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State Supreme Court Decision Highlights Need To Get Insurance And Indemnity Clauses Right In Construction Contracts

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Parties to a construction contract are frequently surprised to discover that a contractual agreement to procure insurance may limit their liabilities to each other. A recent decision from the Indiana Supreme Court illustrates the effect of this rule. And, in a separate portion of the decision that will be equally significant to the construction industry, the court held that a customer's acceptance of a contractor's work strips third parties of the right to sue that contractor for property damage caused by the contractor's alleged negligent workmanship.

In light of this opinion, careful drafting of construction contracts is even more critical, particularly when it comes to the delicate interplay between insurance and indemnity clauses.

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The Common and Recurring Fact Pattern

The March 2023 case, *U.S. Automatic Sprinkler Corp. v. Erie Ins. Exch.,* involved a variation on a common and recurring fact pattern: a property owner (here, an office-complex tenant) hires a contractor (here, a sprinkler company) to perform work; the work is allegedly performed negligently and/or is defective; and the alleged negligence and/or defect causes property damage to the owner's property and to third-party property (here, co-tenants' property). In these circumstances, who is responsible – and to whom? Like most legal questions, the answer is "it depends."

The court held that the negligent contractor was not liable for the property damage – either to its customer or to the third parties whose property was damaged by its defective work – but the court's reasons for each holding differed. The court unanimously held that the contractor was not liable to its customer because the parties' contract placed responsibility solely on insurance. And a 4-1 majority of the court held that the contractor was not liable to the third parties under the so-called "acceptance rule:" Once the customer has accepted the contractor's work, third parties can no longer hold the contractor liable for negligence or defects in that work.

Insurance as Sole Remedy

Construction and other service contracts often contain provisions addressing the risk of loss. These provisions may limit liability for future loss, they may assign responsibility for damage caused by the work to one of the parties through indemnification, or they may require one or both of the parties to insure against future loss. Where the insurance requirement is coupled with a waiver of subrogation, courts often hold that the parties' rights and liabilities are limited to the required insurance – even where that insurance is inadequate to insure against the full loss.

Subrogation is a legal doctrine whereby an insurance company, after paying a loss, steps into the shoes of its policyholder to recover its money from a party responsible for the loss. Importantly, the insurance company has no greater rights than its policyholder; so, if the policyholder waives its right to recover, that waiver also applies to its insurance company.

In *U.S. Automatic Sprinkler*, after the sprinkler system failed and flooded the building, the customer tenant's insurer filed a subrogation claim against the contractor sprinkler company. But, the agreement between the customer tenant and the contractor sprinkler company contained a waiver of subrogation rights providing that, "[n]o insurer or other third party will have any subrogation rights against" the sprinkler company and that the tenant "will be responsible for maintaining all liability and property insurance." The Indiana Supreme Court held that these provisions barred the insurer's claim, explaining:

An agreement to insure is intended to provide both parties with the benefits of insurance regardless of the cause of the loss (excepting wanton and willful acts). Otherwise, each would provide his or its own insurance protection and there would be no need for the contract to place the duty on one of them. As a result, where one party agrees to purchase insurance for the benefit of both parties, this party has no cause of action against the other regardless of their fault in contributing to or inducing the loss. And the same is true for subrogated insurers, as their rights can rise no higher than those of the insured. (internal quotations and citations omitted)

Placing the risk of loss solely on contractually required insurance may not be problematic where both parties knowingly agree and the policy limits are sufficient to cover the loss. Often, however, property owners hiring contractors to perform work on their property assume the contractor will be liable for any damages resulting from any defective or negligent work, and are surprised to discover – often after a loss – that the contractor agreement limits their recovery not only to insurance, but also specifically to their own insurance.

In another Indiana case, *Bd. of Comm'rs of Cnty. of Jefferson v. Teton Corp.,* a county entered into a contract for renovations to its courthouse. The parties entered into a standard American Institute of Architects (AIA) form contract that contained a waiver of subrogation for all "damages caused by fire or other perils to the extent covered by property insurance." During construction, a subcontractor caused a fire that substantially damaged the areas being renovated and other parts of the courthouse. The county's property insurer paid the loss and then brought a subrogation action against the contractor.

The insurer argued that the subrogation waiver applied only to the "work" under the contract and not to other parts of the courthouse that were damaged and that it insured. The Indiana Supreme Court disagreed, holding that the waiver was not so limited on its face but rather applied unambiguously to any property insurance maintained by the county.

In light of these rulings, it is important that policyholders examine the scope of any insurance requirement and subrogation waiver.

Similarly, parties should be clear about whether the waiver applies even if the insurance obtained is insufficient to cover all of the damages. The standard AIA waiver applies "to the extent" the damages are covered by insurance, but other language may be broader. In *Morsches Lumber, Inc. v. Probst,* the Indiana Court of Appeals held that an agreement to insure may limit recovery to insurance even where that insurance is insufficient to cover all of the losses. The court noted, "The fact that [the party] failed to take out a policy sufficient to cover the cost of the undertaking is a cost he will have to bear."

Provocative Move: No Liability to Third Parties

The more controversial portion of the *U.S. Automatic Sprinkler* decision is the 4-1 majority's conclusion that the sprinkler contractor also was not liable for damage to the property of the other tenants with which it did not have a contract. The majority based that conclusion on Indiana's common-law "acceptance rule," which shields contractors from liability to third parties after the work is completed and the owner has accepted the work.

The tenants sought to invoke an exception to this rule for "injury or damage to a third person … where it was reasonably foreseeable that a third party would be injured." The majority, however, rejected this argument, holding that this exception applies only where personal injury "is a foreseeable consequence of a contractor's allegedly negligent work." The majority held that the exception did not apply to claims for property damage.

The majority noted that, "imposing third-party liability on companies – like U.S. Automatic Sprinkler – would force them to insure against a risk the amount of which they may not know and cannot control." But, contractors insure against such risks every day in the form of commercial general liability (CGL) insurance, which applies to liability for bodily injury or property damage caused by an occurrence and generally includes so-called products and

completed operations coverage. And, the majority of states – including Indiana – hold that faulty workmanship may be an “occurrence” when it causes such injury or damage.

In *U.S. Automatic Sprinkler*, Justice Christopher Goff dissented from the majority’s application of the “acceptance rule,” concluding that there is no sound basis for the majority’s distinction between foreseeable personal injury and foreseeable property damage. Justice Goff posited that, “[r]easons of fairness and incentives support the general rule that those who negligently harm the person or property of others should bear the cost. There is no persuasive reason to give contractors special immunity from liability after negligent work has been accepted.”

The majority seems to have reached the conclusion that property insurance, not liability insurance, should be primarily responsible for property damage. Property insurance policies, however, contain exclusions that may apply to bar coverage in this context. For example, many all-risk property insurance policies exclude damage caused by faulty design or construction. One can imagine a scenario where faulty construction causes damage to the property of a third party whose property insurer denies coverage based on this exclusion. If the negligent contractor is not liable, then its liability insurer will not pay for the loss either, leaving the injured third party without recourse.

What About Indemnity?

Under *U.S. Automatic Sprinkler,* a contractor may not be liable to third parties for property damage caused by its negligence or defective work after the customer’s acceptance of that work. The customer, however, may be liable to those third parties. In those circumstances, parties who hire contractors to perform work should consider adding indemnity language to cover future claims based on the work. Such indemnity typically is covered by the contractors’ CGL insurance as an “insured contract.” Indemnity in these circumstances places liability for defective work where it belongs – on the contractor who performed it and on its liability insurance.