Connecticut Law Tribune

November 26, 2012

An ALM Publication

Insurance Coverage & BAD FAITH LITIGATION

The Faulty Workmanship Exclusion

Courts becoming less lkely to draw distinction between 'product' and 'process'

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Builder's risk and other first-party coverages have traditionally excluded loss or damage caused by "faulty workmanship." A principal point of contention in litigation over this exclusion has been whether the exclusion applies to loss or damage caused by a finished product (damage to a desk when a poorly made ceiling falls on it) or the process of workmanship (damage to a windowsill during the process of repairing the window), or to both. In light of recent decisional law, courts appear less inclined to draw a distinction between process and product as a way of limiting the reach of the "faulty workmanship" exclusion.

Although the language varies from policy to policy, a typical "faulty workmanship" exclusion provides that:

> *"We will not pay for loss or damage caused by, resulting from, or arising out of any acts, errors, or omissions by you or others in any of the following activities…*
>
> *3. Any of the following performed to or for any part of…any Covered Property:*
> *a. Design, specifications, workmanship, repair, construction, renovation, remodeling, grading, compaction…"*

Frequently, the term "workmanship" is not defined by the policy, leaving the insured and the insurer to battle over the correct interpretation of the word. That battle has led some courts to break down the concept of workmanship into two distinct parts: process and product. This distinction was explained by the U.S. Court of Appeals for the Ninth Circuit in *Allstate Insurance Co. v. Smith*, 929 F.2d 447 (9th Cir. 1991).

In *Smith,* a roofing contractor removed most of the roof of an insured office building but failed to put a temporary cover over the exposed premises. It rained the following night, and the insured's office equipment and improvements were damaged. Quoting Webster's, the *Smith* court found that the term "workmanship" has two dictionary definitions: (1) something effected, made, or produced: *work* and (2) the art or skill of a workman: *craftsmanship.*

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The court explained that "faulty workmanship" could therefore mean either (1) the flawed quality of a finished product; that is, something inherently damaged about an object; or (2) a flawed process; that is, a clumsy workman who makes a mistake and damages something in the course of his work. Based on the fact that the word workmanship itself has two meanings, one referring to product and the other to process, the circuit panel determined that the term was ambiguous. Because of this claimed ambiguity, the court adopted the interpretation favorable to the insured, the faulty product interpretation, and determined that the loss was not excluded because it involved the ongoing process of repairing the roof. It is clear from the opinion that, had the insured's loss involved a product rather than a process, the Ninth Circuit would still

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have found for the insured by limiting the exclusion under that circumstance to only the process aspects of workmanship.

Under the approach taken in *Smith,* the "faulty workmanship" exclusion is unlikely to ever exclude coverage because, where the loss is a product loss, the exclusion only applies to process losses and vice versa. Notably, the Ninth Circuit did not adopt the approach that the exclusion eliminates coverage for loss caused by faulty workmanship, meaning both types of workmanship. Just as a speed limit applies to both cars and trucks, the exclusion applies to both types of faulty workmanship.

Practical Result

Some courts have followed the *Smith* court in finding an ambiguity in the concept of workmanship and thereby finding coverage for the insured. In *M.A. Mortenson Co. v. Indemnity Insurance Co. of North America,* 1999 U.S. Dist. LEXIS 22641 (D. Minn. Dec. 23, 1999), for example, the court found that the insured was entitled to coverage for damage to a construction site caused by a flood, even though the contractor's protective measures failed to stop the flooding, because the protective measures did not involve a faulty product. The practical and most common result of the holdings of *Smith* and *M.A. Mortenson* is that damage caused by acts of workers are not excluded while faulty products are excluded and therefore not covered.

Other courts have rejected the either-or distinction in *Smith,* reasoning that workmanship means just — workmanship — and encompassing all possible meanings of the dictionary definition of the term, including both faulty process and faulty product. In *Otis Elevator Co. v. Civil Factory Mutual Ins. Co.,* 353 F. Supp. 2d 274 (D. Conn. 2005), the court recognized the dichotomy but applied both definitions anyway, finding that the claimed damage caused by an airport tram car was not the result of either a faulty product or a faulty process and was therefore covered under the policy.

Similarly, in *L.F. Driscoll Co. v. American Protection Ins. Co.*, 930 F. Supp. 184 (E.D. Pa. 1996), the court found that faulty workmanship was unambiguous and, applying the plain and ordinary meaning of the term, compared the damage against both concepts of workmanship to find that the loss was excluded under either definition. Another court simply stated that "while the term 'faulty workmanship' allows at least two definitions, we see no reason why it must mean either a 'flawed product' or a 'flawed process'…an insurer could just as likely have both perils in mind when it drafts a policy's list of exclusions." *Schultz v. Erie Ins. Group,* 754 N.E.2d 971, 976 (Ind. Ct. App. 2001).

Based on the fact that the word workmanship itself has two meanings, one referring to product and the other to process, the circuit panel determined that the term was ambiguous.

Even this small collection of cases demonstrates the uncertainty over the reliable application of the faulty workmanship exclusion. A litigant entering a jurisdiction that has not decided the issue should, therefore, be aware of the uneven treatment of this exclusion by various courts.

A recent decision demonstrates that the older product-versus-process analysis is in decline, *Golan Management LLC v. Hartford Insurance Co.,* 2012 U.S. Dist. LEXIS 62077 (W.D. Okla. May 3, 2012).

Cloudy Windows

In *Golan,* a high-rise office building was damaged when contractors attempted to wash the concrete exterior of the building with a corrosive cleaning agent. In the process of spraying the outside concrete, the contractors failed to adequately cover the glass windows of the building. When the windows were sprayed with the cleaning chemicals, they became etched and cloudy and had to be replaced. Under the *Smith* dichotomy, this type of loss would likely be considered faulty process, as there was nothing intrinsically flawed with the products being used. As such, under the *Smith* case law, had the court applied the faulty product interpretation, there likely would have been coverage.

The insured brought suit after the insurer declined to pay, based, in part, upon the workmanship exclusion in the policy; however, in addition to a general exclusion for workmanship like the one above, the policy also had a specific exclusion for workmanship that read: "We will not pay for the cost of correcting defects in Covered Property, or loss or damage to Covered Property that was caused by, resulting from, or arising out of work done on Covered Property by you, your employees, or others working on your behalf."

That policy language clearly contemplates, and excludes, both faulty product and faulty process. The first clause, excluding "the cost of correcting defects in Covered Property," excludes from coverage the flawed quality of a finished product. The second clause, excluding "loss or damage caused by…you," excludes poor craftsmanship or poor process.

At summary judgment, the insured argued that the policy was ambiguous and cited *Smith* and its progeny for the product/process distinction. The district court disagreed, finding that the specific workmanship exclusion was "clear and unambiguous and specifically excludes the loss suffered by Plaintiff." As a result, coverage was excluded and summary judgment was granted in favor of the insurer.

The specific policy language in *Golan* suggests that the product/process distinction may quickly become a historical remnant, or at least that the distinction can be better controlled through more specific policy language. As more policies adopt more specific language regarding the workmanship exclusion, language that clearly contemplates, and excludes, both process and product, the dichotomy identified in *Smith* becomes steadily less relevant. All attorneys litigating over builder's risk and other first-party coverages are therefore well advised to carefully comb the policy for any potentially applicable workmanship exclusion. ■

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