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Construction Destruction: How to Avoid Pitfalls for Carriers and Counsel While Handling Construction Defect Cases

I. Assignment/Coverage/ Counsel – A New Residential Construction Defect Cast

A. Assignment of Defense

Every construction defect case began as a claim or notice sent to a claim handler's email or inbox. One of the first determinations that must be made is a determination of a duty to defend under the Commercial General Liability (CGL) policy of the insured. A CGL policy is designed to protect an insured against certain losses arising out of business operations of the insured. CGL policies in general create two duties owed to the insured by the insurer: 1) a duty to defend and 2) a duty to indemnify. In a traditional CGL case the duty of the liability insurer to defend its insured is distinct from and broader than its duty to indemnify the insured Westport Insurance Corp. v. VN Hotel Group, LLC, 2012 WL 5262886 at 3 (11th Cir. 2012); Pennsylvania Lumbermans Mutual Insurance Co v. Ind. Lumbermans Mutual Insurance Company, 43 So. 3d 182 (Fla. 4th DCA 2010), Montrose Chemical Corp. v Superior Court 6 Cal.4th287 (Cal. 1993)

The jurisdiction your claim is in is critical to a carrier's analysis of its duty to defend. In many states, a liability insurer's duty to defend is controlled by the allegations in the complaint against the insured and the terms of the policies; the to duty extends even if the allegations may be factually incorrect or without merit SM Brickell Ltd. P'ship v. St. Paul Fire & Marine Insurance Company, 786 So. 2d 1204 (Fla. 3d DCA 2001). In others, the duty is triggered by the complaint, as well as all other information known to the insurer at the time of tender; thus, in those states, the duty to defend is triggered if any covered claim could be asserted based on those facts. Vandenberg v Superior Court 982 P.2d 229 (Cal. 1999)

In situations where only some of the allegations are covered, the insurer has a duty to defend the entire action at least until the covered claims are eliminated from the lawsuit Am Hardware Mutual Insurance Co v. Miami Leasing Rentals, Inc 362 So. 2d 28 (Fla. 3d DCA 1978) Buss v Superior Court 16 Cal.4th 35 (Cal. 1997)

B. Coverage Determination

An insurance policy is a contract and contract interpretation rules apply. The Florida Supreme Court in United Fire Insurance Company v. J.S.U.B Inc, 979 So. 2d 871 (Fla. 2007) cited the following in interpreting the CGL policies at issue: insurance contracts are construed according to their plain meaning, with any ambiguities construed against the insurer and in

favor of coverage. See Taurus Holdings Inc v. U.S. Fid. & Guar. Co, 913 So. 2d 528, 532 (Fla. 2005). In interpreting insurance policies, courts should reach each policy as a whole, endeavoring to give every position its full meaning and operative effect Auto Owners Insurance Co v. Anderson, 756 So. 2d 29, 34 (Fla. 2000); La Jolla Beach and Tennis Club v. Industrial Indemnity 9 Cal.4th 27, 37(Cal.1994)

Most typical CGL policies are occurrence policies. Occurrence policies provide coverage for bodily injury and property damage occurring during the policy period, regardless of when the claim is made. In contrast, claims-made CGL policies provide coverage for such claims only if they are made against the insured during the policy period, and cover "occurrences" that occurred after the retro-active date set in the policy. Most professional liability policies covering architects and engineers polices are also claims-made.

Once you have confirmed whether the policy is "occurrence" or "claims-made", the next step in any analysis is establishing whether the claimant is alleging damages caused by an "occurrence", defined in the ISO CGL policy as "an accident, including continuous or repeated exposure to substantially the same harmful general conditions." In the context of Construction Defect litigation, the claim handler must determine: (1) when was the work performed (to determine if that work could have caused damage during the policy period; (2) based on the nature of the claim, does the policy have an exclusion (either in the policy form or by endorsement) that applies – for example an exclusion for damage to residential property.

In most states, the burden is on the insured to establish that the alleged claims are at least potentially covered by the policy, i.e. within the terms of the insuring agreement. The burden then shifts to the insurer to establish that an exclusion or policy limitation applies. See e.g., Aydin v First State Ins. Co. 18 Cal. 4th 1183, 959 P.2d 1213(Cal.1998) The claim handler is wise to keep these burdens in mind, when lawsuits allege claims that questionably trigger the defense duty.

C. Additional Insured Status

In large construction defect cases, the general contractor will likely have required subcontractors to procure additional insured (AI) coverage during the construction, and some require coverage to be obtained for years following it. There are various benefits to being an additional insured: (1) an AI becomes an insured under the subcontractor's policy, with direct rights to demand defense and indemnity from that carrier, (2) the AI coverage increases available limits of insurance to the general contractor (GC), and (3) once an AI carrier is defending, the leverage to negotiate a settlement of the claims by the GC is increased.

A party obtains AI status in one of two ways. The first is having an endorsement issued by the subcontractor's carrier naming the GC on the policy. The other is referred to as a "blanket" additional insured, and automatically makes the GC an insured on the subcontractor's policy if the subcontractor is obligated to obtain that coverage in a written contract. Regardless of which way status is obtained, the additional insured coverage will be limited to liability relating either to the "work", "ongoing operations" or "completed operations" of the named insured subcontractor. Overall, if AI coverage is provided by each subcontractor, there is a layer of coverage by the subcontractors for the GC before its own coverage is implicated. Significantly, successful risk transfer depends on obtaining this coverage from each subcontractor, and, on

the language of the indemnity language in each subcontractor, which contractually obligates each subcontractor to assume risk relating to its work

D. Reservation of Rights

Assuming that the carrier accepts the defense, but it appears that some of the claims may ultimately not be covered, depending on the outcome of the litigation, a carrier is said agree to defend "under a reservation of rights". When an insurer reserves its right to deny coverage, the insurer is not denying coverage. However, in order for the insurer to effectively reserve its rights, the reservation of rights letter communication should clearly, adequately and accurately inform the insured of the insurer's coverage position. Windt, A,; Insurance Claims and Coverage Disputes, 5th Ed., Sec. 3:14 (Thompson West 2007). Be mindful that in some states, the carrier's reservation of rights is the carrier's position, a failure to raise a potential coverage defense is a waiver of the right to raise it later. Other states do not follow this "raise it or lose it" approach.

E. Assignment of Defense Counsel

Once a duty to defend has been determined to exist, the claims handler must assign defense counsel. While states vary to some degree, under Florida law, an insured is not required to accept the defense offered by an insurer under a reservation of rights. Rather the insured can reject the defense and select counsel of its own choosing without jeopardizing its right to seek indemnification and/or recoupment of its defense costs from the insurer. Bell South Communications Inc v. Church & Tower of Florida,Inc., 930 So. 2d 668 (Fla. 3d DCA 2006). In others, such as Washington and Colorado, the carrier has the right to appoint counsel, since those states find that the lawyer's only client is the insured. In California, the insured *may* have a right to independent counsel paid for by the insurer, if the reservation of rights involves a coverage issue that can be controlled by the manner in which the defense is handled. (Cal Civ. Code Sec. 2860(b))

II. Investigation/Discovery/Reporting

A. Investigation by Claims of the Residential Construction Defect Case

The residential construction defect claim is somewhat different from a "commercial" one. First, there are often "right to repair" laws applicable to construction defect claims that must be strictly followed. It is therefore important to choose counsel familiar with these laws. Second, the parties making claim may be individual homeowners, or an association that is the actual owner of the construction. Third, given the similarities between the different buildings or units, it is common to "extrapolate" or "unit cost" the defects and apply that to all the units in the lawsuit.

As with all construction defect lawsuits, however, the starting point is the insured and its job file. Counsel should obtain the file to ascertain the critical aspects of the evaluation: (1) what was the insured's trade, (2) what was the insured's scope of work – how many units, and what exactly did it do in relationship to other potentially overlapping trades.

The Carrier should also investigate the other insurers on the risk. Most states follow some version of the continuous injury trigger of coverage where multiple carriers are implicated when the damages occur over time from the time of construction to the date of the discovery and/or repair. It is not unusual to have several co-insurers. Each insurer may in fact have assigned separate counsel, and it is not unheard of in western states to have multiple defense counsel for a single subcontractor. The carrier should, however, investigate and then begin the process of determining a fair allocation of defense and indemnity dollars.

B. Discovery and Mediation

Discovery, whether for trial or settlement evaluation generally requires information on the following key facts: (1) when was the work performed, (2) what work was performed and how much of it (number of units/buildings), (3) what is defective about the work, (4) what damages resulted from the defective work, (5) what is the cost of repair of the defective work, (6) what is the cost to the GC or claimant to investigate and determine the damage and (1) through (5) above, and (7) is there any other liability concern like joint and several liability or an insolvent co-defendant that may influence the ultimate liability exposure.

Many states in the west have started using the concept of mediation as a tool to lower the litigation cost. A Case Management Order, or CMO, will provide how documents are to be exchanged, inspections are to be arranged and other management issues. Significantly, however, the CMO may stay formal discovery, and provide that the exchange of information will be in the context of mediation, that continues from the initial assignment to the resolution of the case. While mediation may be less expensive than formal "code" discovery, it is not without its drawbacks. First, most states have a comprehensive mediation protection, so that all materials exchanged between the parties during mediation are protected, except documents, photos and other evidence that wouldn't be protected in any event. However, the lawyer and the claims person need to be cognizant of whether evidence is being obtained that can be verified and, to the extent it favors your insured's position, can be used at trial or, in the event there is subsequent litigation, to support your claim against a non-participant.

Whether information is exchanged through formal discovery or mediation, however, the methods of obtaining it generally falls into the following broad categories: (1) Document exchange (job files, insurance information), (2) plaintiff's statement of claims, (3) visual inspections, (4) destructive testing, (5) Person Most Knowledgeable depositions of the parties, and (6) expert reports and depositions.

Once sufficient information is exchanged the parties then will proceed to mediation before the high cost of depositions and especially expert depositions is incurred. The Plaintiff has an incentive to keep the costs down and, presumably the defense has an incentive to avoid those same costs, creating an environment where compromise may be possible.

C. Reporting

Reporting is complicated in a Construction Defect lawsuit. In a situation where the insured is a small subcontractor, and the carrier has experience with the mediator to get an

early exit from the lawsuit for nuisance sums; thorough investigation/discovery and reporting may cost more than the settlement value identified as soon as the file is opened. While recognizing that this situation exists, however, some generalities regarding reporting in construction defect litigation exist.

First, the focus is on the damages that COULD be awarded against the insured, the damages that are EQUITABLY ALLOCATED to the insured, and the timing and nature of the damage claims so the carriers can do their analysis of: (1) retention satisfaction (SIR/Deductibles), (2) time on the risk and participating carriers, and (3) uncovered damages. At the same time, the reporting must advise whether and what defenses might be available that would affect any of those damage claims.

Second, the reporting must clarify the source of the information. This is particularly true in western states where mediation and the CMO process is prevalent. Is the information reported on "evidence", e.g. verified discovery and authenticated documents? Or, is the information "allegations", e.g. mediation protected expert statements, statements of damages, and counsel allegations concerning proof at trial.

Third, the reporting must be timely. Defense counsel's report is the first, not the last, piece of information used by carriers and insureds to derive settlement strategies. It is rare in all but the smallest participants, that information obtained during the mediation can be used to influence the money that can be paid in any significant way. Furthermore, the information in the reporting must be neutral and complete, as that information will be used to negotiate allocation between the carriers, determine the proper retention (s) that should be paid by the insured, and to discuss coverage limitations and potential contribution from the insured.

III. Multiple Carriers

One facet of construction defect litigation is the presence of multiple carriers for even the smallest participant. In many cases, carriers each hire defense counsel for the insured, creating numerous challenges. It requires constant communications between counsel, and can lead to discord over evaluation and settlement, especially if counsel chooses to report only to the carrier that hired him/her. One example may be a different settlement evaluation, which can make allocation and the respective contributions of the carriers more difficult. Another problem is where one of the insurers is willing to offer "its share" and counsel effectively is handicapped from advocating for the insured for a settlement because "his carrier" has offered "its share". Functionally, the defense attorney becomes more like an adjuster than a lawyer for the insured. Clearly this is what can happen and what *has* happened where multiple counsel are hired, but it is not a blanket statement that it will happen when counsel are aware.

Often times the decision to hire multiple counsel is rooted in the notion that another carrier's choice of counsel will not follow the preferred litigation guidelines, and can in some instances advocate for the carrier that hired him/her in the reporting, evaluation and settlement process. The reaction to that scenario, especially when the carriers understand that they will be funding the settlement, is to each hire their own.

As for the ultimate settlement, the general rule is that the carriers "on the risk" should share equitably. There are many different ways to share the cost of defense and indemnity, including:

(1) equal shares – on the theory that each carrier would have to defend entirely, so it is fair that since the facts are not fully understood that an equal share is borne by all, (2) time on the risk – the carrier that covers "the risk" for more time when damage occurred should bear a larger share of the total, (3) by limits – on the theory that a carrier that was paid for higher limits, and has more at risk should pay a greater share.

IV. Mediation

Ultimately, the case will proceed to mediation, before the final ramp up for trial. A mediation is a voluntary process, where the parties set aside the formal positions and have confidential discussions to determine if a settlement of the dispute is feasible.

Usually, the mediator is a lawyer or retired judge experienced in construction disputes. The accepted role of the mediator is a facilitator of discussions and exchange of information regarding the strengths and weaknesses of the case for each party. However, one significant issue that can arise is where the mediator is simultaneously cloaked in judicial authority. At first, it seems logical that a person hearing the case management and resolving discovery disputes is logical to try and resolve the case. However, consider this: there is an inherent conflict that should be considered. Will this mediator, if the case does not settle, be deciding your motion for protective order or other discovery dispute, and will that leverage be used to seek more money from you (or your client)? In Federal Court, the special master, as they are called, can decide substantive motions as well, so the choice of mediator is important.

While mediation is positive, there are other negatives and lessons to be learned that will be discussed in more detail during the presentation, but those include:

1. If the information was not forthcoming during the exchange period (mediation or discovery), then how is the carrier to evaluate – what assumptions are reasonable? What assumptions regarding liability and damages are unreasonable and should be verified before authority is extended?
2. Mediators are interested in a settlement. The perceived settlement target by a plaintiff rather than the liability and exposure driving the defendants' exposure create expectations by the mediator of your "fair share". The process can become divorced from the reasons to extend settlement authority: the liability and damages reasonably awarded against the subcontractors.
3. The confidentiality of mediation may prevent any reasonable ability to fund a settlement and pursue recalcitrant carriers, as the evidence necessary to do so may be unavailable.
4. There may be significant allocation problems and uncovered damages sought in the lawsuit that must be addressed before any "final" session of a mediation, and the inability to do so efficiently can result in drawing out the process.

V. Best Practices Tips

First, know your jurisdiction. It will drive the decision of whether to defend and what information you should review. It will also influence the number of other carriers that may be participating and the right and ability to enforce coverage limitations.

Second, choose counsel that understands the jurisdiction and the unique issues in construction defect litigation. Be clear on the information you want from defense counsel in reports, and discuss how/whether such information is reasonably available and the cost of obtaining that information. Be sure that reporting is clear as to evidence and mediation protected statements and reports.

Third, be sure to understand the total potential exposure, the equitable allocation, and the indemnity potential when evaluating settlement. Is this an "all sums" state that could make any carrier liable for the entire amount if the case proceeds to trial and has a negative result? Know your exposure for the "total incurred", defense/Supplementary Payments and indemnity.

Fourth, before funding and chasing, calculate the cost of any subsequent litigation in the event of a recalcitrant co-carrier or party that could be sued for subrogation. Can the plaintiff's allegations, claims presented, the likely outcome if settlement is not made be admitted in the subsequent case.