"One for All, and All for One!"

The Team Approach to Defending Subcontractors in Construction Defect Litigation

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INTRODUCTION

"We're In This Together"

Litigation by its very nature is a continuous struggle. One side, proving a point to the other by taking advantage of technicalities. The other, getting back at the other for refusing to negotiate a settlement. Does the relationship between a subcontractor, its insurance representative, and its defense counsel need to be the same way? The answer is a resounding, "No." To be sure, tension and skepticism will always exist between these parties. After all, in most cases, each reserves the right to sue one another should alleged breaches of duties arise. However, it cannot be disputed that the subcontractor, claims professional, and defense counsel share a common

goal in third-party claim litigation, viz. resolution of the claims in the most expeditious means possible.

How do the parties achieve this joint ambition? The strain that often arises in the relationships among insured, insurer, and counsel derives from lack of information and perspective. In life outside construction defect litigation, individuals are sometimes surprised by how differently they see a problem when evaluating it from the perspective of their opponent. This is equally true in liability insurance arena. The purpose of these materials is to discuss the information that influences the subcontractor, claims professional, and defense attorney. It is also to provide the rules of the Tripartite relationship, so that each member of the group may "step in the shoes" of the other and evaluate various third party litigation disputes from the others' perspectives.

With an understanding of the applicable law and an appreciation of the duties of those involved in the insured – insurer relationship, we believe that the reader will acknowledge that the most efficient and cost-effective path to resolution of subcontractor construction defect claims is the ***team*** approach. The subcontractor, the claims professional, and the defense counsel – they are in it together – ***"One for All, and All for One!"***

Section Summary

The materials will proceed with identification and discussion of the team, viz. the subcontractor, claims professional, and defense attorney. The next topic addressed is the one that unifies the team, the Claim. In the Claim section, the reader will find checklists and tables devoted to gathering the information from the insured and others relevant to defending the third-party claim, as well as evaluating the coverage situation. The section will also provide a review of the key concepts of which the members of the Tripartite relationship must be aware to adequately evaluate the coverage decision.

The next section of these materials, the Defense, will discuss the relative duties of defense counsel to the insured and the insurer. Sources of most Tripartite disputes, insured – insurer conflicts of interest will be detailed in the Defense section, also.

The Defense section will be completed with a variety of slides prepared in outline form to assist the reader in understanding concepts that often arise during defense counsel's representation of subcontractors. This section will conclude with discussion of creative ways to resolve third-party construction defect claims.

Now, we invite the reader to begin the journey of appreciation of insured, insurer, and counsel perspectives. We are confident that at the end of the review the reader will understand the ***team*** approach to defending subcontractors in construction defect litigation.

THE TEAM

The Subcontractor

A subcontractor is an individual or entity that enters into a subcontract to perform part or all of the obligations of another's contract. *See* Cal. Bus. & Prof. Code §§ 7026 and 7055 (defining "contractor" and providing for contractor classifications). Subcontractors are generally retained by a general contractor to perform specific tasks as a part of an overall construction project. *See* Cal. Bus. & Prof. Code § 7059 (providing that specialty contractors are limited to work within license classification). General contractors greatly value subcontracting as a means to reduce costs and mitigate project risks. Subcontractors appreciate their role in the construction business, also. While they may earn less than a general contractor per project, long-term business relationships with general contractors may reduce their marketing budget and allow them greater profits in the long run.

Subcontractors are entrepreneurs. As such, they face many concerns in the operation of their businesses. Most subcontractors would agree that the first and foremost concern is the quality of their product or service. Certainly, subcontractors place much pride in constructing the best building component or system they can. However, more importantly, the better the work, the less likely disputes will arise, and the more likely people will continue to seek their services.

A second significant concern of subcontractors is cash flow. Unlike some other businesses, construction contractors must often advance substantial amounts for materials and commit their employees ahead of time to work schedules. Subcontractor goals include advancing as little as possible and being timely paid.

Insurance is the next most important issue in operating a successful subcontracting business. Some argue that obtaining high-limit, broad coverage insurance coverage is one of the most important aspects of the construction business. *See* Kit Werremeyer, *Starting a Construction Business*, 2 (2011) (stating "[i]nsurance is an important asset of your construction company).

Subsidiary subcontractor concerns include labor management, proper licensing, bonding, appropriate contractual terms that facilitate work, marketing, and occupational health and safety. Subcontractors frequently have more immediate concerns than the details of a construction claim, often originating from work that took place several years in the past. Additionally, smaller subcontractors often have little experience with the civil legal system. Their first response to a construction defect claim can be more emotional and less logical. Sometimes, subcontractors respond angrily to the claimant's defect allegations, as opposed to calmly taking measures to protect themselves in the litigation. It is frequently the obligation of claims professionals and defense counsel to assist a subcontractor with the transition from initial frustration and disappointment to organized contemplation of the best methods to defend the subcontractor against the construction defect claims.

The Claims Professional

Among other types of insurance, subcontractors purchase commercial general liability policies for their businesses. In the event of a claim, subcontractors send information related to the claim to their insurers. The job of a claims professional is to receive the information, investigate the claim, determine coverage, accept or reject the claim, and negotiate a settlement. Bureau of Labor Statistics, U.S. Department of Labor, *Occupational Outlook Handbook*, 8 (11th Ed. 2010).

Because claims are usually abundant, claims professionals frequently work long hours, including nights and weekends. For each claim, their specific obligations include responding to claims in a timely manner, processing paperwork, communicating with policyholders, investigating liability, assessing damages, researching and substantiating aspects of each claim, working with product and service providers on time and cost of repairs, negotiating potential settlements with claimants or their representatives, and protecting the interest of the insurance company when dealing with claimants. *Id.*

The final obligation should be emphasized. Generally, claims professionals are employees of an insurance company. An insurance company's business goals include collecting substantial premiums, earning money on the float, and reducing expenditures on claims. Those unfamiliar with successful insurance business may be tempted to conclude that claims professionals, in supporting their employer's goals, will short-change the insureds. In the short run, this practice could increase operational profit. However, ultimately, it is short-sighted. The most important part of the insurance business model is the receipt of premium. Substantial premium is generated by an attractive price, of course, but more importantly, by quality service. Quality service is marked by rapid claim processing, friendly communication, and fair claim settlement. It can aid the reputation of the insurance company and lead to policyholder referrals. Consequently, and perhaps counter-intuitively, claims professionals advance the interests of both the insurance company and the subcontractor by paying claims.

The Defense Attorney

Most CGL insurance policies provide: "We will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance provides. We will have the right and duty to defend the insured against any 'suit' seeking those damages." ISO CG 00011207 (emphasis added). To discharge this duty, insurers often retain private sector attorneys who specialize in insurance defense work for the benefit of the insured. Christopher R. Wagner, *Making Reservations*, Los Angeles Lawyer, June 2003, at 37-38. Subject to policy provisions, the insurer shoulders the responsibility of paying private counsel's attorney fees and costs. Generally, the insured pays nothing for its defense, unless a policy deductible is applicable. Fisher, *supra*, at 1. An insurer's appointment of private defense

counsel is usually limited to defense of the insured in one action. However, the scope of the representation may also include prosecution of transactionally-related cross-actions and collection actions.

In most states, "an attorney retained by an insurance company to defend its insured under the insurer's contractual obligation to do so represents and owes a fiduciary duty to both the insurer and insured." *See Gafcon, Inc. v. Ponsor & Associates*, 98 Cal. App. 4th 1388, 1406 (Cal. Ct. App. 4th 2002). "So long as the interests of the insurer and the insured coincide, they are both the clients of the defense attorney and the defense attorney's fiduciary duty runs to both the insurer and the insured." *National Union Fire Ins. Co. v. Stites Prof. Law Corp.*, 235 Cal. App. 3d 1718, 1727 (Cal. Ct. App. 2d 1991). Because the parties' positions in the representation can be envisioned as points of a triangle, the nature of insurance defense "attorney – clients" dealings has been described as the "Tripartite Relationship." *Purdy v. Pacific Automobile Ins. Co.*, 157 Cal. App. 3d 59, 76 (Cal. Ct. App. 2d 1984). At the center of the triangle is a "coalition for a common purpose, a favorable disposition of the claim – with the attorney owing fiduciary duties to both clients." *Id.*

The Team Approach to Defending Construction Defect Claims

As acknowledged by the *Purdy* court, the ways that interests of the subcontractor, claims professional, and defense attorney may diverge are limitless. However, in most cases, they can be reconciled with recognition of their overarching joint objective. Each of their causes is advanced by resolving the claim, whether by settlement or adjudication, as rapidly and cost-effectively as possible. As the materials proceed, remembering this overall goal will assist in prioritizing the resolution of problems that will arise when handling a construction defect claim.

THE CLAIM

Notice of Claim

The first step in the claims resolution process is the notice of occurrence or claim. The notice is the initial and primary source of information about the allegations against the insured. Careful review of each item reported in the notice will prepare the claims professional to tackle the most important undertaking in the claim review process – taking account of the relevant facts that she does know and determining the significant information she does not know.

At this stage of the process, it is crucial that the claims professional seek out as much information as possible to complete the notice of claim. Since claims are often reported by insurance agents, it is often necessary to speak with the agent and obtain any more information that was inadvertently left out of the notice. Additionally, an initial conversation with the insured is advisable. However, before this conversation takes place, the claims professional should keep in mind the following discussion on parties' respective roles at claim inception.

Perspectives of the Parties

Subcontractor

The claim resolution process is wrought with tension. The claimant may be angry with the subcontractor, or at least, contend it did something wrong. The subcontractor, often occupied with other concerns, may be shocked and overwhelmed. He may be frustrated, because now, on top of everything else, he has to answer pointed questions to an insurance representative when the long ago completed project passed inspection and was accepted by the claimant.

As the claim resolution process continues, the claims professional should strive to keep in mind the subcontractor's perspective. Generally, his honor and pride of work has been assaulted. He is consumed by the details of other projects. If he is presently operating in a depressed economic environment, he is concerned with making enough money to pay his employees, landlord, and insurance premiums. While prudence and actual insurance policy provisions obligate him to respond timely and cooperatively to insurer representatives, the subcontractor likely has much else on his mind when faced with a third party lawsuit.

Claims Professional

Communicating a claims professional's perspectives at the beginning of the claim process is a bit more complex. Ultimately, the claims professional is the representative of a company that supplied a product to subcontractor. In exchange for premium, the insurer promises "to be there" for the subcontractor when he needed it. However, as opposed to a simple tangible product transaction, the insurance product can be amorphous. Simply-stated, the claims professional's job is to give the insured all that he paid for, but no more. So that communications are not misconstrued, it is advisable for the claims professional to advise the subcontractor of this chief purpose at the outset of the relationship. Often direct communication assists in resolving insurer-insured disputes before they arise.

While the claims professional is charged with understanding the subcontractor's perspectives and, hopefully, allaying his concerns, she must be mindful that her oral and written communications should be formulated to include another audience. For whatever reason – an insured's unreasonable expectations – our more litigious society – the team relationship between the claims professional and the subcontractor can devolve. The claims professional must be prepared for the fact that her statements may be scrutinized, characterized, and taken out of context by future attorneys, witnesses, and judicial officers. Adequately prepared claims professionals temper their sympathetic insured discussions with professionalism. You never know when a claims professional's unrefined comment, "This guy's a nut!" however truthful, will be an evidentiary plank in the subcontractor's bad faith action against the insurance company.

Coverage Investigation

The most important duties of a claims professional are performed during a thorough and well-documented coverage investigation. The responsiveness of insurance company representatives to the subcontractor during this process sets the tone for future communications regarding discovery, potential settlement, and possibly trial. Timely and cooperative insurer-insured communications have another bonus. They reduce the likelihood of litigation between the subcontractor and carrier down the road by satisfying the claims professional's regulatory obligations. *See* Cal. Code Regs. tit. 10, § 2695.7(d) (providing that every insurer must conduct and "diligently pursue" a "thorough, fair and objective" claim investigation).

The following discussion in this section focuses on keys to achieving an accurate and complete coverage investigation. After creation of a claims file, claims professionals should follow the proceeding steps. *See* Cal. Code Regs. tit. 10, § 2695.3(a) (requiring insurer's maintenance of a claim file). This will assure that the insured receives the insurance product he paid for and reduce the likelihood of a later challenge to the coverage investigation.

Initial Subcontractor Interview

Distress over a construction defect claim is heightened when the subcontractor has insufficient information about the claim, the insurance coverage, and the legal process. Many times subcontractors' frustration boils over, and concurrently the will to be cooperative withers, when they "can't get anybody from the insurance company on the phone!" The point of a claims professional's initial telephonic interview is not to disgorge the cold technicalities of the reservation of rights letter. The point of the discussion should be to acknowledge that the insurance company has received the claim and is investigating.

The claims professional should state clearly that the purpose of the coverage investigation is not exclusively to uncover evidence supporting the subcontractor's defense. She should explain that because insurance provisions differ from insured to insured and are, frankly, complicated, she first needs to determine from the available information whether the insurance policy could cover the damages alleged in the lawsuit. The claims professional should, again, be up front and state that it is entirely possible that the results of the coverage investigation could lead the insurance company to decide not to pay for defense counsel. She should emphasize that it may be prudent to get advice about the investigation process by an attorney experienced in insurance coverage.

It is natural for individuals facing uncertainty to request an outcome prediction from persons with experience in the subject matter of the unknown. However, claims professionals should resist from offering such a prediction about the outcome of the coverage investigation. For example, even if the window subcontractor is accused of intentionally breaking the windows he

supplied the project, the insurance representative simply has insufficient information to offer "what usually happens." On each claim, she must gather and review relevant documents and interview and re-interview available witnesses before generating an opinion on insurance coverage.

The initial subcontractor interview should be followed with the carrier's written notice of the claim. *See* Cal. Code Regs. tit. 10, § 2695.5(e) (providing that, upon receiving notice of claim, every insurer shall acknowledge receipt of the claim within 15 days).

Document Gathering and Review

As will be detailed below, the central inquiry for a claims professional's coverage investigation is whether the available information creates a potential for coverage by the insurance policy. *See Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 275 (Cal. 1966) (holding that "the carrier must defend a suit which potentially seeks damages within the coverage of the policy"); *Waller v. Truck Ins. Exchange, Inc.*, 11 Cal. 4th 1, 19 (Cal. 1995) (confirming the Gray's holding).

Whether a potential for coverage exists is determined "from all of the information available to the insurer at the time of the tender of the defense." *B & E Convalescent Center v. State Comp. Ins. Fund*, 8 Cal. App. 4th 78, 92 (Cal. Ct. App. 2d 1992). *See also Haggerty v. Federal Ins. Co.*, 32 Fed. Appx. 845, 848 n.4 (9th Cir. 2002) (noting "duty to defend is not judged on the basis of hindsight, but rather on the information available to the insurer at the time of tender"). Consequently, a complete coverage investigation is fostered by making best efforts to gather the following documents and ascertain from them the information set forth in the table below.

New Claim Document Review Checklist

#	Document	Information Needed
1	*Operative Complaint*	Plaintiff Names Counsel Contact Information Location of Project Causes of Action Alleged Alleged Harm-Causing Acts or Omissions Specific Damages Alleged
2	*Developer / GC Cross-Complaint*	Cross-Complainant Name(s) Counsel Contact Information Causes of Action Against G.C. / Subcontractor Additional Specifics on Harm or Damages
3	*Subcontractor's Policy*	Policy Type Exclusions Additional Insured Endorsements Policy Limits / Remaining Limits
4	*Subcontractor Job Files*	Subcontracts and Modifications Change Orders Dates of Work Employee Contact Information Correspondence Certificate of Completion
5	*Sub-Subcontractor Job Files*	Subcontracts and Modifications Additional Insured Endorsement
6	*Insurance History*	Information on all Liability Policies (Primary and Excess) between First Day of Work and Present
7	*Case Management Order*	Trial Date Answer and Cross-Complaint Deadlines Discovery Requirements Summary Judgment / Adjudication Deadlines
8	*Defect List & Cost of Repair*	Defects within Subcontractor Scope of Work Alleged Estimate Cost of Repairs to Defects

Claims professionals confronted with a new claim should always strive to obtain the above information after the initial teleconference with the insured. Oftentimes, some of the needed information is unavailable, and with coverage decision deadlines looming, the claims professional must issue a reservation of rights letter without, for example, complete subcontractor job files or the CMO. *See* Cal. Code Regs. tit. 10, § 2695.7(b) (providing that every insurer, absent written notice of the need for a time extension, shall accept or deny the claim within 40 days of the tender). This is acceptable. *See Othman v. Globe Indem. Co.*, 759 F. 2d 1458, 1464-65 (9th Cir. 1985) (holding insurer investigation must be reasonably thorough, not perfect), *overruled on other grounds by Bryant v. Ford Motor Co.*, 832 F. 2d 1080, 1083 (9th Cir. 1987). However, prudent claims professionals follow-up their document gathering and review with insured re-interviews, and perhaps, witness conferences.

Insured / Witness Follow-Up Interviews

Undoubtedly, initial statements of the insured will contradict the documents. These contradictions are not always due to the subcontractor's quest for coverage. Subcontractors often forget or mis-remember various details about projects constructed years before. Additionally, contractual duties are sometimes satisfied by subcontractors' compliance with oral side agreements. In an attempt to remedy these contradictions and obtain dependable facts on which to base an insurance coverage decision, claims professionals should make a list of ambiguities left after the document review. They should then present the factual questions to the insured in a telephonic re-interview. If questions remain after the re-interview, the claims professional should teleconference with subcontractor employees or non-represented witnesses.

The goal of the coverage investigation should be to inventory and document the allegations that give rise to coverage now, or could create coverage in the future. *See* Cal. Code Regs. tit. 10, § 2695.7(l) (providing that "[n]o insurer shall deny a claim based upon information obtained in a telephone conversation or personal interview with any source unless the telephone conversation or personal interview is documented in the claim file"). Remaining factual ambiguities should be determined in a manner consistent with coverage. Claims professionals who perform a diligent coverage investigation serve the interests of the subcontractor and carrier, equally.

Review of Basic CGL Policy Concepts

CGL Policy Overview

At the culmination of the coverage investigation, the claims professional or coverage counsel must apply the relevant claim information to the policy provisions and decide whether a potential for coverage exists. As most claims professionals are aware, this decision has significant present and future ramifications for the insured, the litigation, and often, the carrier. In breach of insurance contract and bad faith litigation, courts are compelled to scrutinize the coverage decisions of claims professionals. Often, this litigation arises because the potential for

coverage determination is not clear cut. To assist in predicting how a future court might view the coverage decision, the claims professional must have a good understanding of the origin, basic obligations, and covered hazards of a CGL policy.

Origin of a CGL Policy

Before CGL policies, there were "monoline" insurance policies. Sandra A. Toms, *Insurance Coverage for Environmental Cleanup: Are You in Good Hands?*, 10 Santa Clara Comp. & High Tech. L.J. 373, 377 (1994). In the 1800s, American businesses would purchase a separate liability policy for each type of risk from which they sought protection. *Id.* American society advanced, and business risks increased concomitantly. Soon, corporations turned to "scheduled liability" policies for protection. *Id.* Scheduled liability policies allowed companies to purchase different coverages in one policy, but, depending on the type of business, they were complex. *Id.* Each coverage was governed by separate terms and conditions and was difficult to apply. *Id.*

In the late 1930s, the National Bureau of Casualty Underwriters ("NBCU") and Mutual Insurance Rating Bureau ("MIRB") sought to solve the problem. Brette S. Simon, *Environmental Insurance Coverage Under the Comprehensive General Liability Policy*, 12 UCLA J. Envtl. L. & Pol'y 435, 442 (1994). They began a joint effort to draft uniform language for a new type of business liability policy – the comprehensive general liability policy, presently known as the commercial general liability policy. *Id.* In 1941, standard CGL policy language was introduced by the NBCU and MIRB. George B. Flanigan, Ph.D., CPCU, *CGL Policies of 1941 to 1966: Origins of Product Liability*, CPCU eJournal, Aug. 2005, at 1. The standard CGL policy was designed to provide coverage for "all business liability exposures known to exist at the inception of the policy and all unforeseen hazards which could arise during the policy period." Toms, *supra*, at 378. Since their origin, CGL policies have been preferred by companies because they provide the broadest coverage available. *Id.* Generally, ***CGL policies cover all hazards, except those specifically excluded***. Hon. H. Walter Croskey, Hon. Rex Heeseman, Susan M. Popik and Christina J. Imre, *California Practice Guide: Insurance Litigation*, § 7:13 (Rutter Group 2010); Toms, *supra* at 378.

Two Overarching Obligations of Carrier

Duty to Defend

If the policy is triggered, the first duty of a CGL insurer is to defend the insured. *Griffin Dewatering Corp. v. Northern Ins. Co. of New York*, 176 Cal. App. 4th 172, 196 (Cal. Ct. App. 4th 2009). In a CGL policy, the insurer promises "to defend any suit against the insured alleging damages payable under the terms of the policy." *Id.* The California Supreme Court construed the defense duty to require the carrier to pay for the insured's defense against all causes of action alleged against him, including those claims for which there is no potential coverage under the policy. *Buss v. Sup. Ct.*, 16 Cal. 4th 35, 48 (Cal. 1997). The defense obligation lasts until the insurer pays a settlement or judgment or it is determined that a potential for coverage under the policy no longer exists. *See Johnson v. Continental Ins. Cos.*, 202 Cal. App. 3d 477, 486 (Cal. Ct. App. 2d 1988) (deciding that the settlement terminated the defense duty); *Scottsdale Ins. Co. v. MV Transp.*, 36 Cal. 4th 643, 657 (Cal. 2005) (holding that "[t]he duty to defend then continues until the third party litigation ends, unless the insurer sooner proves, by facts subsequently developed, that the potential for coverage which previously appeared cannot possibly materialize, or no longer exists.").

Supplementary Payments

Most CGL policies include a "supplementary payments" provision. The clause generally requires insurers to pay the following types of expenses, inter alia, as a component of their defense obligations: (1) investigation expenses incurred by the insured at the insurer's request; (2) court costs awarded against the insured; and (3) pre-judgment and post-judgment interest. *See* ISO Form CG0001 01/96, CG0001 12/07; *Pritchard v. Liberty Mut. Ins. Co.*, 84 Cal. App. 4th 890, 911 (Cal. Ct. App. 4th 2000) (holding that "the supplementary payments provision providing all 'costs taxed' is a function of the insurer's defense obligation, not its indemnity obligation.").

California courts construe the "costs taxed" language of most supplementary payments provisions to include attorney fees awarded to the opposing litigant. *Employers Mut. Cas. Co. v. Philadelphia Indemn. Ins.*, 169 Cal. App. 4th 340, 349 (Cal. Ct. App. 2d 2008); *Cutler-Orosi Unified Sch. Dist. v. Tulare Cty. Sch. Dist. Liability / Property Self Ins. Auth.*, 31 Cal. App. 4th 617, 632 (Cal. Ct. App. 5th 1995). However, the supplementary payments provisions can only be utilized to pay "costs taxed," including attorney fees, if the insurer actually owed a duty to defend. *Golden Eagle Ins. Corp. v. Cen-Fed, Ltd.*, 148 Cal. App. 4th 976, 996 (Cal. Ct. App. 2d 2007).

Duty to Indemnify

The second duty of the CGL insurer, assuming coverage, is to indemnify the insured. *Id.* A carrier discharges its indemnification obligation by paying, up to the policy limits, the sums the insured becomes legally obligated to pay on account of specified risk. *Id.*

Five Basic Hazards Covered

Often when analyzing a claim, claims professionals skip steps. They jump to questions like, "Where's the 'accident'?" and "Was 'property damage' alleged?" These are all valid questions in a claim analysis. However, the prudent claims professional performs the analysis one step at a time. A question like, "Where do the allegations place the insured in the realm of hazards?" is appropriate at the beginning stage of claim evaluation. The significance of this inquiry stems from the fact that different CGL hazards come with different coverages and exclusions.

Most claims professionals were taught that CGL policies covered four main hazards, viz. premises, operations, products, and completed operations liabilities. American Institute for Chartered Property Casualty Underwriters, *Commercial General Liability Insurance*, 8.7-8.8 (2010). They do, but modern CGL policies also include personal and advertising injury liability. Additionally, it is possible that they cover liability arising from use of automobiles and workers compensation law requirements. *Id.* at 8.8. Even if it is a quick check, claims professionals should determine whether one or more of the five basic hazards covered by CGL policies are implicated by the information available about the claim. A little forethought at this stage will avoid depriving the subcontractor of coverage and the insurer of exclusions. As a review, the five basic CGL hazard coverages are the following.

Premises Liability

A CGL policy offers the insured protection against third-party claims for bodily injury or property damage arising from an activity or condition on the insured's premises. American Institute, *supra*, at 8.7. An example of a claim falling within this type of coverage would be a third-party "slip and fall" at the subcontractor's office. *Id.* at 8.8.

On-Going Operations Liability

CGL policies cover bodily injury or property damage claims allegedly caused by the insured's "operations in progress" or those of the insured's subcontractors. American Institute, *supra*, at 8.7. For example, coverage could be implicated by this coverage if a window subcontractor's door-hanging sub-subcontractor damaged the stucco when installing thresholds before the building was complete. *Id.* at 8.8.

Products Liability

When a third-party claims that a product manufactured, sold, or distributed by the insured caused bodily injury or property damage, the products liability coverage of a CGL policy may be triggered. Allan D. Windt, *Insurance Claims & Disputes: Representation of Insurance Companies & Insureds*, § 11.10, n.4 (5th ed. March 2011). A typical allegation implicating this type of coverage would be when a window manufacturer's defective windows caused water intrusion property damage. American Inst., *supra*, at 8.8.

Completed Operations Liability

Completed operations liability coverage is the king of the CGL hazards in the construction defect context. Most construction defect claims are alleged to fall within the completed operations hazard. Chris Mosley, *Four Key Steps to Maximizing Insurance Coverage for Construction Defects*, Construction Executive Magazine, April 2009, at 1-2. Completed operations liability coverage extends to liability for bodily injury or property damage taking place off the insured's premises and arising out of the insured's completed work. Lee R. Russ and Thomas F. Segalla, *Couch on Insurance*, § 129.23 (3d Ed. 2010). Sometimes, the extent of completed operations liability coverage is misunderstood. The hazard cannot be read to provide coverage for an injury that occurs outside of the effective dates of the policy. *Id.* Consequently, a subcontractor that builds a defective deck in May and cancels his policy in June has no applicable completed operations coverage for the homeowner's deck accident in July. Craig F. Stanovich, *The Hazards of Products Completed Operations: Understanding the Fundamentals*, 1 (International Risk Management Institute, Inc. Oct. 2006). The CGL policy obligates the insurer to pay only if the bodily injury or property damage occurs during the policy period. *Id.*

Personal and Advertising Injury Liability

Personal and advertising injury liability covers damages the insured is alleged to have caused another by false arrest, malicious prosecution, libel, slander, defamation of products or services, violation of the right to privacy, or copyright infringement. Craig F. Stanovich, *No Harm, No Coverage – P&A Injury Liability Coverage in the CGL*, 2 (Jan. 2007). Notice that these types of conduct imply intentional conduct. For the most part, claims giving rise to personal and advertising injury liability coverage involve intentional acts. *Id.* The terms "occurrence" or "accident" have no relevancy to personal and advertising injury liability claims analysis. *Id.* An example of a claim implicating this type of coverage would be a customer's complaint that store owner wrongfully withheld her due to a mistaken belief that the customer had shoplifted. *Id.*

Insuring Clause

Most currently applicable ISO CGL policies include, in Section I, the insuring agreement. Tung Yin, *Nailing Jello to a Wall: a Uniform Approach for Adjudicating Insurance Coverage Disputes*, Cal. L. Rev. 1243, 1279 (1995). In this section, the insurer agrees to pay money

that the insured becomes legally obligated to pay as damages resulting from bodily injury and / or property damage caused by an occurrence during the policy period. *Id.* *See also State v. Allstate Ins. Co.*, 45 Cal. 4th 1008, 1029 n.7 (Cal. 2009).

As noted by the Supreme Court, the CGL insuring agreement is confusing. To assist in understanding, it is useful to separate the elements of the clause. Once the key components of the insuring agreement are isolated, a more accurate evaluation is possible. Visual thinkers may appreciate the following tables for use in the analysis.

Step 1: "Insured"

Insuring Agreement Phrase	Phrase Construction
"Insured"	**Named Insured**: Exact entity named in the CGL Declarations page
	Other Person Within Policy Definition: Section II of the CGL policy may include as insureds spouses, business partners, LLC members, officers and directors, employees
	Additional Insureds ("AIs"): If a potential for coverage of an AI exists, the insurer owes the AI a full and complete defense. *Presley Homes, Inc. v. American States Ins. Co.*, 90 Cal. App. 4th 571, 575 (Cal. Ct. App. 4th 2001). Usually, the difference in the analyses of whether a defense is owed a named insured and whether a defense is owed an AI stems from policy limitations on the indemnity coverage applicable to the AI. When evaluating the AI defense duty, the following key inquiries should be considered: 1. *AI Sole Negligence?*: Does the available information lead to the conclusion that the occurrence took place solely as result of the additional insured's acts or omissions? 2. *How Long Did the AI Coverage Last?*: Early AIEs extended AI coverage for liability arising out of the named insured's work. Neefus Stype Agency, *CGL: Additional Insured Issues*, (2011). Courts construing this language held that AIs had coverage for claims implicating the on-going operations and completed operations coverages of the CGL policy. *Id.* To avoid affording AIs completed operations coverage, ISO replaced the "your work" with "your ongoing operations" phrases in the 20 10 10 93 AIE. *Id.* This amendment did not help the carriers' cause as courts held that 10 93 AIEs could still provide completed operations coverage to AIs. *Id.* The 2001 ISO 20 10 form made it explicit that completed operations coverage was not given to AIs. *Id.* Another 2001 ISO form, 20 37 10 01 gave back completed operations coverage to AIs. *Id.* Thus, the length of AI coverage really depends on the wording of the AIE. *Pardee Const. Co. v. Ins. Co. of the West*, 77 Cal. App. 4th 1340, 1352 (Cal. Ct. App. 4th 2000).

Insuring Agreement Analysis Tables

Step 2: Third Party's "Bodily Injury" and / or "Property Damage"

Insuring Agreement Phrase	Phrase Construction
"Bodily Injury" and / or "Property Damage"	**"Bodily Injury"**: 1. Physical injury, sickness, disease, or death; and 2. Emotional distress when physical injury is alleged to have caused the distress. *See Aim Insurance Co. v. Culcasi*, 229 Cal. App. 3d 209, (Cal. Ct. App. 6th 1991) (holding "bodily injury" does not include emotional distress in the absence of physical injury).
	"Property Damage": 1. *Physical Injury to Property*: No mere economic loss, but includes pollution. 2. *Loss of Use of Property*: Regardless of whether physical injury to property occurred. 3. *Incorporation of Defective Product or Work into Construction*: If the defective product or work has not physically injured another part of the building, it is not "property damage." However, if the incorporated defective product or work contains a hazardous substance, it is "property damage." *Watts Industries, Inc. v. Zurich American Ins. Co.*, 121 Cal. App. 4th 1029, 1044-45 (Cal. Ct. App. 2d 2004). *See also* John K. DiMungno, *Incorporation of Defective Product or Work as Property Damage*, California Ins. Law Handbook, at § 44:30.3 (Mar. 2010) (discussing history of issue).

Insuring Agreement Analysis Tables

Step 3: "Occurrence" During the Policy Period

Insuring Agreement Phrase	Phrase Construction
"Occurrence"	*Definition*: Typically, "means an accident, including continuous or repeated exposure to substantially the same general harmful conditions." An accident is "'an unexpected, unforeseen, or undesigned happening or consequence from either a known or an unknown cause.'" *Delgado v. Inter. Exchange of Auto. Club of So. Cal.*, 47 Cal. 4th 302, 308 (Cal. 2009). *Insured's Expectation*: Analysis focuses on whether the insured intended all the acts giving rise to the harm and whether the insured expected a harmful result from his conduct. *State Farm Fire and Cas. Co. v. Sup. Ct.*, 164 Cal. App. 4th 317, 325-26 (Cal. Ct. App. 2d 2008). *Key Questions*: "Did the insured intend all acts, the manner in which they were done, and the objective accomplished?" If yes, then no accident exists. "Did the insured intend the harmful results of his acts?" If no, then an "accident" exists.
During the Policy Period	For coverage to be triggered, the "occurrence" must result in "bodily injury" or "property damage" during the policy period. Whether an "occurrence" happened while the policy was in effect must be analyzed per hazard: 1. *Premises Liability*: Did the injury or property damage occur on the insured's premises within the policy period? 2. *On-Going Operations*: Was the policy in effect while the subcontractor was working on the project and injury or property damage occurred? 3. *Products Liability*: Did the insured's product cause injury or property damage while the policy was in effect? 4. *Completed Operations*: Did any injury or property damage take place within the policy period? At the time the harm occurred, was the subcontractor's work completed? If the answer to both these questions is, "Yes," then a qualifying "occurrence" exists. Most construction defects are considered to result in "continuous damage." Thus, a defectively installed roof could implicate the on-going and completed operations coverages of multiple policies until the work was corrected. *Aerojet-General Corp. v. Transport Indem. Co.*,17 Cal. 4th 38, 57 (Cal. 1997). Often, claims professionals assume, as a short-cut, that all policies in effect between initiation of work and repair are implicated by an alleged construction defect. 5. *Personal and Advertising Injury*: Did the harm caused by the false arrest, malicious prosecution, libel, or slander take place during the policy period?

Insuring Agreement Analysis Tables

Step 4: Money That the Insured Becomes Legally Obligated to Pay

Insuring Agreement Phrase	Phrase Construction
Insurer's Legal Obligation to Pay	*Definition of the Obligation*: The carrier's duty to indemnify for sums the insured becomes legally obligated to pay is "limited to money ordered by a court." *Certain Underwriters at Lloyd's of London v. Sup. Ct.*, 24 Cal. 4th 945, 960 (Cal. 2001). *See also* Allan D. Windt, *Insurance Claims & Disputes: Representation of Insurance Companies & Insureds*, § 6:23 (Mar. 2011) (explaining the insurer's legal obligation). *Does Not Include Settlement Payments*: The insurer has no obligation to pay an amount the insured paid to settle a claim before the judgment was rendered. *San Diego Housing Com'n v. Industrial Indem. Co.*, 68 Cal. App. 4th 526, 543 (Cal. Ct. App. 4th 1998). An exception to this rule exists when the insurer erroneously fails to defend the insured. *Diamond Heights Homeowners Assn. v. Nat'l American Ins. Co.*, 227 Cal. App. 3d 563, 580 (Cal. Ct. App. 1st 1991).

Step 5: "Damages"

Insuring Agreement Phrase	Phrase Construction
"Damages"	*Definition*: "Damages" payable by an insurance company include money paid to a third-party to compensate for his loss or detriment and amounts incurred to investigate and remedy the harm. *AIU Ins. Co. v. Sup. Ct.*, 51 Cal. 3d 807, 829-30 (Cal. 1990). *Restitution and Rescission Are Not "Damages"*: "It is well established that one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired. Such orders do not award 'damages' as that term is used in insurance policies." *Bank of the West v. Sup. Ct.*, 2 Cal. 4th 1254, 1266 (Cal. 1992).

Exclusions

After determining whether the available information supports coverage, the next task is deciding whether this information excludes coverage. But the evaluation is not as easy as acknowledging coverage, and then taking it away pursuant to the exclusion. When interpreting business, as opposed to insurance, contracts, courts consider the mutual intention of the parties at the time of

the contract formation. Cal. Civ. Code. § 1636. It is the clear and explicit language of the contract that is to primarily govern its interpretation, however. Cal. Civ. Code. § 1638.

In the insurance context, the rules are different. Assuming that carriers have superior bargaining power in insurance transactions and possess the technical sophistication to draft detailed policy clauses, courts often appear to value insureds' reasonable expectations about what the policy covers above clear and explicit provisions that are actually in the policy. *See Steven v. Fidelity & Cas. Co. of New York*, 58 Cal. 2d 862, 869 (Cal. 1963) (holding that inexpensive life insurance policy covered insured's passing notwithstanding arguably clear exclusionary language because of insured's reasonable expectations and circumstances of the insurance transaction). *But see North American Capacity Ins. Co. v. Claremont Liability Ins. Co.*, 177 Cal. App. 4th 272, 289 (Cal. Ct. App. 2d 2009) (holding that contractor warranty exclusion provisions were conspicuous, plain, clear, and enforceable).

Stemming from this broad concept, several more specific exclusion interpretation rules can be synthesized. First, courts are uniform in their view that exclusions from coverage must be conspicuous, plain, and clear to be effective against the insured. Kirk A. Pasich, *Insurance Exclusions Receive Narrow Window*, The Daily Journal, February 19, 2004. See Safeco Ins. Co. of America v. Robert S., 26 Cal. 4th 758, 766 (Cal. 2001) (holding that "[t]he 'burden rests upon the insurer to phrase exceptions and exclusions in clear and unmistakable language.'"); *MacKinnon v. Truck Ins. Exchange*, 31 Cal. 4th 635, 648 (Cal. 2003) (holding that "[t]he exclusionary clause must be conspicuous, plain and clear."). Second, coverage exclusions, and mere limitations, are strictly construed against the insurer and liberally interpreted in favor of the insured. Pasich, *supra*; *Steven*, 58 Cal. 2d at 868. Third, this narrow construction rule applies with particular force when courts believe that the coverage portion of the policy could lead the insured to believe it had coverage for the disputed claim. Pasich, *supra*; *MacKinnon*, 31 Cal. 4th at 648. Finally, even if an insurer's interpretation of an ambiguous exclusion is reasonable, the exclusion will not be given effect unless the insurer establishes its interpretation is the only reasonable one. Pasich, *supra*; *MacKinnon*, 31 Cal. 4th at 655.

What can be gained from review of the above rules is not a rigid method for deciding when an exclusion or coverage limitation affects the duty to defend determination. The broad conclusion to be taken from these rules is that insurers who deny a defense based solely on an exclusion are often embarking on a risky course of action. Given the judiciary's universal view that "insurance coverage is 'interpreted broadly so as to afford the greatest possible protection to the insured,'" policy exclusions and limitations may have less value than many claims professionals think. *See MacKinnon*, 31 Cal. 4th at 648.

On the other hand, insurance policy exclusions and limitations obviously are to be considered in the coverage investigation stage of a third-party claim. They may confine the insurer's later indemnification duty. More importantly, the provisions must be asserted in writing by the carrier

to avoid waiver of their later applicability. *See Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 497-98 (Cal. 2001) (holding that an express reservation of rights protects carrier's coverage defenses). The following tables summarize exclusions and coverage limitations most commonly applicable in the construction defect context.

Exclusion / Limitations Tables

Exclusion / Limitation	Rationale	Effect
Work Product	When engaging in business, contractors must take into consideration the consequences of performing defective work and realize that their obligation is to pay for the replacement of defective work. However, accidental injury to property or persons as a result of construction work exposes the contractor to unforeseeable and almost limitless liabilities. This is a hazard CGL policies were designed to guard the insured against. *See Weedo v. Stone-E-Brick, Inc.*, 81 N.J. 233, 239 (N.J. 1979); *Diamond Heights HOA v. Nat'l American Ins. Co.*, 227 Cal. App. 3d 563, 571 (Cal. Ct. App. 1st 1991).	Excludes coverage for cost to repair insured's defective work and insured's satisfactory work damaged by the insured's defective work. *Diamond Heights HOA*, 227 Cal. App. 3d at 571-72. Thus, CGL policies generally cover insured's damage to completed work of others or completed work performed on the insured's behalf. James Acret, et al., *Construction Contracts, Defects, and Litigation*, § 12.24 (CEB Nov. 2010).

Exclusion / Limitation	Rationale	Effect
Contractual Liability	This provision excludes coverage of claims that are specifically created by contractual language that imposes liability on the contractor for such things as defense costs and indemnification obligations that the contractor would not have under common law in the absence of the language. J. Kent Holland, Jr., *American Family Insurance v. Pleasant Company*, 2 (International Risk Management Institute, Inc. June 2003).	Review of detailed language and analysis makes it clear that the exclusion does not reach an contractor's liability for failing to defend or indemnify the other contracting party pursuant to an indemnification provision in the construction contract. Craig F. Stanovich, *What Is Meant by Contractual Liability?*, 3 (International Risk Management Institute, Inc. May 2002); James Acret, et al., *Construction Contracts, Defects, and Litigation*, § 12.32 (CEB Nov. 2010).

Exclusion / Limitations Tables

Exclusion / Limitation	Rationale	Effect
Continuous / Progressive Injury and Damage	The exclusion was designed to "circumvent the continuous injury trigger of the coverage laid down in Montrose." *Penn. Gen. Ins. Co. v. American Safety Indem. Co.*, 185 Cal. App. 4th 1515, 1532 (Cal. Ct. App. 4th 2010).	This provision excludes coverage of injury or damage that first manifested before the policy period. *See Penn. Gen. Ins. Co.*, 185 Cal. App. 4th at 1525 (Cal. Ct. App. 4th 2010); James Acret, et al., *Construction Contracts, Defects, and Litigation*, § 12.34C (CEB Nov. 2010).

Exclusion / Limitation	Rationale	Effect
Wrap Exclusion	CGL policies should not providing overlapping and duplicative coverages. *See generally St. Paul Fire and Marine Ins. Co. v. Universal Builders Supply*, 317 F. Supp. 2d 336, 343 (S.D.N.Y. 2004). Thus, a contractor CGL policy's coverage should not extend to claims already covered by a "Wrap," "Wrap-Up," OCIP, or CCIP insurance program.	The provision is intended to exclude coverage of all losses arising out of the project insured by a Wrap policy. James Acret, et al., *Construction Contracts, Defects, and Litigation*, § 12.34B (CEB Nov. 2010).

Exclusion / Limitation	Rationale	Effect
Contractors Warranty	The endorsement is designed to force insured contractors to assist their insurers in spreading the risk of loss from third party claims. *North American Capacity Ins. Co. v. Claremont Liability Ins. Co.*, 177 Cal. App. 4th 272, 276 (Cal. Ct. App. 2d 2009). "If the general contractor does not have in its possession certificates of insurance from every independent contractor at the time the work begins and throughout the construction, the insurance is unenforceable." Barry Zalma, *Breach of Contractor's Warranty Defeats Coverage*, 1 (International Risk Management Institute, Inc. Oct. 2009).	Generally, the provision requires contractors to obtain both hold harmless agreements and certificates of insurance from all subcontractors, as a pre-condition to coverage of the insured's liability for subcontractors' acts or omissions. *North American Capacity Ins. Co.*, 177 Cal. App. 4th at 279 n.5, 290.

Exclusion / Limitations Tables

Exclusion / Limitation	Rationale	Effect
Earth Movement	The risk of earth movement and subsidence damage in western states like California is substantial. Therefore, insurers of grading, demolition, and concrete contractors often include earth movement exclusions in their CGL policies. Ann Rudd Hickman, *Construction Defect Crisis Produces Coverage-Restricting Endorsements*, 3 (International Risk Management Institute, Inc. Aug. 2003).	Earth movement exclusions preclude coverage of damage caused by landslides, earthquakes, collapses, and erosion. Hickman, *supra*, at 3.

Exclusion / Limitation	Rationale	Effect
Known Injury or Damage	To counter the impact of the Montrose court's holding that knowledge of a potential claim at the time of policy issuance does not negate coverage, insurers developed the "Known Injury or Damage" exclusion. Hickman, *supra*, at 3.	This exclusion precludes coverage for continuous injury or damage of which the insured was aware prior to the policy period. Amanda M. Riley, *The Exciting Adventure of an Insurer's Duty to Defend*, Orange County Lawyer, Dec. 2004, at 42.

Exclusion / Limitation	Rationale	Effect
EIFS	Exterior Insulation and Finish Systems ("EIFS") are multilayered exterior wall systems, designed to provide increased energy efficiency. However, numerous claims have arisen that stem from the allegation that a given EIFS installation allowed water to penetrate walls and cause wood rot and mold. In an attempt to reduce future losses due to these claims, insurers crafted the EIFS exclusion. Hickman, *supra*, at 3.	The provision generally precludes coverage of all claims related to the insured's work on an exterior fixture of a building if an EIFS is part of any portion of the structure. Hickman, *supra*, at 3.

Policy Limits

Before making the coverage determination, the claims professional must also consider whether information obtained in the coverage investigation has any effect on sums potentially available to discharge the insurer's defense and indemnification duties. Review of information pertaining to the following topics will assure that the claims professional thoroughly completes the coverage investigation.

Typical Policy Limits Provisions

Typically, the limits of an insurance policy govern only the extent of the carrier's indemnity responsibility. CGL policies may include a separate limit for "each occurrence," "products-completed operations aggregate," "personal and advertising," "damage to premises rented" and "medical expenses." Craig F. Stanovich, *How the Limits Apply in the CGL*, 1-3 (International Risk Management Institute, Inc. July 2004). However, in most cases, amounts spent to defend against a third party claim do not reduce the available indemnity limits. Hon. H. Walter Croskey, Hon. Rex Heeseman, Susan M. Popik and Christina J. Imre, *California Practice Guide: Insurance Litigation*, § 7:355 (Rutter Group 2010). Consequently, it is important at the outset of the coverage investigation to determine the extent to which various policy limits have been depleted. See Stanovich, *supra*, at 1. In the interest of full disclosure, the status of policy limits at the time of a new third-party claim should be provided to the insured in writing.

Burning Limits

Burning limits policies differ from standard CGL policies in that both defense and indemnity costs deplete policy limits. Gregory S. Munro, *Defense within Limits: The Conflicts of "Wasting" or "Cannibalizing" Insurance Policies*, 62 Mont. L. Rev. 131, 132 (2001). For each dollar spent on defense, one dollar is removed from policy funds available to settle or satisfy a judgment in the case. *See* Hartley & Hartley, *Defense Costs in the Self-Liquidating ("Burning Limits") Policies*, (1997), at http://www.hartley.com/plpol.html.

Because an insurer's interest in fighting a claim to protect against future claims may interfere with an insured's interest in quickly settling the claim, insurers owe their insureds "extra" duties when a burning limits policy is applicable.

One of these duties stems from the fact that defense costs are expensive and add up quickly. Even after a couple of months of litigation, policy limits can be substantially depleted, and thus, unavailable for a settlement. Predictably, insureds will complain to the carrier that if they had known about the amount of the defense costs earlier, they would have requested defense counsel settle earlier. They will allege the insurer committed bad faith by failing to keep the insureds updated on pending defense costs. To avoid the specter of these claims, carriers and/or defense counsel should send copies of monthly billing statements to insureds. *See* Hon. H. Walter

Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:597 (Rutter Group 2006) (discussing additional obligations owed by carriers of burning limits policies). Additionally, carriers should include a copy of a policy limits balance sheet, showing amounts spent on other claims and the amount of policy funds available.

Because defense costs count against policy funds available to protect the insured's personal assets, insurers should be extra-careful in authorizing these expenditures. They must assume that if the policy exhausts before resolution of the litigation, the insured will review each and every billing statement and complain about defense costs he believes were unnecessary and/or unreasonable. To reduce bad faith liability exposure, insurers should give additional thought to what legal services are actually needed to protect the insured's interests. Croskey, et al., *supra*, at § 12:597.

When defense costs have been expended on the insured's behalf and it becomes apparent that the case cannot be settled within policy limits, the insurer is placed in a difficult situation. It is subject to bad faith liability for requesting the insured contribute to a settlement fund. *J.B. Aguerre, Inc. v. American Guarantee & Liability Ins.*, 59 Cal. App. 4th 6, 15 (Cal. Ct. App. 2d 1997). If it lets the case go to trial, substantial defense costs will be incurred, which will further reduce the available indemnity limit. If the jury renders a verdict for plaintiff in an amount above the remaining indemnity limit, the insurer will be confronted with some unhappy insureds. Inevitably, they will sue the carrier for bad faith or assign bad faith rights to the plaintiff with a covenant not to execute.

The prospect of the above scenario has led commentators to conclude that burning limits policies require insurers to settle the insureds' case as soon as possible once it becomes apparent that defense costs will erode the policy limit and make settlement within policy limits impossible. *See* Hon. H. Walter Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:597 (Rutter Group 2006). *See also* John K. DiMugno, *Insurance Litigation Reporter: Bad Faith / Duty to Settle: Hawaii Federal District Court Permits Insured Whose Liability Insurer Is Defending to Settle Over Insurer's Objections*, 744 (West 2004) (concluding that an insurer's rejection of a policy limits settlement offer when defense and likely judgment exceed policy limits is arguably bad faith). At present, this additional "good faith" duty has not been established in California law. However, given precedent for determining whether an insurer acted "unreasonably" or "without proper cause," it seems clear that courts would consider an insurer's failure to settle when given a reasonable opportunity as a factor in determining whether bad faith was committed.

Deductibles

Generally, a "deductible" is the amount the insured must pay before the insurer is obligated to indemnify for a covered loss. D.W. Duke, *California Insurance Issues and Forms*, § 8:50.20

(1st Ed. 2003). Unless otherwise stated, deductibles have no bearing on an insurer's duty to defend. They merely reduce an insurer's indemnification obligation.

The deductible amount is usually set forth in a policy endorsement. Careful review of this endorsement is required, however, because specific clauses may impact the amount of indemnity available. In the past, deductible provisions commonly made no reference to policy limits. They would provide: "DEDUCTIBLE(S) PER OCCURRENCE: This policy contains various deductibles. Each deductible is per occurrence. Your deductibles are as follows[.]" At present, however, deductibles usually reduce policy limits by the amount of the deductible. Sample language of a deductible reducing coverage is: "Our obligation under the Bodily Injury Liability and Property Damage Liability Coverages to pay damages on your behalf applies only to the amount of damages in excess of any deductible amounts stated in the Schedule above as applicable to such coverages."

Policies also differ with respect to the number of deductibles that apply to a claim. Most often, deductibles are collectible on either a "per occurrence" or "per claim" basis. When a deductible is "per occurrence," the insured is responsible for one payment each time the insurer is called upon to discharge an indemnity obligation to specific claimants. *See EOTT Energy Corp. v. Storebrand Intern'tl. Ins. Co.*, 45 Cal. App. 4th 565, 576-77 (Cal. Ct. App. 2d 1996) (holding that a series of related acts, attributable to a single cause, may be treated as having been caused by one occurrence"). *See also Safeco Ins. Co. v. Fireman's Fund Ins. Co.*, 148 Cal. App. 4th 620, 633 (Cal. Ct. App. 2d 2007) (holding that "[w]hen all injuries emanate from a common source ... , there is only a single occurrence for purposes of policy coverage. It is irrelevant that there are multiple injuries or injuries of different magnitudes, or that the injuries extend over a period of time"). On the other hand, when a deductible is "per claim," separate claims result in separate deductibles. *See Beaumont-Gribin Manag't. Co. v. Cal. Union Ins. Co.*, 63 Cal. App. 3d 617, 623-25 (Cal. Ct. App. 2d 1976) (discussing the definition of "claim" in a deductible provision). This is true even though the claims arise out of the same "occurrence."

Self-Insured Retentions

A self-insured retention or "SIR" is an amount that must be paid before the insurer has any duties under the policy. *Vons Cos., Inc. v. United States Fire Ins. Co.*, 78 Cal. App. 4th 52, 63-64 (Cal. Ct. App. 2d 2000); *General Star Indemnity Co. v. Sup. Ct.*, 47 Cal. App. 4th 1586, 1594 (Cal. Ct. App. 2d 1996). *See also* Scott C. Turner, *Insurance Coverage of Construction Disputes*, § 4:6 (2008) (discussing SIRs). The following is a SIR:

> The insurer shall be liable only for the amount of Loss arising from a claim which is in excess of the retention amount stated in the Declarations Page. The retention amount (a) shall apply only to 'occurrences' under this policy; and (b) shall apply separately to each such 'occurrence'; and (c) shall include all amounts under the Supplementary Payments section of the policy. The Insured's bankruptcy,

> insolvency or inability to pay the retention amount shall not increase the Insurer's obligations under this policy.

The language of the SIR controls how it may be satisfied. Some provisions require the insured to pay the retention out of his own pocket. *See Vons Cos., Inc.*, 78 Cal. App. 4th at 63 n.4 (quoting a SIR stating "[i]n the event there is any other insurance, whether or not collectible, applicable to an 'occurrence', claim or suit within the Retention Amount, you will continue to be responsible for the full Retention Amount before the Limits of Insurance under this policy apply"). Some are silent on the issue. However, in the absence of contrary policy language, any money source, including a contractor's other insurers or jointly and severally liable co-defendant's carriers, may satisfy a SIR. *Id.* at 63-64.

The Court in *General Star Indemnity Co. v. Sup. Ct.*, 47 Cal. App. 4th 1586, 1594 (Cal. Ct. App. 2d 1996) succinctly described a SIR with aggregation:

> An aggregation feature is for the benefit of the insured. Without an aggregation feature, the SIR amount applies anew to each claim. The insured must exhaust that amount separately, over and over again as many times as there are claims. Before the insurer has any obligation on any single claim, the SIR must be exhausted for that claim. If, by contrast, there is an aggregation provision, payments made by the insured may be aggregated until the aggregate limit is exhausted. Thereafter, the insurance will cover any additional claims from dollar one. Additionally -- in the SIR endorsement form here under consideration -- when an aggregate limit is exhausted, all provisions of the SIR endorsement become 'void' and 'all terms and conditions of the policy are reinstated to their full force and effect.' Thus the typical duty to defend would be 'reinstated' if the policy contained an aggregation feature which was exhausted.

Coverage Determination

After obtaining the available information about the claim and reviewing the relevant policy provisions, the next step for the claims professional is determining whether a defense duty exists. The evaluation can be completed using the following rules:

#	Duty to Defend Determination Rules
1	The duty to defend is determined from all information available at the time of the tender. *B & E Convalescent Center v. State Comp. Ins. Fund*, 8 Cal. App. 4th 78, 92 (Cal. Ct. App. 2d 1992).
2	An insurance carrier must defend a suit that potentially seeks damages within the coverage of the policy. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 275 (Cal. 1966).
3	The insurer has no obligation to defend only when the "third party complaint can by no conceivable theory raise a single issue which could bring it within the policy coverage." *Montrose Chemical Corp. v. Sup. Ct.*, 6 Cal. 4th 287, 300 (Cal. 1993).
4	Any doubt as to whether the available information support a defense duty is to be resolved in the insured's favor. *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal. 4th 1076, 1081 (Cal. 1993).
5	An insured may create a duty to defend simply by communicating facts to the insurer, which if true, would create a potential for coverage. *Amato v. Mercury Casualty Co.*, 18 Cal. App. 4th 1784, 1792 (Cal. Ct. App. 2d 1993).

If, after application of the above rules, a potential for coverage of the third-party claim exists, the insurer must defend the insured. The next issue for claims professionals' consideration is the extent of the defense to be offered.

Scope of the Defense Duty

Multiple Insureds

Assuming a potential for coverage exists, the defense duty extends equally to all named insureds, insureds defined in the policy, and additional insureds. *American States Ins. Co. v. Progressive Cas. Ins. Co.*, 180 Cal. App. 4th 18, 26 (Cal. Ct. App. 3d 2009). It makes no difference whether various indemnity limitations exist as to the multiple insureds. *Maryland Casualty Co. v. Nationwide Ins. Co.*, 65 Cal. App. 4th 21, 31 (Cal. Ct. App. 4th 1998).

Multiple Carriers

When multiple carriers have a defense duty, they are required to share the costs to defend the insured equally. *CNA Cas. of Cal. v. Seaboard Surety Co.*, 176 Cal. App. 3d 598, 619 (Cal. Ct. App. 1st 1986).

Termination of the Defense Duty

After evaluation of the extent of the insurer's duty to defend, a prudent claims professional also makes plans for her employer's exit strategy. Four events can trigger termination of the carrier's defense obligation. *See Great American Ins. Co. v. Sup. Ct.*, 178 Cal. App. 4th 221, 234 (Cal. Ct. App. 2d 2009) (stating that "circumstances may change such that there is no longer a potential for coverage by, for example, (1) the discovery of new or additional evidence, (2) a narrowing or partial resolution of claims in the underlying action, or (3) the exhaustion of the policy.").

Exhaustion of Policy Limits

Generally, the duty to defend terminates upon exhaustion of policy limits by settlement or satisfaction of judgment. Mark C. Raskoff, *Arguments Advanced by Insureds for Coverage of Environmental Claims*, 22 Pac. L.J. 771, 780 (1991). *See also Great American*, 178 Cal. App. 4th at 230 (recounting policy provision stating that insurer "shall not be obligated . . . to defend any suit after the applicable limit of [its] liability has been exhausted by payment of judgments or settlements."). As a consequence, in the context of a burning limits policy, the duty to defend terminates when the carrier has entirely depleted the policy limits with defense costs, even though no settlement or judgment has been paid. *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 76 n.29 (Cal. 1997).

Additional Facts Establish No Potential for Coverage

If, during the pendency of the defense with a reservation of rights, the insurer determines that the available information establishes that no potential for coverage of the third-party claim exists, it can refuse to continue defending the insured. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 279 (Cal. 1966). This course of action comes with a risk, however. If, in a later breach of contract and bad faith action, the insured proves a potential for coverage did exist, then the carrier may be liable for the insured's defense costs, settlement or judgment amounts, and attorney fees and costs. *Pruyn v. Agricultural Ins. Co.*, 36 Cal. App. 4th 500, 515 (Cal. Ct. App. 2d 1995); *Andrade v. Jennings*, 54 Cal. App. 4th 307, 325-26 (Cal. Ct. App. 4th 1997).

Insured's Failure to Cooperate

Only if the insured's conduct has substantially prejudiced the carrier's ability to conduct the defense can the carrier withdraw the defense for breach of the cooperation clause in the policy. *Hall v. Travelers Ins. Cos.*, 15 Cal. App. 3d 304, 309 (Cal. Ct. App. 5th 1971); John K. DiMugno & Paul E.B. Glad, *California Insurance Law Handbook*, § 11:21.11 (Mar. 2010). Such a contention can be raised by the carrier in response to breach of insurance contract suit. *Pruyn*, 36 Cal. App. 4th at 516.

Judicial Determination of No Coverage

"When a liability insurer providing a defense to its insured believes there is no longer a potential for coverage and, therefore, it is no longer required to defend, it may bring a declaratory relief action to obtain a judicial declaration that it need no longer do so." *Great American*, 178 Cal. App. 4th at 225. If the action is successful, the insurer may withdraw from the defense without repercussions. *Id.* at 234.

Communicating Coverage Determination

By this time, the coverage investigation is nearly complete. The claims professional has interviewed the insured and relevant witnesses. She has obtained and reviewed various documents providing information bearing on the coverage decision. She has reviewed the applicable provisions of the policy in conjunction with above-described rules of interpretation. Additionally, she has decided whether or not the policy potentially covers the disputed claim. Now what? The claims professional must thoughtfully prepare a letter informing the insured of the coverage decision. It cannot be emphasized enough that the coverage decision letter must accurately set forth the carrier's reasons for whatever determination was made. This correspondence may be repeatedly scrutinized, parsed, and commented upon. Mistakes and inartful discussion may serve as bases for involuntary reversal of the coverage decision and other more grave consequences.

Broadly, three different types of coverage determinations exist. The carrier can agree to defend the insured without reserving its right to later deny coverage. It may defend with a reservation of rights to later assert coverage defenses. Alternatively, the carrier may deny the defense duty. The discussion below highlights significant law relating to these decisions and reminds the claims professional of the consequences of an erroneous coverage decision.

The Coverage Decisions

Defense Without Reservation of Rights

At least in the construction defect context, why would any insurer want to offer a defense without a reservation of rights? Such a decision may result in implied waiver of known coverage defenses. *Stonewall Ins. Co. v. City of Palos Verdes Estates*, 46 Cal. App. 4th 1810, 1839 (Cal. Ct. App. 2d 1996). But it also avoids tripartite relationship conflicts of interest. *See* Cal. Civ. Code § 2860; *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358, 364 (Cal. Ct. App. 4th 1984). When no potential or actual coverage dispute exists between the insured and insurer, most of the possible insured - insurer conflicts of interests are removed from defense counsel's consideration. Additionally, it becomes more unlikely that developments in the case will compel the insurer to pay for the insured's choice of *Cumis* counsel. Consequently, when the claim is valued at an amount substantially below policy limits and speculation exists about whether defense counsel has the ability to develop facts impacting the coverage decision, claims professionals will consider offering the defense without a reservation of rights.

Defense With Reservation of Rights

The benefits of informing the insured that the carrier will defend but may withdraw the defense are two-fold. The insurer avoids waiver of coverage defenses. *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 497 (Cal. 2001). Further, it preserves its right to later insist that the insured reimburse it for defense costs expended on uncovered claims. *Buss v. Sup. Ct.*, 16 Cal. 4th 35, 61 n.27 (Cal. 1997). Such a decision, however, does not eliminate the need to periodically evaluate the existence of insurer - insured conflicts of interest.

No Defense

Good advice for all aspects of the coverage investigation is to provide the insured with timely notice of carrier decisions. This universal recommendation applies to claims professionals who have determined that a potential for coverage does not exist. Generally, insurance companies should inform the insured in writing of the coverage declination shortly after the decision is made. *See* Allan D. Windt, *Insurance Claims & Disputes: Representation of Insurance Companies & Insureds*, § 2:23 (Mar. 2011) (stating that an "insurance company seeking to disclaim liability should do so seasonably").

Ordinarily, with a coverage denial, the length of time from the tender to the coverage decision is not that significant because a rejection of coverage essentially preserves the status quo of the coverage question, viz. the carrier is not paying for the defense. Windt, *supra*, at § 2:23. However, in certain circumstances, the insured may include in its breach of contract and bad faith lawsuit the theory that the delayed denial substantially prejudiced defense of the underlying matter. For example, it could argue that during the time the insurer was "making up its mind" the insured was paying for defense costs that he would not have paid if the declination was prompt. *Id.* It may supplement its argument by stating that it would have settled the case if it had known that the insurer was going to deny coverage sooner. *Id.*

Consequences of Erroneous Coverage Denial

Issuance of a coverage declination should only be undertaken if the claims professional is aware of the ramifications of an erroneous decision. Thousands of attorneys make their livelihood second-guessing carriers and instituting coverage litigation. Sometimes, the lawsuits are completely without merit. However, even these actions must remain a consideration when the claims professional intends to deny coverage because fighting the frivolous actions costs substantial time and money.

Undoubtedly, claims professionals have often made the decision to accept the defense with a reservation of rights even when they cannot identify a conceivable theory of coverage. They justify these decisions by estimating that it would be cheaper to defend and, perhaps, settle the action than it would be to deny coverage, defend a bad faith action, and face potential liability for even greater defense and settlement costs. The next few paragraphs serve as a reminder to claims professionals of the possible consequences of rejecting a defense tender.

Insurance Coverage Litigation

Depending on the sophistication of the insured and the claim value, a coverage declination often spawns a separate lawsuit between the insured and the insurance carrier. Chief among the usual causes of action alleged are breach of insurance contract and breach of the implied covenant of good faith and fair dealing, often referred to as "bad faith."

Breach of Insurance Contract

If the insured can prove that the third-party claim he faces is potentially covered, his carrier is liable for breach of insurance contract, regardless of the relations between the insured and insurance company personnel. *Cal. Shoppers, Inc. v. Royal Globe Ins. Co.*, 175 Cal. App. 3d 1, 35-39 (Cal. Ct. App. 4th 1985). *See Careau & Co. v. Security Pacific Business Credit, Inc.*, 222 Cal. App. 3d 1371, 1394 (Cal. Ct. App. 2d 1990) (detailing differences between breach of contract and bad faith theories of recovery). The proper measure of damages when an insured

proves a potential for coverage existed but cannot prove the claim was ultimately covered by the policy is reasonable attorney fees and costs incurred by the insured in defense of the claim. *Marie Y. v. General Star Indem. Co.*, 110 Cal. App. 4th 928, 961 (Cal. Ct. App. 2003). If the carrier rejects the defense tender and the insured is financially unable to defend, then the carrier must pay the default judgment up to policy limits if the insured proves a potential for coverage existed. *Amato v. Mercury Casualty Co.*, 53 Cal. App. 4th 825, 831 (Cal. Ct. App. 2d 1997). If the insured proves the third-party claim was covered, then the insurer owes the insured's defense costs and the amount the insured paid in a reasonable and good faith settlement of the claim up to the policy limits. *Isaacson v. Cal. Ins. Guarantee Assn.*, 44 Cal. 3d 775, 791 (Cal. 1988).

Bad Faith

In the context of construction defect litigation, two bad faith theories of recovery are most often asserted against carriers. The first is the bad faith refusal to defend. Proponents of this theory allege that the insurer unreasonably failed to defend or did not have proper cause for the rejection of the tender. In addition to the remedies available for breach of insurance contract, the insured asserting the refusal defend theory can recover all sums, without regard to policy limits, reasonably paid to the third-party and attorney fees reasonably incurred to enforce payment under the policy. *Rankin v. Curtis*, 183 Cal. App. 3d 939, 946 (Cal. Ct. App. 4th 1986); *Brandt v. Sup. Ct.*, 37 Cal. 3d 813, 817 (Cal. 1985).

The second common bad faith theory of recovery is referred to as the bad faith refusal to settle. The implied covenant of good faith and fair dealing is breached when an insurer fails to accept a reasonable settlement demand within policy limits, and thereby, exposes its insured to possible personal liability for a judgment in excess of the policy limits. *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 659-66 (Cal. 1958). If the insured can prove that the carrier is liable for a bad faith refusal to settle, it is entitled to recover all amounts incurred by reason of the settlement or judgment, regardless of policy limits. Counsel for plaintiffs who have evidence that the carrier unreasonably refused to settle the case for an amount within policy limits often refer to the policy being "open." The threat of bad faith refusal to settle liability may be the strongest weapon available to plaintiff's counsel for leveraging a settlement with his client. When a claims professional refuses to defend, she must appreciate the risk of a large future judgment against the carrier. However, the possibility of bad faith refusal to settle liability exists, even if the carrier is defending. Consequently, prudent claims professionals view thoughtful consideration of settlement offers as a high priority.

THE DEFENSE

If the claims professional decides a potential for coverage exists, defense counsel should be appointed. A good team approach to defending subcontractors includes consideration of the working relationship between the claims professional, the insured, and defense counsel. If the parties to this tripartite team appreciate the each others' perspectives and interests in the joint resolution of the third-party claim, the defense will go more smoothly. The initial step in achieving this understanding is review of the obligations of defense counsel. Thereafter, review of law applicable to insured - insurer conflicts of interest will assist the claims professional in avoiding possible disputes among the tripartite relationship parties.

Defense Counsel Duties

Duty of Loyalty

The most important aspect of the attorney-client, or "attorney-clients," relationship is the absolute and complete fidelity owed by the attorney to her clients. Cal. State Bar Form. Opn. 1984-83; *Flatt v. Sup. Ct.*, 9 Cal. 4th 275, 289 (Cal. 1994); Cal. R. Prof. Conduct 3-310. An attorney's duty of loyalty serves the twin paramount purposes of ensuring that attorneys do not allow other relations to interfere with their devotion to client interests and encouraging confidences essential to the effective administration of justice. *Santa Clara County Counsel Attys. Assn. v. Woodside*, 7 Cal. 4th 525, 548 (Cal. 1994), *overruled on other grounds, Coachella Valley Mosquito & Vector Control Dist. v. California Public Employment Relations Bd.*, 35 Cal. 4th 1072, 1077 (Cal. 2005); *Jeffry v. Pounds*, 67 Cal. App. 3d 6, 10-11 (Cal. Ct. App. 3d 1977); Cal. State Bar Form. Opn. 1984-83.

Conflict of interest situations are discussed below. Avoiding breach of the duty of loyalty is the primary goal in seeking to resolve these ethical dilemmas. *Jeffry*, 67 Cal. App. 3d at 11 (stating "[a] lay client is likely to doubt the loyalty of a lawyer who undertakes to oppose him in an unrelated matter"). Because a lawyer's duty of loyalty survives completion of the subject of the representation, successive conflicts of interest may arise when the lawyer seeks to represent the interests of a new client to the detriment of a former client. Cal. R. Prof. Conduct 3-310(C)(3).

Case law recognizes the idea that insurance defense counsel owes a greater duty of loyalty to the insured. *See Purdy*, 157 Cal. App. 3d at 76 (noting that "[t]he attorney's primary duty has been said to be to further the best interests of the insured"). However, in reality, this principle is fairly difficult to apply. California courts go so far as to acknowledge that "as a practical matter, the attorney may have closer ties with the insurer than with the insured." *State Farm Mut. Auto. Ins. Co. v. Federal Ins. Co.*, 72 Cal. App. 4th 1422, 1429 (Cal. Ct. App. 5th 1999).

About the only way to give the insured greater loyalty in the day-to-day realities of insurance defense practice is to: (1) not allow insurer instructions or handling guidelines to interfere with defense counsels' professional judgment; and (2) not involve defense attorneys in the insurer's coverage investigation. *Gafcon*, 98 Cal. App. 4th at 1415. Additionally, if defense counsel learns of facts during her representation negating coverage or comes to believe that the insured has fraudulently created a situation in which coverage appears to exist where it actually does not, she owes a duty not to disclose them to the insurer. Cal. State Bar Form. Opn. 1995-139, at 3; *Amer. Mut. Liab. Ins. Co. v. Sup. Ct.*, 38 Cal. App. 3d 579, 594 (Cal. Ct. App. 3d 1974).

Duty of Confidentiality

It is the solemn duty of every attorney to "[t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client." Cal. Bus. & Prof. Code § 6068(e)(1); Cal. R. Prof. Conduct 3-300. However, like most ethical obligations, the duty of confidentiality is subject to two main exceptions: (1) client authorizes disclosure of confidential information after informed consent; (2) disclosure of confidential information is necessary to prevent bodily harm or the client from committing a crime or fraud. Cal. R. Prof. Conduct 3-300(B). Also of note, the duty to maintain client confidences exists even after the attorney-client relationship is terminated. *Styles v. Mumbert*, 164 Cal. App. 4th 1163, 1167-68 (Cal. Ct. App. 6th 2008).

Duty of Competence

Every attorney owes her clients a duty to act competently during the course of the representation. Cal. R. Prof. Conduct 3-110(A). Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation. Cal. R. Prof. Conduct 3-110(B). Included within this broad definition of competence is an attorney's obligation to alert her clients to problems outside the scope of the representation. The Court, in *Nichols v. Keller*, 15 Cal. App. 4th 1672, 1683-84 (Cal. Ct. App. 5th 1993), succinctly described the responsibility:

> One of an attorney's basic functions is to advise. Liability can exist because the attorney failed to provide advice. Not only should an attorney furnish advice when requested, but he or she should also volunteer opinions when necessary to further the client's objectives. The attorney need not advise and caution of every possible alternative, but only of those that may result in adverse consequences if not considered.

Duty of Communication

Rule 3-500 of the California Rules of Professional Conduct provides: "A member shall keep a client reasonably informed about significant developments relating to the employment or representation, including promptly complying with reasonable requests for information and copies of significant documents when necessary to keep the client so informed." *See also* Cal. Bus. & Prof. Code § 6068(m) (providing that an attorney must "respond promptly to reasonable status inquiries of clients and to keep clients reasonably informed of significant developments in matters with regard to which the attorney has agreed to provide legal services").

When an attorney is given a written settlement offer, she must promptly communicate to her client its amount, terms, and conditions. Cal. R. Prof. Conduct 3-510(A)(2); Cal. Bus. & Prof. Code § 6103.5(a). "Any oral offers of settlement made to the client in a civil matter should also be communicated if they are 'significant' for the purposes of rule 3-500."

Insured - Insurer Conflicts of Interest

The Two Most Common Conflict Situations

Reservation of Rights Coupled with Defense Counsel Control of the Outcome of the Coverage Dispute

Legal authorities are of the opinion that a mere reservation of rights does not trigger informed consent or independent counsel remedies because of the "unusual, perhaps unique, interrelationship of insurer, insured and counsel[.]" Cal. State Bar Form. Opn. 1995-139 at 2. In typical situations, the concurrent conflict happenstance has not risen to the level of an actual conflict and the insurance policy puts the parties on notice of the risks attendant to the tripartite relationship. *Id.* In other words, by the very existence of the insurance defense relationship, counsel has substantially complied with professional responsibility requirements. *Id.*

Nonetheless, an actual, coverage-related concurrent conflict may come between the insured and insurer. *See* Cal. Civ. Code § 2860(a) (providing that a right to independent counsel exists when "a conflict of interest arises"); *Native Sun Investment Group v. Ticor Title Ins. Co.*, 189 Cal. App. 3d 1265, 1277 (Cal. Ct. App. 4th 1987) (holding only "actual" concurrent coverage-related conflict provides basis for Cumis counsel).

In these materials, we refer to the basis on which potential *Cumis* issues are analyzed as the "Real Quandary" standard. Defense counsel must be placed in a "Real Quandary" in order for Cumis counsel to be warranted.

Thus, such a conflict of interest may arise when:

- liability in the action turns on:
- the conduct of the insured or
- the cause of the alleged harm; and
- the litigation is such that defense counsel has the ability to develop different characterizations of the insured's conduct or the cause of the alleged harm that could result in non-coverage.

See Cal. Civ. Code § 2860(b) (providing that "when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist"); *Gafcon, Inc.*, 98 Cal. App. 4th at 1423; *Dynamic Concepts, Inc. v. Truck Ins. Exchange*, 61 Cal. App. 4th 999, 1007-08 (Cal. Ct. App. 4th 1998) (holding "[t]he potential for conflict requires a careful analysis of the parties' respective interests to determine whether they can be reconciled (such as by a defense based on total non-liability) or whether an actual conflict of interest precludes insurer-appointed defense counsel from presenting a quality defense for the insured"); *Cumis Ins. Society, Inc.*, 162 Cal. App. 3d at 364.

An observation about the "Real Quandary" standard should be noted. The word "may" is emphasized because an insured may not be entitled to *Cumis* counsel even if the two components of the standard are applicable. *Cumis* counsel is not required in every circumstance in which a defense attorney can control the outcome of the coverage dispute. *Blanchard*, 2 Cal. App. 4th at 350. "There is no such entitlement, for example, where the coverage issue is independent of, or extrinsic to, the issues in the underlying action . . . or where the damages are only partially covered by the policy." *Dynamic Concepts, Inc.*, 61 Cal. App. 4th at 1006 (citations omitted).

The purpose of setting forth a permissive definition for the "Real Quandary" standard is to communicate the time when notice of a circumstance implicating *Cumis* counsel should be given to the insured and insurer. To properly discharge defense counsel duties of loyalty to the insured and insurer, she must know when she should give the insured and insurer notice of a possible need for independent counsel so that they will have sufficient time to investigate the circumstances. *See Cumis Ins. Society, Inc.*, 162 Cal. App. 3d at 371 n.7 (holding "the existence of a conflict of interest should be identified early in the proceedings so it can be treated effectively before prejudice has occurred to either party"); *Dynamic Concepts, Inc.*, 61 Cal. App. 4th 999, 1010 (holding insurers are entitled to a reasonable period of time to investigate a potential *Cumis* conflict).

Synthesis of case law reveals that the "may" in the above standard changes to "does" when an additional component is added to the above definition: "the purported conflict of interest between the policyholder and insurance defense counsel is not dependent upon a presumption that counsel will act in a manner that favors the insurer and harms the policyholder." *See* Wagner, *supra*, at 39 (describing the case law synthesis); *Gafcon, Inc.*, 98 Cal. App. 4th at 1422

(noting that evidence on "what specific way the defense attorney could have controlled the outcome of the damage issue to [insured's] detriment, or had incentive to do so" must be offered for a decision in favor of *Cumis* counsel). More succinctly, offering independent counsel is mandated where defense counsel's representation of the insured is rendered less effective by virtue of the applicable facts and the carrier's coverage position. *Gafcon, Inc.*, 98 Cal. App. 4th at 1423. *See Long v. Century Indem .Co.*, 163 Cal. App. 4th 1460, 1473 (Cal. Ct. App. 2d 2008) (stating the duty to appoint Cumis counsel exists when the conflict actually arises). "A mere possibility of an unspecified conflict does not require independent counsel. The conflict must be significant, not merely theoretical, actual, not merely potential." *Dynamic Concepts, Inc.*, 61 Cal. App. 4th at 1007.

Insurer Seeks to Settle for an Amount in Excess of Policy Limits

Appointment of *Cumis* counsel is required when the carrier requests defense counsel settle a claim for an amount higher than the insurance policy limits. *Golden Eagle Ins. Co. v. Foremost Ins. Co.*, 20 Cal. App. 4th 1372, 1396 (Cal. Ct. App. 2d 1994). In this situation, the insured is exposed to personal liability, and therefore, the interests of the insured and insurer actually conflict. *Golden Eagle Ins. Co.*, 20 Cal. App. 4th at 1396.

Remedying the Insured - Insurer Conflicts

Once defense counsel has identified a "Real Quandary" circumstance, three courses of action will remedy the conflict issue:

- Disclosure to insured and insurer of facts and circumstances giving rise to potential *Cumis* conflict, insured's written waiver of right to independent counsel, and insurer's written consent;
- Disclosure to insured and insurer of facts and circumstances giving rise to potential *Cumis* conflict, insurer's written waiver of coverage defenses, and insured's written consent; or
- Disclosure to insured and insurer of facts and circumstances giving rise to potential *Cumis* conflict and appointment of *Cumis* counsel.

Cal. R. Prof. Conduct 3-110(C); Cal. Civ. Code § 2860(e).

What Challenges Do Subcontractors Face?

- Early Settlement Challenges
- Unfavorable Case Law and Legislative Intent
- Joint and Several Liability
- Exhausted Policy Limits
- Additional Insureds
- Anti-Indemnity Statutes
- Uninsured Subcontractors

Unique Subcontractor Issues

- The Facts: Balancing proof of defects and damages with the cost of doing so.
- Insurance: Getting appropriate coverage to get the contract, keeping coverage in place to protect Sub.
- Indemnity – What is it, and how does it impact the subcontractor

Settlement Challenges

- "You will tell them what you think of the facts by the size of the offer"

  - Anonymous

The facts, the law and practicalities

- The Subcontractor's view of the world
  - Sources of information concerning a sub's liability
    - The Subcontractor's job file
    - The Developer/GC's subcontractor file
    - Plans and Specifications
    - Visual Inspection
    - Destructive Testing
    - Experts

The facts, the law and practicalities

- Whose job is it to prove up the claim against the subcontractor?
  - The plaintiff who is making the claim?
    - Usually sue the GC/Developer only
  - The Developer/General Contractor?
    - Most of case is scope of work and indemnity language?
  - The subcontractor?
    - In best position to know their work, respond to claims of owner

Insurance and Indemnity From the Sub's perspective

- Insurance
  - Need it to bid for projects
    - Good enough to qualify
    - Just enough to qualify
  - Need it to protect the Sub
    - As broad as possible for the premium cost
- Indemnity
  - A promise to stand behind the Sub's work
  - Might be responsible for entire issues if Sub's work is a part of it

Insurance

- A contract whereby someone assumes the risk of another for a price
- Liability insurance
  - The insurance company, not the subcontractor, is responsible for "covered" losses payable to the general contractor or plaintiff

Indemnity

- A contract whereby the subcontractor agrees to stand behind his work, and protect the GC/ Developer if it is sued because of the Subs work.
- Indemnity obligations to a GC/Developer are usually insured – If the sub is liable for damages, the insurance company will cover the sub.
  - Contractual Liability Coverage in Sub's policy

Indemnity

"It is hard to imagine another set of legal terms with more soporific effect than indemnity, subrogation, contribution, co-obligation and joint tortfeasorship . . . Even lawyers find words like 'indemnity' and 'subrogation' ring of an obscure Martian dialect." *Herrick Corporation v. Canadian Insurance Company* (1994) 29 Cal.App. 4th 753

"[Indemnity] is a topic so deadly dull that it makes insurance look interesting." *Crawford v. Weather Shield Mfg.,* (2008) 44 Cal. 4th 541

One court called indemnity "somnolent."

Indemnity

California Civil Code section 1668

- CERTAIN CONTRACTS UNLAWFUL. All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law.

Indemnity

California Civil Code section 2782

- Provisions, clauses, covenants, or agreements contained in, collateral to, or affecting any construction contract and that purport to indemnify the promisee against liability for damages for death or bodily injury to persons, injury to property, or any other loss, damage or expense arising from the sole negligence or willful misconduct of the promisee or the promisee's agents, servants, or independent contractors who are directly responsible to the promisee, or for defects in design furnished by those persons, are against public policy and are ***void and unenforceable***.

Indemnity

California Civil Code section 2782 (con't)

- In short, a Subcontractor shall NOT be obligated to defend or indemnify Contractor with respect to:

SOLE NEGLIGENCE or ***WILLFUL MISCONDUCT***

- This must be specifically stated within the Indemnity provision of the contract otherwise it may be deemed **VOID**.
- **Multiple Indemnity Provisions in Contract**: The Subcontractors gets deference of the least restrictive provision. The contract is *always* construed against the drafter

Anti-Indemnification Statutes

- Anti-indemnification Statutes
  - **Anti-indemnification statutes -** State laws which invalidate contract clauses related to a party being indemnified or held harmless for damages or which limit the ways such contract clauses can be utilized.
  - Generally exclude indemnification for "sole negligence" of indemnitee
- Governed by State Law
  - Often depends on type of Contract
    - Construction contracts
      - Oregon prohibits indemnification for any negligence of indemnitee
        - Walsh Construction v. Mutual of Enumclaw, 104 P.3d 1146 (2005)
      - CA prohibits for construction contracts (*Civil Code* sec. 2782)
  - For contracts in use in many states, limiting language "to the extent allowable by state law"

Considerations for Resolution

DIRECT DEFENDANT

- Potential expressed indemnity Cross-Claims per terms of written contract with other Defendants.
  - *Crawford* fees
- Equitable Indemnity Claims.
  - Extinguished with Good Faith Settlement Determination

CROSS-DEFENDANT

- Resolution must include release of all indemnity rights.

Joint and Several Liability

- Only an issue if a direct Defendant.
- Are claims against client discrete or are they connected to the work of another party?
- Are other parties in the lawsuit without any assets?

Express Indemnity v. Joint & Several Liability

- Indemnity (express v. equitable)
- Expressions at Rancho Niguel Assoc. v. Ahmanson (2001) 86 Cal. App. 4th 1135
  - Joint and several liability is not applicable in indemnity actions.
- Comparative Fault
- Who is responsible for missing trade?

Subcontractor Insurance Issues

- Prior work and continuing damage limitations
  - Limits number of policies to respond to a loss
  - Different language over time leads to finger pointing

Subcontractor Insurance Issues

- Prior Work
  - Excludes coverage for damage arising from work performed prior to the policy – watch for continuous coverage exceptions
- Progressive Loss ("Montrose") Limitations
  - Excludes coverage for damage arising from "occurrence" that first caused damage prior to policy period
- Known Loss
  - In ISO CG 0001 10/01 form

Subcontractor Insurance Issues

- Retained Limits
  - Deductibles versus Self Insured Retentions
    - Condition Subsequent versus precedent
  - Who can satisfy retention?
    - Named Insured Only?
    - Any Insured?
    - Can other insurance be used?
  - Per Claim versus Per Occurrence
    - Huge for residential subcontractors

INSURANCE COVERAGE / TENDER ISSUES
Tendering To AI Carriers On Risk

- Trigger of Coverage for Construction Related Damages:
  - Pursuant to *Montrose*, *supra,* a carrier's defense obligation is triggered by allegations set forth in a complaint that potentially fall within the scope of coverage.
- "Continuous Trigger" Rule:
  - "Where…successive CGL policy periods are implicated, bodily injury and property damage which is continuous or progressively deteriorating through **several policy periods is potentially covered by all policies in effect** during those periods."
    - *Montrose Chem. Corp. of Calif. v. Admiral Ins. Co.,* 10 C4th 645 (1995).

Putting it Altogether

- Subcontractor a part of the project as a whole
- Responsible for damage related to their work through indemnity
- Written indemnity agreement creates liability to Sub – perhaps for just his work, or others if TYPE I agreement or if joint and several liability applies
- Sub protects himself through insurance

Putting it Altogether

- Sub responsible to obtain AI coverage in contract, but insurer's obligations run to AI, not Sub
  - But Sub's policy will be charged for the loss incurred by the AI
- Subs face insurance problems to address common construction claims
  - Limitations in policies not the same from carrier to carrier, even year to year
  - Limitations may not give cohesive coverage for long tail exposure ie, construction defect claim

Subcontractors in Context?

- Individual Subcontractor and Collective Exposure to Defense Costs, and Indemnity to Plaintiff
- What happens when there are Missing subs

Absent Subcontractors

- Bankruptcies/Dissolutions
- Suspended Corporations
- Small Sub with Insurance problems
  - Insolvent carriers
  - Large SIR's
  - Carriers deny coverage

Bankruptcy and Suspended Corporations

- Bankruptcy
  - Filing with Bankruptcy Court
  - Stays actions against Debtor
  - Relief from Stay to pursue action
  - Party still viable, but damages are limited

Bankruptcy and Suspended Corporations

- Suspended Corporations
  - Failure to pay State taxes
  - Corporate status "suspended" – can't sue or defend
  - Other parties can still pursue corporation
  - Unless insurer retained counsel, representing suspended corporation is criminal offense
  - If corporation revived, all actions taken by corporation during suspended are validated

Bankruptcy and Suspended Corporations

- Suspended Corporations – What is an insurer to do?
  - Allow default to be entered
  - Try to revive corporation (seek help from insured)
  - Intervene in lawsuit to protect own interest.
  - *Kaufman and Broad v. Performance Plastering (2006) 136 Cal.App.4th 212.*

Direct Settlement with Plaintiff

- Settlement between plaintiff and subcontractor
- Issue Release
- Scope of Work Release
- Additional Insured
- Express Indemnity Agreement
  - Motion for Summary Judgment
- Good Faith Settlement

Settlement between Developer and Plaintiffs

- Settlement between plaintiff and Developer
  - Mary Carter Agreement
  - Assignment Agreement
    - Developer Experts
    - Express Indemnity Rights
  - Settlement Agreement
  - Good Faith Settlement
  - Recovery by Plaintiff of Attorney's Fees

Other Subcontractor Issues

- The AAS decision: no tort recovery without damage to "other property"
- SB800 (CC 895) Right to Repair Law
- Allocation of Plaintiffs' Costs
  - *Stearman v. Centex* – Litigation Costs?
- The carrier's right to pay and chase
  - *Bramalea v. Reliable Interiors*
  - *Interstate v. Cleveland Wrecking*

Underused Weapons in Subcontractors' Arsenal

- DISCOVERY!
- Motion for Summary Judgment
- CCP 998
- Trial
- Challenge to Pleadings
  - Demurrer
  - Improper Service

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