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Captives and the "Business Risk Doctrine"

Editor's Note: This piece, by **Marshall Gilinsky** and **Scott Turner** of Anderson Kill, P.C., discusses why a recent Second Circuit Court of Appeals' decision should cause construction industry captives to consider how their liability insurance policies handle the "business risk doctrine."

For over a decade, construction businesses of all sizes readily have used captive insurance companies as an important part of their risk management program. For many companies, one key benefit that captives offer is their ability to take standard insurance policy forms and tweak them to broaden coverage in important ways. Sometimes, however, the ability of the captive to broaden coverage is restricted by the ability to get commercial reinsurers to back the insurance program and the enhanced policy wording. That said, it is common for construction industry captives with sophisticated professional guidance to obtain adequate reinsurance for manuscripted policy wordings, so long as those wordings generally align with the coverage afforded by commercial insurance companies and recognized by the courts that interpret those policies.

Looking to the CGL Policy. One particularly thorny area of construction insurance law relates to the question of whether or not a contractor's commercial general liability (CGL) policy covers property damage to the contractor's own work. For example, where a building collapses and damages adjacent property, are the ensuing claims by the building owner for a new building covered, as well as the claims regarding the damage to the adjacent property?

The CGL policy drafters very clearly and very explicitly intended many instances of property damage to a policyholder's own work to be covered. For example, the "your work" exclusion begins by eliminating coverage for any and all property damage to the insured's own completed work. But, it also includes a large exception that allows coverage for property damage either caused by a subcontractor's work or caused to a subcontractor's work. Because general contractors and developers usually perform *all* of their work through subcontractors, this exception completely neutralizes the exclusion for their completed work, such as our collapsed building example.

Likewise, the exclusions that apply to property damage to an insured contractor's ongoing work have many exceptions. The subcontractor exception and companion provisions that liberalize coverage for a policyholder's ongoing work often are referred to as "broad form property damage (BFPD)" coverage, or "broad form" coverage (which derives from the title of the endorsement that first added this expansive coverage by amendment to the 1973 edition Insurance Services Office, Inc. (ISO) CGL form).

Despite the drafters' intent, many courts have ignored the expansive broad form language, reasoning that it violates public policy to allow contractors to receive insurance coverage for their own defective work. Such courts have reasoned that, if insured contractors knew that liability from shoddy workmanship would not come out of their own pocket, there would be more shoddy workmanship and damage resulting therefrom. This refusal to honor the expansive broad form wording of the standard CGL insurance policy has gotten lumped together under the heading "business risk doctrine," even though the means applied to bar coverage are by way of a variety of different policy provisions: the "legally obligated" requirement, the "property damage" requirement, the "occurrence" requirement, and by a broad, anti-coverage application of the various business risk exclusions despite their pro-coverage language to the contrary.

Courts' Response. Although courts in nearly half the states nationwide have barred coverage for property damage to a contractor's own work based on the business risk doctrine, a trend may be emerging whereby many of these courts will now permit coverage for such claims. Several state supreme courts have reversed themselves, and legislatures in other states have been taking the issue away from their courts through legislation.

Most recently, the Second Circuit Court of Appeals reversed its long-held position and found that property damage to a contractor's

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work could indeed satisfy the occurrence requirement. In a break from precedent holding that defective work claims could not satisfy the "occurrence" requirement under the 1973 CGL policy ISO form, the court in *Scottsdale Ins, Co. v. R.I. Pools Inc.*, 710 F.3d 488 (2d Cir. Conn. 2013), focused on the "your work" exclusion in current policy forms—specifically, the exception to the exclusion that expressly preserves coverage for property damage to or arising from work performed by subcontractors—and upheld coverage for the contractor. The court reasoned that if this exception is operative, then the policyholder's work must potentially satisfy the "occurrence" requirement—otherwise, the subcontractor exception would be pointless. Thus, read in the context of the policy as a whole, the term "occurrence" must potentially include instances of property damage to the contractor's own work.

Analysis. By emphasizing that its reasoning was based on updated policy language, the court's decision in *R.I. Pools* highlights the opportunity that exists for construction industry captives to adapt their liability insurance policies to provide valuable coverage for their policyholders' own work. Since such coverage is recognized by courts under commercially available insurance policies, there is every reason to expect that such risk can readily be ceded to reinsurers via existing reinsurance markets.

Moreover, the judicial rationale for the business risk doctrine does not necessarily apply in the captive context and should not adversely affect a captive's ability to underwrite such risks. Again, one key reason for including business risk exclusions in standard form liability insurance policies is to prevent moral hazard; that is, a situation where the contractor knowingly does shoddy work, supposedly comfortable in the knowledge that any future liability will be covered by insurance and will not have to be compensated out of the contractor's own pocket. In the captive context, however, any resulting liability *will* be coming out of the contractor's own pocket (or at least out of its other pocket, via the captive). Also, the moral hazard in question is much less likely to occur with large, long-term contractors—the sort that have captive insurance programs. For both reasons, the need for business risk exclusions is greatly reduced in policies sold by such a construction company's captive.

Since many jurisdictions continue to apply the business risk doctrine in determining coverage under construction liability insurance policies, and do so in different ways, captives in this area should consider the law of the applicable jurisdiction in determining how to address this issue under their policies. To draft around the business risk doctrine, a captive underwriter would have to understand the potential legal obstacles in each jurisdiction and word the policy accordingly. The result could be a policy that delivers the enhanced coverage which captives are uniquely positioned to deliver, without sacrificing access to reinsurance markets. ■