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Building A Successful Approach To Handling Complex Construction Defect Claims And Their Related Coverage Issues

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I. Providing and Paying for the Defense

One of the first steps in not only minimizing a defendant insured's potential liability for a construction defect claim but also in controlling the defense and coverage costs and ensuring that the insurer is not left obligated to pay for otherwise uncovered damages, is to determine who is responsible to pay for and provide a defense, identify all possible payors, and determine what type of defense to provide so as to provide the most effective defense efficiently.

A. Which Policy(ies) Respond and Who Pays

For a typical construction defect defendant, there are three main categories of persons potentially liable to provide a defense: (1) the defendant's own insurance carrier(s), (2) any contracting parties (e.g., subcontractors or suppliers) who have contractual hold harmless and indemnity agreements with the defendant, and (3) other insurers (such as insurer's of subcontractors or suppliers) that may provide additional insured coverage to the defendant.

1. Trigger of Coverage – Determining Which Policy(ies) May Respond

Obviously, the first step in determining which insurer may owe a defense is to determine which policy(ies) potentially provide coverage. For claims made policies such as professional liability and errors and omissions coverage, this typically will be the policy in effect when the claim was first made (or perhaps first made and reported). For complex claims, however, this may not be an easy determination. Is there only one claim, or several – and are they related? The answers to these questions will not only determine which policy(ies) may provide for a defense, but also what deductible(s) apply and what limits (if any) may be eroded by the payment of defense costs.

For occurrence based policies, such as typically CGL policies, identifying which policy(ies) may apply typically involves a consideration of both the trigger of coverage rule applied by the jurisdiction whose law governs the construction of the policy (often, but not necessarily always, the place where the insurance contract was negotiated, paid for and delivered) and the nature of the damages asserted against the defendant. For property damage

claims, many states apply a first manifestation rule – but some, in the case of continuous, progressive property damage, apply a continuous trigger.

2. Additional Insured tenders

It is one thing for a subcontractor or vendor to agree to provide additional insured coverage to another contractor or purchaser; however, it is altogether another thing to see what additional insured coverage, if any, has actually been placed. As a past ABA Newsletter emphasized, "Not all additional insured endorsements are created equal."[1] There are literally dozens of additional insured endorsement variations – providing coverage for different injuries/damages (e.g., bodily injury, property damage, personal injury and/or advertising injury), for different exposures (e.g., ongoing operations and/or completed operations, premises exposures only), and subject to different limitations and exclusions. The precise form of the endorsement can mean all the difference between full coverage and no coverage. Additionally, the tendering party may be sued for its own negligent acts (not just vicarious liability deriving from the named insured's work or product) which may not fall within the scope of the endorsement.

From a risk manager perspective, one needs to ensure that you obtain the coverage you desire. And, from a claim handling perspective, one needs to ensure to tender to all possible additional insurers to see who may be obligated to share in the defense and/or indemnification of your insured – and on what terms.

3. Contractual Indemnity issues

Regardless of whether another insurer has an obligation to share in the defense of an insured, one or more other parties – such as subcontractors or vendors – may have contractual obligations to defend and/or indemnify the defendant contractor or subcontractor. Such obligations may be in the form of a duty to defend and indemnify – which may give rise to an immediate obligation to provide a defense – or, more commonly, a duty to hold harmless and indemnify – meaning that, depending on whether the contractual duty to indemnify is implicated, the indemnitor must also reimburse reasonable costs of defense.

Make sure to obtain and review all relevant construction contracts to understand both what defense and indemnity rights your company or insured may have against other parties, and whether your company or insured owes defense or indemnity to any other party. While any such indemnity obligation is only as good as the financial resources standing behind it, contractual indemnity obligations often are included within an "insured contract" and thus fall within an exception to the "Contractual Liability" exclusion in many insurance policies. This means that there may be an insurance carrier that is obligated to pay those indemnity costs, subject, obviously, to all other terms, conditions, limitations and exclusion in that insurance policy.

[1] Scott P. Pence, Esq, ABA Under Construction Newsletter, Vol. 15, No. 3 (Aug. 2013), "Not All Additional Insured Endorsements Are Created Equal: Brief History of ISO's Additional Insured Endorsements and 2013 Changes."

B. Choice of Counsel and Cost Considerations

Due to the number of potential indemnitors (e.g., insurers and contracting parties) and the number of target defendants named in complex construction defect claims, coupled with the possibility that some of the responding insurance may include defense costs within (not in addition to) the policy limits, controlling the costs of defense is an important consideration.

While there may be occasions in which different insurers will want to retain their own, separate chosen counsel to defend their insured, one way to control the cost is for the parties obligated to provide or pay for the defense to share in a single defense counsel. It is the rare instance in which two or more firms are needed to defend the same contractor defendant.

The foregoing considerations, however, must be balanced against the insured's preference in choosing its own, preferred counsel to provide a defense. When the insured faces similar litigation in multiple cases, allow the insured's preferred counsel to handle all such cases may allow the insured and insurer to realize economies of scale in defense counsel not having to reinvent the wheel. Also, if an insurer reserves the rights to deny coverage based on some issue to be decided in the underlying construction defect litigation, such that defense counsel arguably could steer the result toward or away from coverage, most states recognize that the insured is entitled to retain independent counsel to provide the defense at the insurer's expense.

Another useful way to significantly control defense expenses is to share experts, and sometimes even certain tasks (like document review and summary) with other parties. When multiple defendants are involved in a case, they often share at least some issues/defenses. Thus, for example, all subcontractors performing similar work (the window subcontractors or stucco subcontractors) may be able to use a single expert to opine as to certain issues, like costs of repair/damages.

II. Defense and Claims Handling Practice Tips

A. Issuing A Meaningful Reservation of Rights

Construction defect claims almost always present coverage issues – with some of the alleged damages clearly being excluded from coverage (due to damage occurring outside the policy period and/or policy exclusions, like the your work, your product and business risk exclusions). So, when an insurer decides to offer to defend an insured in a construction defect claim, the insurer often does so pursuant to a reservation of rights. To defeat possible later arguments that a particular coverage issue or defense has been waived, the reservation of rights letter should both cite the relevant policy provisions and should clearly explain how those provisions may bar coverage – discussing, to the extent know, facts from the contraction defect claim that suggest there may not be coverage. Also, keep in mind that, in certain jurisdictions, if independent/Cumis counsel is not provide to the insured, the insurer may be required to obtain a non-waiver agreement from the insured consenting to the insurer's provision of a defense under reservation of rights.

B. Discovery and Claims Handling Considerations – Investigating Liability and Damage Issues Relevant to Coverage

One of the most common issues presented in construction defect claims concerns how to allocate the alleged damages – among the defendants, among policy periods/time periods, and between covered and uncovered amounts. Risk managers and claims handlers should work with defense counsel to obtain relevant discovery and expert reports that may answer these questions – so that you can identify each defendant's potential exposure and the persons (insurers, defendant or third parties) who ultimately may have liability for those amounts.

C. Mediation and Settlement Considerations

The end game in any construction defect case is to resolve the case – by settlement or judgment (preferably in favor of your company/insured). In today's world, most cases settle, rather than try. But, in complex construction defect cases, the number of parties, amount of damages and legal/factual issues often make unassisted settlement difficult. An effective mediator is often useful to help corral the issues, parties and dollars into a meaningful, manageable resolution. Depending on the size and complexity of the dispute, a multi-day mediation may be best – dividing the discussions among trade disciplines, types of damages, etc. – allowing the mediator and parties to address separate facets of the case independently. While a global settlement may be ideal, partial settlements that buy the peace of certain groups may be enough – to protect your company/insured by resolving the claims against them or at least narrowing the issues for further litigation, and thus lessening the costs of the litigation.

III. Protecting The Insured's and Insurer's Interests At Trial

A. Allocation Issues

As noted above, one of the most common issues presented in construction defect claims concerns how to allocate the alleged damages – among the defendants, among policy periods/time periods, and between covered and uncovered amounts. At trial, however, these issues may not always be resolved with sufficient clarity. While liability may be determined as to each defendant, the jury may not be asked to make any further allocation – so, if possible and desired, the defendant and/or insurer may need to request that they do so.

B. Intervention and Special Jury Interrogatories

While expert reports and factual discovery in the underlying construction defect litigation may address some of these issues, they typically do not address all of the relevant allocation issues. Experts and discovery may indicate which defendant(s) have liability for which damages, they often do not discuss when the damages occurred – unless there is some reason to due to a statute of limitations, statute of repose or warranty issue. And, experts and discovery often do not segregate damages between covered and uncovered amounts with the precision desired by an insurer. As a result, where an insurer desires or needs to obtain more clarity concerning allocation issues, the insurer may want to – and in some states arguably needs to – petition to intervene in the construction defect lawsuit for the purpose of requesting special jury interrogatories or a special jury verdict form so that a general, unallocated verdict is not rendered.

C. Declaratory Judgment Actions

Given the many coverage issues presented by complex construction defect claims – including identification of which carriers and which policy periods are implicated and what damages are covered (and which excluded), claims handling may benefit from a pre-judgment declaratory relief action – wherein the insurer(s) seek advanced guidance from a court as to who may face financial responsibility for what. These issues are certainly going to be addressed and argued during any mediation or settlement efforts. Even the mere pendency of coverage litigation can strengthen an insurer's position – by conveying to others the insurer's conviction in its position and forcing others to factor in not only the risk of losing on the coverage issue but also the costs of coverage litigation into any settlement/mediation decision.

D. Bonding Any Judgment

Should the case go all the way to trial and then judgment, the defendant and its carrier(s) will then be faced with the often difficult decision of whether to appeal and, if so, whether to – and most importantly, who will – bond the judgment. Once the judgment is bound, the party obtaining the bond will be liable for the judgment if the appeal is not successful. Thus, as a practical matter, once a carrier decides to bond a judgment, the carrier has accepted coverage for the amount of the bond. Alternatively, if the carrier decides not to bond, the carrier risks the claimant seeking to execute immediately and/or the insured filing to bankruptcy – and then the claimant and/or insured potentially asserting both coverage and bad faith claims against the insurer.

So, to the extent a carrier intends to dispute coverage, obtain any judicial or other guidance you may desire prior to the point of having to make a decision as to bonding. While this is not always possible, commencing coverage litigation sooner rather than later is more likely to allow you to obtain any desired guidance before reaching the bonding issue.