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RECENT DEVELOPMENTS

INSURED-VS.-INSURED EXCLUSION DOES NOT BAR CLAIMS BY ADDITIONAL-INSUREDS AGAINST NAMED INSUREDS

In *Gemini Ins. Co. v. Delos Ins. Co.*, 211 Cal. App. 4th 719 (2012), the California Court of Appeal held that an "insured-vs.-insured" exclusion does not eliminate coverage for a lawsuit brought by an additional insured against the named insured. In *Gemini*, a landlord sued its tenant to recover damages for property damage to the landlord's property sustained during a fire that started on the tenant's premises. The tenant's insurer argued that the insured-vs.-insured exclusion barred coverage for the landlord's lawsuit. But the additional-insured endorsement in the tenant's policy provided that the landlord was an additional insured only "with respect to . . . liability" relating to the tenant's property or conduct. The *Gemini* court concluded that the additional-insured was not an "insured" for the purpose of applying the exclusion to bar coverage for its lawsuit because it did not face liability relating to the fire. This means that the insured-vs.-insured exclusion should not bar coverage for recovery claims by builders against subcontractors, even if the builder is an additional-insured under the subcontractor's policy.

INSURER MUST DEFEND EXECUTIVE ACCUSED OF COMMITTING FEDERAL CRIME

In *Mt. Hawley Ins. Co. v. Lopez*, 215 Cal. App. 4th 1385 (2013), the Second District Court of Appeal held that an insurer must defend a federal criminal prosecution under a directors and officers liability policy ("D&O Policy"). The U.S. government accused Dr. Richard Lopez, a hospital administrator, of falsifying organ transplant records and directing liver transplants to favored patients. After the U.S. government indicted Dr. Lopez in federal court for criminal conspiracy, false statements and concealment, and falsification of records, Dr. Lopez tendered his defense to Mt. Hawley under a D&O Policy that Mt. Hawley had issued to the hospital where Dr. Lopez worked. Mt. Hawley denied coverage and argued that the criminal prosecution was not covered because California Insurance Code § 533.5 prohibits insurers from defending criminal prosecutions. The appellate court disagreed with Mt. Hawley and held that § 533.5 applies only to criminal prosecutions brought by state or local authorities, and that the statute does not bar coverage for criminal prosecutions brought by the federal government. The Court of Appeal also noted

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that Mt. Hawley could be liable to Dr. Lopez for bad faith even though the coverage issue was a close call and Mt. Hawley's coverage position, while wrong, was not unreasonable. Because there was a factual dispute as to whether Mt. Hawley had unreasonably adjusted Dr. Lopez's claim, Dr. Lopez's bad-faith claim could proceed to trial. The appellate court also explained that Mt. Hawley could not rely on the "genuine dispute doctrine" to avoid bad-faith liability since that doctrine likely does not apply to liability insurance.

Mt. Hawley is an important case because it holds that policyholders may secure defense coverage for allegedly criminal conduct. Policyholders can also use *Mt. Hawley* to argue that insurers are liable in bad faith for their unreasonable conduct, even when a court determines that their coverage positions are not unreasonable. Finally, *Mt. Hawley* supports arguments made by policyholders that a "genuine dispute" about coverage does not insulate a liability insurer from a bad-faith lawsuit.

Policy Covering Vicariously Liable Employer Is Excess to Policy Covering Negligent Employee

In *GuideOne Mutual Ins. Co. v. Utica Nat'l Ins. Group*, 213 Cal. App. 4th 1494 (2013), the Fourth District Court of Appeal held that liability policies covering a negligent employee were primary to policies covering only the vicariously liable employer. In *GuideOne*, a pastor, while driving his car on church business, struck and severely injured a motorcyclist. GuideOne, who insured the church and the pastor under a policy issued to the church, sued Utica, who insured only the church, to recover amounts GuideOne paid to settle the motorcyclist's personal injury lawsuit. The appeals court held that GuideOne was not entitled to recover settlement proceeds from Utica because a policy insuring only the vicariously liable tortfeasor (in this case, the church) is excess to a policy insuring the actively liable tortfeasor (in this case, the pastor). Insurers for developers may attempt to rely on *GuideOne* to shift the burden of defending and settling construction disputes to trade contractors and their insurers.

California Supreme Court Depublishes Kaiser

The California Supreme Court has depublished a decision from the Court of Appeals that took a misguided approach to horizontal exhaustive and stacking policy limits. In *Kaiser Cement and Gypsum Corp. v. Insurance Co. of the State of Pa., 215 Cal. App. 4th 210 (April 8, 2013), rehearing denied, (May 01,2013), review and ordered not to be officially published, (July 17, 2013),* the California Court of Appeal delved into the ongoing debate about "horizontal exhaustion," or the principle that excess liability insurance coverage is not triggered until all of the primary policies that cover the same continuous and progressive loss are exhausted, even if they do not sit directly below the excess policy.

In *Kaiser*, the policyholder faced liability for asbestos claims. It had coverage under several successive policies from the same insurer. The policyholder, the liability insurer, and the excess insurer disputed whether all of the underlying policies needed to exhaust before the excess policy could be triggered, or whether only the policy that sat directly under the excess policy needed to exhaust. The Court of Appeal held that an excess insurance policy that conditions coverage on the exhaustion of "any…valid and collectible" underlying insurance requires the policyholder to exhaust each policy that covers the continuous and progressive injury. At the same time, the Court also held that the "per occurrence" primary policy limits in successive policies issued by the same insurer could not be stacked because policy language stated that the limit of coverage applied "per occurrence" not "per occurrence per year" or "per policy."

Kaiser stood in stark contrast to the California Supreme Court's holding in *State of California v. Continental Ins. Co*, 55 Cal. 4th 186 (2012). In that case, the Supreme Court held that when a continuous and progressive loss triggers liability insurance under multiple successive policies, each triggered policy is obligated to up to the policy limit and the insured may stack the limits of all triggered policies. The *Kaiser* Court of Appeal reasoned that *Continental* was distinguishable based on "anti-stacking" language in the "per occurrence" limit in the underlying policies and the fact that the policies in *Kaiser* involved multiple policies issued by the same insurer, whereas *Continental*

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involved multiple policies issued by different insurers.

The Supreme Court's decision to depublish *Kaiser* avoids the tremendous confusion *Kaiser* would have generated.

Feature Article:
The Ongoing Operations Endorsement: "Never Tell Me the Odds!"

A long time ago in a courtroom far, far away, developers became strictly liable for defects in their construction projects. This subsequent flood of expensive construction defect litigation gave way to insurance coverage wars, which pitted the alliance of developers against the empire of insurance companies to determine who must pay for the defense and resolution of these lawsuits.

Part of the developer alliance's strategy in these coverage wars was to require their subcontractors to supplement or replace the developers' own insurance by naming the developers as "additional insureds" on the subcontractors' policies. Since it is generally inexpensive to add an additional insured to a given policy, this tactic effectively shifted the cost of defending and resolving construction litigation onto the insurance empire. Facing these costs, the insurance empire has from that time forward attempted to eliminate (or at least reduce) their obligations to their additional insureds.

Nearly three decades of battle followed. While the developer alliance found early victories in obtaining coverage as additional insureds, the insurance empire struck back by tightening the parameters of available coverage under additional insurance endorsements. A major strike in these coverage wars was the introduction of the "ongoing operations" endorsement, which (the insurance empire argued) limited coverage to only those damages which occur while the named-insured is working on a particular project. This limitation is significant, and the insurance empire relied on it to deny coverage for a large portion of the damages alleged against developers in construction defect litigation.

But all is not lost for the developer alliance, as it appears that the tide may be turning back in their favor. Namely, several courts have recently interpreted the "ongoing operations" endorsement in a way which greatly expands the available coverage to the developer alliance.

Episode One – A New Hope

In the early days of construction defect litigation, the standard additional insured endorsement issued by the insurance empire was the Insurance Services Office's ("ISO") 20 10 11/85 form. This form provided additional insured coverage to the developer for "liability arising out of [the named insured's] work."

The courts interpreted the language of the 20 10 11/85 form as extending coverage to additional–insured developers, even if the developer was being sued for liability arising out of its completed operations. See, e.g., *Pardee Construction Co. v. Ins. Co. of the West,* 77 Cal. App. 4th 1340, 1359 (2000). This was significant for the developers, since many of the damages typically complained of in construction defect litigation do not arise until after all operations have been completed, and the homes sold. Therefore, a developer's odds of securing coverage were always higher when its subcontractors' policies had 20 10 11/85 forms issued in the developers' favor.

Episode Two – The Empire Strikes Back

In response to this broad imposition of coverage obligations, the insurance empire revised the ISO forms in an effort to reduce the temporal limits of their additional insured coverage. Out of this movement the CG 20 10 10 93 and CG 20 10 03 97 forms were born, which limit additional insured coverage to liability arising out of the named insured's ongoing operations. The insurance empire argued that the intent of these "ongoing operations" endorsements was to preclude coverage for liability arising out of a named insured's products or completed operations. In other words, the insurance empire intended to reduce the temporal limit of their coverage obligations by only agreeing to insure covered property damage that occurs while the subcontractor is actually working on the project.

Early decisions supported this argument, holding that the "ongoing operations" endorsement only extends coverage for damages which occur during the subcontractor's operations. See, e.g. *Pardee*, 92 Cal. App. 4th 1359; *Hartford Ins. Co. v. Ohio Cas. Ins. Co.,* 145 Wash. App. 765 (2008); *Weitz Co. v. Mid-Century Ins. Co.,* 181 P.3d 309 (2007). This was, of course, significant for the insurance empire, since most of the potentially-covered damages alleged in construction defect litigation do not occur until after the subcontractors have completed their operations. The effect of the "ongoing operations" endorsement was to drastically limit how many policies were implicated in a given construction defect lawsuit (if any were implicated at all).

The "ongoing operations" endorsement quickly became the choice

of the insurance empire, and additional-insurance coverage became elusive to many developers.

Episode Three – Return of Coverage?

In Arizona, the Ninth Circuit broke with the insurance empire's longstanding position that the "ongoing operations" endorsement limits coverage to only those damages occurring while the named insurer subcontractor is actually performing its work. In *Tri-Star Theme Builders, Inc. v. OneBeacon Ins. Co.,* 426 Fed. Appx 506 (9th Cir. 2011), the court held that the timing of damages was irrelevant to the analysis of an "ongoing operations" endorsement. Instead, the Ninth Circuit reasoned that "[t]he ongoing operations clause… addresses only the *type* of activity…from which the…liability must arise in order to be covered, not when the injury or damage must occur." Id. at 511 (*emphasis added*). The *Tri-Star* court reached this conclusion since the endorsement extended coverage *arising out of* the named insured's ongoing operations, and not *during* the operations. Id. at 510. The court ruled that the tension between the terms "arising out of" and "during" created an ambiguity as to the temporal limitations for coverage under the endorsement. Id. Since ambiguities are generally resolved in favor of the policyholder, the *Tri -Star* court held that the carrier owed a duty to defend the underlying lawsuit, even though the damages did not occur while the subcontractor was working on the development. The practical reading of *Tri-Star* is that the "ongoing operations" endorsement, as currently used, should no longer impose a temporal limit on additional insured coverage.

Tri-Star caused a ripple effect. In California, for example, the Southern District of California recently followed it – finding that the temporal limitation within the "ongoing operations" endorsement was ambiguous, and that the carrier therefore owed the developer a duty to defend. See *McMillin Const. Services, LP v. Arch Specialty Ins. Co.,* 2012 WL 243321.

In Nevada, *Jaynes Corp. v. Am. Safety Indem. Co.,* 2012 WL 6720606 also followed *Tri-Star*, finding that the "ongoing operations" endorsement does not restrict coverage to property damage that occurred during the ongoing operations – but that it extends coverage for damage that occurred after the operation but was *caused* by ongoing operations. Id. (*emphasis in original*).

In all three cases, the courts looked to the "arising out of" language in the "ongoing operations" endorsements. *Tri-Star, McMillin* and *Jaynes* all agreed that "construing the words 'ongoing operations' to exclude damages that arose from conduct performed by [the subcontractor] while its operations were ongoing requires a parsing so abstruse as to be inconsistent with what the ordinary person's understanding of the policy would be. See, e.g., *Tri-Star*, supra, 426 Fed. Appx at 511.

Jaynes went even further, holding that "to construe the plain language of a contractual provision as [the insurance empire] desires – that an AI's coverage for liability *arising out of* a subcontractor's ongoing operations is restricted to coverage for damages occurring during the subcontractor's operations – would be so counterintuitive as to be absurd, and would render the 'arising out of' clause needless surplusage." Id. (*emphasis in original*).

The sum of all three cases is that the developer alliance may take courage that additional insured coverage will once again be available as it was prior to the insurance empire's adoption of the "ongoing operations" endorsement. This optimism, however, must be tempered by three realities: First, this issue that has not been taken up by the California Court of Appeal. Second, at least one recent case addressed the same issue, but came out in favor of the insurance empire. See *Colorado Cas. Ins. Co. v. Safety Co.,* 228 Ariz. 517 (2012) ("ongoing operations" language is not ambiguous and only extends coverage for liability arising while the work is still in progress). Finally, all of the cases which read the "ongoing operations" endorsement as providing coverage for completed operations agree that, if the insurance empire wishes to limit the coverage to the narrow window of time when the named insured is actually working on the project, they only need to modify the endorsement to make it clear that once the named insured's operations are complete, the developer is no longer an additional insured for damages that occurred thereafter.

Help us Coverage Counsel, You're Our Only Hope

While this issue is still developing, *Tri-Star* and its progeny provide assistance to the developer alliance's ability to challenge denials of coverage based on "ongoing operations" endorsements and potentially obtain a defense as an additional insured. The insurance empire will continue to fight for the narrow interpretation of the endorsement, but it appears that the courts may be moving toward the broader interpretation which extends coverage for completed operations. In light of the courts' movement, developers should be emboldened to take a more aggressive position when negotiating for coverage under an "ongoing operations" endorsement.

Developers should also review their subcontractors' additional

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insured endorsements with coverage counsel before allowing the subcontractors to work on a project. Since *Tri-Star* described how the insurance empire can narrow the scope of its "ongoing operations" endorsements by adding temporal language, the insurance empire may add such language to its endorsements. Developers should watch for language which states that its status as an insured under the endorsement ends when the named-insured's operations are completed. Such language could clear up the ambiguity relied on by *Tri-Star* and its progeny, and once again impose the strict temporal limit to coverage afforded by an ongoing operations endorsement.

May the force of additional insured coverage be with you.

This article was written by Nathan Cazier, an associate in Payne & Fears' Insurance Law Group.

Insurers Cannot Seek Reimbursement from Independent Counsel

In *J.R. Marketing., L.L.C. v. Hartford Cas. Ins. Co.*, 216 Cal. App. 4th 1444 (2013), the California Court of Appeal held that an insurer who breaches its duty to defend cannot sue its insured's independent counsel for reimbursement of defense fees and costs.

In this case, the insurer, Hartford, breached its duty to defend, so the insured hired Squire to act as its independent counsel. When Hartford later acknowledged a defense obligation, it tried to appoint its own, presumably less expensive, panel counsel. The court rejected this attempt, holding that Hartford "forfeited all right" to control its insured defense by breaching the duty to defend. After the resolution of the lawsuit, Hartford sued Squire—rather than its own insured—for reimbursement of defense fees and costs. The court concluded that Hartford's lawsuit was an attempt to "[r]etroactively impos[e]" Hartford's "choice of fee arrangement" on its insured, despite Hartford's prior forfeiture of its defense rights. The Court held that allowing Hartford to seek reimbursement against the insured's counsel would frustrate the "clear California law" that an insurer in breach of its duty to defend may not "thereafter impos[e] on its insured its own choice of defense counsel, fee arrangement or strategy."

J.R. Marketing adds teeth to the now well-established California rule that an insurer who breaches its duty to defend loses its right to control its insured's defense by preventing insurers from avoiding the rule by challenging the reasonableness of independent counsel's fees and costs in a direct action for reimbursement.

Reservation of Right Based on "Contractor's Special Condition" Created the Right to Independent Counsel

In *Schaefer v. Elder*, 217 Cal. App. 4th 1 (2013), the California Court of Appeal held that a contractor was entitled to independent counsel in a construction defect action because of its insurer's reservation of rights based on the "contractor's special condition." Elder, a contractor, faced a construction defect lawsuit by a disgruntled homeowner. Although Elder's insurer agreed to defend, and appointed Koeller as counsel, it reserved its right to deny coverage based on the "contractor's special condition"—which states that the insurer will not cover work performed by independent contractors unless Elder first obtained from those independent contractors an indemnity agreement and a certificate of insurance. The Court held that this reservation of rights created a conflict of interest between the insurer and Elder. To succeed on its claim, the plaintiff would need to prove either that (1) the allegedly shoddy work was performed by Elder's employees or (2) the allegedly shoddy work was performed by Elder's independent contractors. This dynamic placed Elder and its insurer's interests at odds because it was in the insurer's interest to prove that independent contractors performed the work, so it could argue the contractor's special condition applied and defeat coverage. In contrast, it was in Elder's interest to prove that his employees performed the work to preserve coverage. As a consequence, the Court held that the insurer must pay for Elder's independent counsel, and it disqualified the Koeller firm from representing either Elder or his insurers. *Schaefer* reaffirms that the right to independent counsel in the construction defect setting is alive and well and it provides a roadmap for persuading a Court to recognize this right.

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