response, the ISO has issued an endorsement, which eliminates the subcontractor exception to the "Your Work" exclusion.[35] With the endorsement in place, a CGL carrier has a persuasive argument that coverage for latent defects is barred by Exclusion (l), regardless of whose hands perform the allegedly defective work.

(iii) Other Coverage Issues

There are a multitude of other issues that may affect coverage for latent defects. A few warrant mention here.

First, under the standard CGL form, an insurer is liable only for those sums the insured becomes legally obligated to pay as damages because of "property damage."[36] CGL carriers have argued successfully that faulty work is not "property damage," as that term is defined by the CGL policy form.[37] For example, in *Capstone Building*, even after finding that faulty work may constitute an "occurrence," the Court went on to hold that construction defects, without more, do not state a claim for *property damage*, unless they result in damage to other, non-defective property. *Id.* at 783. The Court also determined that repairs for defective work itself are not covered under the insuring agreement, but repairs to non-defective property traceable to defective work are covered. *Id.* at 787. In sum, if a latent defect does not cause damage to other defective property, the defect may not represent "property damage" eligible for CGL cover.

Second, under the standard CGL form, the carrier agrees to pay only for "property damage" that occurs during the policy period.[38] If a latent defect does not give rise to property damage until many years after the CGL policy period expires, then coverage may be avoided for this independently sufficient reason.

Third, in the context of large projects, contractors and subcontractors may be insured through a "wrap up" insurance program, such as an "Owner Controlled Insurance Program" ("OCIP") or "Contractor Controlled Insurance Program" ("CCIP"). These programs are referenced collectively here as "CIPs." CIPs provide consolidated insurance to all parties involved in a construction project, and typically include general liability, workers compensation and builders' risk coverages.

Despite their many advantages — for example, broader insurance coverage, increased limits, and cost savings — CIPs may also leave unanticipated gaps in coverage. For example, most CIPs cease to respond once a project reaches substantial completion or a scheduled completion date, and do not cover warranty work or punch list items. Although a CIP may provide tail (or completed operations) coverage, it typically continues only for three years from the date of project completion. In the case of latent defects, this limitation may result in a coverage gap, because a general or sub-contractor may be exposed to tort liability years after the CIP period has elapsed.

In addition, like traditional CGL coverage, a CIP may contain a "your work" exclusion. As previously noted, the "your work" exclusion precludes coverage for damage to the insured's own work "arising out of it or any part of it." *See supra* Part II.A.2.ii. If each enrolled contractor and subcontractor is a named insured, then any property damage would inevitably affect an insured's "own work," which is potentially excluded from coverage. Unless the policy is modified to treat each insured separately, then a coverage gap may manifest itself.

Finally, CIPs may include a waiver of the right to sue another insured participating in the program, which may impede recovery by the sponsor of the CIP against the responsible contractor or subcontractors, if a construction defect is discovered.

B. Overlapping Coverage — A Space No More?

Consistent with the analysis above, there are occasions where neither a performance bond nor a CGL policy

provides cover for construction defects. The obverse is also true — *i.e.*, in some cases, *both* products may be triggered and facially available to cover a latent defect claim. Consider, for example, faulty work that arguably causes property damage under a CGL policy, and also constitutes a breach of a bonded construction contract which the surety may be obligated to remedy. In jurisdictions where faulty work may be considered an "occurrence," where none of the business risk exclusions applies, and where the terms of the performance bond and state limitation periods do not preclude coverage, there may (in fact) be *overlapping* cover for a particular construction defect.

Although this state of affairs may seem ideal from an owner's perspective, the potential overlap may (in fact) have the reverse effect, causing the surety and the CGL carrier each to defer its own coverage decision, in light of the coverage arguably available from the other one. Despite having coverage in place, and an opportunity to demonstrate that its protections were arguably triggered, an owner may (again) find itself in the uncertain "space between" — where gridlock induced by carriers pointing to each other's coverages temporarily nullifies each one — at least until costly and protracted litigation resolves the conflict.

Conflicts occasioned by multiple involved covers are as understandable as they are common in the coverage world. In fact, each side (surety and CGL carrier) has a compelling argument that its contract should not be first to respond based on its underlying purpose. A CGL carrier may argue that its policy was never intended to cover the costs of repairing and replacing defective work, to guarantee the quality of the insured's work, or to ensure tidy consummation of a policyholder's business activities. If it did, CGL covers would be transformed into performance bonds. Instead, these are the mundane and, over a period of extensive experience, predictable costs of doing business to be borne by the contractor — or the contractor's surety — in the event of default. As the Ohio Supreme Court said, CGL policies are:

> [N]ot intended to protect business owners against every risk of operating a business. In particular, [these] policies . . . are not intended to insure "business risks" — risks that are the "normal, frequent, or predictable consequences of doing business, and which business management can and should control and manage."

Westfield, 133 Ohio St. at 480. As a corollary, the CGL carrier will argue that, while the contractor itself may be liable for breach of *contract* — to make good on defective work — that is not the species of risk CGL policies are designed to address. Rather, a CGL policy protects against *tort* liability for physical damages to third parties — not contract liability for economic loss occasioned by a contractor's work or product that did not comport with the owner's estimation of its own bargain. In fact, coverage for breach of that contract is precisely the risk against which a performance bond is issued.

In response, a surety may contend that the primary purpose of a performance bond is to protect an owner in the event of contractor default, but not to indemnify the owner for property damage.[39] Moreover, the existence of overlapping coverage does not negate a CGL policy's express terms or its protective covenants. In other words: "The [CGL] policy covers what it covers. No rule of construction operates to eliminate coverage simply because similar protection may be available through another insurance product." *Capstone Bldg. Corp.*, 308 Conn. at 791. A surety can also point out that there is nothing on the face of the CGL form wording to support a definitive tort/contract distinction, which the CGL insurer may attempt to invoke for the purpose of discriminating between those losses covered and excluded by a CGL policy. In other words, the policy form doesn't expressly exclude cover for contract-based losses. Finally, a surety may argue that, even if the coverages do overlap, the CGL cover should nevertheless be the primary policy to respond — even if the surety pays for a loss on the bond, it will seek to recoup its loss from the CGL carrier anyway, via its right of equitable subrogation and assignment.

Regardless of which side ultimately emerges victorious from such coverage gridlock, the project owner will undeniably find itself in the unsettling "space between" these radically different financial products — at least until its surety or CGL carrier loses a court battle or otherwise relents for business reasons.

III. Conclusion

Reconsideration of the State Convention Center hypothetical introduced above may help to bring the discourse

full circle. Specifically, and against the backdrop of the coverage issues and prospective defenses described in this article, who pays for the damage and loss to the Convention Center occasioned by Contractor's faulty work — the surety, the CGL insurer, both, or *neither*? In the most general terms, the answer is "it depends" — on the terms of the bond; the CGL wording; and the applicable law, which varies by jurisdiction.

Experience teaches, however, that State's claims against both the surety and the CGL carrier will both find traction in the text of the policy and bond and simultaneously be undermined as antithetical to the purpose of each product. CGL cover does not guaranty contract performance, even if the dispute is clad in the idiom of a tort claim (*i.e.*, "negligence" on these facts); and, performance bonds do not indemnify for the kind of property damage sustained here. Among other significant impediments to cover, State will likely be forced to contend with the surety's objections predicated on substantial completion of the Convention Center; a contractual limitation period, in light of the six years elapsed between completion and the discovery of leaks, particularly if the cessation of work or payment to Contractor is the triggering event for limitations purposes; and, State's statute of repose. Likewise, State's attempts to trigger Contractor's CGL cover may be impeded by the absence of an "occurrence"; one of five "business risk" exclusions; or, an inability to prove property damage during the CGL policy period.

Although many commentators have focused on the expansive cover provided by performance bonds and CGL policies alike, few have considered the prospect of a space between them — where an owner may be left without coverage based on the purpose and/or performance of both products. That space will not necessarily be filled by a particular bond or CGL policy. As a result, all parties should closely analyze whether the performance bond and insurance policy they propose to activate each provide adequate cover in the event of a construction defect likely to present itself in the context of a particular project (or, in the case of CGL covers, a type of business activity) or whether, taken together, they arguably leave a "space between" wide enough to engulf a risk likely to come to fruition.

Endnotes

1. *See* "FMI Forecast For 2014 In The Q3-2013 Construction Outlook Report" (September 13, 2013) available at http://www.fminet.com/news/outlook3q2013 (last visited October 31, 2013) ("Forecasts for 2014 show annual [construction put in place] continues moderate growth of 7%").

2. *See* AON, "Surety Market Update 2013," available at http://www.aon.com/attachments/risk-services/2013-Surety-Market-Update.pdf (last visited September 25, 2013).

3. Richard K. Allen and Stanley A. Martin, CONSTRUCTION LAW HANDBOOK (2d. ed. 2009), at § 34.01.

4. Allen & Martin, *supra* note 3, at § 34.03.

5. *See United States Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 887 (Fla. Ct. App. 1982) ("The purpose of a performance bond is to guarantee the completion of the contract upon default by the contractor") (internal citations omitted).

6. 40 U.S.C. § 3131(b)(1) provides: "(a) Before any contract of more than $100,000 is awarded for the construction, alteration, or repair of any public building or public work of the Federal Government, a person must furnish to the Government the following bonds, which become binding when the contract is awarded: (1) Performance bond. — A performance bond with a surety satisfactory to the officer awarding the contract, and in an amount the officer considers adequate, for the protection of the Government."

7. *See, for example*, Illinois Public Construction Bond Act, 30 ILCS 550/1: "Except as otherwise provided by this Act, all officials, boards, commissions, or agents of this State, or of any political subdivision thereof, in making contracts for public work of any kind costing over $50,000 to be performed for the State, or of any political subdivision thereof, shall require every contractor for the work to furnish, supply and deliver a bond to the State, or to the political subdivision thereof entering into the contract, as the case may be, with good and sufficient sureties."

8. On large construction projects, owners may procure CGL insurance — and other covers, such as Workers Compensation and Builders Risk insurance — for all project participants under an owner-controlled insurance policy ("OCIP"), also known as a "wrap" policy. OCIP programs are designed to cover all liability

arising out of a construction project, other than those liabilities specifically excluded by the policy. By utilizing an OCIP, the owner eliminates the need for each general contractor and subcontractor to obtain its own coverage.

9. *See* 2003 Insurance Services Office, Inc. Commercial General Liability form CG 00 01 12 04 ("CG 00 01 12 04"), at Section I (1). The Insurance Services Office, Inc. ("ISO") is an industry organization that promulgates various standard policy forms frequently utilized by insurers in certain markets.

10. CG 00 01 12 04, at Section I (1)(a).

11. *Id.* at Section V (13).

12. According to Henderson: "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 work or product. This liability, however, is not what the coverages in question are designed to protect against. The coverage is for tort liability for physical damages 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." 50 Neb. L. Rev. at 441.

13. *Id.* at Section I (2)(j)(6). "Your work" is defined as: "(1) Work or operations performed by you or on your behalf; and (2) Materials, parts or equipment furnished in connection with such work or operations." "Your work" includes: "(1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of 'your work'; and (2) The providing of or failure to provide warnings or instructions." *Id.* at Section V (22).

14. *Id.* at Section V (16). The standard CGL form defines "products-completed operations hazard," in pertinent part, as follows: "(a) Includes all 'bodily injury' and 'property damage' occurring away from premises you own or rent and arising out of 'your product' or 'your work' except: (1) Products that are still in your physical possession; or (2) Work that has not yet been completed or abandoned. However, 'your work' will be deemed completed at the earliest of the following times: (a) When all of the work called for in your contract has been completed; (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site; (c) When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project . . .". *Id.*

15. *Id.* at Section I (2)(l).

16. *Id.*

17. *Id.* at Sections I (2)(k), (m), and (n).

18. *See* Louisiana Revised Statutes § 22:1269 ("The injured person . . . shall have a right of direct action against the insurer within the terms and limits of the policy . . ."); Wisconsin Statues § 632.24 ("Any bond or policy of insurance covering liability to others for negligence makes the insurer liable, up to the amounts stated in the bond or policy, to the persons entitled to recover against the insured for . . . injury to persons or property . . .").

19. Keith A. Langley and Marchelle M. Houston, *Liability of the Performance Bond Surety for Damages (Under Contract of Suretyship)*, THE LAW OF PERFORMANCE BONDS (2d ed. 2009).

20. Langley & Houston, *supra* note 17, *citing* 4 Philip L. Bruner & Patrick J. O'Connor, Jr., BRUNER & O'CONNOR ON CONSTRUCTION LAW, at § 12.22 (West 2002 & Sup. 2008).

21. *See Gateway Communs., Inc. v. John R. Hess, Inc.*, 208 W. Va. 505, 510 (2000) (referencing A311 bond).

22. *See* AIA Bond Form Commentary and Comparison, *available at* http://www.aia.org/aiaucmp/groups/aia/documents/pdf/aiab083075.pdf (last visited November 1, 2013).

23. *See, e.g., Yeshiva Univ. v. Fidelity & Deposit Co.*, 116 A.D.2d 49, 54 (1st Dep't 1986) (cause of action against surety for latent defect was time-barred by bond provision requiring suit to be initiated two years from the date of final payment); *La Liberte, LLC v. Keeting Bldg. Corp.*, No. 07-1397 (E.D. Pa. Dec. 11, 2007) (dismissing complaint against sureties that was not filed within bond limitations period);

Monreal Funeral Home, Inc. v. Ohio Farmers Ins. Co., 189 Ohio App. 3d 1, 9-10 (Ohio Ct. App. Aug. 13, 2010) (performance bond claim barred by 2-year limitations period in bond; limitations period commenced when the "contractor ceases work on the Contract").

24. *See, e.g., Safeway Stores, Inc. v. Certainteed Corp.*, 687 S.W.2d 22, 25 (Tex. App. 1984) (statutory prohibition prevented parties from agreeing to a period in bond of shorter duration than statutory minimum time).

25. Black's Law Dictionary (8th ed. 2004) (emphasis added).

26. *Id.* (emphasis added).

27. *See, e.g., Adesta Communs. Inc. v. Utica Mut. Ins. Co.*, 2010 U.S. Dist. Lexis 25924, at *7-8 (D. Colo. Mar. 19, 2010) (claim accrued when latent defect was discovered).

28. As previously noted, the ISO form wording provides that the carrier will pay those sums that the insured contractor becomes "legally obligated to pay" as damages because of "bodily injury" or "property damage" caused by an "occurrence." *See* CG 00 01 12 04, at Section I (1)(a). An "occurrence" is commonly defined as an "accident, including continuous or repeated exposure to substantially the same general harmful conditions." *Id.* at Section V (13).

29. *See K&L Homes, Inc. v. Am. Family Mut. Ins. Co.*, 829 N.W.2d 724, 729-31 (N.D. 2013) (collecting cases reflecting split of authority).

30. *See, e.g., Essex Ins. Co. v. Holder*, 372 Ark. 535, 540 (Ark. 2008) ("Faulty workmanship is not an accident; instead, it is a foreseeable occurrence, and performance bonds exist in the marketplace to insure the contractor against claims for the cost of repair or replacement of faulty work"); *Westfield Ins. Co. v. Custom Agri Sys., Inc.*, 133 Ohio St. 3d 476, 482, 484 (2012) (addressing open question under Ohio law whether claim of defective construction brought by property owner is covered property damage caused by an occurrence, and answering in the negative).

31. *See, e.g., Scottsdale Ins. Co. v. R. I. Pools Inc.*, 710 F.3d 488, 492 (2nd Cir. 2013) ("the district court erred in ruling that defects in the insured's work are not within the scope of an 'occurrence' . . ."); *K&L Homes*, 829 N.W.2d at 729 ("the majority of state supreme courts who have decided the issue . . . have decided that [inadvertent faulty workmanship] can be an 'occurrence' "); *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 888 (Fla. 2007) ("We hold that faulty workmanship that is neither intended nor expected from the standpoint of the contractor can constitute an 'accident' and, thus, an 'occurrence' under a post-1986 CGL policy").

32. *See* CG 00 01 12 04, at Section I (2)(l).

33. *Id.*

34. *See Capstone Bldg. Corp.*, 308 Conn. at 789.

35. *See* ISO Properties, Inc., Endorsement CG 22 94 10 01.

36. *See* CG 00 01 12 04, at Section I (1)(a).

37. The standard form CGL policy defines "property damage," in pertinent part, as: "(a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or (b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the 'occurrence' that caused it . . .". *Id.* at Section V (17).

38. *See* CG 00 01 12 04, Section I(1)(b): "This insurance applies to 'bodily injury' and 'property damage' only if . . . (2) The 'bodily injury' or 'property damage' occurs during the policy period . . .".

39. *See, e.g., Capstone Bldg. Corp,* 308 Conn. at 791 ("While a performance bond may, in the appropriate case, cover the costs to remedy property damage under a commercial general liability contract, its main purpose is to benefit the owner upon the default by a general contractor"). ■

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