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Ohio Supreme Court Holds That Defective Workmanship Claims Do Not Trigger Coverage Under a Contractor's Commercial General Liability Policy

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In a recent decision with important consequences for owners and contractors, the Supreme Court of Ohio held that an owner's claims for defective construction or workmanship are not claims for "property damage" caused by an "occurrence" – and thus do not trigger coverage – under a contractor's commercial general liability ("CGL") policy. *Westfield Ins. Co. v. Custom Agri Systems, Inc.*, ___ Ohio St.3d __, 2012-Ohio-4712, 2012 Ohio LEXIS 2485.

Practical Implications of *Custom Agri*

In *Custom Agri*, the Supreme Court of Ohio resolved a long-standing split in authority among Ohio appellate courts regarding whether defective work itself (as opposed to consequential damages stemming from the defective work) constitutes an "occurrence" as that term is defined in most contractors' standard CGL policies. The practical implications of resolving this definitional question are many for Ohio owners and contractors, including:

- Whether an owner will be protected by a contractor's CGL policy where the contractor's work is defective or of poor quality: protection particularly important when dealing with a troubled or defunct contractor;
- Whether a contractor will be provided a defense by its CGL carrier when faced with defective workmanship claims, or be forced to shoulder attorneys' fees and court costs on its own;
- Whether a contractor will be indemnified by its CGL carrier where a plaintiff's allegations sound only in defective workmanship; and
- Highlighting the need to evaluate early in the litigation process the nature and pleading of the alleged defects and damages, so as to trigger (from the owner/contractor perspective) or avoid (from the insurer perspective) a CGL carrier's duty to defend and/or indemnify.

Pre-*Custom Agri*: Luck of the Draw

Prior to *Custom Agri*, in those Ohio jurisdictions that held defective workmanship claims could constitute an "occurrence," coverage was typically available to owners and contractors, subject to any applicable "business risk" or other policy exclusions. *See e.g., Stiggers v. Erie Ins. Co.*, 2008-Ohio-1702, 2008 Ohio App. LEXIS 1471, ¶ 36 (8th Dist.) ("We begin by noting that several cases have determined that 'allegations that a building contractor breached its duty to construct or design a building in a workmanlike manner are sufficient to invoke the general coverage provision for property damage caused by an occurrence." (citations omitted)).

On the other hand, in those jurisdictions holding defective workmanship was not an "occurrence" for purposes of coming within a CGL policy's initial grant of coverage, coverage was typically not available. *See e.g., Heile v. Herrmann*, 136 Ohio App. 3d 351, 353-54, 736 N.E.2d 566 (1st Dist. 1999) ("[C]ourts in Ohio, as well as the majority of courts in jurisdictions throughout the country, have concluded that defective workmanship does not constitute an 'occurrence' in [CGL] policies.").

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Thus, a contractor on a project in Cleveland might be able to secure CGL coverage, while one in Columbus might not: an inequitable result for owners, contractors and carriers alike.

Background to the *Custom Agri* Decision

Custom Agri arose from a multi-party construction dispute involving the allegedly defective construction of a steel grain bin at a feed-manufacturing facility. After the owner withheld payment due to the defects, the general contractor sued in federal court the owner and three other defendants, including Custom Agri, the subcontractor responsible for construction of the grain bin. Custom Agri, in turn, sued its subcontractors, and demanded that its insurer (Westfield) defend and indemnify it against the general contractor's claims. Westfield intervened in the lawsuit, seeking a declaration that it had no duty to defend or indemnify because none of the general contractor's claims for defective construction constituted "property damage" caused by an "occurrence" under the applicable CGL policy.

The federal district court acknowledged that whether defective construction claims constituted an "occurrence" under a CGL policy was an open question under Ohio law. Rather than resolve that issue, the court assumed initial coverage applied, but determined that a policy exclusion removed such claims from coverage. As a result, the federal district court granted summary judgment in favor of Westfield. Custom Agri appealed to the Sixth Circuit Court of Appeals.

The Sixth Circuit likewise found the threshold question of whether defective workmanship could be an "occurrence" under a standard CGL policy a disputed issue among Ohio appellate courts. For guidance, the Sixth Circuit certified the question to the Supreme Court of Ohio, which accepted jurisdiction and agreed to answer the question.

The *Custom Agri* Decision: The Fine Line Between "Business Risks" and "Unanticipated Consequential Damages"

The *Custom Agri* Court's analysis began by looking to (1) the language of the CGL insuring agreement (generally standard across CGL policies when defining the terms "property damage" and "occurrence"), and (2) the policy/risk allocation rationale underlying CGL policies. As the Court noted, "'a CGL policy is not intended to insure business risks that are the normal, frequent or predictable consequences of doing business and which businesses can control and manage . . . rather, it insures consequential damages that stem from such work.'" (internal citation omitted)). *Custom Agri*, at ¶ 10.

The Court next looked to the definition of an "occurrence": typically defined as "an accident," or an event that is "unexpected, as well as unintended." *Id.* at ¶¶ 12-13 (internal citations omitted). Citing an earlier lower appellate decision, the Court noted that "[t]he key issues are whether the contractor controlled the process leading to the damages and whether the damages were anticipated." *Id.* at ¶ 13.

Thus, under the *Custom Agri* analysis, the critical inquiry that will drive the coverage determination "largely turns on damages sought. If the damages are for the insured's own work, there is generally no coverage. If the damages are consequential and derive from the work the insured performed, coverage geneally will lie. The underwriting intent is to exclude coverage for the contractor's business risks, but provide coverage for unanticipated consequential damages." *Id.*

While likely of little solace to owners or contractors looking to trigger coverage under a CGL policy to help cure defective workmanship, the *Custom Agri* Court's analysis was not unanimous. In dissent, Justice Pfeifer criticized the majority

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holding as "too broad for the facts of this case. Determining that defective workmanship cannot result in a covered occurrence under a CGL policy forecloses too many other potential cases." *Id.* at 27 (Pfeifer, J., dissenting).

In Justice Pfeifer's analysis, the proper answer was not to foreclose the initial grant of coverage for "defective workmanship" claims as a whole, but rather to focus on whether policy exclusions applied to bar coverage: "If coverage were inappropriate in this case, it would be by operation of the policy's exclusions, 'not because a loss actionable only in contract can never be the result of an 'occurrence' within the meaning of the CGL's initial grant of coverage. This distinction is sometimes overlooked, and has resulted in some regrettably overbroad generalizations about CGL policies.'" *Id.* at 35 (internal citation omitted).

Take-Aways from the *Custom Agri* Decision

The *Custom Agri* decision has justifiably garnered significant attention in the Ohio construction industry, and stands to have lasting – and potentially costly – impacts on owners and contractors for years to come. Among the most notable take-aways:

- Contractors and owners should understand that the scales have tipped in favor of CGL carriers when it comes to denying coverage for "pure" defective construction claims. Prior to *Custom Agri* – depending on the particular Ohio jurisdiction – it was possible for Court to find that such claims at least came within the initial grant of coverage under a CGL policy, *i.e.*, constituted an 'occurrence,' but might be barred by a policy exclusion. Post-*Custom Agri*, such "pure" defective construction claims no longer stand the chance to even come within the initial grant of coverage.

- Where only "pure" defective construction claims are at issue, contractors should expect their CGL carriers to not only deny their indemnity obligation, but perhaps even more important, deny their defense obligation. Thus, a contractor faced with even the most frivolous defective workmanship claim can no longer count on its CGL carrier provide a defense and cover any associated attorneys' fees and court costs. Contractors must now be prepared to bear such fees and costs on their own, if operating solely under a standard CGL policy and without additional coverage under a separate policy.

- Counsel for plaintiffs and defendants in construction disputes should take great care in pleading and analyzing their claims with an eye toward whether they will be deemed by carriers to constitute "pure" defective construction claims, or claims presenting "accidental," "consequential" or "derivative" damages – separate and apart from the defective work itself – that might trigger coverage. While the devil may prove to be in the details, not giving the devil his due may prove quite costly to the unwary owner, contractor or counsel.

For a copy of the Court's opinion, or for additional information, contact any HL Construction Law professional.