CLM 2016 New York Conference
December 1, 2016
New York, NY

Risk Transfer - Whose Liability is it Anyway?

I. Introduction

Liability in cases involving multiple parties involves complex analysis and strategies. Determining risk transfer mechanisms in multi-party cases like those involving product liability, construction defect, bodily injury claims and the like is often a key to litigation management. Some of the key issues involve how indemnity and additional insured status impact the liability analysis and litigation management, with important consideration given to issues of coverage, options for other policies, and limits of liability.

A. Risk Transfer Mechanisms

A risk transfer occurs where a specified risk of loss is transferred to another party through a contract (e.g., an indemnity/hold harmless provision), pursuant to the terms of a statute, under common law or to a professional risk bearer (e.g. an insured's transfer of risk to an insurer affording pertinent liability coverage or an insurer's transfer of risk to a reinsurer). Risk transfer is needed to allocate risk equitably and place responsibility for risk on the respective parties consistent with their ability to control and guard against that risk. Ideally, liability should rest with whichever party has the most control over the sources of potential liability.

Risk transfer is often thought of in a limited fashion – procuring insurance so that you can shift the risk to another party (i.e., the insurer). However, risk management is now more widely used to shift risk through various other means, including specialized insurance, warranties and guarantees, contractual agreements for indemnification, and hybrid solutions.

Risk transfer by contract typically involves including in the contract between the parties indemnity/hold harmless provisions and provisions requiring the maintenance and documentation (by certificates of insurance) of particular insurance coverage, such as liability insurance with specified limits and appropriate additional insured endorsements, contractual liability coverage, cross-liability coverage, and other types of insurance to cover assumed risks, contractual or otherwise.

As to statutes, there may be state statutes that require specific wording to effectively transfer risk. For example, a statute may require that a contractual indemnitee agreement include an affirmative assumption of the indemnitee's own negligence or the risk of such negligence will not be transferred. In addition, what have become known as "anti-indemnity" statutes can limit the types of indemnity that are permissible.

Risk transfer to a professional risk bearer occurs when an insured transfers risk to an insurer, captive or other entity or program affording liability coverage. The insurer charges a premium for accepting the defined risk, and deductibles, reserves, reinsurance and other financial agreements can modify the financial risk the insurer assumes. Risk transfer to a professional risk bearer also occurs between insurance carriers where the insurer accepting the risk from the insured transfers at least a portion of this assumed risk to a reinsurer.

II. How to Handle Conflicts in Contract Language and Coverage Provided

Indemnity issues are often governed by statute in many jurisdictions. During the course of the claim, the indemnity language should be reviewed in the working contract documents and analyzed for compliance with the local jurisdiction requirements for enforceability. However, the analysis should not stop there. The insurance policy should also be reviewed and analyzed in conjunction with the terms of the operative contracts to determine whether they act in concert or if there is some sort of conflict or ambiguity which should be evaluated and addressed as early as possible.

A. Indemnity issues

Different states have requirements and limitations on what indemnity can be contracted for and where risk can be allocated under the terms of a negotiated contract between parties.

Indemnity claims have become as important in many jurisdictions as the primary defense of defect claims. Practitioners and claims professionals are expected to understand and apply indemnity law in jurisdictions that allow such relief. The prosecution of indemnity claims is especially necessary in large claims or claims with limited coverage in order to spread the risk of exposure to those entities that have actually performed the allegedly defective work.

Indemnity law is a creature of statute in some states, and common law in others. In some states, an indemnitee (the party seeking indemnity protection) is entitled to broad indemnity relief, depending on the level of sophistication of the operative contract. In others, indemnity relief is limited, or restricted altogether. (Washington – RCWA §4.24.115; Nevada – *Reyburn Lawn & Landscape Designers, Inc.,* 255 P.3d 268 (2011); Arizona – ARS §32-1159; Arizona - *Cunningham v. Goettl Air Conditioning, Inc.,* 194 Ariz. 236 (1999); New Mexico – N.M.S.A. §56-7-1; California – Civil Code §2782 (residential construction); 2782.05 (commercial construction); Colorado – C.R.S.A §13-50.5-102; 13-21-111.5; Florida – Fla. Stat. §725.06).

The rise of anti-indemnity statutes

Many jurisdictions have adopted anti-indemnity statutes, which restrict indemnity to various degrees. In some states, an indemnitee (typically the GC or developer) is not able to obtain contractual indemnity relief for its own fault to any degree. New Mexico is one of these states. Instead, multiple parties to a defect action must bear their own percentage of fault for damages that are proven. In other states, like Arizona, an indemnitee is entitled to indemnity relief as long as the contract restricts indemnity where the indemnitee is solely at fault. It is important to understand the limitations that apply in the particular venue.

Negligence/Fault – Can You Procure Indemnity Without It?

Jurisdictions also differ with regard to the level of proof necessary to obtain indemnity relief. In some states like Arizona, an indemnitee can obtain indemnity relief without proving fault on behalf of the subcontractor indemnitor. A good example is a case involving a "specific" indemnity clause, coupled with an assignment of rights by the GC/Developer to the Plaintiff. See *Cunningham v. Goettl Air Conditioning, Inc.,* 194 Ariz. 236 (1999). Where a contract allows indemnity relief for "liability," a subcontractor can be held liable for a stipulated judgment even absent a showing of "fault." On the other hand, some states permit a comparative indemnity system that imposes a fault determination, and several liability based on a proven percentage of fault. And some states do not permit indemnity at all when the indemnitee is even one percent (1%) at fault.

B. Additional Insured Issues

In addition to the indemnity issues under a contract, the insurance obligations and requirements may assist in risk transfer opportunities, particularly in contract where one party is required to name the other as an "additional insured" under the first's insurance policies.

We continue to see developments as insureds are actively pursuing additional insured coverage and are challenging insurers who are denying coverage to the limited additional insured where the policy limits additional coverage to liability arising out of the named insureds "ongoing operations." There has been increasing litigation regarding interpretation of the scope of ongoing operations additional insured endorsement with the analysis centered around the language of the additional insured endorsement and the specific facts alleged in the complaint. Additional insured endorsements under some of the ISO forms contain language similar to or as the following regarding who an insured under the additional insured endorsement ("AIE"):

> "the person or organization shown in the Schedule, but only with respect to liability arising out of your ongoing operations performed for that insured."

The courts have had opportunity to evaluate these provisions and the results are not consistent due to the unique facts presented by each action. While insureds may argue that the court's decision in Tri-Star Theme Builders, Inc. v. OneBeacon Insurance Co., (9th Cir. 2011) 426 Fed.App'x 506, found that the

phrase "arising out of the Named Insured's ongoing operations" could reasonably include property damage that occurred at any time, as long as that property damage related back to the subcontractor's negligent actions or faulty workmanship performed while it was working on the project. (Id. at 510., we note that Tri-Star is an unpublished Ninth Circuit opinion and did not predict how an Arizona court would interpret this language.

An Arizona Court of Appeal later found that the limitation of coverage to "ongoing operations" under an additional insured endorsement is not ambiguous. (Colorado Cas. Ins. Co. v. Safety Control Co., Inc. (2012) 230 Ariz. 560.) The Colorado Casualty decision refutes the Tri-Star federal court's prediction of how an Arizona court would treat that endorsement and adds to the courts that find the "ongoing operations" endorsement to be clear. The Arizona Court of Appeal found that the limitation of coverage to "ongoing operations" under an additional insured endorsement is not ambiguous, defining the term to mean “liability that arises while the work is still in progress." (Colorado Cas. Ins. Co., supra, 230 Ariz. at 568 – 69.). This is consistent with California state court authority that has addressed the issue of the applicability of an ongoing operations endorsement in Pardee Const. Co. v. Ins. Co. of the West (2000) 77 Cal.App.4th 1340. Pardee established precedent for insurers in California that, if an ongoing operations limitation on coverage is included as part of a policy, this indicates an intent not to provide coverage for property damage that first occurs after an insured's operations have been completed. (Id. at 1358.) The court in Pardee further made it clear that an ongoing operations endorsement would bar coverage of a completed operations claim when it stated that, "[d]amage resulting from a subcontractor's work often does not arise for years. Many jurisdictions do not have any definitive law or direction on this issue. It is thus prudent for general contractors to obtain completed operations coverage as additional insureds from their subcontractors' insurers." (Id. at 1360 – 61.)

AIEs and Certificates of Insurance and How to Use Them in Risk Transfer

In evaluating risk transfer, it is important to understand the basics and to differentiate between an endorsement and a certificate of insurance. The AIE is the only document that demonstrates the actual amendment to the policy to add an additional insured while the certificate of insurance provide information from the primary named insured's broker of an intention to do so. Thus, the point to begin your analysis of risk transfer begins even before construction – the general contractor should be sure that it obtains the AIE and not just a certificate of insurance. When issuing tenders, an analysis of the documents should be performed to determine where efforts toward risk transfer can be effectively pursued. In light of many contract's requirement that the subcontractor provide a defense, it behooves the subcontractor to ensure that it provide the AIE as well – otherwise, the subcontractor may be exposed for the defense obligation if there is no carrier to provide the defense.

Satisfaction of Self-Insured Retentions

Risk transfer becomes complicated when self-insured retention ("SIR) issues arise. Risk management concerns again here arise at the outset to evaluate what self insured retentions are required under the potential insurance policies. The case law on this issue is generally suggests that when the language of

the additional insured endorsement provides the SIR must be satisfied by the primary named insured, the additional insured cannot satisfy the SIR, and thus often precluding coverage for the defense by the AI carrier.

Defense Obligations

The trigger of the duty to defend will often turn on the language of the contract and the law of the specific jurisdiction. Some states, like California, have determined that the subcontractor will be obligated to provide an immediate defense upon tender regarding of the finding of any fault. *Crawford v. Weather Shield Mfg., Inc.*, 44 Cal.4th 541 (2008). Some other jurisdictions lean more toward the obligation to find fault to determine the defense contribution. It does appear that most courts are requiring a close read of the actual language of the contract to determine whether a duty to defend is owed See *MT Builders, L.L.C. v. Fisher Roofing, Inc.*, 219 Ariz. 297 (2008).

One of the critical issues affecting the defense of construction defect cases is how to allocate the defense among the parties who owe the defense obligation. The options vary but most often the agreement is to split the defense by equal shares with the option to reallocate at the end of the case. Some of the parties press for allocation of defense to follow indemnity allocations. Some jurisdictions more strictly require participation in the defense by the carriers and do not allow any "gap" to be filled by the insured, such as Illinois.

III. How Attorneys & Claims Professionals Can Effectively Engage in Risk Transfer

Attorneys and claims professionals should endeavor to work as a team to fully evaluate the transfer of risk wherever and whenever possible. While there are some similar steps to be taken on any type of claim, the nuances and substance of each claim will present some key issue that will need to be identified and analyzed to ensure that your risk management team is exploring available risk transfer opportunities.

Tendering of Indemnity & Defense

An important consideration when it comes to proper tendering is to tendering is timing. Often, it is important to tender right away to any and all potentially implicated parties and insurers. Obviously, it is important to understand enough critical information to make an informed decision on which parties should receive tenders. It is not suggested to shotgun randomly to any party that was involved in the project. But, where there is good reason to suspect a party performed work that is potentially implicated, tenders should go out. There is typically no sanction for tendering to a party that ends up not being implicated. Tendering early is important for a variety of reasons, but particularly to trigger the defense obligation, whether on behalf of a carrier, or an implicated indemnitor. Waiting until a complete picture is developed may be too late, and can cause prejudice to the indemnitee, and its carriers.

Tender letters should include as much information as possible, such as:

a. The insured,
b. policy number,
c. claim number (if known),
d. a clear indication that the tender is a demand the defense and a demand for indemnification,
e. factual information about the project and claims asserted, timing of the work performed,
f. procedural status of the case,
g. copy of the operative contract,
h. copy of the Accord form if available,
i. a discussion related to the indemnity provisions in any contract,
j. relevant statutory and case law supporting your demand for defense and indemnity (may overlap with an additional insured tender as well. (See discussion below), and
k. a clear statement of relinquishment of control of the defense, if required by your venue.

The task of procuring the information needed to issue a tender and to support it can typically be done by researching client records, conversations with the insured, inquiring of a client's insurance broker, issuing interrogatories (see California Form Construction Defect Interrogatories), and through discovery if all else fails. Be aware that some states require tenders to be sent by certified mail. As with everything, knowledge of any special rules imposed by the respective jurisdiction is critical.

Although a state by state discussion is beyond the scope of this seminar material, as a general rule, it is important to include the basis on which a tender is based. For example, if the right is statutory, that should be specified. If the right is based on case law, a basic recitation of the case law is recommended. Obviously, the operative contract provision should be referenced, and a copy of the contract enclosed if possible. Because separate defense and indemnity rights exist with regard to an insurance carrier (additional insurance obligation) and a subcontractor (contractual or common law obligation), separate tenders are advisable to each. There are many situations where an indemnitee is entitled to defense by an AI carrier even where the indemnitor (that carrier's insured) is ultimately determined NOT to be responsible for the loss. Accordingly, each right should be separately tendered, and prosecuted, even if the AI obligation arises from, or relates to, an indemnity clause in a construction contract. In other words, the legal basis for a contractual and AI right might overlap, but the rights are ultimately different in most jurisdictions, and should be treated separately unless a particular jurisdiction sets forth otherwise.

Coverage Available

Generally speaking, it is important to have a solid understanding of what insurance policies exist and what contracts were entered into between the parties. These documents should be analyzed. At the outset of a claim, questions should be asked including:

Are there any other policies which may be triggered?
What are the remaining policy limits?
What other claims have been made on the policy?
Is it an eroding-limits policy?
What is covered under the policy?
Is it a wrap up policy?
Who are the insureds under the policy and are they in the claim?

These questions should be asked in any type of claim. For some specific areas of law, however, there are some interesting issues and questions to be examined further.

For example, in Product Liability cases, where there has been some but not aggressive pressures for risk transfer small efforts can have a large impact on the liability analysis. When looking up or down the chain of commerce at potentially responsible other parties, the opportunities to transfer the risk is critical. Part of the analysis is the viability of other parties in the chain and what insurance they have available.

In Construction Defect cases, due to the number of different parties, risk transfer often becomes more critical that some of the other legal and factual issues. Identifying the risk transfer issues and analyzing them early on is critical and complex. First, it is important to review again the legal standards to determine what rules on indemnity may apply, as well as the factual and statutory limitations against indemnification and insurance available to respond to the claims asserted. A further evaluation of the type of insurance available for the claim is important. In many construction projects, there are "wrap up" insurance policies which provide one insurance policy for the entire project. Counsel and claims professionals should be aware of and familiar with the details of the policy, especially a wrap up policy – which may preclude actively seeking indemnity from the other potentially responsible parties. Additional insured obligations and coverage in construction defect claims are also one of the key avenues of risk transfer and can present various issues including potential ethical issues for defense counsel.

In all types of claims, there are several key steps that both the claims professional and counsel should attempt to take. First, the availability of insurance coverage – what insurance is available? Be sure to carefully read the policies that may be applicable and have an understanding of the coverages and exclusions. Additionally, issuing tenders as early as possible is another key step. A timely letter regarding the claim, even before the claim is formally made, can assist in expediting risk transfer. Moreover, it is important to be aware of the erosion of limits as you develop your claim and case handling strategies; your claim management may be impacted by the type of coverage, the remaining limits and whether there is any viable indemnitor for the claim. For risk transfer issues, where the limits are eroding, an early attempt to transfer the risk is paramount. If there is a lack of sufficient insurance coverage, the ultimate exposure for the party may be larger.

All of these considerations are important to plan early on in the life of a claim. Risk transfer issues can be used to foster litigation management by effectively shifting liability to other parties or insurers but this analysis should occur at the outset. It is important to have a clear understanding of available risk transfer possibilities as the claim handling strategy may change claim-by-claim depending on risk transfer possibilities.