"WHAT'S WORKING AND WHAT'S NOT IN THE WESTERN REGION CONSTRUCTION DEFECT ARENA?"

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By: Mediator Matthew W. Argue, Esq. with AMCC San Diego

This article is based on discussions between co-panelists on this same topic at MC Consultant's Conference in San Diego, CA on September 8, 2011, and the author's interviews with many participants in the mediation process in the geographical areas under consideration.

The purpose of this article is to preview what the Panel will be discussing under the topic "WHAT'S WORKING AND WHAT'S NOT" in four controversial topics currently in the construction defect cases namely: (1) SB 800 and the "right to repair" laws; (2) mediation in general; (3) insurance coverage and wrap policies; and (4) defense and indemnity obligations. This article is not intended to be a comprehensive or an in-depth analysis of the specific topics, but merely a discussion of current trends and practices in the market place.

The topic is viewed from the standpoint of whether the cases are being resolved cost effectively. Some think that the system is working as well as it can given the economy. Most agree that there are more challenges to getting cases resolved today. In an industry that has been functioning for more than three decades and seen many improvements, there is no "silver bullet" to make cases more efficient. Nevertheless, there are some that still believe the process is imperfect and an inefficient way to

resolve fundamentally simple problems. New innovations will continue to develop in a dynamic industry that continues to evolve and change virtually every year.

Right to Repair Laws

"Right to repair" laws in several jurisdictions refers to the statutory scheme that requires homeowners to give a "notice to repair" and allows a builder to respond with an "offer to repair" before a lawsuit is filed. California, Nevada, and Arizona have such a statutory scheme allowing a "right to repair". Colorado, Oregon and Washington have a "notice of claim" statute.

a. Typically, Lawsuits are Filed After Repairs are Made

There is broad consensus that "right to repair" laws make cases more complicated to resolve. Almost all those interviewed thought the "right to repair" laws were not particularly effective in avoiding lawsuits. This is due, in part, to the current economic environment with little building in recent years, and few builders who can afford to make repairs. Also, it is difficult to involve carriers in the "right to repair" process due to the short time frames permitted under the statute, difference between the functionality standards and need for property damage under traditional insurance, and large self-insured retentions for both developer/general contractors and subcontractors all of which make carrier involvement rare. Thus, enforcing the "right to repair" can be an extremely expensive proposition for developer/general contractors. More importantly, costs borne by developer/general contractors in investigation, expert fees and repairs may not be recouped from the repair process.

Another problem is that many cases still end up in litigation after "right to repair" is done. A usual scenario is for a plaintiff to serve a broad "notice to repair" to a developer/general contractor. Even if the developer/general contractor wants to make repairs, they rarely can agree with plaintiff's broad "notice to repair" and extrapolation of defects project-wide based on limited testing of individual units. Most of the time, a developer/general contractor's "offer to repair" only covers repairs of defects actually observed by plaintiff. For example, in one case roof repairs were conducted but only about 50% of the issues were addressed. A developer/general contractor may dispute the amount of plaintiff's investigative costs or only agree to pay for the portion of the investigation related to items in developer/general contractor's "offer to repair." These scenarios rarely lead to resolution, but end up with a lawsuit being filed on both the repaired and unrepaired defects.

b. Problems with the Right to Repair Process

The problems for a developer/general contractor to make repairs are numerous, and include, the fact that our current economy may not permit them to do so. In one case, counsel for developer/general contractor and plaintiff spent considerable time with a mediator negotiating a scope of repair. Before starting repairs, both developer/general contractor and a number of subcontractors filed bankruptcy. In this case, the developer/general contractor's insurance carrier solved the problem by making a business decision to settle the case without a lawsuit being filed.

A practical problem with the statute is that repairs must be investigated and accomplished in a relatively short period of time (for example, California Civil Code section 921(b) provides, that "every effort shall be made to complete repairs within 120

days"), which does not allow for meaningful repairs to be done. This time limit makes it nearly impossible to notify subcontractors and have them participate in the repair process. Although the statute considers plaintiff's "notice to repair"" a "claim" for insurance purposes, it takes much longer than 120 days for an insurance carrier to investigate a claim and make a determination of covered damages. In order to make the process work, the parties usual need to stipulate to extend the time limits for repairs to be completed. Developer/general contractors who are serious about making repairs must move carefully because any payments made for warranty repairs may be considered "voluntary payments" which are not covered by insurance.

Under the statute, the developer/general contractor is limited to issues in developer/general contractor's "offer to repair". Any such "offer to repair" shall be accompanied by a detailed, specific, step-by-step statement identifying the particular violation that is being repaired, explaining the nature, scope, and location of the repair, and setting a reasonable completion date for the repair. Some plaintiff's counsel interpret this strictly to limit repairs to only those items included in the "offer to repair." This can lead to some frustration when the repairs are stopped for exceeding the "offer to repair". (See discussion below paragraph d. "Cases Where Right to Repair Fails".)

The "right to repair" statute does not allow for a contingency to be included in "offer to repair", which is necessary to cover unforeseen items found during the repair. If the scope changes during the repair process, a developer/general contractor may be required to submit an amended building permit with revised drawings and disclose value of repair on the permit. Since all evidence uncovered during the repair process is

admissible and may be used by plaintiff in a subsequent lawsuit, this can be a disaster for a developer/general contractor who does not complete the repairs.

The statute also provides that homeowner may require the developer/general contractor to provide the names, addresses, telephone numbers, and license numbers for up to three alternative contractors to make repairs. This can be used by plaintiffs to effectively prevent the developer/general contractor from using its subcontractors which adds out-of-pocket expense to the repair process. When the repairs are completed, the developer/general contractor is not entitled to a release which usually results in a lawsuit being filed involving the same issues as plaintiff's "notice to repair."

Despite these hurdles, some developer/general contractors are committed to the "right to repair" process. From their point of view, the "right to repair" is all they received in the bargain that overturned the *Aas* decision and eliminated the requirement for there to be property damage in order to recover for construction defects. Developer/general contractors believe that significant benefits come from the "right to repair" process: (i) repairing homes and satisfying customers is viewed as a good business investment; (ii) satisfied homeowners do not file lawsuits, and fewer plaintiffs join a lawsuit after repairs; (iii) there is a perception that the value of plaintiff's claim is less after repairs; (iv) the repair process can be effective to reduce the number of issues left in the lawsuit; and (v) the repair process can go on for a considerable period of time testing the commitment of plaintiffs and straining the relationship between plaintiff's counsel and homeowners.

c. <u>Cases Where "Right to Repair" Works</u>

In certain cases, the "right to repair" process may work well. For example, if the developer/general contractor is motivated to do repairs and is able to have carrier

involvement early in the process, the ability to use subcontractors who have an ongoing business relationship with developer/general contractor helps; or cases with a small number of homes as opposed to a mass development works better; or cases with a limited number of issues or primarily “fit and finish” issues that can be addressed with one or two trades; and homeowner’s who can afford to pay out-of-pocket for attorney fees can get their homes fixed for reasonable cost and still have a warranty for future problems. In these types of cases, the “right to repair” can work and homeowners may be satisfied with repairs and not join in a lawsuit after repairs are completed. Developer/general contractors who can afford to make repairs and are willing to reimburse plaintiff’s investigative costs and pay plaintiff’s attorney’s fees may be able to negotiate a release and not face a lawsuit.

d. Cases where “Right to Repair” Fails

Cases where the “right to repair” does not work are those with significant high dollar repairs. If a home has serious issues, then a developer/general contractor has a problem making repairs beyond the scope of its “offer to repair”. In one case, a developer/general contractor attempted repairs on a single home with massive water intrusion problems. After removing stucco and exposing framing, a mold issue was discovered without any provision for mold containment. The developer/general contractor spent tens of thousands in repairs but was not able to complete the repairs because they went well beyond the “offer to repair”. The developer/general contractor was forced to close up the building and leave defects unrepaired. This was an expensive exercise and led to an early settlement with plaintiff. At its worst, the “right to repair” puts “fresh finger prints on defective work” strengthening the plaintiff’s claim.

e. Pre-litigation Mediation

The “right to repair” law allows for mediation to occur of less than four hours “except as otherwise agreed by the parties” (California Civil Code section 919). Presumably, the mediation is limited to the scope of the “right to repair” notice and the developer/general contractor’s “offer to repair”. Despite these limitations, the mediator may be able to assist with the pre-litigation process.

A mediator can help the parties enter into stipulations that allow the repair process to go forward and have a genuine opportunity for success. Issues involving scope of repair, monetary terms of settlement, and scope of release are all ripe for resolution through mediation. The mediation is an ideal forum to invite subcontractors and their insurance carriers to be involved in the process. A mediator can help keep the process moving forward instead of resorting to law and motion in court. And, the mediation provides an opportunity to resolve the case before a lawsuit is filed.

f. Court Involvement

Rarely, if ever, does a court get involved in what is being repaired. The court usually waits to be involved after plaintiff files a lawsuit alleging not all items were repaired or repairs were done defectively. If the “right to repair” process has been followed, then a motion to stay the lawsuit based on the “right to repair” law is generally denied and the case proceeds as a typical construction defect action.

Mediation

a. It is Easy to Blame the Economy

Most people agree that cases are more difficult to resolve and that the worsened economy is having an effect on construction defect cases. At a minimum, the slow recovery is blamed for cases taking longer than usual to be resolved.

b. What Causes Delay in Resolving Certain Cases?

There are many obstacles to overcome before a case is ready for mediation. The cases are taking longer because more discovery, depositions and legal work is going into them. Some question whether mediation works without full discovery and expert witness depositions. Others would like to see early depositions of plaintiff's experts to get them on record and allow all parties to evaluate their exposure to plaintiff's claims. Virtually all agree that having parties do an early evaluation of the claim and effectively communicating information to carriers to evaluate and be ready to negotiate at the mediation is essential to early resolution. Some advocate a "readiness declaration" to be filed before mediation stating each party's readiness for negotiations, or specifically identifying issues they need to resolve before mediation.

Insolvency of developer/general contractors and subcontractors and missing parties creates delay in every case. At a minimum, plaintiffs must file in the bankruptcy court to get relief from the stay to pursue the insurance policies. Many times this is just the beginning of the process to track down missing parties and insurance carriers. Insolvency also affects a carrier's willingness to participate in both defense and indemnity.

c. What Can be Done to Make Mediation More Effective

Everyone involved in the construction defect arena must be more creative in settling cases. One technique that helps to avoid delays inherent in a first mediation is to hold a pre-mediation meeting between counsel for plaintiff and developer to discuss a "ballpark" settlement amount for the case, and to identify issues or parties capable of early resolution. The goal is to avoid pass through demands that do not help settlement.

Coverage mediations are increasingly used to avoid the situation where a case does not settle for many years due to unresolved carrier issues. A coverage mediation is where all insurance carriers participate to address only coverage problems and issues. Until the insurance picture is complete and all participating carriers are satisfied with the level of co-carrier participation, it is difficult to make progress in mediation on resolving plaintiff's claim. Issues that can be addressed at a coverage mediation include satisfaction of self-insured retentions, acceptance of Additional Insured Endorsements, covered and uncovered claims under wrap policies, and exhaustion of primary policies before excess polices contribute. It can be helpful to have coverage counsel involved early in the case to deal with coverage issues and work with non-participating carriers.

Some people are looking for approaches that will save defense fees and make cases more efficient. One approach is called "meditration" or "binding mediation" with the use of a neutral expert. In this case, the parties have selected a group of experts for plaintiff, a group of experts for the defense, and a neutral expert hired by the mediator

which is paid for by the parties. The neutral expert helps the mediator and parties decide which issues will be in the case. If the parties cannot agree, then there is a mediation to decide if the disputed issue is a defect. If the parties still do not agree, there is a short arbitration with the mediator to decide if the issue remains in the case. Plans and specifications are prepared based upon the agreed defect list. The plans are sent out to three competitive bidders. The parties agree on one of the bids. Finally, the parties mediate allocation of the cost of repair among the defendants. The savings in defense and expert costs is expected to be approximately 40% of a typical construction defect case.

Mediators are spending more time on the phone both before and after the mediation session to keep the case moving forward and make sure that information is being disseminated to decision-makers. The number of claims, long distances that carriers travel for cases in different parts of the country, and use of round table decision making make it less and less likely that decision-makers will be in attendance for mediation. The mediator needs to be able to speak to decision-makers on the phone and know they have enough information to evaluate the claim.

More mediations are held at court using mandatory settlement conference rules to obtain more participation and attendance of decision-makers with the potential for sanctions for violating local rules if parties do not appear. This is used as a last resort when all other methods for resolution have failed.

Insurance Coverage and Wrap Policies

a. Epidemic Gaps in Coverage and Other Trends

There is an epidemic of gaps in insurance coverage or exhaustion of policies that is affecting virtually every case. Developers have huge $1-2 million self-insured retentions, and they have not been doing business for several years and not in a position to pay the self-insured retention amounts. Some developer/general contractors with high self insured retentions are more proactive in cases. It is more common to see general counsel at mediation because it is developer/general contractor's own money at risk. Some estimate that missing or insolvent carriers combined with high self-insured retentions account for 50% of the problem of why cases are not resolved sooner.

Many subcontractors who built homes in the 2003-2004 time frame obtained policies with large self-insured retention limits ranging from $5-10-25-100,000 per claim. Since there has been little construction work for residential subcontractors in the last 3-4 years, they cannot afford to pay the high self-insured retention limits to trigger coverage. Subcontractors are going out of business daily, and there are no well healed subcontractors left in the game. Depending on the wording of the self-insured retention, more aggressive carriers will not pay to defend until the self-insured retention is satisfied.

A major obstacle to getting cases resolved is insolvency of contractors and limited liability companies with no assets. It puts a greater burden on the insurance industry which is requiring detailed damage and coverage analysis to justify settling a case. Carriers are pressing harder on insureds to contribute to settlements either through self-insured retentions or payment for uncovered damages. This is similar to

the approach taken by CNA and other carriers several years ago. The problem with this approach is the cost in time, defense costs and potentially higher settlement demands from plaintiffs when cases do not resolve quickly.

Parties are paying more and taking less in settlement than they are used to doing from past experience. Developer/general contractors are paying a higher percentage of settlements due to gaps in coverage, large self-insured retentions, and insolvent co-defendants. Some plaintiff firms understand they are working in a tough environment and are more flexible on the number to settle a case. Other plaintiff firms are working harder to prepare cases for trial and still demanding top dollar. Subcontractors who still have insurance and Additional Insured Endorsements are paying much more than they are used to paying in the past.

The most difficult cases to resolve are those that do not have covered damages. It creates many obstacles to find insurance coverage, or to find leverage to have defendants contribute their own resources to settlement. For example, a case involving a condominium conversion where 50% of the issues involve alleged negligent construction with coverage and 50% of the issues involve failure to replace 100 year old windows and comply with current air and water infiltration standards, which may not be covered by insurance. This is a difficult case to settle.

Resolving problems involving gaps in insurance coverage and satisfaction of self-insured retention limits is crucial to resolving the case. Although nearly all construction defect cases will settle before trial, the amount of time it takes and the expense involved is directly attributable to resolution of the insurance issues. A common theme in cases that either do not settle for many years or end up going to trial is an unresolved

insurance issue. In summary, the insurance situation combined with a depressed economy have made it a very difficult environment to settle cases.

b. Wrap Policies

In general, wrap policies can be an efficient way to resolve cases. A case where a wrap policy works highlights how much money can be saved on the defense side of a case. Wraps have eliminated the old style case with 40 different counsel representing different subcontractors. Some carriers have taken advantage of wraps to save a lot of money.

However, there are potential problems with wrap policies. Developer/general contractor's counsel usually cannot represent subcontractors because of conflicts. If plaintiff directly sues subcontractors, then separate counsel may need to be appointed to represent the subcontractor group. Sometimes, a few subcontractor counsel are appointed to represent several different groups of subcontractors. If subcontractor's counsel is appointed, this can result in increased costs and frustrate purpose of a wrap policy. Plaintiffs should carefully consider if they need to bring in subcontractors.

Certain plaintiff's counsel believe that wraps have reduced the total amount of indemnity dollars available for settlement. Some wrap policies are cost erosive, meaning that defense costs are taken away from policy limits. Plaintiff's counsel must evaluate the claim in light of these limitations and may decide to resolve a case more quickly rather than risk depleting the wrap's policy limits.

Sometimes the claimed damages can exceed the amount of wrap coverage or the wrap carrier is insolvent. This raises the issue of whether the excess carrier will drop down and become primary. It also may implicate subcontractor's primary policies

or lead to litigation between the developer/general contractor and subcontractors over whose duty it was to maintain the limits and notify the subcontractors of the insolvency of the wrap carrier. It may also lead to "claw back" or "alter ego" claims to pierce through the corporate shell and find personal liability against the insured under the wrap.

Most subcontractor policies typically have wrap exclusions. This is important if the wrap limits are going to be exceeded by the claim. Underfunded wrap policies in a situation where subcontractor policies have wrap exclusions may lead to litigation against the broker who sold the wrap policy. Subcontractors may also have to pay significant deductibles to be in the wrap. Sometimes wrap carriers will assert that certain claims are not covered under the wrap. This may lead to battles between enrolled subcontractors and the wrap carrier. This creates a whole new set of issues and expenses that may frustrate purpose of the wrap.

Wrap policies typically do not include design professionals or manufacturers. If these parties are brought into the case, they may file cross-complaints against subcontractors who will tender defense to the wrap and create more issues. There is an increase in product claims against unenrolled product manufacturers and suppliers. This results in a Phase II of the litigation for product defect claims. The bottom line is that wraps may work or can raise an entirely new set of issues that are more difficult to resolve than a non-wrap case.

Defense and Indemnity Obligations

Issues involving defense and indemnity of developer/general contractors by subcontractors have a dramatic impact on early resolution. A sobering reality is that there are very few cases for which the plaintiff's entire claim could not be resolved for less than the collective cost of defense. One point of view held by some plaintiffs is that battles between a developer/general contractor and subcontractor over defense and indemnity can take over a case if it is not handled well by defense counsel. On the other hand, strong indemnity contracts and many Additional Insured Endorsements make cases easier to settle. But, there are fewer and fewer Additional Insured Endorsements and the law on indemnity has changed in favor of subcontractors over the last few years.

The revisions to Civil Code section 2782 which prohibits the use of Type I and Type II indemnity contracts for the indemnification of construction defect claims in residential construction contracts entered into on or after January 1, 2009 has made court battles over interpretation of indemnity contracts ancient history. Subcontractors cannot be required to indemnify a developer/general contractors for liability or defense costs for construction defect claims which arise out of the developer/general contractor's or another subcontractor's negligence. This means that developer/general contractors are no longer able to pass on a developer/general contractor's share of liability under the indemnity agreements to its subcontractors.

However, some developer/general contractor counsel liken the revisions to Civil Code section 2782 to the situation before it was common for developer/general contractors to have airtight Type 1 indemnity contracts. Prior to the practice of using

Type I indemnity contracts, Type II and Type III indemnity contracts were commonplace and subcontractors were expected to pay their fair share of defense and indemnity costs. Civil Code section 2782 now clarifies that subcontractors are only liable for defense and indemnity to a developer/general contractor to the extent that such claims arise from the subcontractor's scope of work. The revision to Civil Code section 2782 does not affect the ability of a developer/general contractor to obtain an Additional Insured Endorsement for completed operations coverage from a subcontractor's insurer. The statute expressly references that the *Presley Homes* case is not affected meaning that a subcontractor's insurer with an Additional Insured Endorsement is obligated to provide a developer/general contractor with a complete and full defense even with a limited indemnity obligation.

Another dramatic change to indemnity and additional insurance provisions in all commercial construction contracts, including public contracts, is currently being proposed in Senate Bill 474 (2011). Under the proposed statute, no Type I indemnity provision would be valid. Only provisions that narrow the indemnity/contribution to the harm caused by the fault of the indemnifying party would be permitted. This would apply to virtually all commercial construction contracts enter into or amended after January 1, 2012. Importantly, the proposed statute would also prohibit the common requirement of Additional Insured Endorsement in favor of the developer/general contractor to the extent such requirements seek coverage for the scope of the prohibited indemnity.

In California, it was anticipated that the *Crawford* decision would help clarify defense duties owed under indemnity contracts. Although *Crawford* clarifies there is an immediate duty to defend in indemnity contracts with language similar to the indemnity provision in that case, it does not explain how to allocate defense fees. *Crawford* motions are no longer being filed in court; if the indemnity language follows *Crawford*, then courts routinely find an immediate duty to defend. However, allocation of the defense fees among subcontractors is left to the end of the case.

Recently, the Nevada Supreme Court decided *Rayburn Lawn & Landscape Designers, Inc. v. Plaster Development, Inc.* citing *Crawford* for the proposition that an indemnitor's duty to defend an indemnitee is limited to those claims directly attributed to the indemnitor's scope of work and does not include defending against claims arising from the developer/general contractor's or other subcontractor's own negligence. Further, the Nevada Supreme Court found that the district court should have apportioned the fees and costs to those claims directly attributed to Reyburn's scope of work, "if any," and should not have assigned all attorney costs and court fees to Reyburn. From the subcontractor's point of view, it limits exposure for defense and indemnity to those issues arising out of the subcontractor's scope of work. Similar to *Crawford*, *Reyburn* does not address the issue of who pays what share of indemnity between subcontractors.

In Oregon, the case of *Walsh v. Mutual of Enumclaw* the Oregon Supreme Court held that a provision in a subcontract that required the subcontractor to name the developer/general contractor as an Additional Insured was void under ORS 30.140.

ORS 30.140 at subsection (1) basically states that a provision in a construction contract is void if it requires the indemnitor (subcontractor), or the indemnitor's surety or insurer, to indemnify the indemnitee (developer/general contractor) against liability caused by the negligence of the indemnitee. However, subsection (2) of the statute creates an exception, specifically allowing indemnity contracts for the fault of the indemnitor. It was undisputed between the parties in *Walsh* that the exception in subsection (2) did not apply because the indemnitor was not negligent with respect to the plaintiff's injury.

In Arizona, Ariz. Rev. Stat. Section 32-1159(A) prohibits indemnity contracts that indemnify a developer/general contractor from liability resulting from their sole negligence.

In Colorado, there is anti-indemnity legislation that invalidates Type I and Type II indemnity agreements. (See CO. Rev Stat Sections 13-50.5, 5-102, 13-21-111.5.) As a result, subcontractors rarely contribute to a developer/general contractor's defense, and pay for indemnity only to the extent of a subcontractor's scope of work. Additional Insured Endorsements are not allowed to have subcontractor's insurers pay for a developer/general contractor's defense.

In Washington, in the case of *Gilbert H. Moen Co. v. Island Steel Erectors* the court reviewed an indemnity agreement to determine the validity of an indemnification agreement in a construction contract pursuant to RCW 4.24.115. The court held that this section specifically refers to indemnification agreements in construction contracts and it expressly makes them "valid and enforceable" to the extent of an indemnitor's negligence. However, an agreement which requires a subcontractor to indemnify a

general contractor for its sole negligence would be unenforceable under RCW 4.24.1159(1).

Summary

The overall question is whether the process is working efficiently to resolve cases. From the author's perspective, the strength of the construction defect industry is the professionalism and camaraderie displayed by the various participants (including but not limited to counsel for plaintiffs, counsel for developer/general contractors, counsel for subcontractors and insurance claims representatives) all working together in resolving highly controversial issues. Without this cooperation, the court system would be completely overwhelmed by cases that generally take months for trial. Instead, historically the vast majority of construction defect cases are handled almost entirely outside of court. In San Diego, I am not aware of any significant construction defect case of a multi-unit project that went to verdict in many years. One San Diego construction defect judge reports that he has not taken a verdict in a large construction defect case for nearly 8 years. In part, this is due to the ingenuity, perseverance and expertise of all those involved in resolving these complicated cases.