Vol. 68 / No. 1
2013

DISPUTE RESOLUTION JOURNAL

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ISSN 1074-8105. For reference, this issue may be cited as Dispute Resolution Journal, Vol. 68, No. 1, JurisNet, LLC, Huntington, New York.

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TIMING IS EVERYTHING: WHEN IS THE BEST TIME TO RESOLVE A CONSTRUCTION DEFECT CASE?

*Matthew W. Argue**

INTRODUCTION

The cost of defending a construction defect case in court is three to five times greater than the amount that is ultimately paid in settlement. This is a significant amount of money. For this reason, and particularly in this struggling economy, all stakeholders involved in a construction defect case, including attorneys, insurance claims representatives, mediators, general contractors, subcontractors, owners and developers, should be looking for ways to save money by cutting the cost of resolving these cases. This article discusses possible ways to achieve early resolution during the "pre-litigation" phase of the case.

WHAT IS NEEDED TO SETTLE A CASE IN THE "PRE-LITIGATION" PHASE?

For purposes of this discussion, pre-litigation does not mean before a complaint is filed. I define it to include such a case as long as it has not gone through any of the following: extensive discovery, expert investigation and testing, expert depositions, or trial preparation. I also consider a case to be resolved in the "pre-litigation" phase if it is fully resolved within one year of the filing of the complaint. The reason for this expanded view of the "pre-litigation" period is that most construction defect cases are not capable of being resolved until all parties and their insurance carriers are involved in the case. Generally speaking, the parties to cases that settle within the first year have only spent about 10-20% of the money

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that would be spent in the next two or three years had a settlement not occurred. For example, in a recent case that settled within one year of filing the complaint, the developer/general contractor spent approximately $250,000 in defense and expert fees. Yet in a related litigation case involving the same parties that took over three years to resolve the developer/GC spent over $2 million in legal fees and costs. Interestingly, the plaintiff recovered substantially less in the related litigation than it did in the case that settled within one year, due to the cost savings all parties benefited as a result of the settlement. These results should lead parties to construction defect cases to question how they can achieve similar results in appropriate cases.

Due to the numerous parties with multiple layers of insurance coverage in every case, what is typically required is the filing of a "friendly" lawsuit and Cross-Complaint naming all the potentially responsible subcontractors. The main reason for filing a lawsuit is to involve the insurance carriers in the process, which generally occurs after a lawsuit is filed, and results in the opening of a file and claim number for the case. Although WRAP[1] cases have fewer parties, they also may require the filing of a lawsuit if the WRAP is underinsured or necessary parties (such as product suppliers or manufacturers and/or design professionals typically not included in a WRAP) are needed to obtain a full resolution of the case.

The elements required for a successful "pre-litigation" settlement are similar to what you would expect for any case to settle. The difference is that all the parties must work harder in a much shorter time frame to accomplish in just a few months tasks that normally take place over several years. However, a "pre-litigation" case can be hindered or become more difficult to settle due to the limited amount of information that may be available since full discovery and investigation has not yet occurred. In these cases, the parties may have to resort to a "leap of faith" on claims and damages issues or design a process of limited inspections and testing to prove the validity of claims without adding a tremendous amount of time or expense to the process.

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[1] "WRAP" insurance generally covers the entire project and subcontractors in one policy as opposed to "Traditional" insurance where all parties purchase their own commercial general liability ("CGL") policy resulting in multiple insurance policies and carriers for a particular project.

Here are the minimum tasks that I suggest need to be accomplished in order to achieve a "pre-litigation settlement":

- All parties have been served with complaint or cross-complaint in the case;
- Filing of Case Management Order ("CMO") with a complete Agenda for exchange of documents, defects list, cost of repair, expert investigation and depositions, mediation (including Mandatory Settlement Conference) and trial date;
- Early exchange of insurance information and preparation of insurance matrices. This is vitally important and case will not move forward until this is done to everyone's satisfaction. As a practical matter, most parties will not voluntarily produce insurance information without entering a CMO which requires a Statement of Insurance Information;
- Insurance coverage issues have been dealt with up front, such as, Additional Insured ("AI") tenders, exhaustion or insolvencies, excess carriers, time on risk, uncovered homes, etc.;
- Need for an agreement on scope of work, including production of job files, subcontracts, payment records, etc.;
- Sufficient expert investigation to prove location and frequency of defects and costs of repair;
- Exchange of "damages" package (including photos of resulting damages caused by defective construction) that can be electronically transmitted to defense counsel and carriers;
- Pre-mediation meeting with plaintiff and developer to determine ballpark number for settlement discussion purposes and basis for initial demands to subcontractors. (Involvement of claims adjusters and coverage counsel at this meeting with plaintiff's counsel is sometimes necessary.);
- Reasonable initial demands from plaintiff and developer to subcontractors that are NOT simply "pass-through" demands;
- Reasonable initial offers from subcontractors recognizing that the negotiation process is being intentionally shortcut;

- All parties must do an early evaluation of the claim, and effectively communicate information to carriers for evaluation prior to mediation; and, most importantly, be ready to meaningfully negotiate at the first Mediation Conference;
- Plaintiff and developer counsel's willingness to negotiate walk-away settlements at the first mediation conference;
- Coverage counsel present at mediation to negotiate Additional Insured buyouts for a complete walk-away;
- Strong desire of all participants to settle based on perceived risk at trial and realistic evaluation of exposure for defense costs and fees. (Note: "Follow on" cases where issues have been fully litigated in a related case involving the same or similar defects and insurance coverage is already well-known are ideal for this approach.);
- In WRAP cases, you may need an expert presentation from plaintiff and defense and a frank exchange between the experts on alternative methods of repair and quantities before the "money mediation"; and
- Court involvement to keep process moving and require attendance of decision-makers at Settlement Conference;
- Finally, the key ingredient to any "pre-litigation" settlement is lots of telephone follow-up with defense counsel and, more importantly, with claims representatives to make sure that information has been communicated and any missing information is provided on a timely fashion.

DOES THE "SB 800" PROCESS PROVIDE AN OPPORTUNITY TO RESOLVE MORE CASES IN THE "PRE-LITIGATION" PHASE?

Senate Bill 800 (commonly referred to as the "Right to Repair law" or "SB 800" for short) became effective January 1, 2003, and requires the parties to make an attempt to resolve cases prior to the filing of a lawsuit. For the developer/general contractor, "SB 800" allows the so-called "right to repair" the properties before the filing of a Complaint. For the Plaintiff, it is an opportunity to see if the case can be resolved in the "pre-litigation" phase before a tremendous amount of money is spent on investigation and discovery. Based on interviews with many lawyers, mediators, and judges involved in the

"SB 800" process, there is general consensus that "SB 800" is not particularly effective in resolving cases or avoiding lawsuits.[2] Based on the listing of tasks and requirements above for a case to result in an early "pre-litigation" settlement, the "SB 800" process falls short in the following respects:

- All parties have been served with Complaint or Cross-Complaint in the case—"**SB 800" prohibits filing of lawsuit before statutory repair process is completed;**
- Filing of Case Management Order with complete Agenda for exchange of documents, defects list, cost of repair, expert investigation and depositions, mediation (including Mandatory Settlement Conference) and trial date—**There is no Case Management Order;**
- Early exchange of insurance information and preparation of insurance matrices. This is vitally important and case will not move forward until this is done to everyone's satisfaction. It is nearly impossible to obtain insurance information without entering a CMO which requires a Statement of Insurance Information. **There is no mechanism for obtaining discovery or insurance information;**
- Insurance coverage issues have been dealt with up front, such as, AI tenders, exhaustion or insolvencies, excess carriers, time on risk, uncovered homes, etc. **Insurance carriers generally do not participate in the "SB 800" process;**
- Sufficient expert investigation to prove location and frequency of defects and costs of repair. **In many cases, the expert investigation is too abbreviated to prove the claims or identify resulting damages covered by insurance;** and
- Reasonable initial demands from plaintiff and developer to subcontractors that are NOT simply "pass-through" demands. **Subcontractors are not part of the "SB 800" process.**

[2] For a more complete discussion, you may be interested in my article entitled, "What's Working And What's Not in The Western Region Construction Defect Arena?" presented to MC Consultant's Conference Construction Defect Conference in San Diego, California on September 8, 2011; available upon email request at mattargue@onemediator.net.

Additionally, the following aspects of a "SB 800" case could prevent it from being an effective means to achieve a "pre-litigation" settlement because:

- The statute provides no mechanism for Releases to be exchanged for repairs;
- The statute provides unrealistically short time frames which do not allow sufficient time for carriers to respond and meaningfully participate in the "SB 800" process;
- The statute provides that violation of prescribed "functionality standards" create liability, but these "violations" may not be covered as "property damage" which is required for insurance carriers to pay damages under traditional insurance policies;
- The statute provides no means for transfer of risk or cost sharing between the developer/general contractor and subcontractors during the "SB 800" process, which makes it an extremely expensive proposition for developer/general contractors to try to achieve an early "pre-litigation settlement" without help from either subcontractors or their insurance carriers;
- The statute provides that all conduct during the "SB 800" process is discoverable, which may result in "fresh finger prints" on defective work and make a subsequent lawsuit even worse for the developer/general contractor giving it a strong reason not to engage in the "SB 800" process and wait until after a lawsuit is filed; and
- Finally, most developer/general contractors and even subcontractors now have large "self-insured retentions" ("SIRs") to satisfy before the insurance carrier is on the hook to pay, which means that insurance may not be "triggered" by the "SB 800" process until these SIRs are satisfied.

Despite the "obvious" problems with "SB 800" outlined above, the process can be modified by stipulations of the parties to add the missing components and allow the "SB 800" process to become a vehicle for achieving "pre-litigation" settlements. One positive aspect of "SB 800" is that the expert witness industry has streamlined its process in order to provide investigation and repairs in shorter time frames and, therefore, become more cost effective. In cases where

"SB 800" has been used successfully, the process from initiation of claim to final resolution has been accomplished in a matter of *months* instead of the *years* that are normally required for the closing of construction defect cases. Thus, "SB 800" cases may be able to be resolved cost effectively *if* the missing elements are added by stipulation.

UNRESOLVED INSURANCE ISSUES PREVENT CASES FROM BEING RESOLVED IN THE "PRE-LITIGATION" PHASE

The leading impediment to resolution in the "pre-litigation" phase is "unresolved" insurance issues. An "unresolved" insurance issue means gaps in insurance coverage for parties or issues due to exhaustion of policies, inability of parties to satisfy large SIRs due to insolvencies or bankruptcies, missing insurance carriers due to missing information or refusals to participate, and/or issues that are not covered by insurance based on exclusions in the insurance policy. Thus, the ability to achieve a "pre-litigation" settlement largely depends on how effectively these insurance issues are dealt with in the *early* stages of the case.

The first priority in any construction defect case is preparation of a detailed insurance matrix for all parties. In a WRAP case, it may be as simply as identifying the primary limits, and/or whether the primary policy is a "burning limits" policy and if there is any applicable excess insurance. If the WRAP limits are not adequate, then it may also require a lawsuit to name product suppliers/ manufacturers, design professionals or other parties not already included in the WRAP. However, a case with traditional insurance or a combination of WRAP and traditional insurance can be more difficult. In these cases, the parties will rarely provide their insurance information without Court involvement through a CMO. Therefore, it can be months or even years before insurance information is obtained without a mechanism, such as a Court or Discovery Referee. In "follow on" cases (with the same developer/general contractor and subcontractors) counsel can expedite this process if the insurance information has already been exchanged in a prior case. Once the insurance matrix is completed, the parties need to identify and solve problems dealing with gaps in coverage due to insolvencies, exhaustion of insurance policies, large or unsatisfied SIRs, uncovered homes, uncovered damages, etc. The other issues to be dealt with are questions related to: missing parties; gaps in insurance coverage;

missing insurance carriers; and whether the liability will be added to developer's share of the settlement, shifted to other parties, or reduce plaintiff's overall settlement demand.

Another issue to be dealt with during the "pre-litigation" phase is that often times the plaintiff has not done a "full blown" investigation or testing to prove its case. From the insurance carrier's perspective, until there is proof of "resulting damages" (that is something other than the insured's own "work product") covered by the insurance policy, the insurance carrier is not required to pay damages to the claimant or plaintiff. Due to the issue of a lack of proof of "covered damages" under the insurance policy, a carrier may chose to offer only nuisance settlement value for the case until more proof of "covered damages" is shown by the plaintiff. For this reason, it's sometimes easier to settle a case after a full investigation and expert depositions because all doubt is then removed as to the level of proof of the claims. However, many subcontractors and their carriers are loath to pay "cost of defense" damages without adequate proof of the claim. One way to handle this problem is to allow defense expert's access to plaintiff and developer's expert's photographs and testing to evaluate the claims. However, some carriers require visual inspections and even testing to prove the claims before offering to pay *any* amount in settlement. The result is that the additional defense fees and expert costs borne by plaintiff will be passed on to the developer/general contractor and/or subcontractors in the form of higher demands and Stearman expenses.

If the insurance issues are not able to be resolved before mediation, then a "coverage mediation" with both indemnity and additional insured carriers may be held. This can be particularly useful where carriers have hired coverage counsel to advise on covered vs. uncovered damages so that those issues can be discussed and hopefully resolved at mediation. Since unresolved insurance issues are the most common type of cases that do not settle during the "pre-litigation" phase, a coverage mediation is a good way to expedite resolution in any such cases.

Finally, insurance carriers need the case to be dismissed *with prejudice* and a "full release of all claims". If a lawsuit has been filed, then there is a mechanism for obtaining a dismissal with prejudice and filing a motion for good faith determination to cut-off liability from other cross-defendants. If no lawsuit has been filed, such as in a "SB 800" case where the statute provides no mechanism for obtaining

any releases, insurances carriers are unwilling to settle without these requirements being satisfied. The bottom line is that without insurance carriers' participation, a "pre-litigation" settlement is impossible.

CONCLUSION

In summary, the current economic climate provides many reasons for resolution during the "pre-litigation" phase to be an attractive alternative. Over the years, the construction defect industry[3] has proven itself resourceful in creating streamlined ways to handle complex litigation. For example, the Case Management Order (essentially a scheduling order of all events from beginning to end of case) was first conceived and used in construction defect cases. However, "pre-litigation" settlement does not mean a process that simply takes short-cuts to reduce costs with the result of less proof of damages and more frivolous claims. Instead, "pre-litigation" settlement means taking a hard look at the tasks that need to be accomplished and the traditional time frames they are accomplished within and looking for ways to shorten the process and save costs. This article suggests that significant savings (50-80%) can result from resolution of construction defect cases in the "pre-litigation" phase which, in turn, may result in reversing the trend of insurance carriers paying 3 to 1, or more, in costs of defense vs. amounts paid in settlement of these cases.

[3] This industry is going on its fourth decade and continues to be a leader in how complex, multi-party litigation can be handled both professionally and cost effectively.