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***A PRIMER ON THE SURETY'S RIGHTS
AGAINST ITS PRINCIPAL'S CGL CARRIER***

DAVID J. KREBS, ESQ.
PREAUS, RODDY & KREBS
650 POYDRAS STREET
SUITE 1650
NEW ORLEANS, LOUISIANA 70130

EDITED AND UPDATED BY
JOHN M. GILLUM, ESQ.
MANIER, HEROD, HOLLABAUGH & SMITH
150 4TH AVENUE NORTH, SUITE 2200
NASHVILLE, TENNESSEE 37219

PRESENTED BY:

Jack R. Pociask, Esq.
FIDELITY & DEPOSIT INSURANCE COMPANY
1100 Ashwood Parkway, Suite 120
Atlanta, Georgia 30338

John M. Gillum, Esq.
MANIER, HEROD, HOLLABAUGH & SMITH
150 4th Avenue North, Suite 2200
Nashville, Tennessee 37219

A PRIMER ON THE SURETY'S RIGHTS AGAINST ITS PRINCIPAL'S CGL CARRIER

Virtually every construction contractor who is substantial enough to be bonded carries Commercial General Liability ("CGL") insurance with significant limits. We have all accepted as an article of faith the difference between an insurer and a surety, arguing that the former assumes liability while the latter only stands behind the debtor. Sureties also know well that they are entitled to assert the rights of their principals.¹ And yet, it is rare for surety companies to call upon their principals' liability carriers for indemnity under a CGL policy. The reasons for this are many, but all too often it is a result of an unquestioning and untrue belief that the surety's obligations never overlap with those of the CGL carrier.

The purpose of this paper is to challenge that belief and to raise briefly some of the primary issues involved in the question of insurance coverage for construction defects. For the purpose of this paper, we will look at three categories of claims: First, the surety's claims for defective work performed by its principal; Second, the surety's claims for defective work performed by its principal's subcontractor; And third, the surety's claims against its indemnitors for defects in work performed by the principal or its subcontractors. This in turn requires some consideration of three typical provisions in the CGL policy -- the insuring agreement, the "work/product" exclusion, and the "contractual liability" exclusion.

I. RECOVERY FOR THE PRINCIPAL'S DEFECTIVE WORK

The first question which we will consider is the extent to which recovery may be had for damages caused by defective work of the principal. The key issues here are whether the defective work

¹ The surety has subrogation rights against the principal's insurer. See e.g. Western World Insurance Co. v. Traveler's Indemnity Co., 358 So. 2d 602 (1st DCA Fla. 1978).

can be considered an "occurrence" under the insuring agreement, the extent to which the losses can be considered to be insured "property damage," and the scope of the work product exclusion found in most CGL policies.

A. THE INSURING AGREEMENT

All insurance policies begin with the insuring agreement, which is usually very broad and is later limited by specific exclusions. A typical insuring agreement² provides as follows:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of

B. Property Damage

to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured

"Occurrence" means an accident. . . which results. . . in bodily injury or property damage neither expected nor intended from the standpoint of the insured. . . .

The newer policies contain a definition of occurrence as being, "occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions. The broader definition is significant in view of the fact that not all property damage is caused by a catastrophic failure but instead an exposure to a defective condition over an extended period of time.

The essence of the agreement is that the insurer is liable for all "property damage" caused by an "occurrence" insofar as that damage was neither intended nor expected by the insured. This raises two distinct issues. The first is whether the defective work is an occurrence. Insofar as it results from a deliberate failure to follow plans and specification, it is neither unintended nor unexpected, and may

² See West Bros. of DeRidder La. v. Morgan Roofing 376 So. 2d 345 (La. App. 3d Cir. 1979).

therefore not be an occurrence.³ However, when the faulty work is the result of negligence and is unintended, it may be considered an occurrence.⁴

In Solcar Equipment v. Pennsylvania Manufacturers Association Ins. Co., 606 A.2d 522 (Pa. Super 1992), the Court held that the insured's substandard performance which contributed to massive property damage in homes was negligence, and an occurrence did not encompass negligence. Additionally, in Solcar, the Court stated that even if they were to find an "occurrence," the work product exclusions which excluded "property damage to the named insured's products" precluded a duty on the insurer's part to defend.⁵ If these defects cause damage to work not performed by the insured or on its behalf, that damage is covered by the policy.

Additionally, cases have generally held that when an insured's defective workmanship results in damage to the property of others, an "accident" exists.⁶ However, when the damage arising out of the insured's defective workmanship is confined to the insured's own product, the damage is often not viewed as accidental.⁷ In Jackson Shipyard, Inc. v. Aetna Cas. & Surety Co., 775 F. Supp. 606

3 See, e.g., Johnson v. Aid Ins. Co. of Des Moines, Iowa, 287 N.W.2d 663 (Minn. 1980); Reliance Ins. Co. v. Mogavero, 640 F. Supp. 84 (D. Md. 1986). Some courts do not accept that faulty workmanship can be an "occurrence" at all. This appears to be the majority view in Louisiana. See, e.g., Bacon v. Diamond Motors, Inc., 424 So. 2d 1155 (La. App. 1st Cir. 1982) writ denied, 429 So. 2d 131 (1983); Vitenas v. Centanni, 381 So. 2d 531, 535 (La. App. 4th Cir. 1980). However, this view appears to be based more on policy considerations than on the plain language of the contract.

4 Missouri Terrazzo Company Inc. v. Iowa National Mutual Insurance, Co., 566 F. Supp. 546 (E.D. Mo. 1983), affirmed 740 F.2d 647 (8th Cir. 1984); Gene & Harvey Builders v. Pennsylvania Manufacturers Assn., 517 A.2d 910 (Pa. 1986); Barber v. Harleysville Mut. Ins. Co., 450 A.2d 718 (Pa. 1982); Hauenstein v. St. Paul Mercury Indem. Co., 242 Minn. 354, 65 N.W.2d 122 (1954); Geddes & Smith v. Saint Paul Mercury Indemnity Company, 51 Cal. 2d 558, 334 P.2d 881 (1959), appeal after remand 63 Cal. 2d 602, 407 P.2d 868 (1965).

5 Id. at 528. See Swarts v. Woodlawn, Inc., 610 So.2d 888 (La. App. 1. Cir. 1992).

6 See Riley Stoker v. Fidelity & Guaranty, Ins. Underwriters, 26 F.3d 581 (5th Cir. 1994); Contra I.A. Construction Corp. v. T & T Surveying, Inc., 822 F. Supp. 1213 (D. Md. 1993) (no "accident" occurred when insured made surveying error which required another contractor to re-do his work.).

7 Calvert Ins. v. Herbert Roofing & Insulation, 807 F. Supp. 435 (E.D. Mich. 1992).

(S.D.N.Y. 1991), the Court held that the property damage suffered was not caused by an "occurrence" but rather from a breach of warranty when a claim was made against the insured based on alleged faulty installation of rudders in boats manufactured by the insured.

An example of a court finding both that an occurrence did not exist as to one carrier and that an occurrence did exist as to another carrier can be found in the United States Fidelity & Guaranty Company v. Bonitz Insulation Company, 424 So. 2d 569 (Ala. 1982) case. In Bonitz, the general contractor, Bonitz, entered into a contract with the City of Midfield for the construction of the roofing and insulation on a gymnasium in 1972. Part of the roofing job was subcontracted to Vulcan Roofing Company. The job was completed in the fall of 1972, and as early as late fall 1972, the roof began to leak. At the time of the contract, and until January 1, 1977, Bonitz was insured by USF&G under a comprehensive general liability policy. On January 1, 1977, the coverage was taken over by Employers. On August 18, 1977, after the roof had been leaking approximately five years, suit was filed by the City. USF&G denied coverage and Employers assumed Bonitz's defense under a reservation of rights. Bonitz then filed suit for declaratory judgment. The trial court without explanation and without findings of fact, ordered both insurance policies to defend the suit and pay any judgment rendered. The Supreme Court reversed.

Both policies defined "occurrence" as "an accident, including continuous or repeated exposure to conditions, which result in bodily injury or property damage neither expected nor intended from the standpoint of the Insured." Both insurance companies first argued that there was no "accident" or "occurrence" if Bonitz was negligent in the installation of the roof. However, the Court held that the term "accident" does not exclude negligent work. The Court went on to hold that when the property damage began vis-a-vis the roof leaks, there was an "occurrence" under USF&G's policy. There was no evidence that Bonitz either expected or intended the roof to start leaking in 1972 when initially installed. However, the Court held that when Employers took over coverage in January 1977, the roof

had been leaking nearly four and one-half years, and therefore, the damage that resulted when the possibility of leaks became a reality under Employers' policy was not unusual, unexpected, or unforeseen and, therefore, not an "accident" or "occurrence."

The second issue is whether the occurrence caused property damage as defined by the policy. Property damage is generally defined⁸ as:

- (1) Physical injury to or destruction of tangible property . . . or
- (2) Loss of use of tangible property which has not been physically injured or destroyed

Most courts are reluctant to allow a contractor to recover from its insurer for the contractor's own shoddy work, and there are several cases which have held that repair and replacement of one's own defective work cannot constitute property damage under a CGL policy.⁹ This judicial interpretation cannot be justified by the plain language of the policy, as most defective work results in loss of use of the work itself, even if it causes no damage. However, this view is strongly ingrained in the judicial system, and probably can be explained by policy considerations. Most judges simply will not entertain an argument that a contractor is insured for the replacement of its own defective work. The jurisprudence often repeats the maxim that liability policies are not performance bonds, without engaging in a very detailed analysis of the policy terms.¹⁰

8 See, e.g., Borden, Inc. v. Howard Trucking Co., Inc., 454 So. 2d 1081 (La. 1983).

9 See, e.g., USF&G v. Advanced Roofing, 788 P.2d 1227 (Ariz. App. 1989); Thermex Corp. v. Fireman's Fund Ins. Co., 393 N.W.2d 15 (Minn. App. (1986)); St. Paul Fire & Marine Ins. Co. v. Coss, 80 Cal. App. 3d 888, 145 Cal. Rptr. 836 (1978).

10 See, e.g., Allen v. Lawton and Moore Builders, Inc., 535 So. 2d 779, 782 (La. App. 2d Cir. 1988).

B. THE WORK/PRODUCT EXCLUSION

In any event, the issue rarely arises, as most policies contain a "work/product" exclusion which eliminates any responsibility on the part of the insurer for replacement of the contractor's own defective work.

Most policies with "work/product" exclusions provide:

Exclusions

* * *

- (n) to property damage to the named insured's products arising out of such products or any part of such products;
- (o) to property damages to work performed by or on behalf of the named insured arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith;
- (p) to damages claimed for the withdrawal, inspection, repair, replacement, or loss of use of the named insured's products or work completed by or for the named insured or of any property of which such products or work form a part, if such products, work or property are withdrawn from the market or from use because of any known or suspected defect or deficiency therein;

The exclusion is targeted at disclaiming liability for damage to the insured's work/product when the damage is caused by that work/product. When the policy contains such an exclusion, there will be no recovery for the cost of replacing the contractor's defective work or for the cost of repairing the contractor's non-defective work damaged as a result of defects in other parts of his work.¹¹

In Bonitz, the Court examined work/product exclusions similar to those above. The Court held:

Since the roof is ultimately Bonitz's product in the sense that it is the end result of work performed by or on behalf of Bonitz, several of the exclusions apply to remove liability for damage to the roof itself from the coverage of the policy.

¹¹ Western World v. Paradise Pools & Spas, 633 So.2d 790 (La. App. 5th Cir. 1994); Rivnor Prop. v. Herbert O'Donnell, Inc., 633 So.2d 735 (La. App. 5th Cir. 1994); Brawdy v. National Grange Mut. Ins. Co., 616 N.Y.S. 2d 846 (A.D. 4 Dept. 1994); Lewis v. Easley, 614 So.2d 780 (La. App. 2 Cir. 1993); Nautilus Ins. Co. v. Long, 431 S.E.2d 624 (S.C. Ct. App. 1993); Ellsworth William v. United Fire & Cas., 478 N.W.2d 77 (Iowa App. 1991); Truck Ins. Exchange v. Heman, 800 S.W.2d 2 (Mo. App. 1990); Gulf Fleet Marine Operations v. Wartsilia Power, 797 F.2d 257 (5th Cir. 1986); Fredeman Shipyard Inc. v. Weldon Miller Contractors, 497 So. 2d 370 (La. App. 3d Cir. 1986); Allen v. Lawton and Moore Builders, Inc., 535 So. 2d 779 (La. App. 2d Cir. 1988).

The Court went on to hold that if damage to the roof itself was the only damage claimed by the City, the exclusions would work to deny Bonitz any coverage under the USF&G policy. However, the City had also claimed damage to ceiling, walls, carpets, and the gym floor (all areas outside the scope of the Bonitz contract), and therefore, the Court stated that there was damage to property other than the insured's product, and the insured's liability for that damage became the liability of the insurer under the policy.

As can be seen by Bonitz, generally, , a different result applies when the contractor's defective workmanship damages the owner's property or property not encompassed by the contractor's scope of work. In such cases, courts (including those who in other cases expressed a belief that defective work is not an occurrence) are far more likely to find coverage for the damage.¹² Thus, in the case of Gardner v. Lakvold, 521 So. 2d 818 (La. App. 2d Cir. 1988), a contractor undertook to remove paint from a house. The work was done poorly and resulted in damage to the new paint job which was applied by another contractor. The court found coverage on the basis that the damage was not to the "work" of the insured, even though it arose out of that work.

A very similar case in California reached the same result applying a "products" exclusion. In that case, the plaintiff ordered 760 doors from the insured, a manufacturer. The doors were so defective that 2,064 were delivered before the owner was satisfied. Justice Traynor, writing the opinion for the California Supreme Court, held that although the cost of the doors themselves was excluded, the damage to the buildings and to the owner's business interests was not.¹³

12 Superior Steel Inc. v. Bituminous Casualty Corp., 415 So. 2d 354 (La. App. 1st Cir. 1982); Hendrix Electric Co. Inc. v. Casualty Reciprocal Exchange, 297 So. 2d 470 (La. App. 2d Cir. 1974); See also Aetna Casualty & Surety Company v. PPG Industries, 554 F. Supp. 290 (D. Ariz. 1983) (interpreting a "products" exclusion).

13 Geddes & Smith v. Saint Paul Mercury Indemnity Company, 51 Cal. 2d 558, 334 P.2d 881 (1959), appeal after remand 63 Cal. 2d 602, 407 P.2d 868 (1965) (citing Hauenstein v. Saint Paul Mercury Indemnity Co., 242 Minn. 354, 65 N.W.2d 122 (1954) with approval). But see Volf v. Ocean Accident & Guaranty Corp., 50 Cal.2d

In Aetna Casualty & Surety Co. v. M&S Industries, Inc., 827 P.2d 321 (Wash. App. 1992), the insured's defective plywood panels were incorporated into the manufacturer's concrete forms systems and caused damage not only to the panels but also to the system. The work/product exclusion stated that it applied "to property damage to the named insured's products arising out of such products or any part of such products." Id. at 326. The court held that the policy provided coverage and the exclusions did not apply, because the case involved damage to other tangible properties.¹⁴

In Home Indemnity Co. v. Wilfreds, Inc., 601 N.E.2d 281 (Ill. App. 2 Dist. 1992), the Court held a completed building fell within the policy definition of "product" contained in the work product exclusion excluding "property damage to the named insured's products arising out of such products or any part of such products." Id. at 284. Thus, the insured contractor had no coverage for alleged faulty workmanship in constructing the building. No harm to other persons or property was alleged. Id. at 286.¹⁵

Reading these cases together, as they must be read, the general rule becomes clear that deviations from specifications, supply of defective materials, lousy workmanship and all of the other large and small disasters that occur on construction projects and result in defective work are usually "occurrences" under standard CGL policies, as long as they were unintentional. If these result in damage to work not performed by the insured or on its behalf, that damage is covered by the policy. The insurer's last line of defense is the completed operations exclusion.

558, 325 P.2d 987 (1957).

¹⁴ Sphere Drake Ins. Co. v. Fremco, Ins., 513 N.W.2d 473 (Minn. App. 1994); Heffernan & Co. v. Hartford Ins. Co., 614 A.2d 295 (Pa. Super. 1992); Indosuez v. Barclays Bank, PLC, 580 N.Y.S. 2d 765 (A.D. 1 Dept. 1992); Hartford Cas. Co. v. Cruse, 938 F.2d 601 (5th Cir. 1991); Harbor Ins. Co. v. Tishman Constr. Co., 578 N.E.2d 1198 (Ill. App. 1. Dist. 1991); Imperial Casualty & Indemnity Company v. High Concrete Structures, Inc., 858 F.2d 128 (3rd. Cir. 1988); Fireman's Insurance Company of Newbark v. Bayer Dental Studio, Inc., 805 F.2d 324 (8th Cir. 1986).

¹⁵ See Riley Stoker v. Fidelity & Guar. Ins. Underwriters, 26 F.3d 581 (5th Cir. 1994) (product exclusion and work exclusion both applied to property damage to steam generators which contractor was hired to build and install.)

C. THE COMPLETED OPERATIONS EXCLUSION

While virtually all CGL policies contain a "work/product" exclusion, many do not contain an exclusion for completed operations. The two clauses are often confused, but they are meant to cover separate risks. The typical "completed operations" exclusion disclaims liability for:

bodily injury and property damage arising out of operations or reliance upon a representation or warranty made at any time with respect thereto, but only if the bodily injury or property damage occurs after such operations have been completed or abandoned. . .¹⁶

Thus, whereas the "work/product" exclusion is meant to exclude damage to the insured's work, the "completed operations" exclusion is intended to exclude any and all damage or injury arising from the work after the completion of the project.¹⁷

In the case of West Brothers of DeRidder, La. v. Morgan Roofing, 376 So. 2d 345 (La. App. 3d Cir. 1979), the owner sued a roofing contractor for the cost of replacement of a roof and for damages to his building caused by leaks. The roofer filed a third party demand against its liability carrier when the latter refused to defend the case. Applying the language of the completed operations exclusion, the court found that there was no duty to defend. It reached this decision even though damages other than those to the work were alleged, stating that the claims were unambiguously excluded by the clause.¹⁸

¹⁶ See, e.g., West Brothers of DeRidder, La. v. Morgan Roofing, 376 So. 2d 345, 349 (La. App. 3d Cir. 1979).

¹⁷ For example, in McRaskill v. Welch, 463 So 2d. 942 (La. App. 3d Cir.), writ denied, 466 So. 2d 469 (La. 1985), the court stated:

Where completed operations and products hazards are excluded from coverage, losses which occur subsequent to completion of the project are not covered.

463 So. 2d at 951.

¹⁸ See also Moreau v. Moran, 465 So. 2d 202 (La. App. 3d Cir. 1985); Buckeye Union Ins. Co. v. Liberty Solvents and Chemicals Co., 17 Ohio App. 3d 127, 477 N.E.2d 1227 (1984); R.A. Owens Construction Co. v. Employers Insurance Co. of Alabama, 392 So. 2d 1180 (Ala. 1981); Adkins v. La Terre Development Corp., 387 So.2d 652 (La. App. 1st Cir. 1980);

However, more recent policies provide additional coverage for "products - completed operations hazard," and those similar policies specifically limit application of the work/product exclusion and provide coverage if the work was performed by a subcontractor. Sample policy language appears as follows:

"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

Consequently, property damage to property not within the contractor's scope of work caused by subcontractor work and included within the additional coverage for "products-completed operations hazard" would be covered.

The surety called to task under its performance bond for latent defects after completion of the project should carefully examine its principal's CGL policy. If it does not contain a completed operations exclusion, all damage other than the work of the principal probably will be covered. If it does contain such an exclusion, the surety probably will respond alone for the damages. However, if coverage for products-completed operations hazard is afforded, then resulting damage from subcontractor work probably will be covered.

II. RECOVERING FOR DEFECTS IN THE WORK OF SUBCONTRACTORS

When the defective work has been performed by a subcontractor rather than by the principal's own forces, the surety's chances of recovery increase. First, if the subcontractor carries CGL insurance, any "work/product" exclusion in its policy likely will not apply as regards damage to the work of other subcontractors and to that of the prime contractor.¹⁹ The reason for this is that the exclusion applies to damage to work done by or on behalf of the insured and, while an argument can be made in the context of the exclusion under the prime's policy that the subcontractor works on behalf of the prime, no reasonable argument can be made that the reverse is true.

Second, when the defective work results from the actions of the principal's subcontractor, the chances are increased that recovery is available under the principal's CGL policy. The issue here is the applicability of the "work/product" exclusion. As discussed above, this exclusion is found in almost all CGL policies. However it is possible to modify the exclusion by means of a "Broad Form Property Damage Liability Endorsement Supplement" to the policy. The Broad Form endorsement changes the language of the "work" exclusion subtly, but significantly, by eliminating the exclusion for work done on behalf of the insured, and only excluding damage arising from the work of the insured itself.

Thus, in the case of Mid-United Contractors, Inc. v. Providence Lloyds Insurance Company, 754 S.W.2d 824 (Tex. App. 2d Dist. 1988), Mid-United was sued by an owner for damages resulting from defects in an office building which it had constructed. It made demand upon its insurer, who refused to defend based inter alia on the "work" exclusion of the policy. The trial court sustained the insurer's motion for summary judgment; the appeal court reversed. Addressing the issue of the "work" exclusion, the appeal court noted that the owner alleged improper installation of prefabricated brick

¹⁹ See cases and text at Footnotes 11, 12, and 13.

panels resulting in moisture penetration and damage to the building. The appeal court noted that the defective work was performed by a subcontractor and was therefore not work of the insured. As the Broad Form endorsement eliminated the exclusion for work done on behalf of the insured, the damage was not excluded.²⁰

In Green Construction v. National Union Fire & Insurance Company, 771 F. Supp. 1000 (W.D. Mo. 1991), National Union relied upon work product exclusions and the broad form comprehensive liability endorsement to exclude coverage of the policy. Exclusion (n) excluded coverage for "property damage to the named insured's products arising out of such products or any part of such products." The Court held that although a dam is not a product, such a structure is "work" within the meaning of the "injury to work exclusion." Exclusions (VI)(A)(3) excluded coverage for "property damage to work performed by the named insured arising out of such work or any portion thereof, or out of such materials, parts, or equipment furnished in connection therewith." Green argued that damage to the dam arising out of work performed by others was not excluded from coverage. National Union conceded that the broad form endorsement may in some circumstances provide liability coverage where liability for the named insured arises out of work performed by a subcontractor. However, National Union took the position that the deletion of the phrase, "or on behalf of" was insignificant. Several courts have concluded that the broad form endorsement "injury to work" exclusion narrows the broad

²⁰ 754 S.W.2d at 827. See also Maryland Casualty Company v. Reeder, 270 Cal. Rptr. 719 (Cal. App. 4th Distr. 1990); Fireguard Sprinkler Systems v. Scottsdale Insurance Co., 864 F.2d 648 (9th Cir. 1988); Dorchester Development v. Safeco Insurance, 737 S.W.2d 380 (Tex. App. Dallas 1987).

standard "injury to work" exclusion.²¹ Other courts, however, have held that the broad form endorsement does not narrow the scope of the standard "injury to work" exclusion.²²

The Court in Green Construction felt the better reasoned cases are those which give effect to the carefully drafted language of the broad form endorsement. The Court held that this exclusion did not exclude coverage to Green for any liability Green incurred for damage to its own work arising out of work performed on its behalf by subcontractors.

In McKeller Development v. Northern Insurance, 837 P.2d 858, (Nev. 1992), the Court held that the broad form property damage endorsement of comprehensive general liability policy provided coverage where the BFPD completed operations exclusions had eliminated the phrase "or on the behalf of" and applied only to work performed by the "named insured." Thus, this indicated the work of the subcontractor was intended to be covered by the policy. In McKeller, the Court held that this indicated that coverage applied to the soil compaction work performed by subcontractors.

This reasoning is not universally followed. Some courts have held that, despite the Broad Form endorsement, the entire project remains the general contractor's work and liability for damage arising out of any defective work is excluded.²³ These cases seem to be based more on the nature of the contract between the owner and the general contractor rather than on that of the insurance agreement. In general, these cases reason that the issue of the contractor's responsibility to the owner determines the scope of the exclusion:

21 Harbor Ins. Co. v. Tishman Constr. co., 578 N.E.2d 1197 (Ill. App. 1 Dist. 1991); Maryland Casualty Company v. Ritter, 221 Cal. App. 3d 961, 270 Cal. Rept. 719 (June 1990); Fireguard Sprinkler Systems, Inc. v. Scottsdale Insurance Company, 864 F.2d 648 (9th Cir. 1988); W.E. O'Neal Construction Company v. National Union Fire Insurance Company, 721 F. Supp. 984 (N.D. Ill. 1989); Mid-United Contractors, Inc. v. Province Lloyds Insurance Company, 754 S.W.2d 824 (Tx. App. Ft. Worth 1988).

22 Knutson Construction v. St. Paul Fire & Marine Insurance (Minn. 1986); Vari Builders, Inc. v. USF&G, 523 A.2d 549, 552 (De. Super. 1986).

23 Knutson Constr. Co. v. St. Paul Fire & Marine Ins. Co., 396 N.W.2d 229 (Minn. 1986); Blaylock & Brown Const. v. AIU Ins. Co., 796 S.W.2d 146 (Tn. 1990); Tucker Construction Co. v. Michigan Mut. Ins. Co., 423 So. 2d 525 (Fla. Dist. 5 1982).

. . . the named insured is the general contractor and work performed by the insured must necessarily be such work as the named insured is required to perform under the construction contract. . . . The contractor can employ subcontractors. . . to do the work, but in the end, all the work called for by the contract. . . must be deemed to be work of the contractor.²⁴

In Ryan Homes, Inc. v. Home Indemnity Co., 647 A.2d 939 (Pa. Super. 1994), a general contractor had to replace roofs, part of the homes which it constructed, because of defective workmanship by subcontractors. The Court stated that the general contractor was not covered under its general liability policy because the subcontractors were required to meet and the contractor was "required to enforce the standards of good workmanship" under the work product exclusions. Id. at 944.²⁵

This logic is flawed. None of the cases consider that the very nature of an insurance policy is to shift risk accepted by a person, that the policy does not reference the construction contract and that it might very well be the intention of the parties to shift risk for work not actually performed by the insured.

Indeed, the latter view is supported by the industry literature. The FC&S Bulletin has flatly interpreted the Broad Form endorsement to provide coverage for damage arising out of a subcontractor's work:

Thus, an insured has coverage for his completed work when the damage arises out of work performed by someone other than the named insured such as a subcontractor. . . . Therein lies the advantages of the Broad Form Property Damage coverage. . . .²⁶

24 Blaylock, 796 S.W.2d at 154.

25 See also Tucker Constr. Co. v. Michigan Mut. Ins. Co., 423 So.2d 525 (Fla. App. 1982).

26 Quoted in Maryland Casualty Company v. Reeder, 270 Cal. Repr. at 725.

This appears to be the better view, and was incorporated into the 1986 revision of the standard policy form.²⁷ Additionally, some of the policy language leaves no room for interpretation and states:

j. "Property damage" to:

* * *

(6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

* * *

Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard".

k. "Property damage" to "your product" arising out of it or any part of it.

l. "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

This clearly is an attempt by the insurance industry to clarify the subcontractor coverage issue.

²⁷ Olson, Ronald D. and Wielinski, Patrick J., "Commercial General Liability Insurance" presented at the Mid-Winter Meeting of the Forum Committee on the Construction Industry of the American Bar Association, January 30, 1986, at Page 31.

III. COVERAGE OF CLAIMS AGAINST THE INDEMNITORS UNDER THE PRINCIPAL'S CGL POLICY

The surety's final protection against loss is the indemnity agreement which it generally requires before it will execute a bond. However, although the agreement purports to protect the surety against all loss and is thus of some comfort to underwriters, those on the claims side of the industry know that all too often the agreement has no financial strength behind it. By the time it is invoked, all of the indemnitor's funds have either been plowed back into the losing business or else entrusted to a discreet banker in Barbados. It is possible, however, that the indemnity agreement may be insured, if the principal has obtained broad form CGL coverage, including contractual liability coverage.

Contractual liability is generally excluded from coverage unless the liability is assumed pursuant to an incidental contract.²⁸ The insurance does not apply:

(a) to liability assumed by the insured under any contract or agreement except an incidental contract . . .

An incidental contract is generally defined as:

. . . any written (1) lease of premises, (2) easement agreement, except in connection with construction or demolition operations on or adjacent to a railroad, (3) undertaking to indemnify a municipality required by municipal ordinance, except in connection with work for the municipality, (4) sidetrack agreement, (5) elevator maintenance agreement, or (6) easement or license agreement in connection with vehicle or pedestrian private railroad crossings at grade; . . .

²⁸ See e.g. *Allen v. Keenv*, 532 So. 2d 521 (La. App. 1st Cir. 1988), writ denied, 456 So.2d 958 (1984).

The question posed is whether an indemnity agreement is an incidental contract in the context of a construction contract, where a bond is required. At least one court has found that it is.

In the case of Merrick Construction v. Hartford Fire Insurance Company, 449 So. 2d 85 (La. App. 1st Cir. 1984), a contractor brought suit against its general liability carrier to recover attorney's fees it paid for the defense of its surety pursuant to an indemnity agreement. The insurer had refused a tender of defense by the surety on the grounds that the surety was not a named insured, but rather a "total stranger," and that the defense costs originated from the indemnity agreement rather than the insured construction agreement. The trial court resolved the matter by holding that the insurer was correct in its position that it had no direct obligation to the surety, but that the principal's obligation to the surety to reimburse it for attorney's fees was an insured obligation.²⁹

The appeal court affirmed, holding that the claim was covered under the contractual liability section of the policy:

The liability of Merrick has its origin in the road construction contract. The surety relationship between Merrick and St. Paul is incidental to and arises from the requirements of that contract.³⁰

As a result, the insurer was cast for \$148,707.85 in attorney's fees in a case in which no liability on the part of the contractor or its surety had been found.

The insured can expressly request such an endorsement. By way of analogy, in AAA Contracting v. United Coastal Ins., 599 N.Y.S.2d 203 (A.D. 4 Dept. 1993), a separate endorsement to the general liability policy expressly included a contract for asbestos removal as an incidental contract.

Furthermore, even should a court disagree and find that the indemnity agreement is not incidental to the construction contract and that the Contractual Liability exclusion therefore bars any indemnity

²⁹ Merrick Construction, 449 So. 2d at 87.

³⁰ Merrick Const., 449 So. 2d at 88. Although not expressly stated, the appeal court's reasoning may have been based on the fact that this was a public contract, and the bond was required by the contract.

claims by the surety, a different result may obtain if the principal has purchased the broad form endorsement which provides Contractual Liability coverage.

The endorsement is limited in scope and is intended to restore only a part of the coverage removed by the exclusion. A typical broadened coverage form extends coverage to:

any other written contract or agreement wherein the named insured has expressly assumed liability to damages to which this policy applies; provided, however, that such liability shall not be construed as including liability under a warranty . . . that work performed by or on behalf of the named insured will be done in a workmanlike manner.

Thus, for an additional premium, the insurer is prepared to undertake the risk of liability for property damage or personal injury assumed under a contract, but it continues to maintain the "work" exclusion.

In Natchitoches Parish School Board v. Shaw, 620 So.2d 412 (La. App. 3 Cir. 1993), the incidental contract definition was extended "to include any oral or written contract or agreement relating to the conduct of the named insured's business." In Natchitoches, the Court held that the roofing contractor's general liability insurer had to indemnify the contractor for attorneys' fees incurred by the contractor's surety in defending against a claim by the school which had hired the contractor to replace a roof. Despite the exclusion in the policy for roofing operations, the insurer's duty to indemnify the contractor arose from an incidental contract in which the insured's agreement to indemnify its surety for attorneys' fees and the policy specifically provided coverage for liability assumed by the insured under incidental contracts. Shaw's liability to Merit Plan pursuant to the indemnity agreement was covered by the expanded contractual liability provisions of the American policy. Id. at 415. The indemnity contract whereby Shaw agreed to pay attorneys' fees and costs was incidental to a roofing construction contract between Shaw and the Board. American's exposure was limited to the liability assumed by its insured, Shaw, under the contract to indemnify or hold harmless. American did not owe Merit Plan a direct defense as an insured under the policy because Merit Plan did not qualify as such.

American's liability is based on the fact that it undertook to cover liability assumed by its insured, Shaw, and an incidental contract.

In the context of the General Indemnity Agreement required by sureties, the insurer may come to grief on the narrowness of the "work" exclusion. It should be remembered that it applies only to the work of the insured. It is common practice for construction companies to include the owners of the company as additional named insureds on their policies. These are the same people who sign general indemnity agreements for surety companies. However, as a legal matter, they are not the persons performing the work. Thus, if the surety's individual indemnitors are additional named insureds on the principal's CGL policy, and if that policy has a broad form endorsement including contractual liability, then the indemnitors' obligation to the surety should be covered unless it arises from their work. As the individual indemnitors perform no work, their obligations should be covered.

IV. CONCLUSION

In most cases, the surety will not be able to call upon its principal's insurer for protection from performance claims. However, it would be a mistake to assume for this reason that it never can. In many cases, particularly those involving actual damage to work, the insurer may very well be liable. Further, depending on the combination of coverages purchased by the insured, the surety may be able to seek reimbursement for the cost of replacement of defective work installed by a subcontractor and, in a few cases, may even be able to recover from the insurer for the indemnity obligations of its indemnitors.