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Bulletin #90, Insurance Subrogation Clauses –– Definition and Application (September 19, 2005)

Insurance subrogation clauses are present in most major construction contracts, yet many contracting parties do not understand the impact of the clauses. This Contracts Bulletin will briefly explain insurance subrogation clauses and give examples of how the majority of courts in the United States interpret these clauses. (For a detailed discussion you may review: B. Wheatley, "Defending Subrogation Claims in Design and Construction Cases," 25 The Construction Lawyer 32 (Summer 2005)).

What Is A Subrogation Clause?

Subrogation clauses are present in many construction contracts, and most prominently in American Institute of Architects (AIA) form general conditions. The contractual provision provides, to the extent insurance coverage exists, the various parties to the contract (whether owner, contractor, subcontractor, agent, employee or architect) will be barred from suing each other if a loss occurs. Instead, parties can seek recovery only from the owner's insurer. In turn the insurance company is also barred from suing the contracting parties. IN the absence of such a clause, an insurance company has the right to sue to collect monies it has paid from a wrongdoer. The clause typically applied is:

> **11.4.7 Waivers of Subrogation.** The Owner and Contractor waive all right against (1) each other and any of their subcontractors, sub–subcontractors, agents and employees, each of the other, and (2) the Architect, Architect's consultants, separate contractors as described in Article 6, if any, and any of their subcontractors, sub–subcontractors, agents and employees, for damages caused by fire or other causes of loss to the extent covered by property insurance obtained pursuant to this Paragraph 11.4 or other property insurance applicable to the Work, except such rights as they have to proceeds of such insurance held by the Owner as fiduciary. The Owner or Contractor, as appropriate, shall require of the Architect, . . . similar waivers each in favor of the other parties enumerated herein. The policy shall provide such waivers of subrogation by endorsement or otherwise. A waiver of subrogation shall be effective as to a person or entity even though that person or entity would otherwise have a duty of indemnification, contractual or otherwise, did not pay the insurance premium directly or indirectly, and whether or not the person or entity had insurable interest in the damaged property.

General Conditions for the Contract of Construction, AIA Document A201 – 1997. The goal of this provision is to avoid disruption and disputes by permitting the parties to agree ahead of time, in the contract, that all parties are protected from property loss under the owner's insurance policy. Therefore, even if a party causes property damage, the owner's insurer simply pays for the repair rather than(as is normally its subrogation right), proceeding with a lawsuit against the contracting party that made the

mistake.

How Broad Is The "Waiver" In The Insurance Subrogation Clause?

The effect of insurance subrogation clauses is to prevent an owner's insurer from bringing a lawsuit against individual contractors, subcontractors, sub−subcontractors, architects, or other parties that cause damage on the construction site. When damage occurs at a construction site, the insurance subrogation clause prevents the insurer from bringing a claim against the party causing the damage. Obviously, insurers would rather have the opportunity to recoup some of their insurance payments by suing the wrongdoer, rather than being barred by insurance subrogation clauses. Therefore, insurance companies have often challenged the scope of AIA Paragraph 11.4.7 and other similar clauses in an attempt to "go after" parties who have caused damage.

The primary way insurers have successfully avoided insurance subrogation clauses is by claiming that the damage was outside the definition of "Work" as defined in the AIA contract because "Work" is referenced in Paragraph 11.4.7. Work is generally defined as:

1.3.1 "Work" means the construction and services required by the Contract Documents whether completed or partially completed and includes all other labor, materials, and equipment and services provided or to be provided by the Contractor to fulfill the Contractor's obligations. The Work may constitute the whole or part of the Project.

General Conditions for the Contract for Construction, AIA Document A201−1997. The majority of courts have held that the definition of "Work" does not control whether the subrogation clause precludes the insurer from bringing a claim. Instead, most courts look only to the scope of the owner's insurance policies. For example, if the owner's insurance coverage contains a broad definition of property damage, that will control, even if the definition "Work" in the AIA contract is more narrow.

An example of an application of an insurance subrogation clause was discussed in *Walker Engineering Inc. v. Bracebridge Corp.,* 201 S.W.3d 387 (Tx. App. 2003). In *Walker,* a subcontractor damaged water pipes not covered by the definition of "Work" in the contract and also flooded an existing office complex. The Texas court rejected the insurer's claim that the insurance subrogation clause did not apply because the damage was not to "Work"; instead the court looked at the scope of the insurer's damage policy. The court found that the property damage was covered by insurance and, therefore, the insurance subrogation clause applied. As a result, the insurer could *not* bring a claim against the subcontractor which caused the damage.

It is interesting to note that some courts have held that the outcome of decisions like *Walker* might be different if insurance companies specifically tied their scope of coverage to the definition of "Work" as set forth in the AIA contract. Currently, the difference between the definition of "property damage" in insurance policies and the definition of "Work" in AIA contracts has benefited contracting parties.

"Fairness" To Insurance Companies

Courts have also rejected insurer's arguments that it is "unfair" to permit insureds to waive subrogation rights. Most courts have rejected this position, noting that insurance policies almost always contain provisions which bar insureds from waiving any rights *after* a loss has occurred.

If damage has occurred, a party cannot waive subrogation rights at that time. However, there is nothing in most insurance policies which preclude insureds from waiving rights to subrogation *before* the loss has occurred. Obviously, AIA contracts entered into prior to construction contain these subrogation clauses which were in existence before the damage occurred and therefore insurers may not equitably object to such clauses.

The Minority Approach

As discussed above, a minority of states have held that insurance subrogation clauses are only effective to the extent they fall within the definition of "Work" in AIA contracts. Put another way, to the extent the damage to the property involves injury outside the definition of "Work," then the insurer may bring a claim against the party which caused the damage. For example, if a contractor is engaging in remodeling on a residence and damages an existing part of the structure which is not subject to the renovation, an insurer would be able to argue that this damage was outside the "Work." The insurer, while contractually obligated to pay the owner for the damage, could bring a subsequent lawsuit against the contractor that damaged the non−Work part of the construction project.

This approach constitutes the interpretation used by a minority of courts because, as a practical matter, it undermines the very reason the parties entered into an insurance subrogation clause. The goal of such clauses is to minimize litigation and allow the parties to focus on the construction, rather than interrupting construction with lawsuits by insurers. In the example above, the contractor who caused damage to the non−Work part of the project would still be required to defend the lawsuit, disrupting construction and creating tension between the contracting parties.

The Owner Has An Affirmative Duty To Obtain Insurance Coverage

If an insurance subrogation clause is present, "an Owner has an affirmative duty to procure property insurance that covers the interest of the Owner, the Contractor, the Architect and the Subcontractor." *General Conditions of the Contractor for Construction,* AIA Document 1−1997 ¶ 11.4.1. If an insurer fails to obtain this coverage, as required under the contract, the Owner effectively becomes the insurer.

Courts show little sympathy for owners who fail to obtain the required insurance coverage as required under the contract. Moreover, if an owner fails to obtain this coverage, courts will very broadly interpret the scope of the insurance subrogation clause. Courts will assume the Owner would have gotten insurance with the broadest possible coverage. Thus, the liability of the Owner, in the event it fails to get the required insurance coverage, is substantial.

Conclusion

As frequently noted in the Contracts Bulletins, it is crucially important that contracting parties carefully read all contractual provisions. It is also important that members be aware of the approach taken by the jurisdiction in which they are contracting. Does your state follow the "majority" or "minority" approach on insurance subrogation?

As a practical matter, for most contractors and subcontractors, the existence of an insurance subrogation clause provides a substantial benefit by permitting the focus to remain on construction, even when property damage occurs.

(This article contains a general discussion of the law. You should consult with your attorney on the issues regarding your contract. This article does not constitute and should not be treated as legal advice as to any particular situation.)

SMACNA wants the Contracts Bulletin to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e−mail: syoch@felhaber.com; telephone 651/312−6040) or Tom Soles (e−mail: tsoles@smacna.org; telephone 703/803−2988).

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