COMMERCIAL GENERAL LIABILITY POLICIES – RECURRING THEMES

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Developments in the law of this State concerning trigger of coverage for "occurrence" based liability insurance policies have combined with cases concerning coverage for construction defects in ways that could significantly affect coverage analyses. Damages that were once thought of as falling within the "products-completed operations hazard" may now be considered to have resulted from the insured's ongoing operations. These developments make it less likely that damages caused by construction defects will fall within the scope of the insuring agreement and may support the application of exclusions that make it less likely that damages caused by an insured's subcontractors will be covered. Recent opinions of the North Carolina appellate courts and the Federal District courts in North Carolina have underscored the maxim that a liability insurance policy is not a performance bond. The case law regarding the interpretation and implementation of additional insured endorsements has also advanced in recent years. These endorsements can significantly alter a carrier's exposure and present unique challenges. This paper discusses developments in these areas of coverage analysis and their implications for claims handling.

Trigger of Coverage

Only losses that occur within the policy period are covered under form GC 00 01, which is the most commonly used primary coverage form in general liability policies. The relevant language varies little, if any, between various policy editions. The December 2004 edition (copy included as appendix to this paper) states:

> b. This insurance applies to "bodily injury" and "property damage" only if:
> …
> (2) The "bodily injury" or "property damage" occurs during the policy period; and
> (3) Prior to the policy period no … (listed insured or authorized "employee") … knew that the "bodily injury": or "property damage" had occurred.
>
> c. "Bodily injury" or "property damage" which occurs during the policy period and was not, prior to the policy period, known to have occurred by an insured listed in Paragraph 1. of Section II – Who Is An Insured or any "employee" authorized by you to give or receive notice of an "occurrence" or claim, includes any continuation, change or resumption of that "bodily injury" or "property damage" after the end of the policy period.

The trigger of coverage issue is easily resolved in cases where the damages or injury are immediately visible and occur contemporaneously with the offending event. This issue can be problematic where damages occur over time as a result of latent defects. In these cases it is difficult to say exactly when the damages began and over what period they continued to accrue. What policy is triggered? Is it the policy during which the damages were first noticed (manifestation trigger)? Is it the period during which the

damages began (injury-in-fact) or is it all periods during which damages accrued (continuous trigger)?

The short answer is that where the date of the injury-in-fact can be known with certainty, the policy or policies in effect on that date are triggered. Where the damages are hidden, the courts will deem the date on which the insured completed its work to be the date of the injury-in-fact. In either case, only one policy period will be triggered.

The long answer is that North Carolina courts are still grappling with these issues. For some fact patterns one cannot confidently predict that the North Carolina Supreme Court will rule similarly as the Court of Appeals. It can also be difficult to predict how the Federal Courts will rule under diversity jurisdiction. Based upon the relevant opinions one can fashion convincing arguments that would create different results than the "short answers" would suggest.

In *Gaston County Dyeing Machine Company v. Northfield Insurance Company*, 301 N.C. 293, 524 S.E.2d 448 (2000), the North Carolina Supreme Court adopted an injury-in-fact trigger of coverage. Before *Gaston County Dyeing*, it was generally assumed that the North Carolina courts would apply a manifestation trigger of coverage, based upon the North Carolina Court of Appeals decision *West American Insurance Co. v. Tufco Flooring East, Inc.*, 104 N.C.App. 312, 409 S.E.2d 692 (1991) and several other North Carolina Court of Appeals decisions applying *Tufco*, *See, Bruce-Terminix Company v. Zurich Insurance Company,* 130 N.C.App. 729, 504 S.E.2d 574 (1998); *The Home Indemnity Company v. Hoechst Celanese Corporation,* 128 N.C.App. 259, 494 S.E.2d 764 (1998). While the *Gaston County Dyeing* case does not explicitly require the

application of an injury-in-fact trigger in cases involving hidden damages, it supports that approach.

The *Gaston County Dyeing* case arose from a product liability action. Sterling Winthrop, Inc. filed an action to recover damages exceeding $20 million from Gaston County Dyeing Machine Company. Sterling alleged design defects in a pressure vessel manufactured by Gaston County Dyeing Machine Company. The evidence showed that the pressure vessel began leaking on June 21, 1992, allowing contaminant to migrate into a dye material from June 21 until August 31, 1992. There was no dispute that the leaking began on June 21. The contamination continued for approximately two months before it was discovered. During this two-month period, certain of Gaston County Dyeing Machine Company's insurance policies expired and other policies became effective. The question of whether coverage under the various general liability and umbrella policies was triggered based upon injury-in-fact, date of manifestation or a continuous trigger was of great importance to the insurers. Until this opinion was handed down, most would have assumed that the North Carolina Supreme Court would adhere to a manifestation trigger.

However, in *Gaston County Dyeing*, the North Carolina Supreme Court examined the various policy languages and found the coverage was triggered as of June 21, 1992, when the initial injury was sustained, and that only one policy period was triggered, notwithstanding the fact that the injury continued through the expiration of one policy period and into another.

> Although our Court of Appeals has addressed the trigger of coverage issue, it is an issue of first impression for this Court. We conclude that **where the date of the injury-in-fact can be known with certainty**, the insurance policy or policies on the risk on that date are triggered. This interpretation is logical and true to the policy language. Further, although other jurisdictions have adopted varied approaches in determining the appropriate trigger of coverage, the injury-in-fact approach is widely accepted.

351 N.C. at 303, 524 S.E.2d at 564. (emphasis supplied) The Court went on to state that: "To the extent that *Tufco* purports to establish a bright-line rule that property damage occurs 'for insurance purposes' at the time of manifestation or on the date of discovery, that decision is overruled." 351 N.C. at 303, 524 S.E.2d at 565. *Gaston County Dyeing* clearly overruled *Tufco* where the date of the injury-in-fact can be known with certainty. The North Carolina Court of Appeals has since construed *Gaston County Dyeing* as overruling *Tufco* where the date of injury-in-fact cannot be ascertained.

Several North Carolina Court of Appeals opinions have held in claims for damages resulting from latent defects that the damages are deemed to have occurred when the insured completed its last act or the insured's work was completed. *See, Hutchinson v. Nationwide*, 163 N.C.App. 601, 594 S.E.2d 61 (2004); *Miller v. Owens*, (166 N.C.App. 280, 603 S.E.2d 168 (2004) (UNPUBLISHED); *Harleysville Mutual Insurance Company v. Berkley Insurance Company*, 169 N.C.App. 556, 610 S.E.2d 215 (2005). In reviewing these cases it is important to keep in mind that the North Carolina Supreme Court has not ruled on trigger of coverage issues since the *Gaston County Dyeing* opinion, over twelve years ago. It is not assured that the Supreme Court would adopt the bright line rule that hidden damages are deemed to have occurred when the

insured completed its work. This rule is difficult to reconcile with the language of the standard CGL policy. To be covered, the damages must occur during the policy period. The policy does not specify the date of the insured's actions as the relevant inquiry.

In *Hutchinson v. Nationwide*, 163 N.C.App. 601, 594 S.E.2d 61 (2004), the Court of Appeals considered a situation involving the faulty construction of a retaining wall. Nationwide's insured allowed coverage to lapse during an 11-month period that included the period during which the wall was constructed. Nationwide's insured reinstated coverage within a month after the retaining wall was completed. The damage to the wall was alleged to have occurred either due to the insured's "failure to install a drainage system in the retaining wall and/or use proper soil under the retaining wall or … the continual entry over water into the soil from the compacted surface area." 163 N.C.App. at 605, 594 S.E.2d at 63. The damage to the wall arguably continued after coverage was in effect, even if it began while the coverage was lapsed. The Court found that the "injury-in-fact" occurred when the wall was completed, a time during which no coverage was in effect.

> In *Gaston,* our Supreme Court held that even in situations where damage continues over time, **if the court can determine when the defect occurred from which all subsequent damages flow, the court must use the date of the defect and trigger the coverage applicable on that date**. … Assuming *arguendo* that the damage was caused by the continual entry of water, if it can be determined with certainty that the entry of water was caused by faulty construction pre-dating insurance coverage, defendants are not liable for plaintiffs' damages.

163 N.C.App. at 605, 594 S.E.2d at 64 (emphasis supplied)[1].

The *Hutchinson* opinion appears to implement a bright line rule that hidden damages resulting from the insured's actions are always deemed to have occurred when the insured completed its work. The Court stated that "without any additional information suggesting the damage was caused during the three days of coverage prior to discovery", it was clear that the damage occurred outside of the coverage period. 163 N.C.App. at 605, 606, 594 S.E.2d at 64. However, the opinion, taken as a whole, leaves little room for the possibility that additional information would have altered the coverage analysis. It appears that the only information that could have affected the outcome would have been evidence that the insured performed additional work on the wall at a later date.

A subsequent unpublished decision of the North Carolina Court of Appeals again indicated that for claims involving hidden damages resulting from defects, coverage will be triggered as of the date of the insured's last act. *See, Miller v. Owens*, 166 N.C.App. 280, 603 S.E.2d 168 (2004) (UNPUBLISHED). The plaintiff was a homeowner who sued her contractor for defects resulting from the use of synthetic stucco on her house. The contractor sold the house to the plaintiff in February of 1994 but did not obtain liability insurance until July 1994. The insurance expired in July 1996. The plaintiff claimed that the damage first manifested approximately July 16, 1999. Therefore, coverage was neither in effect when the house was completed and sold nor when the damages manifested.

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[1] The insured in *Gaston County Dyeing* manufactured and installed a defective pressure tank. The *Gaston County Dyeing* Court determined that the date on which the tank ruptured, due to an increase in pressure caused by the customer, was the date of loss. The Court did not discuss the date on which the insured completed its work.

After obtaining a judgment against her contractor, the plaintiff sued for coverage. On motion for summary judgment, the trial court determined that a manifestation trigger applied and that no coverage was in effect when the damages manifested. The Court of Appeals affirmed this decision, albeit for different reasons. The Court noted that coverage was not in effect when the allegedly defective construction was completed. The Court of Appeals discussed the *Gaston County Dyeing* case and also discussed *Hutchinson v. Nationwide*. It quoted the statement from *Hutchinson* that, "if this court can determine when the injury in fact occurred, the insurance policy available at the time of the injury controls." It also quoted *Hutchinson* as stating, "even in situations where damage continues over time, if the Court can determine when the defect occurred from which all subsequent damages flow, the Court must use the date of the defect and trigger coverage applicable on that date." There may be some difficulty in reconciling these two statements. Coverage is triggered when the injury occurs. Coverage is triggered when the last damaging act occurs. These are different dates where the injury occurs after the insured's last act that contributed to the damages. Applying the maxim that coverage is triggered when the injury occurs, it appears that it would have been appropriate to remand the case for a factual determination as to when rot that resulted from the improper application of the synthetic stucco actually occurred. Without so stating, the Court seems to have concluded that in cases of hidden damages, the date of injury cannot be determined by circumstantial evidence and/or opinion testimony. Instead, the Court appears to have employed a bright line rule that in cases of hidden damages caused by latent construction defects (most commonly moisture intrusion), the date on which the

damages commence cannot be determined. Therefore, the date on which the insured created the latent defect controls for coverage purposes.[2]

The Court's syllabus in *Harleysville Mutual Insurance Company v. Berkley Insurance Company of the Carolinas*, 169 N.C.App. 556, 610 S.E.2d (2005) indicates that the trigger of coverage dispute was resolved by consideration of the fact that the insured's acts and omissions occurred before effective date of the defendant's policy – another application of the bright line rule. However, a reading of the entire opinion indicates that the case need not have been resolved on that consideration alone. In *Harleysville v. Berkley*, not only did the insured complete its work before the effective date of the Berkley policy but it was also clear that the damages began occurring before the Berkley policy was effective. Harleysville and Berkley's mutual insured, RGS Builders, Inc., constructed a house clad in synthetic stucco. It completed the house in 1994. It performed repairs to address moisture intrusion in 1996. Berkley first insured RGS effective May 1, 1997. Harleysville insured RGS before that. The homeowner sued RGS for damages relating to the installation of the synthetic stucco. RGS tendered its defense to Harleysville and Berkley. Harleysville provided a defense and settled the case. Berkley declined to participate. Harleysville sued Berkley for reimbursement. Harleysville argued that a manifestation trigger applied and that the problem first manifested in 2000, when an inspection report stated that the installation of the synthetic

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[2] The underlying claim was against the general contractor. Therefore the defective work damaged other work that also qualified as the insured's work. If, in *Miller v. Owens*, the trigger of coverage analysis had led to a conclusion that the loss occurred during the coverage period, the Court might have also questioned whether damages flowing from latent defects can even constitute "property damage". It does not appear that the property would have ever existed in an undamaged condition.

stucco was defective and that the synthetic stucco should be removed and replaced. Moisture intrusion problems had previously been noted but this was the first indication that the cladding was not salvageable. The *Harleysville* Court stated that it was clear that the damage "was caused by RGS's actions or inactions prior to the effective date of its policy with defendant. Therefore, without any additional information suggesting that the damage was caused during the dates of its coverage, we conclude that the defendant bears no general commercial liability for the damages." 169 N.C.App. at 562, 610 S.E.2d at 218, 219.

The *Harleysville* decision could be cited as affirming the rule that in cases of hidden damages the trigger of coverage is determined by the date on which the insured completed its work. However, the case could be reconciled with a rule that for trigger of coverage the date on which the damages actually occurred controls. In *Harleysville*, assuming a trigger of only one policy period, as opposed to a continuous trigger, it was clear that the damages commenced before the Berkley policy was in effect, regardless of whether one could determine the actual date on which those damages commenced.[3]

In *Auto-Owners, Ins. Co. v. Northwestern Housing Enterprises, Inc*., 2008 WL 901176 (W.D.N.C. 2008) (UNREPORTED), the Court cited *Hutchinson v. Nationwide* and *Nelson v. Hartford Underwriters Ins. Co*., 177 N.C.App. 595 (2006) (involving a homeowner's policy) for the proposition that in a faulty workmanship case "as a matter of law … the damage must exist from the time the faulty work is performed." The

[3] Because Harleysville had already paid the claim, the Court was not required to determine whether, if the damages occurred contemporaneously with the completion of the work, the property ever existed in an undamaged condition.

insured, or those acting under its control, developed a residential community in the mountains. As part of that development, it prepared lots, including grading and the adding of fill dirt to those lots. It then moved pre-existing homes to those lots. Years later, following a heavy rainfall, ten houses in the community were damaged by debris movement on the slope of the mountain. The Court held that the policy in effect when the work was completed would have been triggered, as opposed to the policy that was in effect when the landslide occurred.[4]

Auto-Owners Ins. Co. v. Northwestern was an unpublished decision of a Federal Court sitting in diversity. It has no precedential effect. Even so, it merits attention, as it suggests that there is still uncertainty with regard to trigger of coverage issues in North Carolina. "Where the date of the injury-in-fact can be known with certainty, the insurance policies on the risk on that date are triggered." *Gaston County Dyeing Machine Co. v. Northfield Ins. Co.*, 351 N.C. 293, 203, 524 S.E.2d 558, 565 (2000). Auto-Owners argued that because the site preparation was allegedly defective the injury-in-fact occurred when that preparation was completed. Auto-Owners cited *Hutchinson v. Nationwide* in support of its argument. Northwestern Housing Enterprises, Inc. argued that the injury-in-fact occurred on September 8, 2004, when one house was destroyed and others were badly damaged in a landslide that followed unusually heavy rains. It cited the testimony of a real estate appraiser that none of the properties were devalued before the events of September 8. The Court sided with Auto-Owners.

[4] The Court also held that the loss was not covered, for reasons including the fact that the property never existed in an undamaged condition.

One can easily see how another court might have sided with Northwestern on this issue. Northwestern analogized the facts of its case to those of *Gaston County Dyeing*. The defect in *Auto Owners* occurred when the land was prepared. The damages occurred on a later date that was known with certainty. In *Gaston County Dyeing* the defective pressure vessel was installed on one date and the leak occurred later. The Court differentiated between the date on which the leak was discovered and the date on which it occurred. The Court did not consider the date that the pressure vessel was installed as a possible coverage trigger. Nonetheless, the date on which the leak occurred in *Gaston County Dyeing* appears to be the functional equivalent of the landslide in *Auto Owners*. In both cases, the date on which the property was damaged could be known with certainty. A big difference between *Auto Owners* and *Gaston County Dyeing* is that in *Gaston County Dyeing* the insured's product (a pressure vessel) damaged another's property (the dye), while in *Auto Owners* the insured's work (grading) damaged other property sold by the insured (the houses). The *Auto Owners* Court took the position that the grading and the houses both constituted the insured's work and that the work never existed in an undamaged condition. Other North Carolina Court of Appeals decisions have reached this conclusion. The North Carolina Supreme Court has not addressed this issue.

The North Carolina Court of Appeal's decision in *Alliance Mutual Insurance Company v. Guilford Insurance Company*, 711 S.E.2d 207 (N.C.App. 2011)(UNPUBLISHED), suggests that the Court of Appeals might have reached a different decision on the trigger of coverage issue under the circumstances before the

Federal Court in *Auto Owners*. Alliance Mutual Insurance Company and Guilford Insurance Company both wrote policies to a plumbing company. Guilford insured the plumbing company when it defectively installed a water supply line in a home under construction. Alliance insured the plumbing company when the water supply line separated and damaged the house several years after the plumbing company had completed its work. Alliance defended a suit against the insured for damages caused by the pipe. Guilford refused to participate. Alliance filed a declaratory judgment action against Guilford, contending that the damage actually occurred when the plumbing company improperly installed the water supply line. Alliance cited *Gaston County* and *Hutchinson* for the proposition that the injury-in-fact occurred when the insured completed its work. The Court held that there was no property damage until the line leaked. Therefore, only the Alliance policy was triggered and Guilford did not owe a duty of defense.

> [T]he PEX water supply line was improperly installed in 2004, and this improper installation ultimately caused the leak which caused the property damage. However, this is not a case of a continual leak which began in 2004 and was not discovered until December 2006; the leak began in 2006. The "property damage" thus did not occur, or begin to occur, until December 2006. Therefore, no portion of the property damage caused by the leak "occur[ed] during the policy period" as required by Defendant's policy which had ended on 21 February 2005.

p. 4 of unreported opinion. Suppose, rather than suing PEX, the homeowner had sued the general contractor. Would the Court of Appeals have reached the same result or would it have held that the injury-in-fact occurred when the contractor (or its subcontractor)

installed the pipe, based upon the proposition that the insured's work (the entire house) was never in an undamaged condition? There appears to be enough uncertainty here that the prudent course would be for the insurer to provide a defense, subject to a reservation of rights.

In *Builders Mutual Insurance Company v. Mitchell*, 709 S.E.2d 528 (N.C.App. 2011), the Court remanded the case for a factual determination of whether the date of loss could be "known with certainty." This case was actually a battle between two insurance companies. Maryland Casualty insured Umstead Construction from March 1, 2000 to March 1, 2003. Builders Mutual insured Umstead from March 1, 2003 to March 1, 2006. Umstead performed repairs on an existing home from February 2000 until December 2005. The repairs were not satisfactorily completed and there was evidence that Umstead had overbilled. The homeowner sued Umstead for breach of contract, breach of warranties, negligence, misrepresentation, unfair trade practices and fraud. Facts ascertained outside of the complaint further indicated that the defective repairs had caused additional damage to the existing structure, primarily consisting of water damage.

Builders Mutual provided Umstead with a defense. Maryland Casualty refused to participate in the defense. Builders Mutual filed a declaratory judgment action, naming numerous interested parties as defendants. The underlying case settled at mediation, with Builders Mutual contributing to the settlement. Builders Mutual sought reimbursement from Maryland Casualty for defense and settlement costs. On cross motions for summary judgment the trial court dismissed the claims against Maryland Casualty. The Court of Appeals reversed.

As to the trigger of coverage, the Court noted an affidavit from the repair contractor who took over after Umstead to the effect that most of the damage caused by water intrusion likely began before the last date of coverage under Maryland Casualty's policy. Maryland Casualty had cited *Gaston County Dyeing* for the proposition that, "where the date of the injury-in-fact can be known with certainty, the insurance policy or policies on the risk on that date are triggered." Maryland Casualty argued that because the injury-in-fact date could not be known with certainty, the injury-in-fact test was not the appropriate standard. It appears that Maryland Casualty contended that the last date of the insured's work was the date that triggered coverage. The Court held that "[w]hether the date can be known with certainty is a genuine issue of material fact and should not have been resolved by summary judgment." 709 S.E.2d at 534. The *Builders Mutual* Court adopted the "known with certainty" standard by reference to *Gaston County Dyeing*. *Gaston County Dyeing* stated that the injury-in-fact analysis applied where the date of the injury could be known with "substantial certainty." However, it did not rule out the possibility that the injury-in-fact test should be applied where the date of the injury-in-fact could be determined by a preponderance of the evidence. Although *Builders Mutual* stated that the issue of fact was whether the date of the injury-in-fact could be known with "substantial certainty" a practical reading of the opinion suggests that the real issue was whether the date could be proven by direct or circumstantial evidence sufficient to satisfy the standard for most issues in contractual disputes – a preponderance of the evidence. It is difficult to imagine that one could ever know the

date of the injury-in-fact with "substantial certainty" in a fact situation such as that before the Court in *Builders Mutual*.

The *Builders Mutual* Court held that there was enough uncertainty as to the date of the loss that Maryland Casualty owed a duty of defense. With Builders Mutual having voluntarily provided a defense, there was no ruling that Builders Mutual actually owed a defense. However, it seems to be a pretty safe conclusion that both carriers owed a duty of defense. The case was resolved after the Court of Appeals rendered its opinion. If the case had been tried on remand, a jury could have found that damages occurred during both policy periods. As discussed below, the *Gaston County Dyeing* opinion held that ongoing damages trigger only one coverage period. In the *Builders Mutual* case the insured's activities on the job site continued through two policy periods and there were arguably damages associated with those activities during each policy period. As also discussed below, a continuum of wrongful actions generally constitutes but a single occurrence. *See, Christ Lutheran Church v. State Farm Fire and Casualty Company*, 122 N.C.App. 614, 471 S.E.2d 124 (1996). If the *Builders Mutual* case had continued, would the courts ultimately have concluded that only the Maryland Casualty policy (the policy under which the damages first occurred) was triggered or would they have allocated the damages between the two policies? *Gaston County Dyeing* and the cases discussing one versus multiple occurrences, suggest that only the Maryland Casualty policy would be triggered. However, this outcome is far from assured. It appears that there is a real possibility of further developments in this area.

<u>Number of Policies Triggered</u>

The *Gaston County Dyeing* opinion held that there was only one occurrence and only one policy was triggered, notwithstanding the fact that the damages continued to accrue through multiple policy periods.

> In determining whether there was a single occurrence or multiple occurrences, we look to the cause of the property damage, rather than to the effect. As noted previously, an "occurrence" is an accident, "including continuous or repeated exposure to substantially the same general harmful conditions." In this case, the rupture of the pressure vessel caused all of the ensuing property damage, even though the damage continued over time, contaminating multiple dye lots and continuing over two policy periods. Therefore, when, as in this case, the accident that causes injury-in-fact occurs on a date certain and all subsequent damages flow from the single event, there is but a single occurrence; and only policies on the risk on the date of the injury-causing event are triggered.

351 N.C. at 303, 304, 524 S.E.2d at 565. Although the Court did not cite this policy language, the holding that damages from a loss extending over multiple policy periods trigger coverage only under the first policy period is consistent with the language of subpart c, of the insuring agreement quoted on the first page of this manuscript.

The *Gaston County Dyeing* opinion is at odds with the rule adopted in the majority of the states, holding that multiple policy periods can be triggered where the damage is of a continuing nature. The *Gaston County Dyeing* opinion could be limited to the specific facts of that case: "when, as in this case, the accident that caused the injury-in-fact **occurs on a date certain** and all subsequent damages flow from the single event, there is but a single occurrence." 351 N.C. at 303, 304, 525 S.E.2d at 565 (emphasis supplied).

It appears that the North Carolina Courts would find a single occurrence, even in cases of hidden damage that does not occur on a date certain. *See, Christ Lutheran Church v. State Farm Fire and Casualty Company*, 122 N.C.App. 614, 471 S.E.2d 124 (1996) (where church treasurer wrote twenty-four separate checks to himself in a "continuum of wrongful actions" constituting a single occurrence). Two Federal District Court cases have relied on *Christ Church* and *Gaston County Dyeing* in concluding that multiple injuries arising from a single cause of loss constitute but one occurrence. *See, Western World Ins. Co. v. Wilkie*, 2007 WL 3256947 (E.D.N.C. 2007) (numerous children contracted E.coli due to exposure to a petting zoo during the course of a ten day fair – one occurrence); *Mitsui Sumitomo Ins. Co. v. Automatic Elevator Co.*, 3011 WL 4103752 (M.D.N.C. 2011) (187 persons claimed injury due to exposure to hydraulic fluid mistakenly identified as surgical detergent – one occurrence).

These cases bolster the conclusion that ongoing damages resulting from a single occurrence would trigger only one policy period, regardless of whether the damages continued to accrue after that policy period. Thus, while the facts of *Gaston County Dyeing* can be distinguished from situations in which hidden damages accrue over multiple policy periods, it appears likely that only a single policy period would be triggered in those instances.

The *Gaston County Dyeing* holding regarding the number of policy periods triggered by ongoing damages extending through multiple policy periods runs counter to the rule adopted in most jurisdictions. One authoritative source notes:

> Another recurring issue that arises in the context of determining which policies are triggered is ascertaining the date of injury/damage in a case involving continuing injury/damage that was latent for a period of time. The correct answer, and the rule in the vast majority of the courts to have addressed the issue, is that coverage is triggered from the date of the first latent injury/damage and continues to be triggered at least until the date of the injury/damage becomes manifest. Since coverage is triggered in the event of an injury/damage during the policy period, the foregoing rule merely comports with the express terms of the policy.

Windt, Allan D., *Insurance Claims and Disputes, Fifth Ed.* (West Group 2010) §11:4 (with a lengthy list of citations). Windt notes that in the majority of jurisdictions, the courts have held that: "[W]hen there is an ongoing process of property damage or bodily injury, every policy period in effect during the ongoing damage/injury process provides coverage." *Id.* Windt criticizes the *Gaston County Dyeing* opinion:

> In *Gaston County Dyeing Mach. Co. v. Northfield Ins. Co*., 351 N.C. 293, 524 S.E.2d 558 (2000), the court held that only the policy in effect at the time a leak commenced afforded coverage because there was only one occurrence: the leak. The opinion is incorrect because the court overlooked the fact that, under the policy language, it is the date of the property damage (which was ongoing) that triggers the coverage, not the date of the occurrence. The occurrence can take place long before the inception of the policy; it is enough simply that the property damage was caused, in the past, by an occurrence. The only thing that has to take place during the policy period is the property damage.

Windt, §11.4, footnote #24. One cannot take the word of a commentator over that of the North Carolina Supreme Court. In a case distinguishable from *Gaston County Dyeing*, on grounds that the exact onset of damages is unknown, the considerations urged by Wendt, and apparently by the appellate courts in other states, could conceivably prompt

to the courts to find coverage under multiple policy periods. However, it appears more likely that the North Carolina courts would extend the rule from *Gaston County Dyeing* and find that progressive deterioration stemming from latent defects triggers only one policy period.

Coverage for Construction Defects

Generally speaking, the CGL policy does not provide coverage for defects in the insured's own work but does provide coverage for damage to other property arising from defects in the insured's work. The broadly stated rationale for this conclusion is that:

> "[T]he quality of the insured's work is a 'business risk' which is solely within his own control," and that "liability insurance generally does not provide coverage for claims arising out of the failure of the insured's product or work to meet the quality or specifications for which the insured may be liable as a matter of contract." … Rather, such business risks are the purpose of performance bonds, not liability insurance policies.

Breezewood of Wilmington Condominium HOA, Inc. v. Amerisure, 335 Fed. Appx. 268, 272, 272 (4th Cir. 2009).

The courts have taken differing courses to reach this outcome. It has been stated that defective work does not constitute an "occurrence", that defective work does not constitute "property damage" and that the general liability policy is not a substitute for a performance bond. Additionally, various work product exclusions can apply to claims arising from defective work.

The coverage analysis becomes less certain in claims against a general contractor where work performed by one subcontractor has damaged work performed by another

subcontractor.[5] Precedent from the North Carolina Court of Appeals indicates that general contractors are not covered against claims for damages resulting from defective work performed by a subcontractor. Precedent from the Fourth Circuit, ostensibly applying North Carolina law, indicates that such damages can be covered, based upon the language of the exclusion l, "Damage To Your Work", which includes language stating that the 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." Underwriters are increasingly including endorsement CG 22 95, "EXCLUSION – DAMAGE TO WORK PERFORMED BY SUBCONTRACTORS ON YOUR BEHALF" in CGL policies (copy attached in Appendix to this paper), to eliminate the language excepting subcontractors' work from the "Damage to Your Work" exclusion and to eliminate the uncertainty that has arisen from that excepting language. The exclusion for "Damage To Your Work" applies to "property damage" included in the "products-completed operations hazard." More recent cases on trigger of coverage tend to steer more claims away from the "products-completed operations hazard," further reducing the prospects for coverage based upon the fact that a contractor employed subcontractors to perform its work.

A number of cases have held that defective work does not fall within the scope of the insuring agreement. The insuring agreement in the CGL policy generally reads:

> **This insurance applies to "bodily injury" and "property damage" only if:**
> **(1) The … "property damage" is caused by an "occurrence"**

[5] Where the claim is against a subcontractor who has damaged another subcontractor's work, the offending subcontractor is likely covered under its own CGL policy.

Where the alleged damage is to the insured's own work the courts have held both that construction defects do not result from "occurrences" and that damages resulting from construction defects are not "property damage." Form CG 00 01 defines "occurrence" as follows:

> **"Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.**

In a recent opinion the North Carolina Court of Appeals stated: "It is true that 'a claim for faulty workmanship, in and of itself, is not an occurrence under a commercial general liability policy'." *Builders Mutual Ins. Co. v. Mitchell*, 709 S.E.2d 528, 531 (2011) (quoting, 9A Couch on Insurance 3d §129:4) "A failure of workmanship does not involve the fortuity required to constitute an accident." *Id.* However, "[a]n 'occurrence' as defined by a CGL policy can be 'an accident caused by or resulting from faulty workmanship *including damage to any property other than the work product."* *Id.* (emphasis in the original).

In *William C. Vick Construction Co. v. Penn National Mut. Cas. Ins. Co*., 52 F.Supp.2d 569 (E.D.N.C. 1999), the Court also concluded that defective construction, in and of itself, should not be considered accidental for coverage purposes but that damage to other property might be considered an "occurrence." The Court concluded that damages resulting from defective construction are to be anticipated and therefore do not constitute an "occurrence."

> [A]lthough there is no North Carolina authority on point, given the North Carolina Supreme Court's interpretation of

> the word "accident" in *Tayloe,* this Court concludes that an insured's poor workmanship does not fall within the meaning of that term, and thus does not constitute an "occurrence."

William C. Vick Construction Co. v. Penn National Mut. Cas. Ins. Co., 52 F.Supp.2d 569, 586 (E.D.N.C. 1999) (4th Cir. 2000)[6].

Form CG 00 01 defines "property damage" as follows:

> **"Property damage" means**
> **a. Physical damage to tangible property, including all resulting loss of use of that property. All such loss 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.**

The North Carolina Court of Appeals and Federal Courts applying North Carolina law have concluded that damage to property that has never existed in an undamaged state cannot be considered "property damage." This is so even if a defect combines with other causes to create more extensive damage than originally existed in the property.

> [O]ur courts have interpreted "property damage" to mean "damage to property that was *previously undamaged* and *not* the expense of repairing property or completing a project that

[6] Citing to *Tayloe v. Hartford Accident & Indemnity Company*, 257 N.C. 626, 127 S.E.2d 238 (1962)

> 'Accident' is defined as 'an unforeseen event, occurring without the will or design of the person whose mere act causes it; an unexpected, unusual, or undesigned occurrence; the effect of an unknown cause, or, the cause being known, an unprecedented consequence of it; a casualty. …
> In 1 C.J.S. Accident, page 443, an 'unavoidable accident' is defined 'as meaning an accident which cannot be avoided by that degree of prudence, foresight, care, and caution which the law requires of every one under the circumstances of the particular case, which is not occasioned in any degree, either remotely or directly, by the want of such care and skill as the law holds every man bound to exercise, or which occurs without fault attributable to any one.

257 N.C. at 627, 127 S.E.2d at 239, 240.

> was not done correctly or according to contract in the first instance."

Builders Mutual Ins. Co. v. Mitchell, 709 S.E.2d 528 at 532 (2011) (*quoting, Prod. Sys., Inc., v. Amerisure. Co.*, 167 N.C.App. 601, 606, 605 S.E.2d 663, 666 (2004).

In *Production Systems, Inc. v. Amerisure Ins. Co*., 167 N.C.App. 601, 605 S.E.2d 663 (2004), Amerisure's insured designed and constructed two "foam rubber sheet line systems", each consisting of "an oven, nine conveyor belts, and associated components, including safety and electrical controls, fans, combustion equipment, temperature controls, smoke hood, cooling chambers and belted conveyor sections." 167 N.C.App. at 602, 603, 605 S.E.2d at 664. The systems were problematic almost immediately after being put into operation. It was determined that components of each of the conveyor belts were improperly installed and misaligned and would not track properly. As the result of defects in the conveyor belts, the systems were inoperable. Amerisure's insured sued its client for the amount owed under the contract. The client counterclaimed, seeking damages for the cost of repairing the two line systems and for loss of use of the two line systems. Amerisure denied coverage. After settling the claim against it, the insured brought a declaratory judgment action against Amerisure on the coverage issues. On cross motions for summary judgment, the trial court agreed that the policy did not provide coverage. On appeal, the Court of Appeals affirmed on grounds that no "property damage" had been alleged.

> The term "property damage" in an insurance policy has been interpreted to mean damage to property that was **previously undamaged,** and **not** the expense of repairing property or

> completing a project that was not done correctly or according to contract in the first instance.

167 N.C.App. at 606, 605 S.E.2d at 666. (emphasis in the original) The facts recited in the opinion indicated that subcontractors had worked on the construction of the systems. However, the Court did not discuss the issue of whether defective work performed by one contractor that damaged the work of another subcontractor would support coverage. The Court stated:

> We conclude that there was no "property damage" to the oven feed line systems because the only "damage" was repair of defects in, **or caused by**, the faulty workmanship in the initial construction.

167 N.C.App. at 607, 605 S.E.2d at 667. (emphasis supplied). On its face, one might interpret the Court's inclusion of the phrase "repair of defects in, **or caused by**" faulty workmanship to mean that even damages to previously undamaged property do not qualify for coverage if caused by other faulty workmanship. However, in *Production Systems*, all of the work, including both the defective work and the damaged work, was the insured's work.[7] In its brief to the Court the insured argued that the subcontractor exception to the "Damage to Your Work" exclusion created ambiguity.[8] The *Production Systems* opinion did not discuss this argument.

Several opinions of the Federal Courts have similarly held that damage to property that has never existed in an undamaged condition cannot be considered property damage. "[U]nder North Carolina law to "fall within the scope of a general liability policy, the

[7] Although the Court did not quote this language, Form CG 00 01 defines "your work" to include "work or operations performed by you or on your behalf."
[8] This exclusion is discussed below.

property allegedly damaged has to have been undamaged or uninjured at some previous point in time." *Breezewood Condominium HOA, Inc. v. Amerisure*, 335 Fed. Appx. At 272 (UNPUBLISHED) (quoting, *Travelers Indemnity Co. v. Miller Building Corp*., 97 Fed. Appx. 431, 433-34 (4th Cir. 2004)). In *Auto-Owners, Inc. v. Northwestern Housing Enterprises, Inc.,* 2008 WL 901176 (W.D.N.C. 2008) (unreported), the insured placed some houses on some improperly prepared home sites. Years later the houses were damaged by a landslide that was allegedly caused by the improper grading. The Court held that because the property, consisting of the houses and the home sites combined, was defective when sold, the subsequent damage to the homes, and destruction of one of the homes, resulting from the landslide did not constitute property damage.

Several exclusions in the CGL policy are addressed to defects in the insured's own work. Where the defects in the work and the damages to the work become apparent after the work has been completed, carriers have traditionally considered those exclusions directed to the "products-completed operations hazard" to be relevant. However, the more recent trigger of coverage cases, discussed above, indicate that those exclusions addressed to the insured's work in progress are more likely to apply. The exclusions most likely to apply in construction defects cases are discussed below.

This insurance does not apply to:
a. Expected or intended injury

This exclusion is the mirror image of the "occurrence" requirement. Carriers should cite this exclusion when it is potentially applicable. However, cases in which the

insured expected or intended the injury may be more easily resolved by noting the absence of an "occurrence," an issue on which the insured bears the burden of proof.

> **This insurance does not apply to:**
> **b. Contractual Liability**
> **"Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:**
> **(1) That the insured would have in the absence of the contract or agreement; or**
> **(2) Assumed in a contract or agreement that is an "insured contract", provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement. Solely for the purposes of liability assumed in an "insured contract", reasonable attorneys fees and necessary litigation expenses incurred by or for a party other than an insured are deemed to be damages because of "bodily injury" or "property damage", provided:**
> **(a) Liability to such party for, or for the cost of, that parties defense has also been assumed in the same "insured contract"; and**
> **(b) Such attorneys fees and litigation expenses are for defense of that party against a civil or alternative dispute resolution proceeding in which damages to which this insurance applies are alleged.**

The policy definition of "insured contract" includes:

> "Insured contract" means:
> … f. That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality connection with work performed for a municipality) under which you assume the tort liability of another party to pay for "bodily injury" or "property damage" to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.

An "insured contract" includes an indemnification agreement entered before the

loss. Pursuant to N.C.G.S. §22B-1, discussed below, certain indemnification agreements that protect the indemnitee against liability for its own negligence are void as against public policy. A suit against the indemnitor based on such an agreement is defensible. Normally, an insurance company has an obligation to defend even baseless claims against its insured if the theory of the claim is of such a nature that it would be covered if valid. *See, Waste Management of Carolinas, Inc. v. Peerless Ins. Co*., 315 N.C. 688, 340 SE.2d 374, *reh'g denied*, 316 N.C. 386, 346 S.E.2d 134 (1986). However, in *Pennsylvania National Mut. Cas. Ins. Co. v. Associated Scaffolders and Equipment Co., Inc.,* 157 N.C.App. 555, 579 S.E.2d 404 (2003), the Court of Appeals held that an insurer does not have a duty to defend its insureds against indemnification agreements that are invalidated by N.C.G.S. §22B-1.

Penn National's insured, Comfort Engineers, Inc. rented scaffolding from Associated Equipment Company, Inc. As part of its lease, Comfort agreed to indemnify Associated and also to maintain the scaffolding in accordance with regulatory standards. The scaffolding collapsed and one of Comfort's employees was killed. The employee's estate made a workers'' compensation claim against Comfort and sued Associated in negligence. Associated sued Comfort under the indemnification agreement and also for breach of its contractual obligation to maintain the scaffolding. The indemnification agreement related to a construction contract and purported to indemnify Associated for its own negligence. N.C.G.S. §22B-1 invalidates contracts that would indemnify an entity for liability arising from its own negligence in connection with a construction contract. In the wrongful death action, Associated conceded it could not be indemnified for

liability arising from its own negligence but argued that the agreement also encompassed liability imposed upon Associated through no negligence of its own. *See, Jackson v. Associated Scoffolders and Equipment Co., Inc.*, 152 N.C.App. 687, 566 S.E.2d 666 (2002). The Court found that the language requiring Comfort to indemnify Associated for its own negligence was not severable. Therefore, the entire contract was invalid. *Id.* Because the indemnification agreement was invalid, Penn National was not required to defend Comfort against liability under a contract that, if valid, would have qualified as an "insured contract."

> "[A] construction indemnity agreement may purport to indemnify a promisee from damages arising from negligence of the promisor, but any provision seeking to indemnify the promisee from its own negligence is void." … Although at the time of the complaint the contract had not yet been adjudicated void, an insurer will not be obligated to defend its insured when the insured has stepped outside the protective bounds of the General Statutes. An insurer may assume that its insured will contract within the law and not obligate the insurer to defend an illegal contract.

157 N.C.App. at 559, 579 S.E.2d at 407 (citations omitted).

The claim for breach of contract in failing to maintain the scaffolding was excluded by the standard exclusion for contractual liability that is cited above. The exclusion does not apply to liability that the insured would have in the absence of a contract or agreement. Comfort could not have been liable in tort for the injury to its employee by virtue of the exclusivity provisions of the Workers' Compensation Act.

In *Bruce-Terminix Co. v. Zurich Ins. Co.*, 130 N.C.App. 729, 504 S.E.2d 574 (1998), Terminix settled a suit brought by a customer who had suffered extensive termite

damage and then brought an action against the liability carriers that had refused to provide Terminix with a defense. Among other things, Zurich cited the exclusion for property damage "which the insured is obligated to pay… by reason of the assumption of liability in a contract or agreement," and which liability the insured would not have had in the absence of the contract or agreement. The Court held that "if the exclusion is interpreted to apply to any liability resulting from contracts between Terminix and its clients, it is contrary to the primary objective of a commercial general liability policy." 130 N.C.App. at 736, 504 S.E.2d at 579. The Court did not elaborate any further. The Court may have considered the possibility that tort liability can arise from a contractual relationship. The presence of a contractual relationship between the claimant and the insured should not, in and of itself, trigger the exclusion for liability assumed by contract.

Moreover, it is not clear that the phrase, "assumption of liability in a contract or agreement" encompasses consequential damages arising from a breach of contract or breach of warranty. Such consequential damages could be fortuitous from the standpoint of the insured, satisfying the "occurrence" requirement. There are no reported in cases in North Carolina addressing this distinction.

The exclusion for property owned by the insured gains new significance for construction defects cases under the *Hutchinson* rule that hidden damages are deemed to have occurred when the insured performed the last act necessary to complete its work.

This insurance does not apply to:

j. Damage to Property
"Property damage" to:

(1) Property you own, rent, or occupy, including any costs or expenses incurred by you, or any other person, organization or entity, for repair, replacement, enhancement, restoration or maintenance of such property for any reason, including prevention of injury to a person or damage to another's property;

Recent cases on trigger of coverage indicate that this exclusion should bar coverage in most cases where the general contractor is also the developer. In cases of hidden damages, *Hutchinson v. Nationwide; Miller v. Owens; Harleysville v. Berkley; and Auto-Owners v. Northwestern* indicate that the damages are deemed to have occurred concurrently with the completion of the work or the insured's last act.

Before *Gaston County Dyeing*, the North Carolina courts relied on *West American Insurance Company v. Tufco Flooring East, Inc.,* 104 N.C.App. 312, 409 S.E.2d 692 (1991), for the proposition that the date of occurrence is the date on which the damages are discovered. Significantly, the *Tufco* case was not concerned with which policy period was triggered. Instead, the case was concerned with whether a policy exclusion, which did not apply to the "products-completed operations hazard", was applicable.

In *Tufco*, West American's insured, Tufco, had applied a coating over the floors in a Purdue chicken plant. Two days after Tufco had completed its work, Purdue discovered that the application of the floor coating had caused vapors of a hazardous gas to seep into Purdue's freezers, ruining approximately $500,000 in chicken parts. West American denied coverage, citing an exclusion for "property damage" arising out of the dispersal or escape of pollutants "at or from any site or location on which you … are performing operations." The *Tufco* Court noted the absence of any North Carolina

precedent and found cases from the Fourth Circuit Court of Appeals and other jurisdictions persuasive for the proposition that date of the "occurrence" should be determined to be the date on which the damage was discovered. Because the damages were deemed to have occurred when they were discovered, the pollution exclusion, which applied to "locations on which you are performing operations," did not apply. Under the bright line test used in *Hutchinson, Miller* and *Harleysville*, the exclusion would have applied.

This history indicates that the effects of *Gaston County Dyeing, Hutchinson, Miller* and *Harleysville* extend well beyond the trigger of coverage issue. These cases indicate that the exclusions applicable to claims for hidden damages caused by construction defects are not those exclusions addressed to the "products-completed operations hazard" but the exclusions addressed to the insured's ongoing work. This means that for builders who own the property on which they are building, there rarely will be coverage for damages resulting from hidden defects, regardless of whether subcontractors are employed.

The Court reached this conclusion in *Auto-Owners v. Northwestern Housing Enterprises.* The Court held that even if the damage resulting from defects in the insured's work had qualified as property damage, in light of *Gaston County Dyeing Machine Company* the damage was deemed to have occurred contemporaneously with the completion of the work. "The 'property damage' if any, happened at the time of the completion of the faulty work, which was while (insured) still owned the property." 2008 WL 901176, p. 9. Therefore, the "Property Owned By the Insured" exclusion applied.

This insurance does not apply 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".

The largest issue with these exclusions has been the proper application of the phrases "that particular part of real property" or "that particular part of any property." Suppose, for example, that a contractor installed siding on a building. Due to improper flashing, moisture intrusion damaged the building. Before *Hutchinson, Miller and Harleysville*, one may have viewed this as a case of damages included in the "products-completed operations hazard." However, these cases indicate that, in cases of damages resulting from latent defects, the damages are deemed to have occurred on the date on which the insured's work was completed. Under the new trigger of coverage paradigm, exclusions j(5) and (6) therefore appear to be relevant. Applying these exclusions, what particular part of real property was the siding contractor working on? Was it the house or was it a more discrete part of the house, such as the siding itself? Two recent opinions from the Court of Appeals indicate that the courts will ascribe the most narrow interpretation to "that particular piece of real property" or "that particular part of any property" when applying these exclusions. S*ee, Alliance Mutual Insurance Company v.*

Dove, 714 S.E.2d 782 (N.C.App. 2011); *Builders Mutual Insurance Company v. Mitchell*, 709 S.E.2d 528 (2011).

The insured in *Alliance Mutual* repaired a broken elevator belt in a grain elevator. As the insured was completing its work it repaired a hole in the elevator shaft using a welder. This caused grain dust to ignite, which, in turn, caused an explosion in the elevator. The owner of the grain elevator sued the welding company for "the cost to repair and replace the rail receiving bucket elevator, the cost to repair and replace the rail receiving leg, the cost of having to bring grain in by truck rather than by rail as a result of the damaged rail elevator, and damages incurred for business interruption and lost revenue." This dispute spawned a coverage action in which the courts were required to determine the scope of an exclusion functionally equivalent to exclusion j. (6) of the CG 00 01 coverage form. The exclusion at issue in *Alliance Mutual* read:

> We do not pay for property damage to that specific part of any property that must be restored, repaired, or replaced because of faults in your work.

714 S.E.2d at 784. The Court held that the "specific part" of the property to which the exclusion applied was only the receiving bucket elevator and not the entire grain elevator. The Court noted that ambiguities in the insurance policy will be construed against the insured. The application of this exclusion was a case of first impression in North Carolina. The Court considered opinions from other jurisdictions that gave this exclusion a narrow application. It agreed with the statement of a Federal District Court sitting in Wisconsin that: "if the insurance company wants to exclude coverage for property damage to the entirety of the property on which its insured performed work, instead of

‘that particular part’ of the property on which work is performed, it should say so." 714 S.E.2d at 786 (*quoting, Minergy Neenah, LLC v. Rotary Dryer Parts, Inc*., 2008 WL 1869040 (E.D. Wisc. 2008)(unpublished)). The Court also held that the claims for lost revenue and other consequential damages attributable to the damage to the rail receiving bucket elevator were covered. The Court noted that the exclusion did not “mention lost revenue or consequential damages flowing from the damage to the specific part of any property damaged by the insured.” The Court held that for the exclusion to apply to consequential damages, the exclusion would have to address consequential damages directly.

In *Builders Mutual Ins. Co. v. Mitchell*, 709 S.E.2d 528 (N.C.App. 2011), the Court held that the phrase “particular part of” in exclusions j(5) and (6) limited those exclusions to the work itself. The Court held that the exclusions do not apply “to previously undamaged property that is not part of the insured’s work product.” 709 S.E.2d at 533.

Exclusion l, read in its entirety, has prompted many carriers to defend claims that that they likely would have denied outright, but for the possibility that the exclusion may actually expand coverage.

> **This insurance does not apply to:**
> **l. 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.**

It is ironic that the language regarding work performed by subcontractors is contained in an exclusion, because it could argued that this language expands coverage beyond that granted in the insuring agreement. As discussed above, defective work or damages to work arising out of other defects in that same work do not qualify as "property damage." The insured "has the burden of bringing itself within the insuring language of the policy." *Builders Mutual Ins. Co. v. Mitchell*, 709 S.E.2d 528, 531 (2011) (*quoting*, *Hobson Const. Co. v. Great American Ins. Co*., 71 N.C.App. 586, 590, 322 S.E.2d 632, 635 (1984)). If the insured demonstrates that the insuring language "embraces the particular claim for injury, the burden then shifts to the insurer to prove that a policy exclusion excepts the particular injury from coverage." *Id.* Where the insured fails to bring the claim within the scope of coverage there is no need to examine the exclusions. *See, Hobson Construction Co. Inc. v. Great American*, 71 N.C.App. 586, 590, 322 S.E.2d 632, 635 (1984) (Cost to repair defective dam did not constitute "property damage." No need to "reach the issue of whether the complained of injury is excepted from coverage by an exception in the policy of insurance.") If the coverage analysis would always be resolved without resort to the exclusion, the exclusion is redundant. The first part of exclusion l simply mirrors the conclusion that construction defects are not "property damage", at least insofar as the "products-completed operations hazard" is concerned.

An interpretation of the policy that renders the exclusion superfluous could be problematic. "The various terms of the policy are to be harmoniously construed, and if

possible, every word and every provision is to be given effect." *Woods v. Nationwide*, 295 N.C. 500, 505-506, 246 S.E.2d 773, 777 (1978). "The terms of an insurance policy cannot be read in isolation but must be construed in the context of [the] instrument as a whole." *Henderson v. U.S.F.&G.*, 124 N.C.App. 103, 108-09, 476 S.E.2d 459, 462 (1996). What purpose could the exception to the exclusion possibly serve? If damages arising out of defective work performed by or on behalf of a contractor never qualify as "property damage" and never come within the scope of the insuring agreement, the language in the exclusion regarding work performed by a subcontractor would be superfluous. That would run counter to the general principles for the interpretation of insurance policies.

The North Carolina Court of Appeals could have addressed this concern in *Production Systems, supra*, but did not mention the work product exclusion. It is possible that the Court rejected the insured's assertion that the subcontractor exception created an ambiguity. Because the Court did not address this issue, the opinion offers no guidance on this point.

While the North Carolina courts have not addressed subcontractor exception, the Fourth Circuit Court of Appeals did discuss it in an unpublished opinion. *See*, *Breezewood of Wilmington Condominiums Homeowners' Association, Inc. v. Amerisure*, 335 Fed. Appx. 68 (4th Cir. 2009). The Court reviewed another of its opinions, applying Maryland law to the interpretation of the subcontractor exception to the "your work" exclusion. *See, French v. Assurance Co. of America,* 448 F.3d 693 (4th Cir. 2006).

> The Court noted that the subcontractor exception restored coverage limited by the "your work" exclusion.… The Court also observed that a plain reading, along with a thorough examination of the history of the "your work" provision, compelled the following conclusion: the standard comprehensive general liability policy does not provide coverage to a general contractor to correct defective workmanship of a subcontractor but does provide coverage to the general contractor for the damages caused by the subcontractor's defective workmanship.… Thus, the damage to the general contractor's work was covered only because it fell within the subcontractor exception to the "your work" exclusion.

335 Fed. Appx. 268, 277. The *Breezewood* Court was not required to apply the subcontractor exception because the there was no allegation that the work had been performed by a subcontractor. The *Breezewood* Court did not discuss the potential contradiction between the subcontractor exception and the holding that damages to a contractor's work caused by defects in another subcontractor's work do not constitute "property damage". A strict application of *Production Systems, Inc*. would support a denial in any case in which a contractor is seeking coverage for damage to its work caused by defects in its subcontractor's work. However, a degree of uncertainty remains in this area.

It also appears from the more recent trigger of coverage cases that damages resulting from latent construction defects are deemed to have occurred contemporaneously with the insured's work. Damages in those cases should not be included in the "products-completed operations hazard." Thus, exclusion l, for "damage to your work" and the exception to that exclusion would not come into play. This means that other exclusions, that do not except work performed by subcontractors from the

operation of the exclusions, would apply. There would be no potential inconsistencies between the wording of those exclusions and the conclusion that "property damage" does not include any damages resulting from defects in work performed by the insured's subcontractors.

The bottom line is that one could interpret *Production Systems* and the more recent trigger of coverage cases to eliminate any need to consider the possibility that coverage might apply because work performed by an insured's subcontractor damaged work performed by the insured's other subcontractors. However, until the North Carolina Courts have specifically ruled on this issue, the safest course would be to defend under reservation of rights when the issue arises.

Some policies eliminate this uncertainty altogether by including endorsement CG 22 94, "EXCLUSION – DAMAGE TO WORK PEFORMED BY SUBCONTRACTORS ON YOUR BEHALF." That endorsement eliminates the subcontractor exception by shortening exclusion l to read as follows:

> This insurance does not apply to:
> **l. 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."

The policy defines "your work" to include work or operations performed on the insured's behalf. This endorsement allows the carrier to more confidently take a position on coverage when subcontractors are involved.

Additional Insured Endorsements

Scope of coverage

Claims for additional insured coverage can raise many issues. First, what is the initial scope of coverage? Does the entity claiming to be an additional insured fall within the scope of that coverage? (Frequently, this requires one to examine the contract between the named insured and the entity claiming additional insured coverage.) Has the potential additional insured satisfied its obligations, as established by the policy conditions? What exclusions potentially apply? What other coverages potentially apply and how will those coverages interact with the named insured's policy?

Additional insured endorsements come in many shapes and sizes. The scope of coverage afforded by each endorsement will be determined by the interpretation of the specific language employed. It is important to review not only the additional insured endorsement but also the primary coverage form that it modifies.

CG 20 10 (included in the appendix to this paper) is an example of an additional insured endorsement in which the additional insureds are specifically listed in a schedule. This form provides:

> WHO IS AN INSURED (Section II) is amended to include as an insured the person or organization shown in the Schedule, but only with respect to liability arising out of your ongoing operations performed for that insured.

The language affording coverage with regard to "liability arising out of" the named insured's operations is fairly common in these endorsements. The North Carolina courts will give the phrase "arising out of" a liberal construction when looking for ways

to extend coverage. In *Pulte Home Corporation v. American Southern Insurance Company,* 185 N.C.App. 162, 647 S.E.2d 614 (2007), the Court adopted an expansive view of the additional insured endorsement then at issue. Pulte was the general contractor for the construction of a house. It subcontracted with Transamerica Investment, LLC to perform the framing. Transamerica, in turn, subcontracted with Rudolfo Sanchez. Sanchez' employee, Marcos Mejia, was severely injured when he fell from a rafter. Mejia sued Pulte and others for his personal injury. In its contract with Transamerica, Pulte had required that Transamerica name Pulte as an additional insured under Transamerica's liability insurance. Transamerica had obtained a policy of general liability insurance from American Southern Insurance Company. The policy contained an endorsement naming Pulte as an additional insured, "but only with respect to liability arising out of [named insured's] operations or premises owned by or rented to [named insured]." 185 N.C.App. at 164, 647 S.E.2s at 616. American Southern contended that the phrase "with respect to liability arising out of [Transamerica's] operations" should be interpreted to cover only Pulte's vicarious liability arising out of Transamerica's negligence. The Court reviewed cases from North Carolina and other states interpreting the phrase "arising out of" in this context and concluded:

> [T]he additional insured endorsement, by its plain terms, triggered American Southern's duty to defend Pulte against the Mejia claims, when those claims bore a causal nexus with Transamerica's "operations" at the jobsite.

185 N.C.App. at 170, 171, 647 S.E.2d at 620. The *Pulte* Court equated the "causal nexus" requirement to a "but for" analysis. 185 N.C.App. at 168, 647 S.E.2d at 618

(discussing, *City of Greenville v. Haywood*, 130 N.C.App. 271, 502 S.E.2d 430 (1986)). If the accident would not have happened but for the activities associated with Transamerica's framing operations, Pulte would be covered as an additional insured under the American Southern policy. Because it was undisputed that Transamerica's "operations" included framing activities at the job site, Pulte was entitled to coverage as an additional insured under Transamerica's policy.

The *Pulte* Court relied heavily on *State Capital Ins. Co. v. Nationwide Mutual Ins. Co*. 318 N.C. 534, 350 S.E.2d 66 (1986), *disc. review denied*, 349 N.C. 354, 525 S.E.2d 449 (1998) in reaching its decision. *State Capital* is a classic North Carolina insurance law case. In *State Capital*, a passenger in a car was injured when a rifle discharged while the insured driver was handling it. The driver was insured under an auto policy that provided coverage for injuries arising out of the use a motor vehicle and was also insured under a homeowner's policy that excluded coverage for liability arising out of the use of a motor vehicle. The North Carolina Court held that both policies provided coverage. The lesson from *State Capital* is that no matter how clearly a policy appears to have been written, you don't really know what it means until the courts have ruled on the exact language used.

An important difference between the additional insured endorsement CG 20 10 and the endorsement construed in the *Pulte* case is that form CG 20 10 does not provide coverage for completed operations. In form CG 20 10 the coverage is limited to liability arising out of the insured's "ongoing" operations. Additional insured endorsements frequently vary in this regard. Some limit coverage to liability for injuries or damages

arising out of the named insured's ("your") ongoing operations. Some endorsements, such as that in the *Pulte* case are silent on this issue. Others specifically provide coverage for completed operations only (GL – 4382, included in the appendix, is an example).

The endorsement GL-4276, CONTRACTORS ADDITIONAL INSURED ENDORSEMENT, (copy in the appendix) is an example of an endorsement in which the additional insured is defined by reference to the named insured's contractual obligations, rather than by schedule. This endorsement provides, in part:

> 1. SECTION II – WHO IS AN INSURED is amended to include:
>
> Any "owner", "contractor", "construction manager", "engineer" or "architect" if it is required in your written contract or written agreement executed by you and all other parties to the contract or agreement prior to any loss that such person(s) or organization(s) be added as an additional insured on your policy but only for the project designated in your written contract or written agreement and only with respect to "bodily injury," "property damage" or "personal and advertising injury" caused, at least in part, by your negligence and with respect to liability arising from:
>
> A. Your ongoing operations for the additional insured(s), or
> B. Acts or omissions of the additional insured(s) in connection with their supervision of such operations.

This endorsement goes on to exclude coverage for

> "Bodily injury" or "property damage" or "personal and advertising injury" resulting from any act or omission of the additional insured(s) or any of their employees, other than the general supervision of work performed for the additional insured(s) by you.

The Federal Court for the Eastern District of North Carolina construed similar language in *St. Paul Fire and Marine Insurance Company v. Hanover Insurance Company*, 187 F.Supp.2d 584 (E.D.N.C. 2000) and found that the additional insured endorsement did not extend coverage to a personal injury claim against the additional insured that was based upon allegations that the additional insured was liable by virtue of its own negligence. In the *St. Paul* case Hardin subcontracted with J&A Mechanical. An employee of J&A Mechanical's secondary subcontractor was injured on the job and sued Hardin, among others. Hardin's subcontract with J&A Mechanical required J&A to indemnify Hardin. Hardin's general liability policy, issued by Travelers, contained a blanket additional insured endorsement:

> This endorsement modifies insurance provided under the following:
>
> Commercial General Liability Coverage Part
>
> 1. WHO IS AN INSURED (Section II) is amended to include any person or organization you are required by written contract to include as an insured, but only with respect to liability arising out of "your work." **This coverage does not include liability arising out of the independent acts or omissions of such person or organization.** The written contract must be executed prior to the occurrence of any loss.
>
> 2. Where required by contract, this insurance is primary and noncontributing as respects the person or organization included as an insured under this endorsement and any other insurance available to any such person or organization shall be excess and noncontributing with this insurance....

187 F.Supp. at 587 (emphasis supplied). It does not appear that J &A Mechanical had expressly contracted to name Hardin has an additional insured. However, the Court

inferred from the promise to indemnify Hardin a sufficient intention to protect J&A Mechanical that the Court found that J&A Mechanical was an insured under the blanket endorsement. Travelers contended that the endorsement only provided coverage to an additional insured for its vicarious liability. The Court agreed: "to give meaning to the 'independent acts' provision of endorsement, the Court must construe the 'arising out of [the subcontractor's work]' provision as one providing coverage in cases where the alleged liability is vicarious."

The *Pulte* Court reviewed the *St. Paul v. Hanover* decision, noting that, while it was not controlling precedent, it demonstrated that insurers can write additional insured endorsements to give more limited grants of coverage, if they desire to do so. 185 N.C.App. at 169, 170, 647 S.E.2d at 619. However, the *Pulte* Court also noted that an employer cannot be held vicariously liable for the negligent acts of an independent contractor and that to interpret an additional insured endorsement to limit coverage to vicarious liability would provide no "genuine insurance." 185 N.C.App. at 169, 647 S.E.2d at 619. Notwithstanding this concern, there are areas in which coverage for the vicarious liability of the additional insured could benefit the additional insured. First, the carrier would be required to defend baseless claims against the additional insured. If the claimant in *St. Paul v. Hanover* had alleged a claim for vicarious liability against Hardin, Travelers would have been required to defend. Second, some claims that would be considered to be direct liability in North Carolina, such as liability arising from non-delegable duties, would be considered vicarious liability in other states, such as South Carolina. An endorsement that might provide no coverage in North Carolina might

provide coverage in other states for claims requiring different essential elements than those claims recognized in North Carolina. So long as the endorsement is not geographically restricted in its scope of coverage, the fact that it does not provide coverage for claims recognized in North Carolina does not necessarily mean that it is illusory.

In an unpublished opinion, *St. Paul Fire and Marine Insurance Company v. The Hanover Insurance Company*, 2000 WL 34594777 (E.D.N.C. 2000)[9], the Federal Court for the Eastern District of North Carolina found a broad scope of coverage under a blanket additional insured endorsement providing coverage to the additional insured for liability "with respect" to the named insured's operations. J&A Mechanical hired Herin as a subcontractor. Herin's employee was injured on the job and sued J&A Mechanical. J&A Mechanical was insured by Travelers and was also an additional insured under a policy that Hartford issued to Herin. The additional insured endorsement provided:

> Section C WHO IS AN INSURED
>
> 2.f. Additional Insureds by Contract, Agreement, or Permit. Any person or organization with whom you agreed, because of written contract or agreement or permit, to provide insurance such as is afforded under this Business Liability Coverage Form, *but only with respect to your operations, "your work" or facilities owned or used by you.*

Travelers contended that J&A was entitled to coverage under the Hartford policy and that the Hartford policy was primary. Hartford contended that the endorsement only covered the additional insured for vicarious liability resulting from the actions of

[9] This opinion arose out of the same dispute as St. Paul Fire and Marine Insurance Company v. Hanover Insurance Company, 187 F.Supp.2d 584 (E.D.N.C. 2000) but concerned a different policy.

Hartford's named insured.[10] Neither party was able to cite a case exactly on point as to the scope of coverage provided by this endorsement.[11] The *St. Paul* Court found coverage under the Hartford policy, citing two opinions from other jurisdictions giving a broad interpretation to the phrase "with respect to." It appears likely that the North Carolina courts would also give a liberal interpretation to the phrase "with respect to", just as they have found that a broad scope of coverage is triggered under policies providing coverage for injuries "arising out of" an insured's activities.

It's easy to think of coverage disputes as questions of law to be decided by the courts. However, these disputes frequently involve factual issues. This is equally as true for disputes resolving additional insured endorsements as for other types of coverage disputes. In one recent case APAC- Atlantic, Inc. sued Firemen's Insurance Company of Washington, D.C. for failure to cover APAC as an additional insured. See, *APAC v. Firemen's Insurance Company*, 2012 WL 121244 (N.C.App. 2012) (UNPUBLISHED). APAC was the contractor on a highway paving project and had hired Stay Alert Safety Services, Inc. to install, maintain and remove work zone signs on the project. A driver who lost control of his motorcycle in an area of uneven pavement was killed. His estate sued APAC and Stay Alert, alleging that APAC was negligent in allowing westbound lanes to stay open when the difference in elevation between the lanes exceeded 1.5 inches and alleging negligence by APAC and Stay Alert in failing to install adequate warning

[10] Because the plaintiff in the underlying action was employed by Hartford's insured, the exclusivity provisions of the Workers' Compensation Act applied and there could be no vicarious liability.
[11] This opinion preceded *Pulte.*

signs. APAC was an additional insured under a policy of insurance that Firemen's had issued to Stay Alert. The additional insured endorsement stated:

> **Section II—Who Is An Insured** is amended to include as an additional insured the person(s) or organization(s) shown in the Schedule but only with respect to liability for "bodily injury", "property damage" or "personal and advertising injury" caused, in whole or in part by your acts or omissions or the acts or omission of those acting on your behalf:
>
> A. In the performance of your ongoing operation; or
>
> B. In connection with your premises owned by or rented to you.

2012 WL 121244, p. 1.

Firemen's defended APAC under a reservation of rights but declined to participate in a settlement. After settling the case, APAC sued Fireman's for breach of contract, unfair and deceptive trade practices and bad faith. The trial court dismissed the case on Fireman's motion for summary judgment. The Court of Appeals reversed the case, finding issues of fact as to whether any negligence by Stay Alert contributed to the motorcyclist's injuries.

The Court also found an issue of fact as to whether APAC violated the policy conditions of the Firemen's policy by voluntarily contributing to a settlement. Firemen's reservation of rights letter stated: "we feel no liability rests with our insured, Stay Alert Safety Services, Inc., and for that reason Firemen's… reserves its rights with regard to indemnification. We also reserve the right to withdraw the defense of APAC." 2012 WL 121244 p. 5. The Court found that there was an issue of fact as to whether, by virtue of

its reservation of rights letter, Fireman's denied coverage before APAC settled the underlying case and that expert testimony was admissible on this issue.

Application of N.C.G.S. §22B-1

Contracts by which a subcontractor is required to obtain additional insured coverage for an owner or general contractor frequently include indemnification agreements as well. Indemnification agreements given in connection with contracts relating to the "design, planning, construction, alteration, or repair or maintenance of a building, structure, highway, road, appurtenance or appliance" are governed by N.C.G.S. §22B-1. That statute invalidates indemnification agreements to the extent that they purport to protect the indemnitee against liability for its own negligence. The Court in *St. Paul Fire and Marine Insurance Company v. Hanover Insurance Company*, 187 F.Supp.2d 584 (2000) indicated that contracts requiring a subcontractor to provide additional insured coverage would be invalid to the extent that they purport to protect the contractor against its own negligence.

> Indeed, an agreement between Hardin and J & A Mechanical that required J & A Mechanical to provide insurance for Hardin against its own negligent acts would be void as against public policy in North Carolina. Under North Carolina law, a general contractor cannot require a subcontractor to ensure it against its own negligent acts. Pursuant to N.C. Gen. Stat. §22B-1, any agreement relative to the construction of a building that purports to indemnify or hold harmless a general contractor against liability for damages arising out of bodily injury to a person caused by or resulting from the general contractor's own negligence, in whole or in part, is against public policy and is void and unenforceable. N.C. Gen. Stat. §22B-1.

187 F.Supp.2d 584, footnote #7. This opinion is not binding on the North Carolina courts. *Miller Brewing Company v Morgan Mechanical Contractors, Inc*., 90 N.C.App., 310, 368 S.E.2d 438 (1988), discussed below, suggests a possibility that the North Carolina courts would also find that N.C.G.S. §22B-1 invalidates agreements to procure insurance that would violate the spirit of that statute. There is room for argument on this issue. However, there is little, if any, chance that the North Carolina courts would find that N.C.G.S. §22B-1 invalidates additional insured endorsements once they are in place. N.C.G.S. §22B-1 states that "this section shall not affect any insurance contract, workers'' compensation, or any other agreement issued by an insurer." In light of this provision, it appears that any scheduled additional insured endorsement would be enforceable, regardless of whether it protected the additional insured against liability that would otherwise be affected by N.C.G.S. 22B-1. A more interesting question is whether a blanket additional insured endorsement would be affected. The policy would not be affected in and of itself but the definition of additional insured could only be determined by reference to the underlying contract. Would the underlying contract be invalid to the extent that it would have the effect of indemnifying a party against its own negligence in a construction context?

In *Miller Brewing Company v. Morgan Mechanical Contractors, Inc.,* 90 N.C.App. 310, 368 S.E.2d 438 (1988), the North Carolina Court of Appeals considered a situation in which a contractor agreed to indemnify an owner for liability arising out of the contractor's work and to provide adequate insurance indemnifying the owner and the contractor against all claims arising from such work. The contractor's employee was

injured on the owner's property. The employee sued the owner, alleging that the employee's injuries resulted from the owner's direct negligence. The owner demanded indemnification from the contractor. The Court of Appeals held that N.C.G.S. §22B-1 applied to invalidate the indemnification agreement. The fact that the contractor was required to procure insurance to satisfy its indemnity obligation did not alter the fact that the indemnity agreement ran afoul of N.C.G.S. §22B-1.

Application of Exclusions – Separation of Insureds

The separation of insureds clause can significantly increase the carrier's exposure where an additional insured is involved. A claim that would have been excluded as to the named insured may be covered as to an additional insured. By virtue of the separation of insureds clause the exclusion must be applied separately to each insured seeking coverage as if it were the only insured:

> **7. Separation of Insureds**
> Except with respect to the Limits of Insurance, and any rights or duties specifically assigned in this Coverage Part to the first Named Insured, this insurance applies:
> a. As if each Named Insured were the only Named Insured; and
> b. Separately to each insured against whom claim is made or "suit" is brought.

One clear example of potentially broadened coverage occurs when the named insured's employee alleges that he was injured by the negligence of an additional insured. Form CG 00 01 excludes coverage for "bodily injury" to "an 'employee' of ***the insured*** arising out of and in the course of … employment by the insured, or, performing duties related to the conduct of the insured's business." Importantly, the exclusion refers to an

employee of "the insured", as opposed to "your employee." A literal reading of the exclusion suggests that the exclusion refers only to the employee of the particular insured seeking coverage. The separation of insureds clause, quoted above, supports this conclusion.

An older North Carolina Supreme Court decision indicates that the additional insured will not be covered for claims asserted against it by employees of the named insured. However, more recent decisions have applied the separation of insureds clause more literally and have found coverage in this situation.

In *State Farm Mut. Auto Ins. Co. v. Employers' Fire Ins. Co.*, 256 N.C. 91, 123 S.E.2d 108 (1961) the North Carolina Supreme Court held that a severability clause did not render the employee exclusion ineffective where a defined insured was seeking coverage for liability arising from an injury to the named insured's employee. In the *State Farm* case a customer (Ryck) was test driving a car and negligently injured a salesman who was also in the car. Ryck (and his personal auto carrier) sought coverage under the dealership's auto policy. That policy contained an exclusion for injuries to an employee of the insured. The Court noted the Plaintiff's argument that "under the severability of interests clause in the garage policy, Ryck is afforded separate, complete coverage for injury except to his own employees." Notwithstanding this argument, the Court found no coverage for Ryck under the garage policy.

> When Employers' (the garage carrier) and Foppe (the garage owner) entered into the garage insurance contract we are certain the employees they intended to exclude were Foppe's employees. Without support is the argument that some other

> employees and not Foppe's were within the contemplation of the parties when they made the contract.

256 N.C. at 94, 123 S.E.2d at 111. There is no logical basis for distinguishing omnibus insureds under the primary coverage form from additional insureds under endorsements to the primary coverage form. Unless otherwise distinguishable, *State Farm v. Fire Employers' Fire Insurance Company* should apply to general liability policies.

The *State Farm v. Employers' Fire Insurance Company* did not quote the "severability of interests clause" that was contained in the policy. From the discussion, it appears that the clause was substantially similar to the separation of insureds clause in form CG 00 01. The *State Farm v. Employers' Fire Insurance Company* decision, if taken at face value, indicates that the North Carolina Court will enforce employee exclusions, even when confronted with a separation of insureds clause. Because the decision was based upon the Court's determination of the parties' intentions and recited very little of the policy language, the North Carolina Supreme Court will have plenty of room to distinguish the decision, if inclined to do so.

In cases decided by other courts since *State Farm v. Employers' Fire Insurance Company*, one court distinguished *State Farm v. Employers' Fire Insurance Company*, even though both cases were decided on logically equivalent facts. *See*, *Penske v. Republic Western Insurance Company*, 407 F.Supp.2d 741 (E.D.N.C. 2006). Another court, on slightly different facts that implicated the separation of insureds clause, made no mention of *State Farm v. Employers' Fire Insurance Company*. *See*, *Universal Insurance Company v. Burton Farm Development Company, LLC,* 718 S.E.2d 665 (N.C.App. 2011).

The Plaintiff in *Penske v. Republic Western Insurance Company* leased a truck to Bridgeways Company, Inc. Bridgeway's employee was injured while using the truck and sued Penske, alleging that the absence of handrails on the truck's exterior contributed to his injuries. Republic Western Insurance Company insured Bridgeway under a commercial auto policy. The policy listed Penske as an additional insured. Penske demanded a defense and Republic refused, citing an exclusion for any obligation for which "the insured" may be held liable under any workers' compensation law, an exclusion for bodily injury to an employee of "the insured" and an exclusion for bodily injury arising after "your work" has been completed. Penske settled the claim for $15,000 and sued Republic for the $15,000, together with $150,000 in attorneys' fees incurred in defending the $15,000 claim.

The policy contained the following "severability of interests" clause:

> "Insured" means any person or organization qualifying as an insured in the Who is An Insured provision of the applicable coverage. Except with respect to the Limit of Insurance, the coverage afforded applies separately to each insured who is seeking coverage or against whom a claim or "suit" is brought.

407 F.Supp.2d at 744. The Court held that the severability of interests clause required it to apply the policy separately as to each insured seeking coverage.

> It would be illogical to conclude, in the face of an explicit direction to apply a policy "separately to each insured who is seeking coverage," that an additional insured receives the identical coverage as the named insured. If such were the case, the severability of interests clause would appear to be meaningless and unnecessary.

407 F.Supp.2d at 747. The person suing to recover from "the insured" seeking coverage,

Penske, was not the insured's employee. "The insured" seeking coverage was not liable to the claimant under any workers' compensation laws. Therefore, the exclusions for workers' compensation obligations and for injury to an employee did not apply.

Republic argued that Penske's work was completed when it delivered the truck to Bridgeway. Therefore, the exclusion for "bodily injury" arising after your work had been completed should apply. However, this exclusion did not reference "the insured's" work but "your work." The policy defined "you" and "your" to refer to the named insured, in this case Bridgeway. Bridgeway was using the truck when its employee was injured. Bridgeway's work had not been completed. Therefore, the exclusion did not apply.

The Court considered *State Farm v. Employers' Fire Insurance Company* and found that it was not dispositive because it only alluded to the severability of interests provision in the policy at issue and did not quote or analyze the provision. The *Penske* Court concluded that *State Farm v. Employers' Fire Insurance Company*, "did not consider the language or effect of the severability of interests clause, but rather merely attempted to construe the term 'the insured' and the parties' intent regarding the insured's employees." 407 F.Supp. at 746.

The Court of Appeals applied the separation of insureds clause in *Universal Insurance Company v. Burton Farm Development Company, LLC,* 718 S.E.2d 665 (N.C.App. 2011). Mancuso Development was project manager for Burton Farm Development Company. W.O. White, LLC had contracted with Burton Farm to perform grading work. White sued Mancuso and Burton Farm, alleging, among other things, that

Mancuso had "made false, derogatory and defamatory remarks about White." Universal Insurance Company issued a liability insurance policy to Mancuso Development that listed Burton Farm as an additional insured. Burton demanded a defense and indemnity from Universal Insurance Company under Coverage B, which provided coverage for personal and advertising injury. That coverage contained an exclusion for personal or advertising injury "done by or at the direction of the insured with knowledge of its falsity." 718 S.E.2d at 669. The complaint against Mancuso and Burton alleged that Mancuso, the named insured under the Universal policy, had made the false statements about White with knowledge of their falsity. Therefore, Universal argued that coverage was excluded under Coverage B. It contended that the additional insured could have no greater rights under the policy than the named insured. The Court of Appeals held that Mancuso's actions did not bar coverage for Burton as additional insured. The policy contained the same separation of insureds clause that is quoted above. The Court cited with approval cases observing that:

> "[T]he vast majority of jurisdictions which have addressed the issue" have held that "a separation of insureds clause modifies the meaning of an exclusion phrased in terms of 'the insured[,]' " such that "the exclusion will only be effective if it applies with respect to the specific insured seeking coverage." …"The better reasoned cases adopt a restrictive interpretation of 'the insured' as referring only to the party seeking coverage under the policy."

718 S.E.2d at 669.

Coverage for Injuries to Employees

The standard general liability policy contains several exclusions addressed to claims made by the insured's employees.

> **This insurance does not apply to:**
> **a. Workers' Compensation And Similar Laws**
> **Any obligation of the insured under a workers' compensation, disability benefits or unemployment compensation law or any similar law.**
> **e. "Bodily injury" to:**
> **(1) And "employee" of the insured arising out of and in the course of:**
> **(a) Employment by the insured; or**
> **(b) Performing duties related to the conduct of the insured's business.**
> **…**
> **This exclusion applies:**
> **(1) Whether the insured may be liable as an employer or in any other capacity; and**
> **(2) To any obligation to share damages with or repay someone else who must pay damages because of the injury.**
> **This exclusion does not apply to liability assumed by the insured under an "insured contract".**

As discussed above, by virtue of the separation of insureds clause, omnibus insureds and additional insureds can be covered for claims for injury to the named insured's employees. This can result in situations where carriers who cover all of an entity's exposures end up paying under the workers' compensation policy and the general liability policy issued to the same insured for the same loss. The insurer potentially reduces its exposure by waiving the workers' compensation lien as part of the settlement of the claim against the additional insured. This eliminates a situation where the claimant's attorney collects a contingency fee on a subrogation claim that amounts to a

transfer of funds within the same insurance company.[12] However, this can create a conflict of interest with the insured if the subrogation recovery would reduce the insured's workers' compensation premium by improving its loss experience.

The general liability insurer can also face exposures for injuries to its named insured's employees where the insured has given an indemnification agreement to the entity that caused the injury. Such an indemnification agreement will usually qualify as an insured contract. The exclusion for "bodily injury" to an employee of the insured states that it does not apply to "any obligation to … repay someone who must pay damages because of the injury" but then states that the exclusion does not apply to liability assumed under an "insured contract." The exclusivity provisions of the Workers' Compensation Act will not prevent the enforcement of such an agreement. N.C.G.S. §97.10.1 limits the rights and remedies of the employee against the employer but does not limit a third party's contractual rights against the employer. This scenario frequently arises in connection with construction contracts, in which case N.C.G.S. §22B-1 will invalidate the indemnification agreement.

Conditions of Coverage

Additional insured endorsements are issued in connection with commercial general liability policies that contain primary coverage forms, such as form CG 00 01. That coverage form contains conditions that apply only to the named insured ("you") and

[12] This can be a larger consideration in UM/UIM claims, where, by statute, the reduction of the workers' compensation lien reduces the UM/UIM exposure as a matter of law.

conditions that apply to any insured seeking coverage ("you and any other involved insured"; "no insured").

> **2. Duties In The Event Of Occurrence, Offense, Claim or Suit**
>
> a. ***You*** must see to it that we are notified as soon as practicable of an "occurrence" or an offense which may result in a claim. …
>
> b. If a claim is made or "suit" is brought against any insured, ***you*** must:
>
> (1) Immediately record the specifics of the claim or "suit" and the date received; and
>
> (2) Notify us as soon as practicable.
> You must see to it that we receive written notice of the claim or "suit" as soon as practicable.
>
> c. ***You and any other involved insured*** must:
>
> (1) Immediately send us copies of any demands, notices, summonses or legal papers received in connection with the claim or "suit";
>
> (2) Authorize us to obtain records and other information;
>
> (3) Cooperate with us in the investigation or settlement of the claim or defense against the "suit; and
>
> (4) Assist us, upon our request, in the enforcement of any right against any person or organization which may be liable to the insured because of injury or damage to which this insurance may also apply.
>
> d. ***No insured*** will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.

In *Pulte v. American Southern Insurance Co.,* 185 N.C.App. 162, 647 S.E.2d 614 (2007) the Court of Appeals applied the test from *Great American Insurance Co. v. Tate*, 303 N.C. 387, 297 S.E.2d 769 (1981) to determine whether an additional insured that delayed six months in giving notice of a lawsuit should be denied coverage. *Great American v. Tate* established a three part test for evaluating late notice defenses:

> When faced with a claim that notice was not timely given, the trier of

> fact must first decide whether the notice was given as soon as practicable. If not, the trier of fact must decide whether the insured has shown that he acted in good faith, *e.g.,* that he had no actual knowledge that a claim might be filed against him. If the good faith test is met the burden then shifts to the insurer to show that its ability to investigate and defend was materially prejudiced by the delay.

Pulte v. American Southern Ins. Co., 185 N.C.App. at 172, 647 S.E.2d at 621 (*quoting, Great Am. Ins. Co. v. C.G. Tate Constr. Co.*, 303 N.C. 387, 399, 279 S.E.2d 769, 76 (1981). The *Pulte* Court held that the six month delay satisfied the first prong.[13] Because American Southern admitted that it had not been prejudiced by the delay, the coverage defense hinged entirely on whether Pulte's delay was in good faith. Pulte bore the burden of proof on this issue. Pulte submitted an affidavit showing that after being served with the suit papers it had to conduct an investigation to determine if it could tender the defense to a subcontractor or an insurer. The affidavit explained that the investigation was time consuming because the relevant records were kept in Pulte's local offices. The affidavit further stated that Pulte did not knowingly or deliberately delay or fail to notify a potentially responsible vendor or insurer of the suit. American Southern did not produce any evidence to contradict the affidavit. Because there was no evidence to contradict Pulte's assertion that it did not make a deliberate decision not to notify American Southern, Pulte was entitled to summary judgment on the good faith issue. In *St. Paul Fire and Marine Insurance Co. v. The Hanover Insurance Company*, 200 WL 34594777 (E.D.N.C. 2000), the Court also held that the three part analysis from Great

[13]The duty to give notice "as soon as practicable" applies only to the named insured. As to the additional insured the duty is to "immediately" send to the carrier any demands, notices or suits. This distinction is not likely to make a significant difference.

American applies to claims for coverage made by additional insureds.

The requirements that the insured authorize the insurer to obtain records and cooperate with the insurer could play a large role in claims for coverage under additional insured endorsements. Frequently, the entity claiming additional insured coverage has other policies available, both its own policy and policies issued to other entities that pledged to provide additional insured coverage. The insurer responding to a demand for additional insured coverage must usually depend upon the additional insured to provide copies of all insurance policies that potentially provide coverage, so that it can determine whether it provides primary or secondary coverage. It is best to sort these issues out early on. An additional insured potentially prejudices the insurer by delaying in supplying this information. Once the insurer has committed to providing a defense, it can be much more difficult to persuade other carriers to participate.

The other insurance clause in the standard CGL policy provides:

> **4. Other Insurance**
> If other valid and collectible insurance is available to the insured for a loss we cover under Coverages A or B of this Coverage Part, our obligations are limited as follows:
>
> a. Primary Insurance
> This insurance is primary except when b. below applies. If this insurance is primary, our obligations are not affected unless any of the other insurance is also primary. Then, we will share with all other insurance by the method described in c. below.
>
> b. Excess Insurance
> This insurance is excess over**:**
> **....**

> **(2)**Any other primary insurance available to you covering liability for damages arising out of the premises or operations, or the products completed operations, for which you have been added as an additional insured by attachment of an endorsement.
>
> **When this insurance is excess, we have no duty under Coverages A or B to defend the insured against any "suit" if any other insurer has a duty to defend insured against that "suit".** If no other insurer defense, we will undertake to do so, but we will be entitled to the insured's rights against all those other insurers. …

The additional insured endorsements frequently modify the other insurance clauses in the policies to which they are attached. For example, form GL-4276, "CONTRACTORS ADDITIONAL INSURED ENDORSEMENT" provides:

> Any coverage provided here in will be excess over any other valid and collectible insurance available to the additional insured(s) whether primary, excess, contingent or on any other basis unless you have agreed in a written contract or written agreement executed prior to any loss that this insurance will be primary.

In order to apply this other insurance clause, the carrier must review its named insured's contract with the additional insured and all other policies of insurance available to the additional insured. The entity seeking coverage as an additional insured likely has policies of its own that must be examined. Additionally, an owner and contractor that has obtained additional insured coverage from one subcontractor frequently will have obtained additional insured coverage from other subcontractors or suppliers as well. Once that entity is receiving a free defense from one subcontractor's carrier it may perform the task of obtaining complete copies of the potentially applicable policies with little urgency. In its reservation of rights letter, the carrier responding to a request for

additional insured coverage should notify the additional insured of its duties under the policy conditions and the carrier's need for the prompt supply of all information needed to evaluate the exposure.

Once the purported additional insured has requested coverage, the carrier can find itself in a tenuous position. The carrier must conduct its investigation quickly. If the case is in suit, it will have to make a decision on whether to provide a defense in short order. This is complicated when the carrier does not have access to other policies that may provide coverage for the same claim and that may be primary. The carrier should communicate its expectations to the purported additional insured as clearly as possible regarding cooperation in the investigation and cooperation in making demand upon all other potential carriers for defense and for indemnification and particularly in obtaining copies of all other potentially applicable policies and providing those policies.