

Don't Guess Who's Coming to the Table: Organizing the Mediation Process

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I

INTRODUCTION

Increasingly, mediation is finding favor over arbitration to resolve a wide variety of disputes in the construction industry. For example, revisions to the American Institute of Architects ("AIA") form contracts expand the use of mediation by including compulsory mediation clauses.¹ Moreover, faced with the complexities of managing multiple parties and experts, counsel in construction defect cases are opting more than ever to use mediation. As compared to litigation, the benefits of mediation include its voluntary nature, reputation for quick resolution of claims, ability to save money by avoiding trial and capacity for preserving relationships among the parties. These attributes suggest mediation is an attractive alternative to litigation in the construction industry.²

Despite the differences between mediation and litigation, these processes share a common requirement—the need to involve the "right" parties. In particular, the likelihood of successfully settling a construction defect dispute is directly related to involving all subcontractors and design professionals who performed the work or provided the

¹ See American Institute of Architects, *AIA Document A201-1997*, Art. 4.5 (1997).

² See, e.g., LEE R. CONNELL & MICHAEL T. CALLAHAN, *CONSTRUCTION DEFECT CLAIMS AND LITIGATION* §3.16 (1995).



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professional services that gave rise to the defect claim. In most construction defect cases, however, the real parties in interest are not the parties themselves, but their insurance carriers. If the defendants settle, it is because their carriers have agreed to shoulder the cost. Thus, carriers play a pivotal role in settlement negotiations.

Regrettably, inexperienced mediators and litigators often fail to include key parties, thereby handicapping their chances to succeed. Negotiations that include only the plaintiff (*e.g.*, the owner or the unit owners of a condominium) and the lead defendant (*e.g.*, the general contractor) will be unproductive. The missing parties—the parties who actually performed the work—must attend and participate fully. A general contractor will be unwilling to settle with a plaintiff without first knowing the level of contribution from its subcontractors and the responsible design professionals. In many cases, general contractors maintain indemnity rights under their subcontracts. When necessary parties are absent, however, so are their insurance carriers. Without financial contributions from all potentially responsible parties, settlement is elusive.

Part II of this article addresses the importance of including all necessary parties as participants in the early stages of mediation. Part III describes options for including missing parties and emphasizes the mediator's role in coordinating the process and facilitating resolution.

II

SUBCONTRACTORS, DESIGN PROFESSIONALS AND INSURERS:
IMPORTANT TO NEGOTIATIONS FROM THE OUTSET

These Parties are Important because. . .

Participation by relevant parties can provide
valuable information and avoid further
litigation

Insurers for subcontractors and design
professionals must be put on notice and
participate fully in the process

Successful mediation of underlying
construction defect disputes avoids insurance
coverage litigation

A necessary precondition of mediation
requires adequate information before
proceeding with negotiations

A. Subcontractors and Design Professionals

In order to facilitate a full and final settlement, all necessary parties must be identified and present for the negotiations. When negotiations occur on a piecemeal basis or outside the scope of the mediation, the chances of overall settlement decrease dramatically. Participation by the key players prevents uncertainty regarding future recoveries against additional parties and reduces the risk of insufficient information in the settlement process. Therefore, with the help of the mediator, the parties must identify all key participants and secure their participation early in the mediation process. Identifying missing parties later in the proceedings lengthens the time and increases the cost of mediation.

Involving subcontractors and design professionals in the early stages of a mediation can increase the likelihood of success in settlement negotiations. Not only are these parties potential sources of settlement funds, but they also may be able to identify other responsible parties. Moreover, in many cases, contractors and design professionals can provide important information regarding the causes of damage and appropriate, cost-effective repairs. The inclusion of all parties may be especially helpful if the mediator conducts a site visit. Under the protection of mediation confidentiality, individuals with direct knowledge of what occurred during construction may educate the mediator and inform other parties of their potential exposure in litigation.

Finally, some disputes may be resolved through repairs or other in-kind activity preformed in lieu of paying financial damages. With all of the proper trades and professionals involved in the negotiations, the mediator may be able to craft non-financial remedies.

B. *Insurers*

Participation by subcontractors and design professionals is insufficient unless their carriers also participate in the process. An insured subcontractor or design professional who faces potential liability for construction defects should notify its carrier of the potential claim. So long as the allegations present a colorable cause of action, the carrier must provide a defense under the terms of the standard commercial general liability insurance contract. It is a well-established maxim of insurance law that the duty to defend is broader than the duty to indemnify. Yet, too many mediations begin without notice of potential exposure to carriers who have potential liability.

In almost every case, an insurer will agree to provide the insured with an attorney who defends against a broad range of claims that may fall within the terms of the policy. In addition, the insurance company may be legally required to defend claims that clearly are not covered, provided that the claims are part of a lawsuit that contains potentially covered claims. Even when the carrier concludes that the facts are unlikely to support an obligation to indemnify the policyholder, the carrier nonetheless may be required to provide a defense.

However, notice to insurers alone is insufficient. To maximize the possibility of settlement, insurance adjusters should be involved personally in the mediation process. Carriers may invoke the threat of coverage litigation if they perceive settlement demands to be excessive. Through early participation in the process, claims adjusters—the carriers' decision-makers—will gain an accurate appreciation of their policyholders' exposure. They then may be more likely to compromise their coverage defenses to avoid costly litigation in both the underlying and insurance coverage actions.

Defense counsel retained by an insurer to defend a policyholder owes her allegiance to the policyholder and not the carrier who is paying her fees. Consequently, retained defense counsel cannot ethically represent the carrier's interest concerning coverage issues because the carrier's and the policyholder's interests likely will diverge. While the carrier seeks to minimize claims paid on behalf of its policyholder, the policyholder wants the carrier to settle the claims so long as settlement is within the policy limits. Absent a knowing waiver by the insured, a lawyer attempting both to defend a policyholder and serve the carrier will violate ethical rules and may also lay the foundation for a claim of bad faith against the insurer.³

³ See, e.g., *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc.*, 208 Cal. Rptr. 494, 506 (Ct. App. 1984) (where conflict existed between counsel retained by insurer and insured, insured had right to independent counsel); see also *Nandorf, Inc. v. CNA Ins. Cos.*, 479 N.E.2d 988, 991 (Ill. App. Ct. 1985) (where conflict arises, disclosure must be made to both insurer and insured, securing consent from both before continuing process).

Mediation provides a solution to the conflict. Because the ultimate payor is the insurer, the mediator can negotiate directly with the claims representative and avoid defense counsel's conflict. Unimpeded by ethical constraints that bind defense counsel, the knowledgeable mediator will be able to discuss intelligently the risks and exposures of *both* the underlying defect dispute and the coverage claim.

At times, insurers can be the sole party in interest. If a subcontractor or design professional is missing or bankrupt and their only known asset is the insurance policy, the carrier de facto may be the sole decision-maker in settlement negotiations. In this situation, the insurance adjuster who has been apprised of developments during the mediation process and who understands the nature and scope of the damage will be more inclined to contribute to a settlement.⁴

III

HOW TO GET PARTIES, INCLUDING INSURERS, TO PARTICIPATE

Parties are Likely to Participate if They. . .

Are on notice of their potential liability or are on notice by their insured of possible covered claims

Are aware of the mediation and understand the mediation process

Are kept informed of the work of experts and have seen documentation of damage

Are not asked to pay for parties they do not insure

Are aware of the benefits of settlement and the consequences of a failure to settle

⁴ See *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979) (advancing the business risk doctrine in New Jersey).

All potentially responsible parties do not, as a matter of course, attend the first mediation session. At the earliest stages of litigation, it is important for the plaintiff and the lead defendant (usually the general contractor) to take affirmative steps to ensure that all parties holding potential liability are identified and participate in the mediation. It is also helpful to provide these parties with a compelling reason to participate (*e.g.*, a summons and complaint).

Special care must be taken to involve insurers. As a threshold matter, it is important to put insurers on notice because they may have coverage and/or defense obligations. Insurers must be convinced that covered damages exist - not simply problems associated with the insured's own product or work. An insurer will make indemnity payments only where there has been an accident or "occurrence" triggering property damage (defined under most policies as "physical injury to tangible property. . . including loss of use . . . or loss of use of tangible property that is not physically injured") within the policy period, and where the damages are not excluded under the policy terms.

Under most policies, the definition of an "occurrence" is either a "sudden or unforeseeable" event or an "accident including continuous or repeated exposure to conditions resulting in damage neither expected nor intended by the insured." Although seemingly straightforward, the legal definition of an occurrence varies substantially from state to state. For instance, the rule of trigger in the property damage context can be:

- an event or series of events causing an exposure to damage ("exposure");⁵
- an injury in fact ("injury in fact");⁶
- a manifestation of injury ("manifestation");⁷ or
- a continuous trigger ("continuous" or "triple trigger") that implicates coverage of multiple policies over time, from the time of the incident triggering exposure through the time of the completed repair. Although not widely adapted beyond the world of asbestos claims, the possibility of multiple years of coverage responding to construction defect claims is not uncommon in some states.

⁵ See *Am. Employer's Ins. Co. v. Pinkard Constr. Co.*, 806 P.2d 954, 956 (Colo. Ct. App. 1990) (exposure to the harm constituted trigger of occurrence in case of progressive corrosion of roof installation caused by fill material).

⁶ See *Emar, Inc. v. Webster Homes, Inc.*, 488 So. 2d 346, 348-49 (La. Ct. App. 1986) (time when electrical service boxes were installed and contaminated was trigger of coverage; not fire resulting from installation and contamination).

⁷ See *Wrecking Corp. of Am., Va., Inc. v. Ins. Co. of N. Am.*, 574 A.2d 1348, 1349-51 (D.C. 1990) (where demolition contractor finished site work and wall collapsed two months later, wall collapse was triggering event).

Interpretation of policy exclusions may vary as well. Policies typically exclude from coverage that which is expected or intended. While conventional tort theory suggests that "intent" is the intent to perform only the act, some jurisdictions have held that the insured must possess the subjective intent to provoke the consequences of the act.⁸ Under this test, a subcontractor who installs defective siding that allows water to infiltrate behind it, thereby causing damage to the substrate, must actually intend to cause the damage in order to be denied coverage.

In construction defect cases, the most common set of exclusions are those for "business risks." A business risk occurs, for example, when the insured's own product fails to perform or the insured's own work was faulty. Using the siding illustration noted above, if the siding buckles or detaches from the substrate, the contractor, without more, will not have coverage. Rather, a carrier will contest payment unless its policyholder or a third party can demonstrate consequential damages beyond those related to the work undertaken by, or the products supplied through, the contractor. Even then, coverage will be limited to recovery for those consequential damages. Where coverage is disputed, carriers and their insureds may be required to negotiate a compromise that obligates a policyholder to contribute to the settlement in order to resolve the case. Careful reading of the insurance contract, therefore, is essential.

Although carriers may successfully defend a claim by invoking the business risk exclusions, they may be liable under a different theory. For example, under standard CGL policies issued after 1986, carriers of general contractors usually are obligated to pay for damages resulting from the work of subcontractors.

Finally, where covered damages do exist, the parties bear the additional responsibility of allocating damages appropriately. Insurers must be convinced that they are not being asked to pay a so-called "orphan's share" of the settlement on behalf of an absent, insolvent, or recalcitrant subcontractor or design professional. Insurers are not obligated to pay for damage caused by parties whom they have not insured, nor are they liable for damage occurring outside their policy periods. A mediator who understands basic insurance concepts has greater credibility with carriers and will be more able to stress arguments that resonate with them.

⁸ See, e.g., *Carter-Wallace, Inc. v. Admiral Ins. Co.*, 712 A.2d 1116 (N.J. 1998).

IV

HOW A MEDIATOR CAN HELP

A Mediator Can Help by . . .

Contacting key parties to explain the mediation process and its benefits

Managing the discovery necessary for mediation

Coordinating the work of experts and assisting parties in assessing damages

Exploring settlement options with all parties

An experienced mediator can provide assistance in many ways. For a number of reasons, the mediator is often best situated to facilitate negotiations and prepare the parties for settlement. Because a mediator is neutral and does not represent any party, the mediator is not bound by ethical rules that govern communication with represented parties.⁹ The mediator can assemble parties (including carrier representatives) more easily than counsel involved in the litigation. Moreover, because the parties have charged the mediator with assisting them to settle the case, they are usually more willing to allow the mediator to engage in neutral efforts to assess and allocate damages. Good mediators develop trust with the parties, and can elicit information that otherwise would be withheld. Armed with this information, the mediator can overcome psychological and strategic barriers to settlement.

A. Involving Parties

A mediator who has a specialized understanding of construction defect issues can assist the parties in identifying and including subcontractors and design professionals who have not been named in the lawsuit but hold potential responsibility if the case continues to trial. As a preliminary matter, the mediator will convene an organizational meeting that should be attended by counsel of all parties named in the action. In some jurisdictions, a court can order parties to participate in mediation and attend meetings. The mediator also may facilitate the inclusion of insurers of bankrupt or missing parties as third-party defendants.

⁹ See MODEL CODE OF PROF'L RESPONSIBILITY DR 7-104 (1983).

At the organizational meeting, the mediator can ascertain the informational needs of the parties. The mediator may assist the parties in scheduling the exchange of critical documents and manage limited discovery. An important role of the mediator might involve acting as an informal discovery master to ensure that information necessary to negotiate a settlement has been secured by all parties. Importantly, the mediator may work with parties who recently have been joined. New parties can be brought current much faster than occurs in normal discovery during litigation through the use of strategic meetings with experts and principal defendants, the provision of important documents and a visit to the site. Not only does this save costs for all parties associated with discovery, but it may also establish a positive tone that is more conducive to negotiation.

The mediator also may use the organizational meeting to assess the level of insurance coverage and enlist the participation of insurers in the mediation process. It is at this stage of the process that the mediator can assure participation of individuals with adequate settlement authority. Although many claims representatives resist attending mediation sessions, including their participation in all phases of the process limits their reliance on outside counsel who are often overburdened. A well-informed insurance claims adjuster is the *sine qua non* of successful construction defect mediation. Early in the process, the mediator can contact the claims departments of these carriers directly and encourage their involvement. A mediator who is reputedly even-handed with the insurance industry is more credible and can provide reluctant insurers with the impetus to join the process.

Increasingly, the major carriers have centralized their construction defect units and assigned very experienced adjusters to manage their construction defect claims. The mediator and the adjusters will become acquainted. An experienced and successful mediator will have credibility with carriers; consequently, he or she will be more successful at securing the financial participation of these carriers.

B. *Assessing Damages*

A mediator also can assist the parties in assessing damages by encouraging and coordinating appropriate testing at the site. While expert analysis can be laborious and expensive, often requiring both the plaintiff's consent and the coordination of significant repair and reconstruction work, ascertaining the type and scope of damage may be essential for all the parties and their insurers when considering settlement options.

It also may be necessary to conduct destructive testing to demonstrate consequential damage. In many cases, payment of damages will require the policyholder (subcontractor) to show that the damage extends beyond its own work. While the definition of "consequential damage" may vary, the testing most often involves examining the interface of two or more building materials (often supplied or installed by different subcontractors) in order to ascertain the presence of rot, deterioration or material instability. If this kind of damage is present, the mediator may request documentation of the scope of the damage in order to aid subsequent evaluation by the insurers.

Finally, a mediator can coordinate the efforts of party experts who are assessing the risk of future damage. As part of this process, the mediator may work with the experts

to develop remedial designs and document repair costs. Where appropriate, the mediator may appoint a neutral expert to assist everyone in the process of determining what information parties will need in order to commence substantive settlement discussions and undertake repairs.

C. Exploring Settlement Options

Beyond organizing the mediation process and creating a group dynamic that is conducive to settlement, the mediator's principal task is to meet with the parties and generate realistic settlement options. A credible mediator can be objective in her efforts to explore the costs and benefits of settlement prior to trial.

The mediator who understands the difference between covered and non-covered damages has greater success explaining these concepts to a party frustrated with its carrier. "Reality checks" by the neutral can serve to limit unrealistic expectations. In questioning the unrealistic party on the reasonableness of his or her expectations in light of the facts and the law, the mediator may be successful in encouraging parties to retreat from their entrenched positions and move toward a settlement that is acceptable to both sides. In this way, the mediator can maintain the momentum of the mediation.

Similarly, a mediator can explore settlement possibilities with insurers and address issues related to trigger, exclusions and allocation. Whenever necessary, the mediator can remind the parties of the risks and transaction costs of refusing to settle. Construction defect trials are notoriously long and expensive. These trials are document-intensive, requiring substantial expert analysis and testimony. It is not uncommon for expert fees to exceed \$500,000, even in the smallest case, and to grow proportionately larger as the case becomes increasingly complex.

It is well settled that insurers who fail to accept a settlement demand within the limits of the insurance policy can sometimes be liable for damages awarded against their insureds in excess of the policy limits; they also may incur punitive damages.¹⁰ In some jurisdictions, standards for failure to settle within policy limits on behalf of an insured are closer to strict liability, creating additional incentives to settle.¹¹ In all but a few cases, however, insurers participating in mediation do so in good faith, rendering these issues largely superfluous. Nonetheless, a realistic discussion of the merits of the underlying case and the likely benefits of settlement can prompt an insurer's meaningful participation in settlement negotiations.

¹⁰ See *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 323 A.2d 495 (N.J. 1974) (insurer that failed to authorize a reasonable offer to settle the underlying personal injury case under a \$50,000 policy acted in bad faith and was liable for all amounts paid by its insured who lost at trial, in addition to the full policy amount).

¹¹ See *Shamblin v. Nationwide Mut. Ins. Co.*, 396 S.E.2d 766, 776 (W.Va. 1990).

By definition, a mediator cannot compel parties to participate in mediation or force them to settle. Nevertheless, a mediator who is familiar with the various issues that dominate defect cases and who is respected in the construction and insurance industries can approach parties with a degree of credibility and candor when assessing the merits of the case. That credibility will impact settlement.

V

CONCLUSION

As parties in the construction industry increasingly turn to litigation alternatives, they should be mindful that effective use of any alternative requires a commitment to the process. To ensure meaningful negotiations in construction defect mediation and to create a framework conducive to settlement, the participants should make every effort to include all necessary parties early in the process and to assist these players in appreciating the substance of the case and the risks associated with failure to settle. By taking these affirmative steps with the assistance of a knowledgeable mediator, parties in construction defect cases will be well-prepared to achieve a fair and viable settlement agreement.