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

Risky Business: Risk Transfer Tips and Tricks

I. Walking the Tightrope

A Practical Approach to Additional Insurance and Indemnification Issues Using a Construction Project for an Example.

Construction Projects have a myriad of difficulties for owners, developers, and builders alike. These difficulties, if kept unchecked and not insured, can be devastating to all of those involved including risk managers and insurance carriers. This presentation will take the practical approach of exploring construction projects from contract to completion and how to address any issues that will arise after the project is completed.

We will be discussing the "tightrope" every construction party walks in the never-ending quest to bring in new projects and protect themselves at the same time. In this roundtable discussion, we will examine the risks and exposure that may lurk in construction contracts and the possible steps to be taken as safeguards using real life examples.

We begin with recognizing and negotiating contracts to ensure clear contractual risk transfer language and indemnification parameters while obtaining a greater understanding of 1st party vs. 3rd party indemnification and jurisdictional views.

Next, we will discuss gaining an understanding of insurance coverage in construction projects and how issues such as additional insured and limitations on liability can affect exposure, should issues arise from construction defects.

There has Been a Breach, Now What?

Now that there has been a breach in the contract and the issues have been identified, we will focus on how to present the claim as well as a step-by-step guide to the litigation process with a further explanation of subrogation or derivative lawsuits against your

subcontractors for these construction issues and how to practically manage and present these claims.

It is crucial, during the early stages of claim investigation, to consider the possibility of subrogation, as this may affect the way in which the claim should proceed. With the rise in construction related insurance claims, having the right investigative foundation is paramount to limiting the total damages/exposure. The first step in establishing this foundation is the use of an expert with knowledgeable "boot-on-the-ground" expertise to properly identify the issue at hand. With proper identification we may determine whether the claimed losses were the result of a defect caused by a contractor/subcontractor.

Prompt inspections after discovering a defect are key in determining the nature of the damage as well as the timing of the damage. During the inspection, properly trained personnel can identify the source of damage thereby identifying any other responsible parties when there is evidence of a prior defect. The other necessity to performing inspections promptly is the ability to properly preserve the evidence before repairs are started and avoiding the issue of spoliation if and when the claim is brought to suit.

Once the investigation preserves relevant information, a decision needs to be made about what needs to be done.

Subrogation occurs in property/casualty insurance when a company pays one of its insureds for damages, the makes its own claim against others who may have caused the loss, insured the loss, or contributed to it.

There is an opportunity for subrogation against a party whose human factor added to the loss incurred. When a construction defect occurs, it is important to consider all potential sources of claimed damages, including whether there is any party who had a duty to exercise reasonable care to avoid the loss, and if that party met their duty. In the event the party failed to meet their duty of taking reasonable measures and precautions against the loss, then the insured and the insurer could maintain a subrogation action against that party.

In multi-unit developments and/or planned communities, there are other potential parties with systematic construction defects that would cause other parties to bear responsibility. This could include developer as well as contractor responsibility for these issues.

As construction claims can carry a hefty price tag especially with multi-unit properties, it is important to identify ways to reduce the costs associated with the same through subrogation. In the event of a multi-unit claim, there are many economies of scale to make such claims manageable and efficient for litigation.

One way to limit the total cost of damages is to investigate and determine whether the claimed damages/loss exposure can be shared with other parties for a source for payment. The use of an expert can assist in identifying code violations, construction defects and other issues that may have existed previously which may have contributed to the damage.

Other source of payments will become critical in deferring the anticipated damages in a time where mass building and consistent regulations provide a standard to compare. If a carrier is willing to invest the time and effort necessary to investigate third-party potential in the face of adversity, a loss could possibly turn into a win.

II. Uncertainties in Insurance Coverage

Difference Between Factual Uncertainty and Legal Uncertainty: Why Does It Matter?

In many states, all that is necessary to trigger an insurer's duty to defend is a possibility of coverage. Any uncertainty as to whether an alleged injury is covered works in favor of providing a defense to an insured, and uncertainty may be either factual or legal.

Factual uncertainty arises when it is unclear from the face of the complaint whether an alleged injury occurred in a manner that is covered by the policy. For example, if a policy were active only for the 2019 calendar year and a complaint did not specify when the alleged injury took place, there would be factual uncertainty as to whether the injury was covered because it is impossible to know from the face of the complaint whether the alleged injury took place during the coverage period. This factual uncertainty would give rise to a duty to defend, lasting at least until a court determined when the injury occurred.

Legal uncertainty arises when it is unclear how a court might interpret the policy language at issue, and, as a result, it is unclear whether the alleged injury falls within coverage. Legal uncertainty can arise in at least two ways. First, ambiguous policy language can give rise to the duty to defend. Second, a duty to defend may arise if there is a question as to whether the case law governing the insurance policy will be read to impose coverage in a given situation. That is, when there is a split of authority in other jurisdictions as to the meaning of a particular policy provision, and no appellate authority in the relevant jurisdiction has opined on the matter, the uncertainty as to how a court might interpret the policy gives rise to the duty to defend.

Legal uncertainty can play a critical role in the interpretation of insurance coverage for claims arising out of construction projects. For example, commercial general liability

policies typically include standard "business risk" exclusions, j (5) and j (6), which exclude coverage for "that particular part of property" on which the insured performed its work. There has been considerable litigation nationwide as to what constitutes "that particular part" of the work. Some courts have interpreted the phrase broadly, concluding that ''that particular part'' excludes all damage to the insured's work product caused by the insured's defective work, even if the scope of the damage far exceeds the portion of the property on which the defective work was actually performed. Other states interpret the phrase narrowly, concluding that ''that particular part'' applies only to the specific components on which the insured performed defective work and not to wider damage to the insured's work product caused by the defective work. Finally, courts that determine that both, or other, interpretations are reasonable conclude that the language is ambiguous and, as a result, construe the language in favor of the insured. Given that there is no consensus nationwide as to how to interpret this language, a court deciding this issue in a state with no binding appellate authority may determine that there is legal uncertainty as to whether the exclusion applies and will therefore find that the insurer was obligated to provide a defense.

Policy Interpretation Uncertainties on Renewal

Interpretation of "Your Work" Exclusion

In addition to the common exclusions j (5) and j (6) above, standard commercial general liability policies include exclusion l, which applies to property damage to "your work" included in the products-completed operations hazard (subject to an exception for work performed by the insured's subcontractors). However, what constitutes "your work" can become uncertain, especially where the insured is a construction manager or general contractor. Some courts have interpreted "your work" to include the entire project, while others interpret the phrase more narrowly.

This uncertainty can be avoided by endorsing the policy to state that the exclusion shall apply only to property damage to that particular part of "your work" that the property damage arises out of. To avoid uncertainty as to what constitutes "that particular part" of the insured's work, as discussed above, the policy can be further endorsed to state that the language "that particular part" does not mean the entire project regardless of whether the insured is acting as a construction manager, general contractor, or design builder.

Coverage for Defective Construction

Standard commercial general liability policies cover bodily injury and property damage caused by an "occurrence," which is in turn defined as an "accident." For claims arising out of defective construction, courts have applied different interpretations of the

"occurrence" definition. There are many nuances among the states on this issue, although generally most fall into one of three analytical camps:

> (1) Some states hold that defective or faulty workmanship is an "occurrence," provided the construction contractor did not intend to cause damage. This analytical framework reserves the analysis concerning whether certain aspects or items of damage (for example, the faulty work itself) are uncovered due to exclusionary provisions.
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> (2) Many states have held that defective or faulty workmanship which causes damage to other work or property is an "occurrence." This framework can often lead to coverage for most damage that results from the faulty work – for example, the cost to replace wet dry wall as a result of faulty window installation. However, the analysis may be complicated by court interpretation of what constitutes "other work or property." For general contractors in some states, the entire construction project might be considered their work, leaving them without coverage despite the fact that, at first glance, the case law seems favorable.
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> (3) Finally, a small number of states find that defective or faulty workmanship is never an "occurrence." Courts taking this approach typically cite to one of two rationales: either the contractor was contractually obligated to provide work free from defect; or the contractor should have foreseen that it would be responsible for correcting defects in its work. Courts will often cite to the concept that correcting deficient work is a "business risk" for contractors which is not intended to be covered by insurance.

The mixed holdings on this issue can create uncertainty as to whether and to what extent construction defect claims are covered, especially for construction companies performing work in multiple states or in states where the law on this issue is unsettled. Most insurance companies have the ability to offer endorsements that delineate the scope of coverage available for defective construction. For example, the policy can be endorsed to state: "Notwithstanding case law holding that defective construction may not constitute an "occurrence", an "occurrence" shall include any circumstance where a defect or deficiency in "your work" results in damages because of "property damage" so long as the "property damage" was not intended by you, and including, but not limited to, when "your work" was performed pursuant to a contract or where damages because of "property damage" arise out of a contract." However, this is a non-standard coverage, and the terms are likely to vary amongst insurers.

Reviewing Downstream Policies: Key Takeaways

Parties to upstream/downstream structured subcontracts often assume that carefully crafted insurance requirements on an executed contract are sufficient to ensure the designed risk transfer scheme executes properly. However, this overlooks a critical step:

vetting the insurance program, which requires both parties collaborating to scrutinize the downstream insurance contracts to ensure compliance.

The need to vet downstream insurance is underscored by the reality that not all parties have the resources to ensure that their insurance programs comply with the insurance requirements in their contracts. Though far from a universal truth, some construction contractors lack the internal time, dedicated staff, or experience to appreciate fully the complicated nuance of their insurance program or the full scope of their risk exposure.

While it may seem like the onus to ensure compliance with contractual insurance requirements should fall solely on the subcontractor, in practical terms, this is a challenge to be borne by all parties because failure to procure the required insurance can create costly problems for upstream parties. When the intended risk transfer fails (i.e., a general contractor or owner is unable to obtain additional insured coverage in the face of a third-party liability claim), upstream parties are then saddled with the cost to defend and indemnify the third-party claim, in addition to the cost of bringing a claim against the subcontractor for breach of contract, all of which add delay and cost to the project. Likewise, downstream parties must ensure that their policies provide the scope of coverage that was promised in order to avoid a breach of contract claim.

At a bare minimum, the vetting process should require the submission of (1) policy declarations and schedules of forms for all liability policies, (2) copies of additional insured endorsements and primary and noncontributory endorsements for the primary commercial general liability policy, and (3) full copies of excess policies, which are typically manuscript but significantly shorter than primary policies. Having the declarations provides confirmation of the named insured, policy limits, policy period, and the policy number, while the schedule of forms enables identification of any problematic endorsements, which can be requested on an as-needed basis for review.

Common Surprises

Obtaining and reviewing the schedule of forms is important because it can help identify limiting endorsements that may otherwise come as a surprise to the additional insured. The additional insured should look for endorsements with titles such as “Residential Exclusion”, “Limitation of Coverage for Designated Work”, “Wrap-Up Exclusion”, “Self-Insured Retention”, and any others that may limit coverage.

While reviewing the schedule of forms is a minimum requirement, the best practice is to review the full policy whenever possible, as there can be surprises hidden within the policy. For example, some additional insured endorsements only respond if there is a direct contract between the named insured (i.e., the downstream party) and the additional insured — also referred to as contractual privity. Some states interpret the following common endorsement language to require privity of contract: [An additional

insured is a] NY person or organization for whom you [the named insured] are performing operations when you and such person or organization have agreed in writing in a contract or agreement that such person or organization be added as an additional insured on your policy. Privity conditions also may be written into the schedules of additional insured endorsements that would otherwise not contain privity requirements, including CG 20 10 and CG 20 37. The schedule may be limited to anyone "with whom you have a written contract or agreement" or to anyone "when you and such person or organization" have entered into a written contract or agreement. This limiting language would not be identifiable based on a review of the policy's declarations and schedule of forms.

Contractual privity language in additional insured endorsements can severely restrict who qualifies as an insured on a subcontractor's policy. For example, if a subcontractor's insurance policy contains an additional insured endorsement with a privity condition, only the general contractor who hired the subcontractor will qualify as an additional insured on the subcontractor's policy. The owner and any other parties for whom the subcontractor agreed to provide additional insured coverage will not be entitled to such coverage.

Construction contracts also commonly require that additional insured coverage must be provided on a primary and non-contributory basis; that is, the downstream party's policies must be first in line to respond to a lawsuit against an additional insured. Without specific endorsements to make a downstream party's insurance policy primary to and non-contributory with an additional insured's own policies, there can be multiple risk transfer failures. This could result in an additional insured's own insurance being required to respond as co-primary with the downstream party's insurance, or after the downstream party's primary policy but before its excess policy. Moreover, where a subcontractor agrees to provide primary and non-contributory coverage for all liability arising out of its operations, but fails to have its policies endorsed accordingly, it can be exposed to damages for failure to procure insurance in accordance with the terms of the contract. As such, the policy must be reviewed to ensure that if primary and non-contributory coverage has been promised, the policy(ies) has been endorsed accordingly.

Relying on Certificates of Insurance

Most upstream parties attempt to monitor a downstream party's insurance by collecting certificates of insurance ("COIs"), but the generalities contained in a COI are not the controlling policy terms and may not tell the whole story. It is unlikely that any of the above-referenced issues could be identified based on a review of a COI alone. The ideal solution is a compliance program for downstream parties' insurance that requires submission and review of the policies themselves to ensure that the downstream parties have complied with their contracts' insurance requirements.