CARL WARREN & COMPANY
Claims Management and Solutions

TO DEFEND OR NOT TO DEFEND

The Dilemma for Carriers, Subcontractors and their Counsel in Construction Defect Cases

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CONSTRUCTION DEFECT CASES:
To Defend or Not to Defend

The session focused on the ongoing dilemma in construction litigation regarding demands for defense and indemnity from general contractors and developers to subcontractors and their carriers. The panelists addressed the applicable case law and statutes in the West, Southeast and South regions relating to indemnification and additional insureds. They also discussed firsthand experiences with large loss claim handling, with examples of the pros and cons in accepting tenders of defense.

Duty to Defend

The carriers analysis for duty to defend involves the review of the complaint and the insurance policy. **The "eight corners rule" comes into play-** reviewing 4 corners of the insurance policy and 4 corners of the complaint. *Chestnut Assoc v. Assurance Co, 17 F. Supp 3d 1203, 1209 (M.D. Fla 2014); Wisznia Co. Inc v. General Star Indemnity Co, (5th Cir Louisiana 2014).*

Under Florida law, insurance coverage is available to the insured during each policy period in which damage is alleged to have in fact happened. The most recent cases interpreting latent defect construction damage in Florida have uniformly held that the injury-in-fact trigger applies to such losses. *Trovillion Const. & Development, In v. Mid-Continent Cas. Co., 2014 WL 201678 (M.D. Fla. Jan. 17, 2014); Axis Surplus Ins. Co v. Contravest Constr. Co., 23 Fla. L. Weekly Fed. D. 279 (M.D. Fla. June 5, 2012); and Johnson-Graham-Malone, Inc. v. Atlantic Casualty, 18 Fla. L. Weekly Supp. 870a (Fla. April 29, 2011).*

In the west, The Oregon Supreme Court held that the subcontractor's liability insurer has a duty to defend when a complaint alleges claims where liability could be reasonably interpreted to arise from the subcontractors's ongoing operations performed for the general contractor. *West Hills Development Co v. Chartis Claims, Inc, 360 OR. 650 (Oregon 2016).*

A contractual indemnity claim is one against the named insured. In some states the duty to defend is limited to matters embraced by the indemnity agreement and does not extend to the entire suit (compared with an insurer's obligation to defend an additional insured from all claims.) *Presley Homes Inc v. American States Ins. Co, (2001) 90 Cal App 4th 571.* An indemnity agreement (a named insured's contractual assumption of third party's liability) versus designation of third party as additional insured under the named insured's policy are separate and independent grounds for a third party tender that require separate analysis. For insurer's, if the contractual liability coverage applies to the particular indemnity agreement, the insurer could be obligated to potentially indemnify the named insured indemnitor for its liability under the agreement.

Contractual indemnification is not insurance but a risk transfer, which does not relieve the indemnitee of its liability for damage to the third party. It merely transfers the financial obligation to the indemnitor. If the indemnitor cannot pay, the indemnitee must.

There are three types of indemnification agreements. First, Broad form indemnity which transfersthe entire liability risk to the indemnitor regardless of which party is at fault, this includes the indemnitee's sole negligence.

A majority of states have some form of anti-indemnity statutes that limit or eliminate the right to seek indemnification for negligence of developers, owners, general contractors, designers, and other subcontractors specifically for their own negligence. In California, post January 1, 2009, Broad form indemnity agreements in residential construction contracts which require to indemnify others for their active negligence or willful misconduct are void and unenforceable. Parties to residential construction contracts are to share liability for construction defects according to fault *California Civil Code Section 2782.5.* In states like Florida, the indemnification provision should clearly reflect the intent of the parties. It should state that the indemnitor will indemnify the indemnitee for the latter's negligence with clear, specific, explicit, and/or conspicuous language as well as a monetary limitation and relation to the subject matter of the contract *Florida Statute Section 725.06.*

In some states the agreements must be clear and unambiguous and include limitations on the position of the provisions within the contract. The requirement for insurance should be included in that same paragraph as an indemnity obligation could jeopardize the validity of the obligation. *New Jersey Statute Section 2A:40A-1.*

Second, the Medium level of indemnity agreements transfers the risk with the exception of the indemnitiee's sole negligence. In these agreements, the indemnitor must indemnify all of the loss, as long as the indemnitor is at fault to some degree. **The third final form of agreement obligates the indemnitor to the extent of its fault only.**

How indemnification demands work in practice begins simply with a demand. The general contractor or developer is sued or a demand is made against them for construction work. The general contractor refers to the subcontract with the trades in which the general contractor has an indemnification agreement to transfer this financial risk to the subcontractor whom is ultimately responsible for the work. The subcontractor will be the indemnitor, indemnifying the contractor pursuant to the agreement as the general contractor who becomes the indemnitee.

In some states like California, the subcontractor can owe no defense or indemnity obligation to a general contractor/developer for a construction defect claim unless and until the builder provides a sufficient tender of the claim to the subcontractor. The California Supreme Court held that a subcontractor has an immediate contractual obligation to defend from the outset, any lawsuit against the developer/builder, even if the subcontractor is later absolved of liability. *Crawford v. WeatherShield Manufacturing Inc. 44 Cal. 4th 541 (Cal 2008).* This case allowed California courts to provide guidance on duty to defend an indemnitee further than such agreements are subject to California's anti-indemnity statute. The indemnitor's duty to defend the indemnitee and to what extent or to reimburse depends on the language in the indemnification agreement.

If you are representing the subcontractor in matters where you receive an indemnification demand from the general contractor, the subcontractor carrier can defend the general contractor or deny the request. In California, the defense may be with the subcontractor counsel of their choice. Or they pay a reasonable allocated share of the builders general contractor's defense fees and costs subject to ultimate reallocation based on the proportionate fault that is established. In Florida, there is no such requirement or ability for a subcontractor to pay according to their fault. If a subcontractor accepts a duty to defend they are responsible for all of the general contractor's defense bill. Under Florida law, insurers are jointly and severally liable for defense fees and costs. *Miami Battery Mfg. Co. v. Boston Old Colony Ins. Co, 1999 WL 34583205 (S.D.Fla. April 28, 1999).* It is important for carriers to request and review copies of the general contractor's defense team legal bills.

In assessing these contractual indemnification claims, it is good practice to identify who promised whom to indemnify for what and to determine if there are more than one indemnitor (subcontractors) that will have to respond. The carriers should identify what the proportion of the defense is and discuss if they have to pay immediately. Is the general contractor's insurer obligated to participate in the defense and indemnity? If so, what is the obligation of primary v. excess insurance. The separate obligation of additional insured should also be determined and addressed by the carriers when negotiating the amount of attorney fees each insurer will be obligated to resolve.

The impact of indemnification is at times the developers and general contractors who at mediation or during the life of the case will be hesitant to resolve the indemnity portion of the case with subcontractors. As discussed above, once the general contractor's defense is identified, the subcontractor carrier will review the legal fees incurred to determine the share owed. Where in the legal process the case is postured at the time of pick up is key to revealing how much will be owed. For instance, in Florida there is a pre suit statute for construction defect claims known as *Florida Statute section 558.* The statute requires the claimant, defined as the owner or association of the property, to give the general contractor and any others to include insurers' notice of the defects. The statute allows the contractor to perform testing and notice to subcontractors within a certain timeframe to provide a written response to claimant. Under Florida law there is no description as to whether or not the pre suit notice under Section 558 is deemed to be considered a claim to require an insurer to open a claim, provide a defense, or be responsible for attorney fees and investigation of the defects from the date of the pre suit loss notice. The Florida Supreme Court heard arguments on the issue in April 2017 but as of the date of this article the Supreme Court has not made a decision. *Altman Contractors v. Crum and Forester Insurance Company, SCS16-1420 Florida Supreme Court, (April 6, 2017)*. The majority position has been that the indemnification and duty to share in attorney fees do not begin to incur until the litigation is filed against the contractor.

At mediation it is essential that coverage counsel and/or defense counsel is prepared to address the concerns of the participating insurer's regarding the amount of attorney fees billed and participating co-insurers to the defense to determine the appropriate shares. In a perfect world, the information would be provided prior to mediation. At mediation, it is common to have both coverage and liability adjusters present as well as both defense and coverage counsel. Therefore, there can occasionally be up to five people in attendance for one subcontractor. The sooner the defense team can review all applicable information on coverages and make an informed decision as to what is owed and by whom, the offers and responses as to settlement to the insured subcontractor will be conveyed. This requires an effective coordination between carriers and counsel prior to the mediation. It also requires the general contractor/developer's counsel to properly identify and notice the carriers whom they target for indemnity contribution early and often. Counsel needs to have a prepared demand to the insured subcontractor with both a liability damage number as well as an indemnification number and be prepared during negotiations to provide proof of both numbers to subcontractor carrier/counsel. This proof can be attorney fee bills for indemnification which should be current up through mediation attendance. Proof of liability could be an expert report or having the expert for contractor present at mediation to offer their observations regarding the insured's scope of work. This requires planning, but is essential if the mediation is to be a success for all parties. The carriers need this proof thirty (30) days prior to the scheduled mediation with updates provided at mediation to allow the carriers to properly evaluate exposure and set reserves for the insured.

One of the pitfalls of not having the information available at the mediation to make conveyed offers as to indemnity and liability dollars will prevent the subcontractor from being part of a carve out and early resolution of the matter. The longer the subcontractor stays in the case there is a potential the carrier will owe a larger share in the contribution of attorney fees depending on the state the matter is in.

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Session Takeaways

- Be aware of the law in jurisdiction where case is filed as it will impact both the coverages and the exposure for each participant. Some states are more favourable than others.
- A successful settlement of indemnity at mediation requires a positive relationship between the adjusters and defense and coverage counsel. Proper planning from the demanding contractor of the requested information is also important in order to evaluate exposure and set appropriate reserves.
- The goal of the carrier should be to resolve indemnity contribution early.

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