

# THE IDC MONOGRAPH:

## **Managing the Risk: A Report of the September 20, 2007 IDC/SOICA Construction Insurance Symposium**

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## Panelists/Moderators

### Is it an Occurrence Just Because it's Not Intentional? Construction Defect Coverage Litigation

**Moderator:** William McVisk, *Johnson & Bell, Ltd.*

**Panelists:** Clifford Shapiro, *Barnes & Thornburg, LLP*; Robert Lessman, *Pepper Construction Company*; Hope Nightingale, *Litchfield Cavo, LLP*; Phil King, *Meckler Bulger & Tison, LLP*

### Additional Insureds and Targeted Tenders

**Moderator:** David Levitt, *Hinshaw & Culbertson LLP*

**Panelists:** Terry Galganski, *The Weitz Company, LLC*; David Lewin, *Tribler Orpett & Meyer, P.C.*; John Prusik, *Prusik, Selby, Daley & Kezelis, P.C.*; Scott Little, *Rand Tec Insurance Agency*; Julien Savoie, *Liberty Mutual Group*

### The Employer's Impact on Coverage: *Kotecki/Bray/Virginia Surety*

**Moderator:** Robert Varney, Robert T. Varney & Associates

**Panelists:** Michael T. Reagan, *Herbolsheimer, Lannon, Henson, Duncan & Reagan, P.C.*; John Schembri, *Fru-Con Construction Corporation*; Francis A. Spina, *Cremer, Kopon, Shaughnessy & Spina, LLC*; Greg Vacala, *Rusin Maciorowski and Friedman Ltd.*

### Does Insurance Defense Counsel Represent Only the Insured? Or is the Insurer Also a Client? To Whom Does Counsel Owe Loyalty When There is a Conflict of Interest Between Insurer and Insured?

**Moderator:** Joseph Postel, *Lindsay & Rappaport LLC*

**Panelists:** Michael T. Reagan, *Herbolsheimer, Lannon, Henson, Duncan & Reagan, P.C.*; Bill Barker, *Sonnenschein, Nath & Rosenthal*; Jill Berkeley, *Howrey, LLP*; Charlie O'Connor, *Liberty Mutual Group*

### Professional Liability, E&O, Architects and Engineers and Related Policies

**Moderator:** Eric Singer, *Ice Miller, LLP*

**Panelists:** Werner Sabo, *Sabo & Zahn*; Karen Erger, *Holmes Murphy & Associates*; Phil Best, *XL Insurance*; Don Hackl, *Loebl, Schlossman & Hackl*

### Construction Bonds and Suretyship

**Moderator:** Stanley N. Wasser, *Feldman, Wasser, Draper & Benson*

**Panelists:** Lynn Marie Schubert, *The Surety & Fidelity Association of America*; William D. Lyman, *Lyman & Nielsen*; Lorence H. Slutzky, *Robbins, Schwartz, Nicholas, Lifton & Taylor, Ltd.*; William S. Piper, *Riordan, Donnelly, Lipinski & McKee, Ltd.*

## Introduction

On September 20, 2007, at the Chase Park Plaza in St. Louis, Missouri, the Illinois Association of Defense Trial Counsel [IDC] and the Society of Illinois Construction Attorneys [SOICA] co-sponsored a well-attended symposium in which highly qualified persons discussed and debated the current status of construction insurance law in Illinois. This Monograph is a report of the symposium and features matters raised both in the symposium debates and in the written materials prepared for that program.

The symposium consisted of six panels, each of which focused on one substantive area of insurance coverage. The first panel addressed the topic of construction defect coverage. Moderated by William McVisk, the panel provided interesting insights into the evolution and status of coverage. Clifford Shapiro and Robert Lessman provided insights from the contractor's perspective, while Phil King and Hope Nightingale provided summaries of Illinois coverage decisions.

The second panel took on the related topics of "additional insureds" and "targeted tenders." Moderated by David Levitt, the panel covered a host of hot topics related to additional insureds. Terry Galganski and John Schembri provided interesting views of the expectations of contractors. Scott Little discussed his experience with drafting additional insured endorsements and provided insights as to the expectations of those buying and selling policies. John Prusik discussed the *Kajima*<sup>1</sup> case, which he argued before the Illinois Supreme Court just days before the Symposium. David Lewin provided a coverage attorney's perspective on how coverage attorneys are responding to rulings by the Illinois Supreme Court and some of the "unintended consequences" of those decisions.

The third panel, moderated by Robert Varney, focused on the employer's impact on coverage. The panel featured a fascinating historical perspective on the *Kotecki*<sup>2</sup> decision from Michael T. Reagan, the lead attorney for the appellant in that case. The panel also featured Francis A. Spina and Greg Vacala, the lead attorneys in *Virginia Surety Co., Inc. v. Northern Ins. Co. of New York*,<sup>3</sup> and their debate over the merits and the implications of that decision.

The fourth panel discussed the ethical issues raised by insurance coverage. The panel, moderated by Joseph Postel, featured a good-natured exchange of strong viewpoints between William Barker and Jill Berkeley. Charles O'Connor provided the viewpoint of the insurer, and Michael Reagan also raised some interesting issues.

The fifth panel covered professional liability policies. Eric Singer moderated the panel, which included panelists Phil Best, Karen Erger, Donald J. Hackl, and Werner Sabo. They

provided a discussion of market trends, new areas of coverage, and wrap up policies.

The sixth and final panel, moderated by Stanley N. Wasser, discussed construction bonds. It featured Cornelius Riordan, William S. Piper, Lynn Marie Schubert and Lorence H. Slutzky. Perhaps more than the other panels, the construction bond panel provided both a great introduction to the field of construction bonds and an interesting discussion of the differing perspectives of bond companies and contractors.

Overall, the program clearly met its goal of putting people with differing views on panels to provide multiple perspectives on the status of the law and to discuss what the law should be, as opposed to simply what the law is. The IDC and SOICA sincerely hope that the discussions held on September 20, 2007 can serve as a framework for courts to use to chart the path of Illinois construction coverage law.

### **Panel One: Is it an Occurrence Just Because it is Not Intentional? Construction Defect Coverage Litigation**

The first session of the symposium examined coverage for construction defects. Four panelists provided very different perspectives on the construction defect coverage issues facing construction companies and their insurers. The discussion ranged from the practical reality of contractors beginning work on a large construction project without finalizing all of the construction contracts, to the differences between the "hold harmless" and "additional insured" provisions in a subcontract agreement. Also highlighted was Illinois law with respect to adhering to notice procedures. However, the liveliest discussion during the session involved a debate between two panelists on two interrelated issues: 1) What constitutes "property damage" with respect to construction defects; and 2) Whether construction defects constitute an "occurrence" under the current standard language in a CGL policy.

Conferring on the topic were panelists Robert Lessman of Pepper Construction, Clifford Shapiro of Barnes & Thornburg, LLP, who represents policyholders, and Hope Nightingale of Litchfield & Cavo, who represents both insurers and first-party insureds. Phil King of Meckler Bulger & Tilson also spoke.

Whether analyzing the "occurrence" issue or the "property damage" issue, the panelists' discussion primarily focused on the history and development of the CGL policy language with respect to the policy definitions. Shapiro, a pro-policyholder panelist, presented a detailed analysis of the 1973 and 1986 amendments to the language of the "subcontractor" ex-

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ception to the “your work” exclusion. The substance of Shapiro’s argument was that the 1986 Policy Form amendment contemplated and, ultimately stated, provided coverage to a policyholder for property damage to “your work” that arises from work performed by a subcontractor. Shapiro concluded that this amendment to the Policy Form necessarily means that a construction defect is to be considered an “occurrence” under the coverage grant language, otherwise there would have been no need to include the amendment. According to Shapiro:

[The Policy amendment] must mean and specifically anticipates that construction defects can be an occurrence because why else would we have this intricate set of exclusions that is defining the scope of what is covered if a construction defect could not be an occurrence in the first place.

Without specifically responding to many of the arguments made by Shapiro, King simply stated in reply, “I think it is interesting that they start with the exclusions and work backward up to an occurrence definition that has not changed since 1966.” King focused his commentary primarily on the status of the law, and did not directly address many of the points raised by Shapiro. King discussed the question of whether damage to a structure itself constitutes “property damage” that is not “economic loss.” (All of the panelists appeared to acknowledge that pure economic loss does not fall under the definition of property damage. For instance, if the wrong windows or types of floor tiles were installed in a building, it would not constitute “physical injury” to tangible property as required under the definition.) However, as King noted, the question becomes much less clear when, for instance, one party’s faulty workmanship causes cracks in drywall installed by a different contractor. Similarly, a question arises as to whether “property damage” has occurred if the owner of a building has to break through a structure (plumbing, gas lines, drywall, etc.) in order to access the portion of the property that was defectively installed. According to King, different states have reached different conclusions on this issue. However, the Illinois Supreme Court recently held that damage caused by attempting to access a defective pipe in a wall is not “property damage” under the language of a CGL policy.<sup>4</sup>

Notably, the original 1966 policy definition of “property damage” focused on the distinction between physical and non-physical injuries rather than simply injuries and non-injuries. The 1966 version of the GCL policy form defined “property damage” as “injury to or destruction of tangible property.” The prevailing interpretation was to give the term “injury” a

broad interpretation.<sup>5</sup> However, a minority of courts found no coverage for injuries when there was no physical contact between the injurer and the property damaged.<sup>6</sup> The classic example of this scenario entails a lawsuit against the manufacturer of a crane, which collapses in front of a store, thereby preventing customers from entering the store. Under the minority view’s interpretation of the 1966 definition of “property damage,” there would be no coverage available for the liability incurred by the crane manufacturer, because blocking the storefront would not be construed as “an injury to tangible property,” as required under the definition.

Because of the inconsistency, the definition of “property damage” was amended in 1973 to include a two-part definition. The first part contained the classic language regarding “injury to tangible property” as noted above. Notably, however, the word “physical” was added in front of the word “injury.” The second part included the language “loss of use of tangible use” and was intended to provide coverage for situations like the crane collapse scenario described above.<sup>7</sup> The purpose of the addition of the word “physical” before the word “injury” in the first prong of the definition was intended to distinguish the first prong from the second prong, which only covers instances where there is no “physical” touching of the property.<sup>8</sup>

The result of the inclusion of the word “physical” in the definition of “property damage” has created two separate and distinct interpretations under the first part of the definition. The pro-insurer interpretation merely construes the term “physical injury” to mean an injury that causes a harmful physical alteration of the property. The alternate approach adopted by policyholders finds that physical injury also includes a loss which results from some type of physical contact with the property, and which must be removed in order to prevent the danger from materializing.

In an ironic twist, an attempt to illustrate the two divergent views regarding “property damage” coverage resulted in a policyholder advocate arguing for no coverage in a construction defect scenario and an advocate of insurance carriers arguing for coverage. The panel moderator, William McVisk, asked the panelists to discuss their views on coverage with respect to the failure of the air conditioning system at the State of Illinois building.<sup>9</sup> The State of Illinois Building (a.k.a. the James R. Thompson Center) is a large, glass building designed by Helmut Jahn. It is located in the heart of downtown Chicago. The building first opened in 1985. However, due to the single-paned (non-insulated), curved glass panels that comprised the building’s exoskeleton, the building’s HVAC system did not operate properly. As a result, the State of Illinois sued a number of companies involved in the project,

including the construction and contracting companies, alleging various acts or omissions of improper design, manufacture and installation of the heating, ventilation and air conditioning system.<sup>10</sup> The State sought damages in excess of \$15 million to compensate for more than \$10 million in repairs to the HVAC system and \$5 million in lost rent and lost productivity from State employees.<sup>11</sup> The contractors and construction companies sought coverage with respect to the allegations in the complaint brought by the State of Illinois.

The issue that the panelists were asked to debate was whether the HVAC system malfunction in the State of Illinois building constituted “property damage” under the current definition in a CGL policy. Surprisingly, the panelist representing the construction contractors, Clifford Shapiro, responded that in that particular instance, there was no physical injury “property damage” because there were “no allegations beyond failure of the HVAC system to operate properly. There was, for example, no allegation that the HVAC system failure caused condensation which then damaged drywall.” Shapiro did note that his typical view of this type of situation was that if “property damage” was alleged, it almost always would be an “occurrence,” which, depending on the exclusions available, should create a potential for coverage and trigger a duty to defend. More interestingly, however, the panelist representing the insurance carriers, Phil King, noted that coverage might, in fact, be available to a tendering contractor with respect to the HVAC defect under the definition of “property damage” as a result of “loss of use,” if that is alleged, although not as an injury to “physical property.” Finally, the room returned to normal when Hope Nightingale, a panelist who regularly represents insurers, concluded that there was no property damage in the State of Illinois example and therefore, any analysis as to whether there was an “occurrence” was unnecessary.

## Panel Two: Additional Insureds and Targeted Tenders

The Additional Insureds and Targeted Tenders panel included insurance coverage and litigation attorneys David Levitt, David Lewin and John Prusik, risk managers for general contractors, Terry Galganski and John Schembri, a claims examiner for a large insurance company, Julien Savoie, and a producer and claim manager for an insurance broker, Scott Little. The diversity contributed to an interesting discussion and provided differing viewpoints on common issues.

The panel first discussed targeted tenders. Under *John Burns Construction Co. v. Indiana Ins. Co.*, where an Illinois insured is covered by multiple policies of insurance, Illi-

nois allows the insured to “target” a particular insurer and, in so doing, prevent that insurer from sharing the loss with other insurers that might have coverage.<sup>12</sup> Most Commercial General Liability policies contain an “Other Insurance” clause, which provides that any loss must be split with any other policies that are “available.” *John Burns* held that the tendering party’s insurance policy is not “available” and, therefore, the targeted insurer has no right to contribution from the tendering party’s insurer.<sup>13</sup>

Targeted tenders are prevalent in the construction industry where general contractors target tender their subcontractor’s insurers for defense of lawsuits brought against the general contractor. As the panelists discussed, Illinois is the only state that allows targeted tenders. The panelists agreed that targeted tenders are a creation of the courts.

Illinois courts have yet to decide many of the parameters for targeted tenders. The most notable undecided question concerns the availability of targeted tenders with respect to excess or umbrella policies. The symposium attendees were fortunate to hear a first-hand account of the oral argument in *Kajima Construction Services, Inc. v. St. Paul Fire and Marine Ins. Co.*,<sup>14</sup> which panelist John Prusik had made in the Illinois Supreme Court just days prior to the symposium. As Prusik explained, the main issues before the court in that case are whether a targeted tender includes excess policies, and in particular, whether a contractor can target an excess policy prior to the time that all primary policies are exhausted. The appellate court in *Kajima* held that the general contractor must exhaust all available primary insurance coverage, or its equivalent, before any excess policy can be targeted. Prusik represented the general contractor before both the Illinois Appellate Court First District and Illinois Supreme Courts. He argued that the insured has the right to choose its primary as well as excess coverage and, therefore, can vertically exhaust a targeted insurer’s policy.

Prusik was impressed with the Illinois Supreme Court’s knowledge of *Kajima*’s complicated issues. The issues include horizontal versus vertical exhaustion; comparison of the “Other Insurance” language in the *Kajima* excess policies with the “Other Insurance” language in *John Burns*; the effect of vertical exhaustion on deselected insurers; and whether vertical exhaustion will allow insureds to bypass primary insurers and target excess insurers directly. Prusik felt it was difficult to gauge which way the court was leaning. He anticipates a ruling by the end of 2007.

Scott Little noted that the fallout of *Kajima* could be policy endorsements prohibiting vertical exhaustion or an increase in premiums for excess coverage. Julien Savoie agreed and

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predicted that insurers will draft endorsements protecting themselves from targeted tenders. A general contractor that receives an endorsement that prohibits targeted tenders would have to put all of its potential insurers on notice, rather than just targeting a single insurer. This, in turn, may expose the general contractor's own insurers to equitable contribution (but see the discussion of *Home v. Cincinnati*, below). The effect would be the same as if the general contractor was in a jurisdiction where targeted tenders are not recognized.

The panel then proceeded to a discussion of the practical advantages and disadvantages of targeted tenders. The panel was split as to whether targeted tenders should be recommended when the opportunity to make such a tender exists. John Schembri found targeted tenders to be advantageous to general contractors because the targeted insurer is not allowed to seek equitable contribution from the general contractor's insurer. Therefore, targeted tenders protect the general contractor's insurer from being brought into the litigation, and the general contractor's policy is not triggered.

Little noted that targeted tenders potentially limit the insurers from whom a general contractor can obtain coverage. Little felt that the better approach is to identify those subcontractors that may be liable and place their insurers on notice. This increases the likelihood of obtaining coverage from at least one of several insurers, rather than hoping that the targeted insurer will provide coverage. In addition, if multiple insurers are "in play," it may result in quicker settlements from a cost-sharing standpoint. David Lewin was of the opinion that except in some limited circumstances where the potential loss is almost sure to exceed the primary policies, targeted tenders are in the interest of contractors. David Levitt, on the other hand, stated that he tends to refrain from making use of targeted tenders and instead lets the insurers decide among themselves how to divide the loss.

On a matter related to targeted tenders, the panel discussed the issue of what constitutes a proper tender and whether the Illinois Supreme Court has provided a practical solution to that issue. In *Cincinnati Cos. v. West American Ins. Co.*, the Illinois Supreme Court held that a tender is not required to trigger an insurer's duty to defend.<sup>15</sup> Rather, "actual notice" of a claim triggers the insurer's duty to defend, regardless of the level of sophistication of the insured, except when the insured knowingly forgoes the insurer's assistance.<sup>16</sup> The duty to defend may be discharged by contacting the insured and determining whether the insurer's assistance is needed.<sup>17</sup>

Lewin was concerned with the burden that insurers face with the "actual notice" requirement. This is especially true when a policy contains a blanket additional insured endorse-

ment, which, under *Cincinnati Cos.*, would require an insurer to obtain and review the contracts for the construction project and identify and contact each potential insured. In contrast, the burden for an insured to contact the insurer is much less. Levitt agreed that the "actual notice" requirement makes practice more difficult for insurers.

The panelists also discussed the status of equitable contribution and equitable subrogation in Illinois, and the Illinois Supreme Court's 2004 decision in *Home Ins. Co. v. Cincinnati Ins. Co.*<sup>18</sup> In that case the court held that insurers for two subcontractors that provided additional insured coverage to the same general contractor did not insure the same risks.<sup>19</sup> Therefore, the subcontractor that defended the general contractor was barred from obtaining equitable contribution from the other subcontractor.<sup>20</sup>

According to the panelists, the practical impact of *Home Ins. Co. v. Cincinnati Ins. Co.* is that the insurer that steps forward and meets its obligations is "stuck." The reason the insurer may be "stuck" is that if the other concurrent insurers do not insure the identical entities, interests and risks, the defending insurer cannot receive equitable contribution. From the insurer's side, the dilemma presented by *Home Ins. Co.* is how to make sure that a loss is spread appropriately among insurers. From a contractor's perspective, the issue is how to make any insurer step forward to cover a loss.

When representing insurers of subcontractors, Lewin handles a tender by identifying which other insurers may be involved, and advises insurers against sending a reservation of rights letter until he receives some word as to whether other insurers will step up. Given the impact of *Home Ins. Co.*, an insurer wants to avoid being the first insurer to accept a risk. In the event that other insurers refuse to cooperate, *Home Ins. Co.* may bar the first insurer from seeking the equitable share from those other insurers. As a result, his strategy focuses on reaching an agreement between the insurers and then presenting the purported insured with the deal put together by the insurers.

In contrast, Prusik, who represents general contractors, tenders immediately to the injured plaintiff's employer. He has been successful in having the tenders accepted. Consistent with what Lewin said, Terry Galganski noted that subcontractors' insurers are reluctant to pick up a tender without first conducting an investigation of available insurers.

One of the consequences of *Home Ins. Co.* is that insurers are discouraged from stepping forward to defend the general contractor, because the insurers know that if they do, they will be shouldering the entire costs of defense and, possibly, indemnity. Savoie pointed out that the fallout from *Home Ins. Co.* is exactly the opposite of what was intended. Defense

costs can be very high, especially in construction defect cases, and *Home Ins. Co.* leaves the defending insurer with no ability to share defense costs with other insurers. Lewin agreed and noted that prior to *Home Ins. Co.*, insurers were more inclined to accept risk early.

Another consequence of *Home Ins. Co.* is that if insurers wait too long to defend the tendering party, they may be subject to an estoppel claim for not timely defending. Lewin noted that, despite this risk, insurers are waiting as long as they can before stepping up to assume the defense, with the hope that they can enter into a sharing agreement with other insurers before having to do so. This forces the tendering party to pay its own defense costs while waiting for the insurer's decision, thereby exposing the insurer to a bad faith claim. Levitt commented that *Home Ins. Co.* is bad public policy for both insurers and insureds and should be overturned because it has eroded the concept of risk transfer.

The panel also discussed another practical matter facing contractors: how to make sure that subcontractors provide insurance that results in the general contractor being defended and indemnified for losses caused by the subcontractor. Galganski noted that many subcontractors do not understand additional insured coverage, but nonetheless execute subcontracts requiring it. Schembri commented that a general contractor is limited by what it can negotiate with the subcontractor and, especially, by what the subcontractor's insurer will provide. Although the general contractor can require whatever it wants in regard to indemnity in a subcontract, if the subcontractor does not have the insurance to back it up, the general contractor is limited to whatever financial resources the subcontractor has.

The panel discussed some practical approaches to securing the coverage. One solution was for the contractor to provide a Contractor-Controlled Insurance Policy (CCIP) or Owner-Controlled Insurance Programs (OCIP.) Those programs provide contractors some assurance in securing the coverage they require, although the programs come with high costs and deductibles. OCIPs are advantageous from a litigation standpoint because there is only one policy and one "pot of money," versus multiple insurers fighting over coverage obligations.

Another solution the panelists offered is to draft strong contracts that specifically spell out the required coverage. Lewin noted that in drafting construction contracts for general contractors, he suggests including contractual provisions prohibiting endorsements that limit additional insured coverage. Even when that is done, however, there remains a problem of enforcement. Schembri pointed out that although most contractors require their subcontractors to provide certificates

of insurance before they commence work, supporting documentation like "additional insured" and "waiver of rights of subrogation" endorsements may lag behind by a few weeks before they are issued by the subcontractor's insurer. In addition, subcontractors' insurers may not provide the requested documents at all, forcing the general contractor to decide whether it should retain another subcontractor, which may not be practical if work has commenced.

### Panel Three: The Employer's Impact on Coverage

The third panel focused on the employer's impact on coverage. Robert Varney moderated and the panel included Michael T. Reagan, Francis A. Spina, and Greg Vacala. The panel discussed the issue of whether an employer who makes a "*Braye*"<sup>21</sup> waiver of its *Kotecki* cap is without insurance coverage or whether the employer's liability insurer must step in and provide coverage to the employer, in light of the Illinois Supreme Court decision in *Virginia Surety*.<sup>22</sup>

In order to fully comprehend the recent developments in insurance coverage for an employer, a brief review of the historic developments in this area of the law is necessary. The Illinois legislature created the Workers' Compensation Act (the Act), effective in 1913.<sup>23</sup> Michael Reagan noted that the passage of the Act was an "historic compromise," because it allowed employers a statutory immunity from most direct actions by their employees, in exchange for nearly absolute liability with defined damage exposure limits for most workplace injuries. Between an employee and an employer, the Act provided the exclusive remedy for an employee to recover damages from his or her employer for a work related injury. According to Reagan, every state has now enacted some sort of workers' compensation act to protect employers from direct lawsuits filed by their employees.

In 1967, the Illinois Supreme Court upset the Act's exclusive remedy provision by holding that an employer was potentially liable for indemnity if it was actively negligent and the direct defendant (in the case of a construction project, typically another party involved in the project) was only passively negligent.<sup>24</sup> About ten years later, according to Robert Varney, the Illinois Supreme Court "brought an abrupt halt to immunity from common law liability" in *Skinner v. Reed-Prentice Division Package Machinery Co.*<sup>25</sup> The court in *Skinner* allowed a manufacturer sued in strict tort liability a right of contribution against the employer. The *Skinner* decision was later codified in 1980 in the Joint Tortfeasor Contribution Act (Contribution Act).<sup>26</sup>

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Following the enactment of the Contribution Act, the Illinois Supreme Court in *Doyle v. Rhodes* analyzed the competing interests of the Contribution Act and the protection afforded to employers by the Workers' Compensation Act.<sup>27</sup> The *Doyle* court held that an employer is liable under the Contribution Act for its proportionate share of negligence in causing its employee's injury, without regard to the Workers' Compensation Act.<sup>28</sup> According to Reagan, after *Doyle*, the Workers' Compensation Act essentially did nothing to protect employers from liability in tort. The exclusive remedy provision had little or no impact. The employer would have to defend a workers' compensation claim brought by its employee and be sued via a third party complaint for contribution based on its proportionate share of liability in causing the employee's accident.

According to Reagan, prior to the Illinois Supreme Court's decision in *Kotecki v. Cyclops Welding Corp.*,<sup>29</sup> the landscape of the rest of the country was as follows: 45 states prohibited all contribution against an employer; three states limited an employer's liability to non-compensation by case law or statute; and only one state, New York, expressly permitted unlimited contribution against an employer. Reagan stated that during the post-*Doyle*, post-*Skinner* and pre-*Kotecki* period, some states had examined the Illinois Supreme Court's *Skinner* and *Doyle* decisions and rejected the court's rationale for allowing an employer to be liable for contribution.

Once contribution from an employer had been allowed in Illinois, the next landmark case with respect to an employer's liability in contribution came in 1991, with the Illinois Supreme Court's *Kotecki* decision. In *Kotecki*, the court again analyzed the competing interests of the Workers' Compensation Act and the Contribution Act. The court held that an employer sued for contribution as a third-party defendant could be liable only up to the amount of its statutory workers' compensation liability.<sup>30</sup> This limitation on the employer's contribution liability became known as the "*Kotecki* cap."

Following the supreme court's decision in *Kotecki*, the supreme court in 1997 carved out an exception to an employer's *Kotecki* cap, in *Braye v. Archer-Daniels-Midland Co.*<sup>31</sup> In *Braye*, the Illinois Supreme Court held that an employer could waive its *Kotecki* cap by agreement; i.e. make a *Braye* waiver of its *Kotecki* cap.<sup>32</sup> Therefore, the employer's exclusive remedy protection was again diminished, as the employer could be held liable to its employee directly under the Workers' Compensation Act and as a third-party defendant for its proportionate share of negligence in its employee's third-party suit.

After *Kotecki* and *Braye*, the question in the insurance industry was who was going to pay for the insured employer's

liability when the employer is sued for contribution and the employer has made a *Braye* waiver of its *Kotecki* cap? Was the claim covered by the Employer's Liability (EL) policy, the Commercial General Liability (CGL) policy, or neither because the employer faces a potentially uninsured loss? Until 2007, the Illinois Supreme Court had not addressed whether the EL carrier or the CGL carrier had to provide coverage to the insured employer who had made a *Braye* waiver of its *Kotecki* cap.

The appellate court, however, had addressed the issue of whether the EL or the CGL carrier had to cover an employer sued for contribution after a *Braye* waiver. In *Christy-Foltz, Inc. v. Safety Mutual Casualty Corp.*,<sup>33</sup> the Fourth District Appellate Court addressed the issue whether an EL policy had coverage for the employer that had made a *Braye* waiver of its *Kotecki* cap and answered that question in the negative.

There was, however, a split between the districts of the appellate court as to whether a CGL policy covered an employer sued for contribution after a *Braye* waiver. The Third and Fifth Districts of the appellate court held that the CGL carrier did not have a duty to provide coverage to an employer, even when the employer entered into a contract that contained an indemnification provision.<sup>34</sup> The Second District of the appellate court, however, held that the CGL policy did have to provide coverage to the employer sued for contribution following a *Braye* waiver of its *Kotecki* cap.<sup>35</sup>

In 2006, the Illinois Supreme Court granted a petition for leave to appeal the appellate court decision in *Virginia Surety*, thereby agreeing for the first time to decide whether a CGL policy had to provide coverage to the employer sued for contribution after a *Braye* waiver. In *Virginia Surety*, the general contractor, Capital Construction Group, Inc. (Capital) hired DeGraf Concrete Construction, Inc. (DeGraf) to perform cement masonry work on a construction site.<sup>36</sup> An employee of DeGraf was injured while working and the employee sued Capital. In turn, Capital filed a single count third-party complaint for contribution against DeGraf.<sup>37</sup>

DeGraf tendered the third-party complaint to both its EL carrier, Virginia Surety, and to its CGL carrier, Northern Insurance.<sup>38</sup> Virginia Surety accepted DeGraf's tender and defended DeGraf against the third-party complaint, but Northern denied DeGraf's tender and refused to defend and indemnify DeGraf against the third-party complaint.<sup>39</sup> Northern denied coverage based upon the exclusion in its CGL policy for bodily injury to employees. Northern's CGL policy also contained an exception to this exclusion that stated that the insurer would pay sums for "liability assumed by the insured under an insured contract."<sup>40</sup> Northern's CGL policy defined an insured contract as:

That part of any other contract or agreement pertaining to your business (including an indemnification of a municipality in connection with work performed for a municipality) 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.<sup>41</sup>

After the underlying suit was resolved, Virginia Surety filed a declaratory judgment action against Northern, seeking damages for amounts Virginia Surety paid to defend and indemnify DeGraf. Virginia Surety asserted that the exception in Northern’s CGL policy for “liability assumed by the insured under an insured contract” negated the exclusion for bodily injury to employees; and, therefore, Northern had to defend and indemnify DeGraf.<sup>42</sup> Northern filed an answer and counterclaim for declaratory judgment against Virginia Surety. Both parties filed a motion for summary judgment. The Will County Circuit Court granted summary judgment in favor of Northern, stating that DeGraf’s subcontract agreement with Capital was not an “insured contract” within the terms of Northern’s CGL policy. Therefore, per the trial court’s decision, Northern had no duty to defend or indemnify DeGraf.<sup>43</sup>

The Illinois Appellate Court, Third District, affirmed, stating that since Capital only sought contribution from DeGraf, the exception contained in Northern’s CGL policy did not apply. Per the appellate court, the policy exception would be triggered only when the insured “assumed the tort liability of another” or agreed to indemnify the other party. Because Capital did not seek indemnification, DeGraf would not be assuming the tort liability of another; and Northern was not required to provide defense or indemnification to DeGraf.<sup>44</sup>

The Illinois Supreme Court ultimately affirmed the trial and appellate courts in *Virginia Surety*, holding that Northern had no duty to defend or indemnify DeGraf under the CGL policy. The court held that Northern’s CGL policy exclusion for an employer’s liability did apply. Furthermore, the exception to the employer’s liability exclusion for “loss assumed by contract” did not apply, because DeGraf had not assumed any liability of Capital. According to the supreme court, the language in the subcontract agreement between DeGraf and Capital was merely a waiver of DeGraf’s anticipated affirmative defense of its *Kotecki* cap, not an agreement to assume Capital’s tort liability.<sup>45</sup>

The 16-page opinion written by Justice Fitzgerald in *Virginia Surety* discussed prior appellate court decisions regarding coverage under both CGL policies and EL policies with

respect to an employer’s liability in contribution after the employer had made a *Braye* waiver of its *Kotecki* cap. The last line of the *Virginia Surety* opinion states: “To the extent that *Michael Nicholas, West Bend, and Christy-Foltz* would hold otherwise, they are overruled.”<sup>46</sup> Panelists Francis A. Spina (attorney for Northern) and Greg Vacala (attorney for Virginia Surety) disagreed as to whether *Christy-Foltz* is still good law. Spina argued that *Christy-Foltz* is no longer good case law, citing the following paragraph in the *Virginia Surety* opinion:

Further, we reject Virginia Surety’s, as well as the *Christy-Foltz, Michael Nicholas, and West Bends courts’*, assertion that the employer somehow assumes the joint and several liability of the third-party non-employer.<sup>47</sup>

According to Spina, the word “assumes” is extremely important, as the court did not see excess *Kotecki* exposure as a loss assumed by contract. Rather, it is the employer’s liability and it remains with the employer. Therefore, it cannot be the affirmative assumption of new liability. It is an abandonment of an affirmative defense. Spina was of the opinion that Illinois law has now returned to the “happy circumstance that existed back in 1998 and prior” in which an employer, sued as a third party defendant, has coverage through the EL policy but not the CGL policy.

Vacala, however, argued that the court did not overrule *Christy-Foltz* to the extent that the EL insurer is now required to defend and indemnify the employer. Therefore, post-*Virginia Surety*, the employer is now “naked” as to insurance coverage. According to Vacala, neither the CGL policy nor the EL policy covers an employer who has made a *Braye* waiver of its *Kotecki* cap for contribution.

Vacala also discussed the practical significance of the supreme court’s decision in *Virginia Surety* post judgment. Following a judgment for a plaintiff, under the Illinois joint and several liability statute,<sup>48</sup> the insured defendant(s) will be forced to pay the portion of the uninsured employer’s amount of damages because the employer will be without coverage to pay for its proportionate share of damages. According to Vacala, it will then be up to the defendants with insurance to pay the amount of damages attributable to the uninsured employer’s negligence. The defendant’s insurers will then be forced to go after the uninsured employer to recover the amount they paid that is attributable to the employer’s negligence.

In view of *Virginia Surety*, a CGL carrier does not have to provide coverage to an insured’s employer for contribution

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resulting from a *Braye* waiver. Whether the EL carrier must now step in and defend its insured employer or whether the employer is without coverage for a *Braye* waiver of its *Kotecki* cap, remains to be answered by the courts. In the meantime, the issue will be debated within the insurance industry. Vacala suggested that an employer should get an endorsement on its CGL and EL policies stating that the CGL or EL policy will provide coverage to an insured for a *Braye* waiver, to avoid the pitfall of being without CGL or EL coverage.

**Panel Four: Does Insurance Defense Counsel Represent Only the Insured? Is the Insurer Also a Client? To Whom Does Counsel Owe Loyalty When There is a Conflict Between Insurer and Insured?**

Joseph P. Postel moderated the panel on ethical duties of coverage counsel. The panel included William Barker, Jill Berkeley, Charles O'Connor, and Michael T. Reagan.

In Illinois, insurance defense counsel owes an equal fiduciary duty to the policyholder *and* the insurance company. While this "tripartite" relationship benefits those involved, it also creates potential conflicts with serious ethical implications. The panel on tripartite relationships addressed these issues with insights that are useful to any insurance defense practitioner.

The panelists quickly reached agreement on the benefits of the relationship. Charles O'Connor, a Vice President with Liberty Mutual Insurance, stated the tripartite relationship enables the defense to present a united front, bolstered by the free flow of information under the protection of the attorney-client privilege. In jurisdictions where the tripartite relationship is not recognized, O'Connor noted a marked difficulty in confronting the plaintiff's bar and obtaining a favorable defense result.

Turning to the tripartite relationship in practice, the panel discussed defense counsel's obligation to disclose the dual fiduciary relationship. Disagreement arose with respect to the extent of disclosure required. William Barker stated that the insured was entitled to "full disclosure" of the relationship no later than the initial engagement letter. "Full disclosure" includes defense counsel's relationship with the insurer, the insurer's right to control the litigation and settlement, as well as defense counsel's obligations in the event a conflict arises. Barker suggested the initial engagement letter might also include a prospective waiver of the insured's consent to settle the litigation. According to Barker, by the method of the disclosure, the insured is notified that defense counsel will assume it has the insured's authority to settle within policy lim-

its unless the insured notifies defense counsel otherwise.

In contrast, Jill Berkeley expressed concern about beginning a new relationship by addressing hypothetical conflicts, contingencies, and waivers. Instead, stated Berkeley, defense counsel's engagement letter should convey three points to the insured: "1) I have been retained by your insurance company to represent you; 2) The scope of my representation is limited to the defense of liability and damages associated with this specific claim; and 3) The insurance company is also my client." With respect to the final point, Berkeley also believed it proper for defense counsel to clarify that the dual client relationship results in "no secrets" among defense counsel, the insurer, and the insured.

O'Connor agreed with Berkeley and stated that the practice of disclosing merely potential conflicts at the outset as a matter of routine is "a big mistake." He continued that, in any event, the insurance policy grants the insurer the right to control the defense. Implicit in that right, the insurer is entitled to settle within policy limits (and may well be liable if it fails to do so.) Under those circumstances, the prospective waiver to consent to settlement proposed by Barker is a moot point. Barker responded that, in fact, a waiver *was* necessary because defense counsel represented both clients. While the insurer's claim representative may approach the plaintiff directly to settle within limits, defense counsel could not be utilized in this capacity without the insured's waiver.

Although consensus was not reached, the panel expressed a clear opinion that defense counsel must carefully evaluate representation within the context of the tripartite relationship. As stated by panelist Michael Reagan, the issue leads to a serious re-thinking of whom defense counsel truly represents.

Another consideration for defense counsel is whether to become involved in coverage questions. This may involve tendering the insured's defense and indemnity to another insurer. It may also involve defense counsel's decision to operate with or without the knowledge that the insurer has reserved rights.

Barker believed it was acceptable for defense counsel to participate in a tender, but only if the insured was consulted. He made it clear, however, that the consultation with the insured could not include defense counsel's recommendation on the issue if the insured and insurer have divergent interests in the tender. In fact, it may be appropriate in those circumstances to suggest that the insured consult independent counsel on this issue.

Berkeley flatly rejected the idea that defense counsel should be involved in a tender. Starting with the assumption that the insurer will always desire to tender the defense and indemnity of the insured, Berkeley identified several practical reasons why the insured may not share that desire. Para-

mount was the insured's relationship and comfort level with the insurer, the insurer's choice of counsel, and the familiarity of both with the insured's business, personnel, customs and practices. Given that these concerns raise even the possibility of divergent interests, Berkeley believes it is coverage counsel, not defense counsel, who should be consulted regarding a potential tender. This will ensure that the tender decision is made with the benefit of fully informed consent.

All of the panelists agreed that when an insurer undertakes a defense pursuant to reservation of rights, defense counsel must be notified of the coverage issue. The panelists disagreed as to the degree of defense counsel's involvement in the coverage issue. Insurance defense practitioners may be surprised to learn that the panel's insurance industry representative believed defense counsel's role in this decision was primary. O'Connor stated that, as the insurer, he assumes defense counsel agrees to dual representation until counsel notifies him of a conflict. Defense counsel therefore has the obligation to obtain, review and assess the reservation of rights to determine whether the tripartite relationship may stand. Barker responded that any potential conflict was a real conflict, and the decision to proceed with the tripartite relationship requires informed consent, including the insured's consultation with independent counsel.

Berkeley agreed that informed consent was proper, particularly in the event that an immediate conflict was discovered. In that circumstance, the insured is entitled to independent counsel under *Maryland Cas. Co. v. Peppers*.<sup>49</sup> Although the insured can waive the right to independent counsel, defense counsel's dual loyalty to the insurer and insured precludes counseling either on this question, according to Berkeley.

Disagreement among the panelists arose regarding whether the insured has any tangible interest in independent counsel, as opposed to proceeding with defense counsel pursuant to the reservation of rights and conflict waiver. Barker stated that there might be no real distinction. To suggest independent counsel serves the insured's interests better than defense counsel under a reservation of rights is to suggest that defense counsel will somehow manipulate objective facts to procure or preclude coverage.

Berkeley countered that a number of factors—short of manipulating facts—suggested the insured had a real interest in independent counsel. In this context, the panel discussed *American Family Mutual Ins. Co. v. W.H. McNaughton Builders, Inc.*<sup>50</sup> In *McNaughton*, American Family issued McNaughton a commercial general liability policy.<sup>51</sup> McNaughton was named as a defendant after it erected a home that was later alleged to be defective.<sup>52</sup> McNaughton tendered its defense to American Family, which accepted under a res-

ervation or rights.<sup>53</sup> American Family reserved the right to deny indemnification for damage caused or known to exist before the inception of the policy period.<sup>54</sup>

McNaughton notified American Family that the reservation created a conflict, and that it desired independent counsel.<sup>55</sup> American Family responded by filing a declaratory judgment action seeking a determination that there was no conflict and that American Family could retain control of the defense.<sup>56</sup> American Family prevailed on a dispositive motion and McNaughton appealed.<sup>57</sup>

On appeal, the Appellate Court Second District reversed the trial court and declared that a real conflict was present, entitling McNaughton to independent counsel. The *McNaughton* court recognized that McNaughton and American Family had identical interests in McNaughton being found without liability in the underlying case.<sup>58</sup> However, according to the appellate court, the interests diverged regarding the timing of the damage alleged. The court concluded that defense counsel, operating under American Family's reservation of rights, could not possibly develop facts related to liability and damages, without also developing information related to the date(s) those damages occurred.<sup>59</sup> In the court's opinion, it was "absurd" to suggest that McNaughton could receive full representation by defense counsel when facts central to coverage would necessarily arise in the course of discovery.<sup>60</sup>

Highlighting the pitfall anticipated by the Second District, Berkeley pointed out the case of *Millers Mut. Ins. Ass'n of Illinois v. Ainsworth Seed Co., Inc.*<sup>61</sup> In *Miller's*, in a declaratory judgment action, the Appellate Court Fourth District held that the insurer had no duty to defend or indemnify the insured in the underlying lawsuit.<sup>62</sup> Ironically, as the court put it, the decision was based on an affidavit prepared by defense counsel for the insured in the underlying case.<sup>63</sup> In the affidavit, the insured affirmatively stated that it had completed all work at the time of the alleged injury.<sup>64</sup> Utilizing that very affidavit in its declaratory judgment action, the insurer invoked the Completed Operations policy exclusion to deny its duty to defend or indemnify the insured.<sup>65</sup> In procuring that affidavit, defense counsel clearly subordinated his insured client's interest to those of his insurer client.

The panel also briefly addressed the conflicts associated with defending a case that has potential exposure in excess of the policy limits. Although the situation does not automatically create a conflict of interest for defense counsel, the panelists agreed that it would be "good practice" for defense counsel to suggest the policyholder secure independent counsel, at its own expense, to see if the policyholder's interests are be-

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ing protected by the insurer. Berkeley used the example that defense counsel should consult with the policyholder to fully inform him of the potential risk in deciding not to argue damages in closing argument, where the plaintiff has asked the jury for an award above the policy limits.

The next issue related to defense counsel obtaining information adverse to coverage. This information benefits the insurer (who will not indemnify absent a requirement to do so), yet obviously harms the insured, who will be forced to defend itself and assume responsibility for any liability. Ending on a unanimous note, the panel agreed that defense counsel's conflict was obvious. Further, it is incumbent upon defense counsel to withdraw representation under these circumstances. This raised the question as to whether the information adverse to coverage must be disclosed to the insurer prior to defense counsel's withdrawal.

The panel concluded by addressing some of the more common circumstances that arise in the tripartite relationship. In particular, the panel discussed the scenario under which the insurer is defending the insured for one count of a multi-count complaint, and instructs defense counsel to file a dispositive motion or settle the "covered count." Reagan had first-hand experience with this situation and opined that defense counsel should recognize this potential conflict and notify the insured at the outset of litigation. In that event, when the time came to settle or seek final determination on the issue, the insured would be advised accordingly and given the option to seek independent counsel. Under this course of action, defense counsel may fully and successfully engage in a tripartite relationship, with full disclosure, yet not act in an adverse fashion to either client's interests.

#### **Panel Five: Professional Liability, E&O, Architects and Engineers and Related Policies**

Eric L. Singer, senior counsel with the law firm of Ice Miller, LLP, moderated a panel entitled "Professional Liability, E&O, Architects and Engineers and Related Policies." The following were the panelists: Phil Best, an underwriter for the Design Professional Group of XL Insurance; Karen Ergler, an insurance broker with Holmes Murphy & Associates; Donald J. Hackl, FAIA, an architect with the firm of Loeb Schlossman & Hackl; and Werner Sabo, a partner with the law firm of Sabo & Zahn.

The panel focused on how design professionals, including architects and engineers, can insure themselves against liability arising from errors or omissions in their design work (E&O Claims). As the panel explained, the most common in-

surance policy that design professionals use to insure liability against E&O Claims is a Design Professional Errors and Omissions insurance policy (DPEO policy).

Fortunately, design professionals are not sued very often for their design work. Many design professional firms elect not to obtain any DPEO coverage at all due to the high cost of coverage in proportion to their gross receipts and low frequency of claims. On the other hand, many design professionals obtain insurance coverage to protect themselves from having to pay defense costs and damages in the event a claim is brought against them for liability arising out of an error or omission in connection with their design work.

Virtually any claim alleging negligence against a design professional will be covered, at least in part, by a DPEO policy. In addition to damages for which the design professional is liable, a DPEO policy also covers all costs and expenses incurred by a design professional when defending against an E&O claim. However, DPEO policies do not cover liability arising solely from breach of an express warranty or guaranty. When a claim is covered by a DPEO policy, the DPEO insurer will provide an attorney to defend the claim. It is important to note that pursuant to language in a DPEO policy, an insured cannot settle a claim without the consent of the insurer. In addition, if an insured refuses to settle a claim that the insurer wants to settle, the insured is liable for all damages, defense costs and expenses in excess of the policy limits. Thus, it is important for a design professional to work with his or her defense counsel and insurer to determine the most appropriate defense strategy.

Generally, a DPEO policy is a claims-made policy, which typically means that the policy only covers claims first made against the insured during the year that the policy is in force. Under the policy definitions, a claim typically refers to a demand by an individual or corporation to recover for loss, which may come within that policy. If the design professional receives, or is aware of, a claim prior to the policy period, a DPEO policy usually will not provide coverage. In addition, the error or omission that gives rise to the claim generally must occur after a certain date specified in the policy, which often is referred to as a "retroactive date." In other words, while the claim must be made during the policy period, the act, error or omission giving rise to the claim must occur after a date determined by the insurer for the DPEO policy to provide coverage. Most DPEO policies contain a short period after the policy expires (usually sixty days or less) for insureds to report claims to their DPEO insurers for the policy to provide coverage.

DPEO policies almost always are subject to a deductible. A "deductible" is a portion of covered loss that is not

paid by the insurer and must be paid by the design professional. After the design professional has paid the amount of the deductible in defense fees or damages, the insurer will pay the remaining amount, up to the limits of the DPEO policy. The most important factor used by underwriters in setting a deductible is the design firm's gross annual receipts. Coverage under many DPEO policies is subject to a deductible that is equal to one percent of the design professional firm's gross annual receipts.

Whether a design professional may purchase a DPEO policy, as well as the limits and deductibles provided by DPEO policies, are questions subject to a number of factors. As with setting the deductible, gross receipts often play a significant role in determining the premium for the policy. Another factor is the status of market conditions at the time the design professional applies for the coverage. When there is a "soft" market - often due to a great deal of competition among insurers offering the coverage and favorable economic conditions - DPEO insurers offer broad DPEO coverage with lower premiums, higher coverage limits and lower deductibles. Conversely, during a "hard" market, design professionals may have a more difficult time obtaining a DPEO policy. Also during a "hard" market, DPEO insurers offer DPEO policies with higher premiums, lower policy limits, and higher deductibles.

DPEO insurers consider a number of additional factors when deciding whether to issue a DPEO policy, including the scope of coverage and the calculation of an appropriate premium. One significant factor is the loss history of the design professional firm. A firm that has faced many prior claims may receive less favorable coverage than a firm with fewer claims. Another factor is the type of projects on which the design professional typically works. By way of example, condominiums and health care facilities are considered risky to insure, and design professionals who regularly work on such projects tend to receive less favorable DPEO coverage than those who work on private residences or office buildings. A third factor is the risk management practices employed by the design professional firm. For example, DPEO insurers view firms that use computerized Building Information Systems to manage coordination and scheduling between the contractors and design professionals to reduce errors favorably because such risk management practices reduce the likelihood of claims.

Furthermore, certain types of design professionals have an easier time obtaining coverage than others. Architects have a much easier time obtaining DPEO policies than do structural engineers or geotechnical engineers, because the types of claims brought against engineers typically present a much

higher risk of liability than do those against architects.

Notwithstanding the factors set forth above, most DPEO policies are subject to relatively low coverage limits. Although the coverage limits vary somewhat depending on the size of the firm, approximately 88% of the DPEO policies issued to design professional firms in the Midwest have policy limits of \$1 million or less. A small percentage of design professional firms have DPEO policies with limits between \$1 million and \$5 million, and very few have DPEO policies with limits of more than \$5 million. It is very rare for design professional firms to be able to procure excess DPEO coverage.

Unlike standard-form commercial general liability (CGL) policies, which do not place any limit on defense costs and expenses, defense costs and expenses deplete the coverage limits of a DPEO policy. Also unlike CGL policies, DPEO policies cannot be endorsed to add a project owner or any contractor as an additional insured, notwithstanding the fact that many project owners request such coverage. The reason for this is that DPEO policies only provide coverage for errors or omissions committed by design professionals. While it is possible that an owner who also is a design professional could be added as an additional insured, this would not provide any protection to the design professional for claims brought by the owner against the design professional in light of the fact that DPEO policies specifically exclude claims brought by one insured against another.

### **Panel Six: Construction Bonds and Suretyship**

The panel discussion on the role surety bonds play in the management of risk in construction projects offered an informative and practical dialog on the topic. Each panel member expressed opinions on the issues raised from the perspective of one of the parties typically involved in the surety bond process - owner, contractor, subcontractors, suppliers and surety. Stanley Wasser of Feldman, Wasser, Draper & Benson, moderated the panel and its panelists included Cornelius Riordan and William Piper of Riordan, Donnelly, Lipinski & McKee, Ltd., Lynn Schubert of The Surety & Fidelity Association of America, and Lorence Slutzky of Robbins, Schwartz, Nicholas, Lifton & Taylor, LLC.

Construction projects are high-risk endeavors. Even with the best of participants involved, mistakes happen. Moreover, putting aside acts of God, the performance of a construction project is influenced by many factors, which may not be within a contractor's control. When there is a failure to perform, the risk issues can be onerous: increased costs of completion,

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completion delay, breaches of commitments to lenders, investors and customers, lost rents and/or profits, mechanics liens, payment bond claims, clouded real estate titles, litigation costs, and attorneys fees. In some cases, these risks have ripple effects and impact on other related construction projects.

Surety bonds in the form of performance bonds and payment bonds are the traditional means of managing these risks. Bonds make it possible for the principal (contractor/subcontractor) to provide the obligee (owner/contractor) with the guarantee of a responsible surety that the principal will satisfactorily perform its obligations under the contract, provided the obligee also performs its obligations. Bonds are, therefore, a useful means of ensuring responsible contract performance and financial security and, consequently, are an essential requirement in construction contract procurement. For public projects, surety bonds are mandated by statute.<sup>66</sup>

With performance bonds, the surety guarantees that, under certain conditions, the principal will complete the contract according to its terms. Upon a default that triggers the surety's obligation, after investigation and acceptance of the claim, the surety generally has the options to either finance the defaulting principal's completion of the work, hire a replacement contractor/subcontractor to complete the work, or forfeit to the obligee all or part of the performance bond's penal sum. The surety's obligations on a performance bond are controlled by the specific terms of the bond and, in many cases, by the terms of the contract as well.<sup>67</sup> As a result, the surety's obligations can extend beyond workmanship and performance obligations and include consequential delay, disruption liabilities and design-related obligations.

Payment bonds establish a mechanism by which the surety guarantees that, under certain conditions, its principal's payment obligations to the respective subcontractors, suppliers, and workers' union funds will be honored. Since only contract funds are lienable on public projects, the payment bond may be the only viable protection for those supplying labor or materials on a public project where the contractor is in financial jeopardy and inadequate contract funds are available for assertion of a lien. By requiring payment bonds, owners lessen their risk of possibly having to pay for the same work twice, once to the contractor who may fail to pay its subcontractors/suppliers and again to the lien claimant.

While payment bonds play an important role in managing risk, the panel focused largely on issues related to performance bonds. Accordingly, the remainder of this summary focuses primarily on performance bonds.

In the construction industry, there is no such thing as a "standard" bond. On public projects, either statute or public agency forms govern bond terms and conditions. On private

projects, where the terms and conditions of the bond may be subject to negotiation, the parties often utilize bond forms issued by various construction industry groups, such as the American Institute of Architects (AIA), the Associated General Contractors (AGC) or the Engineers Joint Contracts Document Committee (EJCDC). It is worth noting, however, that panelist Lynn Schubert believes that the bond forms issued by ConsensusDOCS are going to revolutionize the surety bond process in the near future.<sup>68</sup>

In determining which bond form to use, one must pay attention to variations in the default-related provisions. For example, under certain default provisions, the owner must declare the contractor to be in default and the owner must have performed its contractual obligations before the surety's obligations arise. Under other default provisions, the owner need only give notice to the surety of intent to trigger the default before formally declaring a default termination and invoking the surety's obligations under the bond.

As a practical matter, obligees generally prefer bond forms containing fewer conditions precedent to declaring a principal in default than do sureties and principals. This is because obligees view conditions precedent as "hurdles and barriers" to enforcing the surety's obligations. With that being said, if an owner selects a bond form weighing too much in its favor, sureties will refuse to write the bond and/or powerful contractors will refuse to execute the bond. Most contractors and subcontractors, however, are not afforded that luxury and will sign any bond form necessary to get the job.

In addition to establishing default grounds and the process for declaring default, default provisions may also define the consequence of an improper default termination, possibly triggering owner liability for consequential damages. Accordingly, the project owner who intends to look to such surety bonds to manage project risks must ensure that it manages its own contract obligations, and that of its architects and engineers, to guarantee that any default which the owner intends to rely upon to trigger the bond obligations is, in fact, substantively valid. Because owners run the risk of being held liable for wrongful termination, owners' attorneys should require that the client delineate every reason for declaring a principal in default and always advise the client against defaulting a principal for convenience.

The panelists all agreed that defaulting a principal is in no one's best interest. Among other things, the principal loses the revenue generated from working on the project and becomes primarily liable to the surety for any expenses it incurs; the surety either pays a penal sum to the obligee and takes over and completes the project itself or finds a contractor willing to complete project; and the obligee faces, at best,

a delay in completion. In recognition of this lose-lose situation, the panelists believe that both default and the problems that arise as a result of it often can be avoided through communication and coordination.

One of the largest problems attorneys encounter when dealing with bond-related issues is determining the parties' rights and obligations under the bond. While the bond form may clearly set out the parties' rights and obligations, the project's contract documents usually are incorporated into the bond. Oftentimes the terms and conditions of the bond form conflict with those of the contract. There would be significantly fewer bond-related disputes if the parties communicated with one another before executing the bond to ensure that the terms and conditions of the bond and contract documents are easily reconcilable and each party clearly understands its rights and obligations under the documents.

Additionally, many sureties believe that default situations can be avoided if the principal keeps the surety informed as to any problems it is experiencing, and seeks assistance from the surety to remedy those problems. For example, if a principal is having trouble paying its contractors or subcontractors, instead of remaining silent as to that problem and being defaulted, sureties recommend that the principal inform the surety of that problem and seek financial aid from the surety. Even if the surety refuses to aid the principal, the principal is in no worse position than it would have been had it not asked for help.

On that same note, both sureties and owners find it mutually beneficial when the owner communicates with the surety prior to defaulting a principal. Through communication, the parties may come to an agreement as to whether the principal is in default or not, thereby significantly reducing the "downtime" between a default declaration and the surety's acceptance of its obligations.

To conclude the discussion, the panel briefly touched on surety bond alternatives that may be used to manage risk on a construction project. The primary alternative discussed was subcontractor default insurance (SDI). SDI creates a two-way relationship, with the contractor generally purchasing a single insurance policy covering all of its subcontractors, and the insurer directly indemnifying the contractor for costs resulting from subcontractor defaults covered by the policy. SDI, however, provides no payment bond protection for subcontractors, laborers or suppliers; and, if unpaid, these entities have no recourse against the SDI insurer.

Compared to performance bond premiums, SDI premiums can be significantly lower. The SDI deductible and co-payment, however, are often substantial, thus preventing smaller contractors from taking advantage of the SDI prod-

uct. Another disadvantage of SDI is that the insurance policy will have defined limits, as well as, possibly, co-payment requirements. Additionally, SDI is not a viable sole alternative on public projects, which require surety bonds.

## Conclusion

The St. Louis Symposium was the result of a collaborative effort of a great number of people. It managed to epitomize in one fashion or another all of the IDC's core values as stated on its website. The Symposium brought together in one forum diverse perspectives on a number of construction coverage issues peculiar to Illinois. There was a free exchange of ideas with some harsh debate, some consensus and some disagreement. It was a showcase for talented lawyers and insurance and construction industry leaders to discuss issues that affect, in one way or another, all of the citizens of Illinois.

There are serious public policy ramifications that result from all of the issues addressed by the six panels. How do lawyers, insurers and contractors work together to improve this area of law for the benefit of all concerned? How can a balance be achieved between insurers and contractor insureds and how do defense attorneys adapt their practices to accommodate that balancing within a framework of good public policy and legal ethics? While all of the answers were not written on the walls when the Symposium adjourned, the room was certainly brighter. The discussions started in St. Louis should be part of a continuing conversation. The Insurance Law Committee of the IDC is committed to that end.

## Endnotes

<sup>1</sup> *Kajima Construction Services, Inc. v. St. Paul Fire and Marine Ins. Co.*, 368 Ill. App. 3d 665, 856 N.E.2d 452 (1st Dist. 2006), leave to app. allowed, 222 Ill. 2d 609, 862 N.E.2d 234 (2007).

<sup>2</sup> *Kotecki v. Cyclops Welding Corp.*, 146 Ill. 2d 155, 585 N.E.2d 1023 (1991).

<sup>3</sup> *Virginia Surety Co., Inc. v. Northern Ins. Co. of New York*, 224 Ill. 2d 550, 866 N.E.2d 149 (2007).

<sup>4</sup> *Traveler's Ins. Co. v. Eljer Mfg., Inc.*, 197 Ill. 2d 278, 757 N.E.2d. 481 (2001).

<sup>5</sup> Willard J. Obrist, *The New Comprehensive General Liability Policy: A Coverage Analysis* 7, 17 (Defense Research Institute, Inc. 1966).

<sup>6</sup> *See, Sola Basic Industries, Inc. v. United States Fidelity & Guaranty Co.*, 90 Wis. 2d 641, 280 N.W.2d 211 (1979).

<sup>7</sup> *See, Eljer Mfg., Inc. v. Liberty Mutual Ins. Co.*, 972 F.2d 805, 810 (7th Cir. 1992).

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- <sup>8</sup> *Eljer Mfg.*, 972 F.2d at 810.
- <sup>9</sup> See, *Bituminous Casualty Corp. v. Gust K. Newberg Construction Co.*, 218 Ill. App. 3d 956, 578 N.E.2d 1003 (1st Dist. 1991).
- <sup>10</sup> *Bituminous Casualty Corp.*, 218 Ill. App. 3d at 958.
- <sup>11</sup> *Id.*
- <sup>12</sup> *John Burns Construction Co. v. Indiana Ins. Co.*, 189 Ill. 2d 570, 727 N.E.2d 211 (2000).
- <sup>13</sup> *John Burns*, 189 Ill. 2d at 578.
- <sup>14</sup> *Kajima Construction, supra*.
- <sup>15</sup> *Cincinnati Cos. v. West American Ins. Co.*, 183 Ill. 2d 317, 328, 701 N.E.2d 499 (1998).
- <sup>16</sup> *Cincinnati Cos.*, 183 Ill. 2d at 328.
- <sup>17</sup> *Id.*
- <sup>18</sup> *Home Ins. Co. v. Cincinnati Ins. Co.*, 213 Ill. 2d 307, 821 N.E.2d 269 (2004).
- <sup>19</sup> *Home Ins. Co.*, 231 Ill. 2d at 321.
- <sup>20</sup> *Id.* at 321-22.
- <sup>21</sup> *Braye v. Archer-Daniels*, 175 Ill. 2d 201, 676 N.E.2d 1295 (1997).
- <sup>22</sup> *Virginia Surety, supra*.
- <sup>23</sup> 820 ILCS 305/1, *et seq.*
- <sup>24</sup> *Miller v. DeWitt*, 37 Ill. 2d 273, 289-90, 226 N.E.2d 630 (1967).
- <sup>25</sup> *Skinner v. Reed-Prentice Division Package Machinery Co.*, 70 Ill. 2d 1, 374 N.E.2d 437 (1977).
- <sup>26</sup> 740 ILCS 100/0.01, *et seq.*
- <sup>27</sup> *Doyle v. Rhodes*, 101 Ill. 2d 1, 461 N.E.2d 382 (1984).
- <sup>28</sup> *Doyle*, 101 Ill. 2d at 14.
- <sup>29</sup> See, *Kotecki, supra*.
- <sup>30</sup> *Kotecki*, 146 Ill. 2d at 165.
- <sup>31</sup> *Braye, supra*.
- <sup>32</sup> *Braye*, 175 Ill. 2d at 210.
- <sup>33</sup> *Christy-Foltz, Inc. v. Safety Mutual Casualty Corp.*, 309 Ill. App. 3d 686, 722 N.E.2d 1206 (4th Dist. 2000).
- <sup>34</sup> See, *Virginia Surety Co., supra*; *Hankins v. Pekin Ins. Co.*, 305 Ill. App. 3d 1088, 713 N.E.2d 1244 (5th Dist. 1999).
- <sup>35</sup> See, *Michael Nicholas, Inc. v. Royal Ins. Co. of America*, 321 Ill. App. 3d 909, 748 N.E.2d 786 (2nd Dist. 2001); *West Bend Mutual Ins. Co. v. Mulligan Masonry Co. Inc.*, 337 Ill. App. 3d 698, 786 N.E.2d 1078 (2nd Dist. 2003).
- <sup>36</sup> *Virginia Surety*, 224 Ill. 2d at 552-53.
- <sup>37</sup> *Id.*
- <sup>38</sup> *Id.*
- <sup>39</sup> *Id.*
- <sup>40</sup> *Id.*
- <sup>41</sup> *Id.*
- <sup>42</sup> *Id.* at 554.
- <sup>43</sup> *Id.* at 554-55.
- <sup>44</sup> *Id.* at 555.
- <sup>45</sup> *Id.* at 570.
- <sup>46</sup> *Id.* at 570.
- <sup>47</sup> *Id.* at 568-69.
- <sup>48</sup> 735 ILCS 5/2-1117
- <sup>49</sup> *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187, 355 N.E.2d 24 (1976).
- <sup>50</sup> *American Family Mutual Ins. Co. v. W.H. McNaughton Builders, Inc.*, 363 Ill. App. 3d 505, 843 N.E.2d 492 (2nd Dist. 2006).
- <sup>51</sup> *McNaughton*, 363 Ill. App. 3d at 506-07.
- <sup>52</sup> *Id.* at 507.
- <sup>53</sup> *Id.* at 508.
- <sup>54</sup> *Id.*
- <sup>55</sup> *Id.*
- <sup>56</sup> *Id.*
- <sup>57</sup> *Id.* at 509.
- <sup>58</sup> *Id.* at 512.
- <sup>59</sup> *Id.* at 513.
- <sup>60</sup> *Id.*
- <sup>61</sup> *Millers Mut. Ins. Ass'n of Illinois v. Ainsworth Seed Co., Inc.*, 194 Ill. App. 3d 888, 552 N.E.2d 254 (4th Dist. 1989).
- <sup>62</sup> *Millers Mut.*, 194 Ill. App. 3d at 894.
- <sup>63</sup> *Id.* at 890.
- <sup>64</sup> *Id.*
- <sup>65</sup> *Id.*
- <sup>66</sup> For Illinois projects by the Illinois Public Construction Bond Act, 30 ILCS 550/1, *et seq.*; and for federal projects by the Miller Act, 40 U.S.C. §270a-f.
- <sup>67</sup> See, *Bd. of Local Improvements South Palos Twp. Sanitary Dist. ex rel. North Side Tractor Sales Co. v. St. Paul Fire & Marine Ins.*, 39 Ill. App. 3d 255, 350 N.E.2d 36 (1st Dist. 1976) (surety not bound beyond express terms of performance bond); *Lake View Trust & Savings Bank v. Fillmore Constr. Co.*, 74 Ill. App. 3d 755, 393 N.E.2d 714 (1st Dist. 1979) (bond and contract incorporated by reference into the bond read as one instrument.)
- <sup>68</sup> See, ConsensusDocs Home Page, [www.consensusdocs.org](http://www.consensusdocs.org)