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Emerging Subcontractor Battles: On the Front Lines with Crawford and Additional Insured Claims

This is a frank, roundtable discussion of problems arising in the context of construction contract indemnity and insurance requirements, contractual and additional insured (AI) tenders thereunder to subcontractors and their insurers, the problems arising in connection with those tenders, and their impact on resolving construction litigation and on the parties, the insurers, and the construction industry. The discussion starts with a look at the indemnity and insurance requirements of construction contracts and some of the more common problems with them in view of the insurance products reasonably available to most subcontractors since the phase-out of the CG-20-10-11-85 AI endorsement. Next, the group will address the problem of case and settlement management in view of the coverage issues that arise out of the first segment's discussion – and especially the daunting task of 'herding the cats" early on to promote a reasonably efficient litigation and settlement arc. Finally, the group will discuss some potential alternatives to the means and methods now prevailing in the construction litigation industry – for industry it is, now more than ever – and how some relatively small changes in procedure can yield disproportionately large returns – with some cooperation from the insurers and the parties.

A typical subcontract indemnity provision is, in substantial part, as follows:

> ***"To the fullest extent permitted by law, SUBCONTRACTOR shall defend, indemnity and hold CONTRACTOR and OWNER . . . harmless from and against any and all loss, expense, liens, claims, demands, and causes of action of every kind and character . . . arising out of or in any way connected with or alleged to be arising out of the performance of work under this agreement . . . whether performed by SUBCONTRACTOR or any other subcontractor or any independent contractor or any agent, employee, invitee or licensee of the parties, whether resulting from or contributed to by . . . negligence . . . except the sole negligence or willful misconduct of CONTRACTOR or OWNER, its officers, members, affiliates, agents, employees, and other independent contractors directly responsible to it, or . . . any defect in, or condition of the premises on which the work is to be performed or any equipment thereon or any***

materials furnished by CONTRACTOR . . . The defense obligation contemplated herein is contingent only upon the tender by CONTRACTOR or OWNER to SUBCONTRACTOR."

These "all-but-sole-negligence" indemnity provisions are still common in construction subcontracts today but, for reasons we will discuss below, are becoming less and less enforceable.

Such provisions are no longer valid for residential construction in California (per Civil Code section 2782, *et seq*.), at all, for contracts entered into after January 1, 2009. However, similar provisions are still enforceable, to some extent, and in a modified degree, as to both residential and commercial construction in Florida (Florida Statutes, Title XLI, Chapter 725, section 725.06, e.g.) and Texas (Texas Insurance Code section 151.010, *et seq*., e.g. – where no wrap or other enumerated type of insurance coverage is in place).

Where an indemnitee developer or general contractor requires subs to enroll in a Wrap or owner- or contractor-controlled insurance plan, it usually also requires the subs to obtain first-party / primary insurance of their own and name the indemnitee as an additional insured. However, this is often planning for failure because the first party subs' policies are almost certain to contain exclusions for projects covered by wraps, as well as concrete, soils, mold, and a host of other exclusions, dramatically limiting or eliminating coverage to the additional insured(s) under such policies.

As noted above, after January 1, 2009, there are significant limits on the degree to which indemnity agreements in construction contracts are enforceable. Even under the SB800 rubric (CA Civil Code sections 589-945.5), which does way, for all intents and purposes, with the old distinction between technical defects, which were not compensable in tort, and those that caused consequential damage to other components of the work, these limitations apply. In a nutshell, for residential construction agreements, the indemnitor cannot be indemnified for the acts of the indemnitor or individuals and entities responsible to it. Contracts, however, continue to contain language requiring indemnity for all but the sole negligence or willful misconduct of the indemnitee. This lack of updating in contracts can lead to complications in the litigation context, where trade subs are not submitting these contracts to their attorneys – if they have any – for assessment before executing them and starting work.

Multiple project wrap policies frequently exhaust all available coverage after litigation on just one project, both because of limits that are unrealistic in terms of the cost of repair for most foreseeable claims, such as those for soils/foundation movement & damage, window and building envelope water intrusion, and roof/framing deficiencies. Add into the mix statutes like California's "SB800" which eliminates the requirement of consequential damage in order to recover for a claimed defect or deficiency, and the stakes rise quite a bit higher in comparison to per claim and aggregate limits on most wrap policies issued in recent memory.

Consequently, settlements are often under-funded due to inadequate limits on wrap policies, excluded categories of claims, and individual subcontractor insurance and AI endorsement requirements that are doomed to failure due to the common exclusions in those policies and AI endorsements.

> Under California law, all facts available to the insurer at the time the insured tenders a claim are relevant in determining the scope of the insurer's defense obligation, ***including facts outside pleadings***, because of possibility that pleadings could be amended to state covered claim. USF Ins. Co. v. Clarendon America Ins. Co., (C.D.Cal.2006) 452 F.Supp.2d 972.

From an ethical as well as practical standpoint, best practice is to investigate thoroughly all claims tendered, not rely on just the materials submitted with the tender.

To the extent that a tender is a tool used to obtain insurance coverage, the tender must be as soon as sufficient facts are available on which to make a reasoned determination that coverage may exist. Even in states that do not have law similar to California [Presley Homes, Inc. v American States Ins. Co. (2001) 90 Cal.App.4th 572 (defense is owed when there is even a potential for coverage)], the indemnitee / tendering party must recognize that some or even all potential insurance coverage can be lost due to delay in tendering.

Include all pleadings and discovery exchanged through the date of the tender or, if the claim is being tendered prior to litigation commencing, include all known facts and documents that YOU would want to see in order to respond to a tender of defense and indemnity, including not only the documents relating to the facts asserted in support of the claim but also the relevant contracts and insurance information.

> Before insurer rejects tender, it ***must make adequate investigation*** of facts, and ***failure to do so bars insurer from denying tendered defense*** and subjects it to liability for insureds' full attorney fees and costs incurred thereafter with other counsel. Stalberg v. Western Title Ins. Co. (App. 6 Dist. 1991) 230 Cal.App.3d 1223, rehearing denied and modified.
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> Under California law, commercial general liability (CGL) insurer's ***decision to not respond to insured companies' notices*** of earlier asbestos-related claims against insureds ***amounted to denial of coverage***, even though insurer did not explicitly deny coverage, and in turn ***constituted effective waiver of failure-of-notice defense as to later claims*** against insureds, in insureds' breach of contract action against insurer. Flintkote Co. v. General Acc. Assur. Co. of Canada (N.D.Cal.2007) 480 F.Supp.2d 1167.

This waiver of the failure of notice defense appears to be a pretty draconian result. However, what the court was likely concerned with is the fact that the impact of insurers simply denying tenders without adequate investigation has much broader impacts than just the litigation in which the tender is issued.

Policy Endorsements – and limitations they contain:

CG 20 10 11 85 – the one everyone wants… and virtually no one can get anymore; AI coverage for both ongoing and completed operations.

CG 20 10 10 01 - Additional insured has coverage only for “ongoing operations” of the primary

insured.

– "Your work" (work of the primary insured) does not, by itself, trigger coverage.
– No "Completed Operations" coverage for additional insured(s).
– Thus, additional insured has no coverage for construction defect actions.

CG 20 33 10 01 – Additional Insured coverage on an automatic basis, but only for primary insured's "ongoing operations."

– Additional insured is no longer covered when primary insured's "ongoing operations" end.
– Liability for design and supervision are expressly excluded.
– Thus additional insured has no coverage at all for construction defect actions.

CG 20 37 10 01 – Adds "completed operations" for additional insured for primary insured's work ("your work"), making it comparable to the CG 20 10 11 85 which almost no insurers still issue…BUT

• Must be combined with another form (e.g., CG 20 10 10 01 or CG 20 33 10 01) to provide the additional insured with both "ongoing operations" and "completed operations" coverage.

CG 22 94 10 01 – "Blanket" endorsement for all exposures.

– BUT: the subcontractor work exception to the "your work" exclusion (ISO form, Exclusion L of Section 1, Coverage A) ***no longer applies***, so additional insured is ***not covered for damage to the GC's work, including damage caused by subcontractors***.

CG 22 95 10 01 – Essentially the same as the CG 22 94 but used for specific sites or operations; no coverage for damage to general contractor (GC)'s work.

CG 00 57 09 99 – [*Montrose* endorsement] excludes coverage for known injury or damage.

CG 00 01 10 01 –*Montrose* language inserted in insuring agreement prevents coverage being triggered for known injury or damage.

As noted above, most AI endorsements now available do not provide coverage for both products/completed operations ***and*** ongoing operations. In considering what coverages to acquire in satisfaction of the insurance requirements set out in the construction contract, subcontractors and their brokers need to be very careful to make sure that either (a) the right combination of policy and endorsements are available AND the subcontractor can afford the cost / obtain a contract increase to account for the difference between the current policy and the coverage amounts and types the owner / general contractor indemnitee is demanding, or (b) the subcontract terms are negotiated to allow what coverage the subcontractor can afford to obtain. The alternative is to decline the work, which many subs cannot afford to do and remain in business. Owners and general contractors need to scrutinize evidence of coverage received from subcontractors to make sure the required coverage is, in fact, what was obtained, and that an appropriate AI endorsement (or endorsements, depending on requirements) was issued.

Blanket AI coverage requires a contract between the insured and additional insured that contains the specific language required by the insuring agreement. Many contractors fail at this stage by not including the necessary language.

As discussed above, most insurers do not now issue the CG 20 10 11 85 at all. Best case scenario is a somewhat pricey blend of endorsements to achieve the ongoing operations and completed operations coverage that the CG 20 10 11 85 afforded.

Owners / GCs are still demanding CG 20 10 11 85 AI endorsements, despite their lack of availability except at exorbitant premiums that are often far beyond most subcontractors' means and an unjustified expense in view of the potential profit to a subcontractor from most highly cost-sensitive production home and commercial construction contracts.

Consequently, subcontractors are simply agreeing to obtain the coverages demanded and then actually obtaining the coverages they can afford – often with disastrous results at the time of later litigation.

Like any tender, the AI tender should include every piece of relevant information the tendering party can provide to induce a favorable coverage determination. The rejection of tenders is very often the result of inadequate information and documentation provided with the tender. Since an insurer must consider all facts available to it (e.g., under USF v Clarendon, Id., *supra*) in determining coverage, it follows that, as noted above, it behooves the tendering party to include everything that would reasonably affect the coverage decision, including information about other insurance(s), the timeline for the claim(s), and any documents supporting the claim(s), such as contracts and insurance documents – especially the AI endorsement obtained from the indemnitor subcontractor.

Colorado: CRS section 10-1-131; 3 C. C. O. Div. of Insurance section 5-1-15 - a failure to respond to an AI demand within 90 days is ***presumed to be in bad faith***.

California has no analogous statute, nor does it seem that either Texas or Florida have one. It is foreseeable that such requirements will be enacted shortly, in view of the proliferation of lawsuits for contribution to defense costs paid by carriers providing defense to owners and GCs under AI endorsements in their primary insureds' policies in litigation where other insurers who gave AI endorsements are either rejecting or not responding to AI tenders.

> Under California law, an insurer's ***duty to defend is determined*** by those facts known by the insurer at the inception of a third party lawsuit, or ***from the facts and inferences known to an insurer from the pleadings, available information and its own investigations at the time of the tender of defense***. Storek v. Fidelity & Guar. Ins. Underwriters, Inc. (N.D.Cal.2007) 504 F.Supp.2d 803, affirmed 320 Fed.Appx. 508, 2009 WL 728390.
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> A subcontractor's insurer ***must*** provide a defense to a developer listed as an additional insured under the subcontractor's liability policy when the developer is sued by a third party for construction defects allegedly resulting from the subcontractor's work; this ***obligation is based***

on public policy, not the terms of the parties' contract. Transcontinental Ins. Co. v. Insurance Co. of State of Pennsylvania (App. 4 Dist. 2007) 148 Cal.App.4th 1296.

Before insurer rejects tender, it ***must make adequate investigation*** of facts, and ***failure to do so bars insurer from denying tendered defense*** and subjects it to liability for insureds' full attorney fees and costs incurred thereafter with other counsel. Stalberg v. Western Title Ins. Co. (App. 6 Dist. 1991) 230 Cal.App.3d 1223, rehearing denied and modified.

Many insurers are either outright ignoring or significantly delaying responses to AI tenders. The result is lack of funds to effect settlements, increased litigation duration (as well as the attendant costs), and the interventions (where permitted) and follow-on suits for contribution by carriers who are honoring their AI obligations and seeking to recover excessive defense costs they have paid due to other insurers not picking up AI tenders. Whether due to inadequate coverage obtained in the first instance (due to unrealistic demands by the indemnitee) or lack of information in connection with the tender (letter tenders, e.g., without pleadings or repair records, etc.) or just a policy of adopting a "wait and see" attitude toward such tenders (at the expense of their insureds who are then subjected to the aforementioned contribution actions by performing AI carriers), non-response to tenders is an unacceptable policy and may implicate the ethical duty of the carrier to investigate claims independent of the materials submitted and the four corners of the pleadings.

Litigants are attempting to settle matters knowing that often the largest claim – for defense costs paid to the counsel for the owner or developer indemnitee/AI – will be left out of the settlement. As a result, parties are less willing to settle, litigation is prolonged while parties try to work out the coverage and defense cost issues, counsel for owners / GCs fight turning over their billings to prove defense costs paid / allegedly incurred, insurers fight against AI tenders and assert their exclusions against projects involving wrap coverage as well as claim/scope of work exclusions, and subs fight against defense costs that are actually the cost of trying to obtain defense payments, not defend against claims.

As alluded to above, subcontractors are regularly being sued directly by insurers who have honored their AI obligations. The original theory was that the subs were individually responsible for the cost of the owner/GC defense under the project contract, separate and apart from the insurance AI endorsements, and the developer/GC could assign that right to the AI insurer for later assertion against the subcontractors. Recent suits have been more practical, asserting a right of contribution against joint tortfeasors, in accordance with their percentage share of fault, for the defense costs incurred to defend the owner/GC against defect/deficiency claims in the underlying damages action. All such suits are brought as a consequence of the insurers of the defendant subcontractors, vendors, and materialmen failing to respond to / denying AI tenders from the owner / GC.

We are seeing more and more cases in which the brokers and agents of the subcontractors, and in some cases those of the owner / GC, are being brought into the defect action on the ground that they failed to obtain the coverage(s) required under a contract they were given for review before obtaining coverage.

One very big step in the right direction is carriers agreeing to participate in early joint sessions with a special master or even a referee specially appoint ted to handle insurance coverage matters. Whether couched in terms of a "carrier meeting" or an "insurance mediation," the point is to maximize the potential for getting all properly available first party and AI coverages to the table. As a first step, this gives the best chance of early resolution because the carriers – the source of settlement funds, ultimately – are on board and controlling the litigation. Ideally, this is a first step in the resolution process, and can even be built into initial case management orders with some careful relationship management.

Where there is a potential for coverage, pick up the tender and issue a reservation of rights letter. It is easier to withdraw coverage later on a demonstration of good cause than to deny coverage *ab initio* and potentially face a much more costly bad faith action down the road.

Another option is to develop a project-based wrap product with limits adequate to the reasonable repair value for the most commonly-seen defect claims at the category of project for which coverage is sought. The cost of such coverage, amortized properly over the entire contracting population, should be less than the cost of the current litigation model going forward. Under such a product, it is conceivable that conflicts of interest in the representation of the various trades can be eliminated because there is no personal exposure, no allocation of fault among trades, because one payor addresses all claims. One enduring concern, however, would be the allocation of the loss experience among the parties enrolled in the wrap coverage.