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Avoiding the Hammer: Subrogation and Contractual Risk Transfer in Construction Claims

I. Insurance Coverage Issues, Subrogation, and Indemnity Agreements

Derivation of Subrogation Right for an Insurer

An insurer that has paid defense and settlement expenses may pursue reimbursement from other insurers on various equitable grounds, including subrogation and contribution. (See Croskey et al., Cal. Practice Guide: Insurance Litigation ¶¶ 8:65 to 8:65.1, pp. 8–19 to 8–21.) In the case of insurance, subrogation takes the form of an insurer's right to be put in the position of the insured in order to pursue recovery from third parties legally responsible to the insured for a loss which the insurer has insured and paid. The right of subrogation is purely derivative. An insurer entitled to subrogation is in the same position as an assignee of the insured's claim and succeeds only to the rights of the insured. The subrogated insurer is said to "stand in the shoes" of its insured, because it has no greater rights than the insured and is subject to the same defenses assertable against the insured. Thus, an insurer cannot acquire by subrogation anything to which the insured has no rights and may claim no rights which the insured does not have. An insurer's rights of subrogation arise when it pays on behalf of its insured, and a third party is responsible for the loss.

Example: Steel Company, Inc. (Steel) employed Steely Employee ("Employee") who sustained an injury when Steel's rigging failed as it was being lifted by Crane Company ("Crane"). Pursuant to deposition testimony of Employee, and Steel's own internal investigation of the accident, the correct safety pins were not in place as required by both the manufacturer and Steel's policy, resulting in the accident. The underlying accident was settled by the parties, with Crane Service Insurer paying $1M over the SIR on an umbrella policy on behalf of Crane for the incident. Crane Insurer maintains that pursuant to contracts, Steel was required to indemnify Crane and initiates a subrogation action as Crane's insurer to recover the $1M it paid.

With regards to indemnification, the Subcontract provides as follows:

> 5. Mutual Indemnification: STEEL and Subcontractor hereby agree to hold harmless, indemnify and defend each other, its affiliates, officers, directors, shareholders, partners, employees, successors, and assigns from and against any and all liability whatsoever for any claim, suit, judgment, damage, injury, loss, cost, expense or penalty or any kind whatsoever, including attorneys' fees, expert fees, costs (together with "claims") arising out of or in connection with this Agreement, Equipment or Operators, to the extent that such claims are caused by the negligent acts or omissions or willful misconduct of the other party, Subcontractor remains subject to indemnification and hold harmless agreements and all insurance requirements, as stated in the Contract Documents.

Under this provision, Steel expressly agreed to indemnify Crane to the extent "damage, injury, loss, cost, expense" is "caused by the negligent acts or omissions" of Steel.

As to a "waiver of subrogation," a "waiver of subrogation" was only required on "General Liability, Auto and Worker's Compensation" policies. It was not required for "Umbrella Liability" coverage as it was omitted from the listed coverages in the contract. Crane's insurer as an umbrella carrier, was not estopped from subrogating to recover from Steel the money it paid on behalf of Crane.

The right of subrogation is distinct from equitable contribution. Equitable contribution is the right to recover, not from the party primarily liable for the loss, but from a co-obligor who shares such liability with the party seeking contribution. In the insurance context, the right to contribution arises when several insurers are obligated to indemnify or defend the same loss or claim, and one insurer has paid more than its share of the loss or defended the action without any participation by the others. Where multiple insurance carriers insure the same insured and cover the same risk, each insurer has independent standing to assert a cause of action against its coinsurers for equitable contribution when it has undertaken the defense or indemnification of the common insured. Equitable contribution permits reimbursement to the insurer that paid on the loss for the excess it paid over its proportionate share of the obligation, on the theory that the debt it paid was equally and concurrently owed by the other insurers and should be shared by them pro rata in proportion to their respective coverage of the risk.

Scope of Coverage- Indemnity Agreement

The question whether an indemnity agreement covers a given case turns primarily on contractual interpretation, and it is the intent of the parties as expressed in the agreement that should control.

When the parties knowingly bargain for the protection at issue, the protection should be afforded. This requires an inquiry into the circumstances of the damage or injury and the language of the contract—each dependent on unique facts.

Scope of Coverage- The Insurance Policy

The standard of review of an insurance policy has been described by the California Supreme Court as follows: "While insurance contracts have special features, they are still contracts to which the ordinary rules of contractual interpretation apply. If contractual language is clear and explicit, it governs." (*Reliance Nat. Indemnity Co. v. General Star Indemnity Co*. (1999) 72 Cal.App.4th 1063, 1073–1075, 85 Cal.Rptr.2d 627.)Indemnity agreements are no different and "are to be interpreted under the same rules governing other contracts with a view to determining the actual intent of the parties." (*Ralph M. Parsons Co. v. Combustion Equipment Associates, Inc*. (1985) 172 Cal.App.3d 211, 221, 218 Cal.Rptr. 170.)

Coverage Conflicts - Scenario #1 – Indemnity Provisions In Contract conflict with "Other Insurance Provisions" in an Insurance Policy

Subcontractor's insurer brought equitable contribution action against general contractor's insurer, seeking payment of one-half of defense and settlement expenses incurred in defending suit against general contractor filed by injured employee of subcontractor.

In this case, GC was the general contractor on a construction project commonly known as the Project located in California. GC was insured under a CGL policy obtained on its own ("GC Policy") from Contractors Insurers United, Co. ("GC Insurer"). GC enters into a subcontract with Sheet Metal Co. ("Metal"). The subcontract required Metal to obtain its own CGL policy, and include GC as an additional insured. Metal purchased a CGL policy ("Metal Policy") from Metal Insurers United, Co. ("Metal Insurer").

The subcontract also contained an indemnification provision, stating:

> "The Insurance maintained by [Metal] ... shall insure the performance of [Metal's] indemnification obligations as set forth herein, but nothing in ... the insurance ... shall in any way limit the indemnification provided for hereunder. To the fullest extent permitted by law, [Metal] shall defend, indemnify and hold [GC] ... harmless from and against any and all costs, liabilities, losses, expenses, liens, claims, demands and causes of action of every kind and character,including those of [Metal], its agents and employees for death, bodily injury, [and] personal injury ... including costs, attorneys' fees and settlements arising out of or in any way connected with the performance of Work under this Subcontract, by act or omission, whether performed by [Metal] or any other Subcontractor or any independent contractor or any agent, employee, invitee or licensee of [Metal], whether resulting from or contributed to by ... negligence in any form, whether active or passive, except the sole negligence or willful misconduct of [GC]...."

Metal Employee ("Employee") was injured at the jobsite while attempting to carry materials to the roof of a partially constructed building. Employee was following his supervisor, also employed by Metal, to a stairway. They came to an unlit area where Employee fell to the bottom of an open elevator shaft. Employee receives WC benefits from Metal's WC Insurer, who then filed a complaint in intervention against GC for

amounts paid to Employee. GC tendered the claim to GC Insurer, who tendered the claim under the subcontract to Metal's Insurer. Metal's Insurer accepted the defense, and cross claimed against the lighting company responsible for lighting the area around the elevator shaft.

Metal's Insurer accepted the defense agreeing to indemnify GC. Per the indemnity provision in the contract, "full indemnification will be provided except for [your] sole negligence or willful misconduct...." Metal's Insurer's Adjuster evaluated the claim as follows:

1. Metal's Policy is primary except for the sole willful misconduct of GC;
2. GC was 40 to 50 % negligent.
3. Electric Co. 20% negligent.
4. Metal is 30-35% negligent.
5. Employee was 10% negligent, if at all.
6. Case reserved for all negligence except 40-50% from GC.

Case goes to mediation and Employee settles. Metal Insurer files suit against GC Insurer seeking declaratory relief, contribution, and indemnity based on the amounts Metal Insurer had paid to defend and settle the lawsuit by Employee and Metals' WC Insurer. Neither of the insureds, GC or Metal, was sued. The complaint alleged that Employee's injuries were caused by the sole negligence of GC. It was further alleged that the respective insurance policies contained identical "other insurance" provisions, stating when coverage would be primary or excess and describing how multiple insurers would contribute toward defense costs and indemnity. Cross motions for summary judgement were filed.

The Court disregarded the "other insurance" provisions in the policies, stating: "the indemnity provision would be effectively negated if Metal's insurer were permitted to recover against GC's insurer, pursuant to the insurance policies' 'other insurance' provisions or the doctrine of equitable contribution."

The Court found that the indemnity provision in the subcontract stated that GC would not be liable for any claims or damages unless caused by its sole negligence or willful misconduct. In its complaint, Metal Insurer alleged that GC was solely negligent in causing the accident. GC's Insurer established as an undisputed fact that GC was not solely negligent. Pointing to the adjuster's allocation, at most GC was 40 to 50% negligent. The result: the indemnity provision precludes any recovery by Metal against GC. Just as Metal has no right of recovery against GC, so Metal's Insurer has no right to recover from GC's insurer.

Coverage Conflicts - Scenario #2 – Priority of Coverage Issues Arising Between Primary and Excess Carriers Potentially Responsible for Indemnity

GC Construction ("GC") the general contractor on a large construction project, hired respondent Sub Subcontractor ("Sub") as a subcontractor on a phase of the project. The construction contract between GC and Sub contained an indemnity clause in favor of GC. During the course of the work undertaken by Sub, a worker was killed in an

accident. In the underlying action, the worker's family sued GC, Sub and others for wrongful death. Sub's insurers assumed defense of the action on behalf of GC and Sub. A jury found that GC was 20% at fault for the accident and Sub was 70% at fault, and awarded judgment in the amount of $6,853,284 in favor of the worker's family. After trial, the family settled with GC and Sub for a total of $4.9 million.

A second round of litigation ensued between GC and its primary insurer ("GC Primary") and Sub and its excess insurer ("Sub Excess"), from which an appeal was filed. The issue on appeal was:

> Assuming GC's right to contractual indemnity is triggered by Sub is triggered under the facts, then does the indemnity clause control the payment obligations of the parties' respective insurers, or are such obligations determined by the language in the applicable policies of insurance?

The Subcontract contained the following indemnity clause:

> "To the fullest extent permitted by law, Subcontractor shall indemnify and hold harmless ... Contractor and Contractor's agents and employees (the 'Indemnitees') from all claims, damages, losses and expenses ... attributable to bodily injury, ... death or injury ... arising out of or in connection with the performance of the Work of Subcontractor performed ... in connection with the Project, by anyone directly or indirectly employed by Subcontractor, or anyone for whose acts Subcontractor is liable even if caused jointly and concurrently by the negligence of the Indemnitees and Subcontractor.... The above indemnity provisions *do not extend to, or cover any loss, damage, or expense arising out of the sole negligence or willful misconduct of Contractor,* its employees and agents or any other Indemnitees." (Italics added.)

The Subcontract contained the following provision regarding insurance coverage:

> "Prior to the commencement of the Work and periodically thereafter as required by Contractor, subcontractor shall deliver to Contractor satisfactory certificates evidencing compliance by Subcontractor with the insurance requirements set forth in Section VII of the Project Manual to these General Provisions and incorporated herein for all purposes. All policies, with the exception of Workers compensation, shall name contractor and the Owner as Additional Insured parties on a primary basis.... All original insurance certificates are to be sent to GC.... If requested by contractor, Subcontractor shall furnish copies of insurance policies required by the Contract Documents. The requiring of any and all insurance as set forth in these paragraphs, or elsewhere, is in addition to and not in any way in substitution for all the other

protection provided under the subcontract to the Contractor, including Paragraph 11, Indemnity.

GC purchased CGL coverage with a per-occurrence limit of $1 million. Sub purchased CGL coverage in the amount of $2 million, with a per-occurrence limit of $1 million. GC was named as an AI under the Sub policy. Another endorsement added to the Sub policy is that it "shall be considered primary and non-contributory to any similar insurance held by third parties in respect of work performed by you [the insured] under written contractual agreement(s) with said third parties."

In addition, Sub was the sole named insured on a commercial umbrella policy that Sub purchased with a general aggregate and per occurrence limit of $9 million. The Sub Excess policy contained a schedule of underlying policies listing, among others, Sub policy but not GC Primary policy.

The Sub Excess policy states that it will pay "on behalf of the 'Insured' those sums *in excess of the 'Retained Limit'* that the 'Insured' becomes legally obligated to pay." The Sub Excess policy also contains an "other insurance" clause, which states: "If other insurance applies to a loss that is also covered by this policy, this policy will apply excess of the other insurance. Nothing herein will be construed to make this policy subject to the terms, conditions and limitations of such other insurance. However, this provision will not apply if the other insurance is specifically written to be excess of this policy."

The action for declaratory relief filed by GC requested that the court order Sub to indemnify GC for the full amount of the underlying jury verdict and any subsequent judgment in the underlying action pursuant to the terms of the express written indemnity in the Sub/GC contract." GC also sought declaratory relief against Sub Excess, alleging that "GC and Sub clearly intended that Sub would be primarily responsible for fully indemnifying GC ... and GC's own insurance carriers owe no obligation to pay any of the verdict entered in the underlying action."

But here we are faced with a subrogation claim by a Sub Excess, and a primary carrier, GC Primary. California insurance law recognizes a fundamental distinction between primary and excess insurance. With primary coverage, under the terms of the policy, liability attaches immediately upon the happening of the occurrence that gives rise to liability. Excess liability attaches only after a predetermined amount of primary coverage has been exhausted." Excess insurance is insurance that is expressly understood by both the insurer and insured to be secondary to specific underlying coverage which will not begin until after that coverage is exhausted and which does not broaden that coverage.

In California, the duty to contribute applies to carriers that share the same level of coverage (co-primary or co-excess). It does not arise under carriers between levels of coverage (primary/excess).

In this case, the 'retained limit" under the Sub Excess is defined as "the total amounts stated as the applicable limits of the underlying policies listed in the Schedule of

Underlying Insurance *and the applicable limits of any other insurance providing coverage to the insured* during the Policy Period." The undisputed facts here show GC was an additional insured under the Sub Excess and that GC was covered by the GC Primary policy for the damages arising from the accident. Thus, under the terms of the Sub Excess policy, it was excess to the GC Primary policy. Accordingly, having paid a portion of the settlement funds on behalf of GC Primary, Sub Excess was entitled to seek reimbursement from GC Primary by way of its cross-complaint for equitable subrogation.

II. Legal Defense of Subrogation Rights

Review of Contracts and Project Documents

As noted above, the first item that must be identified when determining all available defenses to a subrogation claim is the specific terms and conditions of the construction contract entered into between the parties. The contract is interpreted in a light most favorable to the non–drafting party (usually the sub-contractors) and will normally be reviewed by the courts based upon the plain language in the agreement itself, rather than extraneous communications. The contract should also have a scope of work, setting forth the specific duties and responsibilities of each entity/contractor/professional involved in the project. Problems arise when the contract(s) contain conflicting information/responsibilities or are simply silent due to a failure of the contract language. For example, a framing contractor may be responsible to install windows, but not for an overlap of flashing with the exterior cladding contractor's work. The stucco contractor's contract is similarly silent on the issue. Who, if anyone, would therefore be the responsible party?

Second, one must review the plans and drawings to identify if these (or for that matter, any of the construction documents) contain specificity as to the materials / means and methods / timing involved with the work. While the subrogating party will likely argue the contractor was to follow "industry standards", this term is extremely broad and subject to different interpretations as to the "standard" depending on one's position in the case.

Next, one must evaluate the physical evidence. What is currently available for inspection? If there has been a change in the property (very likely in such subrogation cases), was the defendant placed on notice and given a full / complete opportunity to participate and inspect 1) once the original issue was discovered, 2) prior to and also during any destructive or invasive testing, 3) prior to remediation? If not there is a likelihood that the defense will have a strong argument for spoliation of evidence. It is not sufficient to merely point to the subrogating party's own expert's reports or witness testimony, particularly in a complex construction defects matter.

Technical Experts and the Chain of Command

As for expert reports, these need to be based on actual evidence and scientific theories rather than simply a net opinion.

The chain of command is also a very important issue to consider when defending a subrogation matter. In certain states such as New Jersey, the property owner has a non- delegable duty for safety as it relates to their real property. Usually, they hire an architect or engineer to oversee the project and the work performed by the general contractor. The duties and responsibilities of each, as well as other subcontractors on the project, all must be considered when assigning responsibility for the alleged damages.

The majority of AIA contracts also have choice of jurisdiction provisions, such as requirements that any and all disputes arising from the contract must be heard either in a particular state/forum, such as AAA Arbitration. Each such jurisdiction has their own procedural rules and guidelines which may affect the outcome of the matter.

Finally, in addition to the above, one must remember that in the subrogation action the plaintiff must still prove not only that the defendant's actions were the proximate cause of the occurrence, but also the damages are causally related, fair, and reasonable. In essence, the subrogating party "steps into the shoes" of the original plaintiff, and as such assumes the burden of proof on all aspects of the case. The mere fact one party decided to settle a claim, does not mean the settlement amount was reasonable or a correct decision.

III. Communication between Technical Expert, Claims Professionals, and Legal Counsel

Reports and information provided by technical experts should always be based on actual evidence and science rather than a net opinion. And while technical experts should not be relied on (or encouraged) to evaluate legal theories or policy language, they must be properly directed by the claims and legal professionals to evaluate precisely the questions that need to be answered. Without proper guidance from the claims and legal professionals there is the risk that the time and cost from a technical expert's investigation will not benefit the needs of the team.

It is imperative that the claims professionals and legal counsel have a clear understanding of precisely what is needed from any technical evaluation and that these needs be clearly relayed to the technical experts. However, often the precise technical questions that require technical answers are not be precisely known at the time that a technical expert is retained but become understood during the course of the evaluation by the claims professionals and legal counsel. That is why it is imperative that all parties remain flexible and retain the ability to pivot the direction of a technical investigation even late into the process. This also requires that lines of communication between all of the members of the claims team remain open and that the changing needs of the claims and legal professionals be communicated as early and effectively as possible to ensure that the findings of the technical expert remain useful.

Ultimately, when navigating the intricacies of determining subrogation opportunities in the face of legal and/or contractual limitations, technical experts can be an invaluable resource. However, such resources are only useful when properly directed to determine

the answers to the specific questions that the claims and legal professionals need to properly evaluate subrogation opportunities.