

## NEWSLETTERS

### Seventh Circuit Finds Duty To Defend Triggered In Illinois When Subcontractor's Defective Work Causes Damage To Other Parts Of Project

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#### **Barnes & Thornburg Construction Law Update, December 2017**

As readers of this author's prior published articles know, it is our view (and the view of many other commentators and out-of-state judicial decisions) that Illinois law incorrectly analyzes whether construction defects can constitute an accidental "occurrence" under the standard commercial general liability (CGL) policy. As at least one federal judge in Illinois has acknowledged, this creates a "quandary" for the federal courts when they are required to apply this incorrect analysis to the cases before them. See *Auto Owners Ins. Co. v. John Hagler*, 2015 WL 3862713 at \*4 (S.D. Illinois, June 22, 2015) (Judge Gilbert).

As a reminder, Illinois decisions generally hold (incorrectly) that there can be no "occurrence" unless the defective work causes property damage to something other than the "project," "building" or "structure." Most, but not all, of these decisions address coverage for insured general contractors. This has caused further confusion and uncertainty, especially when the insured was a subcontractor who was alleged to have performed defective work – until now.

The U.S. Court of Appeals for the Seventh Circuit has addressed this issue head on in a recent decision that interprets Illinois law. The decision holds that there can be an occurrence and potential coverage – and, hence, a duty to defend – under a subcontractor's own CGL insurance policy where the claims include allegations that the subcontractor performed defective work that damaged property outside of the subcontractor's own scope of work. *Westfield Insurance Company v. National Decorating Service, Inc.*, 2017 WL 2979654 (7th Cir. July 13, 2017) ("*Westfield*").

In *Westfield*, a subcontractor (National Decorating) was hired by the general contractor to coat a newly constructed, 24-story Chicago high-rise condominium building's exterior with a waterproof sealant. In the underlying lawsuit, the condominium association sued the general contractor and National Decorating alleging that Decorating's application of exterior sealant was defective and caused property damage to the building including water damage to the interior.

Importantly, *Westfield* rejects the notion that inadvertent faulty workmanship cannot be an accident and, therefore is not an "occurrence." The decision holds that negligently performed and defective construction work can give rise to an "occurrence" under the standard CGL policy. Because the underlying complaint alleged National Decorating was

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negligent, the court found there was an “occurrence.”

The decision also rejects the argument that there can be no “occurrence” under a subcontractor’s CGL policy unless the claim involves property damage to something other than the entire building or project. Forced to apply Illinois’ incorrect legal analysis, *Westfield* reaches the only logical result by finding that there can be coverage for a subcontractor under the subcontractor’s own insurance policy where its defective work damages property outside of its own scope of work. Specifically, the Seventh Circuit determined that, under Illinois law, there can be “property damage” caused by an “occurrence” if the alleged damage is outside the scope of the *named insured’s* work, which in this case was the scope of work of National Decorating, the painting subcontractor. The court explained that “[i]t would be illogical to conclude that the scope of the project for which National Decorating contracted was the entire 200 North Building.”

Because the underlying complaint alleged damage beyond National Decorating’s scope of work, the court found that Westfield had a duty to defend National Decorating as the named insured. On similar grounds, the decision also holds that a general contractor may have coverage under its subcontractor’s insurance policy as an additional insured where the general contractor is sued for defective work performed by its subcontractor that caused damage to property outside of the subcontractor’s scope of work.

*Westfield* is therefore good news for insured Illinois subcontractors who face claims from owners or general contractors alleging that the subcontractors performed defective work that caused property damage to something beyond their scope of work. It is also good news for general contractors who are additional insureds on their subcontractors’ insurance policies who face claims from owners or others that allege that the general contractor’s subcontractors performed defective work that caused property damage outside of the subcontractor’s scope of work. If the Seventh Circuit’s analysis of Illinois law is applied, these policyholders will be entitled to receive a defense at the insurance carrier’s expense.

Unfortunately, much of the analysis in *Westfield* is required by the incorrect legal analysis that has become entrenched in Illinois law and is contrary to the actual policy intent. Illinois law continues to turn the actual policy intent on its head by looking at the named insured’s scope of work and nature of the damages that are alleged to determine, in the first instance, whether there was an accidental “occurrence.” This incorrectly collapses what should be a separate analysis of the coverage grant and the “your work” exclusion into a single initial determination of coverage under the CGL policy. Under a correct coverage analysis, the first step would be to determine if there is “property damage” caused by an “occurrence” under the coverage grant, and then a separate second analysis would be used to determine if any of the applicable construction-specific policy exclusions applied to bar coverage, including the “your work” exclusion and the exception to this exclusion for property damage caused by the work of a subcontractor. Based on the incorrect Illinois analysis, Illinois cases continue to hold that there can never be an accidental “occurrence” if the named insured is a general contractor and the alleged property damage is to any part of the entire building or project. Even where it is undisputed that the property damage was caused by a general contractor’s subcontractor, these cases hold that there can be no “occurrence” or coverage for the general contractor

because the property damage was to something within the general contractor's scope of work. There is no basis in the CGL policy for this kind of analysis, and it is contrary to the actual policy intent.

A correct legal analysis would recognize that there is an accidental "occurrence" under the CGL policy coverage grant when a claim alleges that a general contractor and/or a subcontractor caused property damage by accidentally (not intentionally) performing faulty construction work. A correct legal analysis would then analyze the availability of coverage under CGL policy exclusions that are included specifically in the policy to narrow and define the actual scope of coverage for construction defect claims. A correct analysis would also recognize that the "subcontractor exception" in the standard "your work" exclusion specifically preserves coverage for property damage that arises out of defective work performed by a named insured's subcontractors.

Under a correct legal analysis, the alleged damage to other work at issue in *Westfield* would have been analyzed with respect to the applicable policy exclusions in the subcontractor's policy, and not as part of the threshold "occurrence" or "property damage" analysis. Specifically, a correct analysis would have examined the alleged damage to other property to determine whether the "your work" exclusion applied to bar coverage. The correct conclusion would be that the "your work" exclusion applied to bar coverage for the repair or replacement of the subcontractor's own faulty work, in part because the "subcontractor exception" to the exclusion would not apply where the named insured subcontractor itself performed the defective work. However, the "your work" exclusion would not apply to bar coverage for the property damage that the named insured subcontractor caused to other parts of the project that were outside its own scope of work. For these reasons, the correct analysis would hold that the subcontractor had potential coverage for at least some part of the claim, and that the insurance carrier therefore had a duty to provide a defense.

One can only continue to hope that the Illinois Supreme Court will address and correct the "occurrence" analysis in Illinois in the near future, or that perhaps Illinois will enact appropriate legislation to correct this problem (as some other states have done). For now, it remains to be seen whether or to what extent the courts in Illinois will follow the *Westfield* decision with respect to coverage under subcontractor policies in similar circumstances.

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