



# Coverage Analysis for Defective Workmanship

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**F**irst-party insurance—often referred to in the property insurance context as “fire insurance”—provides coverage for the owner of a property right from risks of loss to that property. Property insurance is frequently written on an “all-risk” basis, which generally means the policy insures against loss caused by any risk to the covered property, unless the risk is specifically excluded in the policy.



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One exclusion that frequently leads to litigation is the faulty workmanship/design exclusion. The faulty workmanship/design exclusion limits the scope of coverage for property damage that is available to insureds. However, it may not preclude recovery of *all* damages flowing from a contractor’s faulty work or architect’s bad design. This article identifies some important considerations confronting counsel for the insurer and the insured when coverage is sought for damages caused by defective workmanship.

## Causation

Every jurisdiction employs a causa-

tion analysis to determine whether loss or damage is the result of a covered or uncovered peril. Sometimes, two or more independent events or perils will occur either concurrently or successively to produce a loss. Coverage disputes may arise where both covered and uncovered perils may have caused the loss.

In circumstances where two or more distinct perils operate to cause a loss, Oregon, like most other United States jurisdictions, generally employs the “efficient proximate cause” rule (also known as the “efficient cause” or “efficient moving cause” rule) to determine whether a loss is covered or excluded. Under Oregon law, the “‘efficient proximate cause’ of a loss is the active and efficient cause that sets in motion a train of events which bring about a result without the intervention of any force, starting and working actively and efficiently from a new and independent source.” *Naumes, Inc. v. Landmark Ins. Co.*, 119 Or App 79, 82, 849 P2d 554 (1993). Therefore, the dispute in first-party cases often revolves around determining the efficient proximate cause of the loss in the given case (a fact-based inquiry). In addition, policyholders and carriers sometimes claim that that parties contracted around the

“efficient proximate cause” rule, as will be discussed below.

## Faulty Workmanship/Design

The faulty workmanship/design exclusion is an area of coverage litigation that highlights the importance of determining the cause of loss. Generally, the faulty workmanship/design exclusion excludes “faulty, inadequate, or defective” design, specifications, workmanship, etc. in their entirety. This is an absolute exclusion of all faulty workmanship *and* consequent losses.

Often, the contested issue in the context of a faulty workmanship exclusion will be whether the damages claimed were caused by faulty workmanship, or instead by some other (not excluded) peril. Courts differ as to whether a faulty workmanship exclusion excludes only “process,”<sup>1</sup> only “results,”<sup>2</sup> or both.<sup>3</sup> In jurisdictions where faulty workmanship means only “results,” an insured may still recover for damages caused by a contractor’s negligent acts during the construction process despite the presence of a “faulty workmanship” exclusion.<sup>4</sup> A policy’s ensuing loss exception may also provide coverage for a covered cause of loss despite the presence of faulty workmanship.

*Continued on next page*



## Insurance Coverage for Defective Workmanship continued from page 6

### Ensuing Loss Provisions

Ensuing loss, also referred to as resulting loss, is an exception to a policy exclusion. Ensuing loss provisions are often interpreted as applying when a loss happens that is not covered under the policy, but covered damage caused by or resulting from the non-covered loss results. The ensuing/resulting loss is covered under the policy, even if the triggering event (or depending on the language, the triggering damage) is not. It requires first that the policy exclusion include an ensuing loss provision. The dispute between policyholders and carriers typically comes down to whether, to be covered, the "ensuing loss" must be the result of a separate, independent peril which is itself covered. This area of first-party coverage is generally one of the most heavily contested, because of the variety of factual circumstances in which these disputes arise and the many ways in which carriers have written these clauses. As an example, consider the following:

We will not pay for "loss" caused by or resulting from ... [f]aulty, inadequate, or defective materials, or workmanship.... **But if loss by any of the Covered Causes of Loss results, we will pay for that resulting loss.**

The Policy Excludes: "Cost of making good faulty or defective workmanship, material, construction or design, **but this exclusion shall not apply to the damage resulting from such faulty or defective workmanship, material, construction or design.**"

The litigation issues concerning "en-



suings loss" clauses tend to focus on the separation between the non-covered incident and the resulting damage. Courts have generally developed two interpretations of "ensuing loss." One interpretation is that "ensuing loss" is something that occurs as a consequence of or follows an initial loss. Under this definition, the loss which follows does not have to be separate or distinct from the initial loss; it just has to follow as a result. This interpretation allows for recovery in a greater variety of situations. The second interpretation of "ensuing loss" requires there to be a separate and independent loss, apart from the initial excluded loss. Policyholders and carriers debate whether Oregon courts follow this second interpretation.

While not an Oregon case, *Acme Galvanizing Co. Inc. v. Fireman's Fund Ins. Co.*, 221 Cal App 3d 170, is an oft-quoted case concerning how courts treat "ensuing loss." In *Acme*, the welded seam of a suspended steel kettle containing several tons of molten zinc failed, the kettle ruptured, and the molten metal escaped. The zinc damaged and destroyed surrounding equipment including furnace burners and a refractory system in the plant. The insured submitted a claim to Fireman's Fund,

and a resulting investigation concluded that the kettle failure was principally due to poor welding techniques to the seams that suspended the kettle. Acme's policy included the following exclusion:

13. Inherent vice, **latent defect**, wear and tear, marring and scratching, gradual deterioration, moths, termites or other insects or vermin, **unless loss by a peril not otherwise excluded ensues and the Company shall be liable only for such ensuing loss.**

The insured argued that even if the kettle rupture was caused by a latent defect, the equipment that was destroyed by the discharge of the molten zinc was an "ensuing loss" and therefore was not excluded from coverage. The *Acme* court disagreed, holding that the "ensuing loss" provision only applied to resulting perils that were separate and independent of the original excluded peril. The court reasoned that the damage to the equipment from the faulty welding and kettle rupture was part of the loss directly caused by the excluded peril, "not a new hazard or phenomenon." The court later stated that if the molten zinc had ignited a fire or caused an explosion which destroyed the plant, the "ensuing loss" clause would likely apply.

At least one Oregon federal trial court has followed *Acme*. In *Wal-Mart Stores, Inc. v. Gulf Ins. Co.*, 2005 WL 1231076 (D Or 2005), Wal-Mart's Hermiston distribution center's floors began curling, causing damage to the wheels of equipment and eventually requiring that the floor be repaired and replaced. Wal-Mart's insurance policy included the following exclusion:

*Continued on next page*



## FEATURES

### Insurance Coverage for Defective Workmanship continued from page 7

This policy does not insure: []

b. against the cost of making good defective design or specifications, faulty material, or faulty workmanship; however, **this exclusion shall not apply to loss or damage resulting from** such defective design or specifications, faulty material or faulty workmanship.

The court held that a majority of the damages claimed under the policy, including the costs associated with repairing and replacing the concrete floors and associated structures, were directly related to the faulty construction and were therefore excluded. The court then went on to note that the damage to Wal-Mart's

forklifts, due to the curling floor, was separate and independent of the defective floor and was thus recoverable under the policy. The Ninth Circuit affirmed, acknowledging that "the great weight of authority" prevents insureds from recovering under an "ensuing loss" clause for faulty or defective construction. *Wal-Mart Stores, Inc. v. Gulf Ins. Co.*, 250 Fed Appx 221 (9th Cir 2007) (unpublished).

#### Conclusion

When faulty workmanship or design is a contributing factor to a loss for which the policyholder seeks first-party insurance coverage, the careful practitioner should first consider the specific policy language contained in the insurance policy at issue. Causation is one issue to

be analyzed. Another important issue is whether the policy contains an "ensuing loss" exception. "Ensuing loss" cases illustrate the challenge courts encounter in determining the cut-off point between the damage done by the excluded peril and the resulting damage that may be covered under the "ensuing loss" clause.

#### Endnotes

- 1 *E.g., Kroll Constr. Co. v. Great Am. Ins. Co.*, 594 F Supp 307, 307-08 (ND Ga 1984).
- 2 *E.g., City of Barre v. N.H. Ins. Co.*, 396 A.2d 121, 122-23 (Vt 1978).
- 3 *City of Oak Harbor v. St. Paul Mercury Ins. Co.*, 139 Wn App 68, 74, 159 P3d 422 (2007).
- 4 *City of Barre*, 396 A2d at 122-23.

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