ONE HOUR CLE CREDIT

YOU CAN RUN BUT YOU CAN'T HIDE:
OVERCOMING EVASIVE ACTIONS BY INSURERS IN CONSTRUCTION DEFECT CLAIMS

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Sometimes it seems insurers will do anything to avoid paying a claim. This is especially true in construction defect claims. Although insuring agreements in commercial general liability (CGL) policies state that the insurer will pay all sums the policyholder is liable to pay because of property damage caused by an occurrence,[1] insurers qualify this promise with numerous policy exclusions meant to eliminate coverage. And sometimes during the claim-handling process, insurers engage in tactics that appear calculated to obstruct the insured's ability to enforce its right to coverage.

Despite these efforts, obtaining coverage is often possible. Here are a few pointers for overcoming evasive actions by insurers responding to construction defect claims:

EVASIVE ACTION NO. 1: My layer of insurance isn't triggered because the money paid by the underlying insurer to exhaust its limits was for non-covered claims.

Developers and contractors often purchase multiple layers of insurance. When the money available to pay claims in a primary CGL policy is exhausted, then the first-layer excess liability policy drops down and provides coverage. This excess insurer, in an effort to avoid its obligation to defend or indemnify its insured, may argue that the primary insurer paid out its policy limits for non-covered claims and, therefore, its policy is not exhausted.

The prevailing view, however, is that the excess insurer can only challenge exhaustion of the underlying policy if the excess policy's exhaustion provision specifically requires exhaustion by covered claims. (*See Dresser Ind., Inc. v. Underwriters at Lloyds, London*, 106 S.W. 3d 767, 769 (Tex. Ct. App. 2003)). If the policy language merely indicates that the excess coverage applies after underlying insurance has been exhausted, then the excess insurer cannot challenge exhaustion.

EVASIVE ACTION NO. 2: This class-action construction defect lawsuit constitutes many, many occurrences, making it impossible for you to exhaust your self-insured retention.

Most CGL policies contain a self-insured retention, requiring the policyholder to bear a portion of a loss before the insurer's obligations under the policy arises. These self-insured retentions generally require that the policyholder bear a set amount (e.g., $25,000) for each occurrence.

In construction defect cases, insurers sometimes argue that each alleged defect, home or instance of faulty work constitutes a separate occurrence. Thus, insurers require payment of self-insured retentions for each of these separate occurrences. Insurers know that this would likely render insurance coverage illusory. Because most construction defect cases involve numerous defects, homes and subcontractors performing work, treating each defect, home or instance of faulty work as a separate occurrence would shift most, if not of all, of the risk of loss back to the insured.

Fortunately, most courts reject the insurer's argument. For example, one court held that, "When all injuries emanate from a common source or process, there is only a single occurrence for purposes of policy coverage. It is irrelevant that there are multiple injuries … [T]here can be multiple contributing conditions, yet only a single occurrence." (*State v. Cont'l. Ins. Co.*, 88 Cal. Rptr. 3d 288, 315–166 (Cal. Ct. App. 2009)).

EVASIVE ACTION NO. 3: I'm sorry, but the severe, crippling corrosion of this component, installed by your subcontractor, resulting in its failure to perform, does not constitute property damage.

CGL policies define property damage as physical injury to tangible property, or loss of use. Nevertheless, insurers sometimes argue that there is no property damage unless a damaged component caused damage to another component. This is because CGL policies often contain a "your work" exclusion, which excludes from coverage any property damage arising from the policyholder's own work.

There are many problems with this argument. For instance, the definition of property damage does not require damage to other components. All that is required is physical injury to tangible property, or loss of use.

By grafting the "your work" exclusion into the definition of property damage, insurers attempt to escape the task of proving that the exclusion applies. In insurance law, a policyholder bears the burden of showing that a claim may involve covered property damage; meanwhile, in order to deny coverage based on a policy exclusion, the insurer bears the heavy burden of providing conclusive evidence.[2] Thus, to rely on the "your work" exclusion, the insurer must present conclusive evidence, proving the absence of any potential for damage to other components.

To escape this heavy burden, insurers argue that the definition of property damage requires damage to other components. This argument disguises the fact that they are actually relying on the "your work" exclusion, for which they bear the burden of proof. Insurers hope that, by relying on this altered (and incorrect), definition of property damage, they can shift the burden of proving that there is damage to other components from themselves to the policyholder. This is wrong. The policyholder only needs to show a potential for property damage.[3]

EVASIVE ACTION NO. 4: No, I'm not going to reimburse you for the cost of settling this case, because you can't prove how much of the settlement was for covered claims.

When an insurer fails to provide the policyholder with a defense, and the policyholder eventually settles the construction defect claim, the insurer is presumptively on the hook for the entire settlement amount. (*Axis Surplus Ins. Co. v. Glencoe Ins. Ltd.*, 139 Cal. Rptr. 3d 578, 586 (Cal. Ct. App. 2012) ("The settlement and the amount of the settlement are … presumptive evidence of the insurer's liability and the amount of liability. … [T]he settlement is presumed to be made for only damages covered under the applicable policy.")). Likewise, if the settlement contains an allocation, the allocation is binding on the insurer, absent evidence of fraud or collusion. (*Howard v. Am. Nat. Fire Ins. Co.*, 115 Cal. Rptr. 3d 42, 72 (Cal. Ct. App. 2010)).

EVASIVE ACTION NO. 5: No, I'm not going to show you my claim file, or explain why I denied your claim, because my claim handler is a lawyer and everything my lawyer does is privileged.

When denying a claim, insurers must explain why they denied the claim. (NRS 686A.310(1)(n); NAC 686A.675). This gives the policyholder a chance to challenge the denial.

However, some insurers will use the attorney-client privilege as a shield to avoid explaining why they denied a claim. They may argue that because they use attorneys in their claim-handling process, everything the attorney does, including traditional claim-handling activities, is privileged. This is incorrect.

Courts generally will not sanction this abuse of attorney-client privilege. First, claims handling is not primarily of a legal character and, as such, does not fall under attorney-client privilege. In other words:

> [T]he payment or rejection of claims is a part of the regular business of an insurance company. … Merely because such an investigation was undertaken by attorneys will not cloak the reports and communications with privilege … because the reports, although prepared by attorneys, are prepared as part of the regular business of the insurance company. (*Bertalo's Rest. Inc. v. Exch. Ins. Co.*, 240 A.D.2d 452, 454–55 (N.Y. App. Div. 1997)).

Second, by asserting that it relied on the advice of counsel to make its decision, the insurer may have waived the attorney-client privilege. (*See Aspex Eyewear, Inc. v. E'Lite Optik, Inc.*, 276 F. Supp. 2d 1084, 1092 (D. Nev. 2003); *see, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Lee*, 13 P.3d 1169, 1184 (Ariz. 2000) ("[The insurer] implicitly asserted the advice of counsel as a defense when it made its claim of good-faith conduct turn on its legal research and the resulting subjective legal knowledge of its claims managers at issue in the case and when that knowledge necessarily included the advice of counsel as part of the decision-making process.")).

EVASIVE ACTION NO. 6: No, you don't get to know whether I treat other policyholders with claims just like yours the same way, because how I handle other claims is none of your business.

An insurer cannot withhold evidence of how it interpreted and applied its policy in other similar claims. First, the insurer's prior acts and conduct are relevant to the parties' intent regarding the meaning of the policy at hand. (*Employers Reinsurance Co. v. Superior Court*, 74 Cal. Rptr. 3d 733, 745 (Cal. Ct. App. 2008)). Second, if the insurer treated one policyholder differently from other policyholders with similar claims, such disparate treatment would be evidence of bad faith. (*Campbell v. Superior Court*, 44 Cal. App. 4th 1308, 1321 (1996)). Third, if the insurer mistreated all policyholders with

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similar claims the same way, that pattern and practice is relevant to bad faith and punitive damages. (*Colonial Life & Accident Ins. Co. v. Superior Court*, 31 Cal. 3d 785, 790 (1982)).

Recognizing these evasive actions and understanding the strategies for overcoming them will help you and your clients get the coverage your clients purchased. ■

1. CGL policies generally define the term "occurrence" as "an accident."
2. *Atl. Mut. Ins. Co. v. J. Lamb, Inc.*, 123 Cal. Rptr. 2d 256, 272 (Cal. Ct. App. 2002) ("An insurer may rely on an exclusion to deny coverage only if it provides conclusive evidence demonstrating that the exclusion applies. … Thus, an insurer that wishes to rely on an exclusion has the burden of proving, through conclusive evidence, that the exclusion applies in all possible worlds.").
3. It is important to note that, because a remote potential for property damage triggers the insurer's duty to provide a defense to the policyholder, a careful review of the damage, along with some creative thinking, usually reveals the potential for damage to other components. *See Turk v. Tig Ins. Co.*, 616 F. Supp. 2d 1044, 1049 (D. Nev. 2009).

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