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When Exposure Exceeds Wrap Limits: An Actual Case Study Exploring Ethics and Resolution Obstacles

I. Setting the Scene

A. Project History and Available Insurance, Plaintiff's Claims and Policy Limits Demand, Other Key Facts

In this hypothetical, we will rely on the following "facts" from an actual construction defect case litigated in Hawaii:

An LLC Developer developed a condominium project and hired all of the design professionals as well as the General Contractor. The General Contractor hired the various Subcontractors.

Due to the high market costs of insurance at the time of construction, the LLC Developer purchases a primary OCIP with only $5M in limits. No excess insurance is purchased. The OCIP contains a "defense within limits" clause. The OCIP also contains a provision providing for one defense counsel to be appointed to defend all of the OCIP enrollees for a claim made under the policy. The Developer, General Contractor, and Subcontractors are all named insureds under the OCIP.

The project design professionals are not insureds under the OCIP but had either (1) indemnification in their favor from the LLC Developer, or (2) reciprocal indemnification clauses with the LLC Developer.

After the condominium units were sold, the LLC Developer has no assets and all profit distributions are made to the LLC members. Due to market conditions, the General Contractor becomes a dissolved corporation.

Plaintiff, the condominium Association, sues the Developer LLC and the General Contractor for construction defects right before the expiration of the 10-year statute of repose. Plaintiff's experts investigate the project and develop a $15M cost of repair a large component which included a "life safety" issue involving structural straps to the foundation. The Developer LLC and General Contractor also retain expert consultants, investigate the Project, and develop a defense cost of repair in the $3M range. The parties proceed to mediation/arbitration under the Contractor Repair Act in Hawaii. The lawsuit itself is stayed via stipulation.

Plaintiff then decides to name various design professionals and the quality control inspection company hired by the OCIP insurer during construction of the project for the same construction and/or design defects alleged against the LLC Developer and General Contractor. These new claims must first proceed pursuant to the rules set forth in Hawaii's Contractor Repair Act (Hawaii Revised Statute 672E, *et seq*.) and Design Claim Conciliation Panel (Hawaii Revised Statute 672B, *et seq*.) and as a result, until the statutory requirements are satisfied, are not part of the current mediation/arbitration track with the Developer LLC and General Contractor.

Plaintiff makes a policy limit demand on the LLC Developer and General Contractor for the remaining balance of the $5M OCIP limits which after prior claims, legal fees and costs, expert and vendor fees and costs totals $4.3M.

B. Ethical Implications of Accepting the Policy Limits Demand with Insufficient Limits

1. Insurer/Claims Perspective.

Claims professionals must always be cognizant of their ethical duties when handling claims so as to avoid an action for bad faith. When presented with a policy limits demand, and a demand by the insured to pay the policy limits, a claims professional must be aware the insurer's duty to accept reasonable settlement demands in order to satisfy the covenant of good faith and fair dealing. *See PPG Industries, Inc. v. Transamerica Ins. Co.*, 20 Cal. App. 4th 310, 312 (1999); *Best Place, Inc. v. Penn Am. Ins. Co.*, 82 Haw. 120 (1996). *See also,* California Insurance Code section 790.03.

A potential conflict of interest arises for the insurer/claims professional because settlement within or at the policy limits is almost always in the insured's best interest and eliminates the insured's personal liability, but settlement within or at the policy limit is not in the insurer's financial interest since an insurer can always take the chance with little or no cost (except for defense fees and costs) to have a jury decide the case. There is always the possibility of a defense verdict or the plaintiff's verdict may be less than plaintiff's demand.

Thus, the insurer must exercise good faith in evaluating demands in order to avoid exposing the insured to substantial risk of excess liability. In order to do so, the insurer must evaluate the "reasonableness" of the settlement demand:

> "A settlement demand is reasonable if (insurer) knew or should have known at the time the settlement demand was rejected that the potential judgment was *likely to exceed the amount of the settlement demand* based on (claimant's) injuries or loss and (insured's) probable liability."

See CACI Jury Instruction No. 2334 (emphasis and parentheses added); *Johnson v. California State Auto Ass'n Inter-Ins. Bureau*, 15 Cal. 3d 9, 16 (1975); *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 498 (2001).

As a result, the insurer is faced with two choices: (1) pay the policy limits demand, or (2) take the chance at trial and/or arbitration.

If the insurer is unwilling to accept the policy limits demand because it believes that the settlement demand is excessive and decides to take the case to trial and/or arbitration, the insurer risks a determination that the failure to settle is in bad faith and subject the insurer to liability for any judgment in excess of the policy limits. *Johansen, Id.*

Turning to our hypothetical fact pattern, the insurer needs to consider whether the request to pay the full policy limits when faced with a defense cost of repair less than the full policy limits is reasonable. The insurer must also consider whether all of the damages included in the defense cost of repair are "covered" because they involve resultant property damage (i.e., technical/code violations/life safety issues are not likely covered). This may require hiring coverage counsel to evaluate the damages in comparison to the policy language and/or hiring a separate independent expert to evaluate the damages to categorize them as resultant and/or non-resultant damages. This may be an added expense for the insurer and the timing of when this analysis can be performed can be complicated by any time limits plaintiff sets on an agreement to accept the policy limits demand.

The hypothetical situation is further complicated by the "defense within limits" expenses that are continuing to accrue which lowers the indemnity limits available to the Plaintiff and could increase the risk of an excess judgment. This may increase the insurers' duty to settle the claim as early as possible. Further, while an insurer that provides a defense is generally insulated from an insured entering into a covenanted judgment, the "burning" limits policy raises unique issues as defense costs would cannibalize the limits. *See* DEFENSE WITHIN LIMITS: THE CONFLICTS OF "WASTING" OR "CANNIBALIZING" INSURANCE POLICIES, 62 Mont. L. Rev. 131; *See also Weber v. Indem. Ins. Co. of N. Am.*, 345 F. Supp. 2d 1139 (D. Haw. 2004)(noting ethical dilemmas). There is no specific case law on point, but the risk is that a court could hold that a failure to consider the defense costs in evaluating a settlement allows an insured to enter into a stipulated judgment to settle the case despite the fact that the insurer is providing a defense.

Lastly, the insurer needs to develop a strategy for protecting itself for when the limits are paid, but there is a potential for future claims given the unresolved design professional claims and the fact that the Subcontractors, who were not named in this action by the Plaintiff could potentially be brought in. An insurer can be exposed to bad faith if a settlement on some claims to the detriment of others, leaves the insured exposed to personal liability on the unsettled claims and the insured is able to attack the settled claims as "unreasonable." *See Kinder v. Western Pioneer Ins. Co*., 231 Cal. App. 2d 894 (1965). Paying policy limits may avoid this, but in the instant fact pattern, because the carrier is aware of the additional claims, it needs to work with defense counsel to fashion a settlement agreement with Plaintiff to address these issues. Remember, "reasonableness" of a settlement offer is based on information known or available to the insurer. *Isaacson v. California Ins. Guar. Ass'n,* 44 Cal. 3d 775, 792 (1988).

2. Defense Counsel / Insured Perspectives

The insureds position is they want the case settled and the claim paid by the insurer as soon as possible so no out of pocket expenses are incurred by the insured. Defense counsel is currently representing both the LLC Developer and the General Contractor pursuant to the OCIP language providing for one defense counsel.

Defense Counsel needs to make sure there is an appropriate conflict waiver in place prior to accepting this representation in order to comply with the appropriate Hawaii Rules of Professional Conduct, Rule 1.7. *See also,* California Rules of Professional Conduct, Rule 3-310 and ABA Model Rules, Rules 1.7 and 1.8.

Defense counsel must also be mindful of the fact that any discovery or investigation the defense performs in order to evaluate the ultimate exposure of the claim reduces the total limits available for indemnity and also increases the risk of an excess judgment. Investigation of the defects and pointed discovery regarding damages should be used to develop the exposure analysis of the defects with resultant damage, but as prudently and cost effective as possible keeping in mind a large component of Plaintiff Association's cost of repair includes a "life safety" aspect.

Defense counsel and the insured need to be aware of the fact that if they settle the claim with the Plaintiff Association, there is a potential for claims to be brought against the LLC Developer due to the express indemnity clauses in the contracts between the LLC Developer and the design professionals and claims brought by the design professionals against the General Contractor and Subcontractors under the principles of equitable indemnification. Therefore, a full analysis of the risk transfer potentials against all of the OCIP insureds needs to be performed. If the OCIP policy limits are paid out to settle the claim with the Plaintiff, there would be no insurance limits left to pay for any contractual tenders made by the design professionals, to pay for any judgment against the LLC Developer, the General Contractor, or the Subcontractors; or to pay for the defense of the LLC Developer, the General Contractor, or the Subcontractors for any claims by the design professionals. Defense counsel needs to fashion a settlement agreement with Plaintiff to address these issues and to ensure that its clients are insulated from future claims.

II. Strategies for Resolution

The key strategy for resolution of this claim is a very creative settlement agreement. Depending upon how reasonable Plaintiff's counsel is will determine how far defense counsel and the insurer can push ensure that all areas of potential exposure are mitigated. Another key strategy is anticipating the potential risk transfer problem areas up front.

A. Recognizing Potential Problem Areas Up Front

Claims professionals should insist that defense counsel perform an analysis of all potential risk transfer. This includes an analysis of the various indemnification clauses for contracts involving all of the potentially liable parties such as the design professionals and the quality control inspector in this hypothetical. Defense counsel should make sure that all indemnification clauses of potentially responsible parties are analyzed in order to properly evaluate a policy limits demand. Likewise, coverage counsel for either the insured or the insurer should also request this analysis. Identify all damages that have caused resultant property damage.

B. Settlement Resolution Strategies – Get Creative and Push Back on Plaintiff!

If the policy limits demand will be accepted, specific terms of what will be required in a settlement agreement should be discussed amongst the insured, the insurer, defense counsel and coverage counsel. These terms should be presented to plaintiff before acceptance of the policy limits demand in order to protect the defendants and the insurer.

Specific settlement terms to mitigate the issues discussed in the hypothetical above should include:

- A release by plaintiff of the LLC Developer, the General Contractor, and all unnamed subcontractors (the "Released Parties").
- A hold back from the total remaining policy limits of a certain amount to pay for the following (1) defense fees and costs not paid prior to the payment by the insurer of the remaining limits; (2) payment of defense counsel's monitoring fees to monitor the ongoing litigation between plaintiff and the design professionals; and (3) collateral to secure payment of any judgement against the Released Parties.
- An agreement by the plaintiff fully indemnify and defend (through counsel of the LLC Developer and General Contractor's choice) the Released Parties for any and all claims brought by the unsettled design professionals. Examples of such claims to be indemnified and defended include: (1) attorneys' fees and costs or expert or consultant fees and costs claimed by the design professionals and asserted against any of the Released Parties; (2) any tenders for defense or indemnification on behalf of the design professionals made to the Released Parties; (3) any claims for express indemnification on behalf of the design professionals and asserted against any of the Released Parties; (4) Any claims for subrogation by the design professionals' insurers and asserted against any of the Released Parties; (5) any subsequent actions by the design professionals against any of the Released Parties arising out of the plaintiff Associations' claims against the design professionals; (6) any affirmative claims by the design professionals against any of the Released Parties (i.e., for breach of contract, etc.) as a result of the plaintiff Association's claims; (7) any and all judgments, including an award of attorneys' fees or costs against any of the Released parties in favor of the design professionals
- A covenant not to sue any the Released Parties by the plaintiff.
- A phased mediation schedule should be set forth in the settlement agreement for plaintiff Association to resolve its claims against the design professionals during which time defense counsel will monitor the litigation and be paid for same from the hold back amount of the remaining policy limits. This will give plaintiff Association and incentive to settle quickly in order to maximize the policy limits to be paid to the Association.
- A limitation, if possible, on the claims the Association may pursue against the design professionals in order to eliminate any "mixed claim" arguments (i.e. pure design defects only. No claims that involve any component of allegedly improper construction).

- Good faith settlement motion to be filed to insulate the Released Parties from any equitable claims (keeping in mind the good faith settlement statutes do not allow for extinguishing of express indemnity/contract claims).

A separate agreement between the insured and the insurer should also be considered to release any bad faith claims by the insured against the insurer.