



## **2021 CLM Construction Conference**

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### **Through the Looking Glass How to Handle “Creative” Insurance Arguments in Construction Defect Cases**

#### **I. Where is the Money?**

No one likes to get sued. Defense fees and costs, settlement payments, and judgments take money out of somebody’s pocket. Not surprisingly, some individuals or companies that have an obligation to pay such expenses will try to avoid making those payments.

In most significant construction projects, the involved parties have entered construction contracts and insurance policies that, if done right, provide an orderly assignment of risks, often based on which party should bear liability. But this often-complex web of agreements and insurance policies may lead to opportunities for those who should bear certain expenses to try to pass their obligations to someone else. The claims professional must ensure that his or her company does not pay for something it should not.

#### **A. Parties to a Construction Defect Action**

Step one for the claims professional is to understand the parties to the construction defect action. The developer owns the property and usually hires an architect to design the project and a general contractor to build it. The developer finances the project and usually will not so much as pick up a hammer.

The general contractor oversees the building of the project. Usually, the general contractor will enter subcontracts with trades—e.g., concrete, carpenters, roofers, etc.—who will perform the actual work on the project. The general contractor, however, may itself perform construction work. As discussed below, who performs the actual work has implications regarding who might bear the risk contractually and for insurance.

## **B. Key Documents and Provisions**

Construction contracts provide the roadmap for which parties are responsible for the various aspects of the project. These construction contracts often include provisions that dictate which parties should—or are intended—to bear risk for potential liability arising from the construction. Indemnity provisions often require a party that performs the work to defend and hold harmless the other for any liability that arises from that former's acts or omissions. Insurance requirement provisions may dictate the types and amounts of insurance coverage the parties to the contract should carry. For construction defect cases, the key type of insurance is usually commercial general liability insurance. Such policies provide liability coverage for property damage and bodily injury that arises from the named insured's work. The contract may dictate that the policies be written on certain forms, that they provide a certain specified scope of coverage, and that the policy may not exclude certain risks. The contract may require that one party's insurance name the other party as an additional insured on the former's insurance policies and may specify the form on which such additional insurance must be written to ensure that the scope of the additional insurance is sufficient.

The insurance policies that each party involved in a construction project carries are vital to determining who will ultimately pay for any liability arising from construction. A construction project may be covered by an owner controlled or contractor-controlled insurance program, or wrap. Under such programs, the contractor and the subcontractors must participate in order to be entitled to coverage. Usually, where a wrap exists, the wrap carrier is expected to address all liability questions. But issues may arise if a subcontractor does not participate. This is especially true where the non-participating subcontractor's own insurance may exclude coverage where wrap coverage exists.

If the program does not have a wrap, most entities involved in a construction project will have their own commercial general liability insurance. Those policies will provide liability insurance to their named insureds. But the policies may also contain additional insured endorsements that extend coverage to individuals or entities specified on an additional insured endorsement. Alternatively, the additional insured endorsement may add additional insureds "where required by written contract." That type of additional insured endorsement is called a "blanket." To determine who qualifies as an additional insured under a blanket, the insurer must refer to the construction contracts entered by its named insured to see if the named insured agreed to provide additional insurance to other parties.

If an individual or entity qualifies as an additional insured under a policy, the claims professional must determine whether that individual or entity is an additional insured under the circumstances of the occurrence that leads to coverage. For example, the additional insured endorsement may only cover liability arising out of the named

insured's work, operations, ongoing operations, or completed operations for the additional insured. The claims professional must understand the nature of such coverage and how it will apply to the circumstances at hand. For example, if an additional insured is only covered for liability arising from the named insured's completed operations and a bodily injury occurs during the named insured's ongoing operations, the additional insured may not be entitled to coverage.

The insurance policies also may contain provisions regarding the priority of coverage. Other insurance provisions may state that other policies on which the named insured is included as an additional insured are primary to the named insured's own insurance. But that excess position may be limited by the scope of the additional insured's coverage. For example, if the named insured faces liability separately and apart from the liability for which it is entitled to additional insurance, its own insurer may not be able to take an excess position. In addition, the claims professional needs to be familiar with the law in whichever jurisdiction is applicable; certain jurisdictions have ruled that some other insurance provisions that make the policy excess to other insurance may be unenforceable. The claims professional does not wish to be stuck taking on an obligation that it should not.

## **II. Circumstances that May Give Rise to Creative Coverage Arguments**

Beyond understanding the parties to a construction project and the documents and policies that dictate where liability may land, the claims professional also needs to understand those circumstances that create the potential for creative coverage arguments.

### **A. Liability Questions**

Liability questions are at the heart of who should bear responsibility for any claims arising from a construction defect action. The place to start is to know each party's scope of work and the nature of the claims asserted by the plaintiff. If, for example, the claim relates to water intrusion through the envelope of the building, and if the insured applied paint to the interior of the building, the chances that the insured's work could have caused or contributed to the plaintiff's damages are minimal, if any. If the insured installed the windows, the chances that its work caused or contributed to the damages is significant. If the insured performed grading or concrete work, the question becomes a bit more complicated.

The claims professional must understand which parties are likely liable, which parties likely are not, and which parties may share liability. The nature and scope of liability and potential liability can have a significant impact on indemnity and insurance.

Indemnity obligations under construction contracts generally address vicarious liability; namely, those situations in which the indemnitee faces liability because of the indemnitor's acts or omissions. Knowing the roles each party played in the construction of the project and the causation of the damages or alleged damages is necessary to evaluate indemnity issues.

The claims professional must understand liability or potential liability to determine coverage under liability policies. In most jurisdictions, the potential for coverage gives rise to a duty to defend. But for additional insured coverage, the limitations on such coverage could affect whether that duty arises in the first instance.

## **B. Risk Transfer Issues**

The vehicles for risk transfer are the construction contracts and insurance policies. These contracts and policies provide the targets for creative arguments for those parties and insurers that wish not to take on the obligations that should rightfully be theirs. Parties that are not owed indemnity will assert that they should be indemnified. Parties that are not owed insurance will assert that they are covered. And insurers that cover a risk will seek to get other insurance to fulfill their obligations. This is where the claims professional must be on full alert to make sure that his or her insurer does not assume a risk that it should not.

## **III. Addressing Creative Arguments**

Knowledge is power. And knowledge is the key defense to addressing creative coverage arguments. Knowing the case, the construction documents, and the coverage will allow for the claims professional to make informed decisions when insureds and non-insureds come looking for coverage.

### **A. Know the Case.**

Knowing the case is the starting point for the claim's professional. In an ideal world, the claims professional would have sufficient time to dive deeply into every claim. But doing so could take hours and hours that, as a practical matter, simply do not exist given business constraints. The claims professional must therefore work with defense counsel to learn about and fully understand the plaintiffs' claims, the parties that are potentially liable for those claims, the inter-relationships of the parties, and parties' defenses to plaintiffs' claims. Defense counsel can advise whether the plaintiffs' case is weak or strong. Defense counsel can value the claims against each party. Defense counsel can advise whether a cross-complaint is legitimate or simply designed to apply leverage.

Many insurers have fixed reporting requirements for defense counsel. Often, the format and information requested are done pursuant to a set format and the reports are

to be provided at regular intervals. For most cases, these requirements will suffice. The claims professional can quickly and efficiently find the information he or she needs to address the issues in the case. But some cases do not so neatly lend themselves to such formulaic reporting. It is in those cases that the claims professional must become more proactively involved with defense counsel, specifying specific information required, asking to be kept apprised of any new developments, and possibly setting up regular conference calls regarding the action. To ensure that nothing falls through the cracks, the claims professional should consider using calendaring programs to set calls at regular intervals and employ programs with document sharing capabilities in document intensive cases.

## **B. Understanding the Coverage**

The claims professional must understand the coverage. Participants in a significant construction defect action will come looking for coverage. The claims professional's job follows a straightforward progression. First, the claims professional needs to determine whether its own named insured is or would be entitled to coverage. This usually can be done by analyzing whether the claims are covered by the policy. This is relatively straight-forward, but the insurance professional must guard against insureds trying to get coverage by taking an expansive view of the insuring agreement or by trying to narrow an exclusion or coverage defense. Areas where insureds will push to expand coverage include timing, continuous and progressive damage situations, or by asserting that an exclusion simply does not apply. The claims professional must know the policy inside-and-out.

After determining whether the named insured is entitled to coverage, the claims professional may need to address claims by putative additional insureds. As mentioned above, the scope of additional insurance is dictated by additional insured endorsements. The claims professional must analyze whether the putative additional insured qualifies for coverage in the first instance. Putative additional insured will make arguments to try to get additional insurance on policies that do not apply. For example, additional insured coverage often is limited to liability arising from the named insured's work or operations. A complaint may allege claims against the putative additional insured that have nothing to do with the named insured's work or operations. Even so, the putative additional insured might tender to the named insured's policy, claiming that the plaintiff's claims implicate that named insured's work or operations. If the additional insured claim is declined, the putative additional insured may file a cross-complaint against the named insured for equitable relief and allege that the plaintiff's damages arose from the named insured's work. And after the insurer assigns counsel to defend the named insured based on the putative additional insured's—but not the plaintiff's allegations—the putative additional insured may again seek coverage. The claims professional must know how to respond confidently.

After evaluating coverage, the claims professional should issue a coverage position letter. If the insurer elects to defend, it should issue a letter reserving its rights to assert policy defenses on which the insurer may rely to decline coverage. The claims professional must understand in the governing jurisdiction how this reservation letter could affect coverage. If, for example, the letter does not mention a particular coverage defense, an insured may assert that the insurer has waived or is estopped from asserting that defense. But whether such an omission would preclude such a defense may vary from jurisdiction to jurisdiction, and the claims professional should not assume such a waiver or estoppel.

Similarly, the insured may claim that the assertion of certain claims defenses may require the insurer to provide the insured with independent counsel at the insurer's expense. The issue with independent counsel is that it takes control of the defense away from the insurer and places it in the hands of the insured. Insureds will often assert a right to independent counsel simply to gain that control, even when they are not entitled to it. Whether reserving certain rights gives rise to independent counsel will vary from jurisdiction to jurisdiction. The claims professional must understand how the rules work for each case.

The claims professional must understand the relationship between the insurance and the construction contracts. If the insurance has a blanket additional insured endorsement, an analysis must be made whether the contractual language creates an additional insured obligation. Additional insured provisions in contracts may include limitations that could affect coverage. In some jurisdictions, so long as the provision provides that the party will qualify as an additional insured, the limitations in the contract do not matter, but the limitations in the policy may. Putative additional insureds may try to press these distinctions to their advantage. Construction contracts sometimes contain indemnity provisions but not additional insured provisions. In that circumstance, putative additional insured may assert that the indemnity provision effectively qualifies as additional insurance. The claims professional must understand that its responsibility for the indemnity obligation likely flows to its named insured and not its additional insured, and not allow anyone to try to conflate those obligations.

The claims professional must also understand the relationship between its insurer's policy or policies and other policies. If an insurer has a way to make its policy excess to another, it will do so. Other insurance provisions that are to dictate the priority of coverage often are subject to laws in certain jurisdictions that may make them ineffective. The claims professional must be familiar with how such laws will be applied to determine its obligations and not assume an obligation it should not have.

Given the differences that exist between various jurisdictions, the claims professional may wish to consult with coverage counsel to assist in determining the insurer's obligation.