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Construction Defect Insurance Disputes Are Daunting Puzzles, But Neutrals Fit the Pieces Together

BY MARTY GRAHAM | APRIL 6, 2016

Think construction defects cases are complicated? Try looking at them from the perspective of the neutrals who guide parties to settlement. Complicated only begins to describe what one experienced neutral calls working on a puzzle with dozens of pieces where the task is getting the edges to meet.

"You could write books about the insurance issues that come up in these cases," said Craig Meredith, a neutral with JAMS in Northern California who is widely known for his expertise in the areas of insurance coverage with a primary emphasis on general liability coverage issues for commercial construction, construction defect, engineering and infrastructure, and environmental matters and has resolved hundreds of matters. "Every construction defect litigation is really two cases: the case involving the defects and the builder's liability; and the case involving the insurance, whether or not the carriers have exposure and how much they will pay."

For commercial projects like hotels, museums, high-rises, hospitals and resorts, there are typically between 15 and 50 parties including the developer and design professionals, the general contractor, the subcontractors and their sub-subcontractors. Sometimes, even the manufacturers of the supplies used in the project are also involved.

Then, Meredith said, come the insurance companies – often more than one for each defendant and sometimes with one company insuring several different parties.

JAMS neutral Stacy La Scala, who has worked in both construction and insurance litigation for 25 years and is author of the insurance tort and arbitration sections of Thomson Reuters, *California Civil Practice: Torts*, said that he has been involved in these complex cases where a single mediation has lasted more than a week.

"These matters really push the limits of legal sophistication," he said. "There are a lot of issues on the front end, those of damages and liability. But on the back end, there are also issues beyond the settlement with the plaintiffs – including the question of who will pay the attorneys' fees."

Most cases have between 15 and 50 parties, a half dozen to a dozen insurance policies and multiple plaintiffs' attorneys, which creates an enormous organizational problem.

Often, the plaintiffs have sued the defendants individually, which creates additional issues. Not infrequently, the defendant contractors file countersuits against each other that will need to be sorted out as the facts of the defect and damages become clearer.

"You can't just walk into these cases," Meredith said. "We have very extensive pre-mediation conference calls and briefings – recently I worked on a matter where the briefs, with the expert reports, went to 700 pages."

Craig Meredith, JAMS Mediator and Arbitrator

Meredith calls experienced counsel for general contractors his quarterbacks.

"These cases are very fact intensive," he explained. "The lead attorney or senior associate has to be absolutely up on the facts; the cause of the defect, the defect itself, the costs and nature of the repair and if they are radically different assessments and estimates, why they are so different."

The insurance companies have their own specific issues that start with what the policy covers and excludes, what the policy limitations are, and how much of the maximum aggregate pay-out is still available. Until about 10 years ago, builders' insurance policies were pretty standard, following the format laid out in the Insurance Service Organization forms. But not now, Meredith said.

"Now every insurance policy is 50 to 60 pages, with 15-16 pages of basic coverage and 40 to 50 pages of special endorsements," he said. "You have to read every one, and you cannot assume that any contractor policies have the identical coverage."

The subcontractors and their insurance policies – and they often have more than one – must be focused on and clarified early on, La Scala said.

"A very significant conversation has to take place with the subcontractors," he explained. "There's a lot of subcontractors that have multiple, uniquely crafted policies – and often no coverage for their own defense."

La Scala, said that increasingly the first

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Stacy La Scala, JAMS Mediator

negotiation is fast becoming less about the defects alleged and more about funding sources for fees and costs.

"Fees are rapidly becoming the most important part of mediation discussions," La Scala said. "There's an emerging trend where the amount of money needed to settle the damage claims is significantly less than the money needed to settle the (legal defense) fees."

Since many contractors' policies commit them to defending the general contractor – whether or not the contractor was involved in the defect or damages, the fees for the defense team can't be divided up until the litigation wraps up.

"It is getting more and more difficult to settle with all parties because subcontractors want to incorporate all the subrogated rights that insurers have," La Scala said. "They want to be sure that when the general contractor has released the subcontractors on all claims, the general contractor's insurance company cannot pursue the subcontractors for fees."

The general contractor usually provides the first layers of insurance. If it's not a wrap policy – a single, expensive policy that puts everyone involved in the project under one tent, then you look to the contractor, the subcontractors, the sub-subcontractors and the product suppliers for their individual insurance.

"Each party often has more than one insurance policy," Meredith said. "Policy limits are not the same thing as policy coverage."

Increasingly, while coverage for general contractors will go high into the millions of dollars, the policies also have very high deductibles, Meredith said. Contractors may spend $5 million to $10 million of their own money and they often don't have it.

After that layer, the insurance policy's aggregate policy limits becomes very important.

"It has happened that the insured has used up most of the limit within a few years of policy inception," Meredith said. "It's important to know how much of the limit remains for this settlement before you get far into settlement negotiations."

A 1995 decision by the California Supreme Court, *Montrose Chemical Corp. v. Admiral Insurance Co.*, is widely understood to signal that in matters where property damage that continues over years, every consecutive insurer may be on the hook for all the years of damage

"Many of those issues are around water damage, which occurs over a long period," Meredith said. "Under *Montrose*, even if the contractor didn't find out until seven years after construction, all seven years of coverage during that period may be available."

Policies written since the *Montrose* decision often have exclusions to try to defeat its impact. For example, a policy will indicate there's no coverage for work completed before the policy period.

"Typically, the array of *Montrose* exclusions protects carriers from all but one or two years of exposure," Meredith said. "But you have to make sure that's the case."

At the beginning of settlement talks, Meredith said he asks for every policy from the moment the parties started construction to when they were sued.

"With 30 subcontractors, I may be looking at 210 years of coverage," he said.

La Scala said that subcontractors often have three or four different insurers that have different views of their obligations.

"It is fascinating, complex and sometimes frustrating," he said. "You have to get them on the same page about fees and what they are agreeing to defend. I've had cases with multiple insurance carriers who can't come to agreement about where the edges meet."

"One company says I have a third of the responsibility and another says no, you have nine-tenths. Multiply that by 10 or 20 for any given case and you have a very complex negotiation," he explained.

Sometimes, one of the defendant parties wants to settle but its insurance company does not, and the differences between them have to be worked out before they can move to the larger settlement mosaic.

Different insurance companies have different personalities at different times that originate with the senior management, La Scala said.

"To some insurance companies, a dollar is a dollar whether it's spent on liability or legal fees," he said. "They look at the total exposure in the case, which includes both the expense of fees and costs and the indemnification amounts. Carriers that consider a dollar of expense is equivalent to a dollar of indemnity typically weigh the total risk as part of their evaluation to settle."

Other carriers, he said, are far more willing to spend defense dollars that do not erode the policy limit, and fight the liability claims.

"So you are trying to take all of these different interests and wrap them into a global settlement," La Scala said. "There are a lot of issues on the front side, that include liability and damage issues, but on the backside, we have to identify those entities who have the ability and interest to contribute toward the fee and cost exposure. Mediators have to make sure both the indemnity and expense issues are incorporated into the settlement so when it's resolved, it is resolved completely."

And through all the competing interests, a neutral has to help everyone in the room toward settlement, La Scala said.

"As a mediator, it's really about risk," he said. "Part of the mediator's job is to provide risk analysis for what will occur if the general contractor and subcontractors don't settle."

Marty Graham is a San Diego-based freelance writer whose work has appeared on Reuters, Wired, and other outlets. She writes fiction on the side.

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