Ohio Construction Insurance Law

Policyholder and Insurer Perspectives on *Custom Agri*

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On October 16, 2012, the Ohio Supreme Court weighed in on a frequently litigated issue in construction insurance law, holding at syllabus that "[c]laims of defective construction or workmanship brought by a property owner are not claims for 'property damage' caused by an 'occurrence' under a commercial general liability policy." *See Westfield Ins. Co. v. Custom Agri Sys., Inc.*, 2012-Ohio-4712 ("*Custom Agri*"). It is axiomatic that the syllabus of a Supreme Court opinion "is not to be construed as being broader than the facts of that specific case warrant." *State v. McDermott*, 72 Ohio St.3d 570, 574, 651 N.E.2d 985 (1995). Thus, although this broadly worded syllabus at first blush appears to preclude commercial general liability (CGL) coverage for all defective construction or faulty workmanship claims under Ohio law, a closer review of the facts of the case and the rationale employed by the Ohio Supreme Court reveals that its decision was not so sweeping.

Rather, the Ohio Supreme Court adopted the rule that construction defects are "occurrences" within the meaning of CGL policies, but only to the extent that property other than the policyholder's own work is damaged. *See, e.g., Essex Ins. Co. v. Holder*, 261 S.W.3d 456 (Ark. 2007); *ACUITY v. Burd & Smith Constr., Inc.*, 721 N.W.2d 33 (N.D. 2006); *but see* Ark. Code Ann. § 23-79-155 (eff. July 27, 2011) (requiring any CGL policy offered for sale in Arkansas to "contain a definition of 'occurrence' that includes…Property damage or bodily injury resulting from faulty workmanship"). The Ohio Supreme Court reached its decision without the benefit of briefing or argument by the policyholder, hearing only argument from the insurer, which advocated strongly for the rule of law ultimately adopted by the court.

Not surprisingly, policyholders and insurers have vastly different perspectives on the issue of whether claims of defective construction or faulty workmanship constitute "occurrences" under CGL policies. This article presents the policyholder's and insurer's perspectives on the issue in the context of the *Custom Agri* decision.

IS THE APPROACH ADOPTED IN *CUSTOM AGRI* COMPATIBLE WITH THE POLICY LANGUAGE?

Occurrence-based CGL policies generally provide coverage for "property damage" that is caused by an "occurrence." Typical CGL policies define "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." *See* Ins. Servs. Office, Inc., Commercial Gen. Liab. Coverage Form CG 00 01 12 04 (2003), §V(13), *reprinted in Miller's Standard Ins. Policies Ann.* (5th ed). In analyzing this definition, the Ohio Supreme Court stated that the undefined term "accident" should be given its "natural and commonly accepted meaning." *Custom Agri* at ¶ 12. According to the Court, "accidental" means something "unexpected" and "unintended." *Id.* at ¶ 13, *quoting Hybud Equip. Corp. v. Sphere Drake Ins. Co.*, 64 Ohio St.3d 657, 597 N.E.2d 1096 (1992). The Ohio Supreme Court then observed that "'faulty workmanship claims generally are not covered, *except for their consequential damages*, because they are not fortuitous.'" (Emphasis added.) *Id.*, *quoting JTO, Inc. v. State Auto. Mut. Ins. Co.*, 194 Ohio App.3d 319, 2011-Ohio-1452, 956 N.E.2d 328, ¶¶ 32-33 (11th Dist.). Thus, the Court concluded that there is no coverage if the damages are for the policyholder's own work, but there is coverage if the damages are consequential and derive from the policyholder's work. *Custom Agri* at ¶¶ 13-14.

Policyholder Perspective

The Ohio Supreme Court adopted an approach that is incompatible with the policy language. Under the policy, "occurrence" means "an accident," which the Court broadly defined as an event or happening "unintended" and "expected" by the policyholder. *Custom Agri* at ¶ 13. In *Custom Agri*, the policyholder presumably did not intend or expect to construct the subject steel grain bin in a negligent or defective manner. Nor did it intend or expect the resulting damage to the bin. The defective construction was no less accidental with respect to one type of damages than the other, and all damages resulted from the same defective construction. As observed in Justice Pfeifer's well-reasoned dissent, "the character of the damage is immaterial in regard to the threshold question of whether faulty construction is an occurrence[.]" *Custom Agri* at ¶ 32 (Pfeifer, J., dissenting). The policy language, thus, provides no justification for the Ohio Supreme Court's decision to define "occurrence" vis-à-vis the types of damages being sought.

Insurer Perspective

The Ohio Supreme Court holding follows the majority view: "claims for faulty workmanship are not fortuitous in the context of a CGL policy," and are therefore not an "accident" or "occurrence". *Custom Agri* at ¶ 14. This was the view of the majority of Ohio appellate courts prior to *Custom Agri*, as well as the overwhelming majority of decisions outside of Ohio. Claims for faulty workmanship are breach of contract claims where the purchaser alleges that it has not received the "benefit of the bargain". *Floor Craft Floor Covering, Inc. v. Parma Comm. Gen. Hosp.*, 54 Ohio St.3d1, 17-18, 560 N.E2d 206 (1990). These claims are not based on fortuity, or an accident, but on the theory that the defendant has not delivered what it promised to deliver under the agreement with the plaintiff. "A CGL policy is not intended to insure business risks, i.e., risks that are the normal, frequent, or predictable consequences of doing business, and which business management can and should control and manage." *Custom Agri* at ¶ 10.

IS THE APPROACH IN *CUSTOM AGRI* CONSISTENT WITH FUNDAMENTAL TENETS OF INSURANCE CONTRACT CONSTRUCTION?

Policyholder Perspective

The Ohio Supreme Court failed to read the policy as a whole, as is required under well-established Ohio law. *See Westfield Ins. Co. v. Galatis*, 100 Ohio St.3d 216, 2003-Ohio-5849, 797 N.E.2d 1256, ¶ 11. For example, the "Your Work" exclusion reflects the concept of business risk and generally excludes from coverage "'[p]

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roperty damage' to 'your work' arising out of it or any part of it and included in the 'products-completed operations hazard.'" *See* Ins. Servs. Office, Inc., Commercial Gen. Liab. Coverage Form CG 00 01 12 04 (2003), § I(A)(2)(l), *reprinted in Miller's Standard Ins. Policies Ann.* (5th ed). This exclusion would be rendered meaningless if construction defects causing damage to the policyholder's own work do not constitute "occurrences" under the initial coverage grant. An insurance policy, of course, must be read as a whole, and the existence of such exclusions shows that the grant of coverage for occurrences includes property damage caused by negligent workmanship.

Insurer Perspective

The holding in *Custom Agri*, like the holding in *Westfield v. Galatis,* reads the policy as a whole, rather than taking a portion of the policy out of context. It also interprets the policy in a manner consistent with the purpose of CGL policies, and the intent of the parties. *See Couch on Ins.* §129:1 (such policies are designed "to provide coverage for tort liability for physical damages to others and not for contractual liability of the insured for economic losses"); *Weedo v Stone-E-Brick, Inc.*, 81 N.J. 233, 238, 405 A.2d 788 (1979). Exclusion 1 in the policy does not expand coverage; rather it further limits coverage in other specific circumstances. It is well recognized that in standardized insurance contracts it is not necessary that every contract term be applicable to every scenario.

DOES THE AVAILABILITY OF PERFORMANCE BONDS SUPPORT THE OHIO SUPREME COURT'S DECISION?

Policyholder Perspective

In support of its decision, the Ohio Supreme Court remarked that "to protect itself from faulty performance by a subcontractor, a contractor can require the subcontractor to provide a performance bond." *Custom Agri* at ¶ 18. Performance bonds, however, generally are given to property owners by contractors to financially guarantee, *inter alia*, completion of the projects. No risk of loss transfers because the contractor remains liable for the loss (*i.e.*, through an indemnity agreement). CGL policies, on the other hand, generally protect contractors and subcontractors against claims of third parties, usually the property owners. The risk of loss transfers from the policyholder-contractor to the insurer. Performance bonds and CGL policies serve different functions. Regardless, they are separate instruments, and the only relevant inquiry is whether the CGL policy at issue provides coverage for construction defects under its terms.

Insurer Perspective

Yes, a performance bond is one way that an owner or general contractor can protect itself and insure the performance of the contract by subcontractors. The obligor under the bond remains liable to the surety, but that is the point of the bond and the basis of the relationship between the parties. Businesses need to remain incentivized to fulfill their obligations under the contracts that they assume. Allowing businesses to walk away from their contracts or perform shoddy work without consequences will break the backbone of the business relationship. Contracts are meaningless if a party can breach and pass the cost on to a third party.

CONCLUSION

One has to wonder whether the Ohio Supreme Court would have reached the same conclusion had it enjoyed the benefit of fully developed and balanced arguments from both sides. Nonetheless, Ohio has joined those jurisdictions holding that construction defects are "occurrences" within the meaning of CGL policies, but only to the extent that property other than the policyholder's own work is damaged. The precise boundaries of *Custom Agri* undoubtedly will be litigated in the future, including the issue of what constitutes consequential damages for which there is CGL coverage. When confronting such issues, policyholders and insurers alike should hope that the Ohio Supreme Court will have the advantage of both the policyholder's and insurer's perspectives. Notwithstanding, and because the approaches adopted by different jurisdictions are far from uniform, practitioners should be aware that the choice-of-law analysis can greatly impact coverage determinations for construction defect claims and should advise their clients accordingly.

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