BROWN BAG LUNCHEON: INSURANCE PRODUCTS, POLICY ANALYSIS, AND THE DUTY TO DEFEND

Presented by

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INTRODUCTION

This handout is submitted in conjunction with two brown bag luncheons on April 22 and 29, 2010, by Jeff Bolender, the managing shareholder of Bolender & Associates, A Professional Law Corporation.

Mr. Bolender, a member of the Construction Law Section of the Nevada State Bar, has been working with section members and other lawyers during 2009 and 2010 to prepare a one-day legal education seminar on behalf of the Construction Law Section. The current target date for that seminar is October 2010. The two brown bag luncheons are intended to provide an abridged version of the insurance related topics to be presented at the one-day seminar in October 2010.

This handout contains information provided by Mr. Bolender, as well as Kevin Stolworthy, Esq. of the law firm Jones Vargas, and Dennis Jones, Esq. of the law firm Myers, Widders, Gibson, Jones & Schneider, L.L.P. Additionally, the chair of the CLE subcommittee of the Construction Law Section, Tony M. May, Esq., of counsel at the law firm, Hansen Rasmussen, LLC, assisted with the organization and preparation of the brown bag luncheon.

CONSTRUCTION SPECIFIC INSURANCE PRODUCTS

Performance Bond

A performance bond is a bond issued by the insurance company to guarantee that contractors will complete a project as specified under the terms of their contract. The purpose of the bond is to guarantee the value of a contractor's work and provide debt security in the event of an unexpected event.

For example, if a subcontractor agrees to pour concrete for a construction project but is unable to complete its work, a performance bond executed in favor of the general contractor would ensure timely and satisfactory completion of the work to contract specifications by another subcontractor. See Zuni Constr. Co. v. Great Am. Ins. Co., 86 Nev. 364 (1970).

Payment Bond

A performance bond is a type of insurance purchased by a builder that protects both the bank and the owner by providing that the insurance company will be responsible for payments due to laborers and other parties who provided services for the building project.

Builder's Risk

Builder's risk insurance is a type of first-party property insurance usually purchased by the owner or general contractor to protect a construction project while it is under construction. Builder's risk insurance provides coverage for physical loss or damage to the insured's property during the construction period when caused by a covered event, such as fire, vandalism, wind, etc. Coverage typically extends through the construction period only and is replaced by either a commercial property policy (if the project is a commercial building) or a homeowner's policy (if the project is residential). This type of insurance generally does not provide coverage to subcontractors.

Commercial General Liability

The basic type of insurance most closely associated with construction defect litigation is commercial general liability insurance, commonly referred to as a "CGL policy." CGL policies provide insurance coverage for the legal liability of those entities and persons who qualify as insureds.

CGL policies provide two primary benefits: defense and indemnity. The defense benefit provides the insured entity or person, sometimes referred to herein as the policyholder, with a legal defense at the insurance carrier's expense. The indemnity benefit provides the policyholder with insurance protection for certain types of civil judgments (or a settlement to which the insurer consents). The contractual language in CGL policies place limitations on both the defense and indemnity benefits.

Owner Controlled Insurance Program

OCIP, or Owner Controlled Insurance Programs, are insurance policies (also sometimes known as wrap-up policies) taken out by the owner of the property where construction is taking place. Instead of each individual contractor securing his own liability and/or worker's compensation for the project, the owner secures an OCIP that covers all construction and contractors on the project.

An OCIP's basic features are: (1) the owner purchases insurance coverage to cover all contractors and subcontractors on a project; (2) there is an integrated owner-contractor managed safety program on the project; and (3) claims are processed centrally. Generally, the use of an Owner Controlled Insurance Program can save money on large projects through lower bulk insurance rates, improved safety management processes, and reduced disputes between contractors over who was responsible for a particular loss.

The owner pays for the insurance policy and the contractors are covered under that policy for that particular project, instead of each contractor being covered by insurance he has purchased himself.

The owner then looks to each contractor to credit back to him the cost of the insurance that the contractor would normally include in the bid as overhead costs. The owner requires the contractor to break his bid down and show how much of the bid is insurance costs.

OTHER INSURANCE PRODUCTS

Excess and Umbrella

The terms “excess” and “umbrella” are often used to characterize insurance that provides additional coverage beyond the underlying primary policies.

Generally, excess insurance provides coverage identical to an underlying primary policy. For example, and excess policy can provide an additional five million dollars of coverage, but only after the primary policy’s limit of one million dollars is exhausted. Such policies often follow the form of the underlying primary insurance—that is, the policy terms and limitations in the excess policy are the same or identical to the terms and limitations in the primary policy.

Umbrella policies also provide additional coverage after the all primary policy limits have been exhausted. Depending on the policy’s terms, umbrella policies may also provide coverage for losses that are not covered by the insured’s primary policies.

Errors and Omissions

Errors and omissions insurance, also known as professional liability insurance, provides coverage to professionals, such as architects, against third-party claims arising out of the alleged mistakes of the insured, its employees, or independent contractors. This type of coverage is important in that many standard CGL policies exclude coverage for claims arising out of an insured’s professional services.

Additionally, errors and omissions insurance may be relevant if a policyholder's insurance broker neglected to properly procure insurance. For example, if the policyholder instructs its insurance broker to add a general contractor as an additional insured, but the broker only procures a certificate of insurance, the broker may be subject to liability to the policyholder if the insurance carrier ultimately disclaims coverage as to the general contractor.

Fronting Policy

A fronting policy is an insurance policy where the insured pays a reduced premium for an insurance policy with a large deductible, usually equal to the policy's limits of liability. Additionally, an insured may agree to indemnify the carrier for any potential defense and indemnity costs the carrier expends because of its obligations under the insurance policy.

This type of policy is commonly used when an entity would like to insured itself, but cannot legally do so because, for example, the entity is contractually obligated to carry insurance. A fronting policy satisfies such insurance requirements because the insurance company is responsible for paying a loss covered by its policy. This type of policy also simultaneously satisfies the policyholder's interest in self-insuring because the insurance company will recoup all its costs either through deductibles or indemnification paid by the policyholder.

Risk Retention Groups

A risk retention group is an alternative risk financing tool in which similar businesses join together to share risks. These groups are controlled by their members and usually employ a regimented loss control and claims management process.

Self-Insurance Programs

In a self-insurance program, an entity sets aside a particular amount of money each month to cover the costs of a potential

claim, instead of paying premiums for insurance. These programs can either be kept in-house or through a third-party administrator. A self-insurance program enables the entity to become its own insurer: it retains control over the claims and expenses, but is also exposed to greater risk than if insured by a carrier.

INTRODUCTION

For purposes of construction defect litigation, coverage under CGL policies for property damage liability is the most important benefit. This section of the handout discusses the basic analysis for determining whether a claim for property damage falls within the insuring agreement.

The insuring agreement for Coverage A, Bodily Injury and Property Damage Liability, provides in pertinent part as follows:

> **1. Insuring Agreement**
>
> **a.** 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…

As reflected in the above-quoted insuring agreement, the insurance carrier promises to pay for damages because of bodily injury and property damage. The policy specially defines two distinct types of property damage:

> **17.** "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.

As explained below, the insurance protection afforded under CGL policies is limited to those damages for which the policyholder becomes legal liable because of property damage sustained during the policy period as a result of an accident that is attributable to the policyholder.

MONEY DAMAGES

For purposes of liability insurance, the term "damages," which is not defined in the insurance policy, is limited to monetary awards issued by a court of law to compensate a third-party claimant for a past loss.

The term "damages does not include other forms of judicial relief, such as restitutionary relief, injunctive relief, or declaratory relief. The term 'damages' also does not include a monetary award intended to prevent future losses." Crystal Bay Gen. v. AETNA Cas. & Sur. Co., No. 90-16417, 1992 WL 98269 (9th Cir. Apr. 7, 1992) (holding that construction of sewer bypass does not constitute "damages" because "there was no evidence that it would remedy damage caused by [the sewage spill]. Rather, the bypass was a prophylactic measure designed to prevent future spills.")

PROPERTY DAMAGE

Tangible Property

To constitute "property damage," it must be shown that the damaged property is tangible property. Tangible property generally refers to property that can be seen or touched. "Property damage" does not include damage to intangible property such as goodwill, licenses, leaseholds, easements, patents, copyrights or trade secrets, and claims for economic losses or lost profits.

For example, a claim arising out of a neighbor's lawsuit to enforce an easement across the insured's real estate was rejected. An easement represents only a nonpossessory right to use another's property and is not tangible property. Rendering the easement unusable by paving, and the ability to recover damages for obstruction, did not change its intangible nature. Kazi v. State Farm Fire & Cas. Co. 24 Cal.4th 871 (2001).

Physical Injury

The first type of property damage, and by far the most important part of the definition, requires a physical injury. This generally means the tangible property must sustain some type of observable or measurable harm, degradation, or impairment. Intangible economic losses, such as violation of anti-trust laws and breach of contractual obligations or warranties, do not constitute property damage under CGL policies. Any "loss of use" resulting from the physical injury to tangible property is within the scope of coverage (unless otherwise excluded).

Loss of Use

The second type of property damage refers to pure "loss of use," i.e., loss of use of tangible property that is not physically injured. Arguably, this part of the definition of "property damage" is relatively less important than the first part. Many claims for pure "loss of use" type property damage are excluded by policy provisions known as the "impaired property" exclusion (which is not covered in this handout or the brown bag luncheon).

An important limitation in the second part of the definition of "property damage" is that such damage is deemed to occur at the time of the "occurrence" (i.e., the accident) that caused the loss of use. Case law provides a few examples of this type of property damage.

For example, in one case the policyholder sold defective strawberry plants to a farmer, who eventually pulled the plants leaving the land fallow during the growing season. The court found that the lost profits were because of property damage, since the farmer had lost the use of his land, even though it had not been physically injured. Hendrickson v. Zurich Am. Ins. Co. of Ill., 72 Cal.4th 1084, 1091 (1999).

TRIGGER OF COVERAGE

The term "trigger of coverage" refers to the operative event that must occur during the policy period in order to invoke, or trigger, coverage. The Nevada Supreme Court has held that "a tangible, physical injury" to property must occur during the policy period to trigger coverage under CGL policies. United Nat'l Ins. Co. v. Frontier Ins. Co., 120 Nev. 678 (2008).

It appears, however, that Nevada courts have not yet definitively determined the appropriate trigger for continuous property damage sustained during multiple policy periods. Gary G. Day Constr. Co. v. Clarendon Am. Ins. Co., 459 F.Supp.2d 1039 (D.Nev. 2006) (noting that Nevada courts have not adopted either the manifestation theory or the continuous exposure theory in a progressive loss type of claim).

Determining the appropriate trigger of coverage has a significant impact on construction defect litigation. Consider the following example: water intrusion occurs over the course of three years in which three different CGL policies are in effect. The water causes physical damage to the interior walls, etc., but the property damage does not manifest itself until the third year. Under a manifestation theory, the only triggered policy would be the one in effect during the third year, whereas under the continuous exposure theory, each policy is triggered because the property sustained damage during each policy period.

THE *MONTROSE* RULE

As noted above, the Nevada Supreme Court has apparently not specifically determined which trigger applies in a progressive loss type claim. Historically, Nevada courts have looked to other states, such as California, on unsettled issues relating to insurance law. Accordingly, we discuss below the basic holding of the Montrose case.

In 1995, the California Supreme Court issued the seminal opinion, Montrose Chemical Corp. of Cal. v. Admiral Ins. Co., 10 Cal.4th 645 (1995). The court held that CGL policies are triggered at the time the plaintiff is actually damaged, not at the time the accident (or negligent act) causing the damage occurred. More importantly, the court held that, if the damage is

progressively deteriorating over multiple policy periods, the property damage may trigger coverage under each policy in effect during those periods.

The significance of Montrose to construction defect litigation is that coverage is not limited to the policy in effect at the time when the precipitating event or condition occurred, or to the policy in effect when the property damage first manifested itself. Moreover, the policy's full limit may be exposed, even if the property damage continues after the policy is terminated. As the California Supreme Court later explained in Aerojet-General Corp. v. Transport Indem. Co., 17 Cal.4th 38, 57 (1997), "[i]f specified harm is caused by an included occurrence and results, at least in part, within the policy period, it perdures to all points of time at which some such harm results thereafter."

STACKING AND ALLOCATION

In construction litigation, there are often multiple policies that may provide coverage. When a single policyholder is covered by multiple policies, issues may arise relating to stacking and allocation.

The term "stacking" generally refers to whether a single triggered policy must respond to the claim, or whether multiple triggered policies must respond. Allocation refers to methods employed by insurance carriers to equitably share liability for a covered loss to a mutual policyholder or insured.

This handout, as well as the brown bag luncheons, will not address issues of stacking and allocation in detail. However, we list below some of the most typical forms of allocation identified in the case law:

> Time on Risk Method: allocation based on the relative duration of each primary policy as compared with the overall period of coverage during which the "occurrences" "occurred."
>
> Policy Limits Method: allocation based on the relative policy limit of each primary policy.

Combined Policy Limit Time on Risk Method: allocation based on both the relative durations and the relative policy limits of each primary policy by multiplying the policies' respective durations by the amount of their respective limits so that insurers issuing primary policies with higher limits would bear a greater share of the liability per year than those issuing primary policies with lower limits.

Premiums Paid Method: allocation based on the amount of premiums paid to each carrier.

Maximum Loss Method: allocation among each carrier up to the liability limits of the policy with the lowest limits, then among each carrier other than the one issuing the policy with the lowest limits in equal shares up to the policy limits of the policy with the next-to-lowest limits, and so on in the same fashion until the entire loss has been allocated in full.

Equal Shares Method: allocation among each carrier in equal shares.

OCCURRENCE

In addition to determining whether a claim involves property damage sustained during the policy period, it must be established that the property damage resulted from an "occurrence." CGL policies define "occurrence" to mean an "accident, including continuous or repeated exposure to substantially the same general harmful conditions."

The Nevada Supreme Court has further explained that an "occurrence" is a "happening that is not expected, foreseen or intended." United Nat'l Co. v. Frontier Ins. Co., Inc., 120 Nev. 678 (2004). For example, a sewage spill constitutes an "occurrence" because it is sudden and unexpected. Crystal Bay Gen, 1992 WL 68269. Nevada law, as interpreted by the United States District Court, has found that water intrusion qualifies as an accident and, thus, an occurrence. Gary G. Day Constr. Co. v. Clarendon Am. Ins. Co., 459 F.Supp. 2d 1039 (D.Nev. 2006) (interpreting policy language that differs from standard CGL form's language).

BUSINESS RISK EXCLUSIONS

Overview

CGL policies contain various exclusionary provisions. Some of those exclusions are referred to as "business risks exclusions." Business risks are the normal, foreseeable and expected consequences of doing business, including the replacement of defective products and the repair of faulty workmanship.

CGL policies are not performance bonds or all risk policies and do not insure ordinary business risks. For example, the risk of replacing and repairing defective materials or poor workmanship stays with the insured because it represents an ordinary cost of doing business. Liability insurance generally only provides liability coverage for damage to property other than the product or work itself. Great Am. Ins. Co. of N.Y. v. Vegas Constr. Co., No. 2:06-cv-00911-BES-PAL, 2007 WL 2375056 (D. Nev. Aug. 15, 2007).

As explained below, the work exclusions generally exclude coverage for damage to the policyholder's work; however, the scope of the pertinent exclusions depends on various factors, including when the damage occurs and who performed the work.

Work Exclusions

In most construction defect cases, coverage will be excluded for many of the construction defects at issue. As noted above, the term "property damage" in CGL policies generally requires a physical injury; therefore, work that is merely defective—as contrasted to work that is physically damaged—does not constitute "property damage." And as explained below, CGL policies do not provide coverage for damage to the policyholder's own work, as well as other business risks retained by the policyholder.

In determining what items of loss are excluded, it is first important to determine when the property damage for each item occurred. Property damage during ongoing operations is potentially subject to

certain exclusionary provisions, whereas property damage sustained after completion of operations is potentially subject to different exclusionary provisions. The exclusions for property damage during ongoing operations are broader than the primary exclusionary provisions for property damage after completion.

For example, the following two exclusionary provisions apply to property damage sustained during ongoing operations:

> **j. Damage To Property**
>
> "Property damage" to:
>
> **(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.
>
> * * *

Exclusion j.(5) applies to real property on which either the named insured or its subcontractors are performing operations. Similarly, Exclusion j.(6) applies to any property that must be repaired or replaced if the named insured incorrectly performed work on such property. The term "your work" is defined to include work on behalf of the named insured.

Thus, as to property damage sustained during ongoing operations, coverage is excluded if the work that is damaged is the named insured's work, a subcontractor of the named insured's work, or property on which either the named insured or its subcontractor performed the work.

In contrast, property damage sustained after completion of operations is subject to a different exclusion that contains an important exception—that is, the "subcontractor exception." The exclusion for "your work" states as follows:

> **l. Damage to Your Work**
>
> "Property damage" to "your work" arising out of it or any part of it and including 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.
>
> * * *

As reflected in the second paragraph, the exclusion does not apply in two situations: (1) if the damaged work was performed by the named insured's subcontractor; and (2) if a subcontractor's work caused the damage, even if the damage is to the named insured's work. Thus, where the named insured's is a general contractor or developer, the subcontractor exception essentially "swallows" the exclusion because most, if not all, of the work is performed by subcontractors.

The "Damage to Your Work" exclusion precludes coverage for property damage to the insured's defective or unsatisfactory work if the damage was caused by the insured's defective work.

For example, if the named insured defectively installs drywall, which allows water intrusion and resulting damage to interior furniture, a liability policy's coverage would extend to the cost of replacing damaged furniture, but not the cost of repairing or replacing the insured's faulty workmanship. McKellar Dev. of Nev., Inc. v. N. Ins. Co. of N.Y., 108 Nev. 729 (1992).

Where, however, the claim involves both covered property damage and non-covered damage or defects, CGL policies may provide coverage for repair and replacement of faulty workmanship in certain circumstances. Lennar Corp. vs. Great Am. Ins. Co., 200 S.W.3d 651, 678 (Tex. App. 2006).

For example, in the Lennar Corp. case, a subcontractor negligently applied stucco to a home, thereby causing water intrusion and resulting wood rot, mold, and termite infestation. The resulting damage was covered, while the defective stucco was not. However, a court found coverage for the stucco removal, because doing so was necessary to access and repair the underlying water damage. The court reasoned that such repair costs were "damages because of property damage," and therefore within the scope of covered damages.

In contrast, diminution in value due solely to the incorporation of the subcontractor's defective work does not constitute property damage. N.H. Ins. Co. v. Vieira, 930 F.2d 696 (9th Cir. 1991).

For example, in Vieira, a general contractor hired a subcontractor to install drywall into a housing project to prevent fire from spreading. The subcontractor failed to properly install the drywall, which increased the project's fire risk and decreased its market value. Other than the diminution in value, the defective drywall did not cause injury to other property. Thus, all the damages claimed were to repair or replace the insured subcontractor's defective work, not for damages to his work caused to other property. The court held that, without physical injury to other tangible property, the claim was not within the scope of coverage under the CGL policy, because all damages will stem from the need to repair or replace the insured's defective work.

The subcontractor argued that the defective drywall did cause physical injury to other tangible property because holes had to be cut into the ceiling to repair his faulty workmanship. The court rejected this argument, reasoning that "diminution in value and cost of repair are not two separate harms – they are two different ways of

measuring the same harm." Because the cost to repair the insured's defective work is not a covered harm, diminution in value resulting from the defective work is not covered either. "[T]he nature of the repairs cannot convert non-covered damage into covered damage." Id. at 701-02.

Categorizing Damages

In summary, to evaluate whether the above-discussed exclusions for property damage apply, it is first necessary to determine which exclusions to analyze based upon whether the property damage occurred before or after completion of operations.

After determining the appropriate exclusions, identify the various categories of damages to distinguish between defective work (non-covered), resulting damages (covered), and damage falling within the subcontractor exception.

The following checklist identifies the possible categories of defects and property damage:

1. Property damage to the named insured's work that results from a defect in that work;

2. A defective condition in the named insured's work, or work performed on the named insured's behalf, that does not constitute physical injury to tangible property;

3. Property damage to the work of another contractor that results from a defect in the named insured's work;

4. Property damage to the work of the named insured's subcontractor due to a defect in the subcontractor's work or the subcontractor's defective performance;

5. Property damage to the work of the named insured's subcontractor that results from a defect in the work of

another subcontractor or the other subcontractor's defective performance;

6. Property damage to property owned by a third party that was not constructed by or on behalf of the contractor.

* * *

SUMMARY OF BASIC COVERAGE ANALYSIS

1. Does the claim seek money damages because of a physical injury to or loss of use of tangible property?

2. Was each particular item of property damage sustained during the policy period?

3. Was the property damage caused by an "occurrence"?

4. Was the damage to property or work of the owner or another contractor?

5. Was each item of property damage sustained before or after completion of operations?

6. Are the particular items of property damage limited to the named insured's work, or to the work of the named insured's subcontractors?

* * *

ADDITIONAL INSUREDS ENDORSEMENTS

An additional insured endorsement is an amendment to a liability policy. It amends Section II of a standard form CGL policy. Section II is the part of the CGL policy that describes those entities and persons who qualify as insureds. Typically, the endorsement specifically schedules a particular entity or person, along with language that describes the extent of coverage available to the scheduled entity or person.

Additional insured endorsements, or "AIE's," usually are pre-printed forms; however, many different versions exists, and each must be separately analyzed based on the specific language therein.

Recently, the Nevada Supreme Court addressed various issues relating to an additional insured endorsement. Fed. Ins. Co. v. Am. Hardware Mut. Ins. Co., 184 P.3d 390 (Nev. 2008).

In Federal Insurance, an employee of a maintenance company sued a wine company for injuries sustained on that company's premises. The wine company qualified as an insured under an additional insured endorsement on the maintenance company's CGL policy. The endorsement provided that the wine company was an insured but only for losses "arising out of the operations the name insured performed for the additional insured's benefit." The carrier refused to defend on the grounds that the endorsement's coverage did not extend to the additional insured's direct acts of negligence. The carrier argued that the endorsement's coverage was only triggered when the alleged negligence could be imputed to the additional insured through the named insured's operations.

The Nevada Supreme Court, however, held that, absent explicit limiting language, an endorsement that provides coverage for liabilities "arising out of the operations the name insured performed for the additional insured's benefit" covers losses connected to those operations without regard to fault. Because this term does not allocate fault, it does not preclude coverage for the additional insured's own negligent acts so long as those acts are connected to the named insured's operations and causally linked to the injury.

Courts in California have similarly interpreted additional insured endorsements. For example, in Acceptance Ins. Co. v. Syufy Enterprises, 69 Cal.App.4th 321 (1999), a theater hired electrical contractor to repair its roof. The contractor's employee sustained a severe injury while working on the roof when the hatch unexpectedly closed as he climbed through it. The theater qualified as an insured by way of an additional insured endorsement on the contractor's policy. Specifically, the endorsement qualified the theater as an insured, "but only with respect to liability arising out of [the named insured's work] for that insured by or for [the named insured]." Id. at 330.

The California Court of Appeal initially noted that the language "arising out of" connotes only a minimal causal or incidental relationship. The court then reasoned that the relationship between the defective hatch and the roofing job was more than incidental, because the injured employee could not have done the job without passing through the hatch. The fact that the defect was attributable to the additional insured's negligence is irrelevant since the policy language does not propose to allocate coverage according to such language. The court held that, "[w]hen an insurer chooses not to use such clearly limited language in an additional insured clause, but instead grants coverage for liability 'arising out of' the named insured's work, the additional insured is covered without regard to whether the injury was caused by the named insured or the additional insured." Id. at 330.

CERTIFICATES OF INSURANCE

Certificates of insurance are common in the insurance industry. For example, general contractors routinely require their subcontractors to procure various types of coverage before work commences, including an additional insured endorsement naming the general contractor. Accordingly, a subcontractor will typically obtain a certificate of insurance from their insurance broker, and then present it to the general contractor to demonstrate that insurance is in place.

Often, however, subcontractors neglect to instruct their broker to arrange for the issuance of an additional insured endorsement. Consequently, the situation often arises that the general contractor is identified as a certificate holder on a certificate of insurance, but the actual insurance policy of

the subcontractor contains no additional insured endorsement. Thus, the issue arises as to whether subcontractor's insurance policy provides coverage directly to the general contractor. As explained below, such certificates do not function to independently provide coverage where the certificate holder is not formally added as an additional insured under the insurance policy identified on the certificate.

"Certificate of insurance" refers to a standard, pre-printed form that describes one or more insurance policies in effect as of the date of the certificate. Such certificates typically set forth the name of the insurance carrier; the types of insurance coverages and policies; the policyholder's name; and the policy limits. Certificates of insurance also routinely identify the entity that issued the certificate—typically, the policyholder's insurance broker—and the entity or person for whom the certificate is issued, commonly referred to as the "certificate holder."

The certificate does not ordinarily create any contractual rights in the certificate holder under the liability policies set worth within the certificate. Rather, it is a convenient method for proving the existence of one or more insurance policies. Thus, while a certificate of insurance is a quick and easy way to demonstrate that insurance is in place, it ordinarily does not change the original insurance contract. For example, a certificate holder may not be insured under an insurance policy if that policy has not been amended to add the certificate holder as an additional insured.

CONTRACTUAL LIABILITY COVERAGE

The concept of contractual liability coverage, along with the related concept of "insured contracts," is often misunderstood.

CGL policies generally do not provide coverage for contractual liability. In fact, the insuring agreement for CGL policies does not specifically distinguish between tort and contract liability. However, CGL policies exclude coverage where the insured assumes another's liability, unless such assumed liability is in an "insured contract," as defined by the policy.

The standard exclusion for contractual liability provides as follows:

2. Exclusions

This insurance does not apply to:

b. Contractual Liability

"Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for damages:

(1) That the insured would have in the absence of the contract or agreement; or

(2) Assumed in a contract or agreement that is an "insured contract", provided the "bodily injury" or "property damage" occurs subsequent to the execution of the contract or agreement. Solely for the purposes of liability assumed in an "insured contract", reasonable attorney fees and necessary litigation expenses incurred by or for a party other than an insured are deemed to be damages because of "bodily injury" or "property damage", provided:

(a) Liability to such party for, or for the cost of, that party's defense has also been assumed in the same "insured contract"; and

(b) Such attorney fees and litigation expenses are for defense of that party against a civil or alternative dispute resolution proceeding in which damages to which this insurance applies are alleged.

* * *

As reflected in the above-quoted policy language, CGL policies broadly exclude coverage for liability assumed by the named insured, but creates a broad exception for liabilities assumed in an "insured contract." The standard definition for an "insured contract" is as follows:

> That part of any other contract or agreement pertaining to your business … under which you assume the tort liability of another party to pay for 'bodily injury' or 'property damage' to a third person or organization. Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.
>
> * * *

Most indemnity agreements in construction contracts will qualify as an "insured contract" under the above-quoted definition. Thus, if a subcontractor is the named insured under a CGL policy, its liability to the general contractor under the indemnity provisions of the subcontract will generally not be excluded by the exclusion for contractual liability.

It should be noted, however, that the subcontractor's indemnity obligations must still be within the scope of coverage, i.e., damages because of property damage sustained during the policy period as a result of an accident. Also, the subcontractor's liability under the indemnity agreement is subject to other policy exclusions, such as the work exclusions discussed above.

POLICY LIMITS

Introduction

One of the most important issues to evaluate in analyzing an insurance policy is its limits on insurance. Often, this basic step is overlooked at the initial steps of a construction deficit lawsuit. It is important to understand the nature of each policy limit, as well as their relationship with other policy limits. In order to understand policy limits, it is also important to understand the function of deductibles and self-insured retentions.

General Aggregate Limit

The general aggregate limit is the maximum amount the insurer will pay in a single policy period for all damages because of bodily injury or property damage, except damages paid for bodily injury or property damage sustained after completion of operations. The general aggregate is a separate source of funds. However, the general aggregate may not apply to many construction defect lawsuits, because most such lawsuits concern only property damage sustained after completion of operation.

Completed Operations Limit

The Completed Operations Aggregate Limit, which is also a separate source of insurance funds, is the maximum amount the insurer will pay under a CGL policy for property damage sustained after completion of operations. In order to determine if this limit applies, one must analyze whether the claim for property damage falls within the "products-completed operations hazard." Generally, a claim will fall within this hazard, which is specially defined in CGL policies, if the property damage occurs away from the named insured's property and arises from the named insured's completed work.

Each Occurrence Limit

The Each Occurrence Limit is the maximum amount the insurer must pay for each separate occurrence of property damage. Notably, this limit is not a separate source of insurance funds. Rather, it functions as a ceiling for damages resulting from one occurrence. Thus, the Each Occurrence Limit places a cap on the amount of funds available under a policy's other sources of fund, such as the General Aggregate Limit and the Completed Operations Limit.

For example, if the Each Occurrence Limit under a CGL policy is one million dollars, and the Completed Operations Aggregate Limit is two million dollars, an insurance carrier's liability for damages will be limited to one million dollars where the damages stem from one

occurrence. If the carrier pays one million dollars to settle a claim or satisfy a judgment, one million dollars will remain available under the Completed Operations Aggregate Limit for future claims.

Disputes often arise as to whether a particular claim or related claims result from one or multiple occurrences. If a policyholder can successfully argue that the lawsuit involves multiple occurrences, it may be entitled to additional amounts above the Each Occurrence Limit. In a construction defect lawsuit involving multiple homes, plaintiffs, and items of property damage, an insured contractor or developer may be able to fashion arguments that the claim involves multiple occurrences. Chu v. Canadian Indemnity Co., 224 Cal. App. 3d 86, 274 Cal. Rptr. 20 (4th Dist. 1990), opinion modified, (Oct. 5, 1990) (insured contractor sought liability coverage for certain specific construction defects discovered after condominium units were sold despite having knowledge of numerous and pervasive defects in the property when the property was sold; *held*, knowledge of one construction defect is not the equivalent of knowledge of other distinct defects, thereby implying that each category of defect or damage constitutes a separate "occurrence" triggering per occurrence policy limits and deductibles); Gary G. Day Construction Company, Inc. vs. Clarendon America Ins. Co., 459 F.Supp.2d 1039 (D.Nev. 2006) (framing contractor named in lawsuit involving defects in 53 homes sought coverage under non-standard policy containing "deemer" clause and requiring both the "occurrence" and the first instance of "property damage" be within the policy period; *held*, "[T]he Court must determine whether both the 'occurrence' and the first instance of 'property damage' in each individual home took place during the relevant dates of the Policy.").

In evaluating this legal issue, Nevada follows the "cause theory" to determine how many occurrences there are for purposes of the Each Occurrence Limit. The "'cause theory' focuses on number of acts producing the injuries or damage rather than the number of injuries actually resulting." In performing the legal analysis, courts determine whether there is "but one proximate, uninterrupted and continuing cause which resulted in all the injuries and damage." If a

series of injuries all "flow from a single cause," then there is only one occurrence. If each injury is caused by a different, independent act, then there is a series of occurrences. Ins. Co. of Am. v. Weston, 107 Nev. 610 (1991)

Deductible

A deductible is a portion of an insured loss for which the insured is responsible. It generally is a specific sum that the insured must pay before the insurer owes its duty to indemnify the insured for a covered loss. A deductible relates only to the damages for which the insured is indemnified, not to defense costs. The insurer is fully responsible for defense costs regardless of the amount of the deductible so long as there is a potential for coverage under the policy. Forecast Homes, Inc. v. Steadfast Ins. Co., 181 Cal.App.4th 1466 (2010) citing Croskey et al., Cal. Practice Guide: Insurance Litigation (The Rutter Group 2008) ¶ 7:378, p. 7A-121.

Self-Insured Retention

A self-insured retention, or "SIR," is an amount that must be paid on a claim before the insurer has any duties under the policy. Vons Cos., Inc. v. United States Fire Ins. Co., 78 Cal.App.4th 52, 63-64 (Ct. App. 2d 2000); Gen. Star Indem. Co. v. Super. Ct., 47 Cal.App.4th 1586, 1594 (Ct. App.-2d 1996).

The language of the SIR controls how it may be satisfied. Some provisions require the insured to pay the retention out of his own pocket. See Vons Cos., 78 Cal.App.4th at 63 n.4 (quoting a SIR stating "[i]n the event there is any other insurance, whether or not collectible, applicable to an 'occurrence,' claim or suit within the Retention Amount, you will continue to be responsible for the full Retention Amount before the Limits of Insurance under this policy apply.").

GENERAL RULE

An insurer's duty to defend arises "when the allegations of the complaint and the facts known to the insurer indicate a potential for coverage." Whether such a potential exists is determined by comparing the allegations of the complaint and facts known to the insurer at the inception of the lawsuit with the terms of the policy. If the insurer cannot conclusively prove there is no potential for coverage at the inception of the lawsuit, it has a duty to defend the suit. Any doubts about whether there is a potential for coverage must be resolved in favor of the insured. See United Nat'l, 99 P.3d 1153; Gary G. Day Constr. Co., 459 F.Supp.2d 1039 (D. Nev. 2006); Montrose Chem. Corp. v. Super. Ct., 6 Cal.4th 287 (1993).

The insurer must defend all covered and non-covered claims asserted in the same lawsuit. This means that, even though an action may allege non-covered claims, the insurer must defend the entire action if it also alleges any covered claims. Buss v. Super. Ct., 16 Cal.4th 35, 48-49 (1997).

THE "SUIT" REQUIREMENT

An insurer's duty to defend only extends to suits filed against the insured. The CGL policies define a "suit" as "a civil proceeding in which damages to which this insurance applies are alleged." A "suit" also includes an arbitration proceeding to which the named insured must submit. However, pre-lawsuit proceedings as well as administrative proceedings are generally not considered a "suit."

TENDER OF DEFENSE

Timely notice is a condition precedent to coverage and the insurer's duty to defend. If the policyholder fails to give timely notice, the insurer may deny coverage. The Nevada Supreme Court has held that the insurer need not demonstrate that the delay caused actual prejudice before denying coverage on these grounds. Las Vegas Star Taxi Inc. v. St. Paul Fire & Marine Ins. Co., 102 Nev. 11 (1986); State Farm Mut. Auto Ins. Co. v. Cassinelli, 67 Nev. 227 (1950).

REIMBURSEMENT RIGHTS

As noted above, in a mixed action—i.e., one involving potentially covered claims and non-covered claims—the insurer must provide a complete defense.

However, some states such as California may permit the insurance carrier to seek reimbursement of some of the fees it incurred in defending claims that were not potentially covered. To do so, the insurer must first prove the claims, in fact, were not covered under the policy; that each requested dollar was actually spent in the defense of non-covered claims; and that such fees are solely allocable to the defense of such claims. Buss, 16 Cal.4th at 48-49.

The Nevada Supreme Court has apparently not addressed directly the reimbursement issue as the California Supreme Court did in the Buss case. But it appears the Ninth Circuit Court of Appeals has addressed a similar issue and permitted an insurer to seek reimbursement under Nevada law. See Crystal Bay Gen., 1992 WL 68269. It should be noted, however, that a federal court's interpretation of Nevada law is not binding upon state courts. Moreover, the Crystal Bay case may be limited to its unique facts and not a recognition, such as in the Buss case, of a generally applicable right of a liability insurance carrier to seek reimbursement under Nevada law.

INDEPENDENT COUNSEL

It appears that Nevada law is not entirely settled as to whether a policyholder, who is being defended by an insurance carrier, is entitled to independent counsel—also known as Cumis counsel—if the carrier's agreement to defend is under a reservation of rights.

In light of recent case law, it appears that Nevada may adopt an approach similar to California's, which permits a policyholder to demand independent counsel in certain situations. See Nevada Yellow Cab Corp. v. Dist. Ct., 152 P.3d 737 (Nev. 2007) (holding that both the insurance carrier and policyholder are the clients of the insurer-appointed defense counsel).

In the June 2007 edition of Nevada Lawyer, Jeffrey W. Stempel, Esq., a professor at the William S. Boyd School of Law, wrote that "it would appear that Nevada will follow California's lead" with respect to a policyholder's right to independent counsel. Jeffrey W. Stempel, The Relationship Between Defense Counsel, Policyholders, and Insurers: Nevada Rides Yellow Cab Toward "Two-Client" Model of Tripartite Relationship. Are Cumis Counsel and Malpractice Claims by Insurer's Next?, Nevada Lawyer, June 2007, at 20.

Accordingly, we briefly discuss below the concept of independent counsel as developed under California's statutory and case law.

Whenever a policyholder demands independent counsel, the real issue usually concerns who is going to control the defense. Ordinarily, the insurer has the contractual right to control the defense, including the decision to select a particular attorney and make important decisions concerning litigation decisions. Controlling the defense via panel counsel enables claims handlers to manage many claims in an economic fashion. An insurer's control of the defense is a cornerstone of the insurer-policyholder relationship.

However, California has recognized that an insurer may not be entitled to control the defense in certain, narrow circumstances. When an insurance company retains an attorney to defend lawsuit against the policyholder, the attorney is considered in many states as representing the policyholder as well as the insurer. This relationship is referred to as a tripartite relationship between the insurer, defense counsel, and policyholder. When a coverage dispute between the insurer and insured arises, defense counsel may have a disqualifying conflict of interest. In the vast majority of instances, the conflict arises from the insurer's agreement to defend, coupled with a reservation of the insurer's right to dispute coverage. If an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by the assigned defense counsel, the insurer may be obligated to provide independent counsel to the policyholder. See Cal. Civ. Code § 2860 (West 2009).

The policyholder's preferred attorney is "independent" in the sense that it is the policyholder, not the insurer, who selects the attorney and controls

litigation decisions. Courts have found that the insurer's contractual duty to defend must be free of disqualifying conflicts of interest. Therefore, the insurer's contractual right to control the defense is, in effect, superseded by the policyholder's legal entitlement to defense counsel who is independent of the insurer.

The negative aspects of hiring independent counsel often outweigh the benefits of reserving rights, at least to those reservations that trigger a conflict of interests. Often, the insurers prefer to waive coverage defenses in order to retain control of the defense. Consequently, claims for independent counsel often evolve into negotiations over what coverage defenses, if any, the insurer is willing to waive in order to resolve the dispute concerning the policyholder's demand for independent counsel.

"I think you misunderstood. The million dollar umbrella policy only covers you for claims involving an umbrella."