HUNTON& WILLIAMS

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Arkansas Supreme Court Holds that Faulty Workmanship Is Not an Occurrence under a General Liability Contract; South Carolina Supreme Court Holds that It Is

The Arkansas Supreme Court recently held that defective workmanship, which damages only the work product itself, is not an occurrence. *Essex Ins. Co. v. Holder*, No. 07-803 (Ark. Mar. 6, 2008).

Addressing a similar issue, the South Carolina Supreme Court reached a different conclusion and held that a subcontractor's defective work constitutes an "occurrence" under a general liability contract issued to a general contractor. *Auto Owners Ins. Co., Inc. v. Newman*, No. 26450 (S.C. Mar. 10, 2008).

Arkansas — *Essex Insurance Co. v. Holder*

Factual and Procedural Background

A general contractor was sued by homeowners for defective construction and workmanship. The homeowners alleged that they had sustained damages because of the contractor's delays, employment of incompetent subcontractors, and defective or incomplete construction. The contractor sought coverage from its general liability insurer for the lawsuit.

The insurer filed a declaratory judgment action in federal court arguing that there was no occurrence. The general liability contract at issue defined an "occurrence" as an "accident." The federal court certified the question of whether faulty workmanship is an occurrence to the Arkansas Supreme Court.

Holding

The Arkansas Supreme Court held that defective workmanship, resulting in damages only to the work product itself, is not an occurrence.

The court noted that there was a split among courts across the country as to whether defective construction was an occurrence. The court recognized, however, "the majority of states that have considered this issue have held that defective workmanship, standing alone, which results in damages only to the work product itself, is not an accidental occurrence under a CGL policy." The court was not persuaded by those jurisdictions that had found the term "accident" to be ambiguous.

The court explained that, although "accident" was undefined, Arkansas courts have held that the term is unambiguous. The court also explained that prior Arkansas decisions have defined an "accident" to mean an event that takes place without foresight or expectation — "an event that proceeds from an unknown cause, or is an unusual effect of a known cause, and therefore not expected." Based on this, the court concluded that "[f]aulty 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."

South Carolina — *Auto Owners Ins. Co., Inc. v. Newman*

Factual and Procedural Background

A general contractor built a home. A subcontractor installed defective stucco

siding, which allegedly allowed water to enter into the home and damage the home's framing and sheathing. The homeowners obtained an arbitration award against the general contactor for replacement of the stucco and repairing the resulting water damage.

The general contractor's commercial general liability insurer filed a declaratory judgment, arguing that there was no coverage for the arbitration award. The trial court found that there was an occurrence and, thus, all but four items in the award were covered. The insurer appealed.

Holding

The South Carolina Supreme Court held that the negligent application of the stucco was a covered occurrence causing property damage.

The court began by addressing its decision in *L-J v. Bituminous Fire & Marine Ins. Co.*, 621 S.E.2d 33 (S.C. 2005), which held that faulty workmanship was not an occurrence. *L-J* involved a claim against a general contractor for a defective roadway that had deteriorated. Because the damage was limited to the roadway itself, the *L-J* court held there was no occurrence.

The court acknowledged that the application of its decision in *L-J* had created confusion. The court attempted to clarify its holding in *L-J*. The court explained that the confusion had stemmed from its citation with approval to *High Country Assocs. v. New Hampshire Ins. Co.*, 648 A.2d 474 (N.H. 1994). *High Country* held that a claim for defective installation of siding resulting in water damage was an occurrence because "the complaint was not simply a claim for faulty workmanship seeking damages to repair the defective work product itself, but rather, was a claim for negligent construction resulting in damage to other property." The court explained that in *L-J* "we phrased this distinction as a 'claim for faulty workmanship versus a claim for damage to the work product caused by the negligence of a third party.'" Based on this, the court stated that "it should be clear that this Court intended the 'third party' language [in *L-J*] to refer to subcontractors who are not a party to the CGL policy between the insurer and the contractor."

The court proceeded to apply the holding of *High Country* to the facts before it, viz., whether the application of the defective stucco was an occurrence. The court stated "[a]lthough the stucco subcontractor's negligent application is not on its own sufficient to constitute an 'occurrence,' we find that under the reasoning of *High Country* — adopted by this Court in *L-J* — the continuous water intrusion into the home resulting from the subcontractor's negligence qualifies as an 'accident' involving 'continuous or repeated exposure to substantially the same harmful general conditions.'" The court held that the subcontractor's negligence was an occurrence for the "resulting" property damage but not for the work product.

The court also held that as a "matter of pure contract interpretation," there was coverage for damage resulting from the negligent acts of the subcontractor. The court explained that because the "your work" exclusion, which bars coverage for damage to a policyholder's work, contained an exception for work performed by a subcontractor, the exclusion was limited to the subcontractor's own work product and did not extend to the contractor's entire project.

The court rejected the insurer's argument that the expected or intended conduct exclusion barred coverage. The court stated that the contractor did not expect or intend that a subcontractor would perform its work negligently.

Last, the court rejected the insurer's argument that there was no coverage for replacing the defective stucco itself, i.e., the subcontractor's work product. The court reasoned because the water damage "could neither be assessed nor repaired without first removing the entire stucco exterior, the trial court correctly concluded that the arbitrator's allowance for replacement of the defective stucco was covered . . . as a cost associated with remedying the other property damage that resulted from the 'occurrence.'"

Implications

Arkansas joins the growing majority of jurisdictions that have held that damages stemming from an insured's poor or faulty workmanship do not constitute an occurrence under a general liability policy. These jurisdictions recognize that a general liability insurer is not a surety and does not guarantee the performance of a policyholder's work.

South Carolina, on the other hand, appears to have retreated from its earlier decision that defective construction is not an occurrence. Although *Auto Owners Ins. Co., Inc. v. Newman* did not expressly overrule *L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, which held that defective construction was not an occurrence, it arguably limits its application. Additionally, as opposed to clarifying South Carolina law, the *Newman* decision arguably injects even more confusion by holding that there may also be coverage for replacing or repairing the defective work product itself, i.e., the stucco. Other jurisdictions that have held defective construction may be property damage caused by an occurrence have not gone so far as to hold that there is coverage for replacing the defective work. *See*, *e.g.*, *Auto-Owners Ins. Co. v. Pozzi Window Co.*, No. SC06-779 (Fla. Dec. 20, 2007) (holding there is no coverage for costs to replace subcontractor's defective work because defective work itself does not constitute property damage).