ALERT
JUNE 15, 2010

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THIRD CIRCUIT CONFIRMS THAT PENNSYLVANIA CGL INSURERS HAVE NO DUTY TO DEFEND CLAIMS ARISING FROM CONTRACTOR'S FAULTY WORKMANSHIP AND RESULTING FORESEEABLE DAMAGES

Jacob C. Cohn • 215.665.2147 • *jcohn@cozen.com*
Joseph A. Arnold • 215.665.2795 • *jarnold@cozen.com*
Greg A. Delfiner • 610.832.8368 • *gdelfiner@cozen.com*

On June 8, 2010, the U.S. Court of Appeals for the Third Circuit issued a precedential opinion in *Specialty Surfaces International, Inc. v. Continental Cas. Co.,* No. 09-2773 (3d Cir. 2010), confirming that an insurer has no duty under Pennsylvania law to defend or indemnify a contractor under a CGL policy for claims based on faulty workmanship and resulting foreseeable damages – even where the damage extended beyond the insured's own work product. In so ruling, the court relied heavily on two leading Pennsylvania appellate precedents in the construction defect arena established by members of Cozen O'Connor's Global Insurance Group, *Kvaerner Metals Div. v. Commercial Union Ins. Co.,* 908 A.2d 888 (Pa. 2006), and *Millers Capital Ins. Co. v. Gambone Bros. Dev. Co.,* 941 A.2d 706 (Pa. Super. 2007), as well as its own recent precedent in *Nationwide Mutual Insurance Co. v. CPB International, Inc.,* 562 F.3d 591 (3d Cir. 2009).

Specialty Surfaces International ("Specialty Surfaces") and its wholly owned subsidiary, Empire and Associates, Inc. ("Empire"), do business as Sprinturf, a Pennsylvania-based company that manufactures and sells synthetic turf. Specialty Surfaces is a Pennsylvania corporation, while Empire is incorporated in California. Both companies share a principal place of business in Pennsylvania. The underlying action involved allegations of breach of contract and negligence against Specialty Surfaces and Empire arising out of the installation of Sprinturf and drainage systems on four high school football fields in Shasta, Calif. The school district alleged that defects in materials and workmanship in connection with the synthetic turf systems, as well as failure of the subdrain system under the synthetic turf, resulted in improper drainage and fields with depressions and unstable playing surfaces. The school district further alleged that Spinturf breached the terms of its warranties by failing "to make good the aforementioned defects in materials and workmanship in a timely fashion."

Specialty Surfaces and Empire sought coverage under a CGL policy with Continental Cas. Co. ("Continental"). The policy required Continental to "pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies." It further provided that the insurance applies to "'bodily injury' or 'property damage' only if … [t]he 'bodily injury' or 'property damage' is caused by an 'occurrence'…." In turn, the policy defined an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

Continental initially disclaimed coverage on the ground that the policy did not cover claims based on "poor workmanship and/or product" or any damage based on "improper installation or a defect in the product itself." Subsequent to the disclaimer, the school district amended its complaint and alleged that Empire's negligence resulted in damage to the base below the playing fields and the drainage system. Continental changed its position and agreed to defend Specialty Surfaces and Empire subject to a reservation of rights. However, Continental refused to reimburse the insureds for defense costs incurred prior to the date of the amended complaint.

The insureds subsequently initiated suit in the U.S. District Court for the Eastern District of Pennsylvania seeking a declaration that Continental had a duty to defend and indemnify. The insureds also promptly moved for partial summary judgment on the timing of Continental's defense obligation. Continental cross-moved for summary judgment that it owed no coverage for the claim.

Before determining whether Continental had a duty to defend, the court had to analyze whether Pennsylvania or California substantive law applied. First, the court found that a "true conflict" in fact existed between the law of the two states. Citing *Geddes & Smith, Inc. v. Saint Paul-Mercury Indemnity Co.,* 334 P.2d 881 (Cal.

1959), the court found that coverage potentially existed under California law. By contrast, the court determined that under Pennsylvania law, for the potential for coverage to exist, "there must be a causal nexus between the property damage and an 'occurrence,' *i.e.,* a fortuitous event," and that faulty workmanship (even when cast as a negligence claim), and the natural and foreseeable results of the insured's defective performance, do not constitute such an event (citing *Kvaerner* (claims based upon faulty workmanship do not establish an occurrence), *Gambone* (natural and foreseeable acts, such as rainfall, that exacerbate the damage resulting from faulty workmanship are likewise not "sufficiently fortuitous to constitute an 'occurrence'"), and *CPB International* (consequential damages resulting from faulty workmanship do not constitute an "occurrence"). Based on its analysis, the court found that an actual conflict existed between California and Pennsylvania law. Applying Pennsylvania's choice of law rules, which themselves are guided by the *Restatement (Second) of Conflicts of Laws,* the court determined that Pennsylvania had a far greater interest in the coverage dispute, and therefore Pennsylvania law applied.

Having presaged the outcome of its coverage analysis in its choice of law analysis, the Third Circuit made short work of the insureds' argument that a duty to defend was triggered by allegations in the school district's amended complaint that Empire's faulty work resulted in "damage to the subgrade" – an element of the construction project that was performed by a different subcontractor. "This argument," the court wrote, "is foreclosed by the Superior Court's decision in *Gambone,* in which the Court rejected a similar argument made by the insured." The court explained its reasoning as follows:

> Here, Shasta alleged that Empire installed the subdrain system, the impermeable liner, and the synthetic turf. In addition to defects in Empire's work product, Shasta alleged that "as a direct result" of the problems with the subdrain system, "water has leaked from the subdrain system into the subgrade, dirt has washed from the subgrade into the subdrain system, the subgrade has settled and subgrade soil stablilizer has remulsified. Consequently, the fields have developed depressions and unstable playing surfaces . . . ." Thus, the amended complaint alleges that the damage to the subgrade was caused by water leaks that resulted from the faulty workmanship. But water damage to the subgrade is an entirely foreseeable, if not predictable, result of the failure to supply a "suitable" impermeable liner or properly install the drainage system. Thus, as in *Gambone,* this damage is not "sufficiently fortuitous to constitute an 'occurrence' or 'accident.'" 941 A.2d at 713.
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> Sprinturf insists that *Gambone* is distinguishable from our case because the plaintiffs there did not allege damage beyond the structure of the house, which was the work product of the insured. This argument, however, ignores that the *Gambone* Court, following *Kvaerner,* clearly focused on whether the alleged damage was caused by an accident or unexpected event, or was a foreseeable result of the faulty workmanship when deciding whether the policy covered the damage. Here, water damage to the subgrade was a foreseeable result of the failure to supply a suitable liner or "to ensure the proper design, manufacture and installation of the synthetic turf and subdrain system." Accordingly, we believe the District Court properly predicted that the Pennsylvania Supreme Court would decide that Continental did not have a duty to defend Sprinturf in the California litigation. It follows that Continental had no duty to indemnify Sprinturf.

Once again, an appellate court has recognized and applied the central teachings of *Kvaerner* and *Gambone* – that under Pennsylvania law, CGL policies do not provide coverage for a contractor's faulty workmanship where the resulting property damage was a natural and foreseeable result of the insured's defective performance of its contractual obligations. Particularly in construction defect litigation, water damage to property caused by improper construction is not an "accident" that constitutes an "occurrence" for purposes of coverage under a CGL policy. As the *Kvaerner* court emphasized, to hold otherwise would inappropriately convert a liability policy into a performance bond. Moreover, the Third Circuit's opinion here confirms that the duty to defend under a CGL policy is not triggered merely because damage to property beyond the scope of the insured's own work is alleged where that damage too was the natural and foreseeable consequence of the insured's faulty work.

Cozen O'Connor is a global leader in representing the insurance industry in all coverage areas. For further analysis of coverage issues involving this case or other commercial general liability coverage issues please contact Jacob C. Cohn (jcohn@cozen.com, 215.665.2147) and Joseph A. Arnold (jarnold@cozen.com, 215.665.2795) of Cozen O'Connor's Philadelphia Office, and Greg A. Delfiner (gdelfiner@cozen.com, 610.832.8368) of the West Conshohocken Office.