Essential Understandings

The Anatomy of a Construction Claim

By Brandi Blair and Denise M. Montgomery

Understanding the relationships between the parties, the insured's role in the construction, and the project timeline are essential to the successful management of these complex claims.

Construction-defect litigation is on the rise. On December 3, 2018, the United States Census Bureau estimated that $1.3 trillion was spent in 2018 alone on private and public construction projects. Projects that were halted due to the 2007 recession have resumed, and so have the claims relating to possibly faulty construction. In a multi-unit project or large-scale public project, there may be dozens of defendants implicated in a claim. A carrier with multiple, insured defendants may exhaust construction-defect panel counsel and assign representation to general panel counsel. Practitioners who are new to, or unfamiliar with, this work need to understand the unique challenges that these claims present for the insured, insurer, and assigned counsel.

A construction claim may involve an injury to a person attributable to the faulty design or construction of a building, or it may involve a claim for damages related to the construction itself. A construction defect occurs when construction fails to perform as expected or intended and the failure causes physical injury to an individual, the work itself, or other property or work. The defect can involve the design, the work performed, and the building products and materials. Construction-defect matters that do not involve personal injury can have an extraordinarily long period of viability. Jurisdictions that apply the discovery rule to the applicable statute of limitations or that have an unusually long period associated with the statute of repose allow claims for defective construction to proceed years after the construction was completed.

Understanding the Parties

Upon initial receipt of a complaint, it is imperative that you identify the parties named in the complaint. Plaintiffs often name corporate entities that are "almost right" but do not actually exist or are the incorrect entity. It is important to make sure that the entities named are the proper entities involved in the relevant contract

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or project and they were served correctly. Additionally, it is vital to be aware that the initial complaint rarely includes all of the parties that may be at fault. Construction-defect suits involve a myriad of different parties, which appear in different combinations. The suits will often involve other areas of law, such as personal injury or wrongful death.

Common parties and claims include those filed by homeowner associations against owners or developers of planned communities. Planned communities such as condominium or multi-dwelling communities are generally constructed in phases and involve multiple designers, developers, and prime subcontractors, who perform work over many years. At the end of construction, as part of the transition of ownership of the common elements from the owner or developer to the association, the association will complete two key studies: a transition study and a capital reserve study. The transition study tells the association if there is any incomplete or faulty construction. The reserve study informs the association how much it will need to charge the unit owners in assessments to repair and replace the common elements in the community as needed. The transition report may be performed years after the work was completed, and it often serves the basis for actions filed by the association against the owner or developer to recoup costs that the association believes that it will incur to complete any unfinished work or fix defective work.

If the transition report cites poor design, the architects and engineers responsible for the design are often named as original parties. These are referred to as first-tier parties. The owner or developer will then sue the general contractor that it hired to complete the construction according to the design plans, the prime contractors implicated in the transition report, and the manufacturers of any defective materials used in the project. A prime subcontractor is a subcontractor hired by the general contractor to complete an integral part of the construction, such as structural steel, masonry, HVAC work, roofing, or plumbing. These parties are generally referred to as second-tier defendants. Project inspectors are also common parties when there is an issue involving defective construction involving structural steel or structural concrete. Some project inspectors are retained by the owner while others may be retained by the general contractor. This varies by project.

The third-tier defendants are those entities that the prime subcontractors hired to complete portions or all of the work promised by the prime to the general contractor under the subcontract. Often these third-tier parties hire other contractors to complete their work, a fact that may never have been communicated to the prime subcontractor. These last-tier defendants may not be joined to the litigation until years after the suit is initiated, which presents a variety of challenges to the practitioners assigned to defend them. These challenges apply to claims for poor construction and claims for personal injuries associated with construction.

Other Potential Parties

You should not rely upon your insured or the plaintiff to identify other responsible parties. Often the plaintiff's interest in identifying responsible parties ends after naming the owner or developer and general contractor. It is your responsibility to identify and pursue your insured's subcontractors, product suppliers, and product manufacturers and the third parties hired by others to perform the same kind of work originally subcontracted to your insured.

The first step is to meet with representatives from your insured client and ask to see the insured's physical file. This should contain time records and invoices that will tell you when your client started and finished its work and any payments made by the client to others for work and materials that could identify subcontractors. It is also crucial to understand what kind of work your insured performs, the alleged damages, and the chain of events that led to the damages to identify completely all of the individuals or entities that may be responsible for the alleged loss. In short, it helps to identify who touched the project between its conception and its failure.

Ideally your insured will have signed contracts for the work that the insured completed and the work that it subcontracted to others. However, if the project is old, your client may not have these documents. If that is the case, ask for permission to obtain your client's insurance agent's file. Often the agent will have copies of the contracts that your insured executed for purposes of providing additional insurance status to others. If your insured is out of business, the next step is to look to other parties to provide this information. Site sign-in sheets and safety training records are often a good source, which identify who was on the job site and when. You must be aggressive but also creative in locating the information that identifies other responsible entities.

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The Duty to Defend

In a case that involves personal injuries related to construction, the first notice of claim may occur on the date of the incident. However, in cases that involve damages related to the construction itself, the notice of claim is generally when the insured is served with the complaint. Once the claim is received, the carrier that receives notice of the loss must determine whether or not the individual or entity seeking coverage is entitled to a defense. The two questions that must be answered before tendering a defense are whether or not there is "occurrence" as defined by the policy, and whether or not the individual or entity seeking coverage is an "insured" under the policy.

Generally, a duty to defend is triggered when there is a potentially coverable occurrence. The duty to defend is separate from, and broader than, the duty to indemnify. The duty to defend arises if the complaint filed against the insured alleges facts that fall within the policy's coverage. *Teufel v.*

Am. Family Mut. Ins. Co., 244 Ariz. 383, 419 P.3d 546, 548 (Ariz. 2018); *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 388–89, 267 A.2d 7 (N.J. 1970); *Westfield Ins. Co. v. West Van Buren, LLC*, 406 Ill. Dec. 99, 59 N.E.3d 877, 882 (Ill. App. Ct. 2016); *OneBeacon America Ins. Co. v. Urban Outfitters, Inc.*, 21 F. Supp. 3d 426 (E.D. Pa. 2014), *aff'd on other grounds*, 625 Fed. Appx. 177 (3d Cir. 2015);

Jurisdictions have held that improper or faulty construction may constitute an accident as long as the resulting damage is an event that occurs without the insured's expectation or foresight.

Equine Assisted Growth & Learning Ass'n v. Carolina Cas. Ins. Co., 2011 UT 49, 9, 266 P.3d 733, 736 (Utah 2011). Virginia termed the analysis the "eight corners rule." If the four corners of the complaint fall within the four corners of the policy, there is a duty to defend. *AES Corp. v. Steadfast Ins. Co.*, 283 Va. 609, 725 S.E.2d 532, 535 (Va. 2012).

Typical policy language defines an occurrence as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." In a personal injury action involving a single instance of harm, there is an occurrence as defined by the policy. However, in the context of a claim for damages associated with defective construction, an occurrence varies based upon jurisdiction and the nature of the damages alleged in the complaint.

Damages for defective workmanship are typically not an "occurrence." *U.S. Fid. & Guar. Corp. v. Advance Roofing & Supply Co.*, 163 Ariz. 476, 482, 788 P.2d 1227, 1233 (Ariz. Ct. App. 1989); *Hull v. Berkshire Mutual Insurance Company*, 121 N.H. 230, 427 A.2d 523 (N.H. 1981); *Quality Stone Veneer, Inc. v. Selective Ins. Co. of Am.*, 229 F. Supp. 3d 351, 357 (E.D. Pa. 2017). To qualify as an occurrence, there must be damage to other materials not furnished by the insured. *Desert Mountain Properties Limited Partnership v. Liberty Mutual Fire Insurance Co.*, 225 Ariz. 194, 206, 236 P.3d 421 (Ariz. Ct. App. 2010); Pekin *Insurance Co. v. Richard Marker Associates, Inc.*, 289 Ill. App.3d 819, 822, 224 Ill. Dec. 801, 682 N.E.2d 362 (Ill. App. Ct. 1997); *Liparoto Const., Inc. v. Gen. Shale Brick, Inc.*, 284 Mich. App. 25, 37, 772 N.W.2d 801, 809 (Mich. Ct. App. 2009).

However, some jurisdictions have held that negligent construction is an occurrence under the plain definition of an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." *Architex Ass'n, Inc. v. Scottsdale Ins. Co.*, 27 So. 3d 1148, 1157 (Miss. 2010). Other jurisdictions have held that improper or faulty construction may constitute an accident as long as the resulting damage is an event that occurs without the insured's expectation or foresight. *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 281 Kan. 844, 137 P.3d 486, 491 (Kan. 2006); *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So. 2d 871, 883 (Fla. 2007).

In a "notice pleading" state, a carrier may be obligated to provide a defense in a case for which there ultimately is no occurrence under the policy. Some jurisdictions allow a carrier that has tendered a defense under a reservation of rights to seek declaratory relief once it is apparent through discovery that there is no occurrence under the terms of the policy. This should be monitored by coverage counsel and pursued independently to avoid any potential conflict of interest between the insured and assigned defense counsel.

Determining whether an individual or entity other than a named insured is an additional insured under a commercial general liability (CGL) policy in a construction-defect claim requires that the insurer have all contracts executed by the named insured. The American Institute of Architects (AIA) promulgates contracts that are widely used by owners, designers, and general contractors. The standard AIA contracts executed between the owner and contractor include contractual provisions for indemnification and additional, primary insured status in favor of the owner and designer. The AIA Form A401 is the standard subcontractor agreement. It contains boilerplate language that requires subcontractors to "indemnify and hold harmless" not only the general contractor but also the project owner, the project architect, and the project architect's consultants (engineers).

The subcontractor is contractually obligated to indemnify these parties for damages, losses, or expenses, including reasonable attorney's fees, arising out of or resulting from the performance of the subcontractor's work. This obligation is limited to claims, damages, losses, or expenses attributable to bodily injury, sickness, disease, or death, or to injuries to or destruction of tangible property (other than the work itself), to the extent that these are caused by the negligent acts or omissions of the subcontractor. The indemnification obligation will exist regardless of whether the loss is caused in part by an indemnified party. The standard AIA indemnification language does not require the indemnitor to protect the indemnitee for its sole negligence. Depending upon the jurisdiction, the indemnification requirement may not arise until after a verdict finding that a plaintiff's damages arose out of the named insured's work under the contract.

The standard AIA forms also require subcontractors to provide additional insured status for claims caused in whole or in part by the subcontractor's negligent acts or omissions during the subcontractor's operations, and additional insured status for claims caused in whole or in part by the subcontractor's negligent acts or omissions during the subcontractor's completed operations. "Completed operations" coverage applies when the insured's work results in an occurrence of bodily injury or property damage during the policy period. The insurance must be primary and noncontributory to any general liability policy maintained by the additional insured. If it is commercially available to the named insured, it must provide no less coverage than ISO CG 20 10 07 04, CG 20 37 07 04, and CG 20 32 07 04.

If an insured executed a form AIA subcontract, the insured promised to provide this to the enumerated parties. If the pol-

icy contains language that defines an "additional insured by contract agreement or permit," these parties are potentially additional insureds under most policies.

OCIP/CICIP—Wrap Up Policies

Owner-controlled insurance programs (OCIP) and contractor-controlled insurance programs (CCIP) are insurance policies unique to the field of construction. OCIP and CCIP policies are insurance policies that are either held by the owner or general contractor for the length of a construction project. The owner of a construction project sponsors an OCIP, while a general contractor sponsors a CCIP. The sponsor is in charge of securing insurance coverage, paying for the coverage and administering the insurance program.

The industry refers to these policies as wrap-up policies and they typically provide general liability, workers' compensation, and excess coverage for the duration of the project. They are designed to provide primary coverage for the contractors that work on the project and protect them from liability and loss arising from the construction, rather than requiring each contractor to provide their own insurance. Wrap-up policies are typically used on large, individual projects or on projects completed on a rolling basis by aggregating smaller projects, which are started and completed over a defined time period.

A wrap-up policy is primary to any other coverage that a subcontractor may have promised and purchased as part of its underlying contract. The subcontractors may not be aware if a wrap-up policy was in place for the project, so it is imperative to find out if one exists to determine the primary insurance and to avoid waiving rights that your insured has to a defense and liability coverage.

Construction-Defect Claims and Insurance Coverage Implications

Owners often assert claims that go beyond garden-variety negligence and breach of contract claims and often involve claims for breach of common law or statutory warranties, delay damages, consumer protection violations, fraud, unfair trade practices, and other statutes that are applicable to new housing. Claims for personal injuries related to construction emanating from an OSHA incident may form the basis for punitive damage claims that are not insurable in some jurisdictions.

An insurer must review each policy, endorsement, and exclusion and issue a timely explanation to the insured of the claims asserted in the complaint and which coverage and exclusions may apply. If the policy excludes claims for punitive relief, contract-based claims, fraud, or other damages that are not associated with an occurrence, the insurer must inform the insured which claims are being defended under a reservation of rights.

Insurers must be vigilant in identifying and raising any claims that fall under a policy exclusion. Exclusions vary by policy and may or may not be valid in the jurisdiction that has authority over the claim. A common exclusion can be the type of work completed by the insured such as an earth-movement exclusion. An exclusion may bar claims associated with the products or materials used by an insured in its work, such as an EIFS (exterior insulation finishing system) or Chinese drywall. Exclusions may also pertain to the type of construction itself, such as a high-rise exclusion (generally four stories or more), or a multiple dwelling or condominium exclusion.

As a point of practice, what is required in a reservation of rights letter will depend upon the jurisdiction. Some jurisdictions require that an insurer provide its insured with a right to refuse the appointed defense. A failure to include the required language can have draconian consequences, and in some instances, it can result in a waiver of all coverage exceptions. If there are any questions about which claims are and are not covered, coverage counsel should be engaged before drafting the appropriate reservation of rights to the insured. Assigned defense counsel should receive a copy of any reservation of rights letter sent to the insured so that the insured can be adequately counseled throughout the litigation of any potential exposure for non-covered claims.

Ancillary Claims and Competing Interests: Representing the Insured

A construction-defect claim often involves competing interests between the insured, the CGL insurer, and other parties with a pecuniary interest in the insured's work at the project, *i.e.*, a surety interest. These claims often involve damages associated with unfinished work or punch-list items. A punch-list item is generally not considered to have a defect. It is simply unfinished work that needs to be completed before final payment. Punch-list items, unpaid change orders, and unpaid retainages can be significant hurdles in the overall management of a claim. If an insured wishes to pursue a claim for unpaid work, some jurisdictions require that any claim arising out of the action must be asserted in the underlying action or it can be barred, even if it is not untimely.

Some jurisdictions such as New Jersey impose a continuing obligation upon litigants to identify all parties to pending or contemplated legal actions that are related to the matter in controversy. If a party fails to comply with that requirement in a first lawsuit, a subsequent lawsuit arising out of the same project may be precluded. Assigned counsel needs to ask the represented insured whether or not it has completed its work, has been paid in full, and whether it has any liens for unpaid work related to the project.

This is not to say that assigned counsel is required to file the claim; however, there is a general obligation on the part of the assigned counsel to adequately counsel the insured and advise of the insured's rights and obligations to pursue any potential claims related to the project. In 2016, the Massachusetts Supreme Court was asked to answer certified questions presented by the First Circuit Court of Appeals regarding the obligations that an insurer and insurer-appointed attorney have regarding counterclaims of an insured. In issuing an opinion after the Massachusetts Supreme Court did so, the First Circuit noted that the scenario of an insurer-appointed attorney presents a "dual-representation phenomenon" to both the insured and insurer. *Mount Vernon Fire Ins. Co. v. VisionAid, Inc.*, 875 F.3d 716, 724 (1st Cir. 2017). As the First Circuit wrote, "an insurer-appointed lawyer owes to each a duty of good faith and due diligence in the discharge of his duties, which in turn means that he cannot subordinate the rights of one to those of the other." *Id.* (internal citations and quotation marks omitted). The court held that if an insurer must defend a claim initiated

against the insured, "the insurer's duty to defend that claim does not require it to prosecute any counterclaims its insured is legally required to file." *Mount Vernon Fire Ins. Co. v. VisionAid, Inc.*, 875 F.3d 716 (1st Cir. 2017).

From a practical standpoint, unpaid work, if not prosecuted by an insured client, can impede settlement between the client's insurer and the plaintiff. Most settlement agreements seek to end any and all disputes between the parties. If your insured client believes that it is owed for work, assigned counsel cannot act in a manner that would foreclose any potential recovery by the insured. It is a good practice to memorialize any discussions that you have had with the insured that concerned ancillary claims that the insured needs to pursue, making sure to convey in clear and concise language the steps that the insured needs to take to preserve those claims and a timeline for doing so.

Depending upon the applicable statute of limitations or statute of repose, a claim may not be filed for a decade after construction was complete.

Another common competing interest in construction-defect claims is the role of a surety. A construction bond is a type of surety bond used by investors in construction projects to protect against disruptions or financial loss due to a contractor's failure to complete the project or to meet contract specifications. Bonds are not insurance policies. They do not pay damages to individuals injured by defective construction. They do not reimburse an owner for defective work.

Prime contractors on a public project are generally required to purchase a bond for the project. If parts of the project are not complete, and the surety is a named party, this may impose significant financial obligations upon the insured. Sureties often require individuals (and spouses) of the principals to guarantee personally all sums paid by the surety, including attorney's fees and costs as they are incurred, and any sums paid by the surety, whether by verdict or settlement. Proper representation of the insured may require coordination and cooperation by counsel for the surety and the insured's appointed counsel.

Time on the Risk and Allocation

The majority of complex, construction-defect claims occur over a period of time, with multiple policy years and multiple insurers. Depending upon the applicable statute of limitations or statute of repose, a claim may not be filed for a decade after construction was complete.

Allocation issues arise when the loss is ongoing and indivisible and implicates multiple policies and multiple policy periods. The question that each carrier must answer is when is coverage triggered? Courts do not uniformly choose and generally apply one of four trigger theories and two methods of allocation.

The four trigger theories are the following:

1. exposure, which triggers coverage when the first injury-causing conditions occur;
2. manifestation, which triggers coverage when the personal injury or property damage becomes known, or is discovered by, the property owner or victim;
3. continuous, under which progressive, indivisible injury or damage occurs continuously, from the time of exposure or installation until the time of discovery; and
4. injury in fact, which triggers coverage when the personal injury or property damage underlying the claim actually occurs.

The two allocation methods for allocating an insured's loss under multiple policies are (1) "all-sums," or "joint and several," and (2) pro-rata.

The "all-sums," or "joint and several," method allows a policy holder to pick and choose the policies that are required to pay the loss. In *Keene Corporation v. Insurance Company of North America*, 667 F.2d 1034, 1049–50 (D.C. Cir. 1981), the Court of Appeals for the District of Columbia applied the continuous trigger theory to a long-latency occupational disease case (asbestos) and held that the "insurers' liability to the plaintiff was joint and several, such that the plaintiff was entitled to select one of the triggered policies and collect the full amount of indemnification from that policy." Once the plaintiff had been compensated, the insurers were responsible for allocating the loss among themselves.

The pro-rata method provides that policies in a particular policy period respond in proportion to the amount of the injury or damage that takes place during that policy period. If the insured is uninsured by way of a denial or failure to maintain coverage, the insured is responsible for any period of insured loss.

Some jurisdictions have used a "pro rata by limits" allocation method that prorates coverage on the basis of policy limits, multiplied by years of coverage. Insurers with higher limits may be liable for damages incurred outside their policy period because their percentage of responsibility is not determined by the risk assumed but by the number of available indemnity dollars. *Northern States Power Co. v. Fidelity & Cas. Co. of N.Y.*, 523 N.W.2d 657, 662 (Minn. 1994); *Spaulding Composites Co., Inc. v. Aetna Cas. & Sur. Co.*, 819 A.2d 410, 415 (N.J. 2003). The insurer's liability is determined by comparing its particular exposure to the total amount of exposure assumed by all carriers of the triggered policies. This comparison yields a percentage that is then applied to the amount of loss the policyholder sustained. *Id.* at 416–17. This method requires the insured to pay its share of "both defense and indemnification on account of years in which it was uninsured, self-insured, or its coverage was exhausted or bankrupt." *Id.*

Golden Tickets

The statute of repose is an excellent example of a golden ticket. Depending upon your jurisdiction, the statute of repose is the deadline by which a plaintiff can file a construction-defect claim. The statute of repose is different and typically longer than the statute of limitations. Any claims for any defects regarding the manufacture or construction of the home are barred. It is important to identify the date that the statute of repose begins to run, for pur-

poses of an early motion to dismiss. Keep in mind, as discussed above, that the statute of repose can differ between different entities.

The statute of limitations is typically shorter than the statute of repose and often requires a fact-sensitive analysis into what a plaintiff knew or should have known regarding defects. In matters involving an association, the community management may provide a wealth of information regarding complaints by unit owners that may trigger the statute of limitations and cut off the plaintiff's remedy.

Depending upon the jurisdiction, there are various statutes that protect purchasers of new construction. Many jurisdictions have statutes that require new home warranties and provide administrative remedies available to purchasers of new construction. In some jurisdictions, the remedies are exclusive and if elected, they foreclose subsequent civil actions. If a plaintiff is an association that submitted any administrative claim for relief, even if unsuccessful, these statutes provide an excellent avenue for early dispositive work.

Conclusion

Understanding the relationships between the parties, the insured's role in the construction, and the project timeline are essential to the successful management of these complex claims. It requires assigned counsel to wear multiple hats and advocate the interests of the insured and insurers at every phase of litigation. Identifying the culpable parties, actively pursuing the potential insurance coverage available to the insured, and adequately counseling the insured regarding claims for which there is no coverage are all considerations that assigned counsel need to understand and put into practice when defending these claims.