AMERICAN BAR ASSOCIATION ANNUAL MEETING AUGUST 2010 RESOLVING CATASTROPHIC MULTI-PARTY CONSTRUCTION INSURANCE CASES – IS MEGA-MILLION DOLLAR LITIGATION THE ONLY SOLUTION?

Lisa Enloe, Held Enloe & Associates LLC, Washington, DC

Barry Fleishman, Kilpatrick Stockton, Washington, DC

Ed Henderson, Kilpatrick Stockton, New York, NY

Bill Lewis, Butler Pappas, Tampa, FLA

Kathleen Monnes, Day Pitney LLP, Hartford, CT

Chris Mosley, Sherman & Howard LLC, Denver, CO

Charles Platto, Law Offices of Charles Platto, New York, NY[1]

In the past decade, construction and related insurance coverage disputes have soared with respect to number, size and scope of damages at issue. The prevalence of cross-insurance obligations in construction contracts and additional insured coverage in owner, contractor and sub-contractor insurance policies, has expanded the number of parties potentially involved in damaged building cost workouts, and the dispute resolution proceedings that take place when workouts cannot be resolved through party-discussions and negotiations. The increased cost and complexity of property damage remediation and related business interruption losses, along with the potential for third-party assertions of damage and injury (from residents and former residents, for example), has resulted in enormous expense of time, effort and cost to accomplish global resolution and closure.

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[1] The information contained in this article represents the views of the authors individually and does not represent the views of their respective firms or any of their respective clients.

This paper explores the issue in three parts: (i) a description of certain key reasons why damaged building disputes are so hard to resolve without litigation; (ii) a description of the insurance coverage issues that often defy easy resolution; and (iii) a summary of practical actions that can assist in the resolution of these complex matters.

I. COMPLEXITIES THAT MAKE DAMAGED BUILDING CASES DIFFICULT TO RESOLVE.

Damaged building cases often involve multiple parties, a complex web of claims and cross-claims, and sometimes multiple lawsuits. The root causes of such suits are varied and limited only by the components of a finished structure. Typically, problems manifest in the form of leaks, cracks, stains, fire, collapse, odors, mold or illness. The precise cause(s) of and responsibility for the problems are often initially unknown, or at least unclear.

Therein lies the principal reason why damaged building disputes are difficult to resolve without protracted litigation — uncertainty. The question of what actually caused the damage, and the related question of who is responsible for it, are often difficult to answer without extensive factual investigation and expert analysis. Frequently, the investigation and analysis are complicated because there may be more than one contributing cause. For example, in a representative case there may be water damage and mold. Clearly, there is water intrusion, but is it caused by leaking water pipes? Sweating, poorly insulated HVAC pipes? Building envelope leaks? Groundwater intrusion? Each of those items could itself be the subject of further dispute concerning responsibility for the problem. For example, is the problem a result of poor design? Shoddy construction? Or perhaps a defective product? Is the responsible party the architect? The contractor? One or more subcontractors? A supplier?

Unlike typical property damage cases involving mostly known valuation factors, large construction projects may have a zero dollar value at commencement and full value at completion. Therefore, the value of the project varies over time. Indeed, overall values can be speculative, commencement and completion dates are subject to change, and the parties don't always understand the magnitude of potential losses that can occur. These unknowns and uncertainties further complicate the issues in dispute when owners, contractors, lenders, subcontractors, and insurance carriers contest who is responsible when a construction project goes bad. Other issues often involve:

- Cause of the loss
- Assessment and repair of physical damage to real property
- Impact on the project progress and its effect on contractors, subcontractors, material and equipment suppliers
- Potential impact caused by delay
- Physical damage to contractor's equipment
- Speculative nature of future income

A. Property Repair Basics

Property losses generally involve 3 separate phases: (i) emergency services and remediation; (ii) damage assessment; and (iii) repair. Although disputes can develop regarding any one, or all of these phases, the greatest potential for dispute is in the area of contractor's overhead and allowable fees/profit for repairing damage (including contractor's general conditions).

Repairs ordinarily should commence using existing contracts in effect for the project, and should be conducted subject to the change order process instituted for the project. However, many builders risk policies allow for "reasonable overhead and profit". What is considered "reasonable" is often the subject of debate. The process of determining allowable charges by a contractor and/or subcontractors is document intensive, and insurers are expected and required to obtain and to review existing

contracts (often with the aid of counsel), and react to insureds on a timely basis. A multitude of expert consultants often are required in the assessment, monitoring, estimating and negotiation phases of property loss adjustments, and they must work in concert to mitigate the impact that a loss can have on the project's end date.

B. Time Element Loss Basics

Large property losses can have a number of major impacts on a project relating to disruption of a project's progress. While time element loss is a common aspect of first-party property coverage, such coverage generally is extremely limited in builders' risk policies, with delay typically excluded in those policies. However time element coverage can usually be purchased for certain types of losses that arise from a loss causing an impact to a project's completion. The most common of these limited coverages are: soft costs (expenses incurred during the period of delay, typically limited to construction loan interest, realty taxes, advertising, leasing commissions, design professional fees and project administration expense); business interruption/gross earnings; and lost rents.

There are, however, many other types of consequential losses, which can occur and are typically the source of disputes between insureds and insurers, including:

Productivity loss – wherein a contractor or subcontractor's ability to perform non loss related completion of their contract work is affected by a post casualty loss of productivity;

Contractors extended overhead – typically non insured expenses arising out of a delay caused by a casualty, in which a contractor's time on the project is extended;

Labor and material escalations – In which delay impacts the costs to complete base contract work;

Mitigation efforts which cause productivity loss – using overtime to lessen the impact of a delay caused by a loss, can result in lost production which gives rise to consequential loss/project impact claims.

Time element losses for properties under construction are measured by first determining the date a project would have been completed had the loss not occurred. Once this date is determined, the impact from the delay caused by or resulting from covered physical damage (usually subject to a waiting period deductible) establishes the period of delay of completion, used to calculate covered time element losses. This is wholly different from normal property insurance in which the period of restoration (time to make repairs) and period used for lost rents and business interruption/gross earning normally run concurrently. Setting aside disputes that can develop regarding coverage, typical disputes regarding measurement are:

Agreement on completion date – A project's end date is subject to change over the course of a project. Contractors and owners may often have pre-loss disputes over the completion date for a multitude of reasons. Agreement on the completion date, "had no loss" occurred, is often disputed;

Period of delay – the impact that repairing physical damage can have on a project's completion can be difficult to measure, and is often disputed;

Contractor's extended overhead – typically non insured expenses arising out of a delay caused by a casualty, in which a contractor's time on the project is extended;

Speculative income – economic conditions change over time, often affecting a project's feasibility at completion. This can lead to disputes regarding economic losses that flow from delay caused by physical damage.

C. Litigation and Dispute Resolution Practicalities

Large construction case disputes involve big money and often big emotions as well. Typically, the owner will have incurred great expense in damage remediation and will have suffered business interruption losses such as lost revenue or rental income, extended financing expense, and the like. In many cases, the owner will be facing claims by third-parties, such as displaced tenants and others claiming injury to their person or property.

With that kind of money at stake, project participants are not willing to acknowledge responsibility and come to the negotiating table unless, and until, they are reasonably sure that there is a substantial risk that they could be found liable for the loss. Until that uncertainty is removed through extensive factual investigation and expert analysis, resolution is nearly impossible. The factual investigation is often accomplished through the discovery process which is usually time consuming and often contentious. Discovery disputes themselves lead to delay and often create an atmosphere of further uncertainty, as they increase the level of distrust among the parties and lead some to wonder what others are hiding. Until there has been full and open discovery, and parties are confident that they have all the facts and have had a fair opportunity to have their own experts analyze those facts, resolution remains difficult.

Intertwined with the fundamental factual issues that must be addressed before a meaningful resolution can be reached are a host of potential legal issues, most of which arise out of the contracts that bind together the various project participants and

set forth the rights and obligations between the contracting parties. Particularly significant, in this context, are warranty provisions, pursuant to which contractors and subcontractors will warrant the quality of their work, indemnification provisions, pursuant to which, for example, a subcontractor will agree to indemnify the contractor and the owner against claims for bodily injury or property damage arising from the subcontractor's work, and related insurance provisions, pursuant to which the subcontractor will agree to name the contractor and the owner as "additional insureds" on its commercial general liability policy. Each of these provisions can give rise to legal disputes concerning the scope of the participants' obligations. There may also be disputes concerning the scope of a participants' work. For example, was the window installer or the masonry subcontractor responsible for installing the caulking around the windows? In addition, the contractor and the subcontractors might also have given performance bonds guaranteeing the performance of their work. The involvement of sureties often adds to the level of legal and factual complexity and makes resolution more difficult to achieve.

Like the uncertainty inherent in the factual issues discussed above, these legal issues also create uncertainty. At the onset of a typical damaged building case the answers to these fundamental questions, and others, are unclear. As a result, if litigation is commenced, any project participant that had even a minor role in the construction will likely be dragged into the suit, which may involve many parties and multiple claims based on breach of contract (including breach of warranty and indemnification provisions) and negligence, and cross-claims and counterclaims seeking contribution and indemnity. Until the parties have a clear picture of their legal rights and obligations – that is, until they understand their position with reasonable certainty – resolution without judicial assistance is difficult. That difficulty is

exacerbated and another layer of complexity is added when some or all of the project participants have issues concerning insurance coverage.

II. COMPLEXITIES THAT MAKE DAMAGED BUILDING INSURANCE COVERAGE CASES DIFFICULT TO RESOLVE.

Policyholders and insurance companies often disagree as to the scope and value of coverage applicable to a damaged building loss. We describe below certain issues that often arise in the context of an insurance coverage dispute in a damaged building case.

A. Which Policy Provides Coverage– General Liability/First-Party Property/Builder's Risk/Other

In any given building damage case, several different types of policies may provide coverage and in many the total amount of liability and costs incurred may be allocated amongst the different policies.[2] Certain of these coverages are set forth below:

- Commercial (or Comprehensive) General Liability ("CGL") Policies – These policies generally provide coverage for defense costs and damages arising out of allegations of bodily injury and property damage made by third parties. These CGL policies may provide coverage for claims asserted against contractors, architects and others made by the owner of a damaged building, as well claims against an owner of a building by residents.
- Owner-Controlled Insurance Policies ("OCIP") and Contractor-Controlled Insurance Policies ("CSIP") – These policies provide liability and property damage insurance for all of the contractors and the owner with respect to a specific building under construction. All of the "insured" parties share in the coverage and the limits of liability provided by the coverage.
- Builder's Risk Insurance – These policies provide coverage while a building is under construction. OCIP and CCIP is a form of builder's risk coverage.

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[2] Of course, each particular dispute must be analyzed in the context of the terms of the applicable policies in that case.

- First-Party Property Insurance – These policies provide coverage for the owner of a building and generally cover property damage, extra expense and business interruption loss.
- Pollution Insurance – These more specialized policies cover liabilities and the costs of clean-up arising out of environmental damage, as well as the costs of defending against those claims of damage/injury.
- Additional Insured Coverage – This coverage applies to entities other than the specific purchaser of the coverage and provides insurance to certain other designated entities connected with a damaged building, such as where the owner is included as an additional insured on the policy of a general contractor and the general contractor is included as an additional insured on the policy of a subcontractor. Additional insured coverage often is required in a construction contract between an owner and a contractor and the contract between a general contractor and a sub-contractor.

B. Occurrence

General liability policies typically define "occurrence" as an "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." In the damaged building context, issues can arise regarding whether faulty workmanship is covered, including, but not limited to, questions regarding whether: (i) faulty workmanship constitutes an "accident"; (ii) faulty workmanship claims are non-covered breach of contract claims; and (iii) providing coverage for construction defect claims under a general liability policy improperly transforms the policy into a performance bond. Each of these is discussed below.

1. Does Faulty Workmanship Constitute An "Accident?"

The principal argument insurers make is that faulty workmanship does not constitute an "accident" and, hence, an "occurrence." First, insurers may assert that the damage at issue arose from the contractor's intentional engagement in construction activity. Their argument is that because the contractor intended to engage in the construction activity, the contractor's actions were not "accidental" and, hence, the damage caused by the contractor's faulty workmanship did not arise from an

"occurrence." *See, e.g., ACS Const. Co., Inc. of Mississippi v. CGU*, 332 F.3d 885 (5th Cir. 2003) (applying Mississippi law). Policyholders counter by arguing that the "occurrence" definition focuses on whether the contractor intended to cause the damage, not whether the contractor intended to engage in the construction activity. *See, e.g., Fejes v. Alaska Ins. Co., Inc.*, 984 P.2d 519, 523 (Alaska 1999); *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871, 883 (Fla. 2007); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 281 Kan. 844, 854, 137 P.3d 486, 492 (Kan. 2006); *Corner Const. Co. v. United States Fidelity and Guar. Co.*, 638 N.W.2d 887, 894 (S.D. 2002); *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 8-9 (Tex. 2007); *American Family Mut. Ins. Co. v. American Girl, Inc.*, 268 Wis.2d 16, 673 N.W.2d 65 (Wis. 2004).

Second, insurers argue the "occurrence" definition must be viewed from the perspective of faulty workmanship rather than proper workmanship. Insurers argue that it is faulty workmanship that gives rise to the damage, and damage that is the natural and foreseeable consequence of faulty workmanship (i.e., all damages in a construction defect claim) does not arise from an "accident" and, thus, does not arise from an "occurrence." *State Farm Fire and Cas. Co. v. Tillerson*, 334 Ill.App.3d 404, 409, 777 N.E.2d 986, 991, 268 Ill.Dec. 63, 68 (Ill. App. 2002). Policyholders argue that the "occurrence" definition must be viewed from the perspective of proper workmanship, and that unforeseeable property damage arising out of proper workmanship does arise from an "accident," and if forseeability were based on the assumption of faulty workmanship, a general liability policy would never cover a construction defect claim because damage to a contractor's work product almost always would be the foreseeable result of faulty workmanship. *J.S.U.B.*, 2007 WL 4440232 at *9-10; *Travelers Indem. Co. of America v. Moore & Associates, Inc.*, 216 S.W.3d 302, 308-309 (Tenn. 2007).

Third, some insurers assert faulty workmanship claims cannot arise from an "occurrence" because they do not present the degree of fortuity contemplated by the generally accepted definition of "accident." These insurers assert liability insurance is designed to cover damages arising from fortuitous events and that faulty workmanship is not a fortuitous event. *See, e.g., Pursell Const., Inc. v. Hawkeye-Security Ins. Co.*, 596 N.W.2d 67, 70 (Iowa 1999); *Auto-Owners Ins. Co. v. Home Pride Companies, Inc.*, 268 Neb. 528, 534-535, 684 N.W.2d 571, 577 (Neb. 2004).; *Webster v. Acadia Ins. Co.*, 934 A.2d 567, 572-573 (N.H. 2007); *Kvaerner Metals Div. of Kvaerner U.S., Inc. v. Commercial Union Ins. Co.*, 589 Pa. 317, 335-336, 908 A.2d 888, 899 (Pa. 2006); *Corder v. William W. Smith Excavating Co.*, 210 W.Va. 110, 116, 556 S.E.2d 77, 83 (W.Va. 2001). Policyholders argue that whether an "accident" and, hence, an "occurrence" exists turns on whether the policyholder intended to cause the damage at issue. If not, the defective construction was an accident and, hence, a fortuitous event for which coverage should exist under a general liability policy.

2. Do Breach Of Contract Claims Arise From An "Occurrence?"

Most construction defect litigation involves one or more breach of contract or breach of warranty claims. Insurers frequently base their denial of coverage on the ground that breach of contract and breach of warranty claims do not arise from an "occurrence" because general liability policies only cover tort claims. *Oak Crest Const. Co. v. Austin Mut. Ins. Co.*, 329 Or. 620, 626, 998 P.2d 1254, 1257 (Or. 2000); *Kvaerner*, 589 Pa. at 335 fn. 10, 908 A.2d at 899 fn. 10; *L-J, Inc. v. Bituminous Fire and Marine Insurance Company*, 366 S.C. 117, 122, 621 S.E.2d 33, 35 (S.C. 2005); *Corder*, 210 W.Va. at 115, 556 S.E.2d at 82. Carriers also may assert that a "contract exclusion" bars coverage, to the extent one exists in a particular policy.

Policyholders counter this argument on two fronts. First, they argue that neither the "occurrence" definition nor any other provision in a general liability policy limits coverage to tort claims. Rather, the policy covers claims arising from an "occurrence" defined solely as an "accident." If insurers wish to preclude coverage for breach of contract claims, they can do so by adding the appropriate language in their policies. Indeed, breach of contract exclusion endorsements exist specifically to preclude coverage for breach of contract claims. *J.S.U.B.*, 979 So.2d at 884-885; *Lee Builders*, 218 Kan. at 857-858, 137 P.2d at 494-495; *Lamar Homes*, 2007 WL 2459193 at *8; *American Family Mut. Ins. Co. v. American Girl, Inc.*, 268 Wis.2d 16, 40, 673 N.W.2d 65, 77 (Wis. 2004).

Second, breach of contract claims may arise from negligent, as opposed to intentional, conduct. It is undisputed that general liability policies cover claims arising from an insured's negligent conduct. Some jurisdictions affirmatively distinguish between intentional and negligent breach of contract claims. Accordingly, breach of contract claims premised on a contractor's faulty workmanship arguably arises from an "occurrence" so long as the contractor did not intend to perform the work improperly or cause the damage at issue. *Lamar Homes*, 242 S.W.3d at 8.

3. What Is The Impact Of Performance Bonds?

Performance bonds are common in both public and private construction projects. A performance bond guarantees the performance of the contractor and assures the owner its project will be completed even if the contractor defaults.

Some insurers argue that permitting coverage under a general liability policy for faulty workmanship claims effectively transforms the liability policy into a performance bond. In other words, the general liability policy guarantees the contractor's work by providing an owner with a source of funds outside the

contractor's own pocketbook to correct defective work. This is exactly what a performance bond does. Insurers argue that a general liability policy cannot be interpreted to provide coverage which duplicates that provided by a performance bond. *Pursell Const., Inc.*, 596 N.W.2d at 71; *L-J, Inc.*, 366 S.C. at 124, 621 S.E.2d at 36-37; *Kvaerner*, 589 Pa. at 336, 908 A.2d at 899; *ACUITY v. Burd & Smith Const., Inc.*, 721 N.W.2d 33, 40 (N.D. 2006).

Policyholders counter that the coverage of a general liability policy is defined by its terms and conditions, not the existence of other coverage, and that general liability policies clearly contemplate other "duplicative" insurance may exist as evidenced by their "other insurance" provisions. Policyholders also argue that if general liability insurers truly wanted to exclude coverage for claims falling within a performance bond, they could include appropriate language in their main policy forms or applicable endorsements. *Lamar Homes*, 242 S.W.3d at 10.

Policyholders also argue that general liability policies and performance bonds are different products which provide different coverages, even if those coverages have some overlap:

- A general liability policy spreads the contractor's risk; a performance bond guarantees the contractor's performance.
- A general liability policy is underwritten based on an evaluation of risks and losses actuarially linked to premiums and, thus, the underwriting assumes losses will occur; a performance bond is underwritten based on the contractor's creditworthiness and historical ability to complete contracts – as such, the underwriting of a performance bond does not assume losses will occur.
- A general liability policy offers indemnity protection for the contractor; the performance bond does not – it protects only the owner.
- A general liability policy restricts its indemnification coverage to property damage arising from the contractor's defective construction; a performance bond provides broader coverage as it applies to any default by a contractor, not just property damage arising from defective construction.

Third, policyholders argue that the "business risk" exclusions in the standard general liability policy show that general liability policies are intended to cover construction defect claims. Those "business risk" exclusions include the "property damage" exclusion, "your work" exclusion, "impaired property" exclusion, and "recall" exclusion. These exclusions generally limit coverage for construction defect claims to certain defined circumstances. By limiting rather than outright excluding coverage, policyholders argue that these exclusions demonstrate an intent to cover construction defect claims.

C. Whose Policy Provides Coverage

As discussed above, the policies of a number of different parties may be involved in the dispute. The owner has liability and first-party property coverage. Each of the general contractor and the subcontractors have general liability insurance policies. The architect may have errors and omissions coverage. Entities supplying building products will have liability coverage. Each of these entities may have numerous carriers based upon whether there is both primary and excess coverage involved and whether the policies contain shared responsibilities among more than one insurance carrier on any individual layer of coverage.

D. Duration of Coverage Under Builder's Risk Policies

Builder's risk coverage is not permanent coverage and provides coverage only during the "course of construction." The coverage period for a builder's risk policy depends on the language of the policy itself, as well as the contract between the owner and the contractors. The start date for coverage may begin on the first day of construction, or may even begin before construction has officially started, providing coverage when the contractor is in the preparation phase. *See Patton v. Aetna Ins. Co.*, 595 F. Supp. 533, 534 (N.D. 1984) (holding that fire that occurred after the "unhooking of plumbing and gas lines, the removal of a furnace, the removal of lattice

work around the house, and discussions with two contractors regarding lowering of the house" was during the course of construction because the renovations to be performed required the removal of these items).

The date on which coverage ends is often a point of controversy and provides the most opportunity for disputes between the insured and its carriers. A builder's risk policy may provide that coverage ends on a date certain or upon the happening of a certain event such as occupancy, owner's acceptance, date on which the construction contract is complete, or date certificate of occupancy is issued by a government agency – or it may not provide any termination date. The determination of when a building is "occupied" or when construction is "completed" has been addressed by many courts. Courts consistently have held that a building is "occupied" or "completed," and the builder's risk coverage terminates, only when the building is ready for its "intended use." *Cuthrell v. Milwaukee Mechs. Ins. Co.*, 66 S.E.2d 649, 651-52 (N.C. 1951) ("A building is complete if, and only if, it has reached that stage in its construction when it can be put to the use for which it is intended" and "[a] building is occupied when it is put to a practical and substantial use for the purpose for which it is designed"). For example in *Reliance Insurance Co. v. Jones*, 296 F.2d 71 (10th Cir. 1961), the court held that where only a small amount of grain was placed in a "storage building as a temporary expedient," the building was not complete and the builder's risk policy covered damages to the property. The court explained that the "evidence is indicatory of the fact that the building was never put to anything more than a mere transcient [sic] or trivial use," therefore it was not "occupied" under the terms of the policy and coverage exists under the builder's risk policy. *Id.* at 73. Coverage under a builder's risk policy will also terminate where a building is occupied prior to its completion "where such policy is issued on condition that the building shall

not be occupied before completion without consent of the insurer." *Hendrix v. New Amsterdam Cas. Co*., 390 F.2d 299, 302-03 (10th Cir. 1968).

Regardless of the actual event that triggers the termination of builder's risk coverage, it is imperative that the owner purchase property and fire insurance to provide coverage once the builder's risk insurance expires.

E. Timing of Damage/Cause of Damage

The insuring agreement of general liability policies covers damages arising from (1) "property damage," (2) occurring during the policy period, (3) caused by an "occurrence." Insurers challenging coverage for construction defect claims generally focus on whether the claim arises from an "occurrence." When damage takes place is a key determinant of what policy period applies to a claim. For example, if it takes three years to finish construction and claims alleging damage to a building are made two years after construction is completed, the timing of the damage may determine whether a builder's risk policy applies, or whether post-construction liability and property policies apply. Moreover, if there are different insurance carriers that sold coverage in different years to the policyholder, each carrier will look to determine whether damage took place during their policy years. This often becomes a hotly disputed issue of fact preventing coverage cases from being resolved without motion practice.

Similarly, the cause of damage is key to insurance coverage cases because policies often contain many exclusions that can bar coverage if applicable. For example, if damage is caused intentionally, it may be excluded. Other exclusions that may be at issue are exclusions for pollution, mold, lead, flood, wear and tear, etc.

F. Type of Damage

The type of damage at issue also can determine which policy provides coverage. For example, mold may be excluded under a general liability policy and first-party property policy, but covered under a pollution liability policy. Moreover, even if mold is excluded in one part of a policy, it may be covered if the mold "arises out of" a covered event. For example, certain policies explicitly provide that although mold (or some other type of damage) generally is excluded, mold damage may be covered if it arises out of a covered event, such as "named windstorm." In addition, the same damage may be covered under more than one policy, in which case those policies' "other insurance" provisions could determine how responsibility for that covered damage is to be allocated.

A major dispute between policyholders and insurance companies often takes place when damage or loss potentially is covered under more than one policy. In those situations, insurance companies often take the position that they need not provide coverage until the allocation issues ultimately are determined, while policyholders assert that coverage should be provided first and the allocation amongst covering carriers determined thereafter.

G. "Your Work"

One exclusion deserving of particular attention in construction cases is the "your work" exclusion. This exclusion generally precludes coverage for a contractor's "work" – generally defined as the scope of work set forth in the general contract. The "your work" exclusion typically contains a "subcontractor" exception stating the exclusion does not apply where a subcontractor performed the work on behalf of the contractor. Major disputes can take place regarding whether resulting damage from the initial damage may be covered. For example, if a poorly constructed roof causes water damage that arguably is excluded under the "your work" exclusion in the

roofer's policy, is resulting mold caused by the water damage also excluded? As with many insurance questions, the answer depends upon the specific policy language involved and which state's law governs the issue.

H. Additional Insured Coverage

Insurance policies provide coverage to a "Named Insured." In addition, coverage can be extended to individuals or entities other than the named insured where the policy contains an "additional insured" endorsement. Examples of additional insureds are building project owners, general contractors, owners/lessors of real estate, lessors of leased equipment, and retailers/distributors.

As a general matter, an additional insured is "an entity enjoying the same protection as the named insured." *Pecker Iron Works of New York v. Travelers Ins. Co.*, 99 N.Y.2d 391, 393 (2003). Some courts have held that the scope of coverage for an additional insured generally is not greater than coverage provided to the named insured. *Nat'l Union Fire Ins. Co. v. Liberty Mut. Ins. Co.*, No. 03-80106-CIV**,** 2008 WL 3851496 (S.D. Fla. Aug. 14, 2008). However, additional insured coverage may apply even where coverage for the named insured is excluded. For example, in *Costco Wholesale v. Lib. Mut. Ins. Co.*, 472 F. Supp. 2d 1183 (S.D. Cal. 2007), decided under Connecticut law and citing the severability clause of the policy, the court held that the carrier had a duty to defend the additional insured from a suit brought by the named insured's employee even though coverage for the named insured was excluded.

One issue often arising in the additional insured context is whether the additional insured exposure "arises out of" the activities of the named insured. Once a court determines that the damage "arises out of" the named insured's operations, coverage will generally be afforded. *Lafarge Midwest, Inc. v. Frankenmuth Mut. Ins. Co.*, No. 253591, 2005 WL 1923158 (Mich. App. Aug. 11, 2005); *Home Depot*

U.S.A., Inc. v. Nat'l Fire Ins. Co. of Hartford, No. 3:06-CV-0073-D, 2007 WL 2592353 (N.D. Tex. Sept. 10, 2007). For purposes of determining the defense obligation, whether liability "arose out of" the named insured's work generally is determined from the allegations in the complaint against the additional insured. *Regal Homes, Inc. v. CNA Ins.*, 217 Ariz. 159 (2008). In many states, the "arising out of" standard is a fairly low threshold and the trend is to find coverage for the additional insured when the question is close. *Premcor Refining Group, Inc v. Matrix Industrial Contractors, Inc. v. Catalyst Handling Service Co., LLC*, No. 07C-01-095-JOH, 2009 WL 960567 (Del. Super. Mar. 19, 2009). However, the low threshold is not without limit. For example, transporting an asphalt roller, or providing notice to a contractor that the asphalt roller needed to be transported, was not "maintenance of traffic" within meaning of subcontract, and thus placement of delineation devices (*e.g.*, cones) around the asphalt roller was not part of subcontractor's work; therefore, the contractor was not covered as an additional insured under primary and umbrella liability policies applicable to the contractor's liability arising out of subcontractor's work. *Great Am. Ins. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 574 F.Supp.2d 1294 (S.D. Fla. 2008).

Additional insured coverage applies both to the duty to defend and the duty to indemnify. Serious issues arise when a policyholder's primary carrier alleges that the policyholder is an additional insured on another policy and that other policy must provide the coverage. In those situations, as discussed above, issues of allocation of responsibility abound and the policyholder may find itself without a carrier providing coverage where two or more carriers -- the policyholder's own carrier and an additional insured carrier – may dispute the priority of coverage obligations. Similarly, conflicts between "other insurance" clauses in multiple policies covering a party can be a problem when the two policies have the same "other insurance clauses,"

or when they have conflicting language. The case law does not yet have a clear trend and is growing in frequency.

H. Subrogation Issues

Subrogation allows an insurance carrier to recover a loss, for which it has provided coverage to its insured, from the party who caused the loss. An insurance carrier, however, usually does not have a right of subrogation against its own insured for any loss for which its insured is covered under its policy. *See N. Star Reins. Corp. v. Cont'l Ins. Co*., 624 N.E.2d 647, 653 (N.Y. 1993); *Jos. A. Bank Clothiers, Inc. v. Brodsky*, 950 S.W.2d 297, 303 (Mo. Ct. App. 1997). Accordingly, under a builder's risk policy, the insurance carrier will not able to recover under the owner's rights from the contractor or subcontractors if the contractor or subcontractor is included as an additional insured under its policy. *See Baugh-Belarde Construction Co. v. College Utilities Corp.*, 561 P.2d 1211 (Alaska 1977). Where there are no restrictions on subrogation, the damaged building case becomes even more complicated because the insurance company has the additional interest of seeking reimbursement for amounts paid under coverage from other responsible parties. This is another type of cross-current in liability that makes damaged building cases very difficult to resolve though settlement.

III. ANTICIPATING POTENTIAL DISPUTES – ITEMS TO ATTEND TO BEFORE DAMAGE TAKES PLACE

A. Protective Measures To Take Before A Claim Arises

Many policyholders do not review their insurance programs in detail. Rather, they simply ask their insurance broker to provide a general liability policy at the least cost and then forget about it. Such an approach, while easy to administer, may have severe negative consequences once a claim arises.

There are several actions a policyholder may take to develop a solid insurance program – most of which are relatively easy and all of which a competent insurance broker can assist.

1. Obtaining Completed Operations Coverage

"Completed operations" coverage provides coverage for claims arising after the contractor has completed its project. By contrast, "ongoing operations" coverage only provides coverage for claims which occur during the course of a contractor's project.

Construction claims may arise several years after a project is completed because it takes time for defects to manifest themselves, for owners to investigate the issues, and for counsel to initiate a claim. As such, construction claims almost always involve "completed operations" exposure, and it is important for a general contractor to assure its general liability policies provide completed operations coverage. While most general liability policies do, some do not.

2. Obtaining Proper Coverage Limits

While policy limits can vary widely, a typical general liability policy provides $1 million in coverage per occurrence. Construction claims on even moderate size projects can involve damages ranging into the millions of dollars. Thus, a owners and contractor must pay close attention to the policy limits available under its general liability insurance program to assure sufficient limits exist to cover catastrophic claims.

As discussed above, "when" the damage takes place will impact the scope of coverage triggered and some insurance carriers have sought to limit coverage for continuous injury claims to a single policy period. The endorsement significantly impacts owners and contractors because it eliminates the ability to expand the policy

limits horizontally across multiple policy years. Consequently, policyholders now obtain appropriate levels of coverage vertically through excess or umbrella insurance. The exact amount of coverage required differs by policyholder. A qualified insurance broker can assist a contractor to determine the appropriate amount of coverage based on the loss history for similarly situated general contractors and other pertinent information.

General contractors also should give consideration to obtaining "project specific" policies. As its name implies, a "project specific" policy provides coverage for a specific project. A project specific policy has advantages for insurers and contractors. For insurers, the scope of risk is clearly defined – the project at issue. For contractors, each project has a clearly defined level of coverage available which will not be invaded by claims on other projects. Again, a qualified insurance broker can discuss whether this option makes sense for a contractor.

B. Consider OCIP Policies As An Alternative To Additional Insured Coverage

As discussed above owners generally require general contractors to add them as "additional insureds" to their policies and general contractors in turn typically require subcontractors to add them as additional insureds. The complexities and difficulties involved when there are cross-currents of liability and exposure amongst multiple insureds and additional insureds has been discussed above.

One way potentially to avoid the issues raised with additional insured coverage is to purchase a single policy to provide coverage for all participants in the project. These "owner controlled" or "contractor controlled" insurance policies remove the in-fighting amongst the parties as to fault and priority of coverage, and set out a version of "no-fault" coverage that benefits all participants. Of course, given the number of policyholders that may have a claim to coverage, it is of paramount importance to

make sure that sufficient limits are purchased so that the parties do not exhaust coverage prematurely.

C. Retaining A Qualified Insurance Broker

Insurance brokers, like members of any industry, vary widely in their individual areas of expertise and levels of competence. Thus, it is important that a policyholder carefully select the right broker and, in particular, one specializing in construction. Good brokers can assist owners and contractors obtain proper coverages and limits, deal with additional insured issues and alternatives, and generally advise a policyholder on how best to position its company to procure the best insurance on the most favorable terms. A good broker can be an invaluable asset to a policyholder.

D. Protective Measures To Take After A Claim Arises

Once a construction claim arises, there are several steps a policyholder and its counsel can take to maximize the opportunity the carriers involved will resolve the claim. This paper addresses three of those steps – pursuing coverage timely, preparing the claim for settlement negotiations, and engaging personal counsel to assist with coverage issues. After a catastrophic loss the owner/contractor and subcontractors are expected (and required) to act with prudence and diligence in repairing damage and mitigating the impact of the loss on the project and its completion. Insurers are expected and required to act expeditiously and provide guidance to the insured entity from the outset. This requires an immediate level of cooperation and early recognition of the overall impact from the loss.

1. Timely Pursuing Coverage

A policyholder should notify its insurance broker or insurance company immediately upon receiving a claim. General liability policies typically require an insured to provide notice of a claim as soon as practicable. Insurers frequently raise late notice as a potential ground to deny coverage. Most courts require an insurer to

show prejudice by the policyholder's late notice before permitting an insurer to deny coverage. Some jurisdictions, however, permit insurers to deny coverage without any showing of prejudice.

A policyholder can avoid this issue altogether by providing notice to its broker or insurer as soon as the policyholder receives the claim. Providing notice is simple – typically requiring the completion of a one page form or a short telephone call to the insurer's claims office. To the vigilant policyholder, notice should never be an issue.

2. Preparing The Claim For Settlement Negotiations

Most construction claims settle before trial. Settlements do not just happen, however. Rather, they require a significant amount of preparation and planning both for the policyholder and the policyholder's insurer. Many settlement conferences and mediations fail because the insurer claims it does not have sufficient information about a claim and, hence, cannot properly evaluate the claim for settlement purposes. Little can be more frustrating to a policyholder than to hear these words and realize the case will continue for the indefinite future.

There are three specific steps a policyholder and its attorney can take to avoid this problem. First, the policyholder and its counsel should keep the insurer well informed throughout the case. While insurers may be criticized justifiably for failing to stay on top of their claims, a policyholder and its counsel can minimize problems arising from adjuster neglect by providing regular litigation updates. Indeed, many insurers require periodic updates from counsel. In addition, counsel should discuss the claim with the insurance adjuster personally or by phone from time to time to make sure the adjuster knows the case and its risks. These actions will keep the insurer informed about the case and preclude an insurer from claiming ignorance when settlement negotiations begin.

Second, counsel should provide the insurer a detailed risk analysis well before settlement negotiations begin in earnest (at least 60-90 days before any settlement conference or mediation). The analysis should provide a full and objective view of all relevant facts, legal issues and other factors pertinent to the valuation of the claim. Counsel also should provide the insurer with a recommended settlement value or range. The importance of counsel providing a well thought out settlement recommendation cannot be underestimated. Counsel, as opposed to the insurer, has the best understanding of the case because of counsel's day-to-day work on the claim and counsel's familiarity with the local judges and jury pool. Thus, counsel – and not the insurer – is in the best position to determine the proper settlement value of the case. As such, it is incumbent on counsel to provide the insurer his or her recommendation on a settlement amount.

Importantly, counsel's case evaluation and settlement recommendation must be reasonable based upon counsel's objective view of the litigation. Where there is a covered claim, an insurer has an obligation to accept reasonable settlement offers within policy limits. *Aetna Casualty and Surety Co. v. Kornbluth*, 471 P.2d 609, 611 (Colo. App. 1970). By contrast, an insurer is not obligated to accept unreasonable settlement offers. *Noe v. American Family Mut. Ins. Co.*, 2002 WL 1634251, *3 (D.Minn. 2002).

Counsel who provides a thorough and well-reasoned settlement analysis gives its policyholder two very effective tools to secure coverage where an insurer balks at reasonable settlement offers. First, counsel's analysis may assist a mediator or settlement judge to convince the insurer that an offer is reasonable and should be accepted. Second, counsel's analysis will strengthen significantly any future bad faith claim a policyholder may need to pursue should the insurer refuse to settle a case within counsel's recommended range. As stated above, counsel is in the best position

to evaluate the case, and insurers are hard pressed to explain why their judgment should trump the judgment of the lawyer who lived and breathed the case on a daily basis.

Third, counsel and the policyholder should contact the insurer before the mediation (perhaps 30 to 60 days in advance) to inquire whether the insurer has any questions regarding the case or needs any additional information to inform its settlement evaluation. Counsel and the policyholder also should request the insurer to identify any coverage issues the insurer believes may impact the settlement negotiations. If so, counsel should advise the policyholder to engage personal counsel experienced in insurance coverage to address the insurer's issues. In many circumstances, a "pre-mediation" mediation may make sense to resolve coverage issues in advance so as to avoid wasting precious time during settlement conferences and mediations addressing coverage rather than settlement.

Regular case updates, a thorough case evaluation and the advance resolution of coverage issues can assure the policyholder's insurer will be well informed about the case and well prepared for settlement negotiations, thus giving the policyholder the best chance to resolve the claim and put the defect litigation in its rear view mirror.

3. Engaging Personal Counsel

Policyholders should give strong consideration to hiring independent personal counsel to handle insurance coverage issues, particularly at the settlement negotiation stage. Most insurance defense counsel will not handle coverage disputes between the policyholder and its insurer. Personal counsel can help with these issues. Specifically, personal counsel can advise the policyholder and the defense counsel regarding the coverage issues that exist and how to address those issues as the litigation progresses. Personal counsel also can assist settlement negotiations by

addressing coverage issues proactively, educating the settlement judge or mediator on coverage issues, and urging the insurer to fulfill its duty to settle the case on reasonable terms.

Some jurisdictions require insurance defense counsel to be aware of coverage issues and advise the policyholder to engage personal counsel. How jurisdictions handle this issue is beyond the scope of this paper. Nevertheless, insurance defense counsel would be well advised to research the obligations in their jurisdictions and to know the good coverage attorneys in their locale.