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Minding the Gap: Addressing Liability for Inadequate Insurance Coverage

I. Liability of Insured

Insured's Understanding

Entities purchasing insurance are often unaware of how insurance policies and insurance coverage operates. An insured subcontractor required by contract to name the general contractor as an "additional insured" in its policy may request and receive an endorsement without understanding what that endorsement is required to cover per the contract and what is actually covered. This lack of understanding can lead a number of problems. Subcontractors who believe they secured the necessary AI endorsement often find themselves facing breach of contract claims for failure to secure proper coverage.

Conflicting Policy Provisions

If a policy covers both the subcontractor and the general contractor under an additional insured by contract endorsement, the insured subcontractor and general contractor likely believe they each are covered insureds if the general contractor asserts a claim against the sub in a multi-party construction defect suit. However, if the policy also contains a cross-suits liability endorsement, both the subcontractor and general contractor could face non-coverage.

Understanding the Policy from the Insured's Perspective

It is important for claims handlers to understand the position of the insured for a number of reasons – most importantly, to avoid bad faith claims. Insurance companies may be held liable for inadequate policies sold through an insurance agent, especially when the insured consulted with the agent, conveyed enough to the agent to convey the risks in the insured's industry, and relied on the agent's advice and expertise in purchasing coverage.

II. Potential Insurer Liability

Coverage of Unknown Risks

New or unknown risks present novel challenges for insurance carriers who need to balance their interest in not paying for uncovered claims with the risk of facing bad faith claims brought by the insured. Commercial general liability policies issued to marijuana farms and dispensaries in states with legalized marijuana are a good example. The US District Court in Colorado recently considered this issue in Green *Earth Wellness Center LLC v. Atain Specialty Insurance Company*, 163 F.Supp.3d 821 (2016), involving an insurance policy issued by Atain to Green Earth, a medical marijuana dispensary. Green Earth made a claim to Atain under the policy for smoke damaged marijuana plants. Atain denied the claim, and Green Earth filed suit. Atain argued that the insured's claims should be dismissed, in part, because the lost plants were "contraband or property in the course of illegal transportation or trade" not covered by the policy, and that, in any event, public policy required denial of coverage even if the plants were otherwise covered by the policy.

Because the policy failed to define the term "contraband," the court adopted the term's common and ordinary meaning, as "goods or merchandise whose importation, exportation, or possession is forbidden." While accepting the fact that federal law criminalizes possession of marijuana for distribution, the court noted the ambiguity in federal enforcement in states with regulated marijuana distribution.

Turning to the mutual intention of the parties to the policy, the court found that Atain indisputably knew that Green Earth was a medical marijuana dispensary when it issued the policy, and knew or should have known that federal law prohibited such businesses. Atain chose to issue a policy covering Green Earth's saleable marijuana inventory anyway, suggesting that "the parties shared a mutual intention that the Policy would insure Green Earth's marijuana inventory and that the "contraband" exclusion would not apply."

The court refused to decide whether Atain could legally pay for the damaged plants, because it assumed that Atain consulted with counsel before deciding to insure the dispensary. The court further refused to declare the policy void on public policy grounds. Because Atain entered into the policy "of its own will, knowingly and intelligently," it was obligated to comply with its terms.

Court Defined Policy Terms

Judicial interpretation of policy terms is another variable affecting coverage. Courts construe insurance policies according to what they perceive to be the understanding of the ordinary insurance policy purchaser, and interpret ambiguous

policy terms in favor of the insured. A recent Oregon Court of Appeals decision applied this principle to determine whether a policy exclusion for "residential construction" applied to mixed use construction. *Hunters Ridge Condominium Association v. Sherwood Crossing LLC* et al, 285 Or App 416 (2017). The court found that a mixed use development containing both residential and commercial space was not subject to the residential construction exception and therefore covered by the policy. Reading an exclusion from the vantage point of the insured can help avoid bad faith claims.

The Ugly Side of Bad Faith

A recent Washington case highlights the risk carriers face in assessing claims and making coverage determinations. In *Miller v. Kenny*, 180 Wn. App. 772 (2014), the Washington Court of Appeals ruled that a stipulated judgment with a covenant not to execute constitutes a floor, not a ceiling, of damages recoverable from a third party liability insurer on assigned bad faith claims.

In *Miller*, defendant Patrick Kenny negligently rear-ended a cement truck. The accident injured Kenny's three passengers, including Miller. Safeco insured the vehicle Kenny was driving as a permissive user. Safeco's policy had $500,000 in underlying limits and $1,000,000 in umbrella limits. All three passengers sued Kenny, and Safeco agreed to defend Kenny without reservation. Safeco was notified that all three passengers sustained severe brain injuries and the claimants made a $1,500,000 policy limit demand to Safeco. Defense counsel recommended Safeco tender the limits. Safeco tendered only the $500,000 primary policy limits instead.

Safeco eventually authorized the tender of the $1M umbrella three months before trial, but by that time Kenny and the claims were represented by personal counsel and refused to release Safeco in exchange for tender of the policy limits. Instead, the claimants settled with Kenny for $1,800,000 (including the $1,500,000 tendered by Safeco), and an assignment of Kenny's claims against Safeco. A stipulated judgment of an additional $4,150,000 was entered by the court. The claimants, as Kenny's assignee, sued Safeco for bad faith, violation of the Consumer Protection Act, negligence and breach of contract. At trial, the court instructed the jury to consider $4,150,000 as minimum damages along with other elements of damage, including emotional distress, and placed the burden on Safeco to prove that these other elements did not exist. The jury found Safeco acted in bad faith and awarded $7,750,000 in damages on top of the $4,150,000 minimum.

III. Potential Defense Counsel Liability

Reporting and Obligations

If gaps in coverage appear possible, the insurance defense attorney must be careful not to report facts that could result in such a gap, because the attorney's primary duty of loyalty is owed to the insured. *See* Model Rules of Prof 'l Conduct r. 5.4(a)(4)(c) (2004); Florida Rules of Professional Conduct 4-7.1; *Tank v. State Farm*, 105 Wn.2d 381 (1986) (defense counsel's primary duty is to insured). This often creates insurmountable problems for defense counsel, especially in states that have adopted the "joint client" rule, which hold that the insurer and the insured are the attorney's joint clients, allowing each unfettered access to the defense file. *See*, California Professional Conduct and Formal Opinion Interim Number 96-0012.

A Washington case, *Tank v. State Farm, supra*, addressed carrier and defense counsel obligations. The *Tank* court found that an insurer has a duty of good faith, which requires fair dealing and equal consideration for the insured's interests. In cases involving reservation of rights defense, an inherent potential conflict between insurer and insured was held to mandate an even higher standard: an enhanced obligation of good faith.

The enhanced obligation is fulfilled by thoroughly investigating the cause of the insured's accident and the nature and severity of the injuries and retaining competent defense counsel for the insured. The court reiterated that defense counsel only represents the client. The insurance company is responsible for fully informing the insured of the ROR defense, all developments relevant to the policy coverage, and the progress of the lawsuit, including disclosure of all settlement offers made by the company. The carrier must also refrain from engaging in any action which would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk.

IV. Potential Broker/Agent Liability

Understanding the relationship between insurance companies, insurance brokers, insurance agents, and insured parties is also critical to avoiding liability exposure. Insurance brokers are independent. They solicit business from the public and act as liaisons between the insured and the insurer. Insurance agents represent insurance companies, often only one, and owe certain duties and responsibilities to the company. Agents/brokers have certain duties: to follow the instructions of the insured, to obtain the best coverage at the best price, to keep the insured informed, to advise the insured of her/his rights and obligations under the policy, especially when the insured's lack of knowledge may result in a loss of benefits or forfeiture of rights.

Generally, an insurance agent or broker who undertakes to procure insurance for a client and fails to obtain any coverage, or secures inadequate coverage, or fails to advise the client of that result may be held liable upon the theory that the agent or broker breached a contract to procure a policy of insurance, upon the theory that the agent or broker negligently failed to procure coverage, or upon both of these theories. Whether claims sound in tort or contract varies from state to state, but either way, the policy and evidence of its breach is admissible evidence. An insurance company may be vicariously liable for the actions of its insurance agent(s). An insurance agent who presents himself to an insured as an expert may also be separately liable to the insured.