



ONE WAY TO ELIMINATE THE FINGER-POINTING

Builder's risk policies can help limit time-consuming lawsuits

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Risk transfer is an important component of every construction project. Even under the best of circumstances, construction projects are susceptible to economic losses from unanticipated property damage, bodily injury, and business interruption. To hedge against these potential losses, prudent owners and contractors generally acquire various forms of insurance, thereby "transferring" risk away from themselves and onto their insurance carriers.

A sound insurance program not only accomplishes the objective of protecting the individual insured's interests, but also minimizes the need for the project members to sue each other. Finger-pointing and efforts to assign fault to other contractors leads to further delay, disruption and higher costs. One form of insurance critical to these loss-mitigation objectives is "builder's risk."

A builder's risk policy is a form of "first party" insurance covering losses directly sustained by the insureds during the period of construction. (In contrast, "third party" insurance, such as a commercial general liability policy, covers the insureds' liability for damage sustained by others.) However, as with any form of insurance, builder's risk does not achieve complete risk avoidance. Coverage limitations, such as exclusions, deductibles and sublimits, expose project owners and contractors to some degree of first party losses. Also impacting coverage are certain contractual and equitable rights allowing in-

surers to pursue claims against third parties. "Subrogation" is one such right. Importantly, subrogation can impact coverage and frustrate the objective of avoiding liability disputes between contractors and/or the owner.

A subrogation claim is an action brought by or on behalf of an insurance company against a party thought to be responsible for the loss paid to its policyholder. While it is an action based in equity, most insurance policies contain provisions entitled "Transfer of Rights of Recovery Against Others to Us" (or similar clauses), thereby making subrogation a contractual right. These provisions contain language such as the following:

"If the insured has rights to recover all or part of any payment we have made under this Coverage Part, those rights are transferred to us. The insured must do nothing after the loss to impair them. At our request, the insured will bring 'suit' or transfer those rights to us."

A subrogation claim can neutralize the owner's and contractor's objective of risk transfer, which, as mentioned, is to divert responsibility to the carriers. For example,

if a builder's risk insurer resolves a claim on behalf of its insured, it may choose to exercise a subrogation action against another project contractor that is allegedly responsible for the loss. This could cause the sued



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contractor to file claims of contributory negligence or indemnification against other project contractors, including the very contractor whose claim was paid under the builder's risk policy. Thus the end result is the finger-pointing and assignment of fault sought to be avoided, frustrating the very purpose of the builder's risk insurance.

Contractual Waiver

In recognition of this potential problem, contractors can be contractually required to waive the right to pursue claims directly against the owner and/or other contractors, to the extent there is available insurance. This contractual waiver impacts subrogation because an insurer pursuing a claim of subrogation stands in the shoes of its insured, and therefore, does not have any rights against a third-party that the insured

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itself does not have. Therefore, if the insured waives or releases its claim against a third party, the waiver extends to the insurer.

However, while a waiver may effectively quash an insurer's right of subrogation, it must be remembered that such waiver conflicts with the standard "Transfer of Rights of Recovery Against Others" clause that prohibits the impairment of subrogation. (See policy language above). Thus the waiver could cause the policyholder to breach the conditions of the insurance policy. To reconcile this discrepancy, contractors can purchase insurance containing a waiver of subrogation in circumstances where the construction contract (or other writing) requires the insured to waive such claims. The exception, which is sometimes by endorsement, typically contains language along the lines of the following:

"You may waive your rights against another party in writing: 1. Prior to loss to Covered Property; or 2. After a loss to your Covered Property if, at time of loss, that party is one of the following a. Someone insured by this insurance; b. A business firm; (1) owned or controlled by you; or (2) that owns or controls you; or c. Your tenant."

As one court notes, the waiver is especially pertinent to builder's risk losses:

"A waiver of subrogation is useful because it avoids disruption and disputes among the parties to the project. It thus eliminates the need for lawsuits and yet protects the contracting parties from loss by bringing all property damage under the all risks builder's

property insurance. . . . These 'waiver of subrogation' provisions are intended to cut down the amount of litigation that might otherwise arise due to the existence of an insured loss." St. Paul Fire and Marine Ins. Co. v. Universal Bldg. Supply, 409 F.3d 73, 84(2nd. Circuit 2005)

Narrow Exception

Contractors can otherwise avoid subrogation by identifying other project participants as additional insureds under the policy. The latter method avoids subrogation because insurers generally cannot sue their own insureds. Notably however, some courts have applied a narrow exception to this anti-subrogation rule with regard to builder's risk insurance. The exception concerns certain builder's risk policies that contain language extending coverage to additional insureds "only as their interests may appear." Some courts have interpreted this phrase to mean that the "interest" of additional insureds does not include coverage for third party liability (including liability to a co-insured). Therefore, in such cases the builder's risk insurers can pursue subrogation claims against additional insureds that are unrelated to the coverage provided. This reasoning was adopted in the case of *OPI Int'l, Inc. v. Gan Minster Ins. Co.*, 1996 U.S. Dist. LEXIS 22959, 20-21 (S.D. Tex. Mar. 11, 1996) wherein the court stated:

"An insurer retains the right to subrogate against a subcontractor even where a subcontractor is an insured for a limited purpose, to the limited extent of his own property in the project or 'as his interests may appear' in the project. The subcontractor is not protected

[from his negligence which causes loss to other property beyond his interest and covered by the policy. . . . The waiver of subrogation rights in [the] Policy only applies to assureds "whose interests are covered by this policy," which was limited in the definition of 'other assureds' to contractors and subcontractors with whom [Named Insureds] have entered into agreements or contracts 'in connection with the subject matters of Insurance, as their interest may appear.' This waiver does not protect [Plaintiff], as a subcontractor, for claims arising from its negligence in causing damage to property owned by the general contractor, unrelated to [Plaintiff's] contract work." (Internal citations omitted.)

Given that some courts interpret the clause "only as their interests may appear" to permit builders risk insurers to subrogate against additional insureds (or co-insureds), contractors are best protected by (a) drafting a contract that waives claims to the extent they are covered by first party insurance, (b) obtaining a policy that has a specific waiver of subrogation provision, or (c) assuring that the policy has an additional insured clause that does not contain the "only as their interests may appear" language (or all three).

In general, contractors and owners should carefully review their contracts and builder's risk policies to ensure that the objectives of risk transfer are not undone by the right of subrogation. Otherwise, they could be faced with the undesired situation of quarreling amongst themselves over responsibility for project-related losses instead of obtaining the full benefit of a first party insurance policy. ■