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Construction Defect Bad Faith Insurance Claims: Navigating Duty to Defend and Indemnify Denial and Bad Faith Set-Ups

Assessing Faulty Workmanship, Business Risk Exclusions, AI Issues, Failure to Settle Within Limits and Contribution/Indemnity

THURSDAY, DECEMBER 15, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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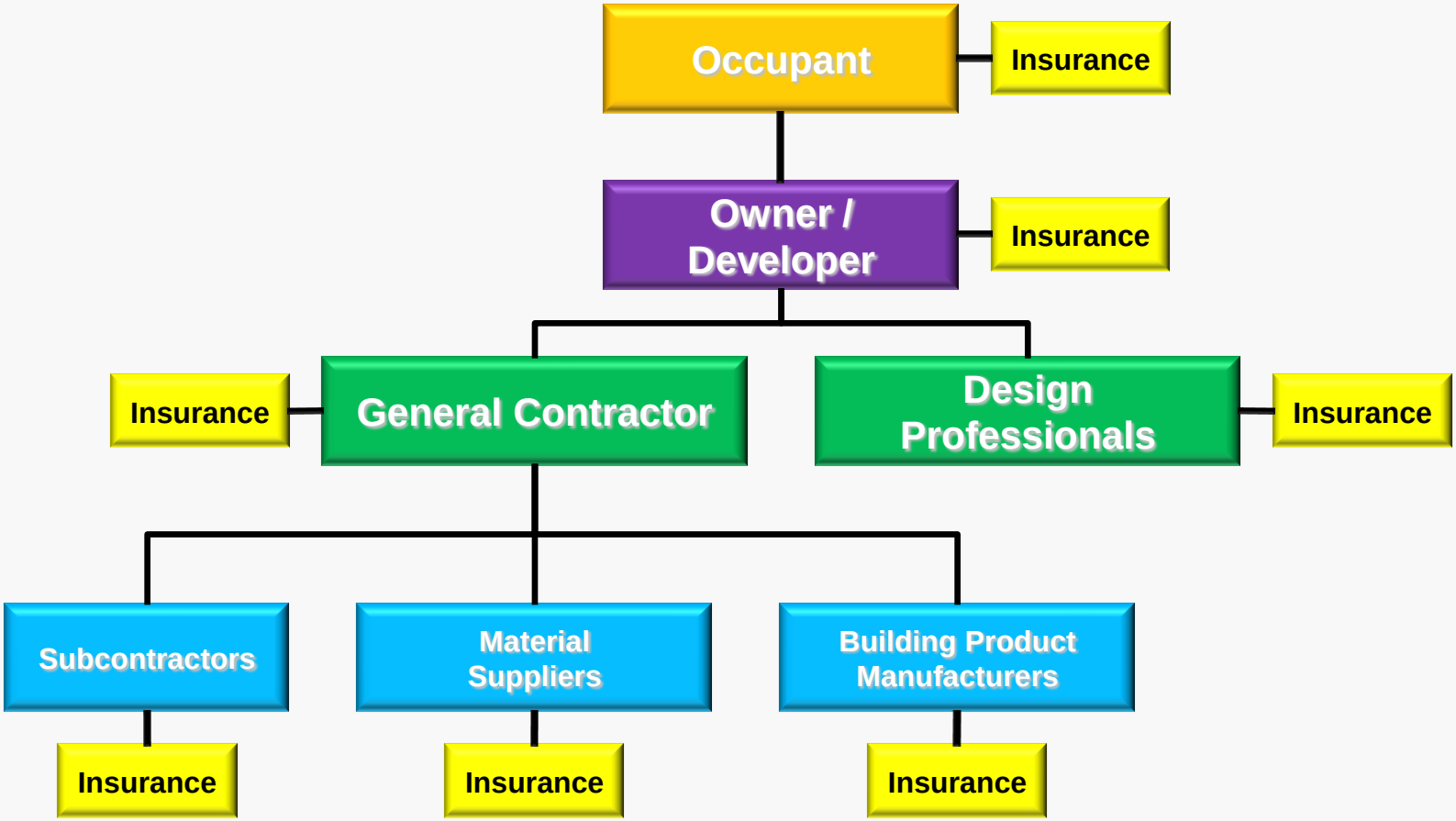
Bad Faith Claims in Construction Defect Insurance Disputes

James P. Bobotek and John C. Bonnie

Insurance in a Typical Construction Defect Case



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Analyzing Coverage for a Typical Construction Defect Claim

- Is there an “occurrence”?
- Is there bodily injury or property damage?
- Did the injury or damage take place during the policy period?
- Is coverage excluded?
- Has the policyholder complied with all policy conditions?

Occurrence

Huge issue in construction industry claims -- is faulty workmanship an occurrence?

Coverage A – Insuring Agreement

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 applies.

ISO Form CG 00 01 12 07

"The Insured"

- Named Insured—Declarations Page
- Insured (Who Is An Insured Section)
  - Employees, officers, directors (acting in scope of employment)
  - Real estate managers
  - Newly formed/acquired organizations (grace period)
- Additional Insureds
- Joint Ventures

“Business Risk” Exclusions

- j.1: owned, rented, or occupied property
- j.3 and j.4: care, custody, and control
- j.5: operations
- j.6: faulty workmanship
- k: your product
- l: your work
- m: impaired property

Exclusion j.1 Owned, Rented, or Occupied Property

- Designed to exclude coverage for exposures that are typically insured through other types of policies, such as inland marine or fire policies.

- Because of the straightforward nature of the exclusion, it has not been the subject of much court interpretation, especially as applied in the defective work context.

Exclusion j.1 Owned, Rented, or Occupied Property

This insurance does not apply to:

j. **Damage To Property**

"Property damage" to:

(1) Property you own, rent or occupy . . . .

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Exclusion j.2 Alienated Premises

This insurance does not apply to:

j. Damage To Property

"Property damage" to:

(2) Premises you sell, give away or abandon, if the "property damage" arises out of any part of those premises;

Paragraph (2) of this exclusion does not apply if the premises are "your work" and were never occupied, rented or held for rental by you.

Exclusions j.3 and j.4 Care, Custody, or Control

This insurance does not apply to:

j. Damage To Property

"Property damage" to:

(3) Property loaned to you;

(4) Personal property in the care, custody or control of the insured;

Paragraphs (3), (4), (5) and (6) of this exclusion do not apply to liability assumed under a sidetrack agreement.

Exclusion j.5 Damage to Property

This insurance does not apply to:

j. Damage To Property

"Property damage" to:

(5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the “property damage” arises out of those operations . . . .

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Exclusion j.5 Damage to Property

- "That particular part . . ."
  - Expansive/indivisible: *Copple Constr., L.L.C. v. Columbia Nat'l Ins. Co.*, 279 Neb. 60 (Neb. 2009)
  - Restrictive/divisible: *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 557 F.3d 207 (5th Cir. Tex. 2009)
- The named insured or its subcontractors must be performing operations on the real property, and the property damage must arise out of those operations.
- Does not apply to products-completed operations.

Exclusion j.6 Damage to Property

This insurance does not apply to:

j. Damage To Property

"Property damage" to:

(6) That particular part of any property that must be restored, repaired or replaced because “your work” was incorrectly performed on it.

Paragraph (6) of this exclusion does not apply to “property damage” included in the “products-completed operations hazard”.

Exclusion k. Your Product

- Limited application in construction defect cases because “your product” is defined to exclude real property.
  - *Md. Cas. Co. v. Reeder*, 221 Cal. App.3d 961 (1990).

- “Your product” defined:

  Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by . . . .

Exclusion l. Your Work

This insurance does not apply to:

l. Damage To Your Work

"Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

This exclusion does not apply **if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor**.

Products-Completed Operations

- Separate sub-limits in a CGL policy.
- Failure to obtain and procure for additional insureds leads to many breach of contract claims.
- Three-part test for coverage.

Products-Completed Operations

Three-part test for coverage:

1. Must occur away from your premises.
2. Must arise out of “Your Product” or “Your Work,” terms defined in the CGL form.
3. Does not apply if the work has not yet been completed or abandoned.

Contractual Risk Transfer Issues

- Additional Insureds
- Certificates of Insurance

Additional Insureds

- Requires a separate endorsement to the basic CGL form - can be either specific or a blanket endorsement.
- Terms of the endorsement must be reviewed.
  - Coverage for the additional insured's own negligence?
  - Coverage for completed operations?
  - Priority of coverage?
- One size does not fit all.

Additional Insureds: April 2013 ISO Changes

1. The insurance afforded to such additional insured only applies to the extent permitted by law; and

2. If coverage provided to the additional insured is required by a contract or agreement, the insurance afforded to such additional insured **will not be broader than that which you are required by the contract or agreement to provide** for such additional insured.

Additional Insureds: April 2013 ISO Changes

If coverage provided to the additional insured is required by a contract or agreement, the **most we will pay** on behalf of the additional insured is the amount of insurance:

1. Required by the contract or agreement; or
2. Available under the applicable Limits of Insurance shown in the Declarations;

whichever is less.

Certificates of Insurance

- What they are:
  - Evidence of insurance issued to the policy's named insured.
- What they are not:
  - Evidence of coverage for additional insureds.
  - Evidence of waivers of subrogation.
  - Evidence of any other special endorsements to the named insured's insurance policies.

Construction Defect Cases Present Unique Issues

- Difference exists between a claim for the costs of repairing or removing defective work and a claim for the costs of repairing damage caused by the defective work;
- CD cases tricky because of complicated/uncertain nature of PD;
- Damage is typically extensive; multifaceted/multiple trades;
- Uncertainty re: what damage attributable to whom;
- Insurers many times must decide whether or not to accept defense without knowing the answer.

What is Insurer Bad Faith?

- Not a universal concept.
  - Classic definition: insurer "placing its own interests ahead of those of its insured."
    - While "the insurer does not have to place the insured's interests above its own interests, it must give 'equal consideration' to the insured's interests." *Ki Sin Kim v. Allstate Ins. Co*., 223 P.3d 1180, 1192 (Wash. Ct. App. 2009).
  - The cornerstone of bad faith is unreasonable conduct, but the standard for finding bad faith varies widely among jurisdictions.
    - *Pavia v. State Farm Mut. Auto Ins. Co.*, 82 N.Y.2d 445 (1993) (gross disregard for the policyholder's interests);
    - *Pickett v. Lloyd's*, 131 N.J. 457 (1993) (no debatable reasons for denial of benefits);
    - *Reid v. Pekin Ins. Co.*, 436 F. Supp. 2d 1002, 1011, 1013 (N.D. Iowa 2006) (insured was not entitled to assert bad-faith tort claim where claim for coverage was "fairly debatable").

What is Insurer Bad Faith?

- Makes a choice of law analysis important – what state's law could apply to bad faith claim?
- What is better for policyholder/insurer?

Choice of Law for Bad Faith Claims

- Does same law that controls the question of coverage control the question of bad faith?
- Dependent on whether bad faith is a tort claim, contract claim, or statutory claim.
- If tort-based, the conduct allegedly supporting bad faith may be in a state other than the state's law that controls application/interpretation of the policy.

Bad Faith Standard/Sources

- Jurisdiction dependent
- Common law (tort claim)
- Implied Covenant of Good Faith and Fair Dealing (contract claim)
- Specific Bad Faith Statutes, Unfair Claims Settlement Practices Acts, Consumer Protection/Unfair Trade Practices Acts (statutory claim)
  - Consider whether they create a private cause of action.

What is Insurer Bad Faith?

- Tort

  - Broad - California “when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.” *Gruenberg v. Aetna Insurance Co.*, 9 Cal.3d 566, 573 (1973).

  - Narrower - Wisconsin “the absence of a reasonable basis for denying benefits of the policy and the [insurer’s] knowledge or reckless disregard of the lack of a reasonable basis for denying the claim.” *Anderson v. Continental Ins. Co.*, 85 Wis.2d 675 (1978).

Uniform Unfair Claims Practices Act

- Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;
- Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;
- Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;
  - investigation by insurer "at best inattentive if not incompetent" where insurer denied coverage for faulty well drilling – *McLaughlin v. American States*, Mass (2016).
- Refusing to pay claims without conducting a reasonable investigation based on all available information;
  - an insurer cannot reasonably and in good faith deny payments to its insured without thoroughly investigating the foundation for its denial." *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal.3d 809, 819 (1979).

Uniform Unfair Claims Practices Act

- Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;
- Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear;
- Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds;
- Attempting to settle a claim for less than the amount to which a reasonable individual would have believed the individual was entitled by reference to written or printed advertising material accompanying or made part of an application;
- Attempting to settle claims on the basis of an application that was altered without notice to or knowledge or consent of the insured;

Uniform Unfair Claims Practices Act

- Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which the payments are being made.
- Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.
- Delaying the investigation or payment of claims by requiring an insured, a claimant, or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.

Uniform Unfair Claims Practices Act

- Failing to promptly settle claims, where liability has become reasonably clear, under one (1) portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage;
- Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.

Unfair Claims Practices Acts – Case Examples

- In some jurisdictions – yes.
  - Insurer failed to timely communicate coverage position/limited coverage despite concluding insured had substantial non-covered exposure. Court found estoppel based on defense without effective reservation of rights; insurer found liable for 4.6M judgment – *Advantage Bldgs. & Exteriors, Inc. v. Mid-Continent Cas. Co.*, 449 S.W.3d 16 (Mo. App. 2014).
  - Communication is a two-way street. No coverage for a consent judgment where insurer reserved rights and asked for more info and insured ignored. Court found a violation of Washington Insurance Code requiring "reasonable assistance" – *Granite State Ins. Co. v. Integrity Structures, LLC*, 2015 WL 136006 (W.D. Wash. Jan. 9, 2015).
  - Even if coverage is debatable, if the insurer did not investigate, it could be liable for bad faith. *Wilson v. 21st Cent. Ins. Co.*, 42 Cal. 4th 713 (2007).

Bad Faith Statutes – Private Cause of Action

- Prohibit insurer from misrepresenting facts or coverage, failing to timely disclaim, failing to attempt a good faith settlement, failing to settle claims promptly or to investigate or pay claims, or failing to promptly provide a reasonable explanation of its basis for denying coverage.
- Remedies can include actual and consequential damages, costs and attorneys' fees, punitive and treble damages.
- Examples: Connecticut Unfair Insurance Practices Act, Conn. Gen. Stat. Section 38a-816 (2008); Massachusetts Unfair Trade Practices Act, Mass. Gen. Laws Ann. Ch. 176D, Section 3 (2008); North Carolina Insurance Unfair Trade Practices Act, N.C. Gen. Stat. Section 58-63-15 (2008).

Bad Faith Scenarios

- Insurer failed to properly defend policyholder in good faith or refused to settle underlying action against its policyholder.
- Focus on insurer's handling of underlying claims brought by third party against policyholder.
- Policyholder may assign rights against insurer to a third party, typically the plaintiff bringing the underlying action.

Bad Faith Scenarios – Duty to Defend

- Refusal to defend
- Defense under reservation of rights
- Claims handling issues
- Standard for defense is low -- duty to defend is broader than duty to indemnify – any “potential” of indemnity coverage triggers the duty to defend
  - Four/Eight corners analysis;
  - Extrinsic evidence.

Bad Faith Scenarios – Duty to Defend

- Is there an “occurrence” – current trend makes it harder for insurers to rely on this defense.
- Exclusions/exceptions
  - Subcontractor exception to “your work” exclusion is a prime example
- Additional insureds
- Contractual liability
- Products/completed operations hazard
- Professional services
- “Other insurance”

Bad Faith Scenarios – Duty to Defend

- Notes from claim files:
  - All 46 houses have to be re built, all the subs have faulty work. My plan is review the documents from the insured and if good disclaim coverage because [Another insurance company] is the primary carrier and because work product of a sub is not covered by our policy. Let [the other insurance company] take the lead. Plus how far would General Contractor go – if they sue it hits the papers about their 46 houses that had to be re built; terrible press. Does General Contractor wish that kind of bad press, I doubt.
  - The [co-defendant] is also insured with us. That file is being handled by [another adjuster] and I think her position is in bad faith.

Bad Faith Scenarios – Duty to Indemnify

- Failure to settle
  - Under New York law, an insurer must consider the *Luria* Doctrine when determining whether a settlement of a claim or lawsuit is reasonable. *Luria Bros. & Co. v. Alliance Assurance Co.*, 780 F.2d 1082, 1091 (2d Cir. 1986).
  - "[T]o recover the amount of the settlement from the insurer, the insured need not establish actual liability to the party with whom it has settled 'so long as . . . a potential liability on the facts known to the [insured is] shown to exist, culminating in a settlement in an amount reasonable in view of the size of possible recovery and degree of probability of claimant's success against the [insured].' *Luria Bros.*,780 F.2d at 1091 (quoting *Diamonti v. A/S Inger*, 314 F.2d 395, 397 (2d. Cir. 1963))."
  - *Luria* requires that the insured meet the "potential liability" criteria by showing that liability may exist vis-à-vis the underlying facts, not the allegations.
  - Evidence related to the reasonableness of a settlement includes: views of defense counsel, opinions of experts, mock trials, verdicts in comparable cases, the likelihood of favorable or unfavorable rulings on liability, defenses to liability, damages, prospects of appeal, and other issues relevant to the potential liability of the insured.

Bad Faith Scenarios – Duty to Indemnify

- Policy “consent to settle” clauses.
- Placing conditions on settlement.
- Excess liability - primary and excess insurers can be held liable for amounts in excess of their limits if they in bad faith failed to consent to a settlement and/or failed to contribute their policy limits.
  - *Walbrook Ins. Co. Ltd. v. Liberty Mut. Ins. Co.*, 5 Cal. App. 4th 1445, 1454-59, 7 Cal. Rptr. 2d 513 (Cal. Ct. App. 1992);
  - *Florida Physicians Ins. Reciprocal v. Avila*, 473 So. 2d 756, 757 (Fla. Dist. Ct. App. 1985).

Policyholder Assignment/Covenant Not to Execute

- Many states permit – settlement amount viewed from a “tainted by fraud or collusion” standard.
  - MN (Miller-Shugart);
  - AZ (Damron/Morris);
  - FL (Coblentz);
  - CO (Bashor/Nunn);
  - R.S. Mo. Section 537.065.

Bad Faith "Set-Ups"

- Most frequently originate in the third-party context;
- In most instances, orchestrated by claimant's counsel looking for a sizeable excess verdict;
- Settlement demand made to insurer with a short response deadline;
- Insurer declines to meet the demand, explaining that it needs further information;
- This position is then portrayed as a failure to settle, and will then be used against the insurance company as evidence of unreasonable conduct in the settlement of the case.

Bad Faith "Set-Ups"

- What can an insurer do?
  - Assuming that there are no prohibitive state statutes or cases (e.g., *Roberts v. Printup*, 595 F.3d 1181 (10th Cir. 2010), attempt to extend the offer in a reasonable manner.
  - Cite the fact that it has a duty to its insured to investigate the claim fully, itemize the information it will need before it can respond to the offer.
  - Issue a "comfort letter" to the insured promising that, in the event of an excess verdict, the insurer will indemnify the insured for the excess.
  - If and when sued for bad faith, challenge the bad faith claims as a set-up. *Porter v. Okla. Farm Bureau Mut. Ins. Co.*, 330 P.3d 511 (Okla. 2014).

Policyholder Remedies for Insurer Bad Faith

- Defense costs;
- Settlement/judgment amounts – can be excess of policy limits under some circumstances;
- Consequential damages flowing from breach of contract;
  - *Bi-Economy Market, Inc. v. Harleysville Ins. Co. of New York*, 10 N.Y.3d 187 (2008) (insurer should have foreseen that it would owe damages to the policyholder for business losses attributable to the insurer's failure to promptly act on claim);
- Attorney's fees (exception to "American Rule");
- Statutory penalties:
  - Punitive damages;
  - Multipliers.

Trends

- Courts are shifting away from finding that a construction defect claim does not trigger a CGL policy's basic insuring agreement;
  - Issue for many courts has been whether or not an accident is an "occurrence"
    - Weedo's demise is the latest
    - Pennsylvania holding out

- Trend now is to accept that insuring agreement is triggered, and instead focus on policy exclusions.
    - Shifts the "burden of proof" to insurers – fomenting more bad faith situations

Trends

- Most courts now recognize and apply the “subcontractor exception” to exclusion l. and recognize its intended effect.
- More jurisdictions are applying Exclusions j.(5) and j.(6) in a manner that gives effect to the “that particular part” language.

Thank you!

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