

Business Risks Exclusions

A Seminar Presented for

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PROPERTY DAMAGE

The Issue:

Does incorporation of the insured's defective product or defective work constitute physical injury to the host product or building?

Policy Language:

17. "Property damage" means:

- a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
- b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

For the purposes of this insurance, electronic data is not tangible property.

As used in this definition, electronic data means information, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMS, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment.

Hypothetical No. 1

Insured Corporation manufactures disk drives. Computer Corporation makes computers which incorporated Insured Corporation's disk drive into its product. Computer Corporation alleged that the disk drives were defective and it sued Insured Corporation on this basis. Insured Corporation requested its insurance company to cover the lawsuit by Computer Corporation. Did the defective disk drives cause property damage to the computers?

Hypothetical No. 2

A building was constructed in part using asbestos containing building materials (ACBM). The ACBM were placed into floor tile and insulation materials. When the building owners discovered the defects caused by the ACBM, they sued the insured ACBM manufacturers for the cost of removing the material and for the diminished value of the building. The manufacturers sought coverage for the building owners' claims. Does the presence of the asbestos constitute physical damage to the building?

Hypothetical No. 3

An insured manufacturer of ingredients for food products made nut clusters, consisting of almonds, walnuts, and pecans, to be incorporated into a breakfast cereal. However the maker of the cereal discovered wooden splinters, which were sharply pointed and ranged from one-fourth inch to two or three inches long, in the cereal. The cereal maker destroyed the contaminated cereal out of necessity and it sued the nut cluster manufacturer for the value of the destroyed cereal. After the insured manufacturer paid the damage, it sought reimbursement from its insurance company asserting that the insurer should have covered the damage to the cereal maker. Did the wooden splinters in the cereal constitute physical damage to property?

PRODUCTS-COMPLETED OPERATIONS HAZARD

The Issue:

Did the "property damage" or "bodily injury" occur before or after completion of operations, i.e., does the claim at issue fall within the "products-completed operations hazard"?

Policy Language:

16. "Products-completed operations hazard":

- a. Includes all "bodily injury" and "property damage" occurring away from premises you own or rent and arising out of "your product" or "your work" except:
 - (1) Products that are still in your physical possession; or
 - (2) Work that has not yet been completed or abandoned. However, "your work" will be deemed completed at the earliest of the following times:
 - (a) When all of the work called for in your contract has been completed.
 - (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
 - (c) When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed.

Hypothetical No. 4

An insured contractor was hired to place a roof on a new residence. The work consisted of placing shingles over the sub-structure of the roof. However, the contractor negligently failed to overlap the shingles properly. As a result of this negligence, when a large rain storm hit the house one month later, water leaked through the shingles and the sub-structure. This caused damage to the plaster ceiling inside the home. Assuming the policy period has not yet expired, would the damage fall within the “products-completed operations hazard” clause?

Hypothetical No. 5

An insured contractor was hired to install a heating system in a residence. As part of the job, the contractor was installing insulation inside the walls of the home when he accidentally made a hole in one wall. The hole was visible from the inside the room. Does the damage to the wall fall within the “products-completed operations hazard” clause?

EXCLUSIONS J5 AND J6

The Issue:

Did the "property damage" occur to that particular part of the property upon which the insured was performing its work?

Policy Language:

2. Exclusions

This insurance does not apply to:

j. Damage To Property

"Property damage" to:

- (5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the "property damage" arises out of those operations; or
- (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".

22. "Your work":

a. Means:

- (1) Work or operations performed by you or on your behalf; and
- (2) Materials, parts or equipment furnished in connection with such work or operations.

b. Includes

- (1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work", and
- (2) The providing of or failure to provide warnings or instructions.

Hypothetical No. 6

An insured electrical contractor was hired to mount circuit breakers to a particular part of a switchboard located in a shopping mall. The switchboard consisted of many interconnected parts, including electrical wires, breakers, conductors, etc. During the course of the work, an employee of the contractor dropped a wrench onto two “buss” bars. This caused phase to phase contact between multiple parts of the switchboard, and resulted in a power shortage throughout the entire switchboard. The shortage caused the entire switchboard to burn and blow up. The insured contractor sought to have his insurance company cover the damage. Does the entire switchboard qualify as “that particular part” of the property upon which the insured was performing its work?

Hypothetical No. 7

A phone company hired insured cable company to remove nonfunctional telephone cable from its cable system. While removing nonfunctioning cable, one of insured’s employees accidentally cut properly functioning cable. The phone company sued the insured cable company to recover costs for repairing and replacing the functioning cable. The insured cable company sought to have its insurer cover the phone company’s costs. Does the functioning cable qualify as “that particular part” of the property upon which the insured was performing its work?

Hypothetical No. 8

A general contractor installed windows and doors in a home. An insured sub-contractor was hired to paint these same windows and doors. The general contractor noticed that the sub-contractor scratched the window panes when he sanded down the window frames. The general contractor sued the insured sub-contractor for the damage to the window panes and the sub- contractor sought coverage from its insurer. Do the window panes qualify as “that particular part” of the property upon which the insured was performing its work?

EXCLUSIONS FOR YOUR WORK AND YOUR PRODUCT

The Issue:

Does the exclusion for “your work” preclude coverage where the insured’s work must be damaged in order to effect repairs?

Policy Language:

2. Exclusions

This insurance does not apply to:

I. Damage To Your Work

"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.

Hypothetical No. 9

An insured sub-contractor was hired to install drywall into the rooms and attics of a housing project to prevent fires. However the sub-contractor failed to properly install the drywall and the owners had to repair the defective work. They installed more drywall to the interior walls, a heat detection system, and additional drywall in the attic, which required cutting holes in the roofs of the buildings. The sub-contractor’s insurance policy excluded property damage to the drywall. However, the sub-contractor alleged that the overall value of the property was diminished by its shoddy work, and that this reduced property value was in fact covered by the policy. Are the reduced value of the building and the damages to the roof, which were caused by the owners in an attempt to repair the defects, damages to “your work” and therefore excluded?

Hypothetical No. 10

An insured contractor was hired to perform concrete work on floors in an apartment building. The building developer discovered problems with the floors. One floor had not set properly and other floors were generally failing. In order to fix the floors, the carpets would have to be removed and replaced in order to repair the floors themselves. The defects in the floors were determined to be the result of the contractor's faulty workmanship. The insured contractor had two insurance policies and the insurance companies could not agree whether or not they had any liability to the insured. Therefore they sought declaratory relief to determine if the contractor's work was covered by their policies. Is the damage to the floors and the cost of removing and replacing the carpets damage to "your work" and therefore excluded?

Hypothetical No. 11

An insured landscaper was hired to construct thousands of feet of retaining walls. A contractor was hired to paint the exterior of the retaining walls. Behind the retaining walls, soil was backfilled and irrigation systems and landscaping were installed by the landscaper and other contractors. The landscaper failed to properly apply sealant to the back of the walls and water seeped through the walls. In order to prevent the damage from reoccurring, the walls had to be resealed, which required the removal and reinstallation of the backfilled soil and the landscaping. The landscaper's insurance covered the costs associated with the damaged paint on the outside of the wall. The costs associated with the sealant on the back side of the wall are not covered because they are costs to repair property damage caused by the landscaper, and thus fall under the "your work" exclusion. But is the damage for removing and replacing the backfilled dirt and the landscaping damage to "your work"?

EXCLUSION FOR IMPAIRED PROPERTY

The Issue:

Does the impaired property exclusion bar coverage for diminution in value claims where there has been no loss of use of property that has neither been physically injured nor destroyed?

Policy Language:

2. Exclusions

This insurance does not apply to:

m. Damage To Impaired Property Or Property Not Physically Injured

"Property damage" to "impaired property" or property that has not been physically injured, arising out of:

- (1) A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or
- (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use.

8. "Impaired property" means tangible property, other than "your product" or "your work", that cannot be used or is less useful because:

- a. It incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous; or
- b. You have failed to fulfill the terms of a contract or agreement;

if such property can be restored to use by:

- a. The repair, replacement, adjustment or removal of "your product" or "your work"; or
- b. Your fulfilling the terms of the contract or agreement.

Hypothetical No. 12

Insured manufacturer made and sold waterworks parts to municipal water systems. These parts contained higher amounts of lead, and lower amounts of copper than the contract specifications required. As a result, various municipalities sued the manufacturer, alleging that the parts wore out sooner than anticipated, that public health and safety was harmed by the increased exposure to lead and that the defective parts would have to be dug up and replaced at tens of thousands of sites. In addition to the replacement costs, the municipalities also wanted the manufacturer to pay for a lead monitoring system. The manufacturer tendered the lawsuit to its insurance company. Did the defective parts cause "property damage" to the water systems? If so, is the property damage excluded by the impaired property exclusion?

Hypothetical No. 13

An insured electronics corporation supplied circuit boards to a manufacturer. These circuit boards were incorporated into scanners sold by the manufacturer. The circuit boards contained defects that caused some of the scanners to intermittently fail. The failures resulted in the manufacturer having to replace the scanners and to incur other costs due to the lost use of the scanners. The electronics corporation sought coverage for the damages to the manufacturer. Under these facts, did the defective circuit boards cause property damage to the scanners? If there was property damage, is the damage excluded? If the property damage is excluded, does the sudden and accidental exception apply to reinstate coverage?

Hypothetical No. 14

Insured manufacturer sells a defective product that is incorporated into airplane engines. The planes containing the defective product are grounded by the Federal Aviation Administration. Assuming the insured was issued a traditional insurance policy, did the defective parts cause property damage? If so, are the damages associated with the grounding of these planes excluded by the impaired property exclusion?

ANSWERS TO HYPOTHETICALS

Answer No. 1

No. Generally, the mere incorporation of a defective product into property does not constitute physical injury to tangible property. More specifically, “physical incorporation of a defective product does not constitute property damage unless there is physical harm to the whole.”

Here, the disk drives did not cause property damage to the computers because there was no evidence presented by Computer Corporation that any other part of the computers, aside from the disk drives, suffered damage. The only complaint alleged by Computer Corporation was for defective design and this does not fall within the definition of physical injury to property.

Seagate Technology, Inc. v. St. Paul Fire and Marine Insurance Company, et al. (N.D. Cal. 1998) 11 F. Supp. 2d 1150.

Answer No. 2

Yes. The use of ACM does constitute physical injury because asbestos is an inherently dangerous product, as the mere presence of such a product is injurious. Once asbestos fibers are released, an area becomes dangerous and courts have found that this contamination constitutes physical injury. Further, even if the asbestos is not released, the mere presence of asbestos is a physical injury for which the manufacturer is liable, because in order to prevent danger from materializing, the asbestos must be removed. “Once installed [the asbestos] is physically linked with or physically incorporated into the building and therefore physically affects tangible property.”

Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co., et al. (1996) 45 Cal.App.4th 1; 52 Cal.Rptr.2d 690.

Answer No. 3

Yes. The wood splinters did constitute physical damage to property because a defective product (in this case the nut clusters) caused the total loss of the host product (the cereal) due to the dangerous nature of the defect. The Court held that there is “property damage when a potentially injurious material in a product causes loss to other products in which the injurious product is incorporated.”

Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc. (2000) 78 Cal.App.4th 847; 93 Cal.Rptr.2d 364.

Answer No. 4

Yes, if the damage occurred between the completion of the contractor's work and the expiration of the policy. Here, the property damage to the plaster ceiling occurred as a result of the contractor's negligent work on the roof. Significantly, the damage occurred one month after the insured contractor completed his work on the roof. Thus, so long as the policy was still in force at the time the roof was damaged, the damage does fall within the "products-completed operations hazard" clause.

Answer No. 5

No. The damage to the wall does not fall within the "products-completed operations hazard," because the property damage to the wall occurred before the insured contractor completed the work he was hired to do.

Answer No. 6

Yes, and therefore the damage to the switchboard is excluded.

The Court refused to interpret the isolated spot where the work was being done as "that particular part", because to do so would narrow the exclusion so drastically that such a "construction would lead to illogical and absurd results", and the exclusion would have no practical effect. Thus, the Court determined that the switchboard was a single, self-contained item which constituted "that particular part" of the property on which the insured was hired to work.

Vinsant Electrical Contractors v. Aetna Casualty & Surety Co. (Tenn. 1975) 530 SW2d 76.

Answer No. 7

Yes, and therefore the damage to the functioning cable is excluded.

The contract between the parties clearly stated that the insurance would not cover "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." Here, the cable company incorrectly performed its work when it cut the functioning cable instead of the nonfunctioning cable. As a result, the functioning cable had to be repaired. The court concluded that preventing harm to the functioning cable was part of the work the insured was hired to do. Thus, the functioning cable was included in "that particular part" of the property on which the insured was hired to work, and the damage to the functioning cable would be excluded under the insurance policy.

LISN, Inc. v. Commercial Union Insurance Companies, et al. (Ohio 1992) 83 Ohio App.3d 625, 615 NE2d 650.

Answer No. 8

Maybe. If the contractor did anything intentional to the window panes, such as tape them to protect them from paint, the panes would qualify as “that particular part” of the property on which the insured was hired to work, and the damage to the window panes would be excluded. However, if the contractor did not do anything intentional to the window panes, then the window panes would not qualify as “that particular part” and the damage would not be excluded.

Employers Mutual Casualty Company v. Pires, et al. (R.I. 1999) 723 A.2d 295.

Answer No. 9

Yes, both are excluded.

First, covered property damage does not include the diminution in the value of the property because property damage is defined as physical injury to tangible property. If defects in workmanship were covered by the insurance policy, the insured would not be discouraged from defective workmanship since he or she would recover from the insurer even if the diminution in value to the project arose solely due to the defectiveness of its own work.

Second, the damage caused by cutting holes in the roof is not property damage under the policy because diminution in value and cost of repair are not two separate harms, they are two different ways of measuring the same harm. Therefore the property damage in question was the contractor’s defective work, and the cutting of the holes was merely an attempt to remedy the defect. As such, both the contractor’s defective work and the attempts to remedy the defect are excluded.

New Hampshire Insurance Company v. Vieira, et al. (9th Cir. 1991) 930 F.2d 696.

Answer No. 10

Yes. Under the terms of the exclusion, property damage to the Contractor’s work, which arises out of that work, is excluded. Here the damage that was done to the contractor’s work was clearly a result of the contractor’s own defective workmanship. The Court held, “[e]xclusions such as those in the policy in this case eliminate coverage for the cost of repairing the insured’s own work, which is considered a business risk of the contractor.” Furthermore, the Court held that the removal and replacement of the carpets was also excluded. This was because the necessary efforts to repair the property would actually end up causing more property damage, as the carpets would have to be destroyed in order to fix the faulty floors.

Golden Eagle Insurance Company v. Travelers Companies (9th Cir. 1996) 103 F.3d 750.

Answer No. 11

Yes, in most cases.

The court found the “Insurer could make an objectively reasonable determination that the costs of removing and replacing the backfilled dirt and landscaping came within the Policy’s ‘own work’ exclusion because those costs were necessary to repair [the insured’s] defective work on failing to apply the correct number of coats of sealant.” In sum, if the damage to the insured’s work is caused by necessary repairs to correct the insured’s defective workmanship, then the “your work” exclusion precludes coverage.

Calfarm Insurance Company v. Tadeusz Krusiewicz, et al. (2005) 131 Cal.App.4th 273, 31 Cal.Rptr.3d 619.

Answer No. 12

Part 1. Yes, the damage to the water system is property damage. (In California, water systems are property of government.) More specifically, the Armstrong and Shade cases make it clear that incorporation of a hazardous product into a functioning product is a form of physical injury to tangible property. In this case, the defective parts qualify as an incorporated hazardous product because they were put into the water system and increased the amount of lead in the municipal water supply.

Part 2. No, the damage is not excluded. The impaired property exclusion applies to two categories of property. One category is property that is not physically injured. Here the water system has been physically injured because of the incorporated hazardous product. The other category is for impaired property. The exclusion would apply one, if the water system was less useful because of the incorporated product, and, two, if the water system could be restored to use by repair, removal or replacement of the defective product. Based on these facts, the water system is less useful because the lead from the product has contaminated the water supply, but the mere removal of and replacement of the parts will not restore the water supply to full use. Therefore, the water system is not impaired property within the meaning of the exclusion.

Watts Industries, Inc., et al. v. Zurich American Insurance Company (2004) 121 Cal.App.4th 1029; 18 Cal.Rptr.3d 61.

Answer No. 13

Part 1. Yes. There was property damage because the failure of the circuit boards in turn caused the scanners to fail. Thus under the definition of impaired property, the scanners were tangible property other than the property of the insured, which became unusable as a result of incorporating the insured's defective circuit boards into the product. More specifically, the defect caused the loss of use of the scanners, and the scanners are other property into which the insured's defective products were installed.

Part 2. Yes. "[The impaired property exclusion] excludes coverage for property damage arising out of a defect in Anthem's [the insured] work or a failure by Anthem to perform a contract as required." In other words, the damage is excluded because it was caused by the insured's defective work.

Part 3. Maybe. The exception to the exclusion may apply if the insured can show that the injury to the scanners was a sudden and accidental injury that occurred once the circuit boards had been put to use. Here the intermittent failure of some scanners suggests that the injury was sudden and unexpected because only some of scanners failed to work properly. The fact that there were functional scanners that were not affected implies that not all the circuit boards were defective at the outset, but rather only some malfunctioned once they were incorporated into the scanners.

Anthem Electronics, Inc. v. Pacific Employers Ins. Co., et al. (9th Cir. 20020) 302 F.3d 1049.

Answer No. 14

Part 1. Yes. The defective parts caused property damage because they caused the lost use of tangible property: the airplanes.

Part 2. Yes, the damages are excluded by the impaired property exclusion. The airplanes are impaired property because one, they are tangible property that is neither the work of, nor the product of, the insured manufacturer, and, two, the airplanes were made less useful because the insured manufacturer's defective parts were incorporated into them. However, the airplanes may be returned to use by replacing the insured manufacturer's defective part. On the other hand, if one of the airplanes had crashed before the FAA acted to ground the planes, the airplane is not excluded "impaired property" because it cannot be returned to use by replacing the insured's defective product.

ANALYTICAL CHECKLIST

Initial Questions

The following checklist can be employed to spot issues for the purposes of identifying possible application of business risks exclusions:

- If the insured's work or product is incorporated into a host building or a host product, is there any physical injury to the host (i.e., damage to something other than the insured's work or product) or is the defective work/product either inherently dangerous or potentially injurious?
- Does the "property damage" fall within the "products-completed operations hazard"?
 - If the insured's product is at issue, did the "property damage" happen away from the named insured's premises and after the named insured had relinquished physical possession of the product?
 - If the insured's work is at issue, did the "property damage" happen away from the insured insured's premises and after the named insured's work was completed?
- If the "property damage" is an ongoing operations claim (i.e., the damage does not fall within the "products-completed operations hazard"), what is that particular part of the property on which the named insured and/or its contractors were working on at the time of damage happened?
 - Was the property on which the named insured was working a single, self-contained unit?
 - Did the named insured's contract requires the insured to take measures to protect the damaged property or was the nature of the work performed such that the scope of the insured's responsibility would ordinarily include preventing that type of damage?
- If repairing the insured's defective work or product will cause additional "property damage" (i.e., access damages), are the repairs limited to correcting the insured's work or are those repairs required to repair damage to property other than the insured's work or product?

- ❑ If the claim involves loss of use of tangible property that has not been physically injured, does the claim arise from either the named insured's defective work/product or the named insured's delay/failure to performed a contract?
 - If so, did the loss of use arise from a sudden and accidental physical injury to the named insured's product after put to its intended use?
 - Can the impaired property be restored to use by either the named insured's repairing/replacing its work/product or fulfilling its contractual promises?

LAWYER JOKES

Q: What do you call a dozen sky-diving lawyers?

A: Skeet.

Q: How can you tell if a lawyer is well hung?

A: You can't get a finger between the rope and his neck.

Q: What do honest lawyers and UFOs have in common?

A: You always hear about them, but you never see them.

Q: What do lawyers use for birth control?

A: Their personalities.

Q: How do you keep a lawyer from drowning?

A: Shoot him before he hits the water.

Q: How do you get a lawyer out of a tree?

A: Cut the rope.