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London and Bermuda Market Claims:
Insurer, General Contractor and Broker Perspectives

I. Construction Policies in Bermuda

Background to the Bermuda Market

The Bermuda Market was formed in the late eighties to provide excess market capacity in response to the crisis in the industry created by long-tail exposures triggering multiple occurrence policies. ACE and XL were the first two companies established – they created their own policy form with a new coverage trigger - occurrence-reported. These Bermudian insurers originally operated as mutual-type companies where Fortune 500 companies could buy into the company and, therefore, have the opportunity to purchase excess liability insurance.

The Bermuda Market has developed over the years and ACE (Chubb) and XL are no longer mutual companies. There are now about 20 other excess carriers on the island offering capacity. Different policy forms are used – occurrence, claims made, as well as occurrence-reported. More companies are coming to Bermuda to procure insurance – typically Fortune 1000 corporations.

Overview and General Features

Typically,_the Bermuda Market insures Fortune 1000 companies including developers and product manufacturers. Most products are excess policies with a minimum underlying or retention of $5M. The coverage is for damages on account of personal injury, property damage and/or advertising liability. Defense costs almost always erode the policy limits.

Unique Features

The unique features of Bermuda policies initially address the coverage trigger, either occurrence or occurrence-reported. The traditional occurrence trigger is usually in policies insuring developers, while the occurrence-reported trigger is used for product manufacturers.
The occurrence -reported trigger requires that occurrence must take place and be reported during the policy period.

The Integrated Occurrence as a defined term is a unique batching mechanism in these policies. The Integrated Occurrence wording allows for prospective claims beyond the policy period to be batched into the policy where the option to declare an Integrated Occurrence is exercised.

The Bermuda policies affirmatively provide coverage for punitive damages as part of the definition of "damages". Insureds often come to the Bermuda Market in particular seeking this type of cover. In the US, some states prohibit coverage for punitive damages on the basis that it is against public policy. We should note, however, that under the Bermuda policies there is no coverage for civil or criminal fines and penalties.

Another significant and unique feature of the Bermuda Market policies is the inclusion of a modified New York choice of law provision. The policy is governed by New York law except insofar as such laws:

Prohibit coverage for punitive damages;
Pertain to NY Insurance Law regulations;
Are inconsistent with the policy provisions.

Under New York law the policy must be construed in an "evenhanded fashion" and interpreted according to the provisions of the policy and without regard to "reasonable expectations" of either party or to *contra proferentum* or parol evidence.

A discussion of unique features of Bermuda policies requires comment on the London Arbitration Clause which mandates that all coverage disputes under the policy be resolved by London arbitration. Bermuda insurers do not and can not litigate in the US for tax and regulatory reasons. Thus, the policies include a London (or sometimes Bermuda or Toronto) arbitration clause. English rules of civil procedure apply to the arbitration itself. In the arbitration proceeding, disputes are decided by a panel of 3 arbitrators – 2 party-appointed and 1 chair. Under the evidentiary rules direct testimony is provided through fact or expert witness statements and cross examination only happens at the hearing. The arbitration proceedings do not allow for depositions or interrogatories. Interestingly, arbitrations are confidential and the results cannot be used as precedent in future cases. Critically, English procedural law grants the Tribunal the power to direct the losing party to pay the legal fees and costs of the prevailing party.

Examples of Construction Defect Claims in the Bermuda Market

The unique features of the Bermuda Market policy have to potential to impact a construction defect claim at critical points in the litigation. Consider the claim against a Developer who buys a complex in California and converts it into condominiums and commercial space in 2007 and begins selling the units and continues to sell them today. In 2012, the homeowners' association becomes aware of 39 defects for the project and commences legal proceedings and the damages estimate is between $5 and $10M. In our example the Bermuda company insures the Developer with a $5M xs $5M xs $100K SIR policy which contains a 10 year completed operations period.

The Developer enters into ad hoc agreements with the HOA to fix certain issues. Between those costs and the payment of defense fees, the SIR and first $5M are exhausted, resulting in the Bermuda insurer paying costs on a going forward basis, which are eroding the policy. At this point the Bermuda insurer might negotiate a discount on costs to account for various coverage defenses under the policy language and New York law. At issue, by way of example, would be whether certain requests for reimbursement properly arise out of an "occurrence" or "property damage"; or whether the owned property exclusion applies to preclude coverage for the units not yet sold and still owned by the insured

Mid-way through the case it is discovered that there is Other Insurance in play but that Domestic Insurance Carrier B is refusing to share in the defense costs and indemnity payments. Since a declaratory judgment action is not an option for the Bermuda insurer, the Bermuda insurer may commence arbitration proceedings against the Insured in order to force the Insured's hand in pursuing the Other Insurance from the Domestic Carrier. While the Bermuda insurer can rely on New York law, the Domestic Carrier might be subject to California law under its policy. Thus, the Insured might find itself in a situation where it is litigating with the Domestic Carrier in California and arbitrating with the Bermuda insurer in London.

An alternative example involves a Product Manufacturer, a subsidiary of a large Fortune 1000 company which manufacturers a tile mortar product and advertised it as being a crack suppressant. The product was used on tile flooring in thousands of homes and cracking in the tiles occurred when the product did not function as intended. Not surprisingly lawsuits are filed in different states, including at least one class action filed on behalf of homeowners whose floors were cracked as a result of the product not working as intended. Over 2000 homes were built using this product and the product is still in use. The lawsuits allege claims for product liability, negligence, breach of warranty, breach of contract, fraud and seek punitive damages.

The Bermuda carrier insures the parent company for $25M xs $100M on an occurrence-reported basis. There is a 1 January 1986 retro date and 1 January 2013 warranty date on the policy. The total tower of insurance might be $500M.

The Insured declares an "Integrated Occurrence" in the 2014 policy year, which purports to batch all product liability claims known or unknown related to the development, manufacture, sale or distribution of this product. The Bermuda carrier will reserve on whether such a broad batch properly constitutes an integrated occurrence, as well as other provisions in the policy.

The insured hires very expensive defense counsel as national litigation counsel for these cases. There may be an MDL to consolidate or the national counsel may fight the cases on multiple fronts. Either way, the defense costs potentially will be millions and millions of dollars. Those costs will erode the underlying layers of insurance.

If a coverage dispute arises, for example, if the Insured enters into a global settlement for $200M and does not consult its insurers, or the Insured is seeking reimbursement for uncovered claims, the coverage action will likely be arbitrated in London or Bermuda according to English rules of civil procedure and applying New York law. Often the timing of the decision

to arbitrate is driven by when the actual coverage issue has been become ripe through an action or payment by the Insured.

II. <u>London Market and Construction Policies</u>

History of the London Market

Many are familiar with the origin of Lloyd's in a coffee shop in the City of London in 1688. The perils of navigation that could result in a total loss if a shipping vessel floundered and sank spawned an insurance subscription market in that coffee shop which met the ship owner's need to insure against such risks by spreading them among the subscribing "underwriters" on a slip of insurance. Driven initially by maritime risks, the Lloyd's syndicates began as an amalgamation of capital pledges by individual investors, called "names," under a syndicate registered at Lloyd's. A lead underwriter determined the appropriate premium to protect the value of the vessel from the perils of the sea (hull insurance), or for the value of the cargo during the voyage (cargo insurance), and agreed to a percentage of the risk that syndicate would insure. The broker would then fill up the remainder of the slip by meeting with following underwriters from other syndicates who would agree to the slip conditions and premium, until the risk was 100 percent insured.

Lloyd's became known as an international insurance market extending well beyond the boundaries of the British Empire, and developed a reputation for insuring difficult or unusual risks. As investors, the individual "names" each pledged their wealth and assets as collateral, down to their cuff links, as legend had it. There was no limited liability. Side by side with Lloyd's syndicates traditional insurance companies existed, with stockholders having limited liability, as the corporate entity had its own balance sheet. Policies subscribed to by Lloyd's underwriters, may also have had London insurance companies as co-subscribers, thus spreading the risk between the two different models with identical but separate Lloyd's and London Companies policies, and with each model having subscribing interests.

To protect the spread of the risk, each subscribing underwriter or London Company on an insurance policy had several and not joint interest. The foundation of the investment model for this type of insurance product was severability of interests, "each for their own and not for the other." If a syndicate had a five percent interest in the policy, and the total indemnity payment was $100,000, that syndicate was only required to pay 5 percent of the loss, or $5,000. Severability of interests caused difficulties when a subscribing London Company became insolvent which we will discuss in the next section.

The names in a Lloyd's syndicate could reorganize on an annual, bi- or tri-annual basis, and as such there was a process in place to buy off the names who were stepping away as investors in the syndicate. Essentially the syndicate conducted an evaluation of risks and reserves to achieve a reinsurance to close figure for those names dropping out, and that figure was paid by the existing names to the reorganized names for the forward going year. The losses

from the risks were then passed on to the new group of investing names. Beginning in the 1980's, the names of syndicates confronted significant loss problems with continuous trigger environmental and construction defect claims, as the last person holding the bag had effectively bought the prior year's exposure.

With so many policies having different subscribing insurers, a system to handle the claims needed to be established. To whom was the claim to be reported, and how was everyone on the slip notified of a claim? Who had the authority to settle the claim, and how was the claim to be collected and paid? Over time a claims scheme developed in which authority was ceded to the leading underwriter, and sometimes a second leading underwriter on the slip to make decisions on the claims. The remainder of the slip was notified usually by the broker, but was not involved in the day-to- day claims handling. The second pair of eyes approach has been in place for quite some time though in different variations. At some points in history, the entire following market hired a representative to address the claim, and this would be the second agreement party on the slip. Today there is still a claims protocol in place to handle the subscription market. The exclusive London broker is the hub for product placement, claims reporting, and policy payment collections.

There has been varied construction liability risks historically placed in the London Market. Typically, the excess market provided a tower of insurance for substantial civil, infrastructure, and energy projects throughout the world. The protection here was for catastrophic losses such as the Deep Water Horizon incident. In the 1960's and 70's, however, many London insurers provided products with lower attachment points, either through direct primary policies, or binding authority on agreed wordings with Managing General Agents (MGU), or through reinsurance of domestic primary policies. These policies were often written on standard comprehensive general liability wordings including ISO forms, with some manuscript wordings.

The Primary Construction Policy and the Perfect Storm

Beginning in the 1980's, the marine sector of the London Market began writing CGL primary policies issued to contractors in the United States. The policies reflected an 11/85 broad form additional insured coverage with language to the effect, "Additional Insured coverage where required by contract automatically included." This language arguably allows for Additional Insured coverage based upon an oral agreement. Many policies were written with a ten year completed operations tail to coincide with the construction defect statute of limitations in California. The construction defect claims began rolling in. The claims were direct against the Named Insureds whether general contractors or subcontractors, and the developers and general contractors as Additional Insureds lined up their tenders of defense. The claims response was to address both coverage and claim value. The insurers hired coverage counsel and the battle was fought over whether there was an occurrence, when there was an occurrence, property damage, and whether the business risk exclusions applied. Rights were reserved and *Cumis* counsel stepped in with high rates. On the duty to defend side of the equation, the *Montrose*

decision confirmed continuous trigger and pro-rata time on risk exposures established in environmental pollution cases. Attachment for indemnity on some policies surprisingly started at dollar one when the courts held that the payment of one deductible under one policy satisfied the deductible requirement under other polices being continuously triggered. Frequently the London Market insurers tried to get out of the litigation, but resignation set in as the mediation process began with no quick, fair, or efficient resolution in sight.

Simultaneously, the asbestos and pollution exposures were suffocating the London Market. Historic London Company insurers with long tail pollution exposures became insolvent. Due to severability of interests, this left a hole in the coverage in the pollution policies, as well as the construction policies in which they took a subscribing interest. Some Named Insureds which had an indemnity agreement exposure to the developer or general contractor would make a claim for separate coverage under the contractual liability coverage to trigger a payment of the gap less the one or two insolvent subscribing interests.

The Lloyd's response to the crises was different than the company insurers who had limited liability. At Lloyd's syndicates, the underwriting of certain risks ceased. Cash calls were required of the names; many individuals liquidated assets or went bankrupt. To release the burden of the long tail exposures that were threatening the viability of syndicates to trade forward, Equitas was established to ring fence all liabilities before 1992 for all syndicates. The funding was calculated, paid and the syndicates moved forward. With respect to syndicate organization, corporate capital with limited liability was permitted as an investment tool underwriting Lloyd's syndicates.

Significantly, every Lloyd's claim on behalf of insureds was paid during this time including those ring fenced claims placed into Equitas. This stability is a feature of the London Market's enduring competitive position. Free from the long tail claim exposures, the London Market remained in the construction insurance sector, embracing insuring construction defect claims, but with policy wordings that provided certain protections.

The London Insurer Response – Wordings to Define the Boundaries of Coverage

The London Market sought to define and limit the scope of coverage from construction defect claims. The wordings focused on three primary concerns: continuous trigger, unenforceability of deductibles, and limited additional insured coverage.

Anti-*Montrose* exclusions were already being explored by the domestic insurer market. In many of the London Market policy forms, the solution to paying for homes constructed and completed before policy inception was the inclusion of the Prior Works Exclusion. The idea of insuring the contractor's conduct performed during the policy period was consistent with the movement over the last 15 years of true comparative negligence where one's liability or indemnity had a reasonable link to culpability and insurance for that culpability. A typical Prior Works Exclusion provides:

> This Insurance does not apply to “property damage”, “personal injury” or medical payments arising out of “your work” performed prior to 1 January 2010.

The London Market claims handling then focused on when the work was performed by the insured. This led to the Close of Escrow as a hard date for the completion of work, a red line where if a home is built and sold before policy inception, the Prior Works Exclusion barred coverage. With continuous trigger risks now excluded on the front end, the universe of claims is limited to construction defects from building performed by the insured during the policy period.

The second response was to establish a self-insured retention as a pre-condition to any policy obligations that could be eroded by defense fees, but only those fees paid by the Named Insured. An example of wordings reads:

> The limits of insurance stated in the declarations shall apply in excess of the Self-Insured Retention…as the Named Insured agrees to assume the Self-Insured Retention.
>
> Our obligation under this policy applies only to the amount in excess of the Self-Insured Retention.
>
> Payment of the Self-Insured Retention is solely the responsibility of the Named Insured and may not be delegated to any other person whether or not an insured under this Insurance.
>
> This insurance (defense and indemnity) shall not take the place of any Self-Insured Retention which is or becomes invalid, uncollectible or otherwise unavailable due to the Insolvency of any Insured.

These wordings reflect an underlying objective of the Named Insured remaining involved in resolving the claim since it has first dollar skin in the game. The SIR protects against the inability to collect of a deductible from an insolvent insured, and requires that the SIR be paid with respect to occurrences covered under the policy, which obviously are not occurrences excluded by the Prior Works Exclusion.

The third response was to limit additional insured coverage for developers to claims arising from the Named Insured’s ongoing operations. No longer is there broad form additional insured coverage.

The claims handling then focused on valuing those defects from work during the policy period, and valuing those defects that caused property damage to resolve the case.

The New Frontier of Partnership Policies

Many developers and general contractors have decided to control the risk and resolution of construction defect claims at an early stage by purchasing project specific OCIPs or a rolling CCIP, into which certain projects are placed through out the year. The key features of these policies, either written by the London Market, or reinsured by the London Market, are relatively high self insured retentions. With those retentions in place, the insured has an incentive to control the job site, or to manage the claim to minimize the exposure, and create profitability. Here the claims vendors take on a communication role and risk analysis for the London Market insurers at their respective attachment points.

With the purchase of the risk with a high self-insured retention by the insured, the policies are now being modified to fully accept construction defect as an occurrence, and Exclusions k, l, a portion of m, are being deleted. To prevent finger pointing between design and construction insurers over the cause of the accident, some London products now offer a policy with combined coverage. Because the reality of certain construction projects includes design build obligations, this trend is likely to increase in the future.

One of the most interest products offered is a Construction Coverage that insures all warranty issues over a certain time period above a certain aggregated Self-Insured Retention. The triggers are a warranty claim at the project made within certain time parameters. Gone are the issues of an occurrence, property damage, the applicability of exclusions. The claims process here is to verify the qualifying triggers, and appropriate SIR erosion.

III. The General Contractor's Perspective

Objectives and the International Market

As an international developer, construction manager and general contractor, our insurance needs are varied by the roles we play, and by the diversity of projects. Thus we need and we require a substantial tower for protection which draws us into the international market.

Our objectives are two fold. We buy insurance to insulate risk and protect the company. Our second objective in insurance has changed over the years. Insurance used to be a line item on the expense side of the ledger. But the costs continued to rise as we build in favorable plaintiff jurisdictions for both personal injury matters, and construction defects. With the claims value increasing and the premiums escalating we looked at risk management differently. We decided to control the risk at the primary policy level with CCIP's, take a high self insured retention, and generate revenue through claims control.

The CCIP as Contractor's Risk Management Tool

The CCIP eliminates the cost of insurance to the subcontractors as we purchase insurance on their behalf. With the money we no longer have to pay, we purchase a rolling CCIP

into which we place projects across the country except for California. California has its own CCIP which will be addressed in a moment. The key to generating revenue is first through a culture of safety. If the project is built with safety as a value, then there are fewer incidents and losses are minimized. The buy in for safety is top down, a leadership issue. Subcontractor buy in is essential in our business partnerships, and those who agree to safety and execute their responsibilities are rewarded. The risk is controlled on the front end by safety.

If an accident does occur, the SIR allows us to control the risk through claims handling and selection of vendors. The vendors include first responder medical treatment at the site, nurse case managers, investigators, workers' compensation adjusters and the defense counsel. All must understand our business, and that it is our nickel being spent. Critical to loss management is appropriate medical treatment and a return to work, the latter we require in our contracts from our subcontractors. Post accident drug testing is negotiated and required from the respective unions.

The details of the risk management directly impact our insurer partnerships. When we are controlling the risk at the bottom of the tower, we need insurers who understand our business, appreciate the policy on safety and the expertise of those who manage and handle the claims. Those insurers must be confident in our ability to manage safety, in our selection of subcontractors who have the talent and expertise, in our selection of vendors, and in ability to defend claims to a reasonable value. Our CCIP tower is now in a strong partnership with the international insurance market. Currently we are running CCIP V. Apart from our domestic first layer the tower is completely overseas. In a matter of 9 years we have moved from a 100 percent domestic tower of up to $100M, to a tower that is now predominately international. When we go to market, the London and Bermuda markets compete for our business.

As to California, the CCIP is uniquely driven by the construction defect completed operations exposure. A different CCIP insurer is needed who understands the CD world. Here the insurer wants to vet our Quality Assurance and Quality Control programs for excellence in construction methods. We needed to be pre qualified. The insurer independently reviews construction methods, procedures and performance before and during construction. Here the Self Insured Retention is lower, and we have a tower of both domestic and London Market insurers who have an appetite for the construction defect risk.

Partnerships are the Future

As we have placed our CCIP and corporate practice insurance towers in the international market, we have discovered that market is a strong model for partnership in addressing risks of a large construction company. That market is built on relationships between us, the broker, and the insurers. The underwriters are personally familiar with our business and executives. We have a mutual interest in minimizing risk, such that our perspective is that addressing risk placement and claims handling requires an insurer/insured partnership team. We understand that we cannot build without someone taking and spreading the risk. We are willing to pay for that. We also need the loss to be paid if that loss contingency comes to fruition.

Relationships eliminate coverage disputes. As underwriters know us and are familiar with our business practices, the international market has demonstrated flexibility in insuring unique and special projects. The flexibility and timeliness of this market contributes to our competitive advantage, especially if we have foreign construction needs.

We have had some bumps along the road. Most in the construction industry have stories concerning tedious coverage disputes that lead to delays in getting the construction defects fixed. The delay usually increases the cost to resolve; but we will advocate for our position if necessary. We can say, however, that in addressing a recent hurricane loss, the partnership worked and we were proactive in repairing the damage.

IV. <u>The Broker as the Bridge</u>

Anticipating the Trap Doors – It's All About Policy Wordings

As a construction broker for an international brokerage firm, one is in a unique position of interfacing with the insurers when placing the risk for the client. The broker builds a relationship with the insurer to communicate insurance needs and expectations. Key to this relationship is advocacy for the insured at placement, and at the claims process when claims need to accepted and paid. While acting as a bridge, the fiduciary responsibility remains to the client.

Regardless of good intentions, the wordings of the policy must be consistent with the expectations of coverage by both the insurer and insured. Inconsistent expectations about the scope of coverage must be identified and resolved or accepted. Wordings that negate coverage in an unanticipated way can be described as trap doors. At times the trap doors open when there is a conflict over the trigger of the loss under various policies in existence at the time of the loss. Each type of policy involved in a construction project has a different coverage trigger; thus familiarity with a CGL form, the Complete Operations coverage in that form, Builders Risk, Sub Guard, Surety and even first party property policies is essential. Is the occurrence during active construction, or subsequent to the course of construction? Is it damage to the work of construction during construction? Was damage caused by failure of performance?

Understanding Owner/Developer/Contractor Coverage Required

The best time to address the trap doors negating coverage is at placement. What is the coverage required by the client, and are the policy wordings appropriately selected? The traditional CGL policy anticipates the sale of a housing unit to a third party, yet the j(2) exclusion for property damage to premises you sell may be implicated in Completed Operations claims. If the Developer or Owner is remodeling existing housing with no intention to sell, exclusion j(1) may impact the coverage. Due to economic conditions the sale may be delayed, or rentals are initiated with condominium conversion deferred. In the construction defect context, the application of j(6) is essentially eliminated, but is it with the additional limitations in Exclusion k and l? The view here is that Developers and Contractors expert construction defect coverage, and the elimination of Exclusion k and l is the most straightforward resolution of achieving an understanding on intent.

International Excess Markets

Often the London and Bermuda Markets are follow form of either an underlying primary policy or a Lead Underlying Policy. The key focus is to ensure consistency of policy wordings between the primary and excess, especially if the excess policy has some stand alone wordings. Potential conflict can occur when the client handles a claim within a large SIR and when that claim burns through the SIR, the excess insurer coverage is restrictive. This results in the excess insurer disputing erosion of the SIR and the scope of coverage available to resolve the claim. This often calls for a face to face meeting to work through the unanticipated claim on the policy to achieve coverage consistent with pre-placement expectations.