THE INSURANCE COVERAGE BLOG
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CGL: Getting a Handle on Large Construction Defect Claims

ATTORNEYS AT LAW
Gregory J. Johnson, Esq.
greg@gjohnsonlegal.com
gjohnsonlegal.com
O: 952.930.2485
C: 612.718.6908
F: 952.223.6999

Having studied, worked with and litigated coverage issues under the commercial general liability (CGL) policy for twenty years, large construction defect claims, particularly those involving commercial and multi-unit residential buildings, present some of the most complex claims encountered by those of us practicing insurance law. While the vast majority of CGL claims involve only one insured seeking the protection of the policy, large construction defect claims present a myriad of potential claims and potential exposures. In construction defect cases, the subcontractor's CGL insurer is often faced with at least three separate exposures under its policy: (1) liability related to its named insured subcontractor's defective or faulty work; (2) liability related to its named insured subcontractor's indemnity obligation to the general contractor under the subcontract agreement; and (3) liability to the general contractor as an additional insured under the policy.

This blog series will address all of the coverage issues related to construction defect litigation and consist of several parts. This post (Part I) provides an overview of the larger issues a subcontractor's CGL insurer will need to address when dealing with a Minnesota construction defect case. Parts II-V of the series will focus on the subcontractor's liability to a general contractor under an indemnity agreement and the "insured contract" coverage designed to protect the subcontractor against that exposure. Part VI-IX will address liability to the general contractor as an additional insured under the policy. Subsequent posts will address the insuring clause requirements, policy exclusions, allocation and primary/excess issues.

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The intent of this blog series is to break down the issues in an understandable format and provide an education ready resource for CGL insurers, brokers, general contractors, subcontractors, suppliers, tradesmen, in-house counsel, claims professionals and anyone else involved in Minnesota construction defect litigation. (If you would like to receive postings automatically via email, simply click on the subscription tab on the blog: **http://gregjohnson89.wordpress.com**

In the construction context, it is a common practice for a subcontractor to agree in a subcontract agreement with the general contractor to both (a) indemnify the general contractor against third-party claims arising out of the subcontractor's work and procure contractual liability insurance to insure that indemnity obligation, and (b) add the general contractor as an "additional insured" to the subcontractor's commercial general liability (CGL) policy.

The subcontractor's obligation to obtain insurance to insure its contractual promise to indemnify the general contractor obligation is separate from its contractual obligation to add the general contractor as an additional insured to the subcontractor's CGL policy. These two obligations, and the widespread confusion surrounding them, give rise to some of the most recurring and complex issues involved in construction defect claims litigation. Among other things, the subcontractor's CGL insurer must determine whether, and to what extent, it is obligated to defend and indemnify its named insured subcontractor against the subcontractor's indemnity exposure to the general contractor under the subcontract agreement and whether, and to what extent, it is obligated to defend and indemnify the general contractor as an additional insured under the policy. While the general contractor obviously cannot collect twice for the same damages, in larger claims -- particularly those involving commercial buildings and multi-unit residential complexes -- it is common for the general contractor to pursue both claims at the same time: a third-party claim against the subcontractor for indemnification via the indemnity agreement (in the main action) and a claim against the subcontractor's CGL insurer in its capacity as an additional insured (in a declaratory judgment action.) Although the third-party's damages

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are subject to the same policy exclusions, whether coverage is sought under the "insured contract" or "additional insured" coverage, it may be turn out that the indemnity agreement is unenforceable for one reason or another or that the additional insured endorsement is not sufficiently broad to cover the general contractor as an additional insured. Consequently, the general contractor typically takes a "two-barrel" approach to make certain that it receives the benefit of any existing coverage.

The standard CGL policy extends "insured contract" coverage to the subcontractor. The "insured contract" coverage is intended to protect the subcontractor against a general contractor's indemnity claim when the subcontractor has assumed the tort liability of the general contractor in a subcontract agreement prior to the subcontractor beginning work on the construction project. Insurance coverage for an "insured contract" is only concerned with the subcontractor's obligation to indemnify or hold harmless another, not breach of contract claims. As noted by the Alaska Supreme Court in Olympic, Inc. v. Providence Wash. Ins. Co., 648 P.2d 1008 (Alaska 1982): "[l]iability assumed by the insured under contract refers to liability incurred when one promises to indemnify or hold harmless another, and does not refer to liability that results from breach of contract." (While a general contractor may benefit from the subcontractor's "insured contract" coverage, the general contractor does not become an insured thereby).

This seems simple enough but the determination of whether the "insured contract" coverage will apply is dependent on an interpretation of the provisions of the underlying indemnity agreement and the subcontractor's policy which, in turn, raise a host of subsidiary issues. With regard to the underlying indemnity agreement, the subcontractor and its CGL insurer will need to analyze whether: (1) the subcontractor agreed to indemnify the general contractor against the latter's own fault (i.e., the subcontractor agreed to "assume" the general contractor's tort liability) in the subcontract agreement; (2) the subcontract agreement qualified as a "building and construction" contract pursuant to Minnesota

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statute 337.01; (3) the indemnity agreement is enforceable pursuant to Minnesota statutes 337.05, subd. 5 (because coupled with an obligation to insure the indemnity obligation); (4) the indemnity agreement, if enforced, would violate public policy; (5) there was a causal nexus between the subcontractor's work and the injury or damage at issue; (6) the indemnity agreement extends to completed operations losses if the injury or damage occurred after the subcontractor completed its work; (7) a finding of fault is required before the indemnity obligation is triggered; and (8) the subcontractor also agreed to reimburse the general contractor for legal fees and costs the general contractor incurred in the defense of the underlying lawsuit and/or to enforce the provisions of the indemnity obligation.

As to the foregoing issues, there is generally no conflict of interest between the subcontractor and its CGL insurer. Both are interested in eliminating or reducing the subcontractor's indemnification exposure to the general contractor.

After completing the foregoing analysis, the subcontractor and its CGL insurer will want to determine whether each item of property damage that is the subject of the claim satisfies the insuring clause of the policy, falls within the "insured contract" provisions (which may have been modified by endorsement) and is not excluded by virtue of an applicable exclusion in the CGL form (primarily the "business risk" exclusions) or attached endorsement. The analysis is, of course, more complex with regard to multiple count complaints. The "insured contract" coverage only embraces that part of the indemnity agreement under which the subcontractor has assumed the tort liability of the general contractor. Not all claims in a multi-count complaint will fall within the coverage. Claims involving progressive or continuing damage involving successively liable insurers pose additional issues (e.g., allocation, known loss/loss in progress, expected damage, etc), but many of those issues are addressed by the incorporation of known damage and "deemer" provisions in the insuring agreement to ISO's more recent CGL forms.

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While a general contractor does not have rights as an "insured" under the subcontractor's CGL policy (unless the general contractor is added as an additional insured, discussed below), the Supplementary Payments section of the subcontractor's CGL policy can obligate the subcontractor's insurer to provide a defense to the general contractor, albeit under very limited circumstances. Among the many conditions which must be satisfied before the defense cost coverage of the Supplementary Payments section is triggered, the subcontractor must have agreed in the indemnity agreement, to "defend" the general contractor, not simply reimburse the general contractor for attorney fees.

As noted, subcontract agreements frequently require the subcontractor to add the general contractor to the subcontractor's CGL policy as an additional insured. There is great misunderstanding of what an additional insured endorsement ("AIE") is intended to cover. This is no doubt attributable to the fact that there are numerous AIE in use and the failure of the parties to the subcontract agreement to specifically define the scope of the subcontractor's "additional insured" obligation. Unlike the subcontractor's obligation to obtain insurance to insure its contractual indemnification obligation to the general contractor (where the indemnity clause itself specifies the risks to be insured against), the parties to a subcontract agreement often just require the subcontractor to add the general contractor as an additional insured to the subcontractor's CGL policy without specifying the risks to be insured by the AIE. The parties to the subcontract agreement add additional confusion when they fail to specify the length of the subcontractor's "additional insured" obligation. Many CGL policies issued to subcontractors use "Blanket" AIE forms which do not specifically name the entities that are additional insureds under the policy. Blanket AIE forms are generally used when the named insured is faced with repeated demands to add others to its policy, as is the case in the construction industry context. Again, unlike the subcontractor's obligation to obtain insurance to insure its contractual indemnification obligation to the general contractor (where the indemnity clause itself generally specifies whether the obligation is

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limited to ongoing operations or also includes completed operation losses), the length of the subcontractor's "additional insured" obligation is often not addressed. The certificate of insurance provided by the subcontractor's insurance agent to the general contractor, although not binding on the insurer, may shed some light on the intent of the subcontractor and general contractor. Some suggest that additional insured coverage is intended to cover the general contractor only for its vicarious liability for the acts and omissions of the subcontractor. Others suggest that an AIE is designed to cover the general contractor as though it had been provided its own separate CGL policy. Still others have suggested that an additional insured is an entity enjoying the same protection as the named insured. None of these views is uniformly correct. The purpose of additional insured coverage is dependent on the intent of the parties to the subcontract agreement and the Insurance Services Office (ISO) has developed over twenty five (25) additional insured endorsement forms depending on the particular transaction or operation which is the subject of the business relationship. The type of AIE that is used by the subcontractor's insurer will have a large impact on whether, and to what extent, a general contractor will qualify as an additional insured under the subcontractor's CGL policy.

The more recent ISO AIE forms substantially decrease the circumstances under which a general contractor will qualify for coverage by, among other things, requiring that the subcontractor bear some portion of the fault for the accident/occurrence at issue.

Assuming the general contractor qualifies as an additional insured under the AIE, the subcontractor's CGL insurer will need to determine whether each item of property damage that is alleged against the lawsuit satisfies the insuring clause of the policy and is not barred by virtue of an exclusion in the CGL form (primarily the "business risk" exclusions) or attached endorsement. As noted above, claims involving progressive or continuing damage which potentially involve successively liable insurers pose additional issues (e.g., allocation, known loss/loss in progress, expected damage, etc), but many of those issues are addressed in the insuring agreement to ISO's more recent CGL forms.

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****

Mr. Johnson has represented CGL insurers, general contractors, subcontractors and suppliers in large commercial and multi-unit residential construction defect claims for twenty years. He successfully handled the seminal construction defect case in Minnesota, Wooddale Builders, Inc. v. Maryland Cas. Co., 722 N.W.2d 283 (Minn. 2006), and has authored several articles on insurance coverage for construction defect claims including Contractual Risk Transfer, Hold Harmless and Indemnity Agreements and Additional Insured Coverages (Wells Fargo March 15, 2009) and Liability Allocation Issues: "Other Insurance" & the Wooddale Home Builder Construction Decision (Minnesota Defense Lawyers Association Insurance Law Institute, Jan. 25, 2007).