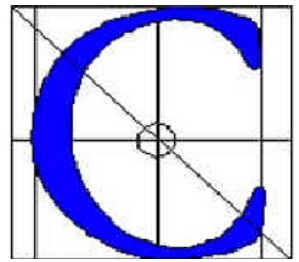




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Barry Zalma, Esq.**



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Breach of Contractors Warranty Defeats Coverage

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Barry Zalma

Insurers who insure the liability of contractors will often include in their policy a warranty that compels the general contractor to obtain proof that all its subcontractors are insured. In an important case, *North American Capacity Insurance Co. v. Claremont Liability Insurance Co.*, No. B207878 (Cal.App. Dist.2 08/04/2009), dealing with a clause rarely litigated, the California Court of Appeal enforced such an agreement and issued a warning to all general contractors who do not comply with similar warranties that they may be eliminating their own coverage. In this case the warranty or condition required that the insured follow its general business practice to get hold harmless agreements and certificates of insurance from its independent contractors. The insured failed to do so and tried to enforce the contracts claiming, unsuccessfully, that it did not need to comply with the warranty.

The warranty provided that coverage afforded by the policy "shall not apply" to operations performed by independent contractors unless the insured (1) "*has received* a written agreement from each and every independent contractor holding the insured harmless from all liabilities incurred by the independent contractor" and (2) "*has obtained* certificates of insurance from each and every independent contractor indicating that the independent contractor will maintain similar coverage as provided by this policy. ..." (emphasis in the original) The insurance industry also uses similar warranties that require that each independent contractor name the general contractor, the owner and/or the developer as additional insureds.

If the general contractor does not have in its possession certificates of insurance from every independent contractor at the time the work begins and throughout the construction, the insurance is unenforceable.

Every general contractor, developer and subcontractor that uses subcontractors must be certain to obtain the certificates required by similar policy terms. Failure to do so can be devastating.

Factual Background

JD Group Inc. (JDG), a general contractor, hired several subcontractors to build a home. After completion of the home, the homeowner sued JDG for construction defects. JDG's insurers, North American Capacity Insurance Co. (NAC) and Claremont Liability Insurance Co. (Claremont), agreed to defend JDG. NAC paid \$800,000 and Claremont paid \$300,000 of a settlement between JDG and the homeowner. Later, NAC sued Claremont for failing to pay its share of the settlement.

The trial court found that JDG failed to comply with the contractors warranty that stated that Claremont would cover damages caused by subcontractors **only** if JDG had obtained agreements and insurance certificates from each subcontractor. Given that JDG failed to do so, the Court of Appeal found that Claremont was not responsible for the \$909,574 in damages caused by subcontractors on the job.

"Any provision that takes away or limits coverage that is reasonably expected by an insured must be conspicuous, plain and clear." This court found that the the contractors warranty endorsement could not have been more clear, given the conspicuous references contained in the policy. The endorsement clearly indicated that it was a condition to coverage, which imposed specific duties on the insured in order to obtain coverage under the policy. Here, JDG failed to obtain the agreements and insurance certifications as required by the condition to coverage.

The parties stipulated at trial that JDG failed to comply with the "hold harmless" provision in the contractors warranty endorsement for eight of the 13 subcontractors involved. Claremont introduced evidence that one subcontractor provided no certificate of insurance to JDG and the certificates of insurance for two more subcontractors showed on their face that coverage was on a "claims made" basis rather than on an "occurrence" basis as required in the Claremont policies. In short, it appeared that JDG had fully complied with the contractors warranty endorsement for only two of these subcontractors.

The Decision

The Court of Appeal, in reaching its decision, applied settled doctrines with regard to the interpretation of an insurance policy. Such interpretation, in California, is a question of law that the Court of Appeal can review as if it were the trial court.¹ Notwithstanding that insurance policies have special features, they are still contracts, to which ordinary rules of contractual interpretation apply.²

The Court of Appeal concluded that fundamental objective of contractual interpretation is to give effect to the mutual intention of the parties. If possible the court will determine that intent solely from a contract's written provisions. The clear and explicit meaning of the contractual provisions interpreted in their ordinary and popular sense, governs judicial interpretation, unless the words are used by the parties in a technical sense or a special meaning is given to them by usage.³ If a lay person would ascribe to the contract language a meaning that is not ambiguous, we apply that meaning.

Reviewing the trial court's factual findings for substantial evidence the appellate court starts with the presumption that the record contains evidence to uphold every finding of fact and person appealing has the burden to demonstrate there is no substantial evidence to support the findings under attack.

In *Scottsdale Ins. Co. v. Essex Ins. Co.* (2002) 98 Cal.App.4th 86 (*Scottsdale*), the appellate court enforced an endorsement substantially similar to the endorsements at issue in this case, finding the special condition endorsement to be unambiguous and therefore enforceable. In *Scottsdale*, the insured, a licensed architect and general contractor, built a large single family residence purchased by the Operas. The final inspection was completed in April 1991, and the Operas purchased the home in October 1991. Within months, water began to infiltrate the home, and, several years later, sewage spilled in and under the home due to a failed pump, leading to a buildup of mold. The Operas filed a claim against the insured. The insured in turn referred the claim to his insurers. Essex Insurance Company provided comprehensive general liability insurance to the insured from February 15, 1991, to March 21, 1993, and Scottsdale Insurance Company provided such insurance from March 21, 1993, through April 20, 1994.

Essex denied the claim, but Scottsdale accepted the insured's tender of defense, settled with the Operas and then sought equitable contribution from Essex. (*Scottsdale*, supra, 98 Cal.App.4th at p. 89.) The Essex policy of insurance contained a special condition endorsement, similar to the

¹*Powerine Oil Co., Inc. v. Superior Court* (2005) 37 Cal.4th 377, 390; *AIU Ins. Co. v. Superior Court* (1990) 51 Cal.3d 807, 818.)

²*Powerine Oil Co., Inc. v. Superior Court* (2005) 37 Cal.4th 377, 390; *AIU Ins. Co. v. Superior Court* (1990) 51 Cal.3d 807, 818.)

³*Bay Cities Paving & Grading, Inc. v. Lawyers' Mutual Ins. Co.* (1993) 5 Cal.4th 854, 867

endorsement in the present case, requiring that the insured (1) obtain certificates of insurance from all subcontractors, (2) obtain hold harmless agreements from all subcontractors indemnifying the insured against all losses for work performed, and (3) ensure that it was named as an additional insured on all subcontractor general liability policies. (*Id.* at p. 89.)

The appellate court in *Scottsdale* held that the endorsement did not render the policy illusory, because the parties exchanged promises that represented legal obligations. If the person insured satisfied the condition i.e., required his subcontractors to obtain insurance naming him an insured, then Essex was required to participate with those insurers in defending or indemnifying the insured. As so interpreted, the court held the Essex policy was not illusory.

The appellate court also held the endorsement was not analogous to a disfavored escape clause, because the endorsement was merely a condition precedent to coverage, not a clause that eliminated coverage in the presence of other insurance. Nor did the appellate court find the endorsement ambiguous. The requirements were clearly set forth, and "[t]he endorsement plainly states that meeting those requirements is a condition of coverage." The insured clearly was required, as a condition of coverage, to obtain certificates of insurance from all subcontractors, to obtain hold harmless agreements from subcontractors against all loss for the work performed, and to make certain the insured was named as additional insured on all subcontractors' liability policies.

Moreover, we find the contractors warranty endorsements in this case to be conspicuous, plain and clear. The Claremont primary policy provision contains conspicuous references to "Forms Applicable to All Coverage Forms" on the pages listing the premium and limits of insurance, announcing, "Forms List Attached." This reference appears on the first page, directly under the statement that "[i]n return for the payment of the premium, and subject to all the terms of this policy, we agree with you to provide the insurance as stated in this policy." The reference also appears on the second and third pages of the policy, which reflect the amounts of premium and limits of insurance. The forms list itself appears on the fourth page of the policy and includes a reference to a "Contractors Warranty Endorsement." The contractors warranty endorsement is included as a separate page attached to the policy, together with other policy exclusions and endorsements.

The Court of Appeal concluded that the language of the endorsements clearly indicate the endorsement is a condition to coverage rather than an exclusion from coverage.

A condition *precedent* refers to an act, condition or event that must occur before the insurance contract becomes effective or binding on the parties. In general, conditions neither confer nor exclude coverage for a particular risk but, rather, impose certain duties on the insured in order to obtain the coverage provided by the policy.⁴

JDG knew, or is presumed to have known, of this precondition prior to acceptance of the Claremont policies. JDG could have protected itself by obtaining from its independent contractors agreements for indemnity and certificates of insurance before entering into the policy or by seeking modification of this policy term, e.g., by paying a larger premium. Indeed, JDG's president testified, and the trial court found, that it was JDG's normal practice to obtain hold harmless agreements and certificates of insurance for projects on which JDG worked. Merely requiring that JDG continue its normal business practice of obtaining hold harmless agreements and certificates of insurance as a precondition to coverage did not render either the Claremont primary or umbrella insurance contractors warranty endorsements impossible of performance.

⁴*Cal. Practice Guide, Insurance Litigation* (The Rutter Group 2008) § 3:158, p. 3-47.

The court found the "clear and explicit" meaning of the contractors warranty endorsements, as used in their "ordinary and popular sense" by a layperson establishes a precondition of coverage as to work done by subcontractors for whom JDG failed to secure both a written hold harmless agreement and a certificate of insurance.

In conclusion, the Court of Appeal, found that the trial court did not err in finding the contractors warranty endorsement enforceable under the facts of the case.

Barry Zalma



Barry Zalma is an insurance coverage attorney and Certified Fraud Examiner. He is the founder of Barry Zalma, Inc., a California law firm whose practice emphasizes the representation of insurers and those in the business of insurance. Mr. Zalma is the author of Insurance Claims – A Comprehensive Guide, “Construction Defects” and “Mold: Claims and Litigation” published by Specialty Technical Publishers, Vancouver, BC with details available at <http://www.stpub.com>, California Claims Regulations and Insurance published by Carolina Academic Press with details at <http://www.cap-press.com/authors/860>.

Mr. Zalma writes the monthly Zalma’s Insurance Fraud Letter which is available, FREE, from ClaimSchool and over the Internet at <http://www.zalma.com>.

Mr. Zalma has testified as an expert witness in the California Superior Court, the United States District Court and the Superior Court of Nebraska. He is an internationally recognized expert on insurance claims handling, the commercial general liability policy, the comprehensive general liability policy, bad faith, insurance fraud, Jewelers' Block Insurance and other inland marine coverages. Mr. Zalma can be reached at telephone 310-390-4455, fax 310-391-5614, cellular 310-738-6818 or by e-mail at zalma@zalma.com.