COMMON INSURANCE COVERAGE ISSUES ON CALIFORNIA CONSTRUCTION PROJECTS

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Introduction and Overview

- Common Insurance Coverage Issues encountered as a Construction Lawyer
- Coverage under CGL Policies for damage during construction
- Coverage under Builder's Risk policies for damage during construction, and how to get around an insurer's denial of coverage based on the "faulty workmanship" exclusion.
- Impact of mold exclusions on coverage under CGL and Builder's Risk policies

Introduction and Overview

- The Duty to Defend and what happens to an insurer if it wrongly refuses to defend
- How to manage coverage by a subcontractor's liability policy when the sub is out of business
- Independent Contractor endorsements under a General Contractor's liability insurance policy and why they should not be allowed
- Self-Insured Retentions, how they are different than deductibles, and how they can affect coverage

CGL and Builder's Risk Insurance

- General Liability Insurance
- Covers "occurrences"
- Generally, means liability to third parties for property damage and personal injury
- "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."

CGL and Builder's Risk Insurance

- Builder's Risk Insurance, also known as Contractor's All Risk ("CAR") or Course of Construction Insurance
- CAR policies insure against physical loss or damage to works, plant, equipment and materials during the course of construction.
- Provide coverage similar to the Property portion of a homeowner's policy

1. General Liability Insurance

- There is damage to the property while it is under construction.
- Is it covered under the General Liability Insurance policy?
- It depends on the kind of damage and under whose policy coverage is being sought.

General Liability Insurance

- No coverage under the General Contractor's policy under exclusions J5
- J5: Excludes coverage for 'Property Damage' to "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."
- For the general contractor, this is all the work so it is all excluded

General Liability Insurance

- J6: Excludes coverage for 'Property Damage' to "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it."
- Again, it is all the general contractor's work
- There is a clause under j that provides that "Paragraph (6) of this exclusion does not apply to 'property damage' included in the 'products-completed operations hazard.'"

General Liability Insurance

- Where the work has been substantially completed, coverage is afforded under the "completed operations" exclusion.
- J5 no longer applies because the contractor and subcontractors are no longer performing operations.
- J6 no longer applies because there is an exception for work included in the "products completed operations hazard."

General Liability Insurance

- Exclusion I excludes coverage for

  "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.

General Liability Insurance

- Same rules apply to defective work performed by a subcontractor, no coverage under the subcontractor's general liability insurance policy.

- If there is damage by one subcontractor to work of another subcontractor, even during construction, there will be coverage under the policy issued to the subcontractor that caused the damage.

- If a contractor on a remodel project damages existing work, there may also be coverage

General Liability Insurance

- These are the only scenarios involving property damage during construction where there will be coverage under a CGL policy.
- Atherton mansion case study
- These limitations do not apply to personal injury or death, just property damage.
- There MAY be coverage under the Builder's Risk policy

2. Builder's Risk Policies

- So you have damage on a construction project, no coverage under the CGL Policies, so you turn to the Builder's Risk policy.
- The damage does not involve a fire, which is what the insurance company will try to limit the coverage under the Builder's Risk policy.
- Generally, if there is damage to the property during construction the insurer will deny coverage unless there is a fire.

Builder's Risk Insurance

- Generally, Builder's Risk Insurance policies include an exclusion for "faulty, inadequate or defective workmanship."
- It is a rare case on a construction project where there is property damage that does not involve a fire where the insurance company cannot point to some negligence of the contractor or subcontractor.
- Claims will typically be denied based on this exclusion, and others.

Builder's Risk Insurance

- Issue: How to get around this exclusion.
- Answer: Efficient Proximate Cause Doctrine
- Insurance Code Section 530

"An insurer is liable for a loss of which a peril insured against was the proximate cause, although a peril not contemplated by the contract may have been a remote cause of the loss; but he is not liable for a loss of which the peril insured against was only a remote cause."

Builder's Risk Insurance

- *Sabella v. Wisler* (1963) 59 Cal. 2d 21
- House was damaged by land movement
- Policy had exclusion for "settlement"
- Held: Damage was covered because efficient proximate cause was the rupture of a negligently constructed sewer line.
- "Where there is a concurrence of different causes, the efficient cause – the one that sets others in motion – is the cause to which the loss is to be attributed, though other causes may follow it, and operate more immediately in producing the disaster."
- No discussion of "faulty workmanship"

Builder's Risk Insurance

- *Garvey v. State Farm* (1989) 48 Cal. 3d 395
- "Efficient proximate cause" means "predominating cause" (*Sabella* "moving cause" can be misconstrued to deny coverage erroneously)
- House damaged by earth movement
- Policy excluded losses "caused by, resulting from, contributed to or aggravated by earth movement"
- Expert opined that cause was too shallow footing
- Held: If negligence was the efficient proximate cause, then there is coverage
- No discussion of "faulty workmanship"

Builder's Risk Insurance

- Court refined the definition of efficient proximate cause test.
- "When a loss is caused by a combination of covered and specifically excluded risks, the loss is covered if the covered risk was the efficient proximate cause of the loss," but "the loss is not covered if the covered risk was only a remote cause of the loss, or the excluded risk was the efficient proximate, or predominate cause."

Builder's Risk Insurance

- If the cause of the damage is the negligence of the contractor or subcontractor, there may be coverage.
- If the cause of the damage is a combination of factors, and the negligence of the contractor is the efficient proximate cause of the damage, there can be coverage, even if the combined factor is excluded.
- *Garvey* held that if third party negligence is not excluded under the policy, it is a covered peril.

Builder's Risk Insurance

- *Tento International, Inc. v. State Farm*, 222 F. 3d 660 (9th Cir. 2000) and *Allstate Ins. Co. v. Smith*, 929 F. 2d 447 (9th Cir. 1991)
- Both involved roofs that had been removed and rainfall and resulting damage
- Insurer invoked "faulty workmanship" exclusion

Builder's Risk Insurance

- Court focused on the distinction between a defective "product" and a defective "process"
- Court found nothing defective in the way the work was performed (the product), just defects in the timing and planning of the work.
- Courts held that faulty workmanship exclusion did not apply
- *Allstate* held that the "efficient proximate cause" of the damage was not rain (also excluded) but the negligence of the contractor.

Builder's Risk Insurance

- After *Allstate* and *Tento* insurance companies added an exclusion for damage caused by rain unless "the building or structure first sustains damage by a Covered Cause of Loss to its roof or walls through which the rain … enters".

Builder's Risk Insurance

- Case Study
- Theater in Monterey under construction
- Interior finishes are installed before roof is completed
- Rain enters through incomplete roof and causes damage to the interior of the building
- Contractor's general liability insurer denies coverage – it is all the Contractor's "work"
- Coverage, if any, will be under Builder's Risk

Builder's Risk Insurance

- Builder's Risk insurer denies coverage based on "defective workmanship" clause
- Theater Owner files declaratory relief action in Federal Court (diversity with out of state insurance company and need *Allstate* and *Tento* as binding authority)
- Efficient proximate cause was contractor's negligence, not rain, MSJ granted
- Rain exclusion also did not apply

Builder's Risk Insurance

- Erosion of the Efficient Proximate Cause Doctrine
- *Julian v. Harford Underwriters Ins. Co.* (2005) 35 Cal. 4th 747
- Landslide caused by heavy rain caused damage to a house
- Homeowners made a claim against Property Policy (same type of coverage as a Builder's Risk Policy)

Builder's Risk Insurance

- Policy excluded losses caused by weather conditions, but only where weather conditions "contribute in any way with" earth movement (e.g. landslide), water damage (e.g. flood), or another excluded peril.
- Court phrased issue as whether the efficient proximate cause test prohibits an insurer from insuring against some manifestations of weather conditions, but not others.
- Held, it does not. No coverage for damage.

Builder's Risk Insurance

- *De Bruyn v. Superior Court* (2008) 158 Cal. App. 4th 1213
- Homeowner returned home from vacation and found that toilet overflowed causing damage. Insurer denied the portion of the claim for remediation of mold damage.
- Policy provided that any loss resulting from mold is always excluded, no matter how it was caused.

Builder's Risk Insurance

- Insured argued that this violated the efficient proximate cause test.
- Insurer relied on *Julian,* that an insurer is free to exclude certain types of losses or damages, "however caused" regardless of efficient proximate cause doctrine.
- Court of Appeal disagreed, as the *Julian* court "explicitly limited its discussion to the application of the exclusion at issue to the loss caused by the specific peril alleged in the case before it."

Builder's Risk Insurance

- Court held no coverage because the insurer is "permitted to limit coverage for some, but not all, manifestations of water damage, and the policy expressly provides there is no coverage for losses caused by mold resulting from a sudden and accidental discharge of water."
- Policy "does cover losses caused by water damage resulting from a sudden and accidental discharge of water, but it 'never, under any circumstances, cover[s] … mold, …even if resulting from that specific peril."

Builder's Risk Insurance

- So up to this point, the *Allstate* and *Tento* analysis still appears viable.
- When you have contractor negligence, look to the type of negligence – if it is a negligent process, there is coverage; if it is a negligent product (a defect in the work causing damage) it is excluded.
- Then in 2009 the bombshell hit.

Builder's Risk Insurance

- *Freedman v. State Farm Ins. Co.* (2009) 173 Cal. App. 4th 957
- Contractor installing drywall drove a nail into a water pipe. Years later, after corrosion, the pipe leaked and caused extensive damage.
- Insurer denied coverage, relying on exclusions for defective construction, corrosion and water damage (including seepage or leakage from … a plumbing system)

Builder's Risk Insurance

- Insured argued that the efficient proximate cause of the damage was contractor negligence
- Court held that the Insured's argument was "based on a form of analysis that has been superseded by the Supreme Court in *Julian*"
- "*Julian* applies straightforwardly here. The third-party negligence provisions of the Freedmans' policy exclude third parties' negligent conduct and defective workmanship whenever they interact with an excluded peril, just as the Julians' policy excluded weather conditions whenever they interacted with an excluded peril."

Builder's Risk Insurance

- The *Freedman* court did not discuss the *Allstate* or *Tento* decisions.
- Nor did it make a distinction between a defective process and a defective product.
- The decision could be rationalized as involving a defective product and not a defective process, and thus distinguish *Allstate* and *Tento*.
- And the Supreme Court in *Julian* did not simply throw out the efficient proximate cause test, as the *Freedman* court appears to do.

Builder's Risk Insurance

- The law in this area is presently unsettled.
- *Freedman* appears to have clearly taken *Julian* too far.
- But the California Supreme Court denied review of *Freedman*
- Where you have a coverage issue like this, and the insurance company is from out of State, file the complaint in Federal Court, where *Allstate* and *Tento* are still good law, and where *Freedman* is not binding.

3. Mold Exclusion - Property

- Mold Exclusions on Property Policies
- They all have them
- But in many cases the insured can argue that the efficient proximate cause of the mold was something else that is covered, like the contractor's negligence.
- That is why insurance companies write their property policies to not only include a mold exclusion, but to also add a rider that says that if there is coverage for mold, the most they will pay for mold is, say, $10,000.
- Contractor's need pollution policies for mold.

4. Mold Exclusion - CGL

- In most construction defect cases, there will be mold present.
- Usually General Liability Insurance carriers do not attempt to rely on the mold exclusion, as there is plenty of other resulting damage in a water intrusion construction defect action.
- Mold exclusion is typically not a factor in construction defect actions.

5. The Duty to Defend

- It is very broad
- Consequences to an Insurer that refuses to defend are severe
- Where an insurer has breached its duty to defend, "[I]t is stated to be the general rule that 'an insurer who has had an opportunity to defend is bound by the judgment against its insured as to all issues which were litigated in the action against the insured.'" *Clemmer v. Hartford Ins. Co.* (1978) 22 Cal. 3d 865.

The Duty to Defend

- The Insurer is bound by the judgment EVEN IF THE UNDERLYING CLAIMED DAMAGES WERE NOT COVERED!
- *Amato v. Mercury Casualty Co.* (1997) 53 Cal. App. 4th 825
- *Pruyn v. Agricultural Ins. Co.* (1995) 36 Cal. App. 4th 500
- *Executive Risk Indemnity, Inc. v. Jones* (2009) 171 Cal. App. 4th 319

Duty to Defend

- *Executive Risk* Case
- $10 million Errors and Omissions policy issued to investment advisor
- Demand for arbitration by former client seeking damages of $22 million
- Insured tendered to carrier
- Policy required insured to pay first $250,000 of defense costs
- Defendant was insolvent and could not defend

Duty to Defend

- Insured notified insurer of insolvency and asked insurer to defend
- Insurer said "call us after you have spent $250,000"
- Default award in arbitration turned into a judgment for $22 million
- Insurer "was bound by the results of the arbitration" and "cannot contest the validity of [the insured's] liability to [Plaintiff] or the amount of damages as established by the judgment."

6. CGL – The Insolvent Sub

- Construction defect action is filed
- Many of the subcontractors that performed the work are out of business
- They had general liability insurance that would apply to the claims and damages
- General contractor is not an additional insured, or, as is now very common, the additional ensured endorsement only applied to the subcontractor's "ongoing operations" and the operations have been completed.

CGL – The Insolvent Sub

- Because the general contractor is not an additional insured, and because the sub is out of business, there is no bad faith liability if the insurer just refuses to defend.

- The general contractor should sue the insolvent sub and provide notice to the sub's liability insurer that it going to enter the default of the subcontractor if the insurer does not step in to defend, as the insured is entitled to do under California law.

CGL – The Insolvent Sub

- Under Insurance Code Section 11580 the general contractor can file a separate action against the insurance company to enforce any judgment against the subcontractor.
- Case law has established that an insurer who had notice and an opportunity to defend and who chooses not to defend is bound by the judgment, to the extent that it encompasses losses covered under the policy.
- See, e.g., *Garamendi v. Golden Eagle Ins. Co.* (2004) 116 Cal. App. 4th 694.

7. CGL Independent Contractor Endorsements

- Two types of Independent Contractor endorsements
- They provide limits with respect to independent contractors, that is, subcontractors
- Very unfair and unreasonable for general contractors.
- Get a new insurance broker if policy has either type of clause and the broker did not discuss.

7. Independent Contractor Endorsements - Excess

- Independent Contractor endorsement
- "This insurance is excess over any other insurance issued to independent contractors employed by the insured."
- Impact of excess insurance
- Horizontal and vertical exhaustion
- Excess insurance usually much cheaper

7. CGL – Independent Contractor Endorsements - Additional Insured

- Endorsement requires Contractor to obtain, from all subcontractors, insurance that provides coverage "as broad as that covered under this policy" and to have the contractor named as an additional insured and to include an indemnity clause in the subcontract "as broad as is allowed under applicable law".
- Not making this up
- Law on indemnity clauses in Subcontracts has gotten complicated recently – Civil Code 2782

7. CGL – Independent Contractor Additional Insured

- This is an enforceable provision under California law. *Scottsdale v. Essex* (2002) 98 Cal. App. 4th 86
- Some insurers write the endorsement so if the Contractor does not get the AI endorsement and does not get the broad indemnity language, there is a $100,000 deductible for that subcontractor.
- Still a very unfair and unreasonable clause

8. Self-Insured Retentions

- Many CGL policies now have self-insured retentions.
- Used to be deductible, which applies to indemnity payments.
- SIR's apply to defense costs and thus come off the top.
- SIR's can raise some interesting issues.

Self-Insured Retentions

- *Forecast Homes, Inc. v. Steadfast Ins. Co.* (2010) 181 Cal. App. 4th 1466
- Subcontractor polices had $2,500 SIRs
- Policy stated that "it is a condition precedent to our liability that you make actual payment of all damages and defense costs … until you have paid the self-insured retention…"
- Forecast, the Developer, was an insured under additional insured endorsements from subcontractors.

Self-Insured Retentions

- Forecast was sued for construction defects and tendered to the subcontractors' liability insurers
- Steadfast denied the tender because the subcontractors had not paid the $2,500 SIR, even though Forecast could show that it had incurred defense costs sufficient to satisfy the per occurrence amounts in the SIR endorsements.
- Held: Only named insureds could satisfy the SIR so no coverage under the Subs' policies.

Self-Insured Retentions

- OCIP policies frequently have high SIRs
- When Construction Defect lawsuit is filed, and defense is tendered, Insurer will respond "call me when the SIR has been paid."
- If the SIR is $50,000 or $100,000, and your client does not have that much money, what to do?
- Answer: See the *Executive Risk* case. Notify the Insurer that the client does not have the money to pay the SIR.

Self-Insured Retentions

- And also tell the Insurer that if it does not step up and provide a defense on behalf of the client, the client will have no option but to enter into a settlement with the Plaintiff, to include a judgment with a covenant not to execute and an assignment of bad faith rights.
- Remember, where an insurer has notice of a lawsuit and an opportunity to defend, and the complaint alleges potentially covered claims, the insured is BOUND by the judgment.