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Developments Regarding the Completed Operations Exclusion

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In a hypothetical situation, Smith Construction installs stucco on the curbside wall of the Jones Office Building. Six months later, during a severe rainstorm with high winds, the stucco falls off the wall, landing on a pedestrian. Rainwater seeps into the Jones building, causing structural damage, and also causing a six-week shutdown of several floors of the building and consequent loss of rent.

Smith is insured by XYZ Assurance with a comprehensive general liability policy. The policy includes the standard requirements of (a) "an occurrence" as the cause of the damage, and (b) the customary "completed operations exclusion," which provides that the insurer shall not be responsible to replace that which the insured was contractually required to install.

The pedestrian sues Jones and Smith for bodily injury. Jones sues Smith for breach of warranty, defective workmanship and negligence. Jones sues Smith on a cross-claim for indemnification and contribution, and as a third-party defendant for Jones' costs of repairs and for loss of rent.

Smith demands coverage and a defense from XYZ, which declines both legal defense and indemnity, asserting that an "occurrence" did not cause the damage. A declaratory judgment suit between XYZ and Smith is brought in the state where the accident occurred, raising two questions: Which state's law applies and who wins, Smith or XYZ?

In 2010, the 3rd U.S. Circuit Court of Appeals in *Specialty Surfaces v. Continental Cas.* provided a workable framework for analyzing these disputes, and reflects both Pennsylvania's narrow approach to workmanship claims and emphasis on lex loci contractus in conflict analysis.

As to substantive law, were the damages to the pedestrian and to the Jones Office Building proximately caused by an "occurrence"? Can mere poor workmanship constitute an "occurrence"? Pennsylvania says no. In the 2006 case *Kvaerner v. Commercial Union* , the Pennsylvania Supreme Court noted that standard policy language defines an occurrence as an "accident." The dictionary defines "accident" as an unexpected event caused by a degree of fortuity.

Poor workmanship, even if presented as a negligence claim, cannot be considered an unexpected accident. To do otherwise would be to transform a CGL policy into a performance bond. In the 2007 case *Millers Capital Ins. v. Gambone* , the Superior Court held that rainfall did not constitute an "occurrence" because it is not unexpected, even if it resulted in damage to the interior of a building from faulty workmanship of a stucco contractor. Ohio, Kentucky, Massachusetts, Mississippi and Arkansas have all reaffirmed since 2008 a similarly restrictive view of "occurrence."

Other states hold to the contrary. In 1959, the California Supreme Court held that the faulty installation of defective doors, which subsequently failed, constituted an "accident" and that proximately caused water damage to the building (not including replacement of the faulty doors themselves, which is excluded by the completed operations exclusion), and loss of use, were damages covered by the policy. An "unexpected, unforeseen, or undersigned" happening is an accident. Certainly a construction failure must be undersigned and unintended to be covered. Other than blatantly obvious accidents waiting to happen, damages to third parties from faulty workmanship seem to be within the scope of California's CGL coverage.

New Jersey's Supreme Court in the 1979 case *Weedo v. Stone-E-Brick Inc.* held that faulty workmanship that causes physical injury to a person or to the property of another is a covered occurrence in a CGL policy even if the defect develops as a gradual deterioration of the contracted-for work rather than a sudden event. The issue for the determination of a duty to defend is not how long the damage takes to develop, but whether it was unexpected.

In 2010, the Indiana Supreme Court, and in 2011, the Georgia Supreme Court, reiterated that unintentional damage caused by the insured's poor workmanship falls within the scope of "occurrence." The damage must not be caused within the expectation or foresight of the insured. Texas and Florida held the same in 2007.

In 2011, the South Carolina Supreme Court readdressed its traditional restrictive construction of "occurrence." The ambiguity surrounding the term "occurrence" must be construed against the insurer. At least as to damage caused by subcontractors of the insured (the "subcontractor exception"), the court overruled existing precedent and adopted a "time on risk" framework to determine the extent to which damage caused by repeated and continuous exposure to a condition ("progressive property damage") falls within the scope of CGL coverage. The decision emphasizes that replacement of the contracted-for work product itself is excluded from coverage by the completed operations exclusion. But damage to third parties is not excluded. Maryland, Kansas and Wisconsin have adopted the same subcontractor exception.

Which state's substantive law will apply? The litigator will have more room to maneuver the multifactor balancing conflicts tests than in challenging any particular state's substantive law.

The law of the state where the accident occurred is generally not applicable, unless a "site-specific" risk is specifically identified in the policy. The declaratory judgment suit for coverage sounds not in tort but in contract. It is not a suit in tort grounded upon the accident itself, but a suit seeking to interpret the provisions ("occurrence," "accident") of an insurance contract.

The conflict-of-laws principles of the forum state will be applied. For diversity, see *Klaxon v. Stentor* . For contract cases, most states follow the "governmental interest" test of the Restatement (Second) of Conflicts of Laws §193, which applies the law of the state that the insurer and insured understand to be the location of the insured risk, unless some other state with a more significant relationship applies.

Is a site-specific risk identified in the policy? If there is only one jurisdiction where operations are covered, then a site-specific risk can be inferred. But if the policy provides for multiple states where operations are covered, then the mere fact that a specific state is listed does not in itself justify an inference of site-specific coverage. In that case, designation of the site of the insured risk must be expressly made, and multiple designations of site-specific risk for different locations are permissible.

If no site-specific provision appears, the courts will look to the Restatement §188(2) for the applicable factors to consider in designating the state with the greatest interest: (a) the place of contracting; (b) the place of negotiation of the [insurance] contract; (c) the place of performance; (d) the location of the subject matter of the contract; and (e) the domicile, residence, nationality, place of incorporation and place of business of the parties.

The place of negotiations depends upon the location of the negotiation, issuance and delivery of the policy. The place of performance of the insured is the location where the insured maintains its business office, or the location from where it mailed or electronically transferred its payments for insurance premium. The insurance company performs in the forum state where it may be required to proffer a defense, which may or may not be the location of the accident. The location of the construction work is not the place of performance of the insurance contract.

All of these factors are weighed qualitatively.

States do not uniformly apply §188 and its factors. Some, such as Pennsylvania, consider the location of the negotiations of the insurance policy to be the predominant factor, because it is where the insurer and insured formed their intent. The place of the insurer's performance, where a defense must be tendered, is of lesser value to the Pennsylvania courts because that location was not known at the time the policy was issued and the parties formed their intent.

Some states, such as Indiana — particularly with regard to environmental risk — Nebraska and Kansas, emphasize the place of intended performance under §193. New York places less emphasis on the site of contracting and applies the "most intimate contacts" test. Mississippi places great weight on the location of the intended risk, and uses a "center of gravity" or the "grouping of contacts" analysis to determine the most significant contacts, the state with the greatest concern with the rules to be applied and the outcome reached. There are many nuances as to the weight a particular state's courts may give to the particular factors specified in §193.

The take-home is to encourage transactional attorneys and construction executives to be aware of the substantive law governing the scope of the occurrence clause in their home state and the state where construction is to be performed, and to make site-specific designations, even multiple designations for different projects, to obtain the most favorable

coverage terms possible, and be aware if any special endorsements are advisable. The take-home for litigators is to examine, prior to filing suit, how the conflict-of-laws analysis will play out in different potential forum states so as to select the state whose conflict principles will land you in the substantive law of a state whose policy interpretation principles are favorable to their client. •

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