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NACD members should find the information presented in this article quite interesting and beneficial with regard to understanding the concepts of business risk and insurable risk. It is important for a business owner to understand these concepts and how typical insurance programs are structured to protect against insurable risks, not business risks. Eliminating or mitigating business risk is achieved through management control practices, quality control programs, and strong environmental, health and safety programs. NACD members are very fortunate to follow the Responsible Distribution ProcessSM as it provides substantial protection against business risk.

The Business Risk Exclusion

By C.B. Newcombe¹ and Eugenie Gifford Baumann²

Most insureds are aware that commercial general liability (CGL) policies do not provide coverage for every loss. In particular, CGL policies do not cover the risk of repairing defective workmanship or replacing a defective product which the insured itself manufactured. Such losses are considered commercial risks. These risks, also known as business risks, are generally not the kind of risks that are the subject of insurance, because CGL policies are designed to protect against the risk of accidental injury to property or persons of others. CGL policies are not designed to provide coverage against the ordinary business risk of faulty work.³ Put another way, "poor performance by an insured is a cost of doing business, not a component of the insurance objective of shifting risk."⁴ This is why, as one court said, "business risk exclusions [are] common features in commercial general liability insurance policies."⁵

What this means as a practical matter is that damages arising from an insured's own "poor workmanship" or "faulty workmanship" are excluded from coverage under one or more of the business risk exclusions contained in most CGL policies. For example, design and construction defects relating to a home remodeling project performed by a home improvement contractor are excluded from coverage under the "your work" business risk exclusion of the contractor's CGL policy.⁶ Similarly, another business risk exclusion applies to exclude claims for damage to "your product." The term "your product" generally means the insured's own product. The term can include any goods manufactured, sold, handled, or distributed by the insured.

Excluded vs. Covered Risks: The principle underlying the "your product" or "your work" business risk exclusions is to distinguish between two separate types of liability incurred by an insured, one of which

is typically excluded and the other covered. The first type of risk is the business risk that an insured may have to replace or repair its own defective work to make a product comply with contractual requirements. This type of risk is excluded from coverage under a business risk exclusion found in most CGL policies. The second type of liability that an insured contractor can incur is the risk that his defective work will cause personal injury or physical damage to other property. It is this second type of risk, and the "potential for limitless liability" associated with it, that is the type of risk "for which CGL liability is contemplated."⁷

Put another way, the business risk exclusions contained in most CGL policies are intended to distinguish between contract liability and tort liability.

The risk most CGL policies cover is the possibility that the work, product, or goods of the insured, once completed, will cause damage to property *other than to the product or completed work itself*, and for which the insured may be found liable. This is tort liability. Tort liability is entirely different from the liability of an insured who may become liable as a matter of contract law to make good on products or work which is defective or otherwise unsuitable. This type of liability "may even extend to an obligation to *completely replace or rebuild the deficient product or work*. *This liability, however, is not what [CGL] coverages...are designed to protect against.*"⁸

The business risk exclusions are based on the premise that a CGL policy is not intended to function as a guarantee of the quality of the insured's work. If the work performed or product provided fails to meet contract requirements, this is not a risk covered under most CGL policies.⁹ CGL policies exclude coverage for e.g., faulty workmanship because "it would [be] economically inefficient for an

insurance policy to protect against risks that appropriate business management could and should control."¹⁰ Put another way, "[b]usiness risks mean those risks that are predictable and normal consequences of doing business. The reasoning behind excluding business risks from coverage is that the insured can control these predictable risks. Risks that the insured can control should not be the subject of insurance."¹¹

The most often cited explication of this particular type of exclusion was made by a New Jersey judge who wrote that a CGL policy "does not cover the accident of faulty workmanship, but rather faulty workmanship which causes an accident."¹² Not surprisingly, CGL policies do not cover the costs of inspecting, repairing, and replacing a defective product. To take an example from the chemical manufacturing industry, if a manufacturer of dry cleaning solvent enters into a contract to supply its product to a dry cleaning establishment, but is later sued by the purchaser because the concentration of the chemical agent in the solvent is too weak to provide effective cleaning, coverage for such a suit would likely be excluded by the "your product" exclusion in the manufacturer's CGL policy. That manufacturer-insured would be required to foot the bill for its error in producing a substandard product.¹³ If, by contrast, the concentration of the agent was too strong, and the manufacturer was sued for physical damage to garments cleaned at the dry cleaning establishment, the "your product" exclusion would *not* apply.

In addition to the "your work" or "your product" exclusion, most CGL policies include a so-called "product recall" or "sistership" exclusion. This type of business risk exclusion "operates to bar coverage for costs associated with the recall or removal" of a product.

Definition of Impaired Property

A significant business risk exclusion generally found in most CGL policies as exclusion “m” (or sometimes “n”) is the “impaired property” exclusion. This exclusion applies to property damage, to impaired property or to property that has not been physically injured. An integral part of the impaired property exclusion is found in the definitions contained in the policy. These definitions are used to clarify coverage. Under the standard CGL policy definition, “impaired property” means: “tangible property, other than your product or your work that cannot be used or is less useful because:

“a. it incorporates ‘your product’ or your work that is known or thought to be defective, deficient, inadequate or dangerous; or

“b. You have failed to fulfill the terms of a contract or agreement;

“if such property can be restored to use by:

“a. the repair, replacement, adjustment or removal of ‘your product’ or ‘your work;” or
“b. Your fulfilling the terms of the contract or agreement.”

Examples of Impaired Property

The concept of impaired property can best be illustrated by an example. In *Dorchester Mutual Fire Ins. Co. v. First Kostas Corp.*,¹⁴ a painting contractor entered into a contract to paint the outside of a house. After the job was finished, the homeowners sued the painter claiming that lead paint chips and dust had contaminated the inside of their house. Based on the impaired property exclusion, the painter’s general liability insurance company denied coverage for the claim and a state court agreed. The court found that it was an expected incident of doing business as a painter that paint chips and dust might contaminate the surrounding area. The court went on to hold that the allegations in the case “encompass a scenario expressly excluded from coverage.”¹⁵ Specifically, the court found that in the paint trade:

“The possibility of chips and dust may contaminate the surroundings is clearly a *normal foreseeable, and expected incident of doing business*. This risk can and should be reduced...by...measures such as drop cloths and closed windows...but the possibility cannot be completely foreclosed because of the *nature of the business*. This is a *classic business risk scenario*, the cost of which is properly reflected in the price of the painting service.”¹⁶

Another example of the impaired property exclusion is found in the case of a masonry

contractor who sought coverage under his CGL policy for the cost of correcting his faulty workmanship after the stucco he applied cracked. In justifying its decision to deny coverage for the claim, the court explained that the insured:

“can take pains to control the quality of the goods and services supplied. At the same time that he undertakes the risk that he may fail in this endeavor and thereby incur contractual liability whether express or implied. The consequences of not performing well is part of every business venture; the replacement or repair of faulty goods and works is a business expense to be borne by the insured-contractor in order to satisfy customers.”¹⁷

More recently, a manufacturer and vendor of paint filed an action against an insurance company to recover for a settlement he made after he sold defective paint. A federal court held that the impaired property exclusion barred coverage.¹⁸ The paint had been placed on the walls of certain homes. The homes had to be repainted. During the time it took to repaint the houses, the owners were deprived of the use of their houses. One of the issues before the court was whether the property, which the insurance company claimed was impaired, could be restored to use by repair or replacement as those words were used in the exclusion. The insured paint company (CMS) had argued that the defective paint was not “replaced” within the meaning of the exclusion, because it was still on the walls and the new paint was not supplied by CMS. The court disagreed, finding instead that “the plain ordinary meaning of the term ‘replace’ is dispositive....[T]he homes were restored to use by replacement of the defective CMS paint with ...new paint, which put something new in place of the defective paint. Replacement does not require that the defective paint be removed from the walls...”¹⁹

Returning to the example of the dry cleaning solvent manufacturer, the impaired property exclusion would apply to bar coverage for a claim by the dry cleaning establishment that the solvent formula supplied to it was overly viscous, causing the applicator equipment to jam and become inoperable. The problem can be solved by eliminating the product from the equipment and the insured will not be permitted to shift the costs of this remedial action to its insurer. Where, by contrast, the solvent manufacturer is sued for damage to the environment, private property, or persons arising from leeching of its product from clay pipes into soils and ground water, there is irreparable damage that cannot be eliminated by the simple removal of the chemicals. This harm would not implicate the impaired property exclusion.

The key, then, to understanding the vital distinction between business risks that must be borne by the insured and insurable risks that are covered by CGL policies, is to understand the nature of the failure that led to the loss in the first instance, the nature and identity of the damaged or impaired property, and the remedies for the harm once it has arisen. •

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³ *Burlington Ins. Co. v. Oceanic Design & Construction*, 383 F.3d 940, 948 (9th Cir. 2004).

“The risk of replacing and repairing defective materials or poor workmanship has generally been considered a commercial risk which is not passed on to the liability insurer. Rather liability coverage comes into play when the insured’s defective materials or work cause injury to property other than the insured’s own work or products.” *Id.* at 948 (citations omitted).

⁴ *Lerner Corp. v. Assurance Co. of America*, 707 A.2d 906, 912 (Md. App. 1998) (citing 30 TORT & INS L.J. at 786).

⁵ *Mid-Continent Cas. Co. v. JHP Development, Inc.*, 537 F.3d 207, 211 (5th Cir. 2009).

⁶ *Stuart v. Weisflog’s Showroom Gallery, Inc.*, 753 N.W. 2d 448 (Wis. 2008).

⁷ *Century Machine Works, Inc. v. Harleysville Mut. Ins. Co.*, ___ F.Supp.2d ___, 2008 WL 2690998 (M.D. Ga. Jun. 30, 2008).

⁸ *Id.* at *5 (emphasis in original).

⁹ *Thommes v. Milwaukee Ins. Co.*, 641 N.W.2d 877, 880 (Minn.2002).

¹⁰ *Parrott v. Hoosier State Constr., Inc.*, 2006 WL 861307, at *3 (W.D. Ky. Mar. 26, 2006).

¹¹ Caroline B. Newcombe, *The Impaired Property Exclusion*, 52 Fed’n Def. & Corp. Counsel Q., 365, 373 (2002). As another commentator noted: “Business risks, then are those risks which...are a normal, foreseeable and expected incident of doing business and should be reflected in the price of the product or service rather than as a cost of insurance to be shared by others.” *Id.* at 373 n.46 (citations omitted).

¹² *Wedo v. Stone-E-Brick, Inc.* 405 A.2d 788, 796 (1976).

¹³ *Brosnahan Builders, Inc. v. Harleysville Mut. Ins. Co.*, 137 F. Supp. 2d 517, 528-529 (D.Del. 2001). The discussion of this case, and the one which follows it, is taken from an article written by the author titled, *The Impaired Property Exclusion*, 52 Fed’n Def. Counsel Q., 365 (2002).

¹⁴ 731 N.E. 2d 569 (Mass. App. 2000).

¹⁵ *Id.* at 571.

¹⁶ *Id.* at 572-73.

¹⁷ *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788, 791 (N.J. 1979).

¹⁸ *SWA Painting, Inc. v. Golden Eagle Ins. Co.*, 268 Fed. Appx. 521, 2008 WL 510535 (9th Cir. 2008).

¹⁹ *Id.* at 523.