2018 Construction Conference
September 26-28, 2018
Chicago, IL

Complex Catastrophic Injury and Construction Defect Matters in the Midwest: Practice Pointers from Claims, Coverage and Defense Perspectives

I. Construction Claim Issues

Understanding the Different Types of Risk Transfer

One of the first issues a Claims professional or attorney must face when handling a new construction claim is determining whether there are any risk transfer opportunities and whether any other party can transfer risk to them. To properly address these issues, it is critical for the claims handler and attorney to understand the types of risk transfer that can occur and the extent to which tenders or risk transfer create coverage issues and public policy issues.

There are generally three ways in which a party can transfer risk to another party: (1) through a contribution action; (2) through an indemnity agreement or implied indemnity; and (3) through the use of an additional insured endorsement. Each of these methods depends greatly on the law of the state involved, the relationships among the parties, their agreements and the provisions of the insurance policies they obtained.

The Differences Between States with Joint and Several Liability (Like Illinois) And Those with Several Liability Only (Like Indiana) And the Use of Contribution Actions in States With Joint and Several Liability.

Each state has a different system for allocating loss among the plaintiff and other parties that are at fault for the plaintiff's injuries in tort cases. For example, under Illinois law, all parties whose conduct proximately caused the plaintiff's injuries are jointly and severally liable for the entire amount of the plaintiff's damages, minus any fault attributed to the plaintiff. To mitigate against the unfairness of requiring a defendant with a small percentage share of fault pay 100% of the damages, Illinois allows a defendant that has paid more than its share of the fault to obtain contribution from joint tortfeasors. Illinois Contribution Among Joint Tortfeasors Act, 740 ILCS 100/0.01, et seq. In contrast, under the Indiana Comparative Fault Act, Ind. Code §34-51-2-7, each defendant is severally liable for its own percentage of fault only and is therefore not entitled to contribution from other tortfeasors. R.L. McCoy, Inc. v. Jack, 772 N.E.2d 987 (Ind. 2002); Control Techniques v. Johnson, 762 N.E.2d 104 (Ind. 2002).

In construction cases involving an injury to the employee of one of the contractors or subcontractors, the employer of the injured worker is generally not liable in tort for the workers' injuries, as the worker's exclusive remedy is under each state's workers' compensation act. In a state like Indiana, where each party is only responsible for their own share of fault, the jury will typically be instructed to consider the fault of the plaintiff, the defendants, and non-parties, such as the employer, who contributed to the plaintiff's injuries. Ind. Code §34-51-2-7.

In a state which has joint and several liability and contribution, the question becomes whether the defendants can sue the employer for contribution, despite the workers' compensation exclusive remedy provision. Illinois addressed this question and held that an employers' contribution liability is limited to the amount of its Workers' Compensation lien. Kotecki v. Cyclops Welding, 146 Ill.2d 155, 585 N.E.2d 1023 (1992). This means that the other defendants can seek contribution from the employer, but the employer's liability will be no more than it paid the plaintiff under workers' compensation, and it can be dismissed from the suit if it agrees to waive its workers' compensation lien.

In addition to contribution claims, in some states there can be an action for implied indemnity. Most states only recognize implied indemnity in cases where one party is vicariously liable for the conduct of another. For example, a principal can recover from a negligent agent if he principal is held vicariously liable for the agent's actions. This is rarely a significant issue in construction litigation.

II. Risk Transfer Strategies and Obstacles Present by Anti-Indemnity Statutes

Under most construction contracts, the owner and general contractor require all subcontractors to agree to defend and indemnify the owner and general contractor for losses arising from the work of the subcontractors. The extent to which these indemnity agreements are enforceable varies from state to state. Many states have statutes that prohibit agreements requiring one party to a construction contract from indemnifying another for liability resulting from the indemnified party's own negligence. However, the extent to which this precludes indemnification varies from state to state.

In Illinois, as in most states, indemnity agreements are strictly construed, and will not be construed as providing indemnity for one's own negligence unless such an intent is clearly expressed in the agreement. Also, the Indemnity Act, 740 ILCS 35/1, prohibits provisions in construction contracts by which one party agrees to indemnify another for the indemnitee's negligence. Thus, when a general contractor seeks indemnification from a subcontractor in a construction context, such an action will generally be dismissed. A significant exception to this is when the general contractor seeks indemnification for an injury to a subcontractor's employee. As mentioned above, the employer's contribution liability would generally be limited to the amount of the employer's workers' compensation lien. However, if there is an indemnity provision, the courts will interpret that indemnity agreement to be a waiver of the employer's worker's compensation limit on contribution liability, so the general contractor can obtain contribution from the employer to the full extent of the employer's fault. Braye v. Archer-Daniels-Midland Co., 175 Ill.2d 201, 676 N.E.2d 1295 (1997); Liccardi v. Stolt Terminals, Inc., 178 Ill.2d 540, 687 N.E.2d 968 (1997).

Indiana courts have held that indemnification clauses in subcontractors' agreements that clearly and unequivocally state that subcontractor is to indemnify contractor for contractor's own negligence are enforceable, whether or not contractor was at fault. GKN Co. v. Starnes Trucking, Inc., 798 N.E.2d 548 (Ind.App. 2003). The Indiana Indemnity Act, I.C. 26-2-5-1, prohibits construction contracts calling for indemnity for the indemnitee's sole negligence, but does not prohibit indemnity for a party's own negligence where that party is not solely responsible for the damages. Moore Heating & Plumbing, Inc. v. Huber, Hunt & Nichols, 583 N.E.2d 142, 147 (Ind.App. 1991). However, such clauses will be strictly construed, and will not be held to provide indemnification unless it is so stated in clear and unequivocal terms. Sequa Coatings Corp. v. Northern Indiana Commuter Transportation Dist., 796 N.E.2d 1216, 1222 (Ind.App. 2003).

III. Coverage Issues and Obstacles Relating to Indemnity Agreements

The standard CGL insurance policy excludes coverage for bodily injury or property damage for which the insured is obligated to pay damages "by reason of the assumption of liability in a contract or agreement." ISO form CG 00 01 12 04. However, there is an exception to this exclusion for liability assumed in a contract that is an "insured contract", provided that the claimed damages occur subsequent to the execution of the contract. An "insured contract" is defined to include that "part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) under which you assume the tort liability of another party to pay for 'bodily injury' or 'property damage' to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement." Id. Thus, in general, valid contractual indemnity provisions in construction contracts, under which a subcontractor agrees to indemnify the general contractor or owner, are covered under a CGL policy.

In Illinois, coverage for indemnity agreements raises some other issues. As mentioned above, an agreement to indemnify a party to a construction contract for that party's own negligence are void under the Illinois Indemnity Act. However, the Illinois Supreme Court has interpreted indemnity contracts in construction contracts to be a waiver of the workers' compensation limitation on contribution, so an employer that has signed an indemnity agreement will be liable in contribution for up to its full share of any liability. Does this waiver of the workers' compensation limit on liability constitute an "insured contract", so that it would be covered under a CGL policy? In Virginia Surety Co. v. Northern Ins. Co. of New York, 224 Ill.2d 550 (2007), the Illinois Supreme Court ruled that an employer's agreement to indemnify the general contractor was not an "insured contract," so it was not covered by a CGL policy. The court reasoned that a waiver of the worker's compensation cap on damages was merely the waiver of a defense, and not an agreement to "assume the tort liability of another." An employer's unlimited contribution liability may be covered, instead, under an employer's liability policy.

Coverage Issues and Obstacles Relating to Additional Insured Endorsements

The typical construction contract includes some type of provision requiring the subcontractors obtain insurance coverage in specified amounts. Frequently, such a contract will also provide that before commencing work on the project, the contractor or subcontractor will furnish to the owner or general contractor a "Certificate of Insurance … evidencing the issuance of the insurance to the Contractor … and certifying that the Owner shall be given not less than 30 days written notice prior to any material change …." A frequent variation adds a sentence stating that the certificate of insurance must specify that the owner, architect and engineer are additional insureds under the required policies. Note that the first sentence requires only that the certificate of insurance must show that the required insurance has been obtained – it does not specify that additional insured coverage must also be obtained. In the absence of a clause requiring additional insured coverage, the contract will not be construed as requiring the subcontractor to provide coverage for the owner or general contractor. Instead, it will be assumed that the purpose of this requirement is to ensure that the contractor would have the resources to satisfy a judgment. Barney v. Unity Paving, 266 Ill.App.3d 13, 19, 693 N.E.2d 592, 596 (1st Dist. 1994).

The second variation appears to require additional insured coverage, since it specifies that the certificate of insurance must show that the owner is an additional insured under the required policy. However, a contract provision requiring the insured to obtain a certificate of insurance naming the owner or general contractor as an additional insured is not the same as a contract provision requiring that the owner or general contractor actually be added to the insurance policy as an additional insured. West Bend Mut. Ins. Co. v. Athens Construction Co., Inc., 2015 IL App (1st) 140006 (1st Dist. 2015). All that is required in such a situation is that the certificate of insurance name the owner or general contractor as an additional insured, but the certificate of insurance has no impact on the policy itself. Id.

Notably, courts in Indiana and Illinois have held that where the parties to a contract agree that insurance will be provided as part of the bargain, the parties are deemed to have agreed to look solely to the insurance in the event of loss and not impose liability on the part of the other party. Briseno v. Chicago Union Station Co., 197 Ill. App. 3d 902, 557 N.E.2d 196 (1st Dist. 1990). Indiana Erectors v. Trustees of Indiana Univ., 686 N.E.2d 878, 880 (Ind. App. 1997). This is designed to prevent an insurer from seeking to recover from one of its insureds. Where the insurance procured by one of the parties does not fully compensate that party for the full extent of its liability, then that party may recover from the other in contribution or indemnity for the uncovered portion of its liability. Kirincich v. Jimi Construction Co., 267 Ill. App. 3d 51, 55, 640 N.E.2d 958, 961 (2d Dist. 1994).

The measure of damages for failure to procure required coverage is the amount that would have been paid under the policy if it had been procured. Doherty v. Davy Songer, Inc., 195 F.3d 919, 927 (7th Cir. 1999).

IV. Scope of Coverage Under Additional Insured Endorsements

Assuming the contractor or subcontractor obtains additional insured coverage, the question becomes the extent of coverage provided to the additional insured. Not surprisingly, insurers generally argue for narrow interpretations of these endorsements, and maintain that the endorsements provide coverage solely for the additional insured's vicarious liability for the named insured's conduct, or at most only when there is proof that the named insured's negligence was a proximate cause of the damages. In contrast, the additional insureds argue for broad coverage, so that nearly any liability having even a slight connection to the named insured's work will be covered. The success of these arguments has generally been determined on the basis of the wording of the additional insured endorsement.

The older additional insured endorsements provided additional insured coverage when the additional insured faced liability "arising out of the named insured's" work or operations. Courts interpreted such provisions broadly, holding that that (1) there is no requirement that the insured's work proximately caused the injury, so long as there was a "but for" causal relation; and (2) there was no requirement that the named insured is negligent or that the additional insured's negligence was not a cause of the occurrence. E.g., Shell Oil Co. v. AC&S, Inc., 271 Ill.App.3d 898, 649 N.E.2d 946 (5th Dist. 1995); 291 Ill.App.3d 336, 683 N.E.2d 510 (1st Dist. 1997); Casualty Ins. Co. v. Northbrook Property & Casualty Ins. Co., 150 Ill.App.3d 472, 477-78, 501 N.E.2d 812, 815-16 (1st Dist. 1986); Philadelphia Electric Co. v. Nationwide Mutual Ins. Co., 721 F.Supp. 740, 742 (E.D.Pa. 1989); R.R. Donnelley & Sons Co. v. Fireman's Fund Ins. Co., 2004 U.S. Dist. LEXIS 24583 (E.D. Pa. 2004); Township of Springfield v. Ersek, 660 A.2d 672, 676 (Pa. Commw. 1995).

In an effort to restrict the broad coverage granted by these endorsements, in 2004 ISO changed the additional insured endorsement form by replacing the phrase "arising out of" with the phrase "caused, in whole or in part, by." In addition, new form specified that the additional insured's liability must be caused by the named insured's "acts or omissions" rather than the more general "ongoing operations." ISO Form CG 20 10 10 04. Under this language there should be no coverage where the additional insured's actions were the sole cause of the accident. Likewise, some act or omission of the named insured must have been at least a contributing cause of the accident to trigger coverage for the additional insured. However, the courts have not yet developed a consensus about whether the named insured's actions must have proximately caused the accident or whether the named insured's actions must have been negligent.

Arguably, the phrase "caused in whole or in part by" is not substantially narrower than "arising out of," since the phrase "arising out of" required at least cause in fact. However, several courts interpreting this language have held that there is no coverage for the additional insured unless the named insured's conduct was a proximate cause of the injuries. E.g., Gillane Bldg. Co. v. Admiral Ins. Co., 664 F.3d 589 (5th Cir. 2011) (Texas law); National Union Fire Ins. Co. v. XL Ins. America, Inc., 2013 U.S.Dist. Lexis 68467 (S.D.N.Y. 2013) (New York law); Dale Corp. v. Cumberland Mut. Fire Ins. Co., 201 U.S. Dist. Lexis 127126 (E.D. Pa. 2010) (Pennsylvania law).

Other courts have construed the language more broadly, focusing on the "in whole or in part" language. E.g., Pro Con, Inc. v. Interstate Fire & Cas. Co., 831 F. Supp. 2d 367 (D. Me. 2011) (Maine law). As the court stated in Pro Con, "the 'in whole or in part' language of the Interstate policy specifically intended coverage for additional insureds such as Pro Con to include 'occurrences attributable in part to acts or omissions by both the named insured and the additional insured.'" 831 F.Supp.2d at 374. As another court stated, the "phrase 'caused by' does not materially differ from the … phrase, 'arising out of.' … In turn, the phrase 'arising out of' focuses 'not on the precise cause of the accident but the general nature of the operation in the course of which the injury was sustained.'" National Union Fire Ins. Co. of Pittsburgh, PA v Greenwich Ins. Co., 103 A.D.3d 473, 474, 962 N.Y.S.2d 9 (2013) (internal citations omitted).

Courts have also differed on the question of whether the named insured's "acts or omissions" have to be negligent to trigger coverage. In Garcia v. Fed. Ins. Co., 969 So.2d 288 (Fla. 2007), the Florida Supreme Court ruled that a similar endorsement required that the injuries be caused by the named insured's negligence, stating that an "additional insured's liability must thus be caused by the acts or omissions – that is, the negligence – of the named insured." 969 So.2d at 292 (emphasis in original). Other courts have not been so fast to read the word "negligent" into the phrase "acts or omissions." In Maryland Cas. Co. v. Regis Ins. Co., 1997 U.S. Dist. LEXIS 4359, 1997 WL 164268 (W.D. Pa. 1997), the court reasoned that "the plain and ordinary meaning of 'act or omission' is not negligence." Likewise, in Dillon Cos. v. Royal Indem. Co., 396 F.Supp.2d 1277 (D. Kan. 2005), the court ruled that the phrase "acts or omissions" in an additional insured endorsement "includes any act or failure to act" by the named insured or its employee, not just negligent acts or omissions. 369 F.Supp. at 1288.

Other courts have interpreted this language to provide coverage to the additional insured only where the additional insured is vicariously liable for the named insured's actions. Thus, if the additional insured was liable for its own conduct, there was no coverage. Schafer v. Paragano Custom Building, Inc., 2010 N.J. Super. Unpub. LEXIS 356 * 6, 2010 WL 624108 (N.J. App. 2010) ("The additional insured endorsement issued by Harleysville clearly states that Paragano is covered only as to liability caused by the acts or omissions of K&D Builders. It provides coverage for a claim asserted against Paragano for vicarious liability; it does not provide coverage for a claim against Paragano for its own direct negligence."); 373 Wythe Realty, Inc. v. Indian Harbor Ins. Co., 2010 U.S. Dist. LEXIS 45947 * 8, 2010 WL 1930256 (E.D.N.Y. 2010) ("The only reasonable interpretation is that the duty to defend an additional insured is invoked once a lawsuit alleges that an additional insured is responsible for the conduct of the named insured.").

Another formulation used by some insurers to limit the scope of an additional insured endorsement is the phrase "liability incurred solely as a result of some act or omission of the named insured." One Illinois court held this language to be plain and unambiguous; the term "solely" implies exclusively or entirely, and by the "express terms of the endorsement, the [named insured's] acts or omissions must be the sole ground for alleging liability against [the insured] for coverage to apply." Village of Hoffman Estates v. Cincinnati Ins. Co., 283 Ill. App. 3d 1011, 1014, 670 N.E.2d 874, (1st Dist. 1996).

V. Other Issues for Additional Insured Coverage – Targeted Tenders

Under Illinois law, an insured can avoid the effect of another insurance clause by making a targeted tender, in which the insured advises that it does not want its own insurer to defend or indemnify it in the suit. John Burns Construction Co. v. Indiana Ins. Co., 189 Ill.2d 570, 727 N.E.2d 211 (2000). Thus, and insured can choose which of two policies to trigger, and the "other insurance" clause does not affect that right. If insured chooses not to trigger one policy, then that policy is not "available" for purposes of the other insurance clause. 189 Ill.2d at 578. The insured can deactivate coverage with a carrier to which it had previously tendered the defense and can place its carrier on "standby" notice, in case the selected insurer declines to defend. Alcan United, Inc. v. West Bend Mutual Ins. Co., 303 Ill.App.3d 72, 707 N.E.2d 687 (1st Dist. 1999).

The right to make a targeted tender does not extend to excess policies. Under the doctrine of horizontal exhaustion, all primary policies must be exhausted before any excess policies will be triggered, even if the insured has made a targeted tender to one of the primary policies. Kajima Constr. Servs. v. St. Paul Fire Ins. Co., 368 Ill. App. 3d 665, 856 N.E.2d 452 (1st Dist. 2006). The doctrine of horizontal exhaustion is not limited to "true excess" policies. It also extends to policies where the "other insurance" clause provides that the policy is excess over all other policies. Lamp Inc. v. Navigators Ins. Co., 2013 IL App (1st) 122863-U, 2013 Ill. App. Unpub. LEXIS 2535, 2013 WL 5987318 (1st Dist. 2013). However, once all primary policies have been exhausted, the insured may again choose among available excess carriers through the use of targeted tenders among policies on the same layer. North River Ins. Co. v. Grinnell Mutual Reinsurance Co., 369 Ill.App.3d 563, 860 N.E.2d 460 (1st Dist. 2006).

VI. Best Practices for Analyzing Risk Transfer Issues and Timing Issues

The first step in analyzing a risk transfer opportunity is to determine the scope of the tender (i.e. tender of defense, indemnity or both). Most tenders are based upon contractual agreements and therefore it is imperative for the claims handler or attorney to obtain a complete copy of the relevant contract, insurance policy and any endorsements to confirm that there is some nexus or connection between the claimed liability and the work or project to enforce the indemnity provision. It is also imperative to make sure that you have the most current contract, and any amendments, to confirm that (1) the contract was in effect on the date of loss and (2) that the indemnitor and indemnitee are actual parties to the contract. After this information is obtained, it should be set forth in the tender letter.

If a lawsuit has already been filed, the claims representative must obtain a copy of the complaint and any exhibits to determine if it alleges facts and legal causes of action that trigger insurance coverage. If the complaint does not provide sufficient facts to make a determination if coverage should be afforded, the tender should generally be accepted the tender with a reservation of rights. The claims handler can also file a Declaratory Judgment action.

As a result, it is best practice for a tender of defense or indemnity to be made (1) immediately; (2) in writing and (3) attach all contracts, pleadings and investigation documents upon which the tender if predicated. A tender of defense should be made immediately because the defense costs and fees are typically determined from the date of tender.

In addition to reviewing the underlying contract, the claims representative should also analyze the policy issued to the named insured to determine whether there is potential coverage for the tendering party as an additional insured. In some cases, especially with older policies, there will be an additional insured endorsement that specifically names the tendering party as an additional insured.

In others, the policy may have a blanket additional insured endorsement, under which the policy provides additional insured coverage whenever the named insured has agreed in a written contract to provide coverage to some other party. In these cases, it is important to determine (1) whether there is a written contract requiring the named insured to name the tendering party as an additional insured; (2) whether the contract was executed prior to the occurrence for which coverage is sought; and (3) whether there are limitations on coverage under the additional insured endorsement.

It is important to respond to tenders expeditiously. In most cases, the party claiming coverage is seeking a defense to an ongoing lawsuit as well as indemnity for any liability. Where coverage is sought under an additional insured endorsement, there will be a duty to defend whenever the underlying complaint creates a potential for coverage. Allen v. Continental Western Ins. Co., 436 S.W.3d 548, 552 (Mo. 2014); U.S. Fidelity & Guar. Co. v. Wilkin Insulation Co., 144 Ill.2d 64, 73 (1991). There can be severe consequences for breaching the duty to defend. For example, in Illinois, an insurer that breaches the duty to defend will be estopped from denying coverage. Employers Ins. Of Wausau v. EHLCO Liquidating Trust, 186 Ill.2d 127, 152 (1999). Moreover, if the insurer waits too long to either defend or file a declaratory action, it can be estopped from raising its coverage defenses. Insurance Co. of the State of Pennsylvania v. Protective Ins. Co., 227 Ill.App.3d 360, 368 (1st Dist. 1992). In Indiana, an insurer that denies a duty to defend must either file an action for declaratory relief or hire independent counsel and defend subject to a reservation of rights. If it refuses to defend, "it does so at its peril." Walton v. First American Title Ins. Co., 844 N.E.2d 143, 146 (Ind.App. 2006). In Missouri, an insurer which breaches its duty to defend is guilty of breach of contract and is liable for all resultant damages and waives its right to control the defense and settlement of the suit. Truck Ins. Exchange v. Prairie Framing, Inc., 162 S.W.2d 64, 89 (Mo.App. 2005). Thus, a prompt determination as to whether there is a duty to defend is essential.

Independent Counsel Obligations

When making a decision regarding whether a tender of defense or indemnity should be accepted, denied or accepted under a reservation of rights, the claims handler should retain coverage counsel separate and apart from defense counsel. This is because defense counsel has a conflict of interest in determining if coverage is owed because it owes a fiduciary obligation to the insured.

A conflict of interest giving rise to an independent counsel obligation can also arise with the context of defending a case when a lawsuit alleges claims both covered and not covered under the insurance policy. In Maryland Cas. Co. v. Peppers, 355 N.E.2d (Ill. 1976), the Illinois Supreme Court held that an insured has the right to choose its own counsel because the underlying lawsuit alleged claims both covered (negligence) and not covered (willful and wanton) under the insurance policy. In such situations, the counsel appointed by the insurance carrier has an ethical conflict because the appointed counsel would be faced with representing opposing interests or could potentially steer the litigation to non-coverage.

The duty to provide independent counsel in Illinois is, for the most part, narrow and an insurance carrier must only provide independent counsel when a conflict arises such that "the insurer's interest would be furthered by providing a less than vigorous defense. . ." R.G. Wegman Constr. Co. v. Admiral Ins. Co., 629 F.3d 724 (7th Cir. 2011). Generally, there are two classes of cases that require independent counsel: (1) where the insurer is obligated to defend two insureds that have adverse interests; and (2) where proof of certain facts would shift liability from the insurer to the insured. E.g., Murphy v. Urso, 88 Ill.2d 444, 452-54 (1981) (adverse interests between two insureds); Illinois Municipal League Risk Management Ass'n v. Seibert, 223 Ill.App.3d 864, 873 (4th Dist. 1992). The consequence of failing to offer independent counsel can be the waiver of coverage defenses.