

STATE OF MICHIGAN
IN THE SUPREME COURT

Appeal from the Court of Appeals of Michigan
Davis, P.J., Cavanagh and Talbot, J.J.

HASTINGS MUTUAL INSURANCE COMPANY,

Plaintiff-Appellant/Cross Appellee,

Supreme Court No. 131546
Court of Appeals No. 258271
Oakland Circuit Court
Court No. 04-056508

v.

MOSHER, DOLAN, CATALDO & KELLY, INC.

Defendant-Appellee/Cross Appellant,

and

LISA FEINBLOOM AND DAVID FEINBLOOM,

Defendants

Brief of Amicus Curiae
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JURISDICTIONAL STATEMENT

Amerisure Mutual Insurance Company does not dispute Defendant-appellee/Cross-appellant's statement regarding jurisdiction.

INTEREST OF AMICUS CURIAE

Amerisure Mutual Insurance Company (“Amerisure”) was founded in Michigan in 1912. Amerisure maintains its home office in Farmington Hills, Michigan. Amerisure exclusively provides commercial property and casualty insurance coverage to a variety of contractors and manufacturers throughout Michigan and in several other states. Amerisure regularly issues standard commercial general liability (“CGL”) policies throughout the United States. Through its *amicus curiae* participation, Amerisure seeks to assist this Court in deciding the significant insurance coverage issues presented herein which could have far reaching ramifications for insurers and insureds alike.

The critical issue presented in this matter involves the interpretation of an Insurance Services Office¹ (“ISO”) standard CGL policy in a common construction scenario involving the defective work of a contractor. Specifically, this Court has been asked to decide whether damage to an insured contractor’s own work or product resulting from faulty workmanship is an “occurrence” under a CGL policy. Additionally, this Court may examine whether an exception to the “your work” exclusion in standard policies creates coverage for an insured general contractor’s own work or product when the faulty work is performed by a subcontractor.

As an issuer of CGL coverage in Michigan, Amerisure has a substantial interest in the interpretation and potential expansion of such policies by Michigan courts. This Court’s decision could have a considerable impact on policyholders within this state and may substantially increase the cost of CGL insurance in the State of Michigan.

¹ ISO is the industry organization responsible for drafting the industry-wide standard forms used by insurers.

ISSUES PRESENTED

- I. Are the actions of the defendant cross-appellant (the insured) or its subcontractors for which the defendant cross-appellant was held liable by the arbitrator an “occurrence” within the meaning of the comprehensive general liability policies issued by the plaintiff cross-appellee (the insurer)?

The trial court answered “Yes”

The Court of Appeals answered “No”

The defendant-appellee/cross appellant (the insured) answers “Yes”

The plaintiff-appellant/cross appellee (the insurer) answers “No”

Amerisure respectfully answers “No”

This Court should answer “No”

- II. Does the Subcontractor Exception to Exclusion “I” in a standard CGL policy create coverage for defective work performed by a subcontractor?

The trial court answered “Yes”

The Court of Appeals answered “No”

The defendant-appellee/cross appellant (the insured) answers “Yes”

The plaintiff-appellant/cross appellee (the insurer) answers “No”

Amerisure respectfully answers “No”

This Court should answer “No”

Amerisure respectfully has not briefed the additional issues set forth in this Court’s May 23, 2007 Order granting leave to appeal.

STATEMENT OF FACTS

Amerisure incorporates by reference the statement of facts in the brief before this Court of plaintiff-appellee/cross-appellee Hastings Mutual Insurance Company ("Hastings"). Amerisure highlights only those facts relevant to its arguments.

David and Lisa Feinbloom contracted with Mosher, Dolan, Cataldo, & Kelly, Inc. ("Mosher") to construct a custom residence in Franklin Village, Michigan. The Feinblooms were dissatisfied with the quality of construction and pursuant to an arbitration clause in their contract, initiated an arbitration to resolve the dispute.² The arbitrator described the dispute as follows:³

Claimants and Respondent entered into a contract for the construction of a residence on property owned by the Claimants. The contract established the obligations that Respondent was required to fulfill. Claimants contend that Respondent breached the contract and express warranties by furnishing defective products and defective workmanship.

Mosher sought insurance coverage from Hastings. Hastings initiated a declaratory judgment action seeking a declaration that no coverage was provided under its CGL insurance policy for the claims made by the Feinblooms.⁴

The arbitrator ultimately concluded that for certain items, Mosher had performed its work in a defective manner and/or had provided defective materials in the course of its work. The arbitrator awarded the costs of correcting the defective work to the

² See Mosher Appendix, May 18, 2006 Court of Appeals Opinion, pp. 17a-25a

³ See Mosher Appendix, November 12, 2004 Arbitration Award, pp. 31a-49a, specifically, p. 32a.

⁴ See Declaratory Judgment Complaint and Mosher Appendix, 2003-2004 Hastings Insurance Policy, pp. 95a-127a.

Feinblooms.⁵ The arbitrator found that all of the problems resulted from defective workmanship and that all be corrected by repairing or replacing the improperly performed work. The arbitration award was entirely for costs to repair and replace defectively performed work.⁶

⁵ See Hastings' Appendix, July 8, 2005 Arbitration Award, pp. 9b-32b, August 17, 2005 Arbitration Award, pp. 33b-37b and Mosher appendix, November 12, 2004 Arbitration Award, pp. 31a-49a.

⁶ See *id.*

ARGUMENT

INTRODUCTION

CGL policies do not provide “all risk” coverage for defective construction or irresponsible contractors. Rather, CGL policies provide coverage for tort liability for physical injury to tangible property or bodily injury sustained by third parties. A CGL policy does not provide coverage for contractual liability to repair or replace an insured’s own work or product as the result of shoddy workmanship by an insured or its subcontractors.

The nature and extent of insurance coverage for defective workmanship in the construction setting has been the subject of extensive debate and litigation for several years. A number of articles and treatises have attempted to outline the conflicting positions. The only clear conclusion is that there is no uniform consensus on these issues. For a complete discussion of the majority and minority opinions see Berry, Stephen *Recent Developments in Insurance Coverage of Construction Defects*, *Tort Trial & Insurance Practice Law Journal*, Summer 2006 (41:4) at 1079.

The majority of jurisdictions conclude that policies do not provide coverage where the damages claimed are limited to the cost of correcting the work itself, even in the context of the broad protections offered by CGL policies.⁷ Michigan courts have followed this approach for twenty years. The minority view, espoused by some policyholders, suggests that an occurrence based CGL policy provides coverage for

⁷ *Kvaerner Metals Div of Kvaerner US, Inc v Commercial Union Ins Co*, 389 Pa 317, 335; 908 A2d 888 (2006); *Lenning v Commercial Union Ins Co*, 260 F3d 574, 583 (CA6, 2001).

defective work, so long as the resulting property damage was 'unintended' or performed by subcontractors.⁸

Like the majority of other jurisdictions to address the issue, Michigan courts also conclude that faulty work which results in damage only to the work itself is not an "occurrence", regardless of the actor responsible for the faulty work. *Radenbaugh v Farm Bureau General Ins Co*, 240 Mich App 134; 610 NW2d 272 (2000). Further, our courts conclude that the repair and replacement of faulty workmanship or defective materials is a risk properly borne by an insured as a normal, predictable and expected consequence of conducting business and it *does not* constitute a fortuitous or accidental loss under a CGL policy. *Id.*; *Hawkeye-Security Ins Co v Vector Construction Co*, 185 Mich App 369, 460 NW2d 329 (1990).

Unlike CGL policies, performance bonds are intended to guarantee the completion and quality of a contractor's work in accordance with contract specifications. *US Fidelity & Guaranty Co v Black*, 412 Mich 99; 313 NW2d 77 (1981). If CGL policies are triggered to remedy defective work, they will effectively be converted into performance bonds.

In the instant action, the Court of Appeals agreed with the view articulated in *Vector*, supra which held that defective work, standing alone, is not the result of an "occurrence". To reverse the Court of Appeals decision in this case will have wide sweeping, adverse consequences for property and casualty insurers doing business in Michigan and, more importantly, will adversely impact policyholders throughout this

⁸ *American Family Mutual Ins Co v American Girl, Inc.*, 268 Wis2d 16; 673 NW2d 65 (Wis 2004).

state. Amerisure urges this Court to uphold the decision of the Court of Appeals in favor of Hastings.

I. A CGL POLICY PROVIDES COVERAGE FOR TORT LIABILITY ARISING FROM AN OCCURRENCE OR ACCIDENT

A. The Function Of A Commercial General Liability Policy

The function of CGL insurance is to provide protection for liability arising out of bodily injury to a third party or for property damage caused by the insured's defective work or product and *not* for the insured's contractual liability for economic loss because a product or completed work fails to meet contractual specifications or warranties. *Weedo v Stone-E-Brick Inc*, 81 NJ 233; 405 A2d 788 (NJ, 1979). "A [CGL] policy is not intended to protect business owners against every risk of operating a business, nor was it ever intended to serve as a guarantee of the quality of an insured's product or work or to perform a similar function of a performance bond." *Columbia Mutual Ins Co v Schauf*, 967 SW2d 74 (Mo Banc, 1998) citing *Weedo*, 405 A2d at 791-792.

The New Hampshire Supreme Court in *McAllister v Peerless Ins Co*, 124 NH 676; 474 A2d 1033 (1984), a case relied upon by the Court of Appeals in *Vector Construction, supra*, came to a similar conclusion. That Court held:

The fortuity implied by reference to accident or exposure is not what is commonly meant by a failure of workmanship... . Despite proper deference, then, to the reasonable expectations of the policyholder,...we are unable to find in the quoted policy language [the definition of an occurrence] a reasonable basis to expect coverage for defective workmanship.⁹ *McAllister v Peerless Ins Co*, 124 NH at 680

⁹ See *Hawkeye-Security Insurance Co v Davis*, 6 SW3d 419 (Mo App, 1999); *Norwalk Ready Mixed Concrete Inc v Travelers Ins Companies*, 246 F3d 1132 (CA 8, 2001) (applying Iowa law); *Travelers Ins Co of Illinois v Elger Inc*, 197 Ill 2d 278; 757 NE2d 281 (Ill, 2001); *Amerisure Inc v Wurster Construction Co Inc*, 818 NE2d 998 (Ind App, 2004); *Viking Construction Management v Liberty Mutual Ins Co*, 358 Ill App 3d 34; 831 NE2d 1 (2005).

The Third Federal District Court of Appeals, in *Intermetal Mexicana SA v Insurance Company of North American*, 866 F2d 71 (CA 3, 1989), succinctly stated the law with regard to the necessity of a fortuitous loss. The Court, applying Pennsylvania law, specifically held that every liability policy contains an unnamed exclusion – that the loss must be fortuitous. The fortuity principle arises from the term accident which defines an “occurrence.” An accident provides the starting point for all CGL coverage.

The arbitrators in the underlying action determined that the home of David and Lisa Feinbloom was damaged. It is undisputed that the entire Feinbloom home was the work product of Mosher, the insured under the Hastings CGL policy. Mosher was contractually obligated to construct the Feinbloom home in a workmanlike matter. When the Feinblooms sought to recover the benefit of their construction bargain, Mosher likewise sought to recover economic damages under the Hastings policy for its failure to construct the home in accordance with the contract.

As determined by the Court of Appeals below, no fortuitous loss was alleged and accordingly, the Hastings policy was not triggered. This holding is not only consistent with Michigan law and the law in the majority of jurisdictions to have addressed the issue, but also with the function and intent of CGL coverage. The findings of the Court of Appeals should be upheld.

B. A Defect In The Policyholder’s Own Work Is Not An “Occurrence”

Previously this Court established that an insured indisputably bears the burden of establishing that a loss falls within the provisions of an insuring agreement before any exclusionary provisions are even relevant. *Heniser v Franklin Mutual Ins Co*, 449 Mich 155; 534 NW2d 502 (1995).

The Hastings insuring agreement provides in relevant part:

This insurance applies to “bodily injury” and “property damage” only if:

- (1) The “bodily injury” or “property damage” is caused by an “occurrence” that takes place in the “coverage territory”; and
- (2) The “bodily injury” or “property damage” occurs during the policy period.

“Occurrence” is defined in the policy as:

An accident, including continuous or repeated exposure to substantially the same general harmful conditions.

“Property damage” is defined in relevant part as:

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

The Court of Appeals correctly placed the burden on Mosher to initially demonstrate that the Feinbloom claim constituted an “occurrence” resulting in “bodily injury” or “property damage”.¹⁰ The Court of Appeals correctly determined that Mosher failed to satisfy even this initial burden and did not demonstrate an “occurrence” or resulting “property damage”.¹¹

¹⁰ Clearly no “bodily injury” was alleged by the Feinblooms.

¹¹ The Courts of several jurisdictions have also concluded that damage to the insured’s own work product as a result of faulty construction techniques do not constitute “property damage” within the meaning of a CGL policy. See *Production Systems Inc v Amerisure Ins Co*, 167 NC App 601; 605 SE2d 663 (2004); *Century Indemnity Co v Golden Hills Builders Inc*, 561 SE2d 355 (SC, 2002); *Rockwood Ins Co v Federated Capital Corp*, 694 F Supp 722 (D. Nev, 1988).

The Feinblooms claimed that Mosher failed to deliver the quality home they bargained for. No accident was alleged. This warranty claim seeks contractual damages which are not compensable under a liability policy triggered by an “occurrence” or accident. There was no intervening act of negligence that damaged the Feinbloom home. Rather, the Feinbloom home was allegedly improperly constructed. Mosher argued that since it did not intend the damage to the Feinbloom home, the damage was accidental and thus ‘covered’. Under Mosher’s scenario any work negligently performed would be repaired or replaced by liability insurance and the necessity of an intervening accident or “occurrence” could be avoided completely. CGL insurance simply does not respond to such claims.

Michigan Courts have consistently held that an insured’s poor workmanship, regardless of the actor responsible for the work, is not an “occurrence” under a CGL policy.¹² As noted above, an “occurrence” is defined in the CGL policy as an ‘accident’. Because the term ‘accident’ is not defined in the policy, the Michigan Courts define the term according to common usage. *Cavalier Manufacturing Co v Employers Ins of Wausau, (On Remand)*, 222 Mich App 89; 564 NW2d 68 (1997). This Court has held that the term ‘accident’ as it is commonly used is an “undesigned contingency, a casualty, a happening by chance, something out of the usual course of things, unusual, fortuitous, not anticipated and not naturally to be expected.” *Frankenmuth Mutual Ins Co v Masters*, 460 Mich 105; 595 NW2d 832 (1999).

¹² See *Vector, supra; Auto Owners Ins Co v Long’s Tri-County Mobile Home, Inc*, unpublished opinion per curiam of the Court of Appeals, entered June 28, 2005 (Docket No. 252580); 2005 WL 1522169; *Groom v Home Owners Ins Co*, unpublished opinion per curiam of the Court of Appeals issued April 19, 2007; 2007 WL 1166050.

The Michigan Court of Appeals in *Hawkeye-Security Ins Co v Vector, supra*, concluded that poor workmanship, regardless of whether the actor was a contractor or a subcontractor, is not an accident or “occurrence” within the meaning of a CGL policy. In that case, Vector was retained to install concrete at a waste water treatment plant. The concrete provided by Vector’s subcontractor failed to meet contractual specifications and Vector was required to remove and re-pour 13,000 yards of concrete. Vector sought recovery of the costs incurred for its breach of contract from its CGL insurance carrier. The Court in *Vector* specifically held that poor workmanship without physical injury to tangible property other than the work itself is not an “occurrence” within the meaning of the policy. Thus, the insurer had no duty to indemnify Vector for the costs of repairing and replacing the subcontractor’s work.

Subsequent unreported decisions of the Michigan Court of Appeals, including the Court of Appeals panel in the instant case, have concluded that an insured’s defective workmanship, regardless of who is responsible for the defect, is not accidental and does not trigger coverage under a CGL policy.¹³

In *Z & R Electric Service Inc v Cincinnati Ins Co*, unpublished opinion per curiam of the Court of Appeals, issued June 5, 2001; 2001 WL 619973, the insured maintained, as Mosher does here, that as long as the shoddy workmanship was unintended by the insured, it constituted an “occurrence”. Z & R further claimed that pursuant to the exception found in the policy’s “your work” exclusion, shoddy workmanship performed by a subcontractor, was covered under the policy.

¹³ *Auto Owners Ins Co v Long’s Tri-County Mobile Home, Inc, supra*; *Groom v Home Owners Ins Co, supra*.

In *Z & R*, *supra*, the insured was retained to install a condenser system for a third party. Part of the system involved the installation of a motor to drive the system. The insured completed the work after the subcontractor installed the motor, however, the motor malfunctioned causing the system to fail. There was no physical injury to anything other than the motor itself, however, extensive repairs were required over a period of several months. The insured tendered the claim to its general liability carrier. The carrier refused to defend or indemnify on the basis that there had been no “occurrence” within the meaning of the policy. The Court rejected the insured’s claim that the damages were accidental in nature. While the Court recognized that *Z & R* did not expect or intend the motor to malfunction, it nevertheless concluded that there was no “occurrence” within the meaning of the policy. Relying upon the *Vector* decision, the Court stated:

The insured in *Vector*¹⁴ was no more responsible for making the defective concrete than *Z & R* was responsible here for the defective design and manufacture of the motor. In each case, a third party caused the problem in the materials the insured used, which ultimately failed. However, critically, unlike the damage to other individuals’ property at issue in *Bundy*¹⁵, *Calvert*¹⁶, and *Radenbaugh*¹⁷, the record here does not include evidence that the motor’s failure damaged any other part or aspect of the Mead facility. The malfunction merely made the system inoperative in the same way that the defective concrete made the water treatment plant in *Vector*¹⁸ unusable, with the defects in both cases requiring massive repair and replacement efforts.

Though the Trial Court erroneously concluded that there had been an “occurrence” under the policy, summary disposition under MCR

¹⁴ *Vector, supra*

¹⁵ *Bundy Tubing Co v Royal Indem Co*, 298 F2d 151 (CA 6 1962).

¹⁶ *Calvert Ins Co v Herbert Roofing & Insulation Co*, 807 FSupp 435 (ED Mich, 1992); *Radenbaugh v Farm Bureau General Ins Co of Michigan*, 240 Mich App 134, 148; 610 NW2d 272 (2000)

¹⁸ *Vector, supra*

2.116(C)(10) was proper because there was no dispute in the record that the damages at issue were confined to the condenser system Z & R designed and installed, of which the motor was an integral part. The magnitude of the repairs in this case make the impulse to seek insurance coverage understandable. Nevertheless, to paraphrase *Calvert*¹⁹, this insurance protects Z & R from bearing a cost of liability for tortious damage it causes to others or their property, not the costs it might sustain in remedying a breach of its contract to construct an operational condenser system for Mead. *Z & R, supra* at 4.

Similarly, in *Auto Owners Ins Co v Long's Tri-County Mobile Home Inc.*, unpublished opinion per curiam of the Court of Appeals, entered June 28, 2005 (Docket No. 252580); 2005 WL 1522169, the insured was retained to construct and install a manufactured home for a third party. The insured retained a subcontractor to backfill the area where the home was to be placed. The subcontractor improperly performed the work. As the result of the improper backfill the basement walls constructed by the insured cracked. The ensuing dispute was arbitrated. The arbitrator concluded that as the general contractor, the insured was responsible for the installation of the manufactured home in its entirety. The insured tendered the claim to its CGL Carrier, Auto Owners. Auto Owners maintained that there was no "occurrence" because the only damage sustained involved the work product that the insured was retained to construct. The Court of Appeals agreed with the carrier and stated:

Thus, the rule is clear: where an insured cannot show damage to anything more than his defective product, there is no occurrence under the terms of the policy. Here the damaged portions of the Scotts' property – the manufactured home – that needed to be repaired, replaced or restored as a result of defective workmanship by defendant's subcontractor was limited to the defendant's own product (the basement and manufactured home). The record is devoid of any evidence that there was any damage to anything other than the product manufactured, sold and installed by the defendant. The Trial Court correctly granted plaintiff's motion for summary disposition based upon its reading that defendant's claim was not an

¹⁹ *Calvert, supra*

occurrence under the terms of that policy. *Long's Tri County Mobile Home Park, supra* at 3.

The Court of Appeals in the instant case came to the identical conclusion. CGL coverage is founded on the fundamental tenet of fortuity. It does not afford coverage for contractual liability for an insured's economic loss arising out of construction deficiencies or product failure without resulting tort liability. Whereas accidents are uncontrolled and unanticipated events by their very nature, the failure to properly construct a home or building is well within the control of the insured general contractor. These fundamental concepts have been applied by the Michigan Courts for almost twenty years and have aligned Michigan with the majority position on these issues.²⁰

A general contractor is typically responsible for an entire project and is contractually obligated to insure that the entire project is completed in a workmanlike manner in accordance with contractual specifications. A general contractor may have recourse against a subcontractor but cannot pass its resulting economic losses onto its CGL insurer. A subcontractor's failure to construct its portion of a project in a workmanlike manner in accordance with the contractual specifications cannot convert an otherwise non-fortuitous loss into an "occurrence" so as to fall within the insuring provisions of a CGL policy.

²⁰ *Lerner Corp v Assurance Co of America*, 120 Md App 525; 707 A2d 906 (1998); *State Farm Fire & Casualty Co v Tillerson*, 334 Ill App 3d 404; 777 NE2d 986 (2002); *McDonald Construction Co Inc v Bituminous Cas Corp*, 279 Ga App 757; 632 SE2d 420 (2006); *Nabholz Construction Corp v St Paul Fire & Marine Ins Co*, 354 F Supp 2d 917 (ED Ark, 2005); *Kvaerner Metals Division of Kvaerner US Inc v Commercial Union Ins Co*, *supra*; *Adair Group Inc v St Paul Fire & Marine Ins Co*, 477 F3d 1186 (CA10, 2007).

II. CGL COVERAGE FOR CONSTRUCTION DEFECT CLAIMS WILL CONVERT CGL COVERAGE INTO A PERFORMANCE BOND

CGL policies do not insure the contractual liability of a general contractor for economic loss caused when its completed work fails to meet the contractual specifications bargained for. When constructing a new building or home, a project owner routinely seeks assurance that a contractor will fully perform in accordance with the construction contract. The financial resource to insure performance, however, comes from a performance bond rather than a CGL policy. This Court has recognized that the purpose of a performance bond is to guarantee completion of a project in accordance with the contractual specifications upon default by the contractor. *US Fidelity & Guaranty Co v Black*, supra.

A performance bond responds only if the contractor cannot or will not honor its contractual obligations.²¹ Unlike a CGL insurer, the issuer of a performance bond enters into the contractual obligation with its principal with the knowledge that it has a variety of legal rights if it is ever called upon to pay under the bond. The bond is underwritten based upon the financial ability of a contractor to repay the issuer in the event of a default. Bond principals and their accountants recognize this economic reality as well.²²

The primary protections for the issuers of performance bonds in extending such economic protection to the principal include a priority right to any contractor funds and

²¹ Bruner & O'Connor, *Construction Law* (Thomson/West, § 12:2, 2007).

²² Dufek, *Performance Bonding in the Constructing Industry* (The CPA Journal Online, Oct 1992).

the right to be reimbursed by the principal. The issuers of performance bonds are sureties entitled to recover any amounts paid under the bond from the principal. See generally, 23 Mich Civ Jur Suretyship §71 (August 2007); *Sentry Ins Co v Lardner Elevator Co*, 153 Mich App 317, 395 NW2d 31 (1986). These protections preclude the issuer of a performance bond from becoming unwitting business partners with irresponsible, unscrupulous or incompetent general contractors. A CGL carrier has none of these protections.

Performance bonds do not transfer risk. Instead they leave the financial risk of defective workmanship with the general contractor who has ultimate control over the quality of that workmanship. 1 Couch, Insurance, 3d (rev ed) §1:18 pp.1-2. A liability policy transfers the financial risk of a fortuitous loss from the insured to the carrier in exchange for a reasonable premium. 7 Couch, Insurance, 3d (rev ed) §101:1, pp. 1-2.

The fundamental distinction between a liability policy and a surety relationship was clearly explained by the Seventh Circuit Court of Appeals in *American Inter-Fidelity Exchange v American Re-Insurance Co*, 17 F3d 1018 (CA7, 1994). *American Re, supra* questioned whether a federally mandated endorsement on a trucker's policy whereby the insurer retained a right to reimbursement actually transferred risk so as to be considered "insurance" or a surety mechanism. The Court noted that "the difference between suretyship and insurance lies in the identity of the person ultimately responsible for the loss. An insurer pays the claimant without the right of recourse against its client; a surety pays the claimant but is contractually entitled to reimbursement from its client." 17 F3d at 1022.

A surety's liability and a CGL insurer's liability are not coextensive. In this case, a reversal of the Court of Appeals would create coextensive liability for these vehicles which differ significantly in the protections they afford in the construction industry context. To afford coverage for construction defects under a CGL policy, as proposed by Mosher, would place the onus of payment on the CGL insurer rather than on irresponsible contractor that has control over how the work is actually performed.

CGL policies and performance bonds serve distinct, yet essential functions in the construction industry. CGL carriers do not construct homes, nor do they receive a premium to guarantee the completion and quality of work performed by their insureds. Moreover, CGL carriers have no avenue to recover any funds paid on behalf of their insured to repair defective work. Therefore, this Court should refuse to create performance bond coverage under the guise of a CGL policy. The "occurrence" language and definition in the CGL policy undoubtedly compels this conclusion.

III A REVERSAL OF THE LOWER COURT'S DECISION WILL RESULT IN A HOST OF HARMFUL ECONOMIC, REGULATORY AND SOCIAL CONSEQUENCES

A. A Reversal Of The Lower Court Decision Will Have Adverse Economic And Regulatory Effects.

The reversal of almost twenty years of Michigan precedent with regard to coverage for construction defects under a CGL policy will not reverse the law of economics. The effects of extending CGL coverage beyond its intended use will be widespread. If CGL carriers are called upon to pay for losses for which they collected no premium and did not anticipate, two things will undoubtedly occur. Fewer carriers will be willing to offer CGL coverage to general contractors and for those that do, coverage terms will be restricted. Additionally, reinsurance for carriers providing such

coverage will become more expensive and accordingly premiums charged by insurers will increase dramatically. Distortions of the CGL policy so as to unnaturally create performance bond coverage will result in a number of insureds being unable to obtain coverage in the normal insurance market.

The Michigan Insurance Commissioner has jurisdiction over rates and forms for all admitted carriers writing CGL coverage in the State of Michigan. MCL §500.200 *et seq.* The excess and surplus lines market, however, is not regulated by the Michigan Insurance Commissioner. See MCL § 500.1901 *et seq.* The likely unwillingness of authorized insurers to offer CGL coverage to contractors will undoubtedly result in growth in this area in the excess and surplus lines market. Thus, Michigan insureds will operate at the mercy of surplus lines insurers over whom the Michigan Insurance Commissioner has little or no authority. The increased cost and narrowing of terms regarding available CGL coverage for general contractors will increase the cost of doing business in Michigan, a state that can ill afford any further impediments to potential economic growth.

B. A Reversal Of The Lower Court Decision Will Have Adverse Social And Business Consequences

To allow a general contractor to circumvent the function and intent of CGL coverage as Mosher proposes will in effect rewrite the CGL policy. Irresponsible contractors will benefit from a safe harbor under which CGL carriers will be called upon to guarantee the completion and quality of the contractor's work without any recourse against the defaulting contractor. A deluge of filings by contractors seeking insurance coverage for defective work will undoubtedly follow causing an accompanying increase in CGL premiums for all insured contractors in the State of Michigan. Moreover, an

increase in premiums will likely lead to a reduction in the number of insurers willing to risk capital in a state where its CGL policies will be transformed into performance bonds for contractors who never paid premium for such protection.

In addition to placing the burden of shoddy workmanship on the CGL insurer, an insured contractor who failed to meet its contractual obligations would then be rewarded for the defective work by receiving duplicative payments. A general contractor who initially receives payment for its work from the customer would then receive subsequent payment from its CGL carrier to repair or correct deficiencies in its own work. A number of Courts to specifically address the inequities of this result conclude that a CGL insurer should not as a matter of public policy be required to provide performance bond protection.²³

C. *A Reversal Of The Court of Appeals Decision Will Result In An Unacceptable Increase In Moral Hazard*

A hazard is a condition that creates or increases the chance of loss.²⁴ A moral hazard is a character defect such as dishonesty in an individual or organization which increases the frequency or severity of loss.²⁵ A moral hazard refers to the effect of insurance in causing the insured to relax the care he takes to safeguard because the loss will be borne either in whole or in part by an insurance company. *AIM Diamond Co v Hanover Ins Co*, 397 F3d 528 (CA 7, 2005).

The Federal Courts interpreting Michigan law have specifically advised that Courts should not interpret policies to provide insurance coverage where to do so would

²³ See *George A. Fuller Co v United State`s Fidelity & Guaranty Co*, 613 NYS 2d 152 (1994); *Columbia Mutual Ins Co v Schauf*, 967 SW2d 74 (Mo Banc, 1998); *WDC Venture v Hartford Accident and Indemnity Co*, 938 F Supp 671 (D. Haw, 1996).

²⁴ Rejda, *Principles of Risk Management and Insurance* 7 (5th Ed., 1995).

²⁵ *Id.*

create a moral hazard by encouraging insureds to reduce efforts to preclude losses. In *Aetna Cas & Surety Co v Dow Chemical Co*, 28 F Supp 2d 421 (ED Mich, 1998), the court examined whether insurance coverage was available for an insured's pollution activities. The Court focused on whether the insured engaged in culpable conduct. The Court recognized that important public policy issues arise in providing insurance coverage when an insured knew or should have known that its actions would potentially cause loss. The Court noted that "[c]ourts must avoid providing insurance coverage where to do so would create a 'moral hazard' by encouraging policyholders to reduce efforts to mitigate harm." 28 F Supp 2d at 430.

Numerous commentators have recognized that expanding coverage in areas where the policy intent was never to provide such coverage expands the potential for moral hazard problems.²⁶ Moral hazards also increase the cost of providing insurance and have a corresponding effect on the premiums charged to prudent insureds. As a matter of public policy such a shifting of costs must be avoided.

In the instant case, allowing general contractors to shift the risk of retaining disreputable or substandard subcontractors to a CGL carrier presents an unacceptable increase in moral hazard. The unscrupulous general contractor would have little incentive to provide quality work and would likely under bid reputable contractors by retaining less costly unskilled or unqualified subcontractors. Further, if CGL policies must respond to replace or repair defective work, there will be little incentive to invoke

²⁶ See generally, Posner, *Economic Analysis of Law* 108 (4th Ed., 1992); Shavell, *Moral Hazard and Insurance*, 93 QJ Econ 541 (1979); Cohen & Dehejia, *The Effect of Automobile Insurance and Accident Liability Laws on Traffic Fatalities*, 47 Journal of Law & Economics 357 (2004).

proper risk transfer mechanisms with subcontractors. The costs of this increased burden will be born by CGL carriers and ultimately by all reputable insured contractors.

IV THE SUBCONTRACTOR EXCEPTION TO THE WORK EXCLUSION DOES NOT CREATE COVERAGE

In the instant case, Mosher's assertion that the exception to the "Your Work" exclusion either creates coverage or an ambiguity sufficient to allow coverage, must be rejected. Coverage cannot be created by a policy exclusion. Mosher claims that the exception to exclusion "I" in the Hastings policy creates coverage because the defective work at issue was performed by a subcontractor. The exclusion in the CGL policy upon which Mosher relies provides:

This insurance does not apply to:

I. Damage To Your Work

"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard".

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

"Your work" is defined in the CGL policy as:

a. Means:

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

b. Includes:

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

Michigan Courts have held that exclusions to a CGL policy are intended to be read in conjunction with the insuring agreement and independently of every other exclusion. *Vector, supra*. Additionally, coverage can never be granted by exclusions, as exclusions by their terms are coverage limitations, not coverage grants. *Fresard v Michigan Millers Ins Co* 414 Mich 686, 698; 327 NW2d 286 (1982).

This Court has found that the interpretation of an insurance policy ultimately requires a two-step inquiry. First, a determination of coverage according to the general insurance agreement is made. Secondly, a determination regarding the application of an exclusion which negates coverage is undertaken. *Auto Owners Ins Co v Harrington*, 455 Mich 377, 382; 565 NW2d 839 (1997) quoting *Raska v Farm Bureau Mut Ins Co of Michigan*, 412 Mich 355, 361-362; 314 NW2d 440 (1982).

Mosher maintains that poor workmanship performed by its subcontractor constitutes an "occurrence" within the meaning of the CGL policy. In making this argument, Mosher argues that because it did not intend for its work or the work of its subcontractor to fail, that any failure in the work constitutes an "occurrence". As outlined above, however, such analysis is flawed. Mosher attempts to bootstrap its argument by maintaining that the subcontractor exception to the work exclusion actually creates coverage under the CGL policy to repair or replace a subcontractor's poor work. Not only have the Michigan courts rejected this analysis, but the courts of numerous other jurisdictions have done the same.

For example in *Norwalk Ready Mixed Concrete v Travelers Ins Co*, 246 F3d 1132 (CA 8, 2001), the insured was sued for breach of contract and negligence arising out of the construction of a parking lot. Part of the alleged defective work was

performed on the insured's behalf by a subcontractor. The insured maintained that in light of the exception found in the "your work" exclusion, the subcontractor's poor work constituted an "occurrence". In rejecting the insured's argument that the subcontractor's involvement converted non-accidental conduct into an accident, the Eighth Circuit concluded "defective workmanship, regardless of who is responsible for the defect cannot be characterized as an accident." *Id.* at 1137.

Similarly, in *Hawkeye-Security Ins Co v Davis*, 6 SW3d 419 (Mo App, 1999), the Court squarely addressed whether an insured's poor work product, even if performed by a subcontractor, constituted an "occurrence" and whether the subcontractor exception to the work exclusion was ambiguous so as to create insurance coverage. The Court specifically rejected both arguments stating:

An exclusion provision in an insurance policy by definition excludes risk. Stated otherwise an exclusion is a policy provision which declares that certain causes of loss, or certain consequences of an insured event are not covered by the policy.

* * *

However, when an exclusion is not relevant under the facts at hand, an alleged ambiguity therein is also irrelevant. This follows, at least in part because ***an exclusion provision has no function to endow coverage but serves only to limit the obligation of indemnity undertaken by the policy.***

Here Appellants urge us to analyze and find ambiguity in the policy because of exclusion 2(l) [the work exclusion] and as a consequence declare there is coverage for their losses. They apparently would have us do this without first considering whether there is an insured event, i.e. an obligation of indemnity undertaken by the policy for this type problem. The foregoing cases teach that such an analysis would be flawed. ***We have already determined that the evidence before us does not satisfy Appellants' burden of showing an occurrence within the meaning of the policy; consequently, Hawkeye need not invoke the paragraph 2(l)***

exclusion to relieve itself of its insuring agreement...²⁷ *Id.* at 427, emphasis added.

Mosher, like a number of other insureds in various jurisdictions, asserts that the exception is meaningless if its intent was not to grant coverage for the defective work of subcontractors. This is simply not true. The exception undoubtedly carves out a niche of claims which fall outside of the exclusion. For various reasons, insurance carriers often except certain types of claims from an exclusion.

Despite the assertions of a number of creative insured contractors, the subcontractor exception has a practical, understandable application in a modern construction setting. In an age where entire neighborhoods and developments are constructed by a single general contractor with the assistance of numerous subcontractors, the application of the exception is clearly understandable. One such example arises when a general contractor constructs two homes in a subdivision utilizing the services of an electrical subcontractor. Despite being sold to two different individuals, both homes would be considered the general contractor's work. If, due to the electrical subcontractor's faulty wiring of one of the homes, a fire started damaging both homes, the subcontractor exception to the work exclusion would be triggered to provide coverage for the physical injury to the second home. In this example, the general contractor could utilize contractual remedies to pursue the subcontractor for damages to the first home and look to its CGL carrier to respond to liability claims arising out of the damages to the second home. Without the subcontractor exception

²⁷ See *Travelers Indemnity Co of America v Miller Building Corp*, 142 Fed Appx 147 (CA 4, 2005); *Cincinnati Ins Co v Venetian Terrazzo Inc*, 198 F Supp 2d 1074 (ED Mo, 2001); *McDonald Construction Co v Bituminous Cas Co*, 279 Ga App 757; 632 SE2d 420 (2006).

the insured would have no coverage for the damage sustained to either home because both would be considered the general contractor's work.

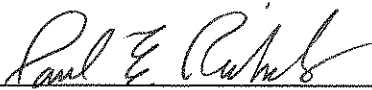
The Court of Appeals properly concluded that the insured's work included the entire Feinbloom home. The fact that subcontractors assisted Mosher in constructing the home should not convert an otherwise uncovered loss into a covered one. Poor workmanship, regardless of the actor, does not fall within the purview of an accident or "occurrence". The subcontractor exception to the work exclusion does not create coverage for an otherwise uninsurable event. The Court of Appeals ruling in this matter should be affirmed.

CONCLUSION

Amerisure respectfully requests that this Court affirm the Court of Appeals decision in *Hastings Mutual Ins Co v Mosher*, and re-affirm nearly twenty years of Michigan precedent by concluding that damage to an insured's work, arising out of its own faulty workmanship or that of its subcontractors, is not an "occurrence" under a CGL policy.

Respectfully submitted,

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