FIRST PARTY CLAIMS CONFERENCE

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INTERPRETATION OF THE "FAULTY WORKMANSHIP" EXCLUSION: ADJACENT CONSTRUCTION AND ENSUING LOSS.

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I. Accepted Tenets of Insurance Policy Interpretation.

An insurance contract is an agreement where the insurer is obligated to confer a benefit upon an insured, that has a material interest in the subject of the insurance policy, upon the happening of a fortuitous event[1]. A fortuitous event is "any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party"[2].

The rational for the fortuity doctrine is that parties who enter into insurance contracts are, in effect, making a wager as to the likelihood that a specified loss will occur[3]. If the loss has already occurred, or the insured knows that the loss is certain to occur for reasons not disclosed to the insurer, then the insurance contract is not a fair bet. "Broadly stated, the fortuity doctrine holds that 'insurance is not available for losses

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[1] New York State Insurance Law ("Ins. Law") § 1101(a)(1).
[2] Ins. Law § 1101(a)(2).
[3] *Bartholomew v. Appalachian Ins. Co.*, 655 F.2d 27 (1st Cir. 1981).

that the policyholder knows of, planned, intended, or is aware are substantially certain to occur'"[4].

A contract of insurance is construed, like any other contract, according its terms. So long as the terms are clear and unambiguous, the terms are interpreted by their plain meaning."[5] Courts may not extend coverage, or enlarge the liability of the insurer, beyond the plain meaning of the express terms of the insurance policy[6]. In other words, a court may not create or re-write an insurance contract, or give the policy a strained construction contrary to its terms[7]. The policy must be interpreted in light of the reasonable expectations of the parties[8], which are the "reasonable expectation[s] and purpose[s] of the ordinary business [person] when making an ordinary business contract."[9]

In an insurance coverage case, it is the insured's burden to first prove that it suffered a loss that is covered by the insurance policy[10]. Once the insured establishes coverage under the policy, an insurer who seeks to avoid coverage must establish that the loss is excluded by an unambiguous exclusion to coverage contained in the policy[11]. As part of its burden, the insurer must establish that the exclusion is set forth in "clear and unmistakable language, is subject to no other reasonable interpretation, and

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[4] *National Union Fire Ins. Co. of Pittsburgh, PA. v. Stroh Companies, Inc.*, 265 F.3d 97, 106 (2nd Cir. 2001). Internal citations omitted.
[5] *Preston v. Aetna Ins. Co.*, 193 N.Y. 142, 85 N.E. 1006 (1908).
[6] *Moshiko, Inc. v. Seiger & Smith, Inc.*, 137 A.D.2d 170, 529 N.Y.S.2d 284 (1st Dept. 1988), *aff'd at* 72 N.Y.2d 945, 533 N.Y.S.2d 52 (1988).
[7] *Bretton v. Mutual of Omaha Ins. Co.*, 110 A.D.2d 46, 492 N.Y.S.2d 760 (1st Dept. 1985), *aff'd. at* 66 N.Y.2d 1020, 489 N.E.2d 1299, 499 N.Y.S.2d 397 (1985).
[8] *Bird v. St. Paul Fire & Marine Ins. Co.*, 224 N.Y. 47, 120 N.E. 86 (1918); *Throgs Neck Bagels, Inc. v. GA Ins. Co. of New York*, 241 A.D.2d 66, 671 N.Y.S.2d 66 (1st Dept. 1998).
[9] *Bird v. St. Paul, supra.*
[10] *Gongolewski v. Travelers Ins. Co.*, 252 A.D.2d 569, 569, 675 N.Y.S.2d 299 (2d Dept. 1998), *lv. app. den. at* 92 N.Y.2d 815, 705 N.E.2d 1215, 683 N.Y.S.2d 174 (1988).
[11] *Throgs Neck Bagels, supra, citing Continental Cas. Co. v. Rapid-American Corp.*, 80 N.Y.2d 640, 609 N.E.2d 506 (1993).

applies in the particular case"[12]... and that "its interpretation of the exclusion is the only construction that "could 'fairly be placed thereon'".[13] If the court determines that the exclusionary clause is ambiguous[14], the ambiguity will be resolved in favor of the insured[15].

Whether a court believes that the exclusion should not act to exclude coverage is irrelevant. Courts may not rewrite an otherwise unambiguous contract "to accomplish [their] notions of abstract justice or moral obligation"[16], or to extend coverage "beyond [the policy's] fair intent and meaning in order to do raw equity..."[17]

II. Interpretation of the "Faulty Workmanship" and Other Exclusions: Adjacent Construction.

A. The Faulty Workmanship Exclusion

In the case of *242-44 East 77th Street, LLC v. Greater New York Mutual Insurance Company*, 31 A.D.3d 100, 815 N.Y.S.2d 507 (1st Dept. 2006), the court found ambiguities in the "faulty workmanship" exclusion asserted in defense of the insured's claim for damage to its property. In that case, the insured claimed that its building was damaged by the activities of contractors at an adjacent site, who removed earth from underneath the insured building and constructed faulty underpinning under the insured building's foundation.

The language of the "faulty workmanship" exclusion to coverage addressed in the *77th Street* decision provides:

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[12] Id.
[13] *Sincoff v. Liberty Mut. Fire Ins. Co.*, 11 N.Y.2d 386, 183 N.E.2d 899 (1962), *quoting Hartol Products Corporation v. Prudential Ins. Co. of America,* 290 N.Y. 44, 47 N.E.2d 687 (1943).
[14] *Breed v. Insurance Co. of North America,* 46 N.Y.2d 351, 413 N.Y.S.2d 352 (1978).
[15] *Breed*, supra; *Greaves v. Public Service Mut. Ins. Co.*, 5 N.Y.2d 120, 181 N.Y.S.2d 489 (1959).
[16] *Breed*, supra; *Teichman v. Community Hosp. of Western Suffolk*, 87 N.Y.2d 514, 640 N.Y.S.2d 472 (1986).
[17] *Breed*, supra, *quoting Weinberg & Holman v. Providence Washington Ins. Co.*, 254 N.Y. 387, 391, 173 N.E. 556, 557 (1930).

3. We will not pay for loss or damage caused by or resulting from any of the following: ...

* * *

c. Negligent Work

Faulty, inadequate or defective:

(1) Planning, zoning, development, surveying, siting;

(2) Design, specifications, workmanship, repair, construction, renovation, remodeling, grading, compaction;

(3) Materials used in repair, construction, renovation or remodeling; or

(4) Maintenance;

of part or all of any property on or off the described premises.

(Emphasis supplied.)

One can argue that, in interpreting this provision, the *77th Street* court departed from the long-standing rules of insurance policy interpretation discussed above. Despite the fact that the court failed to find any particular ambiguity in the exclusionary language itself, it held that the "faulty workmanship" exclusion applied only to work done "on the part of plaintiff or its agents with respect to the described premises". The court, in effect, re-wrote the policy to read, "of part or all of any property on or off the described premises... **if the negligent work was performed 'by or on behalf of the insured in planning, designing or constructing the insured building, which results in damage to the building.**'"[18] (emphasis supplied).

[18] ID, 31 A.D.3d at 106, 815 N.Y.S.2d at 512.

The court held that "on or off the described premises" must refer to personal property or to covered off-premises buildings or structures, because "all other references to property in the policy refer to property owned by the insured or under its control." However, there is no reason to assume that the words of the policy must mean something that they do not say. The absence of language limiting the exclusion to "property owned by the insured or under its control" should have led the court to find in favor of the insurer.

Furthermore, the *77th Street* court appeared to havae ignored the doctrine of ejusdem generis[19] that it applied in other parts its decision. Terms such as "siting, grading, design, construction, renovation and remodeling", set forth in the faulty workmanship exclusion, are all terms associated with real property. From this language, it is clear that the insurer intended this exclusion govern real, not personal, property. The court apparently failed to consider that this exclusion's reference to "any property" omits the reference, found elsewhere in the policy to "property you own" and "property in your care, custody or control". This omission makes it clear that the insurer never intended, nor could a reasonable business person reading this exclusion understand, that the "faulty workmanship" exclusion would be limited to work performed by or on behalf of the insured on the insured property.

The *77th Street* court noted that its decision was contrary to findings of courts in other jurisdictions. In *El Rincon Supportive Servs. Org. v. First Nonprofit Mut. Ins. Co.*[20], the court interpreted the word "construction" to include excavation. In *Slaby v. Safeco*

[19] In brief, "the meaning of a word is determined by the company it keeps".
[20] *El Rincon Supportive Servs. Org. v. First Nonprofit Mut. Ins. Co.*, 346 Ill.App.3d 96, 281 Ill.Dec. 128, 803 N.E.2d 532 (1st Dist., 6th Div. 2004).

Ins. Co.[21], the court found that faulty maintenance and removal of subjacent support was not a covered loss where the policy excluded [faulty workmanship] "of property whether on or off the 'insured location' by any person or organization".

The *77th Street* court did not discuss the lower court's decision in the neighboring 2nd Department of *Harris v. A. Uliano Construction Corp., et. al.* (Nassau County Supreme Court, Index No. 000702/01)[22], where the court found that the faulty workmanship exclusion "of any property such as land, structures or improvements of any kind, whether on or off a residence named on the Coverage Page", clearly and unambiguously excluded damage to the insured's property that was caused by the excavation and re-installation of sewer pipe under and adjacent to the plaintiff's home. There, the court found that "[p]laintiff's contention that the policy 'should' provide coverage for property damage caused by third parties over which she had no control, is nothing more than pure supposition and to a great extent, 'wishful thinking'".

While the *77th Street* decision legitimized that "wishful thinking" so that it is now law for cases brought in the Appellate Division, covering Manhattan and Bronx courts, the question remains unresolved in the remainder of New York.

B. The "settling, cracking, shrinking or expansion" exclusion.

The insurer defending the *77th Street* action also claimed that coverage was excluded based upon the policy exclusion for losses caused by or resulting from "settling, cracking, shrinking or expansion". In interpreting this exclusion, the court

[21] *Slaby v. Safeco Ins. Co.*, 972 F.2d 1342 (9th Cir. 2001). An unreported, non-binding decision.
[22] *Harris v. A. Uliano Construction Corp., et. al.* (Nassau County Supreme Court, Index No. 000702/01). Located at http://decisions.courts.state.ny.us/10jd/nassau/decisions/index/index_new/martin/2001dec/000702-01.pdf.

found that all of the exclusions set forth in this portion of the insurance policy[23] shared the same characteristic, in that they were naturally occurring phenomena. Applying the doctrine of "ejusdem generis", the court found that the "settling, cracking, shrinking or expansion" exclusion only applied to losses caused by naturally occurring events, and thus, did not exclude damage to the insured's property caused by construction activities.[24]

In the recent case of *Pioneer Tower Owners Association v. State Farm Fire & Casualty Company*[25], New York's Court of Appeals settled the question for all of New York, holding that the "settling, cracking" exclusion did not bar recovery under the policy for settling and cracking of the insured's building caused by earth removal on an adjacent property.

C. The "earth movement" exclusion.

Neither the *77th Street* decision, nor the First Department's previous decision in *Burack v. Tower Ins. Co. of N.Y.*[26] resolved the question of whether the earth movement exclusion[27] excluded losses caused by excavation on an adjacent property. In *77th Street*, the court found that the policy's "earthquake" endorsement had removed the earth movement exclusion, possibly preserving the exclusion for earth movement

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[23] Wear and tear; rust, corrosion, fungus, decay, deterioration ... or any quality in property that causes it to damage or destroy itself; smog; nesting or infestation; and loss to personal property caused by dampness or dryness of atmosphere or changes in or extremes of temperature.

[24] *242-44 East 77th Street, LLC v. Greater New York Mutual Insurance Company,* 31 A.D.3d 100, 103, 815 N.Y.S.2d 507, 510 (1st Dept. 2006),

[25] *Pioneer Tower Owners Association v. State Farm Fire & Casualty Company,* 12 N.Y.3d 302, 908 N.E.2d 875 (2009).

[26] *Burack v. Tower Ins. Co. of N.Y.,* 12 A.D.3d 167, 784 N.Y.S.2d 53 (1st Dept. 2004).

[27] The policy sets forth anti-concurrent causation language before excluding "Earth Movement... Any earth movement (other than sinkhole collapse), such as an earthquake, landslide, mine subsidence or earth sinking, rising or shifting..."

caused by construction in the absence of any earthquake causing or contributing to this loss.

In *Burack,* the court refused to resolve the question of whether the earth movement exclusion could be applied to non-natural phenomena[28] as a matter of law. However, *Lee v. State Farm Fire & Cas. Co.*[29], decided in the neighboring Second Department, found that the earth movement exclusion did not apply to "physical removal by excavation of earth from underneath the plaintiffs' dwelling"

The question of whether the earth movement exclusion barred coverage for losses caused by adjacent excavation performed by others was resolved by New York's highest court on April 30, 2009. In *Pioneer Tower Owners Association v. State Farm Fire & Casualty Company*[30], the Court of Appeals determined that, although it was a "close question", the earth movement exclusion does not bar coverage for damage caused by faulty workmanship on properties adjacent to the insured property.

II. Interpretation of the "Faulty Workmanship" Exclusion: "Ensuing Loss".

Where there are two causes of loss, one excluded and one not excluded, and the non-excluded cause grows out of [ensues from] the excluded cause, the court must determine whether the ensuing cause of loss is independent of the excluded loss or inextricably connected to it. If the ensuing loss is connected to the excluded loss, the exclusion will apply.

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[28] *Holy Angels Academy v. Hartford Ins. Group*, 127 Misc.2d 1024, 487 N.Y.S.2d 1005 (1985); *Barash v. Insurance Co. of N. Am.*, 114 Misc.2d 325, 330, 451 N.Y.S.2d 603 (1982); *Peters Twp. School Dist. v. Hartford Acc. & Indem. Co.*, 833 F.2d 32, 36 (3d Cir.1987).
[29] *Lee v. State Farm Fire & Cas. Co.*, 32 A.D.3d 902, 904, 822 N.Y.S.2d 559, 561 (2d Dept. 2006).
[30] *Pioneer Tower Owners Association v. State Farm Fire & Casualty Company,* supra.

A. Principles of "Ensuing Loss" Interpretation.

In *Bird v. St. Paul Fire & Marine Ins. Co.*[31], the insured's boat was damaged by the concussion from an explosion caused by a distant fire. In that case, where the policy covered for loss and damage caused by fire, the Court held that, due to the distance between the fire and the plaintiff's boat, it was the concussion, and not the fire, that caused the insured's loss. "There is no use in arguing that distance ought not to count if life and experience tell us that it does."[32]

In *Album Realty Corp. v. American Home Assur. Co.*[33], a sprinkler head in the insured's building froze and cracked. Once the sprinkler head cracked, water escaped and a flooding loss ensued. The Court of Appeals was faced with the question of whether the damage was caused by freezing (an excluded cause of loss), or water (a covered cause of loss). The *Album* Court, interpreting the policy in light of the parties' intent, found that the loss was caused by water. The Court held that "[w]e are to follow the chain of causation [only] so far as the parties meant that we should follow it"[34], and that a reasonable business person would conclude that the loss was caused by water "and would look no further for alternate causes."[35] While freezing was in the chain of causation, the court found that freezing was too remote to be the cause of the resulting flood damage when viewed in light of the expectations of a reasonable insured.

In *Continental Ins. Co. v. Arkwright Mut. Ins. Co.,*[36] a flood case in which the water caused electrical arcing, the court held that the loss was caused by the flood.

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[31] *Bird v. St. Paul*, supra.
[32] Id., 224 N.Y. at 52, 120 N.E. at 87.
[33] *Album Realty Corp. v. American Home Assur. Co.,* 80 N.Y.2d 1008, 592 N.Y.S.2d 657 (1992).
[34] *Album,* supra, *quoting Goldstein v. Standard Acc. Ins. Co.*, 236 N.Y. 178, 140 N.E. 235 (1923).
[35] *Album*, supra, 80 N.Y.2d at 1010, 607 N.E.2d at 658.
[36] *Continental Ins. Co. v. Arkwright Mut. Ins. Co.,* 102 F.3d 30 (2nd Cir. 1996).

The arcing damage, which occurred when floodwaters came in direct contact with energized electrical panels, did not take on the status of an independent cause because there was no spatial or temporal separation between the flood waters and the resulting loss. Citing *Bird v. St. Paul,* the court distinguished the facts of this case from those in *Home Ins. Co. v. American Ins. Co.*[37], where the court held that denial of coverage based upon this exclusion was proper, because substantial time and space separated the water from eventual electrical damage[38].

In the case of *Parks Real Estate Purchasing Group v. St. Paul Fire and Marine Ins. Co.*[39], particulate matter released after the World Trade Center collapsed on September 11, 2001 damaged the insured's building located approximately one-quarter mile away. The court determined that it was not the collapse of the World Trade Center, but contact between the particulate matter and the insured's building, that caused the loss. In that case, the large cloud of noxious particulate matter became an independent peril that had ensued from the initial collapse.

B. "Ensuing Loss" and the "Faulty Workmanship" Exclusion

Courts throughout the nation have interpreted "ensuing loss" policy provisions in light of the "faulty workmanship" exclusion contained in many "all risk" insurance policies.

In *80 Broad Street Co. v. U.S. Fire Insurance Co.*[40], the façade of the insured building buckled due to two causes of loss; improper installation and "rain, frost,

[37] *Home Ins. Co. v. American Ins. Co.,* 147 A.D.2d 353, 537 N.Y.S.2d 516 (1st Dept. 1989).
[38] *Continental Ins.*, supra, 102 F.3d at 36-37.
[39] *Parks Real Estate Purchasing Group v. St. Paul Fire and Marine Ins. Co.,* 472 F.3d 33 (2nd Cir. 2006).
[40] *80 Broad Street Co. v. U.S. Fire Insurance Co.,* 88 Misc.2d 706, 389 N.Y.S.2d 214 (Sup. Ct. N.Y. County 1975) aff'd. at 389 N.Y.S.2D 214, 54 A.D.2d 888, 390 N.Y.S.2d 768 (1st Dept. 1975), *appeal den. at* 2 N.Y.2d 801, 366 N.E.2d 292, 397 N.Y.S.2d 1025 (1977).

seepage, rust and corrosion." In rejecting the insured's contention that its loss was caused by the covered causes of seepage and moisture, rather than the excluded cause of faulty workmanship, the court found that "[t]he alleged non-excluded causes grow out of and are directly related to the excluded ones. They do not take on the character of a subsequent fortuitous event[41].

In *Aetna Cas. & Sur. Co. v. Yates,*[42] the insured's floor joists, sills and sub-flooring substantially rotted away because the crawl space, when chilled by air conditioning, produced condensation and consequent rotting. While the policy excluded various causes of loss, including defective construction (failure to ventilate the crawl space) and rotting, it provided coverage if a loss ensued from water damage. In issuing its decision affirming the denial of coverage, the court found that construing this loss to be one ensuing from water damage would nearly destroy the exclusionary clause. "A court may not properly give the clause such an unnatural effect unless the words compel."[43]

In *Hartford Cas. Ins. Co. v. Evansville Vanderburgh Public Library*, [44] the court found that damage to a building caused by the use of unsuitable tools and materials during excavation was faulty workmanship and that there was no ensuing loss because the construction activities "withdrew support from the building." In *Acme Galvanizing Co. v. Fireman's Fund Ins. Co.,*[45] faulty workmanship (inadequate welding of a kettle)

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[41] *80 Broad Street Co.,* supra, 88 Misc.2d at 708, 389 N.Y.S.2d at 216.
[42] *Aetna Cas. & Sur. Co. v. Yates*, 344 F.2d 939 (5th Circuit 1965).
[43] Id. at 344 F.2d 941.
[44] *Hartford Cas. Ins. Co. v. Evansville Vanderburgh Public Library,* 860 N.E.2d 636, (Ind.App. 2007).
[45] *Acme Galvanizing Co. v. Fireman's Fund Ins. Co.*, 221 Cal.App.3d 170, 270 Cal.Rptr. 405 (Cal.App.1.Dist. 1990).

created a latent defect allowing a release of molten zinc. The court found that the loss was a direct result of the latent defect, not an ensuing loss.

New York courts have rejected the argument that the faulty workmanship exclusion applies only to the faulty product created by the workmanship, and not to the faulty process used in creating the product.

In *Wider Heritage Maintenance Inc.*[46], where a contractor damaged the interior of the insured building by using a faulty process to clean the building's exterior, the court rejected the product/process distinction:

> There is no reasonable conflict in finding that "workmanship" can refer to the quality of both the process by which the work is done and of the finished product. Finding that the term 'workmanship' is ambiguous because it can mean either would 'strain the contract language beyond its reasonable and ordinary meaning'... An ordinary business person applying for a commercial property insurance policy and reading the language of this Exclusion would understand that, depending on the type of work done, the Faulty Workmanship Exclusion could apply to the process of doing the work or the finished product.[47]
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> (internal citations omitted)

In *Henry Modell and Co., Inc. v. General Ins. Co. of Trieste & Venice,*[48] the insured claimed damage to its property caused by construction dust generated by a nearby subway construction project. The court found that the loss was caused by excluded pollutants that entered the insured's premises the insured's own failure to maintain its ventilation systems (a process).

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[46] *Wider Heritage Maintenance Inc.*, 14 Misc.3d 963, 827 N.Y.S.2d 837 (Sup. Ct. N.Y. Cty. 2007).
[47] Id. 14 Misc.3d at 975, 827 N.Y.S.2d at 847-848, quoting N.Y. Jur. Insurance § 769.
[48] *Henry Modell and Co., Inc. v. General Ins. Co. of Trieste & Venice,* 193 A.D.2d 412, 597 N.Y.S.2d 75 (1st Dept. 1993).

Courts in other states have rejected the product/process dichotomy as well. In *Hartford Cas. Ins. Co. v. Evansville Vanderburgh Public Library,* [49] a contractor was hired to perform excavation in preparation for the construction of an underground parking garage and to protect a nearby historic building. The contractor's faulty use of high frequency variable movement pile driving hammer, and an inadequate cantilevered earth retention system, damaged the historic building to such an extent that it had to be demolished. There, the court found that the faulty workmanship exclusion precluded recovery under the policy.

In *Arnold v. Cincinnati Ins. Co.*[50]*,* the court found that damage to the insured's home caused by improperly applying stain and power washing was the result of faulty workmanship and not an ensuing loss, but that rain which entered the home because of the faulty workmanship was an ensuing loss. The faulty workmanship in that case was the "failure to use protective coverings, to properly use the pressure washer and to properly clean up in performing the task of removing and reapplying stain to the siding [of the] house[51].

The Indiana Court of Appeals, in *Schultz v. Erie Ins. Group,*[52] rejected the product/process distinction made by the Federal 9th Circuit Court of Appeals (California)[53], holding:

> First, while the term "faulty workmanship" allows at least two definitions, we see no reason why it must mean either a "flawed product" or a "flawed process." Since "workmanship" denotes both "process" and "product," an insurer could just as likely have both perils in mind when it drafts a policy's list

[49] *Hartford Cas. Ins. Co. v. Evansville Vanderburgh Public Library,* 860 N.E.2d 636 (Ind. App. 2007).
[50] *Arnold v. Cincinnati Ins. Co.*, 276 Wis.2d 762, 688 N.W.2d 708 (Wis. App. 2004).
[51] Id., 276 Wis.2d at 776, 688 N.W.2d at 715.
[52] *Schultz v. Erie Ins. Group,* 754 N.E.2d 971, 976-977 (Ind. App. 2001).
[53] *Allstate Ins. Co. v. Smith,* 929 F.2d 447 (C.A.9 1991).

> of exclusions. Second, the "either/or" approach creates a false distinction, failing to take into account that a flawed process will often lead to a flawed product. This is especially true where, as here, the policy excludes losses caused by faulty materials used in construction. R. at 39. If the materials used are adequate and a flawed product still results, it is likely that a flawed process led to the flawed product. Third, the immediate context of Erie's policy indicates that "faulty workmanship" means more than just the finished product.
>
> [policy language quoted]
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> Read in context, "workmanship," falling between planning and maintenance, at the very least signifies a component of the building process leading up to a finished product. Therefore, we find that "faulty workmanship" is unambiguous and should not be construed, in the context of this policy, to mean only a flawed finished product...

These findings do not mean that losses caused by faulty products and process, no matter how remote, will act to bar coverage. Courts may still find that, under the principles set forth in *Bird*[54], the faulty workmanship exclusion does not exclude losses where the contractor's work is so far removed from the work being performed that the resulting loss was not a defective product or the result of a faulty process.

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[54] *Bird v. St. Paul*, supra.