PROPERTY INSURANCE POLICIES: THE COVERED CAUSES OF LOSS AND EXCLUDED PERILS

By

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I. Introduction

Property insurance is first party coverage that compensates the policyholder for damage to property. First party property policies are so-called because they are intended to cover direct losses to the policyholder and not to third-parties. [1] Damages to third parties are handled by third party liability insurance.

The purpose of property insurance is to provide financial protection against fortuitous loss. The main features of property insurance policies are the covered causes of loss and the excluded perils. This is so for commercial property policies, including builders risk, as well as homeowners policies. These main features are the subject of this chapter.

II. Covered Causes of Loss

Often the cause of the loss is the factor that decides whether or not there is coverage. Property insurance policies are subject to the general rules of construction for insurance contracts. It is the intention of the parties that governs, which is gathered from the language employed in the policy in connection with the character of the insurance, its object and purpose, and the surrounding facts and circumstances. [2] However, when the language in the policy is ambiguous and reasonably susceptible to more than one interpretation, the policy is will be construed in favor of the insured. [3]

A. Fire Policy

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[1] *See* Tower Automotive, Inc. v. American Protection Ins. Co., 266 F.Supp.2d 664 (W.D.Mich. 2003).
[2] *See* 10A Couch on Insurance § 148:6 (3d ed. 2006).
[3] *See* Wachovia Bank & Trust Co. v. Westchester Fire Ins. Co., 276 N.C. 348, 354, 172 S.E.2d 518, 522 (1970).

The standard fire policy insures only against the hazards of fire and lightning. Most states have adopted the standard policy by statute. Determining coverage for a fire or lightning loss sometimes involves statutory construction. The coverage is written into property policies which insure far more than just fire and lightning.

B. All-Risk Policy

An all-risk property policy provides coverage for losses from all fortuitous hazards unless they are excluded expressly by the policy. The typical all-risk policy will describe this coverage as "all risks of direct physical loss or damage to Covered Property described herein except as hereafter excluded." All-risk insurance is not as prevalent as it once was. Many insurers have withdrawn the coverage from the market in response to courts construing the insuring language broadly. But many homeowners policies, and coverages for large construction projects, continue to be written on all-risk paper. So, litigation battles will continue to be fought over all-risk language..

As suggested above, all-risk insurance is a type of coverage that provides indemnification for "fortuitous and extraneous" events. [4] A fortuitous event is one "happening by chance or accident," [5] or "occurring unexpectedly or without known cause." [6] Insurance is not available for losses that the policyholder knows of, plans, intends, or is aware are substantially certain to occur. [7] This is the "fortuity doctrine," which protects insurers from having to pay for losses arising from undisclosed events that existed prior to coverage, as well as events caused by the manifestation during the policy period of inherent defects in the insured property that existed prior to coverage. [8] This sometimes is called the "unwritten exclusion." Losses that are not fortuitous are not

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[4] Andrew C. Hecker and M. Jane Goode, Wear and Tear, Inherent Vice, Deterioration, etc.: The Multi-Faceted All-Risk Exclusions, 21 Tort & Ins. L.J. 634, 634 (1986); *see also* Meridian Leasing, Inc. v. Associated Aviation Underwriters, Inc., 409 F.3d 342, 350 (6th Cir. 2005); Int'l Multifoods Corp. v. Commercial Union Ins. Co., 309 F.3d 76, 83 (2d Cir. 2002); Avis v. Hartford Fire Ins. Co., 283 N.C. 142, 146, 195 S.E.2d 545, 547 (1973); John S. Clark Company, Inc. v. United National Ins. Co., 304 F.Supp.2d 758 (M.D.N.C. 2004).

[5] 80 Broad Street Co. v. United States Fire Ins. Co., 88 Misc.2d 706, 389 N.Y.S.2d 214, 215 (1975); *see also* 525 Fulton St. Holding Corp. v. Mission Nat'l Ins. Co. 256 A.D.2d 243, 682 N.Y.S.2d 166, 166 (1st Dep't 1998).

[6] Black's Law Dictionary 664 (7th ed. 1999); Restatement of Contracts § 291, Comment A (1932).

[7] *See* Nat'l Union Fire Ins. Co. of Pittsburgh v. Stroh Companies, Inc., 265 F.3d 97, 106 (2d Cir. 2001); *see also* 40 Gardenville, LLC v. Travelers Property Casualty of America, 387 F. Supp.2d 205, 211 (W.D.N.Y. 2005); Mattis v. State Farm Fire & Casualty Co., 118 Ill.App.3d 612, 621, 73 Ill.Dec. 907, 454 N.E.2d 1156 (1983).

[8] *See 80 Broad Street Co.,* 389 N.Y.S.2d at 215 (*citing* Greene v. Cheetham, 293 F.2d 933, 936-37 (2d Cir.1961)).

covered because the risk feature inherent in insurance is lacking. [9] The requirement of fortuity assures that an insurance company will not pay for certain and inevitable losses.[10]

"Direct physical loss" under the policy exists when there is physical injury to the property, but can exist also without actual injury, destruction or structural damage to the property. It may suffice that the insured property is injured in some way, such as the presence of asbestos fibers or odors from a methamphetamine laboratory, [11] but this does not mean coverage exists for intangible and economic losses. [12]

In *Trinity Indus., Inc. v. Ins. Co. of N. Am.*, the Fifth Circuit noted that the language "physical loss or damage" "strongly implies that there was an initial satisfactory state that was changed by some external event into an unsatisfactory state – for example, the car was undamaged before a collision dented the bumper." [13] Accordingly, courts have found that "physical loss or damage" is not ordinarily thought to encompass faulty initial construction. [14] "When an insured has made claims for the collapse of the insured subject matter because of faulty design, district courts have awarded as damages the cost to rebuild the structure in its defective state [but] have not awarded as damages the cost to redesign or rebuild the structure so as to eliminate the defect." [15] "Physical loss or damage" also does not exist for the mere presence of intact asbestos- and lead-containing materials in an insured building. But it does exist for the contamination condition caused by asbestos and lead in a building. [16] According to a Massachusetts court in *Pirie v. Federal Ins. Co.,* an internal defect in a building such as lead paint does not rise to the level of a physical loss. [17]

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[9] *See* Kilroy Indus v. United Pacific Ins. Co., 608 F.Supp. 847, 857 (C.D.Cal. 1985).
[10] *See Hecker & Goode*, *supra*, at 635; *see also* Johnson Press of America, Inc. v. Northern Ins. Co. of New York, 339 Ill.App.3d 864, 791 N.E.2d 1291 (2003).
[11] *See* Sentinel Mgmt. Co. v. New Hampshire Ins. Co., 563 N.W.2d 296, 300 (Minn.App. 1997); *see also* Farmers Ins. Co. of Oregon v. Trutanich, 123 Or.App. 6, 9-11, 858 P.2d 1332, 1334-35 (1993); General Mills, Inc. v. Gold Medal Ins. Co., 622 N.W.2d 147, 151-52, (Minn.App. 2001).
[12] *See* Best Friends Pet Care, Inc. v. Design Learned, Inc., 77 Conn.App. 167, 181-83, 823 A.2d 329, 338-39 (2003).
[13] 916 F.2d 267, 270-71 (5th Cir. 1990), *rehearing denied,* 923 F.2d 851 (5th Cir. 1991).
[14] *See id.*; *accord* City of Burlington v. Indem. Ins. Co. of N. Am., 332 F.3d 38, 45 (2d Cir. 2003); Whitaker v. Nationwide Mut. Fire Ins. Co.,115F.Supp.2d 612, 617 (E.D.Va. 1999); Bethesda Place Ltd. P'ship v. Reliance Ins. Co., 1992 WL 97342 (D.Md.1992); Wolstein v. Yorkshire Ins. Co. Ltd., 97 Wash.App. 201, 211-13, 985 P.2d 400, 407-08 (1999); North Am. Shipbuilding Inc. v. S. Marine & Aviation Underwriting , Inc., 930 S.W.2d 829, 835 (Tex.App. 1996).
[15] *Trinity Indus.*, 916 F.2d at 271.
[16] *See e.g.,* Yale University v. Cigna Ins. Co., 224 F.Supp.2d 402, 413 (D.Conn. 2002); BellSouth Telecommunications, Inc. v. W.R. Grace & Co., 77 F.3d 603 (2d Cir. 1996); Port Authority of New York & New Jersey v. Affiliated FM Ins. Co., 311 F.3d 226 (3d Cir. 2002).
[17] 45 Mass.App. 907, 908, 696 N.E.2d 553 (1998).

The term "all-risk" does not stand for the proposition that an "all-risk" policy permits an insured to recover for *all* losses or damages resulting from the accident. [18] All-risk policies contain express written exclusions that greatly limit the coverage. [19] Exclusionary clauses are strictly construed against the insurer. [20] The burden is on the policyholder to demonstrate that the loss falls within the terms of the policy, and thereafter the burden is on the insurer to prove the applicability of any exclusions. [21]

C. Named Peril Policy

Unlike all-risk policies, named peril policies provide coverage only for causes of loss specifically enumerated therein. Unnamed hazards are not covered. Under the typical insuring language, the "insurer will pay for direct physical loss of or damage to Covered Property at the premises described in the Declarations caused by or resulting from any Covered Cause of Loss," [22] or the policy insures against "risks of direct physical loss or damage unless the loss or damage is excluded or limited as described." [23]

The enumerated perils insured against include, among others, fire, lightning, windstorm, hail, explosion, riot, riot attending a strike, civil commotion, aircraft, vehicles, smoke, leakage from fire protection systems, vandalism and malicious mischief, except as excluded elsewhere in the policy. [24] Another policy form contains the enumerated peril of "water damage, meaning accidental discharge or leakage of water or steam as the direct result of the breaking apart or cracking of any part of a system or appliance containing water or steam," subject to certain limitations such as "continuous or repeated seepage that occurs over a period of 14 days or more." [25]

Another such specified peril is windstorm. The policy insures against "Windstorm or hail, but not including: Loss or damage to the interior of any building or structure, or the property inside the building or structure caused by rain, snow, sand or dirt, whether driven by wind or not, unless the building or structure first sustains wind or hail damage to its roof or walls through which the rain, snow, sand or dirt enters." [26] As noted by a Pennsylvania court in *Adams Apple Prods. Corp. v. National Union Fire Ins. Co.,* courts have construed the policy term "windstorm" to mean "wind, strong and

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[18] *See* Fireman's Fund Ins. Co. v. Tropical Shipping and Const. Co., Ltd., 254 F.3d 987, 1008 (11th Cir. 2001).
[19] *See Yale University*, 224 F.Supp.2d at 411.
[20] *See* Fragner v. American Community Mut. Ins. Co., 199 Mich.App. 537, 540, 502 N.W.2d 350, 352 (1993).
[21] *See id.*.
[22] ISO CP 00 10 04 02.
[23] Assurance Co. of America v. Wall & Associates LLC of Olympia, 379 F.3d 557 (9th Cir. 2004).
[24] *See e.g.,* Yale University, 224 F.Supp.2d at 413.
[25] ISO CP 10 20 06 95.
[26] ISO CP 10 20 06 96.

sustained enough to damage the insured property," as used in the policies and within the contemplation of the parties. [27] In the absence of a definition or further limitation in the policy, a "windstorm" is a wind of sufficient violence to be capable of damaging insured property "either by impact of its own force or by projecting some object against the property." [28]

D. Collapse Coverage

Property policies typically exclude collapse of covered property (*e.g.,* a building) in one part of the policy, but then provide separate, additional, coverage for collapse in another part. The coverage states that the insurer "will pay for direct physical loss or damage to Covered Property caused by collapse of a building or any part of a building insured under this Coverage Form, if the collapse is caused by one or more of the following: . . . b. [h]idden decay; c. [h]idden insect or vermin damage…."

Courts have not agreed on what constitutes the collapse of a building under the collapse coverage. [29] Some courts have adopted the traditional "narrow" interpretation, requiring coverage only where a building has fallen down or caved in. [30] This so-called actual collapse standard has been criticized as encouraging the insured to neglect repairs and allow a building to fall. This, say the critics, is economically unsound, contrary to the insured's duty to mitigate damage and does not advance the best interests of the insured, the public, or even the insurer. [31]

The modern majority rule does not require actual collapse but instead requires something less - serious impairment of structural integrity making the support system no longer capable of supporting the structure. [32] Focusing on the word "imminent," a South Carolina court in *Hilton Head Resort v. General Star Indemnity Co.*, held that the definition of a collapse "must be taken to cover any serious impairment of structural integrity that connotes imminent collapse threatening the preservation of the building as a

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[27] 85 A.2d 702, 705 (Pa. Super. Ct. 1952); *see also* Gerhard v. Travelers Fire Ins. Co., 18 N.W. 2d 336 (Wis. 1945).

[28] Kemp v. Am. Universal Ins. Co., 391 F.2d 533, 534 (5th Cir. 1968).

[29] *See e.g.,* Buczek v. Continental Casualty Ins. Co., 378 F.3d 284 (3d Cir. 2004); Ocean Winds Council of Co-Owners Inc. v. Auto-Owner Ins. Co., 350 S.C. 268, 565 S.E.2d 306 (2002).

[30] *See e.g., Buczek*, 378 F.3d 284; Fidelity and Casualty Co. of New York v. Mitchell, 503 So.2d 870 (Ala.App. 1987); Heintz v. United States Fidelity and Guaranty Co., 730 S.W.2d 268 (Mo.App. 1987).

[31] *See e.g.,* Hilton Head Resort v. General Star Indemnity Co., 357 F.Supp.2d 885 (D.S.C.2005); *Assurance Company*, 379 F.3d 557.

[32] *See e.g.*, Whispering Creek Condominium Owner Association v. Alaska National Insurance Company, 774 P.2d 176 (Alaska 1989); Doheny West Homeowner's Association v. American Guarantee and Liability Insurance Company, 60 Cal.App. 4th 400, 70 Cal.Rptr.2d 260 (1997).

structure or the health and safety of occupants and passers-by." [33] Some courts construe "imminent" as meaning collapse is "likely to happen without delay; impending or threatening" and require a showing of more than substantial impairment; other courts rule that substantial impairment is sufficient. [34] The substantial impairment standard has been criticized as tending to convert collapse coverage into a maintenance agreement by allowing recovery for damage which, while substantial, does not threaten actual collapse. [35]

Other collapse coverage insures against "direct physical loss or damage to Covered Property *caused by* collapse of a building or any part of a building". This policy language requires not just the threat of collapse, and not just collapse itself, but actual loss or damage caused by a collapse. [36]

E. Causation

Coverage under property policies is established in large part by the cause of loss. To be covered, the policyholder must sustain a loss caused by a covered hazard (per the specified peril policy) or a loss not caused by an excluded hazard (per an all-risk policy).

When there appear different causes of damage, the proximate cause to which the loss is to be attributed is the "dominant, the efficient one, that sets the other causes in operation, and causes which are incidental are not proximate, though they may be nearer in time and place to the loss." [37] This is the efficient proximate cause doctrine and is the generally recognized method for resolving coverage issues involving the occurrence of covered and excluded perils. [38] As aptly put by a West Virginia court in *Murray v. State Farm Fire & Casualty Co.*, the doctrine "looks to the quality of the links in the chain of causation." [39] Under the doctrine, a loss that is caused by a combination of covered and excluded risks is covered if the covered risk is the efficient proximate cause of the loss. [40]

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[33] *Hilton Head*, 357 F.Supp.2d 885.
[34] *Id.*; Island Breakers v. Highland Underwriters Ins. Co., 665 So.2d 1084 (Fla.App. 1995); *Ocean Winds*, 350 S.C. at 271, 565 S.E.2d at 308.
[35] *See Hilton Head*, 357 F.Supp.2d 885.
[36] *See id.*
[37] Hartford Steam Boiler Inspection & Ins. Co. v. Pabst Brewing Co., 201 F.617, 626 (7th Cir. 1912); *see also* Garvey v. State Farm Fire & Casualty Co. 48 Cal.3d 395, 403, 257 Cal.Rptr. 292, 770 P.2d 704 (1989).
[38] *See e.g.* Western National Mut. Ins. Co. v. University of North Dakota, 643 N.W.2d 4, 12 (N.D. 2002).
[39] 203 W.Va. 477, 488, 509 S.E.2d 1, 12 (1998).
[40] *See e.g.,* Penn-America Ins. Co. v. Mike's Tailoring, 125 Cal. App. 4th 884, 897, 22 Cal. Rptr.3d 918, 923 (2005); Pieper v. Commercial Underwriters Ins. Co., 59 Cal.App.4th 1008, 1012, 69 Cal.Rptr.2d 551 (1997).

The essence of the rule is that, when an insured cause sets in motion other causes which may not be insured, the loss is covered. [41]

The rule is applied after there is a determination of which single act or event is the efficient proximate cause of the loss and there is a determination that the efficient proximate cause of the loss is a covered peril. [42] "When, however, the evidence shows the loss was in fact occasioned by only a single cause, albeit one susceptible to various characterizations, the efficient proximate case analysis has no application." [43]

Another doctrine - the concurrent cause doctrine – sometimes is, but should not be, confused with the efficient proximate cause doctrine. The concurrent cause doctrine applies when multiple causes of loss are independent, whereas the efficient proximate cause doctrine applies when the causes of loss are dependent. [44] Causes are independent when they are unrelated such as an earthquake and a lightening strike, or a windstorm and wood rot. [45] Causes are dependent when one peril instigates or sets in motion the other, such as an earthquake which breaks a gas main that starts a fire. [46] The Ninth Circuit in *Safeco Ins. Co. v. Guyton*, applied the concurrent cause doctrine to find coverage when heavy rains from a hurricane broke a levee system and houses sustained water damage due to the broken levees. Though the loss was excluded by the flood exclusion, it was covered by the peril of negligent design and maintenance of the levees. Thus the court allowed the homeowners to recover. [47]

In an effort to limit both the efficient proximate cause and concurrent cause doctrines, policy writers have added a lead-in clause to the exclusions. The standard lead-in states: "We do not insure for such loss regardless of: a) the cause of the excluded event; or b) other causes of the loss; or c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss." [48] In the Alabama case of *State Farm Fire & Casualty Co. v. Slade*, lightning (a covered peril) had caused earth movement (an excluded peril) which led to cracks in an insured's property. Because of

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[41] *See e.g.,* American States Ins. Co. v. Rancho San Marcos Properties, LLC, 123 Wash.App. 205, 97 P.3d 775 (2004); Graham v. Pub. Employees Mut. Ins. Co., 98 Wash.2d 533, 656 P.2d 1077 (1983).

[42] *See e.g.,* McDonald v. State Farm Fire & Casualty Co., 119 Wash.2d 724, 732, 837 P.2d 1000 (1992).

[43] Kish v. v. Ins. Co. of North America, 125 Wash.2d 164, 170, 883 P.2d 308 (1994) (*quoting* Chadwick v. Fire Ins. Exch., 17 Cal. App.4th 1112, 1117, 21 Cal. Rptr.2d 871 (1993).

[44] *See e.g.*, Paulucci v. Liberty Mut. Fire Ins. Co., 190 F.Supp. 2d 1312, 1319 (M.D.Fla. 2002); *but see Kish,* 883 P.2d at 311 ("The efficient proximate cause rule applies only where two or more independent forces operate to cause the loss.").

[45] *See Paulucci,* 190 F.Supp. 2d at 1319.

[46] *See id.*

[47] 692 F.2d 551, 555 (9th Cir. 1982); *but see Garvey*, 48 Cal.3d at 405.

[48] ISO CP 10 20 (6-95).

the above lead-in clause in the earth movement exclusion, the court applied the exclusion to bar coverage. [49]

F. Ensuing Loss

An ensuing loss provision "does not cover loss caused by the excluded peril but rather covers loss caused to other property, wholly separate from the defective property itself." [50] An example of an ensuing loss provision is: inherent vices are not covered "unless loss or damage from a peril insured herein ensues and then this policy shall cover for such ensuing loss or damage." Thus, the cost of correcting design defects cannot be covered under the ensuing loss provision where the cost was incurred to correct an excluded peril. [51]

The Third Circuit in *GTE Corporation v. Allendale Mutual Ins. Co.,* found the following illustration helpful in understanding the coverage: "[I]f defectively installed roof flashing allows water to leak into the wall cavity, then subsequent damage caused by water, such as dry rot or mold, to the interior of the house is caused by the faulty workmanship and not covered. If, however, the water migrates into an electrical box and causes an electrical short which in turn causes a fire, then the fire damage is a covered 'ensuing loss.' [That is,] … mold, unlike fire, is not an 'ensuing loss' due to the lack of any intervening cause other than time beyond the initial water damage." [52] In the Texas case of *Allstate Ins. Co. v. Smith,* a water pipe within a concrete slab burst resulting in water damage to the insureds' home. The cost of tearing out the wall and floor to find defective pipe and repairing the wall and floor was a covered "ensuing loss," although the replacement of the defective pipe was excluded by the inherent vice exclusion. [53]

G. Ordinance Enforcement

The ordinance enforcement provision states that the insurer "shall be liable also for the loss occasioned by the enforcement of any state or municipal law, ordinance or code, which necessitates, in repairing or rebuilding, replacement of material to meet such requirements." A North Carolina court in *John S. Clark Company, Inc. v. United National Ins. Co.,* concluded that this provision does not cover the costs incurred by an insured to correct defectively built portions of the construction project in the absence of a

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[49] 747 So.2d 293 (Ala. 1999); *see also* Boteler v. State Farm Casualty Ins. Co., 876 So.2d 1067 (Miss.App. 2004).
[50] Montefiore Med. Center v. Am. Protect. Ins., 226 F.Supp.2d 470, 479 (S.D.N.Y. 2002).
[51] *See e.g.,* Swire Pac. Holdings, Inc. v. Zurich Ins. Co., 284 F.3d 1228, 1231 (11th Cir. 2002); Swire Pac. Holdings, Inc. v. Zurich Ins. Co., 845 So.2d 161 (Fla. 2003); Laquila Construction, Inc. v. Travelers Indem. Co. of Illinois, 66 F.Supp.2d 543 (S.D.N.Y. 1999); Schloss v. Cincinnati Ins. Co., 54 F.Supp.2d 1090 (M.D.Ala. 1999).
[52] 372 F.3d 598 (3d Cir. 2004), *quoting* Prudential Property Cas. Ins. Co. v. Lillard-Roberts, 2002 WL 31495830, at 10 (D.Or. 2002).
[53] 450 S.W.2d 957, 961 (Tex.App. 1970).

covered loss under the policy. Accordingly, the provision provides coverage after a covered loss has already occurred such as when an insured repaired or rebuilt the damaged or destroyed property and incurred additional costs because the insured necessarily used replacement materials to comply with any state or municipal law, ordinance or code. [54] A Tennessee court also refused to allow ordinance deficiency coverage for the costs of upgrading code violations which were discovered in areas of the insured building not affected by the fire. [55]

The converse of this coverage is the ordinance or law exclusion, which excludes coverage for loss "resulting from the enforcement of any ordinance or law: (1) regulating the construction, use or repair of any property; or (2) requiring the tearing down of any property, including the cost of removing this debris." [56]

III. Exclusions

The reach of property insurance is narrowed by exclusions. In insurance parlance, "'all-risk' does not mean 'every risk.'" [57] It means all risk that is not excluded. However, exclusions are strictly construed against the insurance company.

A. Faulty Workmanship Exclusion

The faulty workmanship exclusion provides that damage resulting from the faulty, inadequate, defective or negligent construction of part or all of any property on or off the premises described in the policy is excluded. [58] Specifically the exclusion reads: "We will not pay for loss or damage caused by or resulting from … [f]aulty, inadequate, defective or negligent: … [d]esign, testing, specifications, workmanship, repair, construction, renovation, remodeling, grading or earth compaction; … of part or all of any property on or off the described premises."

The dictionary definition of "construction" is "something built or erected." [59] The construction process includes multiple phases or parts, and faulty workmanship signifies

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[54] 304 F.Supp.2d 758 (M.D.N.C. 2004); *see also* Commonwealth Ins. Co. v. Benihana of Tokyo, Inc., 1997 WL 361617 (N.D.Tex. 1997); Davidson Hotel Co. v. St. Paul Fire and Marine Ins. Co., 136 F.Supp.2d 901 (W.D.Tenn. 2001). *But see* St. Paul Fire and Marine Ins. Co. v. Darlak Motor Inns. Inc., 1999 U.S.Dist. LEXIS 23283 (M.D.Pa.1999), *affirmed without opinion*, 205 F.3d 1330 (3d Cir. 1999).

[55] Chattanooga Bank Associates v. Fidelity and Deposit Company of Maryland, 301 F.Supp.2d 774 (E.D.Tenn.2004).

[56] ISO CP 10 30 10 91; *see also Sentinal Mgmt.*, 563 N.W.2d at 300.

[57] *Port Authority*, 311 F.3d at 234.

[58] *See* El Rincon Supportive Services Organization, Inc. v. First Nonprofit Mutual Ins. Co., 346 Ill.App. 3d 96, 803 N.E.2d 532 (2004).

[59] Webster's Third New International Dictionary 498 (1993).

a component of the building process leading up to a finished product. [60] The Illinois court in *El Rincon Supportive Services Organization, Inc. v. First Nonprofit Mutual Ins. Co.,* has extended the reach of the exclusion to exclude property damage resulting from the construction excavation operations on the adjacent property – "it is commonly understood that excavating activities are necessary to lay the foundation in the construction of a building." [61] A more common application of the exclusion is a subcontractor's defective execution of waterproofing. [62]

Of course, the faulty workmanship exclusion is not bullet proof. The Ninth Circuit in *Allstate Insurance Co. v. Smith,* construed an all-risk business property insurance policy on a doctor's office, where equipment was rain damaged when a roofing contractor removed a portion of the roof but failed to put a cover over the resulting opening. The court concluded that the exclusion for "faulty workmanship," as applied to those facts, was ambiguous. The term "faulty workmanship" was susceptible to at least two reasonable interpretations: "flawed process," and a "flawed product." The "flawed product" interpretation was reasonable, and thus the property damage caused by the roofer's dereliction was not faulty workmanship because the roofer had not completed any portion of the new roof. Thus there was no flawed product. [63] Similarly, negligence occurring after the built product has been properly completed – as when its electronic controls are being tested to confirm their compliance – has been found by a court not to come the faulty workmanship exclusion. [64]

B. Wear and Tear Exclusion

Wear and tear exclusions have long been a part of all-risk insurance contracts.[65] Courts frequently interpret wear and tear by looking at the popular meaning of the expression. They employ adjectives such as "ordinary" and "natural" to limit the breadth of the exclusion. [66] In the context of building collapse coverage, wear and tear also is an

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[60] *See e.g.,* Capelouto v. Valley Forge Insurance Co., 98 Wash.App. 7, 990 P.2d 414 (1999); Tzung v. State Farm Fire & Casualty Co., 873 F.2d 1338 (9th Cir. 1989); Schultz v. Erie Insurance Group, 754 N.E.2d 971, 976-77 (Ind.Ct.App. 2001).

[61] 346 Ill.App. 3d 96, 803 N.E.2d 532 (2004).

[62] Kroll Construction Co. v. Great American Insurance Co., 594 F.Supp. 304, 305 (N.D.Ga. 1984).

[63] 929 F.2d 447, 450 (9th Cir. 1991).

[64] *See,* Otis Elevator Co. v. Factory Mutual Ins. Co., 353 F. Supp. 2d 274, 280-281 (D. Conn. 2005); *see also* City of Burlington v. Hartford Steam Boiler Inspection and Ins. Co., 190 F. Supp. 2d 663, 672 (D.Vt. 2002); Dow Chem. Co. v. Royal Indemnity Co., 635 F.2d 379, 387 (5th Cir. 1981).

[65] *See e.g., Meridian Leasing*, 409 F.3d at 350; Mellon v. Fed. Ins. Co., 14 F2d 997, 1002 (D.C.N.Y. 1926).

[66] *See e.g., Meridian Leasing,* 409 F.3d at 350; *see also* Cyclops Corp. v. Home Ins. Co., 352 F.Supp. 931, 936 (W.D.Pa. 1973).

exclusion: a policy does not cover the collapse of a building if the collapse was due to, among other things, wear and tear. [67]

C. Inherent Vice/Latent Defect Exclusions

The property policy also typically does not insure against loss "caused directly or indirectly by … inherent vice, latent defect." A Washington court in *Port of Seattle v. Lexington Ins. Co.,* described "inherent vice" succinctly: "An inherent vice is defined by various courts as "'any existing defects, diseases, decay or the inherent nature of the commodity which will cause it to deteriorate with a lapse of time.'" The court also defined it "as a cause of loss not covered by the policy, does not relate to an extraneous cause but to a loss entirely from internal decomposition or some quality which brings about its own injury or destruction. The vice must be inherent in the property for which recovery is sought." [68] In other words, the question is whether the insured property "contain[s] its own seeds of destruction … [or whether it] was threatened by an outside natural force." [69] If it is the former, the exclusion applies to bar coverage. In one of the few Year 2000 cases, *GTE Corporation v. Allendale Mutual Ins. Co.,* the Third Circuit found the insured's Y2K problem to be an excluded inherent vice because the date field is an internal quality that brought about its own problem – the insured was not threatened by any external force; the threat is entirely internal. [70]

A close cousin to inherent vice is latent defect. Usually the policy does not define "latent defect." Courts, however, have defined it as "a defect that is hidden, or which could not have been discovered by any known or customary test or examination." [71] In other words, where a defect is "not discoverable upon known and customary inspection," the loss is excluded from coverage. [72] The Second Circuit in *City of Burlington v. Indemnity Ins. Co. of North America,* applied the latent defect and inherent vice exclusions to damage caused by leaking welds in a boiler unit of an electric generating facility because the damage was intrinsic. The cause of the leaking welds was a lack of full penetration in the welds themselves, rather than any external cause. [73]

D. Dampness Exclusion

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[67] *See e.g., Johnson Press*, 339 Ill.App.3d 864, 791 N.E.2d 1291.
[68] 111 Wash.App. 901, 48 P.3d 334, 338-39 (2002), *quoting* Mo. Pac. R.R. Co. v. Elmore & Stahl, 377 U.S. 134, 136, 84 S.Ct. 1142 (1964); *see also* Employers Cas. Co. v. Holm, 393 S.W.2d 363, 367 (Tex.App. 1965).
[69] American Home Assurance Co. v. J.F. Shea Co., Inc., 445 F.Supp. 365, 368 (D.D.C. 1978).
[70] 372 F.3d 598 (3d Cir. 2004).
[71] *City of Burlington*, 190 F.Supp.2d at 688-89.
[72] *Id.; see also* Essex House v. St. Paul Fire & Marine Ins. Co., 404 F.Supp. 978, 992 (S.D. Ohio 1975). General American Transportation Corp. v. Sun Ins. Office, Ltd. 369 F.2d 906 (6th Cir. 1966).
[73] 346 F.3d 70, 74 (2d Cir. 2003).

A property policy also may exclude "loss caused by or resulting from … dampness." In *40 Gardenville, LLC v. Travelers Property Casualty of America,* a New York court ruled that the exclusion was clear and unambiguous in the context of mold contamination in a building. The court concluded that the plain and ordinary meaning of the term "dampness," as noted in a dictionary, was "wetness" and "moistness." [74] The Court found the water or dampness present in the building was the proximate cause of the mold contamination, and the exclusion operated as a bar to the insured's recovery for mold loss. [75]

E. Water Exclusion

The water exclusion has long been in use, with little or no change, and courts usually have found it clear and unambiguous, [76] The flood portion, discussed next, was also declared unambiguous by the United States Fifth Circuit Court of Appeals in the Hurricane Katrina litigation, although it was initially declared ambiguous by the Federal district court . [77]

One common version of the water exclusion states, "We will not pay for loss or damage caused directly or indirectly by … Water. (1) Flood, surface water, waves, tides, tidal waves, overflow of any body of water, or their spray, all whether driven by wind or not." [78]

1. Surface Water.

The policy does not define "surface water." However, under the widely accepted definition, "surface water" means: "water which is derived from falling rain or melting snow, or which rises to the surface in springs, and is diffused over the surface of the ground, while it remains in such diffused state, and which follows no defined course or channel, which does not gather into or form a natural body of water, and which is lost by evaporation, percolation, or natural drainage." [79] A variation on this definition of surface water is water that "(1) derives from natural precipitation such as rain or melting snow;

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[74] 387 F. Supp.2d 205, 211 (W.D.N.Y. 2005), *quoting* The American Heritage Dictionary of the English Language (4th Ed. 2000).
[75] *Id.* at 211.
[76] *See e.g.,* Newark Trust Co. v. Agric. Ins. Co., 237 F. 788 (3d Cir. 1916); Hardware Dealers Mut. Ins. Co. v. Berglund, 393 S.W.2d 309, 313 (Tex. 1965).
[77] *In re Katrina Canal Breaches Consolidated Litigation,* 466 F. Supp.2d 729 (E.D.La.), *reversed,* 495 F.3d 191 (5th Cir. 2007).
[78] ISO CP 00 10 06 95 and CP 10 20 06 95.
[79] State Fire ad Tornado Fund v. North Dakota State University, 694 N.W.2d 225 (N.D. 2005); *see also* Selective Way Ins. Co. v. Litigation Technology, Inc., 270 Ga.App. 38, 606 S.E.2d 68 (2005).

(2) flows over or accumulates on the surface of the ground; and (3) does not form a definite body of water or follow a defined watercourse." [80]

It is not always easy to determine if facts fit within the exclusion for surface water. A North Dakota court in *State Fire and Tornado Fund v. North Dakota State University*, upheld the exclusion where water from a heavy rainstorm entered a tunnel from a sports stadium and then entered the insured's plant and building at the other end of the tunnel. The water being "altered … by paved surfaces, buildings, or other structures" and "being artificially channeled underground" still maintained its character as surface water and the loss was excluded. [81] On the other hand, a Georgia court, in *Selective Way Ins. Co. v. Litigation Technology, Inc.*, weighed similar facts and found the exclusion inapplicable. There rain water flowed into a 13-foot-deep pit which the City had dug under a road adjacent to the insured building. As the rain water rose in the pit, it entered an uncapped pipe, flowed through the pipe under the street and sidewalk and into the basement of the building. The court concluded that the water "is no longer diffused, is no longer on the surface of the ground, has gathered into a body, and has followed a defined course through the pipe and into the building." [82] The exclusion did not apply.

2. Flood.

The flood portion of the water exclusion has been litigated in the many claims involving Hurricane Katrina in August 2005 – whether the storm surges and water flowing through failed levees constitute a "flood" in the exclusion and whether the damages were caused by flood or a covered peril such as windstorm. One dictionary definition of flood is "an overflowing of water in an area normally dry; inundation; deluge." [83] In a pre-Katrina case, *Valley Forge Ins. Co. v. Hicks, Thomas & Lilienstarn, L.L.P.,* a Texas court enforced the flood exclusion where a tropical storm caused a bayou to overflow and water rushed into a convention center through its basement wall into a parking garage into a pedestrian tunnel and into a bank building where the insured tenant's premises became damaged. The exclusion was applied to bar coverage because the water "flowed onward, as flood and surface water is wont to do, obeying the law of gravity and flowing into man-made underground structures." [84] The flood exclusion reflects that the property insurance industry has not wanted to insure property against flood and hence Congress enacted the federal flood insurance program in 1968. [85]

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[80] Smith v. Union Auto Indem. Co., 323 Ill.App.3d 741, 257 Ill.Dec. 81, 752 N.E.2d 1261, 1267 (2001).
[81] 694 N.W.2d 225 (N.D. 2005).
[82] 270 Ga.App. 38, 606 S.E.2d 68 (2005). *See also* Heller v. Fire Ins. Exchange, 800 P.2d 1006, 1009 (Colo. 1990).
[83] Webster's New World Dictionary 535 (2d ed. 1974).
[84] 174 S.W.3d 254, 259 (Tex.App. 2004). *See also* Wallis v. Country Mut. Ins. Co., 723 N.E.2d 376 (Ill.App. 2000); E.B. Metal & Rubber Industries, Inc. v. Federal Ins. Co., 444 N.Y.S.2d 321 (App.Div. 1981); Kane v. Royal Ins. Co. of America, 768 P.2d 678 (Colo. 1989).
[85] National Flood Insurance Act of 1968. 42 U.S.C. §§ 4001-4129 (2000).

In November 2006, in the case of *In re Katrina Canal Breaches Consolidated Litigation,* a Federal district court applying Louisiana law issued a decision on the flood exclusion favorable to policyholders, only to have its ruling reversed by the Fifth Circuit in August 2007. [86] At issue was coverage for damages arising from breaches or overtopping of the walls of the 17th Street, Industrial, and London Avenue Canals. Plaintiffs alleged their water damage was not the result of "natural" flooding. Rather, it was caused by the failure of the Orleans Levee District to correct the break in the canal walls, or to warn of impending water intrusion. A key issue, then, was whether the flood exclusion applied only to natural events or to natural and man-made events. The district court ruled that the flood exclusion in some policies at issue is ambiguous because the term "flood" is susceptible to two reasonable interpretations – one which limits itself only to a flood which occurs solely because of natural causes, and one which encompasses both a flood which occurs solely because of natural causes and a flood which occurs because of the negligent or intentional act of man. [87]

The Fifth Circuit, however, reversed and held that the flood exclusion unambiguously precluded recovery for damage cause by flooding that followed Hurricane Katrina. In consideration of the definition of the term "flood" in dictionaries, treatises and case law, the Court concluded that "what occurred here fits squarely within the generally prevailing meaning" of the term: "[w]hen a body of water overflows its normal boundaries and inundates an area of land that is normally dry, the event is a flood." [88] Further support for the Court's conclusion was evident in the purpose of a levee. A levee is "a *flood*-control structure; its very purpose is to prevent the floodwaters of a watercourse from overflowing onto certain land areas, i.e. to prevent floods from becoming more widespread." [89] Citing to the Fifth Circuit's decision, the Supreme Court of Louisiana in July 2008 came to the same conclusion in *Sher v. LaFayette Insurance Company,* holding that water flowing through levees broken by Hurricane Katrina was "flood" within the meaning of the exclusion and it was unreasonable to restrict the definition of "flood" to flood which is entirely natural. [90]

3. Groundwater.

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[86] 466 F. Supp.2d 729 (E.D.La.), *reversed,* 495 F.3d 191 (5th Cir. 2007).
[87] *Id.* at 14-15, 23-25. The district court did side with the insurers in two respects. State Farm's flood exclusion was held not ambiguous because it stated precisely there is no coverage for any flooding "regardless of the cause" and because Louisiana's state courts would enforce such an anti-concurrent cause clause despite the efficient proximate cause doctrine. *Id.* at 30-31. Hartford's flood exclusion was upheld because it specifically excluded flood damage caused by negligently maintained levees. *Id.* at 31-32.
[88] 495 F.3d at 214.
[89] *Id.*
[90] 988 So.2d 186, 194-196 (La. 2008); *see also* Northrup Grumman Corporation v. Factory Mutual Insurance Company, 538 F.3d 1090, 1095 (9th Cir. 2008) (Mississippi shipyards, which were covered in up to ten feet of water, "unquestionably experienced 'an inundation of water over normally dry land,…'").

The groundwater portion of the water exclusion states, "We will not pay for loss or damage caused directly or indirectly by … Water. ... (4) Water seeping under the ground surface pressing on, or flowing or seeping through: (a) Foundations, walls, floors or paved surfaces." The Sixth Circuit in *AKG Holdings, Inc. v. Essex Ins. Co.,* considered whether this exclusion barred coverage for damage to an empty, in-ground, swimming pool that raised out of the ground over the winter. The court ruled the damage was excluded because the groundwater pressing on the pool caused at least part of the buoyancy that led to the eruption of the pool from the concrete deck and because a "floor" or "paved surface" in the exclusion can be applied respectively to the bottom or interior surface of the swimming pool. [91]

4. Seepage/Leakage.

A different water exclusion comes into play in the property policy's coverage for collapse. Collapse coverage is barred for "loss or damage caused by or resulting from … wear and tear, … decay, deterioration, … continuous or repeated seepage or leakage of water that occurs over a period of 14 days, … faulty, inadequate or defective maintenance." In one case, the roof collapsed as a result of lack of maintenance and water seepage, which caused decay and weakened the wood structures. As such, the causes of the roof collapse fit squarely within the exclusion of the policy. [92]

5. Rain.

Another form of water exclusion is addressed to rain. As stated, the policy "will not pay for loss of or damage to … the interior of any building or structure caused by or resulting from rain, snow, sleet, ice, sand or dust, whether driven by wind or not…." A loss attributed to rainwater which enters the building through the roof is barred by this exclusion, according to a Nebraska court in *Einspahr v. United Fire & Casualty Co.*: it is a "tortured reading" of the exclusion to argue that once rain water enters a building it loses its nature as rain. [93] Damage to a basement flooded by a severe rainstorm is barred by the exclusion, the damage having been caused by or resulted from rain. [94]

F. Earth Movement Exclusion

The standard property coverage form excludes "earth movement, defined as: any earth movement (other than sinkhole collapse) such as an earthquake; landslide; mine subsidence; or earth sinking, rising, or shifting." [95] Courts are not in agreement over whether this exclusion applies only to naturally occurring events or also to man-made

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[91] 2005 WL 1869514 (6th Cir. 2005).
[92] *Johnson Press*, 339 Ill.App.3d 864, 791 N.E.2d 1291.
[93] 2000 WL 758654 (Neb.App. 2000).
[94] *See* Horizon III Real Estate v. Hartford Fire Ins. Co., 186 F.Supp.2d 1000 (D.Minn. 2002).
[95] IOS CF 00 11.

events. The majority of courts that have considered earth movement exclusions in the context of contractor negligence have found them to be ambiguous. [96] For instance, according to the West Virginia court in *Murray v. State Farm Fire & Cas. Co.,* the exclusion could bar coverage for natural events, such as earthquakes, but it could also be interpreted to bar coverage for man-made events, such as earth movement caused by equipment. Because the policy language is reasonably susceptible to different interpretations, the court ruled that the earth movement exclusion is ambiguous, and must have a more limited meaning than that assigned to it by the insurer. In determining the limited meaning of the exclusion, the *Murray* court applied the rule that "in an ambiguous phrase mixing general words with specific words, the general words are not construed broadly but are restricted to a sense analogous to the specific words." [97] Other jurisdictions have taken the opposite approach, enforcing the exclusion when man-made activities, such as faulty construction, cause earth movement and a resulting loss. [98]

G. Pollution Exclusion

The standard property policy contains a pollution exclusion. It excludes "loss or damage caused directly or indirectly by … [d]ischarge, dispersal, seepage, migration, release or escape of 'pollutants' unless the discharge, dispersal, seepage, migration, release or escape is itself caused by any of the 'specified causes of loss.'" The policy defines "pollutants" as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste." The exclusion was enforced by an Alabama court in *Haman, Inc. v. St. Paul Fire & Marine Ins. Co.,* where the insured's premises became uninhabitable because of the release of a chemical the use of which was restricted by federal regulations to uninhabitated open fields. [99]

A Wisconsin court in *Richland Valley Prods., Inc. v. St. Paul Fire Cas. Co.*, has stated that the term "contamination" connotes "a condition of impurity resulting from mixture or contact with a foreign substance, and that it means to make inferior or impure by mixture; an impairment of impurity; loss of purity resulting from mixture or contact, …" [100] Thus, taking a literal approach, the court ruled that a contaminant in a pollution exclusion included bacteria. Thus the insurance policy excluded coverage for any losses resulting from bacterial outbreak at the insured's food processing facility. [101] Other jurisdictions, however, such as New York in *Pepsico, Inc. v. Winterthur International*

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[96] *See e.g.,* Murray v. State Farm Fire & Cas. Co., 203 W.Va. 477, 509 S.E.2d 1, 9 (1998); Cox v. State Farm Fire & Casualty Co., 217 Ga.App. 796, 796-97, 459 S.E.2d 446, 447-48 (1995); Peters Township School District v. Hartford Accid. & Indem. Co., 833 F.2d 32, 35-36 (3d Cir. 1987).
[97] *Murray*, 509 S.E.2d at 9.
[98] *See e.g.,* State Farm Fire & Casualty Co. v. Bongen, 925 P.2d 1042, 1045-47 (Alaska 1996); Toumayan v. State Farm General Ins. Co., 970 S.W.2d 822, 825-26 (Mo.App. 1998); *McDonald*, 119 Wash.2d at 735-36, 837 P.2d at 1006.
[99] 18 F.Supp.2d 1306, 1308-08 (N.D.Ala. 1998).
[100] 201 Wis.2d 161, 167-68, 548 N.W.2d 127 (Ct.App. 1996).
[101] *Id.; see also Yale University*, 224 F.Supp.2d at 413.

America Ins. Co., reject this literal approach in favor of a "commonsense" interpretation which recognizes that the general purpose of a pollution exclusion is to exclude coverage for environmental pollution and environmental-type harms.[102] To the extent the exclusion could be read to have two reasonable interpretations – contamination includes only environmental-type harm or it includes both environmental and product contamination. Accordingly the courts deem the exclusion ambiguous and construe it in favor of the insured. [103] Rejecting the insurer's argument that lead paint dust from repairs in a building comes within the pollution exclusion, another court complained of the overbroad language in the exclusion: reading the clause broadly would bar coverage for one who slips and falls on a bottle of spilled Drano or who sustains injury from chorine in a pool.[104]

Then there is mold damage. The pollution exclusion was found by a Wisconsin court not to apply to mold caused by water vapors trapped in the building's walls because the damage was not seen as involving a release of contaminants. [105] On the other hand, other courts have found the mycotoxins from mold to constitute "pollutants" under the exclusion, and that the release of mycotoxins into the air is a discharge, dispersal or release of pollutants. [106]

H. Mold Exclusion

Property policies usually exclude loss caused by mold. Yet when mold and a covered hazard combine to cause mold damage, questions of fact arise as to which is the dominant efficient cause of loss. If a covered peril such as vandalism or a water leak is the efficient proximate cause, the mold damage is not barred by the mold exclusion. [107] Mold presents a unique problem in insurance coverage disputes because the nature of the damage is not always clear. [108] Property policies usually exclude coverage for "loss caused by or resulting from … corrosion, rust, fungus, mold, rot." The intent of the exclusion is to eliminate coverage for conditions associated with the property's normal aging process. [109] One court in Arizona in *Cooper v. American Family Mutual Ins. Co.,*

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[102] 788 N.Y.S.2d 142 (App.Div. 2004).
[103] *See id.*; Herald Square Loft Corp. v. Merrimack Mutual Fire Insurance, 344 F.Supp.2d 915 (S.D.N.Y. 2004).
[104] Pipefitters Welfare Educ. Fund v. Westchester Fire Ins. Co., 976 F.2d 1037, 1043 (7th Cir. 1992).
[105] Leverence v. U.S. Fidelity & Guaranty Co., 462 N.W.2d 218, 222 (Wisc.App. 1990).
[106] *See e.g.,* Reliance Ins. Co. v. Moessner, 121 F.3d 895 (3d Cir. 1997); Western American Ins. Co. v. Band & Desenberg, 925 F.Supp 758 (M.D.Fla. 1996), *aff'd* 138 F.3d 1428 (11th Cir. 1998).
[107] *See e.g.,* Shelter Mutual Ins. Co. v. Maples, 309 F.3d 1068, 1070-71 (8th Cir. 2002); Bowers v. Farmers Ins. Exchange, 99 Wash.App. 41, 46-48, 991 P.2d 734, 737-38 (2000).
[108] *See* Raymund C. King, Toxic Mold Litigation, p. 68 (2003).
[109] *Id.* at 75; *see also* Aetna Casualty & Surety Co. v. Yates, 344 F.2d 939 (5th Cir. 1965).

enforced the mold exclusion where a plumbing leak had damaged flooring and drywall in a closet and bedroom, and had caused mold damage. The reason for the ruling: the exclusion specifically barred coverage for mold, regardless of the cause. [110]

IV. Practice Tips and Conclusion

Property insurance is a critical piece of nearly all business ventures and is a must for most homeowners. More often than not, the cause of a loss that will determine whether the insurance is tapped to protect the insured, or is unavailable because of an exclusion. But understanding and applying property insurance provisions can be a daunting task. The facts of property claims often are complicated, extensive and require a thorough investigation. Often it is the discovery of a particular material fact that will determine whether the peril is covered or excluded. Given the myriad potential causes of loss, and exclusions that may be in play, it is an absolute must to have a copy of the entire policy. Applying the known facts to the language of the property policy with meticulous care, and in light of the governing law, should result in a clear picture of whether a claim is covered or not. A rush to judgment does no one any good.

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[110] 184 F.Supp. 960 (D.Ariz. 2002).