

CONSTRUCTION DEFECT SEMINAR***SIRS AND DEDUCTIBLES/
RESULTANT DAMAGE***

Presented by

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Mr. Meredith is a presenter for Monday's all-day seminar, "Construction Defect." He formed his own insurance coverage practice in Larkspur, California, in September 1991, after serving as partner in the San Francisco firm of Farella, Braun & Martel. He practices exclusively in the area of insurance coverage, with a primary emphasis on general liability coverage issues. The majority of his practice involves the insurance coverage available for construction defects.

Mr. Meredith is most widely known for his expertise in the area of construction defect coverage. This extensive coverage experience includes his successful argument before the Fourth District Court of Appeal in *Maryland Casualty Co. v Reeder*, 222 Cal App 3d 961 (1991), on behalf of the insureds. The Court of Appeal affirmed the breadth of the coverage provided to developers and general contractors through broad form property damage coverage in commercial general liability insurance policies. The opinion is generally regarded as a landmark decision concerning such coverage. Shortly thereafter, Mr. Meredith argued similar broad form property damage coverage issues before the Second District Court of Appeal in *State Farm v Dean* on behalf of the insureds, and again prevailed against the insurers in an unpublished opinion.

Mr. Meredith has developed substantial contacts with insurer representatives and outside counsel. Local Special Masters often refer clients to him for assistance in raising the insurer contributions required to settle major litigation. In addition, Mr. Meredith has served as Special Master and mediator in numerous Northern California cases involving insurance disputes.

Mr. Meredith has participated in more than 200 settlements of major construction litigation as coverage counsel for the developer or general contractor. His primary function in such cases is to work with the insurers and defense counsel to maximize the insurer funds available for the ultimate resolution of the action. This includes working with the insurers for subcontractors and others who provide additional insured or contractual indemnity coverage. Mr. Meredith is well known and respected by the insurers and is often able to use his reputation to establish shortcuts to the desired goals.

Notes

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SIRS & DEDUCTIBLES/RESULTANT DAMAGE

**Craig S. Meredith
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I. Self-Insured Retentions and Deductibles

- A. Introduction
- B. Deductibles—characteristics and operation
- C. Self-insured retentions—characteristics and operation
 - 1. Cautionary note—read the endorsement!
 - 2. Sample forms with focus on different characteristics
- D. Key issues in the construction defect context
 - 1. Multiple deductible or self-insured retention obligations
 - a. Per claim
 - b. Per project or building
 - c. Per occurrence
 - 2. Who must satisfy?
 - a. Named insured
 - b. Additional insured
 - c. Claimant/Developer
 - d. Developer's self-insured retention paid by additional insured contributions
 - 3. Insolvent insured with a self-insured retention

- 4. Impact of multiple deductibles and self-insured retention's on contribution rights
- 5. General contractor claiming additional insured rights under subcontractor policies; who must pay the subcontractor's self-insured retention?

II. Resultant Damage

- A. Introduction
- B. Insured's burden to establish claim within insuring agreement
- C. "Property damage" as defined in policy
 - 1. First prong--physical injury to tangible property, including loss of use
 - 2. Second prong--loss of use of undamaged property
 - 3. Property damage within the policy period
- D. Property damage issues
 - 1. The need for resultant damage
 - 2. The "pure defect" and the incorporation doctrine
 - 3. Damage during repair
 - 4. Loss of use during repair
 - 5. Prophylactic versus mitigative repairs

Notes

SIRS & DEDUCTIBLES/RESULTANT DAMAGE

Construction defect litigation is one of the most troublesome problems faced by developers and contractors, especially those involved in residential construction. Because most developers and contractors carry some form of general liability insurance covering the complete operations risk, construction defect litigation also involves difficult insurance coverage issues that must be resolved during the course of the underlying construction defect litigation. Two disputes arise with some frequency: disputes surrounding the payment of any applicable deductibles or self-insured retentions; and disputes pertaining to the existence of “resultant damage” that would constitute “property damage” as that term is used in a standard general liability policy.¹

SELF-INSURED RETENTIONS AND DEDUCTIBLES

Introduction

Deductibles and self-insured retentions represent the insured’s obligation to contribute toward a covered claim. While 15 years ago it was typical for developers and general contractors to have deductibles as small as \$1,000 per occurrence, deductibles and SIRs of \$250,000 to \$1 million per occurrence are now typical. In “continuous trigger” states, where multiple policies may be triggered by a single construction defect claim, the issue of whether multiple deductibles or self-insured retentions must be paid by the insured has become extremely significant. It is important that any disputes pertaining to these issues be resolved as early in the claim as is possible.

It is extremely important to understand that deductibles and self-insured retentions are most often addressed in specially drafted endorsements to the policy. For the most part, carriers who insure developers and general contractors do not use standard forms for the deductible or self-insured retention obligation, instead employing their own favorite manuscript forms. It is accordingly extremely important to read very carefully the deductible or self-insured retention endorsement for each and every policy that is potentially triggered by the construction defect claim. In a claim involving multiple years of coverage, you may find that there will be several different types of obligations pertaining to deductibles or self-insured retentions.

Deductibles—Characteristics and Operation

The key distinguishing feature of a deductible is that it is payable by the insured at the end, rather than at the beginning, of the claim. An insured with a deductible, as opposed to a self-insured retention, has what is commonly referred to as “first dollar coverage”. In other words, the insurance carrier must begin paying defense cost from the beginning of the claim. Any deductible will be assessed to the insured only after the claim is fully and finally concluded.

Again, it is important to read the deductible endorsement carefully. Some endorsements entitled “Deductible” actually assess a self-insured retention, because on close reading you will note that the deductible amount is due at the beginning, rather than at the end, of the claim. (Similarly, some “self-insured retention endorsements” assess the retention amount at the end of the claim, and are accordingly truly deductibles rather than “self-insured retentions”).

¹These disputes would be resolved in accordance with the actual language of the policies triggered by the claim and with the applicable insurance law of the state whose laws govern the insurance dispute. It is impossible to predict the outcome of these disputes in every state, with every conceivable variation of insurance language, in a paper of this length. Instead, I will simply be discussing several key issues that commonly arise in construction defect coverage disputes and providing some of the arguments made on either side of the issue.

For the last approximately ten years, the liability policies insuring most builders contain self-insured retentions rather than deductibles. I will accordingly spend most of these materials on self-insured retention issues. Please note that many of the issues addressed below pertaining to self-insured retentions (e.g., multiple self-insured retentions, who must pay, etc.) apply equally to deductibles.

Self-Insured Retentions

Self-insured retentions obligate the insured to pay the “first dollars” expended in a construction defect claim. There are many different types of self-insured retention endorsements, and each contains its own peculiar characteristics and requirements. *It is accordingly very important to read very carefully any and all self-insured retention endorsements that potentially apply to any given claim.*

Most, but not all, self-insured retentions provide that the self-insured retention can be satisfied through the payment of claims or defense costs. Thus, in a typical construction defect claim, the insured satisfies its self-insured retention by paying the earliest of the attorney and expert bills. Once the insured can demonstrate that it has satisfied the self-insured retention amount through payment of these defense invoices, the insurance carrier will assume the defense of the case and begin paying defense costs over and above the self-insured retention amount.

As noted above, there are many different types of self-insured retention endorsements. The following is a sample of different types of self-insured retention requirements:

- Self-insured retention applies on a “per occurrence” basis

Typically, “occurrence” is not redefined in the SIR endorsement, and accordingly the definition found in the standard CGL form applies. In a claim involving many homes within a development that suffer from the same or similar types of construction defects, most carriers recognize that the claims arising from the multiple homes constitute a single occurrence.

- Self-insured retention applies “per claim”

Many self-insured retention endorsements provide the option for applying the self-insured retention amount on a “per claim” basis. This could be very significant in certain types of claims. For example, many of these endorsements expressly state that in claims involving multiple-homes, the claim of each homeowner constitutes a separate “claim” and requires the application of a separate self-insured retention amount. If the builder has a significant “per claim” SIR applying on a “per claim” basis, it may be that all but the most serious claims will be resolved entirely within the SIR amount.

- “Indemnity only” self-insured retentions

Endorsements providing for “indemnity only” self-insured retentions typically state that the insured can pay its SIR only toward indemnity and not toward defense costs. Policies with “indemnity only” self-insured retentions typically do not require that the carrier participate in the defense of the claim. Under such endorsements, the insured must pay the entire cost of the defense and can only pay its self-insured retention once the claim is settled or a judgment is paid. Typically at that point, there is a proration of defense costs, and the carrier will reimburse the insured for defense costs in proportion to the amount paid by the carrier and the amount paid by the insured toward indemnity.

- Self-insured retentions applying differently to different types of construction

Some self-insured retention endorsements recognize that certain types of construction involve a greater risk of litigation than others. For example, some endorsements provide that there will be a \$50,000 self-insured retention for claims involving single-family dwellings, but a \$300,000 SIR for claims involving condominiums. Other endorsements provide that the self-insured retention for

single-family dwellings applies on a “per occurrence” basis but claims involving condominiums or town homes apply on a “per building” basis.

- Self-insured retentions with aggregates or maintenance aggregates

Self-insured retentions applying on a per occurrence or per claim basis may include a cap in the form of a self-insured retention aggregate. For example, the endorsement may provide that the self-insured retention is \$100,000 per occurrence, but \$300,000 in the aggregate. Thus, if the insured has had multiple claims within a single policy year and has aggregated SIR payments of \$300,000, there will be no further SIR obligation under that policy. Some endorsements, however, provide for a smaller “maintenance” self-insured retention that must be paid even after the annual aggregate self-insured retention amount has been satisfied. For example, the endorsement may provide that after the \$300,000 aggregate SIR has been satisfied, subsequent claims will trigger a \$10,000 “maintenance” self-insured retention.

Self-Insured Retentions in the Construction Defect Setting

As was previously mentioned, self-insured retention endorsements often raise issues and disputes that must be resolved quickly. This is especially true where the self-insured retention is satisfied in the payment of defense costs. Unless any self-insured retention disputes are resolved early in the claim, there will be no clear understanding as to how defense costs are to be paid on a timely basis.

Some of the key issues are as follows:

- Is the *insured* required to pay *multiple* self-insured retentions?

In “continuous trigger” states, the typical construction defect case can trigger many policy years. In California, where the statute of repose for construction defects is ten years, a construction defect claim can involve ten separate policy years, each of which may have a different type of SIR endorsement. The question often arises as to whether the insured must pay more than one SIR in order to trigger the obligations of the participating carriers.

In recent years, many insurance carriers have attempted to address this issue with express language in the self-insured retention endorsement. Historically, however, most SIRs applied on a “per occurrence” basis. The definition of occurrence found in the Standard Commercial General Liability Policy is as follows:

“Occurrence” means an accident, including continuous or repeated exposure to substantially the same general harmful conditions”.

Based upon this definition, the courts in many states have held, that where a self-insured retention applies on a “per occurrence” basis, the insured is required to pay only a single self-insured retention, even where multiple policy years are involved. In those states, the insured may tender the claim to any one of the carriers whose policy is triggered by the claim, and pay that policy’s SIR amount. That insurance carrier is then required to respond to the claim, although it may seek equitable contribution from the other carriers whose policies are triggered by the claim.

Some insurance companies contend that this was not their intent in requiring a self-insured retention on a per occurrence basis. Some of those carriers are attempting to resolve this issue through drafting new self-insured retention endorsements that expressly state that the self-insured retention for that particular policy must be paid regardless of whether self-insured retentions on previous policies have been satisfied in the same amount.

- *Who* must pay the self-insured retention amount?

Some insurance carriers take the position that the self-insured retention can be satisfied only by the named insured under the policy. Unfortunately, many self-insured retention endorsements do not spe-

cifically address the issue of who must pay the self-insured retention amount. In fact, many self-insured retention endorsements state that the self-insured retention amount is satisfied once it has been "incurred" in defense costs, and there is no reference as to who must have paid that amount or even whether it must actually have been paid.

This issue often arises where the developer or general contractor has been named as an additional insured under insurance policies issued to the subcontractors who worked on the job. Assume that a developer with a \$500,000 self-insured retention, applicable to the defense costs, tenders the claim to all of the 50 subcontractors that performed work on the job. Assume further that the subcontractor carriers acknowledge their obligation to defend and are prepared to provide a defense to the developer on a first dollar basis. Unless the developer's own policy expressly states that the self-insured retention can be satisfied only through a payment by the named insured, the developer can take the position that it has satisfied the self-insured retention once the *subcontractor carriers* have paid the total sum of \$500,000.

Again, many insurance carriers have argued that this was not their intent and that the self-insured retention must be paid by the named insured. Some of these carriers have redrafted their self-insured retention endorsements to state this requirement expressly.

- What happens when the named insured is insolvent?

Some self-insured retention endorsements provide that the payment of the self-insured retention by the named insured is a condition precedent to the obligations of the insurance carrier. What happens when, as is often the case, the general contractor is no longer in business when the claim arises and, accordingly, there is no named insured to pay the self-insured retention amount. Some insurance carriers have argued that this would absolve them from any obligation to participate in the claim because the "condition precedent" of the self-insured retention payment cannot be satisfied. This would seem, however, to violate the following provision, which is not only found within most insurance policies, but is also found in the Insurance Code of most states:

"Bankruptcy or insolvency of the insured or of the insured's estate will not relieve us [the carrier] of our obligations under this Coverage Part".

Under this provision, it seems doubtful that the insolvency of the insured, resulting in its inability to satisfy the SIR amount, will relieve the carrier of its obligations under the policy. Instead, it seems more likely that the claimant would still be able to assert its claim against the carrier for satisfaction of the judgment against the insolvent builder. The claimant, however, would in all likelihood recover only those amounts in excess of the applicable SIR.

RESULTANT DAMAGE

Introduction

Another dispute that frequently arises between builders and their carriers in connection with construction defect litigation involves what carriers often refer to as the "resultant damage" issue. Carriers argue that they do not provide coverage for the repair of a construction defect that has not in turn resulted in damage to other parts of the building. For example, assume that the electrical wiring within an apartment building is determined to violate the applicable electrical codes and that the defective wiring poses a risk of fire. Assume, however, that no fire has yet occurred. Most insurance carriers would characterize the electrical wiring as a "pure defect" that has not yet resulted in "resultant damage" and would deny coverage for this claim.

Typically, the insurance carriers base their argument on the definition of “property damage” found in the standard Commercial General Liability Policy. This definition is as follows:

“Property Damage” means:

- (a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
- (b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the “occurrence” that caused it.

Based upon the language found in subparagraph (a), insurance carriers would argue that while the faulty electrical wiring may well be a defect, it has not yet resulted in “physical injury” to the home and therefore does not constitute “property damage”.

This is a very significant issue to a builder. The repair of defects like the faulty electrical wiring can be very costly. Additionally, in most states it is the insured’s burden to prove that the claim falls within the insuring agreement of the policy, and this burden must be carried before the burden shifts to the carrier to prove the application of one or more of the exclusions found within the policy. Proving the existence of “property damage” is an element of proving that the claim falls within the insuring agreement, so it is important that builders be prepared to demonstrate that property damage has occurred.

Arguments That Property Damage Has Occurred

- The Incorporation Doctrine

In some states, courts have held that the incorporation of a defective element into a building constitutes a “physical injury” as that term is used in the definition of “property damage”. This is especially true where the defective element is difficult to access during repair. For example, where the defective element is the water pipes found within a home’s floors, walls and ceilings, courts have held that the incorporation of defective pipe into the building can constitute property damage. On the other hand, where the defective element was exterior wood siding, courts have held that this does not constitute property damage because the exterior siding could be removed relatively easily without significant damage to other portions of the building.

Whether a court will recognize incorporation of a defective element as property damage depends on several factors. One important factor is the certainty with which the defective element will fail. For example, if the insured can demonstrate that the failure rate for a defective furnace is, over a given period of time, virtually 100%, it is more likely that a court would find that the incorporation of the defective furnace constitutes property damage. If, on the other hand, the insured demonstrates that galvanized pipe manufactured by a certain manufacturer fails only on a 20 or 30% basis, the court may be less likely to find that the incorporation of any and all pipe manufactured by that manufacturer is property damage.

Another important factor is whether the particular defect involves a life/safety risk. Some courts have indicated that they would be more likely to find that the incorporation of a defective element involves the risk of bodily harm (as with a defective electrical system likely to cause a fire) than where no such bodily harm is at risk (defective hardboard siding).

- Damage During Repair

Some defects that have not yet resulted in damage to other portions of the home may be very difficult to repair. The repair of the defect itself, however, may involve very significant damage to the home. For example, assume that the contractor failed to install and properly nail plywood shear panels at key locations within the home. Installing these panels after construction is completed may involve such things as removal of kitchen cabinets and appliances, removal of sheetrock, damage to or destruction of fin-

ished surfaces such as flooring or countertops, and other similar damage. This constitutes very serious “physical injury” to the home, but the injury results from the repair of the defect and not from the defect itself.

Arguing that the damage during the repair constitutes the physical injury required by the “property damage” definition raises the issue of when that damage occurred and which policies are triggered by the damage. The insuring agreement of the standard Commercial General Liability Policy states that the policy applies only to “property damage” that occurs *during the policy period*. If the only physical injury arising from the construction defect is the injury that occurs during the repair, this injury would occur in most cases only after the claim has been resolved and the claimant performs the repair using funds obtained in settlement or through judgment. It seems unlikely that a builder’s policy in effect after a claim has been resolved would be the one triggered by the claim. Accordingly, if courts are to recognize that the damage during repair constitutes physical injury, it seems that they will necessarily have to recognize additionally that the very existence of the defective element in the building was a continuous injury occurring since the date of original construction so that earlier policies will be triggered by the claim.

- Loss of Use

You will note that the definition of “property damage” includes the concept of coverage for loss of use of the property. Under subheading (a), there is coverage for loss of use of property that has been physically injured or destroyed. Under subheading (b) there is coverage for loss of use of tangible property that has not been physically injured. The repair of defective elements of the building is often so substantial that the homeowners are required to move out of the home during the repair. Such homeowners often make claims for the loss of use of the home during the repair.

Note that under subsection (b), the loss of use of property not physically injured is deemed to have occurred at the time of the occurrence that caused it. This would arguably trigger policies in effect during the period of construction.

- Prophylactic v. Mitigative Repairs

Some states have held that there is coverage for the repair of a defect where the repair is necessary to mitigate further damage of the same type that has already occurred. There would not be coverage, however, for the purely “prophylactic” repair of a defect that has never resulted in damage.

An example would be helpful. Assume that a particular manufacturer of galvanized pipe, used for the fresh water supply within a home, is found to have distributed defectively manufactured pipe for a period of five years. Assume that this pipe was installed in thousands of homes within a particular state over that five-year period. The pipe is virtually certain to fail over time, resulting in severe water damage to the home. The failure rate, however, is three to six years after construction.

Assume further that seven years after the manufacturer started distributing the pipe, several lawsuits have been filed rising from actual failures in the homes that received some of the earliest of the pipe distributed within the state. These lawsuits are followed by others filed by the owners of the later homes, in which the homeowners claim that, while the pipe within their homes has not yet failed, it is virtually certain to fail within the next two to three years. These homeowners are accordingly demanding the replacement of the pipe even though they have not yet suffered any water leaks resulting from the defect.

In this situation, there should be coverage for the replacement of all of the pipe, even in those homes where leaks have not yet occurred. This is because the replacement of the pipe in the later homes is required to mitigate further damage of the same type that has occurred in the earlier homes and that is virtually certain to occur in the later homes in the next two to three years.

Courts might reach a different conclusion, however, if the defect in the pipe had been discovered before it had ever resulted in a water leak within *any* home. Courts may argue in that situation that the replacement of the defective pipe is purely “prophylactic” because no physical injury other than the installation of the defective pipe has yet occurred.

CONCLUSION

Deductibles, self-insured retentions and “resultant damage” issues can lead to very serious disputes between builders and their insurance carriers. Resolution of these issues requires a detailed analysis of the relevant policy language on all potentially applicable policies; a firm grasp of the insurance related legal precedent in the state whose law will apply to the claim; and a detailed understanding of the precise nature of the defects and damage involved in the claim. Given the complexity of construction defect litigation and the insurance coverage issues arising therefrom, many of the disputes are not resolved with certainty by either the policy language or the applicable legal precedent. In such instances, it is important to make every effort to resolve disputes between the builder and its carriers through compromise, as early in the claim as is possible. Only through such compromise resolution can the builder and its carriers then join forces to effectively and economically handle the claim, without the distraction of actual or threatened insurance litigation.