PUBLICATION

Contractors Beware - Be Careful in Settling a Construction Defect Claim Without Your Insurer's Prior Consent [Ober|Kaler]

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A recent decision by the U.S. Court of Appeals for the Fourth Circuit, *Perini/Tompkins Joint Venture v. ACE American Ins. Co.*, 783 F.3d 95 (2013), provides an important reminder for contractors defending against construction defect claims – be sure to get your liability insurer's consent before entering into a settlement agreement. Otherwise, you risk losing coverage for the claim, which will prevent recovery from the insurer of any settlement amount that you paid.

In that case, developer Gaylord National, LLC hired Perini/Tompkins Joint Venture (PTJV) in 2005 to serve as the construction manager for a $900 million hotel and convention center project at the National Harbor along the Potomac River in Maryland. Gaylord purchased and maintained an Owner Controlled Insurance Program from ACE American Insurance Co. (ACE), which included commercial general liability (CGL) and excess liability policies – both naming PTJV as an additional insured. The project also was insured by a builder's risk policy.

During construction, a portion of an 18-story, 2,400 ton glass atrium collapsed, causing damage and delaying final completion. Shortly after completion, PTJV sued Gaylord to establish and enforce a mechanic's lien and for breach of contract, claiming that Gaylord still owed it $79,656,098 because of the alleged late delivery of design documents and changes to the original scope of work. Gaylord countersued, alleging that PTJV failed to properly manage the work and failed to deliver a high-quality project at the agreed-upon contract price. Gaylord sought reimbursement of $64,994,374, which it claimed to have overpaid to PTJV during the project.

The parties ultimately settled the dispute in November 2008, with Gaylord paying PTJV an additional $42,301,875 and PTJV crediting $26,157,912 back to Gaylord. Significantly, PTJV did not seek ACE's consent prior to entering into the settlement agreement with Gaylord. Nevertheless, six months later, PTJV sent a letter to ACE, advising that, to the extent the builder's risk policy did not cover the claim related to the glass atrium collapse, PTJV intended to seek reimbursement under the CGL and excess liability policies. PTJV's letter, however, did not mention the Gaylord counterclaim or the settlement at all. Ten months later, ACE issued a reservation of rights letter, citing business risk exclusions, late notice, and voluntary payments made without ACE's consent as possible grounds for coverage being denied.

PTJV thereafter sued in the U.S. District Court of Maryland for breach of contract, bad faith, and a declaratory judgment. After limited discovery, ACE filed a motion for summary judgment, arguing that PTJV had failed to obtain ACE's consent prior to entering into the settlement with Gaylord, and that this failure breached the following clauses in the CGL policy:

Voluntary payment clause: “No insured will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.”

-- and --

No-action clause: “No person or organization has a right under this Coverage Part: … [t]o sue us on this Coverage Part unless all of its terms have been fully complied with. A person or organization may sue us to recover on an agreed settlement. … An agreed settlement means a settlement and release of liability signed by us, the insured and the claimant or the claimant's legal representative.”

The excess liability policy contained similar voluntary payment and no-action clauses, which are standard in CGL and excess liability policies and, from the perspective of an insurer, designed to protect it from indemnifying an insured for a collusive, overly generous, or unnecessary settlement. According to ACE, because PTJV failed to satisfy the “prior consent” conditions, it could not seek reimbursement for the monies paid to Gaylord.

PTJV countered that ACE could not deny liability coverage under Maryland law unless it established that PTJV's lack of notice resulted in actual prejudice to ACE. That argument arose primarily from Section 19-110 of the Insurance Article of the Maryland Code, which provides:

An insurer may disclaim coverage on a liability insurance policy on the ground that the insured or a person claiming the benefits of the policy through the insured has breached the policy by failing to cooperate with the insurer or by not giving the insurer required notice only if the insurer establishes by a preponderance of the evidence that the lack of cooperation or notice has resulted in actual prejudice to the insurer.

PTJV also argued that ACE had a like duty under common law principles to prove prejudice before denying coverage.

The District Court agreed with ACE and granted its motion for summary judgment. On appeal, the Fourth Circuit affirmed that decision, analyzing the coverage issue under the laws of Maryland (where the project was built) and Tennessee (where the liability policies were made). Under Maryland law, the Fourth Circuit rejected PTJV's prejudice argument, finding that the requirement for an insurer to prove prejudice before denying coverage – whether derived from statutory or common law principles – did not apply where an insured has failed to satisfy the prior-consent conditions set forth in the no-action and voluntary payment clauses. The appellate court held that the no-action clause provided that PTJV could not sue ACE to recover on the settlement unless it had fully complied with all terms of the CGL and excess liability policies and, moreover, that PTJV could not sue unless the settlement agreement was signed by ACE. The voluntary payment clause, in turn, required PTJV to get ACE's consent before ACE would be required to make a payment, assume any obligation, or incur any expense (such as reimbursing PTJV for amounts paid to settle a claim arising from the glass atrium collapse).

In reaching that decision, the Fourth Circuit concluded that the prior consent provisions in the no-action and voluntary payment clauses were conditions precedent to coverage, meaning that they required certain events to occur (unless excused) before ACE had any obligation under the liability policies. Because PTJV did not obtain ACE's consent prior to settling with Gaylord, thereby failing to satisfy this condition precedent to coverage, ACE did not have to prove any prejudice before it denied coverage.

The Fourth Circuit also concluded that even if ACE were required to show prejudice, it could meet that burden. In particular, the Fourth Circuit found that an insurer is prejudiced if its insured unilaterally settles a claim without obtaining prior consent because (1) the insurer loses its right to investigate, defend, control, or settle the claim, and (2) the insurer would always have the nearly impossible burden of proving collusion or demonstrating, after the fact, the true value of the settled claim.

The lesson from the Fourth Circuit's decision in *Perini Tompkins/Joint Venture* is clear. A contractor must obtain the consent of its liability insurer before settling a construction defect claim; otherwise, the insurer can

deny coverage without having to prove that it suffered any prejudice. Should that happen, the contractor will lose the ability to seek reimbursement for the amount of the settlement, even if that amount otherwise would be considered fair and reasonable.