

ENVIRONMENTAL

Subrogation and Intervention in Construction Defect Case Involving Water and Mold

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By paying a portion of its insureds claims for property damage to their house, State Farm Insurance obtained partial subrogation rights under the homeowners policy entitling it to intervene in a construction defect lawsuit that the homeowner brought against third parties who they alleged caused the loss.

The homeowners ("Hodges") submitted a claim in the amount of \$1,699,680 to State Farm under its homeowners policy for water and mold damage to their house. They alleged the damage was caused by the negligence of third parties. State Farm denied the claim for mold damage but paid \$150,000 for water damages.

Homeowner Suit against Third Parties

The Hodges subsequently filed a construction defect suit against the former owner, the developer, the general contractor, and a subcontractor who had constructed the house. They alleged the defendants caused the water and mold damage by performing defective work, violating building codes, failing to comply with plans and specifications, using unauthorized or unqualified subcontractors, failing to repair defective work, conducting inadequate repair work, and negligently supervising construction of the



house.

Homeowner Suit against State Farm

A couple months after filing that lawsuit, the Hodges filed a separate lawsuit against State Farm, in the same county court in California. This suit alleged that State Farm acted in bad faith in denying coverage. State Farm filed a motion with the court to consolidate the construction defect case and the bad faith case. The trial court denied the motion.

State Farm Moves to Intervene in the Third Party Suit

State Farm then filed a motion for leave to intervene in the construction defect case to file a subrogation complaint to recover what it had paid its insured homeowner as a result of the alleged negligence of those responsible for the construction defects. The trial court in the third-party suit ruled against State Farm and denied the motion to intervene in the suit.

As a result of the adverse outcomes of both trial courts against State Farm's motions, State Farm would be unable to participate in the underlying actions involving those that were allegedly responsible for the loss to the homeowner—which loss State Farm had already partially paid, and which loss State Farm might potentially be required to pay additional amounts.

State Farm Appeals

State Farm appealed the denial of its motion to intervene. The appellate court concluded that as a partially subrogated insurer, State Farm had an interest "relating to the property or transaction" that was the subject of the construction defect lawsuit. The court explained that:

Under the doctrine of subrogation, when an insurer pays money to its insured for a loss caused by a third party, the insurer succeeds to its insured's rights against the third party in the amount the insurer paid.

The court also stated that, "Upon subrogation, the insurer steps into the shoes of its insured." An insurer has a direct pecuniary interest in the outcome of the litigation between the insured and the responsible third party, says the court, and in this case "State Farm has a direct pecuniary interest in the Hodges' action against the allegedly responsible third parties."

The appellate court concluded that intervention in the construction defect case is necessary because the outcome of that case could impair or impede State Farm's ability to protect its subrogation rights. The safest course to protect the interests of an insurance company is to seek intervention in the insured's lawsuit against the legally responsible third party. The court pointed out that there are two theoretical alternatives to intervention. These are for the insurance company to (1) file a separate lawsuit against the responsible third party, or (2) to recoup payments directly out of the insured's recovery from the responsible third party. But both of these alternatives would be inadequate and inconsistent with the purpose of intervention.

Absent intervention, "the insurer is to a large extent at the mercy of the insured's efforts and success in recovering from the responsible third party." If State Farm had to rely only on recoupment from its insured, "State Farm would not be able to assert its rights of recoupment against the Hodges until they fully recovered from the construction defect lawsuit defendants, and then only to the extent the Hodges recovered more than the amount of their insured loss." This could be particularly problematic because as the court noted, "the Hodges' interests are not necessarily aligned with State Farm's. The Hodges would have little incentive to invest time, effort, and fees pursuing defendants to recovery for covered claims."

Indeed, State Farm's interests would potentially be inadequately represented by the parties in the construction defect case because, as noted by the court, the Hodges and State Farm have opposing interests as concerns proving whether the losses resulted from mold damages or from water damages. State Farm's interests are not adequately represented by the Hodges because they have an incentive to advance their interests in the construction defect lawsuit at the expense of protecting State Farm's subrogation rights. For these reasons, the appellate court held that State Farm was entitled to intervene in the case and, therefore, reversed the trial court. *Douglas M. Hodge v. Kirkpatrick Development, Inc.* (Cal. 4th App. Div., G034361).

Comment

State Farm was found, pursuant to the terms of the insurance policy as well as by law, to be entitled to intervene in the construction defect case. The subrogation paragraph in Hodges policy stated in relevant part:

An insured may waive in writing **before** a loss all rights of recovery against any person. If not waived, we may require an assignment of rights of recovery for a loss to the extent that payment is made by us.

In this case, subrogation rights had not been waived before the loss in question. State Farm, therefore, had a right under the terms and conditions of the policy to participate in the lawsuits to protect its right of subrogation. State Farm needed to exercise its right in this matter to assure that the strongest case was made against the construction defect defendants. It had an interest in assuring that the facts and evidence were fairly presented to determine who and what caused the damages. In particular, it was important to determine to what extent losses resulted from mold versus water damage.

As with the standard insurance policies, this policy included a condition requiring that the Insured "do nothing after a loss to prejudice

State Farm's subrogation rights." If the Hodges had proceeded in the construction defect litigation without State Farm's participation (as they desired to do), and had they obtained a result that State Farm reasonably believed was designed to harm State Farm's interests, State Farm would have been legally entitled under the policy to bring a law suit against the Hodges for impairment of its subrogation rights.

It would appear that the interests of all parties were best served by having State Farm intervene in the underlying construction defect action. The court in this case reached the correct decision. It provided a well-reasoned opinion that will serve as a valuable educational tool for others contemplating similar issues concerning subrogation and the right to insurance company intervention in litigation.

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