2021 CLM Construction Conference
Sept 22nd – 24th 2021
San Diego, CA

Too Many Damages Too Little Coverage: Creative Settlement Strategies for Engaging the Insured Beyond the Limits

I. The Insurer's Obligation to Settle a Claim

Any discussion of creative settlement of construction defect claims must start with a thorough understanding of the insurer's obligation to its insured. The most common Insuring Agreement, e.g., ISO CG 00 01 04 13, states the insurer has the right and duty to defend any "suit" seeking damages, but is has no duty to defend the insured against any "suit seeking damages to which the insurance does not apply." The insurer may, at its discretion settle any claim or suit. To trigger the insurer's duty to settle, the settlement demand generally must be within policy limits. Even though the insurer has no duty to accept a settlement demand that exceeds policy limits, the insurer is obligated to act to protect its insured by attempting to negotiate a settlement because the insured is prevented under the terms of the policy from attempting settlement on its own. Under Duties in the event of Occurrence, Offense, Claim or Suit, the insured cannot "except at the insured's own cost, voluntarily make a payment, assume any obligation . . .with [the insurer's] consent. For this reason, the insurer is obligated, so longer as it is exercising control over the claim litigation, to protect the interests of the insured in any settlement discussions.

Conflicts between insureds and insurers can arise where one party wants to settle, and the other does not. In that situation, the insurer is generally free to move forward with settlement, over the insured's protest, but the insurer must keep the interests of its insured at the fore. For instance, an insurer cannot agree to a settlement that may create additional or future liability for the insured; or a settlement that denies the insured some risk transfer opportunity by release of other parties.

The more common scenario is where the insured wants to be done with litigation, but the insurer does not want to meet the current demand. While the insurer makes the ultimate decision about settlement, it often makes that decision at its own risk. For instance, under Missouri law, an insurer that fails to accept a reasonable settlement

offer within the policy limits has laid the predicate for a later bad faith claim. If the court determines that the insurer acted in bad faith, it can be responsible for all damages awarded, even those in excess of the policy limits. This is based on the somewhat tenuous principle that by refusing the demand, the insurer has breached the insurance contract, thereby opening itself to all damages that flow from that breach. See, *e.g.*, *Advantage Bldgs. & Exteriors, Inc. v. Mid-Continent Cas. Co.*, 449 S.W.3d 16, 19 (Mo. App. 2014).

Some states, such as California, grant the insurer more latitude in that it can settle a claim while reserving its right to assert a defense of noncoverage even if it accepts a settlement offer. If, having reserved such rights and having accepted a reasonable offer, the insurer subsequently establishes the noncoverage of its policy, the insured can then seek reimbursement from the insured for non-covered damages. *Johansen v. California State Auto Ass'n Inter-Ins. Bureau*, 15 Cal. 3d. 9, 19 (1975 Cal.). See also *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 498-499 (2001).

One member of the policyholders' bar has offered the following suggestions for insureds that want to settle, when the insurer does not:

- First, the policyholder may offer to contribute a portion of the settlement in order to resolve the lawsuit, although any attempt by the insurer to force the policyholder to contribute to a settlement may subject the insurer to bad faith. *See Hamilton v. Maryland Cas. Co.,* 41 P.3d 128, 130 (Cal. 2002).

- Second, the policyholder could settle the action with its own funds. But the policyholder should notify the insurer of that fact, reserve its rights against the insurer, and seek a waiver of the voluntary payment's clause. Even so, the policyholder may forfeit the right to recover the amount of the settlement from the insurer if it is later found that the insurer acted properly in refusing to settle.

- Third, the policyholder could proceed with the litigation, but protect itself against an excess judgment. It can do so by assigning its bad-faith claim to the third party with a covenant not to execute against the policyholder's assets, and the third party can proceed against the insurer in any subsequent bad-faith action. *See Executive Risk Indem., Inc. v. Jones,* 89 Cal. Rptr. 3d 747, 752 n.6 (2006).[1]

[1] https://www.orrick.com/en/Insights/2012/06/The-Settlement-Dilemma-When-a-Policyholder-and-Insurer-Disagree-on-Settlement

Each of these proposed strategies are discussed, *infra*, in the context of claims that both the insured and the insurer think the claim should be settled, but the policy limits are insufficient to settle the claim.

II. The Settlement Demand Must Be Reasonable

The insurer need only accept a reasonable settlement, but the $10M question frequently is what is reasonable? And second, from whose perspective is reasonableness evaluated? At the least, the insurer must consider the extent of the damage, the insured's liability as assessed both by the insurer and defense counsel, and jury verdicts for similar matters. In states such as California and Florida, the insurer must evaluate the settlement demand as though it alone would be liable for the entire amount of any judgment. *Johansen, supra, 15 Cal. 3d* at 9; *see also Boston Old Colony Ins. Co. v. Gutierrez,* 386 So. 2d 783, 785 (Fla. 1980) ("The insurer must investigate the facts, give fair consideration to a settlement offer that is not unreasonable under the facts, and settle, if possible, where a reasonably prudent person, faced with the prospect of paying the total recovery, would do so."); *Johnson v. Tennessee Farmers Mut. Ins. Co.,* 205 S.W.3d 365, 370-371 (Tenn. 2006) (insurer must investigate and evaluate the facts in the underlying action "to such an extent that it can exercise an honest judgment regarding whether the claim should be settled").

Where only some of the claims against the policyholder are covered, some courts have found that the insurer must nevertheless attempt to negotiate a settlement that resolves both the covered and uncovered claims. *Magnum Foods, Inc. v. Continental Ins. Co.,* 36 F.3d 1491, 1506 (10th Cir. 1994). The insurer can request that the insured contribute to the settlement, but the amount of any such contribution must be commiserate with the insured's uncovered liability. *See J.B. Aguerre, Inc. v. American Guar. & Liability Ins. Co.,* 68 Cal. Rptr. 2d 837, 843 (Ct. App. 1997). It is in this realm that creative settlements flourish. Insurers should engage with the insured and its private counsel, if there is one, to explore other options for settlement. This could include non-monetary consideration, whether that is transfer of interest in property, future business assurances, etc. When the insurer is controlling the defense, and the settlement, it is crucial to engage with the insured to devise a settlement strategy that provides the greatest protection to the insured. It is also important that any settlement negotiated by the insurer preserves any risk transfer opportunities that the insured may have.

If the insurer can ask the insured for contribution, what form does that take? Are there non-monetary options that may appeal to the claimant? Each claim will be unique, so it is up to the claims handler to be creative and candid with the insured and to demand the same in return. The insured may not have liquid assets to put toward a settlement, but it may have other interests, whether it be a unit in the condominium development,

the provision of labor and/or materials to assist with necessary repairs, or future opportunities for business, that can help close the settlement deal.

Any discussions with the insured regarding contribution to a settlement will need to be thoughtful and well-documented. First, in approaching the insured for contribution, the insurer must be very clear that it is working in the best interest of the insured to resolve the claim. The adjuster should be prepared with facts and figures as to the insured's potential liability, and what of those damages are covered versus non-covered. Only then can the adjuster engage in a meaningful discussion with the insured about possible creative settlements involving the assets or goodwill of the insured. It is key for the adjuster and the insured to agree on the value of any contribution to settlement in relation to the overall liability. In some instances, this may entail some outside evaluation of the asset the insured is offering to contribute to ensure that it is not bearing more than it share of the settlement.

As noted above, any attempt to force the insured to contribute to settlement may be grounds for a later bad faith claim, so this strategy must be thoroughly explored with coverage counsel in the appropriate jurisdiction. See*, e.g.*, *Hamilton v. Maryland Cas. Co.,* 41 P.3d 128, 130 (Cal. 2002).

III. When the Insured Can Go It Alone.

The opportunity for a settlement without the agreement of the insurer traditionally has occurred where an insurer breaches its duty to defend, leaving the insured "to its own devices" to settle the case or proceed to trial. In those circumstances, the insured is left unprotected and may enter into a reasonable settlement agreement with the third-party claimant and consent to an adverse judgment for the policy limits that is collectable only against the insurer. *Perera v. United States Fid. & Guar. Co*., 35 So. 3d 893 (2010 Fla.) citing *Coblentz v. Am. Surety Co. of N.Y.*, 416 F.2d 1059, 1063 (5th Cir. 1969).

An insured who has the benefit of coverage counsel will likely request the insurer waive the voluntary payments clause and allow the insured to move forward with settlement. There are certainly situations where the insured may have more leverage to settle a claim, however, before the insurer agrees to waive the voluntary payment obligation, it should first consider how it can work with the insured to effectuate a settlement. Again, this is where creativity and flexibility can achieve results that standard claims adjusting may not.

In other states, such as Missouri, the insurer may not be given this opportunity to engage with this type of creative settlement once it has refused to settle within the policy limits. Under Section 537.065 (RSMo.), an insured can enter a contract to limit recovery with a claimant where an insurer has refused to defend it without reservation. The contract to limit recovery generally allows the claimant to move forward with

proving its damages and obtaining a judgment which will then be enforced through garnishment of the insurance policy. The insurer cannot challenge the factual basis for such judgment. *Schmitz v. Great Am. Assur. Co.*, 337 S.W.3d 700, 703, (Mo. 2011). While Section 537.065 was amended in 2017 to provide the insurers the ability to intervene in the litigation to obtain the damage award, Plaintiffs quickly identified a work around by taking the claim to arbitration. The Missouri legislature has passed another amendment that will defeat that tactic which is expected to be signed into law by this presentation.

IV. Conclusion

Construction claims, with their multiple layers, various risk transfer mechanisms, and high dollar value, provide a unique opportunity for creative settlement. In addition, many of the contractors and subcontractors involved routinely work with each other and have the desire to maintain those business relationships. In jurisdictions where it is permissible to ask the insured to contribute to settlement, it is important for the insurer to engage with its insured so it can understand the opportunities available for crafting a settlement. Each claim will require careful consideration, but these opportunities should not be overlooked simply because they take an additional layer of work.