

III. The Liability Carrier's Response

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When a property owner (insured) reports a claim of a construction defect to a contractor, the contractor "tenders" the claim to its insurance carrier. Upon receipt of the initial tender, the insurance carrier must immediately decide whether to: (1) accept coverage; (2) deny coverage; or (3) determine that it does not have sufficient information to make a coverage determination and is thus still investigating the claim.

If the claim is accepted, meaning that it falls within a policy because it is the type of claim for which the policy was written, it falls within the policy period, and it meets specific conditions under the policy, then the company has two options: (1) the acceptance will be made as unconditional; or (2) the acceptance will be made under a Reservation of Rights. When a liability carrier reserves its rights, it has agreed to participate in the defense of the insured, but leaves open the possibility that not all of the damages sought in the lawsuit may be covered under the policy. If the carrier reserves the right to deny coverage for damages based on claims that can be controlled by the manner of the defense, the insured may be entitled to independent counsel, paid for by the insurer. (California Civil Code §2860(a)).

Alternatively, if the carrier can determine that the claim is not covered, it will decline entirely. In that event, the insured will need to retain counsel to defend itself. If the insured believes its tender was wrongfully denied, it can be reviewed through the California Department of Insurance at:

California Department of Insurance
Claims Services Bureau (Consumer Services Division)
300 South Spring Street, South Tower
Los Angeles, CA 90013
Tel: 1-800-927-HELP (4357) or 897-8921

Finally, if the facts are not clear, the liability insurance carrier also has the option to not make a coverage determination if it does not have sufficient information to do so at its disposal, by simply stating that they are still investigating the claim.

The policyholder should bear in mind that it will need to show facts that demonstrate that the loss falls within the insuring agreement, i.e., that there is “property damage” or a “bodily injury” that occurred during the policy period, and that the party seeking a defense qualifies as an “insured.” Once those facts are shown, the carrier has the burden to establish that an exclusion to coverage applies. *See, e.g., Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 300.

A. The Duty to Defend and the Duty to Indemnify

Liability insurance usually imposes two separate obligations on the insurer: (1) the duty to defend such claims against its insured (by furnishing competent counsel, and paying attorney fees and costs); and (2) the duty to indemnify its insured against third party claims covered by the policy (by settling such claims or paying any judgments against the insured).

1. The Duty To Defend

Generally, the duty to defend is broader than, and independent of, the duty to indemnify. *Horace Mann Insurance Co. v. Barbara B.* (1993) 4 Cal.4th 1076, 1081. An insurer “must defend a suit which *potentially* seeks damages within the coverage of the policy,” so long as the claim is of the nature and kind covered by the policy. *Gray v. Zurich Ins. Co.* (1966) 65 Cal.2d 263, 275. The presence of any potential recovery within scope of the policy obligates the insurer to defend, even if “the majority of any recovery” lies outside of coverage. *St. Paul Fire & Marine Insurance Co. v. Sears, Roebuck & Co.*

(9th Cir. 1979) 603 F.2d 780, 786. “The duty of an insurer to provide a defense is broad and applies when there is only a potential for coverage even if no covered loss is ultimately incurred.” Presley Homes v. American States Ins. Co. (2001) 90 Cal.App.4th 571, 574.

In California, there is a duty to defend if the lawsuit presents a “potential for coverage.” Unlike some jurisdictions, California states that the duty to defend arises from allegations contained within the complaint, as well as other information available to the insurer (i.e., extrinsic evidence). If the facts and circumstances of the loss suggest that there is a potential that the insured could be liable for a damage claim covered by the policy, there is a duty to defend. Montrose Chemical Corp. v. Superior Court, supra, 6 Cal.4th 287, 293-294.

However, the duty to defend is not unlimited. Where the carrier can demonstrate that the loss could not be covered by the policy, there is no duty to defend. Proof can be shown from information outside of the complaint itself. Montrose Chemical Corp. v. Superior Court, supra, 6 Cal.4th 287, 300 (emphasis added). Thus, for example, even if the complaint alleges a claim that would be covered by the policy, if extrinsic evidence demonstrates unequivocally that there could be no covered damage, the carrier need not defend. An example is the policy that specifies coverage for designated premises. If the complaint does not allege the location of the loss, and if the undisputed evidence demonstrates that the fall occurred at an uninsured location, there would be no duty to defend.

With regard to the “potential for coverage” and the scope of the duty to defend, California courts have stated that even the formal cause of action chosen by the plaintiff

is irrelevant. Prior to 1999, California recognized a distinction between obligations imposed in contract, and obligations imposed by law. Purely contractual obligations were not insured by a general liability policy, and thus did not trigger a duty to defend, because they were not damages imposed upon the insured “by law.”

In 1999, the California Supreme Court reversed this distinction, finding that the only relevant inquiry concerning whether an insured was “legally obligated to pay” was whether a court of competent jurisdiction was awarding damages. Thus, in a lease dispute between a landlord and tenant, the court found that there is a duty by the insurer to defend the landlord/insured because, aside from the contractual nature of the dispute, there were claims of “property damage” caused by an “occurrence.” Vandenberg v. Superior Court (1999) 21 Cal.4th 815.

2. The Duty To Indemnify

In contrast, the duty to indemnify arises at the conclusion of the case. If the insured is found liable for damages that are actually covered by the policy, the carrier has a duty to indemnify. Montrose Chemical Corp. v. Superior Court, *supra*, 6 Cal.4th 287. California courts find that these two duties, the duty to defend and the duty to indemnify, are distinctly different.

In sum, the duty to defend exists if there is any potential that the claimant could recover against the insured on a claim covered by the policy, regardless of how the claim is actually framed in court pleadings. The duty to indemnify exists if the actual basis of liability against the insured is covered by the policy.

3. “Arising Out Of”

In the construction setting, many insurance policies require that “liability “arise out of” a given circumstance. Common examples where this phrase is used would include the following:

- To be covered, liability of the additional insured general contractor must “arise out of” the work or “ongoing operations” of a particular subcontractor;
- To be covered, the incident must “arise out of” operations at a particular location;
- A loss is excluded under the general liability policy if it “arises out of” the ownership operation or use of an “auto.”

Commencing in 1999, the court in Acceptance Insurance Co. v. Syufy Enterprises (1999) 69 Cal.App.4th 321, gave great breadth to the “arising out of” phrase, finding, “this language does not import any particular standard of causation or theory of liability into an insurance policy. Rather, it broadly links a factual situation with the event creating liability, and connotes only a minimal causal connection or incidental relationship.” Id. at p. 328.

In Acceptance, a contractor’s employee was working on the roof of a building and was injured when he climbed through a hatch providing the only roof access. In the personal injury action filed by the employee, the building owner sought coverage under an Additional Insured Endorsement issued by the contractor’s Commercial General Liability (CGL) carrier.

The court found the liability to the building owner “arose out of” the work of the insured contractor and therefore the Additional Insured Endorsement applied to the

benefit of the building owner. The relationship between the defective hatch and the job was no more than incidental, in that the plaintiff could not have done the job without passing through the hatch. The fact that the defect was attributable to the building owner's negligence was irrelevant, since the policy language did not purport to allocate coverage according to fault.

The Acceptance case was reiterated in the case of Fireman's Fund Ins. Co. v. Atlantic Richfield Co. (2001) 94 Cal.App.4th 842. In Fireman's Fund, an employee of a construction company was injured during the course of work that the construction company was performing for an oil company, at the oil company's plant. The injury arose from the collapse of the step owned and maintained by the oil company. The employee brought a personal injury action against the oil company, and the construction company's insurer was found to have an obligation to defend the oil company as an Additional Insured under the construction company's insurance policy.

A year later, the court in St. Paul Fire & Marine Ins. Co. v. American Dynasty Surplus Lines Ins. Co. (2002) 101 Cal.App.4th 1038, reached a different result based upon a significantly different endorsement. There, the injured party was an employee of the Named Insured/subcontractor. He was working when a pipe explosion occurred, such exploding unrelated to his actions. This time the endorsement included the phrase "ongoing operations." It provided that the general contractor was an Additional Insured for claims arising out of the Named Insured's "ongoing operations." Id. at p. 1043. Alternatively, the indemnity agreement required indemnity for liability arising out of any "act or omission" of the subcontractor. Id. at p. 1044.

The St. Paul court held that the Named Insured's mere presence on the job was not sufficient to trigger the endorsement. It held that the Additional Insured Endorsement was ambiguous. Given that the indemnity agreement was narrow, the court found that the Additional Insured Endorsement should also be read narrowly. In other words, the court looked to the underlying contract to determine the meaning of the Additional Insured Endorsements, in particular, the phrase "ongoing operations." Finally, the same Court of Appeal that decided Acceptance rendered the Vitton Construction Co., Inc. v. Pacific Insurance Co. (2003) 110 Cal.App.4th 762 decision. In this case, the court did not specifically decide whether the "arising out of" language was ambiguous, but found that whether or not ambiguous in some circumstances, it clearly required only a "minimal causal connection" between the work and the injury. Vitton Construction Co., Inc. v. Pacific Insurance Co., supra, 110 Cal.App.4th at p. 767. That connection existed in Vitton, where the Named Insured created a hole, left it uncovered, and a roofer fell through it while he was working on the roof. This was a connection sufficient to trigger the broad language of the Additional Insured Endorsement, since the court used "common sense" to determine that plaintiff's fall "arose out of" the Named Insured's work.

B. Suit v. Claim

Under Commercial General Liability (CGL) policies, coverage is only triggered when a suit is filed against the named insured. For example, the Coverage Section of ISO Form CG 00 01 01 96, provides, in pertinent part, as follows:

We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. However, we will have no duty to defend the insured

against any “suit” seeking damages for “bodily injury” or “property damage” to which this insurance does not apply. We may, at our discretion, investigate any “occurrence” and settle any claim or “suit” that may result. [Emphasis Added]

California case law has stressed the distinction between a “suit,” which triggers an insurer’s duties under the policy, and a “claim,” which does not. In other words, the insurer is only required to pay for those sums that its insured is “legally liable” for. The logic behind this is that it ensures that the policy does not cover liability the insured voluntarily assumes, such as “good will” payments to a customer the insured is not legally obligated to make. See, e.g., Foster-Gardner, Inc. v. National Union Fire Ins. Co. (1998) 18 Cal.4th 857; Certain Underwriters at Lloyd’s of London v. Superior Court (Powerine Oil Co.) (2001) 24 Cal.4th 945; San Diego Housing Com’n v. Industrial Indem. Co. (4th Dist.1998) 68 Cal.App.4th 526.

Therefore, in some cases, it may actually be an advantage to have a “suit” presented, so as to trigger the insurance company’s defense obligation.

C. Voluntary Payments

An insured should be sure to notify their insurance company(ies) of all claims being made against it, especially when they become suits. When an insured makes a payment on its own behalf, before notifying its insurer of a suit against it, the insured may not be entitled to reimbursement of a so called “voluntary payment.”

The California court in Jamestown Builders, Inc. v. General Star Indemnity Co. (1999) 77 Cal.App.4th 341, addressed the issue of the application of voluntary payments clauses in insurance contracts. “California law enforces such no-voluntary-payments provisions in the absence of economic necessity, insurer breach, or other extraordinary circumstances.” Id. at p. 346. In this case, the court carves out a small exception when it

states “an insured may be able to avoid application of a no-voluntary-payments provision where the previous payments were made involuntarily because of circumstances beyond its control.” Id. at p. 348.¹

D. Primary v. Excess Coverage

Typically, an insured obtains two types of liability coverage, a primary layer and an excess layer. The excess layer is designed to provide coverage to the insured once its primary coverage has been exhausted. Often, there are multiple excess layers, starting with “umbrella” coverage, and additional layers extending the limits of coverage above the umbrella. Excess coverage should be obtained to protect the insured against large claims made against it.

Whether coverage is “primary” or “excess” is important to the policyholder because it will determine when their carrier has an obligation to respond, either immediately, or after the exhaustion (or payment) of other policies first.

Primary coverage is insurance coverage whereby, under the terms of the policy, liability attaches immediately upon the happening of the occurrence that gives rise to liability. (Oil Base, Inc. v. Transport Indem. Co. (1956) 143 Cal.App.2d 453, 467.)

“Primary insurers generally have the primary duty of defense.” Olympic Ins. Co. v. Employers Surplus Lines Ins. Co. (1981) 126 Cal.App.3d 593, 597. “‘Excess’ or *secondary* coverage is coverage whereby, *under the terms of the policy*, liability attaches only after a predetermined amount of primary coverage has been exhausted. It is not uncommon to have several layers of secondary insurance... Secondary insurance is

¹ The California court in Fiorito v. Superior Court (1990) 226 Cal.App.3d 433 held that when an insured is faced with a situation requiring an immediate response to protect its legal interest, the no-voluntary-payments provision may not apply. In that case, the insurers were permitted to try to prove they

sometimes referred to as ‘umbrella’ insurance. When secondary insurance is written to be excess to identified policies, it is said to be ‘specific excess.’” Id. at p. 589 (original italics).

Because all primary insurance must be exhausted before any excess carrier must respond, and because California follows the “continuous injury trigger of coverage” for “progressively deteriorating” property damage claims,” (Montrose Chemical Co. v. Admiral Ins. Co. (1995) 10 Cal.4th 645), coverage must be exhausted horizontally.

In other words, all of the “primary” insurance applicable to a single “occurrence” must be exhausted before there is any exposure to the “excess” or secondary layer of coverage. Once again, this is dependant upon the precise language of the policy, but it will be applied in the appropriate fact circumstances. Therefore, for example, in a soil subsidence case, where there was a single exhausted primary policy, the excess carrier had no obligation to defend or indemnify along with the insured’s other primary insurance. The policy language at issue stated that the umbrella policy applied in excess of the scheduled underlying policy and all other underlying policies providing coverage for the same “occurrence.” Community Redevelopment Agency v. Aetna Casualty and Surety Co. (1996) 50 Cal.App.4th 329.

However, the policy language is critical, and the court refused to apply “horizontal exhaustion” principals in in Travelers Casualty & Surety Co. v. Transcontinental Insurance Co. (2004) 122 Cal.App.4th 949. In that case, Federal Insurance Company had issued an excess policy which provided for two types of coverage. Coverage A simply extended the limits of the underlying policy. Coverage B

involuntarily incurred pre-tender defense costs in order to respond to a lawsuit and avoid a default judgment.

provided umbrella coverage in the event that there was a claim covered by the Federal policy, but not the underlying policy. The Court of Appeals, in reversing the Trial Court, found that while the Federal policy was “excess” or secondary, the precise language of the policy indicated that it indeed applied immediately upon the exhaustion of the scheduled underlying policy. In other words, Federal was not entitled to rely on the rule of horizontal exhaustion.

E. Policy Exclusions

It is the responsibility of the insured to bring a claim within the scope of the policy language, but once the claim is made within the policy, it is the duty of the insurer to then determine whether there are any applicable exclusions under the policy that would preclude coverage for the claim. Most policies have a myriad of exclusions, so below is a discussion of the most common exclusions; the J, K, L, and M Exclusions.

The CGL policy is not intended to operate as a guarantee that an insured contractor’s work will be constructed in a workman like manner and free of defects. The risk of having to repair or replace defective work is considered a risk of being in the construction business, distinct from the risk that construction work may injure or damage the property of a third party. See, e.g., Western Employers Ins. Co. v. Arciero & Sons, Inc. (1983) 146 Cal.App.3d 1027. To accomplish this distinction, the CGL policy incorporates so-called “business-risk” exclusions.

Exclusion “J” provides as follows:

j. Damage to Property

“Property damage” to:

(1) Property you own, rent, or occupy;

- (2) Premises you sell, give away or abandon, if the “property damage” arises out of any part of those premises;
- (3) Property loaned to you;
- (4) Personal property in the care, custody or control of the insured;
- (5) That particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the “property damage” arises out of those operations; or
- (6) That particular part of any property that must be restored, repaired or replaced because “your work” was incorrectly performed on it.

Paragraph (2) of this exclusion does not apply if the premises are “your work” and were never occupied, rented or held for rental by you.

Paragraphs (3), (4), (5) and (6) of this exclusion do not apply to liability assumed under a sidetrack agreement.

Paragraph (6) of this exclusion does not apply to “property damage” included in the “products-completed operations hazard.”

Exclusions J (5) and (6) negate coverage for “property damage” to that particular part of property on which the insured is performing work which directly results in damage to that property or to property which must be repaired or replaced because the insured’s work was performed on it incorrectly. These exclusions apply to damage that falls within the operations hazard.

While we are not aware of any existant case authority in California dealing with the interpretation of present day exclusions J (5) and (6), the case of Rafeiro v. American Employers Ins. Co., (1970) 5 Cal. App. 3d 799, construed an earlier version of those exclusions. The Rafeiro court found that a CGL policy was not intended to act as a contractor’s performance bond and would not indemnify a contractor “for direct damages resulting because the contractor furnished defective materials or workmanship.” Id., at p.

808. However, these exclusions are limited in scope to the particular part of the property being worked on when damage occurs and would not negate coverage for resulting damage to other building components.

Exclusion J (6) contains an exception to the exclusion which provides that the exclusion is not applicable to any damage included in the “products-completed operations hazard.” There is no existant California case authority on this point. However, the Court Of Appeals in South Carolina considered the issue in Laidlaw Environmental Service, Inc. v. Aetna Cas. & Sur. Co., (S.C. App. 1999) 524 S. E. 2d 847, and concluded that “when an insured abandons work on a project the insured has effectively ‘completed’ its work for that project, even if the project remains unfinished, thus invoking products-completed operations coverage.” Id., pg. 850.

Exclusions “K” and “L” are the product and work performed exclusions. Often, these are referred to as the “Work-Product” exclusion(s). These exclusions preclude coverage for property damage to the insured’s product, or to the insured’s work arising out of it or any part of it.

Exclusion “K” precludes coverage for “property damage arising out of work performed by an insured, the products of an insured, premises alienated by an insured and participation in a joint venture which was not itself named as an insured under the policy.” Maryland Casualty Co v. Reeder (1990) 221 Cal.App.3d 961, 966 at p. 975-976.

Exclusion “L” provides as follows:

1. **Damage to Your Work**
“Property damage” to “your work” arising out of it or any part of it and included in the “products-completed operations hazard.”

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

Exclusion “M” commonly known as the “impaired property” exclusion, has not been construed in any existing California case authority. However, the intent appears to be to negate coverage for delay damages caused by the insured’s refusal to perform work.

Exclusion “M” provides as follows:

m. Damage to impaired Property or Property Not Physically Injured

“Property damage” to “impaired property” or property that has not been physically injured, arising out of:

- (1) A defect deficiency, inadequacy or dangerous condition in “your product” or “your work”; or
- (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to “your product” or “your work” after it has been put to its intended use.

Under California Case Law, property damage to the insured’s product or work is generally considered an uncovered risk that the insured must assume as part of doing business, and a risk which the insured has the ability to control.

F. Appointment Of Independent Counsel v. Panel Counsel

As part of its duty to defend, the insurer must provide a full defense by competent counsel. That duty is breached when an insurer furnishes defense counsel whose ability to represent the insured is impaired by a disqualifying conflict-of-interest. In such cases, the insured is usually permitted to hire independent counsel, at the insurer’s expense. San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc. (1984) 162 Cal.App.3d 358. (*Cumis* counsel is counsel selected by the insured to represent its interests, and is paid for by the insurer in a conflict-of-interest situation.) A plaintiff is entitled to *Cumis* counsel

if a clear conflict-of-interest exists between the insured and the insurer, and the insured refuses to, or withdraws its consent to the representation provided by the insurer. *Id.* at p. 375.

1. California Civil Code Section 2860.

As a consequence of the San Diego (Cumis) decision, California Civil Code §2860 was codified in 1987 and states both that “a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage” and that a conflict exists where the outcome of a coverage issue may be controlled by counsel retained by the insurer for the defense of the claim.

In Gray Cary v. Vigilant Ins. Co. (2004) 114 Cal.App.4th 1185, the insured, as its own *Cumis* counsel, paid the legal fees incurred for third party counsel to represent its agent. When the insured sought reimbursement, the insurer denied the request on the ground that the agent was not an employee, and therefore not an insured under the policy. The insurer refused the insured's request to arbitrate the dispute under California Civil Code §2860(c). In affirming the denial of arbitration, the Court held that the dispute did not fall within the arbitration requirement of §2860(c), because it did not involve attorney fees as contemplated by that provision. It was conceded that the agent was not an insured covered by the policy, and the statute did not envision the arbitration of any disputes regarding attorney fees other than those incurred by independent counsel for the insured. The court also declined to read the term "attorney fees" as encompassing defense costs. The plain language of §2860(c) did not support this conclusion. While the insured correctly noted that an insurer was responsible for paying *Cumis* defense expenses and

attorney fees, the court did not believe the legislature intended parties to arbitrate disputes involving *Cumis* defense expenses.

2. Reliance Upon Policy Exclusions Does Not Necessarily Trigger A *Cumis* Conflict.

In the case of Blanchard v. State Farm Fire & Casualty Co. (1991) 2 Cal.App.4th 345, it was held that a *Cumis* conflict does not arise when an insurer accepts the defense, but points out that certain definitions and exclusions might limit the extent of damage which the insurer would indemnify.

In particular, the Blanchard Court evaluated the work-product exclusion in the policy and determined that by relying upon that exclusion, the insurer did not create a *Cumis* conflict. It should be noted that neither a prayer for punitive damages, nor a prayer for damages in excess of the policy limits, alone, trigger the right to independent counsel under California Civil Code §2860.

3. The Existence Of Both Covered And Uncovered Claims Does Not Create A *Cumis* Conflict.

The case of Dynamic Concepts, Inc. v. Truck Ins. Exchange (1998) 61 Cal.App.4th 999, held that an insurer in an action involving covered and uncovered claims is not automatically obliged to provide *Cumis* counsel.

4. The Insurer Cannot Rely Upon California Civil Code §2860 To Limit Post-Tender And Pre-Acceptance Fees Where There Is No *Cumis* Conflict.

The court in County of San Bernardino v. Pacific Indemnity Co. (1997) 56 Cal.App.4th 666 held that where there is no *Cumis* conflict, the insurer cannot use California Civil Code §2860 to limit the attorney's fees.

5. Reliance Upon The "Occurrence" Definition Is Considered To Trigger A *Cumis* Conflict.

If damage can be either attributable to a negligence cause of action or a cause of action with an intentional element, then it is arguable that defense counsel could act to determine coverage. Thus, a *Cumis* conflict arises.