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# Insurance Exhaustion – Managing the insurance coverage landscape and defending claims

## I. INITIATING A CONSTRUCITON CLAIM

### A. FLORIDA STATUTES AND CASE LAW OVERVIEW WHICH GOVERN ALL CONSTRUCTION DEFECT CLAIMS IN FLORIDA.

Florida has reserved an entire section (F.S. 553) to codify and enforce the Florida Building Code, which is adopted from the International Building Code (see F.S. 557.73(3)). The Florida's legislature has created a separate cause of action to bring claims for a breach to Florida's Building code, under F.S. 553.84 which states:

> 553.84 Statutory civil action.—Notwithstanding any other remedies available, any person or party, in an individual capacity or on behalf of a class of persons or parties, damaged as a result of a violation of this part or the Florida Building Code, has a cause of action in any court of competent jurisdiction against the person or party who committed the violation; however, if the person or party obtains the required building permits and any local government or public agency with authority to enforce the Florida Building Code approves the plans, if the construction project passes all required inspections under the code, and if there is no personal injury or damage to property other than the property that is the subject

of the permits, plans, and inspections, this section does not apply unless the person or party knew or should have known that the violation existed.

## F.S. CH. 558 - PRESUIT REMEDIES AND REQUIRED CONDITION PRECEDENT TO A 553.84 CLAIM IN FLORIDA.

In 2003 the Florida legislature enacted F.S. §558 to provide "an alternative method to resolve construction disputes" between owners and contractors. (Fla. Stat. §558.001 (2017)). The §558 process commences when a "claimant" serves a "written notice of claim" on the contractor describing the nature of any alleged defects, the location of each defect, and any resulting damages. The Florida Legislature created a statutory confidential settlement vehicle to potentially avoid costly litigation. F.S. Ch. 558 provides the contractor 60 days to inspect the property (or 120 days if an association exists with greater than 20 units), perform destructive testing if necessary, and gives the contactor the opportunity to make an offer to repair, provide financial compensation, or refute Plaintiff's claims (see F.S. Ch. 558.004). Should a party file a construction defect claim in Florida without first filing a 558 notice, any contractor may file a Motion to Stay the legal action, and allow the parties to commence with the §558 process (see F.S. Ch. 558.003).

Although Florida's §558 process does not provide the contractor a right to repair, it does have its benefits. Because the §558 inspection is typically performed while the owner is present, offers to repair can be made directly to the owner, and said offers are confidential and inadmissible in future proceedings. Furthermore, the Florida Legislature snuck in this little gem, "if the claimant refuses to agree and thereafter permit reasonable destructive testing, the claimant shall have no claim for damages which could have been avoided or mitigated had destructive testing been allowed when requested and had a feasible remedy been promptly implemented. §558.004(2)(g).

### B. RECENT DEVELOPMENTS IN STUCCO RELATED CLAIMS

Because of the increasing number of stucco claims in Florida over the past decade, many of the stucco contractors have exhausted their insurance policies. Plaintiffs cannot simply abandon their stucco claims, so they've resorted to alternative theories of causation for the stucco damage. Plaintiff counsel have increasingly begun to focus on alleging the resulting stucco damage is caused by other trades that adjoin the stucco system. These include the window manufacturer, window installation subcontractor, weather resistive barrier (WRB) installer, roofing subcontractor, and painting/caulking subcontractor.

For example, one area of potential stucco damage and/or water intrusion exists where the stucco-clad wall and roof adjoin one another. This is commonly referred to as the roof-two-wall-transition and is located where the exterior cladding or siding material intersects a roof at the terminal point where the roof ends but the sidewall continues for some length. It is critical the water from the roof is not allowed to enter the wall or

building envelope, thus the necessity for special transition flashing normally referred to as a “kick-out” flashing.

There are two general types of accepted kickouts that are used in Florida consisting of the manufactured kickout and the in the field-created kickout. The manufactured kickout is formed in a sheet metal facility and designed with an approximate 45 degree turn out to divert the water a minimum of 2” away from the adjoining vertical wall. The field-created kickout is an individual piece of metal flashing which is cut with shears and folded inwards over itself resulting in a unit that will set on top of the eaves drip to divert water away from the wall and the roof edge. This component can be soldered or sealed with an adhesive for additional protection. However, often the unit itself will be installed without soldering the flange folded. In order to make this fold, a microscopic ‘hole’ or opening can be present. This very small opening can be and has been accused of causing excessive damage throughout the building envelope, specifically to the stucco.

While it is possible for a poorly designed or installed ‘kick-out’ flashing to leak, it is far more prevalent to find the source of leakage in other components in close proximity. First, the microscopic hole in the corner will become clogged with dirt, granules, debris such as leaf residue as well as numerous other elements. Second, the ‘hole’ itself is located on top of or outside the eaves drip flange. Any water penetrating at that area would be lead out on top of the eaves drip to the exterior. Third, any leakage would not only be miniscule in volume but would be highly localized to that immediate area.

The strongest defense to kickout claims is to challenge the evaluation performed to identify the alleged leak(s) in the area. Challenging plaintiff’s experts to provide documentation of such testing is often easier than setting about having a defense expert do so, as plaintiff always has the burden of proof. Primarily the area where the eaves drip, fascia, or fascia cover intersect the stucco. These are areas of significant expansion and contraction and the actual sources for most leakage.

Another roofing defense is to deflect the blame onto other subsequent trades, such as the stucco subcontractor or painter. Generally speaking, the stucco is applied after the roofing materials are in place with the eaves drip and fascia sealed in a bed of stucco. Therefore, any concerns with the kickout could have been addressed before the stucco contractor covered the area with their stucco. Additionally, the sealant or caulking contractor, painter, WRB and/or stucco subcontractor are prime targets to shift the liability of the ‘kick-out’ diverter as the subsequent trades could have easily applied a flexible sealant (caulking), which is outside the scope of the typical roofing contractor.

Ultimately, proper, analytical analysis of any leakage pattern is required to adequately determine the source of leakage at this very critical area. The leakage problem itself is much larger than a microscopic hole in the corner of the flashing. Significant claim values are being demanded and paid because of a lack of understanding of how to professionally analyze this specific and complex situation.

In addition to roof-to-wall transitions or “kick-out” flashing allegations, Florida has seen increased claims associated with other building components more commonly related to water intrusion within buildings clad with stucco. The building components most commonly associated with water intrusion in these areas include the WRB, window installation/flashing, window products and exterior sealants. While these components have commonly been related to water intrusion of building exteriors for some time, Plaintiff experts are increasing their focus on the interface of the WRB and window flashing as well as the original window installation. Increasing numbers of the WRB, flashing and caulking products along with varying references to sequences and methods as provided by the various window manufacturers create challenges for the various trades to implement the most current methods and product utilizations available in the industry. This allows Plaintiff counsel increasing opportunities to identify alleged deficiencies in some components of the exterior cladding construction, not just the stucco installation alone.

Typical wall and roofing penetrations also create challenges for various trades to properly implement WRB and flashing guidelines on a consistent basis. The varying levels of plan details and specification guidelines from project to project sometimes hinder the various subcontractors from producing consistent conditions at all wall and roof penetrations. Plaintiff experts will investigate numerous locations to find irregularities attributable to a subcontractor trades scope of work.

An increasing number of recent claims in Florida involve allegations related to framing subcontractors. These include structural issues of alleged inadequate anchoring, firewall construction, inadequate blocking and other related shear wall installation issues. Some of these allegations relate to issues potentially acting the stucco cladding. Some of the more basic structural issues are not necessarily related directly to stucco cladding deficiencies or water intrusion issues but are increasingly used to inflate claim values.

An increasingly common issue related to potential stucco cracking in wood framed walls is inconsistent sheathing installation. Allegations vary from inconsistent gaps or spacing between individual wall sheathing and roof sheathing panel installation and/or inadequate size or spacing of fasteners. Defense experts are increasingly asked to evaluate the rest conditions identified during plaintiff instructive testing and offer alternatives to the items that were discovered and identified as defective construction. Defense experts are often able to present adequate information to successfully argue adequate faster strength and/or capacity and minimize the impact of the various framing allegations on the exterior stucco cladding.

More recent claims in Florida have also included allegations of inadequate footing embedment resulting in negative foundation conditions attributable to differential building settlement. The allegations generally include localized soil shear failure allegedly related to the lack of confining pressure on the soils below the foundation of the building. This alleged condition ultimately leads to allegations of compromised in-place soil strength which typically results in allegations of building settlement, rotation,

building movements negatively impacting other building components within the structure. These allegations are usually accompanied with extensive remediation plans requiring modification of subgrade conditions to stabilize the alleged deficient soil conditions.

Therefore, Florida claims increasingly include allegations related to stucco cladding components and even items that were not directly associated with stucco but can have the potential of increasing claim values and broadening the allegations of buildings and residential homes to allow a wider base of financial contributions to satisfy plaintiff demands.

## II. EFFECTS OF EXHAUSTION ON THE AVAILABILITY OF INSURANCE COVERAGE

### A. What Is Exhaustion?

When a policy reads, "'Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted,"' the insurer's duty to defend continues until exhaustion of coverage occurs either through settlement of a claim against the insured or through a judgment against the insured.[1] Resolving coverage disputes hinges on understanding the relationship between primary and excess insurers and the point at which coverage from the excess policy is triggered. Courts have recognized two legal theories on assigning priority of insurance coverage: "vertical" and "horizontal" exhaustion. Exhaustion rules are also critical in determining which policy pays first among different parties--the contractor's primary policy or policies of the subcontractors. More complex and contentious challenges arise when additional insured coverage is present.

#### *1. Horizontal Exhaustion*

When focusing on the policy language instead of underlying contract of "other insurance" clauses within the policy, horizontal exhaustion analysis is used. Horizontal exhaustion is the theory that the downstream party's excess policy is not triggered unless all applicable primary policies have been exhausted, including the upstream parties' own primary CGL insurance. Under the principle of horizontal exhaustion, excess insurance is not required to begin paying indemnity until after all triggered primary insurance is exhausted.[2]

#### *2. Vertical Exhaustion*

In focusing on the underlying contract's indemnity obligation, not the policy language, a Vertical Exhaustion analysis is used. Vertical exhaustion is the theory that primary and excess policies purchased by the downstream parties must pay before any policies purchased by the upstream parties. Typically, vertical exhaustion reflects the intent of the parties seeking to transfer risk to the downstream party. Vertical exhaustion allows access

[1] Brown v. Lumbermens Mutual Casualty Co. 326 N.C. 387, 390 S.E.2d 150 (1990).
[2] See Montgomery Ward & Co. v. Imperial Cas. & Co., 81 Cal. App.4th 356, 365 (2000).

to an excess policy upon exhaustion of the underlying scheduled policies or insurances covering the same term.

### *3. Vertical v. Horizontal Exhaustion in Construction*

The debate of vertical vs. Horizontal exhaustion arises often in Construction defect. An example of this is construction defect cases causing injury over several policy years. In these situations, the "vertical vs. horizontal" debate is also known as "exhaustion by years" vs. "exhaustion by layers."

A common situation in the construction industry, that can give rise to an exhaustion debate is where the general contractor requires of its subcontractors the following: (1) name the general contractor an additional insured under the subcontractors' general liability policies; (2) agree that the subcontractors' insurance will be primary and non-contributing with the general contractor's coverage; and (3) indemnify the general contractor for all loss arising out of or related to the performance of the subcontractors' work. Under this common contractual arrangement, the general contractor's corporate primary policy is intended by the parties to respond last to an insured loss.

In horizontal-exhaustion jurisdictions, however, this is not generally the case where the excess policy contains common "other insurance" language. In these jurisdictions, the policy language will be given effect notwithstanding the conflict with the insureds' contractual arrangements, resulting in the exhaustion of the general contractor's corporate primary policy before the subcontractor's excess policy is triggered.[3] The adoption of horizontal exhaustion in the general contractor/additional insured (under a subcontractor's policy) scenario frequently means that, if the loss is large enough to exhaust the subcontractor's primary coverage such that the general contractor's primary layer is invaded, an additional action must be instituted by the general contractor's primary carrier by subrogating to the interests of its insured's indemnity rights against its subcontractor. The success of the suit depends upon a number of factors including the application of the jurisdiction's anti-indemnity laws. Under the doctrine of horizontal exhaustion, the primary insured and additional insured's general liability policies must be exhausted before the additional insured's excess policy is triggered.

## B. Exhaustion Impact

When it comes down to it, the impact of exhaustion is largely dependent on the language of the insurance contract or policy.

### *1. Exhaustion Impact On Duty To Settle*

When policy limits are not sufficient to settle all the claims against the insured. Under those circumstances, the insurance company has a duty to manage the insurance proceeds

[3] See Bovis Lend Lease LMB, Inc. v. Great American Ins. Co., 53 A.D.3d 140, 155, 855 N.Y.S.2d 459 (1st Dep't 2008) ("The rights and obligations of the insurers are governed by their respective insurance policies, not by the underlying trade contracts among the insureds.")

in a manner reasonably calculated to protect the insured by minimizing total liability.[4] As a result, depending on the facts, an insurer may be held liable either for settling or for not settling. In general, it is good practice to attempt to obtain complete protection for an insured in return for the payment of the insurer's policy limits. It is not reasonable, however, for an insurer to act in accordance with the foregoing rule when the insurer is aware that doing so would prejudice the insured.

For example, it would likely constitute a breach of an insurer's duty to settle if (a) there are multiple claimants against an insured, (b) the only severely injured claimant makes a settlement offer to the insured, (c) the settlement value of that one (covered) claim materially exceeds the policy limit, (d) that claimant makes it clear that his or her settlement offer will not be renewed if the insurer counter-offers requesting a release from all claimants, and (e) the insurer nevertheless makes such a counter-offer. There is a practical solution to the insurance company's dilemma. The insurer should notify all the potential claimants that the value of the claims will doubtless exceed the policy limits, and invite them or their attorneys to participate jointly in efforts to reach agreement as to the disposition of available funds[5]. If that course of action is not fruitful, rather than

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[4] See, e.g., Williams v. Infinity Ins. Co., 745 So. 2d 573, 576-77 (Fla. Dist. Ct. App. 5th Dist. 1999) (insurer acted reasonably by not exhausting its policy limits by paying two of several claimants); Holtzclaw v. Falco, Inc., 355 So. 2d 1279, 1286–87 (La. 1977); cf Voccio v. Reliance Ins. Companies, 703 F.2d 1, 3 (1st Cir. 1983) (Rhode Island law) (insurer cannot be liable by virtue of its division of insurance proceeds among claimants unless its actions were "highly unreasonable, reckless or in bad faith"); Merritt v. New Orleans Public Service, 421 So. 2d 1000, 1001 (La. Ct. App. 4th Cir. 1982) ("insurer may enter into reasonable, good faith settlements even though such settlements exhaust or diminish the proceeds available to other claimants"); Castoreno v. Western Indem. Co., Inc., 213 Kan. 103, 515 P.2d 789, 795 (1973) (insurer may settle part of multiple claims arising from negligence of its insured even though such settlements deplete or exhaust the policy limits if it acts in "good faith"); Levier v. Koppenheffer, 19 Kan. App. 2d 971, 879 P.2d 40, 45 (1994). See generally Peckham v. Continental Cas. Ins. Co., 895 F.2d 830, 835, 15 Fed. R. Serv. 3d 1375 (1st Cir. 1990) (Massachusetts law). But see Babcock v. Liedigk, 198 Mich. App. 354, 497 N.W.2d 590, 593–94 (1993); Farmers Ins. Exchange v. Schropp, 222 Kan. 612, 567 P.2d 1359, 1367 (1977) (suggesting that insurer can meet its obligation of good faith and fair dealing simply by attempting "to settle claims within the policy limits as they [are] presented"); Rosell v. Farmers Texas County Mut. Ins. Co., 642 S.W.2d 278, 280 (Tex. App. Texarkana 1982) (the policy "provided for coverage of a maximum of $10,000 per person. Farmers should not be required to offer the total $20,000 per occurrence limit of liability thereby transferring a portion of the $10,000 coverage for the claim of Donna Rosell to the claim of Alicia Downs"). Contra Texas Farmers Ins. Co. v. Soriano, 881 S.W.2d 312, 315, (Tex. 1994) ("when faced with a settlement demand arising out of multiple claims and inadequate proceeds, an insurer may enter into a reasonable settlement with one of the several claimants even though such settlement exhausts or diminishes the proceeds available to satisfy other claims." Court then defined a reasonable settlement solely in terms of the settlement value of the settled claim, without regard to the existence or value of the other claims). See, e.g., Johnson v. Pennsylvania Natl. Mut. Cas. Ins. Co., 447 F. Supp.3d 372, 380 (D. Md 2020) (insurer did not breach duty to settle by using its policy limit to settle other claims because “there is no indication that” by doing what it did, the insurer “substantially increased the danger to the insured of a judgment or judgments over policy limits”); DeMarco v. Travelers Ins. Co., 26 A.3d 585, 613–14 (R.I. 2011).

[5] Cf. Belizaire v. Aetna Cas. & Sur. Co., 171 Misc. 2d 473, 654 N.Y.S.2d 982, 986 (Sup 1997) ("In the case of multiple claims against a limited liability policy, a carrier, who has notice of multiple claims, must consolidate such claims in the interest of dividing as fairly as possible the limited assets available. If the carrier fails to consolidate the claims, as here, then the carrier must be prepared to pay each claim that is awarded within the policy limits, even if cumulatively the awards exceed such limits").

attempting to determine whether a particular settlement is in the insured's best interests, the insurer should, assuming that it has no reason to suspect that the insured will squander the money, and assuming that it is not in a jurisdiction that attributes third-party beneficiary status to the injured person immediately on sustaining an injury[6], simply pay the entire policy proceeds to the insured[7], leaving it to the insured to distribute the money as he or she chooses. If reasonable to do so under the circumstances—because a settlement with less than all of the claimants would not be reasonable under the circumstances, an advantageous settlement with less than all of the claimants could not be achieved—the insurer can interplead the policy limit into court and continue defending the insured[8]. The insurer's duty to settle is owed to the insured, not the claimants, and the only duty owed is to use the policy proceeds with the insured's interests in mind.

### *2. Exhaustion Impact On Insurer's Duty To Defend Insured*

When a defense is afforded to an insured, the insured expects the defense to continue until the end of the litigation, i.e., settlement or dismissal of the claim. Typically, the exhaustion of the limits through the payment of judgments or settlements will end an insurer's duty to defend.

## III. ALTERNATIVE RESOLUTIONS TO CLAIMS

There are a number of alternative dispute resolution options, besides the typical settlement for a fixed dollar amount, which are available to the carriers/defendant roofer. Contractor self-performance which is typically offered during the §558 process. Blended contractor repairs whereby the manufacturer provides the materials and the roofer volunteers the labor to resolve the claim, or the carrier agrees to a partial payment and the roofer self-performs repairs on an agreed upon roofing location. Last, but not least, settlement for a minimal amount with Plaintiff and assigning the roofer's rights to Plaintiff to seek downstream claims against the roofer's sub-subcontractors.

### A. SELF–PERFORMANCE.

This is the simplest and quickest dispute resolution option, save for immediately offering money to resolve the claim. Self-performance of the roofing system repairs/replacement can oftentimes cut or completely avoid litigation costs if offered during the 558 process. Furthermore, it can often reduce the impact on the plaintiff's

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[6] See § 9:16. In such jurisdictions, the insurer should consider filing an interpleader action and paying the policy limits into court.

[7] Also, in the event that such payment does not discharge its duty to defend, the insurer should provide the insured with a defense in all the actions that are brought against the insured. See § 4:32.

[8] See generally McReynolds v. American Commerce Ins. Co., 225 Ariz. 125, 235 P.3d 278, 284 (Ct. App. Div. 1 2010) ("(1) the prompt, good faith filing of an interpleader as to all known claimants with (2) payment of the policy limits into the court and (3) the continued provision of a defense for the insured as to each pending claim, acts as a safe harbor for an insurer against a bad faith claim for failure to properly manage the policy limit (or give equal consideration in settlement offers) when multiple claimants are involved and the expected claims are in excess of the applicable policy limits").

home and mitigate any ongoing damage to other property, which saves the carriers money. Unfortunately, this option will not work when the homeowner or association has entered into a contingency retainer agreement with the Plaintiff's attorney as they will typically require financial compensation to release their lien rights against their client.

B. BLENDED SELF-PERFORMANCE

The second most common alternative resolution option is the blended self-performance offer. This option works well when the plaintiff has entered into a contingency agreement with their attorney, or when they have incurred significant expert costs to identify and trigger a defense of the alleged claims. What we've had success doing is identifying they're legal fees, and negotiating their fees down and having the carrier pay off the legal fee, or any legal liens (expert fees, court costs) and having the contractor self-perform the repairs. This option typically is only feasible and cost effective on single family home claims, or in situations in which the scope of repairs are limited to a single location on multiple locations, such as the kickouts, window flashings, or applying sealants. This option does not make financial sense when it calls for a complete reroof/replacing all windows of an entire Association.

This option also works well when the manufacturer has been brought into the case. If the plaintiff will agree to a non-disclosure agreement, we have had great success involving the manufacturer in the settlement agreement, whereby they provide the material(s) at their own expense, and the contractor installs and incurs the labor cost. This is often incredibly beneficial to all involved, as the Plaintiff receives a partial or completely new system, the manufacturer avoids a public record of a products liability resolution, the contractor controls the costs of repair and the carrier avoid the plaintiff's overblown repair costs.

C. SETTLE AND ASSIGN CLAIMS

The final alternative dispute resolution is only available when the roofing contractor utilized sub-subcontractors. Since most subcontractors rarely utilize sub-subcontractors, this is a rarer occurrence and therefore is not as readily available to resolve the typical stucco related claim. The process involves settling the claims with plaintiff, or third-party plaintiff, at a discount, and assigning the remaining downstream claims to recover the remainder sought by same. This is not a common practice because it shifts the burden of proving the sub-subcontractor negligently performed their work to the party assigned the claims. The most often time this resolution is accepted by plaintiff is when the sub-subcontractor's carrier has exposed their insured and a bad faith claim is identified.

This brief presentation is certainly not offered as an answer to a significant problem. It is offered as an opening gesture to further analyze in depth what we are accomplishing

with our current system and how can we adjust, adapt and continue to develop a system that will result in the best possible outcome.