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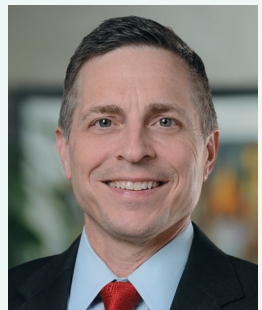
SDI Insured Must Shoulder Burden to PURSUE CLAIMS AGAINST CGL POLICY

SUBCONTRACTOR DEFAULT INSURANCE (SDI) is one tool in the general contractor's risk management arsenal—particularly on larger, more complex construction projects. SDI typically does not guarantee subcontractor performance and payment as more conventional surety bonds; instead, SDI insures the project's general contractor against the added cost/risk of contractual default by a subcontractor. Most SDI policies contain high aggregate limits to insure against the added cost of subcontractor defaults on multiple projects being performed by the insured general contractor. SDI is generally not a replacement for more traditional general liability (CGL) coverage insuring against the risk of defective work. A recent federal court decision raises some concern, however, that an SDI policy may be used as a funding scheme for the insured to recover for a subcontractor's defective work claims. In allowing this approach, however, the SDI-insured is at risk for expending significant additional time and expense to recapture these funds for the SDI insurer.

Pavarini Construction Co. (Se) Inc. (Pavarini) served as the general contractor on a high-rise condominium construction project in south Florida. As part of the project, Pavarini enrolled in an Owner-Controlled Insurance Program (OCIP), which provided CGL coverage. Two insurers furnished the CGL coverage—one primary and one excess—totaling \$29 million in aggregate coverage. Pavarini also carried SDI with \$25 million in aggregate coverage.

Pavarini subcontracted portions of its work on the project. One subcontractor, Alan W. Smith, Inc. (AWS), was responsible for building the project's concrete masonry wall units with reinforced steel. Another subcontractor, TCOE Corporation (TCOE), subcontracted to install reinforcing steel within load-bearing concrete columns, beams, and shear walls. Both of the subcontractors performing this work were extended CGL coverage under the OCIP. Additionally, Pavarini's SDI policy covered it against the risk of contractual default by these subcontractors.

Inspections revealed significant defective work performed by AWS and TCOE. This defective work compromised the structural integrity of



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the entire building, causing destabilization within other building components. The project owner demanded that Pavarini repair these defects. Ultimately, Pavarini incurred more than \$25 million in direct costs to remediate this defective work and to repair other construction work that was impacted by these defects. Pavarini demanded indemnification from its subcontractors for the added costs to repair their defective work and other affected work. Pavarini

and AWS also sought coverage for these repairs under the OCIP's CGL policies. Both of the CGL carriers initially denied coverage. This denial of coverage apparently contributed to the contractual defaults of AWS and TCOE, thus triggering the SDI policy.

Under the SDI policy, Pavarini had to pay roughly the first \$1 million in damages. Thereafter, the SDI insurer agreed to make payments to Pavarini to fund the repairs. In exchange for these payments from the SDI insurer,

Pavarini had to seek reimbursement from the CGL insurers. Eventually, Pavarini recovered funds from the primary CGL insurer, American Home Assurance Company, and paid these funds to the SDI insurer. But after receiving the limits under the American Home policy, Pavarini was still faced with more than \$23 million in unreimbursed damages. Here, in order to satisfy its obligations to the SDI insurer, Pavarini sought reimbursement from the excess CGL policy carrier, ACE American Insurance Company (ACE). ACE steadfastly refused to pay out any amounts under the excess CGL policy. Accordingly, a lawsuit followed.

In the case styled *Pavarini Construction Co. (Se) Inc. v. ACE American Insurance Co.*, Case No. 14-CV-20524, Pavarini, for itself and for the SDI insurer, Steadfast Insurance Company, sued ACE in the United States District Court for the Southern District of Florida. Pavarini sought declaratory judgment "of the rights, duties and obligations under the ACE policy" and claimed that ACE was liable for monetary damages due to its breach of contract. The central issue in this case was whether ACE, as the excess CGL insurer, was ultimately responsible to reimburse the SDI insurer. Under the terms of the SDI policy, Pavarini had to fight this battle on behalf of the SDI insurer.

In an October 30, 2015 ruling, the federal district court judge presiding over the *Pavarini* case issued an order on the parties' motions for summary judgment. The court ruled in Pavarini's (and the SDI insurer's) favor on two key issues. First, the court found that Pavarini had standing to bring the lawsuit. ACE had challenged Pavarini's ability to even bring the lawsuit, arguing that Pavarini had been made whole by virtue of receiving payments from the SDI insurer. The court, however, disagreed, finding that Pavarini had "demonstrated invasion of its legally protected interest" in the SDI policy. In short, Pavarini was able to show the court that it had incurred significant



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expense based on its contractual obligations to the project owner as well as its contractual obligations to the SDI insurer, such that it could pursue claims for reimbursement of these damages against ACE.

Second, on the reimbursement question, ACE argued that the CGL policies and the SDI policy should combine to pro-rate the costs of the subcontractors' defective work. ACE based this argument on the CGL policies' so-called "other insurance" provisions. The court disagreed with ACE, reasoning that the CGL policies and the SDI policies did not address "the same subject matter, risk, and interest." The court supported this reasoning by finding that the ACE's CGL insured the project owner, Pavarini, and the covered subcontractors "against the risk of claims of property damage and bodily injury[.]" while the SDI policy insured Pavarini "against the risk of subcontractor contractual default." On this proration argument, the court ultimately

concluded, however, that SDI policy should not have been reached **first** before the CGL policies to reimburse Pavarini for its costs to repair the defective work.

Although the *Pavarini* court recognized a key distinction between risks covered under CGL insurance and those covered under SDI, this decision leaves open the question of whether SDI should cover a subcontractor's defective work. Here, the court did not explore or explain what, if any, limitations should be placed on coverage for "subcontractor contractual default." Further, applying the court's reasoning, SDI could very well be extended to cover defective work if it is determined that the CGL carrier does not have a duty to offer such coverage or if the limits of the CGL policy (or policies) are less than the claimed damages.

Perhaps the key takeaway here for surety professionals and contractors is that with SDI the contractor-insured is contractually obligated to recover

funds paid out under such policy. If any of the multiple insurers involved in a complex construction project, such as in the *Pavarini* case, seek to challenge responsibility for defective work, the burden and expense for contesting such determinations will likely fall on the contractor—leaving it potentially to devote significant unanticipated time and resources not reasonably related to delivering a construction project. ●

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