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The Rights and Obligations of Performance Bond Sureties in Connection with Construction Defect Claims Made by Obligees

By Marc R. Lepelstat, Esq. and Diana Minchella

THE RIGHTS AND OBLIGATIONS OF PERFORMANCE BOND SURETIES IN CONNECTION WITH CONSTRUCTION DEFECT CLAIMS MADE BY OBLIGEES

Marc R. Lepelstat, Esq.
Wolff & Samson PC
140 Broadway, 46th Floor
New York, New York 10005
(212) 973-0572

Diana Minchella
Vice President
Vertex Construction Services, Inc.
45-18 Court Square, Suite 602
Long Island City, NY 11101
(646) 553-3500

I. INTRODUCTION

Claims are commonly made by project owners against performance bond sureties for damages sustained as a result of construction defects. Often, these claims are made many years after the physical work on the project has been completed. These claims may still be timely, as against completing sureties, based on separate warranty obligations which they may incur. A surety which has sustained a loss under its bond may seek to recoup all or a portion of its loss through its right of subrogation.

This article explores the time periods in which sureties may be exposed for construction defect claims under New York and Connecticut law. This article also provides an analysis, under New York and Connecticut law, as to the subrogation rights which are available to performance bond sureties in connection with losses sustained as a result of construction defects. This article further examines whether a performance bond surety may recover all or a portion of its losses from an insurer which issues a commercial general liability insurance policy (a "CGL policy") naming the bond principal as an insured.

A. The Exposure of Performance Bond Sureties for Construction Defects

If the conditions precedent of the performance bond are satisfied, the performance bond typically obligates the surety to remedy construction defects for which its bond principal was responsible. A commonly used bond form, the AIA Document A312 Performance Bond explicitly addresses defaults consisting of construction defects. The A312 Performance Bond provides that "if the Contractor performs the Construction Contract, the Surety and the Contractor shall have no obligation under this Bond, except to participate in conferences as provided in Subparagraph 3.1." That bond includes as a condition precedent, the declaration by the Owner of a Contractor Default. A Contractor Default is defined as the "failure of the Contractor, which has neither been remedied nor waived, to perform or otherwise comply with the terms of the Construction Contract." Once the Owner satisfies the conditions precedent of the bond, the A312 Performance Bond specifically obligates the surety for "the responsibilities of the Contractor for correction of defective work."

The question remains as to the temporal limit of the performance bond surety's obligation to correct any defective work of the bonded contractor or subcontractor. The time to sue the surety under its bond depends on the language of the bond. The A312 Performance Bond provides that the suit "shall be instituted within two years after a Contractor Default or within two years after the Contractor ceased working or within two years after the Surety refuses or fails to perform its obligations under this Bond, whichever occurs first."

Another commonly used bond form, a hybrid between the A312 and AIA-A311 performance bond forms, which has been the subject of court decisions by two federal

appeals courts[1], contains the following limitations period of the time to sue under the bond: "Any suit under this bond must be instituted before the expiration of two (2) years from the date on which final payment under the Contract falls due."[2]

Construing an identical suit limitations provision, an appellate court in the case of *Yeshiva University v. Fidelity and Deposit Company of Maryland*[3] held that a completing surety was not liable for damages occurring as a result of latent defects which were discovered after final payment had been made for work performed under the applicable subcontract. The action against the surety was dismissed based on the failure of the obligee to commence suit within the time permitted in the performance bond, which provided the following: "Any suit under this bond must be instituted before the expiration of two (2) years from the date on which final payment under the Contract falls due."[4]

The court held that the suit under the performance bond was untimely since it was commenced more than two years after final payment was made to the surety for work performed under the subcontract.

The appellate court in *Yeshiva University* reversed the order of the lower court, which had ruled in favor of the obligee and against the surety. The lower court in *Yeshiva University* erroneously found that the existence of a defect meant that the work

[1] *Elm Haven Construction Ltd. Partnership v. Neri Construction LLC*, 376 F.3d 96 (2d Cir. 2004); *Hunt Constr. Grp., Inc. v. Nat'l Wrecking Corp*., 587 F.3d 1119, 1121 (D.C.Cir. 2009).

[2] This limitation is also contained in the AIA-A311 performance bond.

[3] 116 A.D.2d 49, 500 N.Y.S.2d 241 (1st Dept. 1986).

[4] *Id*., 116 A.D.2d at 50, 500 N.Y.S.2d at 243.

had not been completed and that final payment never fell due, notwithstanding the check sent to the surety ostensibly as the final payment due under the subcontract. In its rejection of the lower court's construction of the subcontract and performance bond, the appeals court held the following:

> Such a construction leads to a somewhat startling paradox: not only was a provision in the bond purporting to modify the otherwise applicable statutory period of limitations read out of the bond, but, by postponing accrual until such time as a defect became manifest, the statutory period was rendered inoperative as well, leaving Fidelity liable on the bond, at least theoretically, for all time. If indeed that were the intention of the parties to the bond, their agreement would not be enforceable. [5]

Based on this analysis, the time to commence suit under the performance bond containing the language in the bond which was the subject of the *Yeshiva* decision, should be limited to the two-year suit limitation period contained in that bond. That limitations period accrues on the "date on which final payment" under the bonded subcontract or contract, whichever is applicable, "falls due."

However, contracts commonly provide that final payment does not become due until the Contractor delivers to the Owner all guarantees and warranties which the Contractor is required to provide under the Contract. If the performance bond surety effectuates the completion of the bonded contract pursuant to a takeover agreement, it will likely assume each of the responsibilities which the bonded principal undertook in its

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[5] *Id.* at 51. The court in *Yeshiva University* stated in dictum that the remedy for damages attributable to the latent defects was available against the bonded principal for a period of six years measured from the time final payment fell due under the subcontract. The court based this dictum on the applicable statute of limitations for breach of contract, which is set forth in New York CPLR Section 213(2).

The *Yeshiva University* Court also noted in dictum the difference between latent and patent defects: "As a rule, acceptance of performance under a construction contract is a waiver of the right to recover for defects that were known or discernable with reasonable inspection, i.e. patent, as opposed to latent, defects (*Town of Tonawanda v. Stapell, Mumm & Beals Corp.*, 240 App.Div. 472, 270 N.Y.S. 377, *aff'd*, 265 N.Y. 630, 193 N.E. 419)." *Id.* at 52.

contract, including the delivery of warranties. Once the completing surety executes and delivers warranties to its obligee, it may assume separate contractual obligations under those warranties, with separate contractual limitations periods for each breach of those warranties. Accordingly, even if the two-year suit limitations period expires under the terms of the performance bond, the surety may still have a separate obligation to perform any warranties which it issues, including, but not limited to, those warranties required by the applicable contract and specifications.

For example, if the bonded contract contains a specification which provides for a written warranty signed by the contractor, and endorsed by the materials manufacturer guaranteeing that the contractor's work will remain structurally intact for a period of at least thirty (30) years, the completing surety which delivers that warranty as part of the obligations which it may have assumed under a takeover agreement, may incur a separate thirty year obligation for the scope of work set forth in that warranty.

A cause of action in New York based upon the breach of a contractual warranty for the provision of services is governed by the six-year Statute of Limitations applicable to actions founded upon breach of contract.[6] The Statute of Limitations begins to run at the time of the breach of warranty. *Id.* Thus, this issue may remain open for at least 36 years under the scenario set forth above.[7]

Additionally, under Connecticut law, there exists neither statutory limitations periods nor an enforceable contractual limitations period in an action which is

[6] *See, Marchig v. Christie's, Inc.*, 762 F.Supp.2d 667, 670 (S.D.N.Y. 2011), *aff'd in part , rev'd in part,* 430 Fed.Appx. 22, 2011 WL 2685608 (2d Cir. 2011) *cf.* CPLR 213(2).

[7] In Connecticut, a six-year statute of limitations would also apply to a breach of warranty claim. Gen.Stat. § 52–576(a).

commenced by the state, unless specifically provided for by statute. *See, State v. Lombardo Brothers Mason Contractors, Inc.*, 307 Conn. 412, 54 A.3d 1005 (2012). In that case, the State of Connecticut commenced suit against a construction management firm and others to recover, *inter alia*, damages for the allegedly defective design and construction of the library at the University of Connecticut School of Law. Each of the defendants raised time based defenses, relying on statutes of limitations, statutes of repose[8] and one defendant relying on a contractual limitations period. The court rejected these defenses based on the doctrine of nullum tempus occurit regi ("nullum tempus") (no time runs against the king), a common law rule that exempts the state from the operation of statutes of limitation and statutes of repose and from the consequences of its laches[9] in a manner similar to the closely related doctrine of sovereign immunity. The court further held that to the extent that a contract by the state with one of the defendants purported to waive the state's immunity from the operation of a repose period set forth in General Statutes § 52-584a,[10] the provision was invalid because the chief deputy

[8] "[W]hile statutes of limitation are sometimes called statutes of repose, the former bars [a] right of action unless it is filed within a specified period of time after [an] injury occurs, [whereas] statute[s] of repose [terminate] any right of action after a specific time has elapsed, regardless of whether there has yet been an injury." (Internal quotation marks omitted.) *Baxter v. Sturm, Ruger & Co.*, 230 Conn. 335, 341, 644 A.2d 1297 (1994).

[9] "Laches consists of two elements. First, there must have been a delay that was inexcusable, and, second, that delay must have prejudiced the defendant." *Kurzatkowski v. Kurzatkowski*, 142 Conn. 680, 684–85, 116 A.2d 906 (1955). "Laches is purely an equitable doctrine, is largely governed by the circumstances, and is not to be imputed to one who has brought an action at law within the statutory period." *A. Sangivanni & Sons, v. F.M. Floryan & Co.*, 158 Conn. 467, 474, 262 A.2d 159 (1969).

[10] General Statutes § 52–584a provides in relevant part:

> (a) No action or arbitration, whether in contract, in tort, or otherwise, (1) to recover damages (A) for any deficiency in the design, planning, contract administration, supervision, observation of construction or construction of, or land surveying in connection with, an improvement to real property; (B) for injury to property, real or personal, arising out of any such deficiency; (C) for injury to the person or for wrongful death arising out of any such deficiency, or (2) for contribution or indemnity which is brought as a result of any such claim for damages shall be brought against any architect,

commissioner of public works ("commissioner") who had waived nullum tempus in the state's contract with one of the defendants ("Gilbane") lacked authority to waive the state's immunity.

In rejecting the defendants' contention that the state was bound by the limitations period set forth in the statute of repose, the court reaffirmed a general principle, traceable to English common law, pursuant to which a statutory provision limiting rights is not to be construed as applying to the state unless the statutory language expressly or by necessary implication provides otherwise. The court stated that this general principle applies to statutes restricting the time period within which an action may be brought. The court added that there was no substantive distinction between statutes of limitations and statutes of repose. The court held that since the statutes of limitations and repose raised by the defendants did not contain language which compelled the conclusion that those statutes applied to the state, they were inapplicable to the state's claims against the defendants.[11]

> professional engineer or land surveyor performing or furnishing the design, planning, supervision, observation of construction or construction of, or land surveying in connection with, such improvement more than seven years after substantial completion of such improvement.
>
> (b) Notwithstanding the provisions of subsection (a) of this section, in the case of such an injury to property or the person or such an injury causing wrongful death, which injury occurred during the seventh year after such substantial completion, an action in tort to recover damages for such an injury or wrongful death may be brought within one year after the date on which such injury occurred, irrespective of the date of death, but in no event may such an action be brought more than eight years after the substantial completion of construction of such an improvement....

[11] The defendants contended that the state's claims were barred by the periods of repose contained in General Statutes §§ 52–577 (governing actions founded upon a tort); 52–577a (governing product liability claims); 52–584 (governing actions for injury to person, or to real or personal property, caused by negligence, or by reckless or wanton misconduct) and 52–584a (set forth in footnote 10 above) and the limitation period set forth in General Statutes § 52–576 (governing actions for breach of contract).

Gilbane contended that the state should not be permitted to avoid its contractual obligations, and to conclude otherwise thwarts the ability of the parties to rationally allocate and rely on the risks and costs of their bargain. The court rejected this argument and held the following:

> (I)t is not for this court to decide whether nullum tempus is sound policy generally or whether the interests it serves are more important than those served by the enforcement of contractual repose provisions. That decision rests solely and exclusively in the hands of the legislature, and, to date, the legislature has not seen fit to abrogate the doctrine of nullum tempus. To the extent that the commissioner purported to contractually waive the state's immunity from the repose period of § 52–584a, he lacked the authority to do so, and, consequently, the provision is a nullity.[12]

Based on this holding in *Lombardo Brothers,* a court could find that a limitations period contained within a performance bond constitutes a contractual limitations period, which would be unenforceable against the state, unless specifically waived, under Connecticut law, pursuant to the doctrine of nullum tempus. The decision bears significant repercussions for projects in the State of Connecticut. Nullum tempus, which, absent the applicability of a contrary statute, allows the State to file suit *ad infinitum*, may increase the difficulty in obtaining insurance coverage and bonding and may increase the cost of such coverage.

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[12] In *Suffolk County Water Authority v. H. T.Schneider*, 288 A.D.2d 297, 733 N.Y.S.2d 441 (2d Dept. 2001), a New York appeals court, in dismissing an action brought by the Suffolk County Water Authority as untimely, rejected the Water Authority's argument that the doctrine of nullum tempus precluded the application to that case of any Statute of Limitations. However, the court did not make clear whether its holding was limited to the plaintiff in that case, the Water Authority, or whether the holding was intended to have broader application to actions commenced by the state under New York law.

A practical aspect of statutes of limitations and repose is also overlooked by this decision; the actual people involved in the project may no longer be alive to provide testimony or may no longer recall useful information. As such, this decision bolsters the importance of proper document control and photographic documentation for construction managers and contractors. Project documentation should be retained digitally indefinitely.

Additionally, this decision has significant legal implications. In nullifying the commissioner's waiver of immunity, the decision calls into question the enforceability of common contract provisions and the jurisdiction of executive officers in entering legally-binding contractual repose provisions.

II. THE PERFORMANCE BOND SURETY'S RIGHT OF RECOUPMENT UNDER A CGL POLICY

A. The Surety's Right Of Subrogation

1. New York Law

A performance bond surety which sustains a loss in connection with a claim for construction defects must consider whether it is able to recoup all or a portion of its loss from third parties which may be liable. Under New York law, a surety who answers for the default of his principal pursuant to the terms of a performance bond, either by completing the work required under the principal's contract with the owner-obligee, or by paying compensation to the owner-obligee, is entitled to be subrogated to the rights of the obligee whom he has paid, or on whose behalf he has completed the contract.[13]

Based on this principle, performance bond sureties, as subrogees of project owners have been permitted to assert breach of contract claims against culpable third parties with whom the owners had contractual relationships, including architectural firms[14] and construction managers.[15]

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[13] *See, Menorah Nursing Home, Inc. v. Zukov,* 153 A.D.2d 13, 17, 548 N.Y.S.2d 702, 705 (2d Dept. 1989); *cf. Pearlman v. Reliance Ins. Co.,* 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962); *Scarsdale Nat. Bank & Trust Co. v. United States Fid. & Guar. Co.,* 264 N.Y. 159, 190 N.E. 330 (1934); *Kolb v. National Surety Co.,* 176 N.Y. 233, 68 N.E. 247 (1903); *Lewis v. Palmer,* 28 N.Y. 271 (1863); *State Bank of Albany v. Dan–Bar Contr. Co., Inc.,* 23 Misc.2d 487, 199 N.Y.S.2d 309 (Sup. Ct., Albany Co. 1960); *affd.* 12 A.D.2d 416, 212 N.Y.S.2d 386 (3d Dept. 1961); *affd.* 12 N.Y.2d 804, 235 N.Y.S.2d 835, 187 N.E.2d 19 (1962); *American Surety Co. of N.Y. v. Town of Islip,* 268 A.D. 92, 48 N.Y.S.2d 749 (2d Dept. 1944); 63 N.Y.Jur.2d, Guaranty and Suretyship, §§ 440, 585; Simpson, Suretyship § 47; McClintock, Equity § 123 (2d ed.).

[14] *Am. Man. Mut. Ins. Co. v. Payton Lane Nursing Home Inc.,* No. CV 05-5155, 2007 WL 674691 (E.D.N.Y., Feb. 28, 2007).

[15] *Aetna Cas. & Sur. Co. v. Manshul Constr. Corp.*, 95 CIV 3994, 2001 WL 225043 (S.D.N.Y., Mar. 6, 2001).

However, the right of a surety under these circumstances to be subrogated to the rights of its obligee is not exclusive of all other equitable subrogation rights. The general rule is that, upon answering for the default of its principal, a surety may be subrogated to any claims which the defaulting principal might have against third parties whose wrongful conduct allegedly was a cause of the default.[16]

Accordingly, under New York law, a surety which executed a performance bond on behalf of a general contractor, as principal, which was potentially liable to a project owner as a result of its principal's default, was permitted to seek indemnification from its principal's subcontractors, whose misconduct allegedly caused the default.[17]

2. Connecticut Law

The doctrine of equitable subrogation is recognized under Connecticut law. As noted by a Connecticut appeals court:

> "[t]he right of [equitable] subrogation is not a matter of contract; it does not arise from any contractual relationship between the parties, but takes place as a matter of equity, with or without an agreement to that effect." *Hartford Accident & Indemnity Co. v. Chung,* 37 Conn.Supp. 587, 592, 429 A.2d 158 (1981). "The object of [equitable] subrogation is the prevention of injustice. It is designed to promote and to accomplish justice, and is the mode which equity adopts to compel the ultimate payment of a debt by one who, in justice, equity, and good conscience, should pay it." (Internal quotation marks omitted.) *Cottiero v. Ifkovic,* 35 Conn.App. 682, 686, 647 A.2d 9, cert. denied, 231 Conn. 938, 651 A.2d 262 (1994). As now applied, the doctrine of equitable subrogation "is broad enough to include every instance in which one person, not acting as a mere volunteer or intruder, pays a debt for which another is

[16] *See, Menorah Nursing Home, Inc., supra,* 153 A.D.2d at 17, 548 N.Y.S.2d at 705.

[17] *Id.*

> primarily liable, and which in equity and good conscience should have been discharged by the latter." (Citations omitted.).[18]

Under the doctrine of equitable subrogation, a surety which has paid a loss under a payment or performance bond is entitled to seek reimbursement of the debt "by one who in good conscience ought to pay it."[19]

One Connecticut court recognized that "[u]pon total satisfaction of the underlying obligation, the [surety] is subrogated to all rights of the obligee with respect to the underlying obligation to the extent that performance of the [surety obligation] contributed to the satisfaction."[20]

Further, under Connecticut law, a performance bond surety should be able to subrogate to any claims which the defaulting principal may have against third-parties whose wrongful conduct was a cause of the default. In that instance, subrogation would be predicated on the principle that the surety "pays a debt for which another is primarily

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[18] *Westchester Fire Insurance Company v. Allstate Insurance Company*, 236 Conn. 362, 371, 672 A.2d 939, 944 (1996).

[19] *See, Balboa Insurance Co. v. Bank of Boston Connecticut*, 702 F.Supp.34, 36 (D. Conn. 1988) ("The doctrine of equitable subrogation is fully applicable where, as here, a party seeks reimbursement for a debt paid under the compulsion of a payment and performance bond"), *cf. Hartford Accid. and Indem. Co. v. Chung,* 37 Conn.Supp. 587, 594, 429 A.2d 158, 162 (Appell.Sess. 1981) (Subrogation is an equitable remedy, the purpose of which is to "compel the ultimate discharge of a debt or obligation by one who in good conscience ought to pay it."); *Pearlman v. Reliance Ins. Co.,* 371 U.S. 132, 137, 83 S.Ct. 232, 235, 9 L.Ed.2d 190 (1962); See 4 A. Corbin, Corbin on Contracts § 901 (1951).

[20] *See, Town of Southington v. Commercial Union Insurance Company*, 71 Conn.App. 715, 724, 805 A.2d 76, 83 (2002), *cf.* Restatement (Third), Suretyship and Guaranty § 27(1), p. 113 (1996).

liable, and which in equity and good conscience should have been discharged by the latter."[21]

B. The Surety's Subrogation Rights Against its Principal's CGL Carrier

A meritorious argument exists that a performance bond surety may assert subrogation rights against its principal's CGL insurer to recover losses which it sustains in connection with construction defects. Although there do not appear to exist any reported cases under New York or Connecticut law addressing this issue, there does exist a case under Florida law containing pertinent dicta, which should be instructive.[22]

This section of the article discusses the coverage afforded by the CGL policy and standard exclusions contained within that policy. This section also discusses the performance bond surety's potential right of subrogation against a CGL insurer.

1. CGL Coverage Provisions and Exclusions

CGL policies are designed to protect an insured against certain losses arising out of business operations.[23] The first standard form comprehensive general liability insurance policy was drafted by the insurance industry in 1940.[24] The standard policy was the result of a voluntary effort in the insurance industry to address the

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[21] *Westchester Fire Insurance Company, supra*, 236 Conn. 362, 371, 672 A.2d 939, 944 (1996), *cf. Sehremelis v. Farmers & Merchants Bank,* 6 Cal.App.4th 767, 777, 7 Cal.Rptr.2d 903 (1992).

[22] *See, Auto Insurers Insurance Company v. Travelers Casualty & Surety Company*, 227 F.Supp.2d 1248 (M.D. Fla. 2002).

[23] *See, Travelers Indem. Co. of Am. V. Moore & Assocs., Inc.*, 216 S.W.3d 302, 305 (Tenn. 2007).

[24] *See* 21 Eric Mills Holmes, *Holmes' Appleman on Insurance 2d,* § 129.1, at 7 (2002). In 1986, the "Comprehensive General Liability" policy was renamed the "Commercial General Liability" policy. However, the acronym "CGL" is commonly used to refer to both. *Id.*

misunderstanding, coverage disputes, and litigation that resulted from the unique language used by each liability insurer.[25]

Since 1940, the standard policy has been revised several times.[26] With regard to the insuring agreement, the language was expanded from providing coverage only for damages "caused by an accident" to include coverage for damages caused by an "occurrence," which is defined as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."[27]

Like the insuring language, the exclusions in standard CGL policies have been modified over the years.[28] The exclusions that are of significance to this analysis are the "business risk" exclusions, including the "your work" and "your product" exclusions. The 1973 standard CGL policy contained broad exclusions for damage to "your work" and "your product" stating that the insurance did not apply

> (n) to property damage to the named insured's products arising out of such products or any part of such products;
>
> (o) to property damage to work *performed by or on behalf of the named insured* arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith.[29]

(Emphasis added).

Beginning in 1976, the insured could purchase a Broad Form Property Endorsement.[30] This endorsement replaced exclusion (o), set forth above, and exclusion

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[25] *Id.*

[26] *Id.* at 7–8.

[27] *Compare* 16 *id.* § 117.1, at 215, *with* 20 *id.* § 129.2, at 104.

[28] *See generally* 21 Holmes, *supra,* § 132.1–132.9, at 5–158.

[29] 21 Holmes, *supra,* § 132.1, at 11 (emphasis supplied).

(k), which excluded damage to property owned by or within the control of the insured. As to exclusion (o), the endorsement replaced it with more specific exclusions and also differentiated between property damage that occurred before and after operations were completed. The endorsement provided that the insurance did not apply:

> (d) to that particular part of any property ...
>
> (i) upon which operations are being performed by or on behalf of the insured at the time of the property damage arising out of such operations, or
>
> (ii) out of which any property damage arises, or
>
> (iii) the restoration, repair or replacement of which has been made or is necessary by reason of faulty workmanship thereon by or on behalf of the insured; ...
>
> (3) *with respect to the completed operations hazard* and with respect to any classification stated in the policy or the company's manual as "including completed operations," to property damage to work *performed by the named insured* arising out of such work or any portion thereof, or out of such materials, parts or equipment furnished in connection therewith.[31]

(Emphasis added).

Thus, with regard to completed operations, the endorsement eliminated the exclusion for "work performed on behalf of the named insured."

When the CGL policy was revised again in 1986, it contained new provisions that incorporated and clarified the Broad Form Property Endorsement.[32] New exclusion (j)(6)

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[30] *See Am. Family Mut. Ins. Co. v. Am. Girl, Inc.,* 268 Wis.2d 16, 673 N.W.2d 65, 83 (2004).

[31] 21 Holmes, *supra,* § 132.9, at 149 (emphasis supplied).

[32] *See id.* at 149, 153.

and the exception to this exclusion clearly stated that the exclusion for faulty workmanship did not apply to work within the products-completed operation hazard:

> This insurance does not apply to:
>
> **j. Damage to Property**
>
> "Property damage" to:
>
> ....
>
> (6) That particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.
>
> ....
>
> *Paragraph (6) of this exclusion does not apply to "property damage" included in the "products-completed operations hazard."*[33]

(Emphasis added).

The 1986 policy also added new exclusion (l), the "your work exclusion," with an express exception for subcontractor work as follows:

> This insurance does not apply to:
>
> ....
>
> **l. 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.*[34]

[33] *Id.* at 145, 153 (emphasis supplied).

(Emphasis added).

The reason for this 1986 revision that added the subcontractor exception has been explained as follows:

> [T]he insurance and policyholder communities agreed that the CGL policy should provide coverage for defective construction claims so long as the allegedly defective work had been performed by a subcontractor rather than the policyholder itself. This resulted both because of the demands of the policyholder community (which wanted this sort of coverage) and the view of insurers that the CGL was a more attractive product that could be better sold if it contained this coverage.[35]

Moreover, the Insurance Services Office promulgated a circular on July 15, 1986, confirming that the 1986 revisions to the standard CGL policy not only incorporated the "Broad Form" property endorsement but also specifically "cover[ed] damage caused by faulty workmanship to other parts of work in progress; and damage to, or caused by, a subcontractor's work after the insured's operations are completed."[36] Of course, the subcontractor's exception to the general exclusion for a contractor's defective work becomes important only if there is coverage under the initial insuring provision.

Under New York law, even if the performance bond surety were able to assert a claim under its principal's CGL policy, as its principal's subrogee and/or assignee, the

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[34] *Id.* at 145, 152 (emphasis supplied).

[35] *See* 2 Jeffrey W. Stempel, *Stempel on Insurance Contracts* § 14.13[D] at 14–224.8 (3d ed. Supp. 2007).

[36] Insurance Services Office Circular, Commercial General Liability Program Instructions Pamphlet, No. GL–86–204 (July 15, 1986). The Insurance Services Office, Inc., also known as ISO, is an industry organization that promulgates various standard insurance policies that are utilized by insurers throughout the country. *See, e.g., Hartford Fire Ins. Co. v. California,* 509 U.S. 764, 772, 113 S.Ct. 2891, 125 L.Ed.2d 612 (1993) ("Insurance Services Office, Inc. (ISO), an association of approximately 1,400 domestic property and casualty insurers ..., is the almost exclusive source of support services in this country for CGL insurance. ISO develops standard policy forms and files or lodges them with each State's insurance regulators; most CGL insurance written in the United States is written on these forms.") (citations omitted).

surety would have the burden of demonstrating that the damage for which it seeks coverage was the result of an "occurrence."[37] The damage alleged does not arise out of an "occurrence" when the costs sought pertain to the correction of the defective installation.[38]

"It is well-settled under New York law that 'the issuer of a commercial general liability policy is not a surety for a construction contractor's defective work product.'"[39] A CGL policy does not insure against faulty workmanship in the work product itself but rather faulty workmanship in the work product which creates a legal liability by causing bodily injury or property damage *to something other than the work product.*[40] It has been held that the CGL policy was never intended to provide contractual indemnification for economic loss to a contracting party because the work product contracted for is defectively produced.[41]

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[37] If a surety completes its principal's work under a takeover agreement and executes a completion subcontract, the surety will typically require that the completion subcontractor secure a CGL policy naming the completion subcontractor, the surety and the obligee as insureds. In that case, the surety would have a direct claim against the CGL insurer with respect to any covered losses. For example, on a recent project, a CGL insurer agreed to pay a completing surety on a project in New York the cost to replace drywall ceilings damaged by excessive condensate leaks resulting from a subcontractor's improper installation of air-handling units.

[38] *Adami v. C.J. Rubino & Co., Inc.*, 2009 WL 632712, at *3 (Sup. Ct., N.Y. Co. 2009).

[39] *Amin Realty, LLC v. Travelers Prop. Cas. Co.,* 2006 WL 1720401, at *3 (E.D.N.Y. 2006) (*quoting Bonded Concrete, Inc. v. Transcon. Ins. Co.,* 12 A.D.3d 761, 762, 784 N.Y.S.2d 212 (3d Dep't 2004)*; see also Cont'l Ins. Co. v. Huff Enters., Inc.,* 2010 WL 2836343, at *4 (E.D.N.Y. June 21, 2010); *Transp. Ins. Co. v. AARK Constr. Grp., Ltd.,* 526 F.Supp.2d 350, 356 (E.D.N.Y. 2007).

[40] *Id.*

[41] *George A. Fuller Co. v. United States Fid. & Guar. Co.,* 200 A.D.2d 255, 259, 613 N.Y.S.2d 152 (1st Dep't 1994) (emphasis added); *see also Bonded Concrete, Inc.,* 12 A.D.3d at 762, 784 N.Y.S.2d 212 (finding that "precedent dictates that [CGL] policies like defendant's were never intended to provide indemnification to contractors from claims that their work product was defective").

However, it has been our experience that the CGL carrier may be inclined to settle claims for defective installation despite the "your work" exclusion. For example, if the insured contractor improperly installs window flashing resulting in water infiltration, drywall damage and mold, the CGL carrier will often adjust the claim to include the cost to repair the damaged drywall, remediate the mold *and* repair the window flashing. The resolution of this type of claim may make economic sense to the CGL carrier. It may become evident to the CGL carrier that if the root cause of the property damage is not corrected, such as the improperly installed window flashing, the damage may continue to occur and may eventually becme more expensive to correct.

Under Connecticut law, a court recently held that unintended construction defects may form the basis of an "occurrence" or "accident" under CGL policies.[42] Furthermore, the court found that damage to an insured's nondefective work is "property damage" within the CGL policy's initial grant of coverage.[43] However, the court also stated that claims limited to damages for the replacement of defective components or poor workmanship, without more, do not constitute "property damage" under the policy.[44] Finally, in that case, the court held that the policy in question excluded damage caused by the plaintiff/general contractor's work, but did not exclude damage caused by a subcontractor's defective work.[45]

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[42] *Capstone Building Corporation v. American Motorists Insurance Company*, 308 Conn. 760, 67 A.D.3d 961 (Conn. 2013).

[43] *Id.*

[44] *Id.*

[45] *Id.*

Considering that many general contractors today do not self-perform work, or at least do not self-perform the work most prone to construction defects (e.g. building envelope work), the fact that a subcontractor's defective work is not included in the "your work" exclusion, broadens a general contractor's insurance coverage. This, in turn, broadens coverage for a completing surety that steps into a general contractor's shoes.

2. Subrogation Against the CGL Carrier

In a Florida case,[46] an insurer issued a CGL policy to a contractor, which entered into a contract with a project owner, in connection with a boat manufacturing facility. Part of the contract required the installation of an underground galvanized piping system to convey acetone. A surety issued a performance bond, which named the contractor as principal and the owner as the obligee. After the completion of the contract, it was determined that the pipe system which had been installed by two subcontractors had leaked. The owner commenced suit against the contractor, its subcontractors and the surety for damages related to the leak, including property damage. The surety settled with the owner.

The surety then asserted a claim against the contractor's CGL policy, asserting that it had standing as both subrogee and assignee of the contractor's own rights to coverage under the policy. The court stated in dictum, that if the surety performed or paid on behalf of the contractor an obligation that was covered under the policy, then the surety would stand in the contractor's shoes to that extent, would be equitably subrogated to the rights of the contractor, and would further be considered a first party claimant on

[46] *See, Auto Insurers Insurance Company v. Travelers Casualty & Surety Company*, 227 F.Supp.2d 1248 (M.D. Fla. 2002).

the CGL policy. The court further found that an indemnity agreement which the contractor executed in favor of the surety would also give the surety standing to assert a claim against the CGL carrier. The court noted that the indemnity agreement contained an assignment by the contractor to the surety of the contractor's rights arising out of the bonded contract and gave the surety full power of authority to make claims on behalf of the contractor arising in any manner out of the contract.

However, the court held that there was no coverage for the construction defects under the CGL policy. The court noted that the CGL policy "only protect(s) against personal injury or damages to personal property which might result from defective workmanship. The policy does not afford coverage for the repair of the defective workmanship itself."[47] The court further stated that in order to have coverage under a CGL policy, there must not only be a covered loss, but the loss must also occur within the policy period. Under the CGL policy in question, the bodily injury or property damage for which coverage was sought must have occurred during the policy period in order for there to be coverage; and the "occurrence" need not take place during the policy period. The court held that the "trigger" for coverage was the time that the damage manifested itself or was discovered.

In that case, the property damage that the surety was liable for under the performance bond consisted of the costs to shut down the facility, dig up the leaking pipe,

[47] *Id.*, 227 F.Supp.2d at 1261, *cf. Auto Owners Ins. Co. v. Tripp Constr., Inc.*, 737 So.2d 600, 601 (Fla. 3rd DCA 1999). However, as previously noted, in our experience in construction defect cases (in Colorado and New Jersey specifically), most of which settle, the settlement figures include the cost to repair the defective work itself. For example, the cost to repair the defective exterior insulation and finishing system ("EIFS"), masonry and roof installation (e.g. building envelope work) which result in water damage is typically included in the final settlement figures.

replace it and replace the floor of the facility. The leak in the pipe which gave rise to those damages occurred sometime prior to February 21, 1991, when it was discovered. Since the date of discovery of the leak preceded the policy period, the court found that there was no coverage.

IV. CONCLUSION

Performance bond sureties may face claims for construction defects which are discovered many years after their principal completes its work under a bonded contract or subcontract. Exposure may exist with respect to these claims even after the limitations period contained within the bond has expired. Sureties may be subject to losses after the expiration of the bond period due to separate warranty obligations which they may incur as the completing contractor or subcontractor under a takeover scenario. Further, under Connecticut law, as surety may be liable for construction defects in situations in which the state is an obligee even after any bond limitations period has expired, under the doctrine of nullum tempus.

The surety which sustains losses as a result of construction defects may be able to significantly offset those losses through its rights of subrogation. Performance bond sureties, as subrogees of project owners, may be permitted to assert breach of contract claims against culpable third parties with whom the owners/obligees had contractual relationships, including architectural firms[48] and construction managers.[49] Further, a surety which executes a performance bond on behalf of a general contractor, as principal,

[48] *Am. Man. Mut. Ins. Co. v. Payton Lane Nursing Home Inc.,* No. CV 05-5155, 2007 WL 674691 (E.D.N.Y., Feb. 28, 2007).

[49] *Aetna Cas. & Sur. Co. v. Manshul Constr. Corp.*, 95 CIV 3994, 2001 WL 225043 (S.D.N.Y., Mar. 6, 2001).

may be able to recover indemnification from its principal's subcontractors, whose misconduct allegedly caused the default.[50]

Finally, either as an insured under a CGL policy, or under its right of subrogation, a performance bond surety may be able to assert a claim for covered losses under that policy.

Based on the foregoing, a thorough investigation by the surety as to all parties which may share potential responsibility to pay for any damages sustained as a result of construction defects may significantly reduce the surety's ultimate losses. While there may be no case law or dicta that notes this, in practice, insurers often pay for the cost to correct defective work that would otherwise lead to continued damage covered by their policy if uncorrected. The CGL policy is, therefore, a valuable avenue of recovery for sureties when faced with construction defect claims and requires the early involvement of the CGL carrier. We recommend that the obligated surety attempt to persuade the CGL carrier to address payment for repairs up front, rather than fall into a pay-and-chase scenario.

During the performance bond claim investigation, the surety should identify and collect policy information from its principal and subcontractors. Additionally, in a scenario where the surety is financing or partially-financing the principal, the surety should consider payments towards its principal's CGL policy to ensure continuous coverage.

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[50] *Id.*

Considering the recent uptick in claims against performance bond sureties for damages sustained as a result of construction defects across the spectrum of time periods for which sureties may be exposed, it is important for sureties to ensure that they enable themselves to recoup their losses from parties which may share the responsibility to pay construction defect claims, including the CGL carrier.