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DOES A GENERAL CONTRACTOR'S LIABILITY INSURER HAVE A DUTY TO DEFEND THE POLICYHOLDER'S SURETY IN A LIABILITY ACTION? THE UNITED STATES FEDERAL DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA SAYS "NO"

By Joshua S. Leach

This article explores the issue of what duty, if any, a liability insurer has to defend a policyholder's surety under the supplementary payments provisions when both the policyholder and surety are sued in the same construction defect action.

When working on a commercial construction project, a general contractor typically insures against a number of risks. Among other things, a general contractor will often purchase:

1. liability insurance, to insure against the risk of accidental damage that the general contractor causes to third parties; and

2. a surety bond that promises to pay to complete the project if the general contractor cannot (or will not).

While these instruments cover different risks and are triggered in different ways, they sometimes interact in confusing ways.

This article addresses the following, narrow issue:

> When an owner sues a general contractor and its surety in the same construction defect action, is a defending liability insurer obligated to defend both the insured contractor and its surety under the liability policy's Supplemental Payments provision?

As discussed below, this issue turns in part on whether the surety bond is an "insured contract" as defined by the liability policy. While there is very little case law on this issue, one of the few courts to have examined it recently found that the surety bond is not an "insured contract" and therefore the surety was not entitled to a shared defense from the liability insurer under the Supplementary Payments provision.[1]

Hypothetical Facts

To frame the discussion, assume the following facts (drawn from the *JDS v. Scottsdale* case). A school district ("District") hires a general contractor ("General Contractor") to renovate a high school, which includes painting the school exterior. Per the project requirements, General Contractor purchases both commercial general liability insurance and a surety bond. The surety bond contains a standard indemnity provision; if the surety ("Surety") pays under the bond, General Contractor must indemnify Surety to the fullest extent allowed by law.

Around the time the renovation is complete, District discovers that the exterior paint is failing. The only viable fix is to strip and re-paint the school exterior. General Contractor lacks the funds to re-paint the school.

Pre-suit, District asks Surety or Liability Insurer to fund the fix. Surety refuses, taking the position that the contractor's liability insurance covers the loss. Liability Insurer also refuses, taking the position that the loss is fully excluded by the policy's "faulty work" exclusions.

District sues General Contractor for breach of contract and negligent construction, and Surety for breach of the surety bond. Surety tenders its defense to General Contractor per the surety bond's contractual indemnity provision. However, General Contractor is insolvent and cannot afford to defend Surety.

General Contractor tenders its defense to Liability Insurer. Liability Insurer agrees to defend General Contractor subject to a reservation of rights. Liability Insurer has determined that this claim is likely not covered, but since it cannot definitively rule out coverage for all alleged damage (e.g., minor damage to the substrate), the Liability Insurer agrees to defend its insured against the suit while reserving its right to deny coverage for any judgment for non-covered damages.

Surety then tenders its defense to Liability Insurer, citing an obscure sub-section of the Supplementary Payments provision of the liability insurance policy. As discussed further below, this sub-section promises to pay for the defense of the insured's indemnitee so long as a list of conditions are met. Because Surety is General Contractor's indemnitee with respect to this suit, Surety claims that Liability Insurer must defend Surety against the District's suit.

Under these facts, does the liability insurer owe the surety a defense against the owner's claim?

Relevant Liability Insurance Policy Language

Broadly speaking, a standard liability insurance policy provides the policyholder two main benefits: (1) defense against a claim that alleges liability for a potentially covered loss; and (2) indemnity against a covered judgment (or other legal obligation to pay). The insurer will pay a covered judgment up to a fixed sum (e.g., $1 million), referred to as the "liability limit." In standard general liability policies, defense costs (e.g., defense counsel's fees, expert fees, etc.) typically do not erode the liability limit. This is important to an insured because it preserves the policy's liability limit for the payment of judgments.

The Supplementary Payments section, which is part of the standard Insurance Services Office Ltd. ("ISO") liability form, lists certain costs that the insurer will pay as part of its defense obligation. These costs include investigation costs, costs taxed against the insured and pre- and post-judgment interest.

Of relevance to this article, a little used subsection of the Supplementary Payments provision promises to pay to defend an indemnitee of the policyholder provided certain conditions are met. For example, the Supplementary Payments provision in ISO Form No. CG 00 01 12 07 (which is typical of this type of provision) provides, in relevant part:

2. If we defend an insured against a "suit" and an indemnitee of the insured is also named as a party to the "suit", we will defend that indemnitee if all of the following conditions are met:

a. The "suit" against the indemnitee seeks damages for which the insured has assumed the liability of the indemnitee in a contract or agreement that is an "insured contract";

b. This insurance applies to such liability assumed by the insured;

c. The obligation to defend, or the cost of the defense of, that indemnitee, has also been assumed by the insured in the same "insured contract";

d. The allegations in the "suit" and the information we know about the "occurrence" are such that no conflict appears to exist between the interests of the insured and the interests of the indemnitee;

e. The indemnitee and the insured ask us to conduct and control the defense of that indemnitee against such "suit" and agree that we can assign the same counsel to defend the insured and the indemnitee; and

f. The indemnitee:

(1) Agrees in writing to:

(a) Cooperate with us in the investigation, settlement or defense of the "suit";

(b) Immediately send us copies of any demands, notices, summonses or legal papers received in connection with the "suit";

(c) Notify any other insurer whose coverage is available to the indemnitee; and

(d) Cooperate with us with respect to coordinating other applicable insurance available to the indemnitee; and

(2) Provides us with written authorization to:

(a) Obtain records and other information related to the "suit"; and

(b) Conduct and control the defense of the indemnitee in such "suit".

So long as the above conditions are met, attorneys' fees incurred by us in the defense of that indemnitee, necessary litigation expenses incurred by us and necessary litigation expenses incurred by the indemnitee at our request will be paid as Supplementary Payments. Notwithstanding the provisions of Paragraph 2.b.(2) of Section I – Coverage A - Bodily Injury And Property Damage Liability, such payments will not be deemed to be damages for "bodily injury" and "property damage" and will not reduce the limits of insurance.

Our obligation to defend an insured's indemnitee and to pay for attorneys' fees and necessary litigation expenses as Supplementary Payments ends when we have used up the applicable limit of insurance in the payment of judgments or settlements or the conditions set forth above, or the terms of the agreement described in Paragraph f. above, are no longer met.

An "insured contract" is defined in relevant part as:

> 9. "Insured contract" means:
>
> …
>
> f. 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

In sum, the insurer agrees to defend the insured's indemnitee if: (i) the insured agreed to indemnify the indemnitee in an "insured contract"; (ii) the insured and its indemnitee have a unity of interest; and (iii) the insured and its indemnitee agree to share appointed defense counsel and cooperate in the defense.

Discussion

Commercial General Liability Insurance vs. Surety Bonds – What Risks Each are Intended to Cover

A standard general liability policy promises to defend and indemnify the insured against liability for bodily injury or property damage caused by an occurrence. In other words, if an owner sues the insured general contractor alleging a potentially covered loss (e.g., because the insured contractor negligently damages the owner's property), the liability insurer is obligated to defend its insured against the suit. If the suit results in a covered judgment against the insured, the liability insurer is obligated to pay the judgment.

In contrast, a surety is "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor."[2] A surety bond is a written instrument executed by the principal and surety in which the surety agrees to answer for the debt or default of the principal. Thus, under our facts, if General Contractor fails to finish the project for whatever reason, Surety (typically a financial institution or some entity with sufficient resources to guaranty performance) will pay to finish the project.

Unlike liability insurance, the general contractor typically promises to indemnify the surety if the surety is called upon to finish a project. Thus, the surety is not "assuming the risk" of an adverse event (like insurance) – the general contractor will be liable to the surety if the surety must perform under the bond. In part for this reason, surety bonds are underwritten and sold like loans, and are not considered insurance.

What is an "Insured Contract"?

Under our assumed facts, whether Liability Insurer owes Surety a defense under the Supplementary Payments provision turns on whether the surety bond is an "insured contract" as defined by the policy. ("The 'suit' against the indemnitee seeks damages for which the insured has assumed the liability of the indemnitee in a *contract or agreement that is an 'insured contract.'*")

The standard ISO form defines an "insured contract" in relevant part as "[t]hat part of any other contract or agreement pertaining to your business … under which you [the named insured] assume the tort liability of another party [e.g., Surety] to pay for … 'property damage' to a third person or organization." "Tort liability" is further defined in the standard form as "liability that would be imposed by law in the absence of any contract or agreement."

California courts have held that a construction subcontract containing a standard indemnity provision in favor of the general contractor qualifies as an "insured contract" under the standard ISO definition.[3] This is because in a standard construction subcontract, the subcontractor assumes the general contractor's liability for, among other things, negligence.

In short, under our assumed facts the surety bond is an "insured contract" if General Contractor assumed the "tort liability" of Surety.

Is a Surety Bond an "Insured Contract?

No California case has addressed the specific issue of whether a surety bond is an "insured contract" as that term is defined by the standard ISO form.[4] However, in *Bernstein v. Consolidated American Ins. Co.*, the California Court of Appeal held, applying similar language in a different context, that a surety that issues a bond to a general contractor does not assume the "tort liability" of that general contractor.[5]

Bernstein was a coverage action that arose from of an underlying construction defect case. The policyholder was a mechanical subcontractor hired to renovate a bus terminal.[6] After the work was complete, the general contractor sued the insured and his surety for construction defects. The surety, in turn, sued the insured under the indemnity agreement in its surety bond. The insured tendered its defense against the surety's suit to its liability insurer. The liability insurer denied owing the general contractor a defense against the surety's claim because the surety alleged only breach of contract.

The litigants agreed that the policy covered only contractually assumed tort liability.[7] However, the policyholder argued that because the surety was being sued for property damage potentially caused by the policyholder's negligence, the surety's indemnity claim against the policyholder was covered as potential tort liability. The court disagreed, finding that the surety could only be liable for contract damages, not tort, so therefore there was no coverage.

> [T]he relevant inquiry is not the nature of the damages which the City recovered from [general contractor], and for which [general contractor] is seeking reimbursement. Rather, the question is on what basis does [general contractor] claim a right to recover from [surety]? *And the answer is clear: The sole premise for [surety's] liability to [general contractor] is the performance bond, a contractual obligation*. That is to say, but for [surety's] contractual agreement to be liable to [general contractor] under the conditions set forth in the performance bond, [general contractor] would have no cause of action against [surety]. Whether the terms of the performance bond were purportedly breached by reason of [insured's] negligence in performing the subcontract, or due to [insured's] intentional misconduct, or for any other reason, is of no consequence. [Surety's] liability to [general contractor] is not tort liability, arising by operation of law, but contractual liability, based solely on the agreement of the parties.[8]

The holding in *Bernstein* is consistent with the plain language of the ISO form policy and the scope of a surety's liability. The California Supreme Court has held that a surety cannot be sued in tort for a breach of its bond obligations.

> The question before us is this: Is tort recovery appropriate for a breach of the implied covenant of good faith and fair dealing in the context of a construction performance bond? In answering that question, we are reminded that "[c]ontract law exists to enforce legally binding agreements between parties; tort law is designed to vindicate social policy." [Citation.] … With that guiding principle in mind, we answer the question in the negative.[9]

Turning to our assumed facts, District (the obligee of the surety bond) cannot sue Surety in tort; District's sole recourse against Surety is for breach of the surety contract. An "insured contract" by definition assumes the tort liability of the indemnitee. General Contractor cannot have assumed Surety's tort liability because Surety has no tort liability. Thus, Surety's bond cannot be an "insured contract" as defined by Liability Insurer's policy.

If the foregoing analysis is correct, the surety bond is not an "insured contract" and Surety is not entitled to a defense from Liability Insurer under the Supplementary Payments provision against the District's action.

The Federal District Court for the Northern District of California Recently Found That a Surety Bond is not an "Insured Contract," And Therefore the Surety was not Entitled to a Defense from a Liability Insurer

On essentially the same facts as assumed to frame our discussion (involving an alleged paint failure at a school, followed by a construction defect action in which the liability insurer refused a defense tender by the surety), the Federal District Court for the Northern District of California (*JDS v. Scottsdale*) sustained the liability insurer's ("Scottsdale") motion to dismiss the policyholder's ("JDS") breach of contract claim. Among other things, JDS alleged that Scottsdale's refusal to defend the surety breached the Supplementary Payments provision.

The district court granted Scottsdale's motion to dismiss, finding that the indemnification agreement between JDS and the surety was not an "insured contract." Interestingly, the district court avoided citing *Bernstein*, perhaps out of concern that *Bernstein* was no longer good authority after *Vandenberg*. Instead, the district court relied on the plain language of the definition of "insured contract" and the *Cates Construction* holding that a surety has no tort liability to an obligee.

Conclusion

Despite this being a common fact pattern, there is very little published authority on this issue. For the reasons discussed above, the better reasoned position is that a surety bond is not an "insured contract" and therefore a liability insurer is not obligated under the standard ISO policy to defend a surety against a construction defect claim arising out of the work of the named insured

(Endnotes)

1. *JDS Builders Group, Inc. v. Scottsdale Ins. Co.* (N.D.Cal. June 6, 2015, Civ. A. No. 3:15-cv-00297-VC) Docket No. 43 (online citation unavailable) ("*JDS v. Scottsdale*"). The author's former firm represented Scottsdale Insurance Company.
2. Cal. Civ. Code § 2787; *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 38.
3. *Golden Eagle Ins. Co. v. Insurance Co. of the West* (2002) 99 Cal. App. 4th 837, 846-47.
4. *But see, Sanders v. Ashland Oil, Inc.* (La. Ct. App. 1995) 656 So.2d 643, 650 (writ denied, (La. 1995) 661 So.2d 1389) (finding that a *surety* bond was not an "insured contract" as defined by the liability policy).
5. *See, Bernstein v. Consolidated American Ins. Co.* (1995) 37 Cal.App.4th 763 (applying the same language and holding that the bond issuer's liability is contract not tort liability) (disapproved on other grounds by *Vandenberg v. Sup. Ct.* (1992) 21 Cal. 4th 815) *Vandenberg* found that when used in a liability insurance policy, the phrase "legally obligated to pay" includes both tort and contract damages. (*Vandenberg, supra*, at 840.) Unlike the language considered by *Vandenberg*, the Supplementary Payments provision explicitly conditions coverage on the insured assuming the *tort* liability of another. Thus, while *Vandenberg* overruled *Bernstein's* interpretation of the phrase "legally obligated to pay," *Bernstein's* finding that a surety's liability is based solely in contract arguably remains unaffected by *Vandenberg*.
6. *Bernstein, supra*, at 767.
7. *Id.* at 772.
8. *Id.* (emphasis added).
9. *Cates Construction, Inc. v. Talbot Partners* (1999) 21Cal.4th 28, 60.

About the Author

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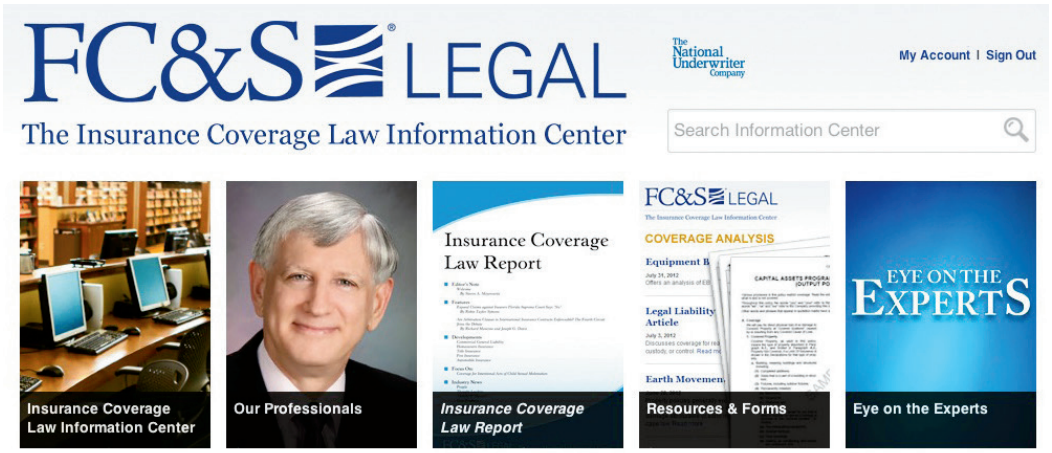

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