



CGL ISSUES AND DEVELOPMENTS

ADDITIONAL INSURED ISSUES

Presented by

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The commercial general liability policy is a cornerstone of a contractor's insurance program. It is in reference to this policy that the majority of construction insurance disputes are litigated. Because of the complexity of construction claims and the constantly evolving case law relating to the CGL policy, those on both sides of the fence (insurer and insured) often misunderstand even some of the basic coverages. Coverage disputes are the inevitable result. This session will provide an overview of case law on the scope of key CGL coverages for construction risks, including contractual liability coverage, coverage for construction defects, and coverage for additional insureds. A construction broker and underwriter will offer strategies for avoiding coverage gaps and modifying problematic provisions in a way that maximizes the value of the insurance to the contractor.

Monday, November 13, 9:00 a.m.–5:00 p.m.

[Ours]

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Mr. Menter is one of the presenters for Monday's all-day seminar, "CGL Issues and Developments." He is a partner in the Newport Beach, California, law firm of Newmeyer & Dillion. Mr. Menter regularly represents real estate developers in matters involving construction litigation and insurance coverage. He also has a substantial appellate practice and is currently representing The William Lyon Company before the California Supreme Court in *Aas v Superior Court*, 64 Cal App 4th 916 (1998) (application of economic loss rule in construction defect litigation). Other recent cases in which Mr. Menter has participated include *Vandenberg v Superior Court*, 21 Cal 4th 815 (1999), and *Pardee Construction Co. v Insurance Company of the West*, 77 Cal App 4th 1340 (2000).

Mr Menter is a member of the Editorial Advisory Board of the *California Tort Reporter* and is the author of a number of articles, including *Expansion of the Duty to Defend in California?*, Insurance Litigation Reporter, Volume 20, Number 1 (West, January 15, 1998); *Defense and Indemnity of Additional Insureds*, Mealey's Construction Defect Litigation Conference (December 7, 1999); *If You Don't Mean It, Don't Say It: Fourth District Court of Appeal Rejects Insurers' Attempt To Limit Coverage Available To Additional Insureds*, California Insurance Law and Regulation Reporter, Volume 12, Number 3 (West, March 2000); and *The Economic Loss Rule & Construction Defect Litigation*, Nevada Lawyer, Vol. 8, No. 9 (Sept. 2000).

Mr. Menter holds a B.A. in English from Virginia Polytechnic Institute. He received his law degree from Washington & Lee University and a Master of Laws degree in Environmental Law from George Washington University. He is a member of the California, Nevada, Arizona, Colorado, Maryland, and District of Columbia bars as well as the bar of the United States Supreme Court and numerous federal courts.

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Notes

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ADDITIONAL INSURED ISSUES

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Defense and Indemnity of Additional Insured Developers

I. INTRODUCTION.

Requiring and maintaining additional insured coverage should be an integral part of construction risk management. Being covered as an insured under subcontractor liability policies can eliminate or reduce “out-of-pocket” expenses for third party claims. Implementing risk management procedures that ensure additional insured coverage may also reduce the premiums required by a developer’s own insurers. Accordingly, risk managers, construction lawyers, insurers and coverage lawyers need to have an understanding of the coverage benefits and concurrent obligations that go along with being an additional insured.

In the past few years, some of the most hotly debated construction defect related insurance coverage issues have involved the obligations between an insurer and a developer claiming additional insured status under liability policies issued to its subcontractors. Insurers often contend that coverage under the endorsements is derivative of the named insured subcontractor and, therefore, coverage is provided only for the developer’s vicarious liability resulting from the work of the named

insured subcontractor. Conversely, additional insured developers argue that they have a severable interest under the subcontractor’s policy that affords broad coverage without regard to fault on the part of the named insured.

These differing positions have raised a number of questions relating to the scope of the insurers’ obligations. What is the effect of the additional insurers’ obligation to defend and indemnify the additional insured? Are these obligations altered by the presence of other insurance with concurrent duties? What are insurers’ claims handling obligations vis-a-vis additional insureds? What obligations do additional insureds have when seeking coverage under the subcontractor’s policy? Under what circumstances is the additional insurer entitled to reimbursement of defense costs? What happens when the interests of the subcontractor and the developer are adverse?

Additional insured endorsements vary widely, but, as a general rule, an additional insured is an insured like any other insured. The additional insured developer has a right to expect a defense and indemnity from the insurer according to the terms and conditions of the policy. Likewise, courts have confirmed that reciprocal duties of good faith and fair dealing between insurers and insureds apply equally to additional insurers and additional insureds.

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II. ADDITIONAL INSURED STATUS.

Real estate developers generally require their subcontractors to be covered by a policy of comprehensive, or commercial general liability (“CGL”) insurance. The subcontract should also require that the subcontractor obtain an additional insured endorsement naming the developer as an insured on the subcontractor’s CGL policy.

The term “additional insured” is actually a misnomer. An additional insured is in fact an “insured.” Either through a “blanket” endorsement or specific additional insured endorsement, the developer is provided coverage under the pertinent policy by being added as either a “named insured” or an “insured.”² These endorsements can vary widely. For example, the Insurance Services Office (“ISO”)³ form CG 20 10 11 85 (“2010 endorsement”) additional insured endorsement is commonly used to add the developer as an insured under a subcontractor’s liability insurance policy. The 2010 endorsement states:

WHO IS AN INSURED (Section II) is amended to include as an insured the person or organization shown in the Schedule, but only with respect to liability arising out of “your work” for that insured by or for you.⁴

Written on an occurrence basis, a CGL policy containing this or a similar endorsement essentially provides the developer with liability cover-

age for the work of the named insured. *See, Pardee Construction Company v. Insurance Company of the West*, 77 Cal.App.4th 1340 (2000). The “but only” language has been said to prevent the additional insured from “enjoying blanket coverage under the policy for liability unrelated to the work.” *Time Warner Entertainment Co. v. Travelers Cas. & Sur. Co.*, 1998 U.S. Dist. LEXIS 19460 at *25-26 (E.D. Pa. 1998). It means that there is no coverage for liability unrelated to the named insured’s work. *Id.* at *26. The primary advantage of the 2010 endorsement is that it provides coverage for completed operations.⁵

On the other hand, another widely used additional insured endorsement is the ISO form CG 20 09 11 85 (“2009 endorsement”) which excludes coverage for completed operations through the following language:

This insurance does not apply to:

- (2) “Bodily injury” or “property damage” occurring after:
 - (a) all work on the project (other than service, maintenance or repairs) to be performed by or on behalf of the additional insured(s) at the site of the covered operations has been completed; or
 - (b) that portion of “your work” out of which the injury or damage arises has been put to its intended use by any person or organization other than another contractor or subcontractor engaged in performing operations for a principal as a part of the same project.⁶

²A “blanket” endorsement provides that every entity that falls within a certain class is an insured under the particular policy. These types of endorsements often provide that when the named insured is required by contract to name another as an insured under the policy, that entity assumes insured status. *See, e.g., Hartford Fire Ins. Co. v. Brutto*, 2000 WL 1060708 (N.Y.A.D. 3 Dept.); *City of Cedar Rapids v. Insurance Company of North America*, 562 N.W.2d 156 (Iowa 1997); *Rosato v. Karl Kock Erecting Co. Inc.*, 865 F. Supp. 104 (E.D.N.Y. 1994).

³ISO is a trade association that provides policy forms and drafting services to approximately 3,000 property and casualty insurers. *See, Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal.4th 645, 671, n.13 (1995). Most U.S. insurers use ISO forms as the policies themselves or at least as a starting point for the drafting process. *Id.*

⁴Scott C. Turner, *Insurance Coverage of Construction Disputes* app. J at A-67 (West Group 1999).

⁵The 1993 version of the 2010 endorsement limits coverage to the “ongoing operations” of the named insured. This language has been interpreted as excluding coverage for completed operations. *See, Pardee*, 77 Cal.App.4th at 1356-1360.

⁶Turner, at app. I, p. A-66. At least one court has held that the 2009 endorsement does not exclude coverage for property damage that occurs during operations. *See Urban West Communities v. Industrial Indem.*, No. G019729 (Cal. App. Dist. 4 June 10, 1999).

In addition to the 2010 and 2009 endorsements, there are many other manuscript or insurer specific additional insured endorsements that provide varying degrees of coverage. Under virtually all endorsements, however, the additional insured is specifically stated to fall within the definition of an “insured” as that term is defined in the policy.

A CGL policy may in fact provide coverage to numerous specifically-identified or generally-categorized entities as insureds. The categories of insureds typically include (1) the “named insured,” which is the organization(s) or person(s) actually named in the declarations and to whom the words “you” and “your” refer; and (2) “omnibus insureds,” those insureds identified in the “WHO IS AN INSURED” portion of the policy as including relatives, employees and other persons or organizations performing duties related to the named insured’s business. Additional insured endorsements often amend the “WHO IS AN INSURED” portion of the policy. As such, the additional insured is usually a type of omnibus insured, and the word “insured” is usually construed to refer to additional insureds, as well as other omnibus insureds. C.A. Beard, “Additional Insureds and Indemnitees: an Analysis Matrix,” DRI Insurance Coverage and Practice Seminar (1997) on LEXIS at *5.

Most CGL policies also contain a “separation of insureds” clause which effectively creates a severability of interests with respect to insureds under the respective policies. The effect of the provision is that the policy is to be construed as though “a separate policy is issued to each insured against whom claim is made or suit is brought.” D. Malecki, *The Additional Insured Book*, ch. 6 at 137-139 (4th Ed. IRMI 2000); see also, *Erdo v. Torcon Construction Company, Inc.*, 645 A.2d 806, 810 (N.J. Super. 1994)(severability clause “creates multiple policies with identical terms but different insureds”); *Carlyle King v. Dallas Fire Ins. Co.*, 2000 WL 892869 (Tex. App.-Hous. (1 Dist.)).

Although a point of some disagreement, it is a common misconception that the insurer receives no premium for the additional insured coverage provided to the developer. In fact, the developer’s payments to the subcontractor pursuant to the sub-

contract can include amounts sufficient to cover the premium charged by the additional insurer for the additional coverage. This premium may materialize as either a part of the premium charged initially to the subcontractor, later through special premiums charged for the issuance of the endorsement, or through a hybrid method. See, e.g., *Chevron U.S.A., Inc. v. Bragg Crane & Rigging Co.*, 180 Cal.App.3d 638, 646 (1986). The additional premium may be insubstantial because the insurer has already taken into consideration the contractual liability coverage provided for the named insured’s obligation to indemnify the additional insured. *Malecki on Insurance*, Volume 8, No. 4, p. 4 (February, 1999).

In sum, additional insured status can be thought of as a reinforcement of the underlying construction contract’s hold harmless or indemnity provision. Malecki, *The Additional Insured Book*, ch. 4 at 59 (4th Ed. IRMI 2000). However, it is not a perfect risk transfer technique. It is therefore important to carefully review the endorsements that are provided by the subcontractors. While it may sometimes seem impractical, insisting upon compliance with contractual insurance requirements will ultimately provide great benefits when construction claims arise. Strict compliance is especially important with respect to the subcontractors whose work is generally the focus of the largest liability claims. Additional insured status, however, should be considered a compliment to and not a substitute for careful drafting of indemnity/hold harmless agreements. *Id.*

III. THE DUTY TO DEFEND THE ADDITIONAL INSURED.

Conflicts generally first arise between the additional insured developer and the additional insurer over the duty to defend. An understanding of the duty to defend as it applies to the additional insured is therefore vital from both the insured’s and insurer’s claims handling perspective. Coming to terms with the defense issues at the outset of a case will also help to establish a positive relationship between insurer and insured for the duration of the action. Further, properly dealing with these issues and working together will ultimately promote a quicker and more cost efficient resolution of the action.

(a) The General Rules Regarding the Duty to Defend.

Most states require an insurer to immediately defend its insured if the allegations in an underlying complaint potentially fall within the scope of coverage provided by the terms and conditions of a policy. *See, e.g., Lee v. Aetna Cas. & Sur. Co.*, 178 F.2d 750 (2d Cir. 1949); *Gray v. Zurich Insurance Co.*, 65 Cal.2d 263 (1966); *Trizec Properties, Inc. v. Biltmore Construc. Co., Inc.*, 767 F.2d 810, 811 (11th Cir. 1985).⁷ A duty to defend may exist in an action even where coverage is questionable and there ultimately may not be an actual duty to indemnify. *Horace Mann Insurance Co. v. Barbara B.*, 4 Cal.4th 1076, 1081 (1993). It has also been held that a duty to defend exists until the insurer can conclusively establish that "... the third party complaint can by no conceivable theory raise a single issue which could bring it within the policy coverage." *Montrose Chemical Corp. v. Superior Court*, 6 Cal.4th 287, 300 (1993). On the other hand, there is generally no obligation to defend when the complaint shows either the non-existence of coverage or the applicability of a policy exclusion. *Prudential Prop. & Cas. Ins. Co. v. Calvo*, 700 F. Supp. 1104 (S.D. Fla. 1988).

Likewise, most courts have held that when the duty to defend exists, an insurer is required to provide its insured with a complete defense including a defense of claims for which there is no potential for coverage.

⁷The law favoring determination of the duty to defend by exclusive reference to the pleadings developed out of concern that insureds under liability policies "get the benefit of an insurer-provided defense, an important right for which insureds pay substantial premiums." Randall, S. "Redefining the Duty to Defend," 3 Conn. Ins. L.J. 221, 222 (1996/1997). However, a "single-minded focus" on the exclusive pleading rule can lead to unjustifiable results and foster improper pleading practice. In reaction, a number of courts have allowed consideration of extrinsic evidence to determine the existence of the duty to defend. *See, e.g., Gibbs v. General Accident Ins. Co.*, 693 N.Y.S. 2d 719, 720 (N.Y. App. Div. 1999); *Guaranty Nat'l Ins. Co. v. Vic Manufacturing Co.*, 143 F.3d 192, 194 (5th Cir. 1998); *State Farm Fire & Cas. Co. v. Bullock*, 1997 Conn. Super LEXIS 1506 (Conn. Super. 1997).

Buss v. Superior Court, 16 Cal.4th 35 (1997)(duty to provide defense of uncovered claims is a "prophylactic" duty imposed by law). Offering less than a full defense can be considered the equivalent of a defense denial. *Haskel, Inc. v. Superior Court*, 33 Cal.App.4th 963, fn. 9 (1995). Other courts sometimes permit insurers to pro-rate or allocate defense costs between covered and non-covered claims where a reasonable basis exists for segregating legal activity. *See, Gulf Chemical Corp. v. Assoc. Metals & Minerals Co.*, 1 F.3d 365 (5th Cir. 1993); *Gon v. First State Ins. Co.*, 871 F.2d 867 (9th Cir. 1989).

(b) The General Rules Regarding the Duty to Defend Apply to the Additional Insured.

Initially, CGL policy terms generally refer to the obligation to defend "insureds" with no distinction as to the obligation vis-à-vis the named insured. The policy language itself, therefore, requires the same duty to defend the additional insured as would be required for the named insured.

Likewise, courts regularly apply the general rules regarding the duty to defend to additional insureds. *See, e.g., Pardee*, 77 Cal.App.4th at 1350-1351; *Maryland Casualty Company v. Nationwide Mutual Insurance Company*, 81 Cal.App.4th 1082 (2000). Indeed, state and federal courts throughout the United States have required insurers to provide additional insureds with a defense pursuant to the same broad requirements as are applicable to named insureds. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Sears, Roebuck & Co.*, 603 F.2d 780 (9th Cir. 1979)(court held that "additional insured" entitled to broad duty to defend entire action); *National Union Fire Insurance Company of Pittsburgh, Pa. v. Glenview Park Dist.*, 632 N.E.2d 1039 (Ill. 1994) (insurer had duty to provide complete defense to additional insured); *Pennzoil Co. v. United States Fidelity & Guar. Co.*, 50 F.3d 580 (8th Cir. 1995)(insurer must defend additional insured for entire action despite the fact that aspects of the action may not be covered under the endorsement); *First Ins. Co. of Hawaii, Inc. v. State of Hawaii*, 665 P.2d 648 (Hawaii 1983) (ap-

plying broad rules regarding duty to defend and requiring insurer to defend entire action including uncovered claims); *but see*, *Gulf Chemical, supra*.

Even though the duty to defend is extremely broad, its existence does not mean, however, that the insured has “carte blanche” to an unlimited defense on the insurer’s nickel. The duty to defend is not unlimited. It is measured by the nature and kinds of risks covered by the policy. *Pardee*, 77 Cal.App.4th at 1350. In the context of a claim by an additional insured, there can only be a duty to defend when some aspect of the claim falls within the coverage grant given to the additional insured. Thus, when the additional insured’s liability does not arise out of the operations or work of the named insured there is no coverage and no duty to defend. *See, e.g., Hartford v. State of California*, 41 Cal.App.4th 1564 (1996); *Granite Construc. Co. v. Bituminous Ins. Cos.*, 832 S.W.2d 427 (Tex. App. 1992).

IV. CONDUCTING THE DEFENSE.

(a) Is an additional insured entitled to a complete defense?

Despite the applicable policy language and the decisions of numerous courts, some insurers argue that they do not owe additional insureds the same broad duty to defend as they admit that they would owe their named insureds. In the context of construction defect claims, this position usually arises when the insurer agrees to defend but only offers a limited defense of the vicarious liability of the developer for the work of the named insured subcontractor. This position arguably confuses the duty to defend with the generally narrower duty to indemnify. For instance, in *Maryland Cas. Co. v. Nationwide Ins. Co.*, 65 Cal.App.4th 21 (1998) (*Maryland Casualty I*) the court rejected the insurer’s argument that its endorsement only contained an obligation to indemnify the additional insured. The court went on to note that the broader scope of the duty to defend is applicable to the additional insured and held that the limiting language in the additional in-

sured endorsement did not eliminate the insurer’s defense duty, but instead simply defined the scope of the insurer’s indemnity obligation. *Id.* at 30.

The *Maryland Casualty I* case was an action by a developer’s insurers to recoup defense fees from an additional insurer. After the decision by the court of appeal, the case was remanded for a determination of the monetary damages to be awarded. The trial court awarded the developer’s insurers all of their fees and the additional insurer appealed. The same appellate court then issued its decision in *Maryland Cas. Co. v. Nationwide Mut. Ins. Co.*, 81 Cal.App.4th 1082 (2000) (*Maryland Casualty II*). In *Maryland Casualty II*, the court held that both the developer’s own direct insurers and the additional insurer owed the additional insured developer a complete defense of the entire action. As between the insurers, however, principles of equitable contribution would apply.⁸

Those additional insurers that elect not to provide a complete defense for their additional insureds generally do so by either offering to appoint counsel to represent the additional insured solely with respect to claims relating to the work of the named insured subcontractor, or by offering to pay a percentage of the defense which they assert is commensurate with the presumed liability of the subcontractor. Both of these scenarios present significant problems from a practical, legal and ethical standpoint.

(1) Association of counsel for an issue defense.

If insurers could associate counsel on discrete issues, a developer could have dozens of law firms separately representing different issues. Thus, the devel-

⁸It is noteworthy that the court in *Maryland Casualty II* implied in dicta that if the developer’s excess insurers were making a claim against the additional insurer, principles of equitable subrogation would apply and then, presumably, they would be entitled to complete reimbursement from the additional insurer.

oper would have numerous attorneys, each with their own agenda, pointing a finger at each other. For instance, the attorney representing the developer solely on the roofing issues might blame the framing and sheet metal subcontractors, among others, for the roof leaks. In this way, the attorney would be blaming the developer itself, since it was responsible for each of the other subcontractor's work. Since the insurer responsible for coverage of the roofing issues would take the position that it is not responsible for framing and sheet metal issues, there would be every incentive to blame these trades. Who would make the opening statement at time of trial? Would the roofing attorney cross-complain against the roofer for indemnity? In short, this scenario presents a number of problems.

Additionally, the ethical consideration for defense counsel can be serious. In this regard, the Supreme Court of Montana has recently held that a lawyer that submits to insurer-imposed limitations on representation violates rules of professional conduct. *In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2000 WL 502545 (Mont. April 28, 2000). In this case, the court heard from a plethora of insurance companies and insurance industry associations. The specific issue addressed was whether "an attorney ... [could] agree to abide by an insurer's billing and practice rules which impose conditions limiting or directing the scope and extent of the representation of his or her client, the insured?" 2000 WL 502545 *2.

The court first noted that there was agreement by the parties that defense counsel "may not abide by agreements limiting the scope of representation that interfere with their duties under the Rules of Professional Conduct." 2000 WL 502545 *11. The court then found that insurer requirements of prior ap-

proval of defense activities "fundamentally interferes with defense counsels' exercise of their independent judgment." *Id.* The court also found that such prior approval creates a "substantial appearance of impropriety." *Id.* Other courts have also held that insurer imposed limitations on the defense provided to the insured were improper. *See, e.g., Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 61 Cal.App.4th 999, 1009 (1998)(insurer restrictions that inhibit counsel's ability to adequately defend the "entire case" "may well violate the insurer's duty to defend as well as the attorneys' ethical responsibilities to exercise their independent professional judgment in rendering legal services").

(2) Payment of a percentage of the defense.

The second scenario can be equally problematic. An insurer's proposal to pay a particular percentage of the defense requires that the insured assume the time-consuming and substantial financial burden to apportion "responsibility" to the respective subcontractors for alleged damage before the additional insurer funds any portion of the defense. This arrangement also requires that all participating insurers agree to such an apportionment. The purpose of the insurance contract and the additional insured's reasonable expectations under the contract are defeated in this way. The objectively reasonable additional insured expects to receive an "immediate" and "complete" defense against any action where even one claim potentially falls within the coverage of the policy. Further, this scenario presumes that the additional insured could very rapidly obtain funding of 100% of its defense. This is not always the case. In such a circumstance, the insured would again be left with either a substandard defense or without any defense at all.

(3) The Joint Defense Agreement Alternative.

When a developer is served with a complaint for construction defects, the lawsuit should normally be tendered to both its own direct insurers and the subcontractor insurers that named the developer as an additional insured. Depending upon the particular case, a developer may have ten, twenty or more potentially obligated insurers, each with their own independent duty to defend. In this situation, each of the insurers will likely assert some common and specific defenses to coverage. The insurers may also ask the developer's assistance in establishing a joint-defense agreement in order to spread the defense between each responsible insurer. This is generally accomplished by dividing the defense of the developer by some objectively understandable method. For instance, the defense can be divided by equal shares to each insurer, by equitably allocating the defense based upon projected liability attributable to particular defects, or by some type of time on the risk/limits analysis.

If such an agreement can be established at the outset of the case, it may be a relatively easy mechanism for the insurers to spread the expense of the defense. It may also provide a way to quickly provide the developer with a defense without costly time consuming negotiation/litigation over a particular insurer's obligations. However, the incentive for the developer to enter into such agreements is significantly lessened if it is deprived of counsel of its choosing or subject to multiple requirements from the various insurer participants, contradictory reservations of rights or later to claims for reimbursement.

In order for joint defense agreements to be a realistic alternative to traditional defense arrangements, all parties involved must be willing to negotiate in good faith. Each insurer-participant

must be also be willing to recognize the substantial benefit of not being required to defend the entire action and be ready to give up one or another contractual/legal right. Likewise, avoiding coverage litigation and obtaining a quick and complete defense until the conclusion of the action is a strong incentive to the policyholder to cooperate in such an agreement.

(b) Obligations of the Developer when seeking a defense as an Additional Insured.

An additional insured, like any other insured, must comply with the policy's terms and conditions. Compliance with a policy's "late notice" and "voluntary payments" provisions can become an issue in the additional insured/insurer relationship. Depending upon the law of the relevant jurisdiction, the additional insured's failure to comply with these provisions can significantly affect its right to a defense and recovery under the policy.

In New York, for example, compliance with a notice provision is a condition precedent to an insurer's liability under the policy. *Commercial Union Ins. Co. v. International Flavors & Fragrances, Inc.*, 822 F.2d 267, 271 (2d Cir. 1987). Therefore, failure to comply with the notice requirement will relieve the insurer of its duty not only to indemnify, but also to defend the insured. *Olin Corp. v. Insurance Co. of North America*, 743 F. Supp. 1044, 1055 (S.D.N.Y. 1990), *aff'd*, 929 F.2d 62 (2d Cir. 1991) (per curiam). New York law also holds that in a case where two insureds are not similarly situated, but adverse to each other, notice by the named insured to the insurer will not be also deemed applicable to a claim of the additional insured. The additional insured's failure to give the notice required by the policy will also be fatal to its claim. *Delco Steel Fabricators, Inc. v. American Home Assurance Co.*, 40 A.D.2d 647 (N.Y. App. Div. 1972), *aff'd* 341 N.Y.S.2d 619 (N.Y. 1973); *National Union Fire Ins. Co. v. INA*, 590 188 A.D.2d 259 (N.Y. App. Div. 1992). Other states hold that late notice gives rise to a presumption of prejudice to

the insurer, which the insured must rebut. *See, e.g., Bankers Ins. Co. v. Macias*, 475 So.2d 1216 (Fla. 1985). Even states that graft a prejudice requirement onto a notice provision have held that an insured has no duty to offer a defense uninvited, particularly where the insured is sophisticated. *See, e.g., Casualty Indem. Exch. Ins. v. Liberty Nat'l Fire Ins. Co.*, 902 F. Supp. 1235 (S.D. Mont. 1995).

The circumstance that an additional insured fails to give the carrier timely notice can, in such states, raise a number of significant questions bearing upon whether the developer can rebut the presumption of prejudice to the insurer. How diligently must the additional insured search its records for applicable insurance policies after a lawsuit is filed? Does the insured have an obligation to exercise reasonable care in maintaining its insurance policies and other insurance records to facilitate such a search? How much evidence of the existence of any particular insurance policy must the insured possess before the duty to provide notice and tender arises? Similar questions could be asked of the carrier who is notified of a claim by the named insured but was or should have been aware that another party was an additional insured. In any event, the additional insured developer must take steps to tender claims to its additional insurers. In that regard, a systematized and organized risk management program that deals with the maintenance of insurance documentation on a project-by-project or subcontractor-by-subcontractor basis is extremely helpful.

If notice is not promptly given, insurers will also typically assert the "voluntary payments" provision of their policies. The applicable law can dramatically affect an additional insured's right to recover defense costs incurred prior to the tender of its defense to the insurer. Beard at 17. Some courts that require a demonstration of prejudice in connection with a late notice defense nevertheless enforce the prohibition against voluntary payments without any showing of prejudice. *See, T. S. Schenk, "Payment of Pre-Tender Defense Costs," For the Defense, DRI, Vol.*

41, no. 7 (1999). One such court explained the differing treatment of the notice and voluntary payments provisions this way:

[T]he policies that prompted courts to graft the prejudice requirement onto the notice requirement have little bearing on the question of pre-tender defense costs. The prejudice requirement was adopted to prevent complete forfeiture based upon technical failure of the insured to provide timely notice. In contrast, enforcement of the rule that pre-tender defense costs are not recoverable does not result in complete forfeiture of an insured's right to recover fees. Rather, the rule gives the insured the choice of defending some or all of a claim on its own. There are tactical reasons why an insured may want to withhold the defense from an insurer that clearly covers a risk. For example, especially in a high-profile case, an insured may not want to lose control of events to the insurer.

American Mut. Liab. Ins. Co. v. Beatrice Cos., 924 F. Supp.861, 873-74 (N.D.Ill. 1996).

In contrast, some courts hold that an insured's breach of the voluntary payments provision precludes coverage for pre-tender defense costs only where the insurer can demonstrate actual prejudice. *See also, Aetna Cas. & Sur. Co. v. Dow Chem. Co.*, 10 F. Supp. 2d 800 (S.D. Mich. 1998) (Michigan law); *TPLC, Inc. v. United National Insurance Co.*, 44 F.3d 1484, 1493 (10th Cir. 1995) (Pennsylvania law); *Clark Equipment Co. v. Arizona Property & Casualty Insurance Guaranty Fund*, 943 P.2d 793, 803 (Ariz. App. 1997). Other courts have held that pre-tender costs are recoverable by the additional insured when it acted reasonably in delaying notice to the insurer. *See, e.g., Shell Oil Co. v. National Union Fire Ins. Co.*, 44 Cal.App.4th 1633, 1648-1650 (1996).

An insured's compliance with conditions of the policy can also be critical to an insurer's ability to recover contribution from a co-insurer. Although some states permit contribu-

tion between insurers for defense costs where coverage is provided by more than one insurer,⁹ the conduct of the insured and the insurer seeking contribution can be relevant to the inquiry whether contribution will be allowed in a particular case. In New York, for example, a cause of action against an insurer for contribution will not lie where the insured has not complied with conditions of the policy. *Blank*, 27 F.3d at 793. Thus, where the insured fails to provide prompt notice, “a co-insurer hoping to benefit from the presence of another insurer, must ensure that the notice provisions of the insured policy with the second insurer are complied with.” *Id.* at 794. That is, if the insured fails to give notice to one co-insurer, the co-insurer that received notice must give notice to the co-insurer that did not. Conversely, if the insured provided notice to only one co-insurer and if the co-insurer who received notice fails to give prompt notice to the co-insurer that did not, the co-insurer who received notice may not seek contribution from the co-insurer who did not. *Id.*; *See also, Truck Ins. Exch. v Unigard Ins. Co.*, 79 Cal.App.4th 966 (2000) (Insurer not put on notice of claim has no obligation to contribute to defense or indemnity).

(c) The right to independent counsel.

Most courts recognize what is known as the “tripartite relationship” between insurer, insured and insured’s attorney. *See, e.g., Finley v. Home Ins. Co.*, 975 P.2d 1145, 1149–1150 (Hawaii 1998) (“tripartite” relationship uniquely involves insured represented by counsel selected by insurer whose interests may differ from that of the insured). As one court stated:

Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client the one who is paying his fee and from whom he hopes to receive future business the insurance company. Al-

though it has perhaps become trite, the biblical injunction found in Matthew 6:24 retains a particular relevancy in circumstances such as these, “No man can serve two masters”

United States Fidelity & Guar. Co. v. Roser, 585 F.2d 932, 938 n.5 (8th Cir. 1978).

When a potential conflict exists for insurer appointed defense counsel as a result of diverging interests between the insurer and the insured, the insured may be entitled to independent counsel at the expense of the insurer. *See, e.g., San Diego Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal.App.3d 358 (1984).¹⁰ The independent counsel requirement may be triggered when an insurer issues a reservation of its rights to disclaim coverage, and at the same time, appoints defense counsel to represent the insured in a situation where the outcome of the case may be “steered” toward covered or uncovered damages by the insurer-appointed counsel.

Typically, additional insurers agreeing to defend additional insureds in construction defect cases do so pursuant to reservation of rights letters asserting various coverage defenses. As a general practice, these insurers will seek to reserve a right of reimbursement, to limit indemnity payments to the work of the named insured, and, in a broad catch-all manner, reserve all other rights that it may have under the terms of the policy. In this situation, an independent counsel requirement is often present if the additional insurer requires the developer to use the insurer’s panel counsel.¹¹ When the interests of multiple

¹⁰The independent counsel requirement of the *Cumis* case was later codified as California Civil Code § 2860.

¹¹*See, Pacific Greystone Corp. v. Aetna Ins. Co.*, No. B124297 (Cal. App. Dist. 2 April 26, 2000)(reservation of rights in construction defect case on grounds of “work performed” exclusion, timing of property damage and whether alleged damages constituted an “occurrence” each sufficient to trigger independent counsel requirement); *but see, Blanchard v. State Farm Fire & Casualty Co.*, 2 Cal.App.4th 345 (1995)(reservation of rights in construction defect case does not create conflict of interest requiring appointment of independent counsel).

⁹*See* discussion, *infra*.

insureds are adverse, the retention of independent counsel may also be necessary. *Atlantic Mut. Ins. Co. v. Struve*, 621 N.Y.S.2d 5 (N.Y. App. 1994).

Additional insured reservations for construction defect cases generally involve not only the type of damages, but also the *causation of the damages* which is clearly subject to manipulation through control of the defense. For example, the roofer's insurer will disclaim coverage for damages caused by the sheet metal subcontractor. If the roofer's insurer appoints defense counsel to represent the developer, that counsel will have the ability to shift the focus of liability from the roofer to the sheet metal subcontractor, i.e., from a covered to an uncovered claim. This is apparent through defense counsel's ability to select experts, settle claims, determine witnesses, establish the order of proof at trial, focus cross-examination etc., all of which demonstrates how the outcome of coverage, causation and timing of damages may be controlled by counsel.

In a multiparty construction defect case where the additional insurer issues a typical reservation of rights letter, it is easy to see how a conflict may arise for insurer-appointed defense counsel. This is especially true where the insurer fails to identify the scope of its reservation by including some sort of broad catch-all language. Obviously, this type of sweeping reservation puts the insured in the position of being defended by the insurer's appointed defense counsel without any firm understanding of what ultimately will or will not be covered.

Nonetheless, insureds and insurers should evaluate claims independently with an eye to the facts and contentions of the particular case and the respective interests of the insurer and insured. *Dynamic Concepts, supra*, 61 Cal.App.4th at 1007–1008. In *Dynamic Concepts*, the court discussed that the facts of each case must be closely evaluated to determine the need for independent counsel. Accordingly, the additional insurer must carefully review an insured's request for independent counsel and, if possible, attempt

to come to an agreeable resolution with its insured.

(d) Can a declaratory judgment action be brought to determine the duty to defend?

Defense costs in handling construction cases often represent 50% to 70% of the total cost. As such, the obligation to defend the additional insured is often more important from a financial standpoint than the duty to indemnify. Beard at *3–4. In a case where the insurer believes coverage is questionable, the carrier will often desire to have the issue of whether a defense is owed determined as quickly as possible. Likewise, an insured may wish to file a declaratory judgment action on the duty to defend if the insurer refuses to defend or offers a substandard defense. Given the disputes that often arise in the relationship between additional insurers and additional insureds, coverage litigation, usually in the form of a declaratory relief action, is frequent.

Courts in the United States consistently hold that the duty to indemnify is not ripe for adjudication prior to the conclusion of the underlying lawsuit. *See, e.g., United Nat'l Ins. Co. v. Dunbar & Sullivan Dredging Co.*, 953 F.2d 334, 338 (7th Cir. 1992); *Endre v. Niagara Fire Ins. Co.*, 675 A.2d 511 (Maine 1996); *Calvo*, 700 F. Supp. at 1105-06 (S.D. Fla. 1988); *Montrose Chemical Corp. v. Superior Court, supra*. However, at present there is a split of authority in the country over whether declaratory judgment actions should be allowed to proceed on the duty to defend. *See, e.g., Calvo*, 700 F. Supp. at 1105-06 (court has discretion to stay declaratory judgment action where underlying tort suit will decide identical issue in declaratory action); *State Farm Fire & Cas. Co. v. Poomaihealani*, 667 F. Supp. 705 (D. Hawaii 1987)(same); *Montrose Chemical Corp. v. Superior Court*, 6 Cal.4th 287 (1993)(declaratory relief action appropriate on duty to defend during pendency of underlying action).

Before initiating a coverage action, both insurers and insureds should attempt to informally resolve whatever issues exist. The pos-

sibility of losing is only one factor that should be considered. From the insurer's standpoint, filing a declaratory relief action often results in cross claims for bad faith. Further, some jurisdictions have held that an insurer that sues its insured for declaratory relief may be responsible for the insured's attorney fees.¹² Likewise, insureds must recognize that coverage litigation may be very expensive and losing will likely preclude any possibility of coverage in the underlying action.

V. EQUITABLE CONTRIBUTION/ SUBROGATION AND REIMBURSEMENT.

(a) Contribution v. Subrogation.

In some states, insurers have rights of contribution between themselves to equitably shift the burdens of defending and indemnifying their insureds. *See Maryland Casualty Co. v. National American Ins. Co.*, 48 Cal.App.4th 1822, 1828-29 (1996) (insurer that faithfully discharges defense obligation entitled to equitable contribution from insurer that breaches defense obligation); *Blank*, 27 F.3d at 793 (New York law provides a cause of action for contribution between co-insurers "when several insurers cover the same risk and payment for loss has been made by one"); *but see, Continental Cas. Co. v. United Pacific Ins. Co.*, 637 So.2d 270 (Fla. 5th DCA 1994) (en banc), review denied, *Continental Casualty Co. v. United Pac. Ins. Co.*, 645 So.2d 451, (Fla. 1994) (Florida law does not recognize a right of contribution between insurers for defense costs).

When rights of contribution exist, disputes usually occur between insurers as to which policies are primary and which are excess.

¹²*See, State Farm Fire and Casualty Co. v. Sigman*, 508 N.W.2d 323, 324 (N.D. 1993); *Olympic S.S. Co., Inc. v. Centennial Ins. Co.*, 811 P.2d 673, 680-681 (Wash. 1991); *Security Mutual Casualty Co. v. Donald Luthi*, 226 N.W. 2d 878 (Minn. 1975); *Allstate Insurance Company v. Robins*, 597 P.2d 1052, 1053 (Colo. 1979); *Standard Accident Ins. Co. of Detroit v. Hull*, 91 F. Supp. 65, 68 (S.D. Cal. 1950).

This is especially true when it comes to disputes involving claims being made by or against additional insurers. *See, e.g., Reliance Nat. Indem. Co. v. General Star Indem. Co.*, 72 Cal.App.4th 1063 (1999). One court has held that the developer's primary insurer and the subcontractor's primary insurer, which added the developer as an additional insured, constituted "co-primary" insurers requiring application of the principles of equitable contribution. *Maryland Cas. Co. v. Nationwide Mut. Ins. Co.*, 81 Cal.App.4th at 1089-1093.

In attempting to resolve these disputes, some courts have focused upon the language of the indemnity agreement between the developer and the subcontractor in order to determine which insurer provides primary insurance. *See, Rossmoor Sanitation, Inc. v. Pylon, Inc.*, 13 Cal.3d 622, 628-635 (1975). Other courts have focused on "other insurance" or like provisions which attempt to shift the risk to other insurers. *See, e.g., Wal-Mart Stores v. RLI Ins. Co.*, Civ. No. 99-5074 (D. Ark. Feb. 23, 2000). Finally, some courts rely primarily upon the nature of the particular insurance policy, i.e., primary or excess. *See, e.g., Reliance Nat. Indem.*, 72 Cal.App.4th at 1077-1079 (equitable contribution not available between primary and excess insurers).

When claims are made between insurers at different levels (i.e., primary and excess), some courts utilize the doctrine of equitable subrogation. *See, Reliance Nat. Indemnity*, 72 Cal.App.4th at 1077-1079. Courts have explained that application of principles of equitable subrogation allow an insurer to shift the entire loss to another insurer that has primary liability. *Fireman's Fund Ins. Co. v. Maryland Casualty Co.*, 65 Cal.App.4th 1279, 1291 (1998).

Construction defect cases often implicate the coverages provided by many insurers. Some insurers attempt to avoid their obligations to defend and indemnify by pointing to other insurers that also have such duties. While these other insurers may in fact have obligations to the insured, courts have found that it is not the insured's responsibility to secure

their participation. Rights of contribution (if they exist) exist only between insurers. *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal.4th 38, 72 (1997).

When more than one insurer owes a coverage obligation, the insured is entitled in some jurisdictions to select a policy to protect it without regard to the obligations of other insurers. See, *Armstrong World Industries, Inc. v. Aetna Cas. & Sur. Co.*, 45 Cal.App.4th 1, 49-55 (1996); *Continental Cas. Co.*, 637 So. 2d at 274 (court suggests in dicta that where a policyholder is both a named insured under its own policy and an additional insured under the policy of its contractor, the policyholder is entitled to choose which coverage to use). The Illinois Supreme Court has held that an additional insured general contractor (with its own direct insurance) may elect to require the additional insurer (which issued a policy to the general's subcontractor) to bear the entire burden of defending a claim. *John Burns Construction Co. v. Indiana Ins. Co.*, 727 N.E.2d 211 (Ill. 2000). In reaching this conclusion, the court in *John Burns* found that the insurer had the right to make such an election regardless of the additional insurer's "other insurance" provision and making such an election foreclosed the additional insurer's right to equitable contribution. *Id.* at 216-218.

If an insurer has a duty to defend or indemnify, it must agree to perform these duties without regard to how another similarly situated insurer may respond. If other insurers also have these duties, the insured may, but is not obligated, to obtain their participation. Since full participation by all implicated insurers is often to the benefit of the insured, insurers recognizing their legal obligations should offer to fully perform and concurrently ask for their insured's assistance in obtaining participation of other insurers. Indeed, when the developer and its insurers can work together in the defense of the plaintiffs' claims, a united strategy can be maintained that will reduce defense costs, expedite resolution of the construction defect case, and avoid coverage and bad faith litigation.

(b) Reimbursement vis-à-vis the Insured.

As between the insurer and the insured, the insurer may be entitled to reimbursement if it satisfies certain prerequisites and can meet its burden regarding such entitlement. Akin to the right to allocate defense costs discussed *supra*, some states allow an insurer to obtain reimbursement of certain defense costs from its insured. Unlike the right to allocate, the right of reimbursement presupposes payment by the insurer.

The California Supreme Court has held that an insurer could reserve its right for reimbursement, but only for those costs incurred in providing a defense for claims for which there was no potential for coverage. *Buss v. Superior Court*, *supra*. This right of reimbursement, however, is predicated upon the insurer having provided a complete defense to the entire underlying action. *Buss*, 16 Cal.4th at 49-53; *State of California v. Pacific Indem. Co.*, 63 Cal.App.4th 1535, 1549 (1998). The California Supreme Court also determined that only those costs *solely* allocable to claims that were not even potentially covered would be subject to reimbursement. *Buss*, 16 Cal.4th at 52. The Court went on to hold that the insurer had the burden of proof in terms of any claim for reimbursement. *Buss*, 16 Cal.4th at 53.¹³

Other states have held that insurers have no right of reimbursement against their insureds. Courts reaching this conclusion usually rely upon the standard CGL language requiring the insurer to defend a "suit", not particular claims within the suit. See, *e.g.*,

¹³In practice, *Buss* sets up a system that makes it extremely difficult to obtain reimbursement. As a general matter, most work performed in defense of an action cannot be solely allocated to one claim or another. While in some cases such allocation may not be impossible, it is nonetheless a daunting task for an insurer attempting to make such an allocation. The difficulty in making such an allocation has long been recognized by courts that have struggled with this issue. *Crist v. Insurance Co. of North America*, 529 F. Supp. 601, 605 (D. Utah 1982). The *Buss* court also acknowledged that an insurer's burden for obtaining a reimbursement of defense costs from its insured will be "extremely difficult." *Id.* at 57-58.

Shoshone First Bank v. Pacific Employers Ins. Co., 2 P.3d 510 (Wyo. 2000).

In the context of the coverage provided by additional insurance for defective work, the right to reimbursement may be a significant problem for developers. In a standard lawsuit for construction defects, claims are made for damage arising out of the work of many subcontractors and for the independent negligence of the developer. Since the insuring provision of the additional insured endorsement effectively limits the coverage provided to that linked in one way or another to the work of the subcontractor, an additional insurer that complies with its obligations may have the ability to recover a sizeable portion of the amounts spent on behalf of the developer. Accordingly, when the insurer has an effective right of reimbursement, the developer has significant incentive to limit this risk at the outset by entering into a joint defense or other agreement with its insurers.

VI. THE DUTY TO INDEMNIFY THE ADDITIONAL INSURED AND CONSTRUCTION DEFECT CLAIMS.

(a) General Principles.

Insurers have a duty to indemnify their insureds based upon the particular language of their policies. The insuring provisions of most policies are broad enough to cover all types of claims for covered damages. Thus, while not as broad as the duty to defend, courts have found that the duty to indemnify may not be determined simply by reviewing the form of the particular claim. *Vandenberg v. Sup. Ct.*, 21 Cal.4th 815(1999)(under California law insuring provision of CGL policy broad enough to cover all claims that insured may be “legally obligated to pay” including claims for breach of contract); *but see, Aetna Cas. & Sur. Co. v. McLbs, Inc.*, 684 F. Supp. 246, 249 (D. Nev. 1988), *aff’d*, *Aetna Cas. & Sur. Co. v. ARC Metals*, 878 F.2d 385 (9th Cir. 1989)(CGL policies not intended to cov-

er contractual liability).¹⁴ It has also been held that each insurer on the risk is required to indemnify for “all sums” up to its policy limits. *Armstrong*, 45 Cal.App.4th at 49-55. These same general principles apply to the additional insured.

(b) Concerns Regarding Coverage for Additional Insureds.

As an initial consideration, additional insured developers must take account of the coverage that is actually provided. Additional insureds are often dismayed to learn after the occurrence of injury or damage that their subcontractor solicited coverage from its insurer on terms less favorable than the developer would have preferred. Whereas the developer may have contemplated that the subcontractor would secure broad coverage, the insurance that is in fact provided may be significantly limited. Subcontractors (understandably desirous of keeping their premiums low) frequently request coverage from insurers on terms that include reduced limits and self-insured retentions (SIRs) that may be applicable to the additional insured. Sometimes these limits are inclusive of defense costs; that is, the defense costs erode

¹⁴Some courts have held that the mere performance of defective work does not constitute an occurrence under a CGL policy and is therefore not covered. *See, e.g., Fuller Co. v. USF&G*, 613 N.Y.S.2d 152 (App. Div. 1st Dept. 1994); *Reliance Ins. Co. v. Mogavero*, 640 F. Supp. 84 (D.Md. 1986); *Yegge v. Integrity Mut. Ins. Co.*, 534 N.W. 2d 100 (Iowa 1995). A number of other courts have held that a CGL policy is not intended to be a substitute for a performance bond on a contractor. *Castigliola v. Department of Community Dev.*, 538 So.2d 1139 (La. Ct. App. 1989). However, the performance of defective work can constitute an occurrence where damage is sustained to other property neither expected nor intended from the standpoint of the insured. *See, La-Farge v. Hartford Cas. Ins. Co.*, 61 F.3d 389 (5th Cir. 1995); *Hartford Cas. Co. v. Cruse*, 938 F.2d 601 (5th Cir. 1991); *Coland v. American Family Mut. Ins. Co.*, 709 P.2d 11 (Colo. App. 1985). Other courts have held that the incorporation of a defective component into a larger structure may constitute an occurrence and resultant property damage to the structure. *See, e.g., Eljer Manufacturing Inc. v. Liberty Mutual Ins. Co.*, 972 F.2d 805 (7th Cir. 1992).

the available limits of liability. Likewise, although the developer may have contemplated that the subcontractor would secure coverage protecting the developer against claims due to its own, active negligence, subcontractors may provide endorsements that limit the developer's coverage solely to its vicarious liability. Subcontractors also do not always request completed operations coverage. If a subcontractor fails to purchase the insurance it promised the developer, the additional insured generally cannot look to the insurer for protection. Ultimately, the insurer's obligations are determined by the terms of the policy purchased. *See*, D.R. Richmond, 'The Additional Problems of Additional Insureds,' 33 Tort & Ins. L.J. 945 at § III A (1998) (citations omitted).

When the additional insured developer discovers that the coverage provided is not as required by the subcontract or not provided at all, it usually must look to two courses of action. First, the developer can bring a claim against the subcontractor for failing to comply with the subcontract insurance requirements.¹⁵ Second, the developer should review the documentation it was provided, if any. For example, subcontractors often provide certificates of insurance as proof of compliance with their subcontract. These certificates often specify particular coverages that are provided. Insurers regularly claim that these certificates are only informational and do not, in and of themselves, provide a basis for coverage. *American Cas. Co. of Reading, Pa. v. Krieger*, 181 F.3d 1113 (9th Cir. 1999). However, if the broker that issued the certificate had the authority of the insurer, the insurer may be bound to provide coverage. *Id.* at 1121–1123. Likewise, other facts may exist to raise an issue of estoppel to preclude the insurer from denying coverage. *See Touchette Corp. v. Merchants Mut. Ins. Co.*, 429 N.Y.S.2d 952, 955 (1980).

To the extent that a claimant has asserted claims against an additional insured for damages arising from the work of the named insured, the developer must also—again like any insured—establish that at least some portion of the claims are fortuitous and fall within the terms of the policy's insuring agreement. The damages or injuries alleged must be within the period of coverage and must have been due to an occurrence, which most policies define as an accident. Where property damages are sought, most CGL policies require physical injury or loss of use of "tangible property."

However, many exclusions applicable to claims for property damage will be applied from the standpoint of the named insured.¹⁶ This is because these exclusions refer to the word "you" or "your" which is generally defined to refer to the named insured. Applying these exclusions from the standpoint of the named insured thus creates an exception to the general rule that the coverage provided to the additional insured tracks that provided to the named insured. For example, the named insured subcontractor is subject to the "owned property" exclusion whereas coverage would only be denied to the additional insured developer if the subcontractor owned the damaged property. In other words, the "owned property" exclusion may not preclude coverage for damage to property owned by the additional insured developer.

(c) The Specific Language of the Endorsement Controls the Duty to Indemnify.

With regard to the duty to indemnify, it is very important to note the particular type of endorsement at issue. As a general rule, the scope of the duty to indemnify under additional insured endorsements will be controlled by the language of the endorsement itself and the policy—not the underlying

¹⁵*See, e.g., Borough of Wilkensburg v. Trumbell-Denton Joint Venture*, 568 A.2d 1325, 1326 (Pa.Super. 1990) ("Where a party breaches an agreement to obtain insurance, the breaching party is liable for the full amount of the damages sustained.")

¹⁶Exclusions applicable to defective work claims include ISO Exclusions (j), (k), (l), (m) and (n) apply to deny coverage to an additional insured from the standpoint of the named insured's work. P.J. Wieleinski, "Selected Insurance Coverage Issues in a Construction Defect Claim," *Construction Law DRI* (March 1998).

construction contract. For example, even though the use of a blanket endorsement requires reference to the construction contract to determine *who* is an additional insured, courts have held that only the policy determines the scope of the coverage afforded. *Mobil Oil Corp. v. Maryland Cas. Co.*, 681 N.E.2d 552, 559 (Ill. App. 1997) (additional insured entitled to limits of policy, not only limits required by contract). Where, however, the endorsement specifically limits coverage to the extent required by contract, the construction contract will be read with the policy to determine the scope of coverage. *Certain Underwriters at Lloyd's v. Oryx Energy Co.*, 957 F. Supp. 930, 936 (S.D. Tex. 1997).

An additional insured endorsement may provide broad indemnity protection for all liability arising out of the work of the named insured subcontractor. On the other hand, the additional insured may only be entitled to coverage for its vicarious liability for the work of the named insured. Further, the endorsement may or may not exclude or restrict completed operations coverage. However, even under the broadest additional insured coverage available, the liability of the developer must—in some fashion—be related to the named insured's work or operations for the additional insured. Malecki, *The Additional Insured Book*, Chapter 5, p. 112 (discussing CG 20 10 11 85). *See also*, *Time Warner*, 1998 U.S. Dist. LEXIS 19460 at *25–26. There is no coverage for liability totally unrelated to the named insured's work. *Id.* at *26.

In *Acceptance Ins. Co. v. Syufy Enterprises*, 69 Cal.App.4th 321 (1999), the court addressed the scope of the insurer's duty to indemnify its additional insured with respect to liability "arising out of" the named insured's work. As noted above, this language is contained in the 2010 endorsement as well as other commonly used additional insured endorsements. The court found that the language "arising out of" "broadly links a factual situation with the event creating liability, and connotes only a minimal causal connection or incidental relationship." *Id.* at 328.

Thus, the *Syufy* court held that an additional insured is covered without regard to whether the injury was exclusively caused by either the named insured or the additional insured. *Id.* at 330. As a result, the court specifically rejected the insurer's contention that the additional insured is only covered for vicarious liability emanating from acts of the named insured.¹⁷

In contrast, the court in *National Union Fire Ins. Co. v. Nationwide Ins. Co.*, 69 Cal.App.4th 709 (1999), made findings regarding the duty to indemnify pursuant to a form "4190" additional insured endorsement. This endorsement only provided coverage for the additional insured to the extent that the additional insured was "held liable" for the acts or omissions of the named insured. In *National Union*, the court noted, and it was apparently conceded, that the indemnity language limited coverage to the vicarious liability of the additional insured. *See also*, *Container Corp. of America v. Maryland Cas. Co.*, 707 So.2d 733 (Fla. 1998) (where an endorsement utilizes specific language limiting coverage to the vicarious liability situation, it will be enforced).

The decisions in *Syufy* and *National Union* make it abundantly clear that the specific wording of additional insured endorsements is of great importance. The particular language used in the endorsement will ultimately decide whether or not the additional insured's coverage is limited to its vicarious liability for the fault of the named insured.

As most construction defect lawsuits allege claims for damages occurring after the completion of the subject property, developers should be extremely careful that the coverage that is being obtained includes coverage for completed operations. Insurers must also recognize whether the endorsements that they issue provide coverage for completed operations. Failing to recognize the coverage that is actually provided can be an expensive

¹⁷The *Syufy* court also noted that the insurer could have utilized "clearly limited" language and chose not to do so. *Id.* at 330.

proposition for both insurers and insureds. For instance, in *Pardee Construction Co.*, *supra*, the court rejected the additional insurers' claims that the 2010 and like endorsements supplied to the developer were not intended to provide completed operations coverage. *Pardee*, 77 Cal.App.4th at 1356-1360. The result of the *Pardee* case was to remand the matter to the trial court for further consideration of the developer's bad faith claims arising from the insurers' failure to defend.

VII. BAD FAITH AND THE ADDITIONAL INSURER.

When an insurer fails to act in good faith and thereby injures its insured, the insurer may be liable for consequential and punitive damages pursuant to its breach of the implied covenant of good faith and fair dealing. If an insured brings an action to obtain policy benefits wrongfully withheld by the insurer, the insurer may also be liable for attorney fees incurred by the insured to obtain these policy benefits in the coverage action. *Brandt v. Sup. Ct.*, 37 Cal.3d 35 (1997).

Like the duties to defend and indemnify, the duty of good faith and fair dealing applies equally to additional insureds. In *Campbell v. Superior Court*, 44 Cal.App.4th 1308, 1319 (1996), the court held that an insurer breaches the implied covenant of good faith and fair dealing if it unreasonably fails to defend its additional insured.

In *Campbell*, a general contractor was an additional insured on a subcontractor's CGL policy. The additional insured endorsement provided coverage to the general contractor for liability arising out of the work of the subcontractor. The insurer provided a defense to its named insured subcontractor. However, the insurer failed to provide a defense to its additional insured general contractor. The court ultimately held that such conduct supports a prima facie case of bad faith against the additional insurer. Likewise, in *Shell Oil Co.*, *supra*, 44 Cal.App.4th 1633 (1996), the court held that the additional insurer's duty of good faith and fair dealing in paying policy benefits applies equally to its additional insured.

The failure of an insurer to treat additional insureds in conformity with its internal guidelines and established state regulations will certainly be admissible evidence in any subsequent bad faith case. Further, if multiple insureds are involved in the same litigation, separate adjusters and "Chinese walls" may be required to handle the claims. Such division of claims handling is required to prevent one person from having any measure of control over the defense of insureds with conflicting interests. In any event, claims handlers must take care to protect the interests of each insured under their charge.

VIII. CONCLUSION.

The long-standing insurance law principles regarding an insurer's duty to defend and indemnify its insured also apply to an additional insured developer. When a potential for coverage exists in multi-party construction defect cases, insurers' first priority must be to make sure that their named insured subcontractor and additional insured developer are treated equally through the provision of an immediate and complete defense. The additional insurer should work with the developer and its other insurers to fund the defense and indemnity based upon principles of contribution. However, intra-insurer disputes should never prejudice the insured. An insurer who unreasonably fails to defend or indemnify its additional insured may be liable for the breach of the implied covenant of good faith and fair dealing.

Likewise, the additional insured developer is well advised to take preemptive measures to minimize risks and avoid costly coverage litigation. This may be accomplished by instituting risk management procedures that ensure compliance with subcontractor insurance requirements. Additionally, the additional insured developer must recognize its own obligations to its additional insurers and be willing to work with them to the common goal of reducing ultimate liability exposure.

In sum, knowledge and cooperation on the part of the additional insured and insurer are the keys to a more cost efficient mechanism for handling construction defect claims.